SM/08/273
Correction 2

CONFIDENTIAL

December 1, 2008

To: Members of the Executive Board

From: The Secretary

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

The attached corrections to SM/08/273 (8/20/08) have been provided by the staff.

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 14, para. 13, line 5: for "...limited room for further rate hikes..."
read "...limited room for further rate hikes at this juncture, ..."

Page 17, para. 18, line 5: for "However, with no specific plans in the near term, ..."
read "However, with no other specific plans in the near term, ..."

Page 19, para. 21, line 5: for "...and increasing transparency as regards the condition of the banks."
read "...and increasing transparency as regards banks' ownership and lending relations."

Page 20, para. 23, 3rd bullet: for "In response to a query about possible enhancements to the domestic deposit insurance scheme and its LOLR capacity, CBI officials mentioned no specific plans or intentions to boost these facilities."
read "In response to a query, CBI officials mentioned no specific plans or intentions to boost the CBI's LOLR capacity. A review of deposit insurance is underway."

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

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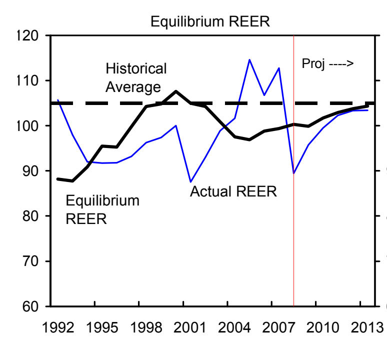
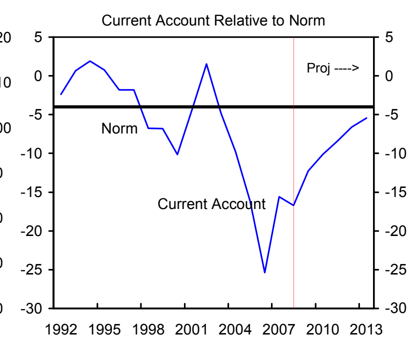
risen, also on account of the banks. The reserve coverage of short-term debt is low. Moreover, potential difficulties to finance the current account could arise if net capital inflows decrease substantially—for example, significant amounts of Glacier bonds[2] are maturing in the coming quarters, and rollover could be limited—triggering a further króna depreciation, and risking debt-servicing difficulties (Annex I). With banks' funding risks at the core, these vulnerabilities are large and could unwind quickly in the currently turbulent global financial climate. Consequently, staff is concerned about the presence of capital-account based instability; this, however, is not a result of exchange rate policy, as the króna is freely floating and the authorities do not intervene in the foreign exchange market. The authorities generally agreed that there are significant capital account-based vulnerabilities, but pointed to a number of mitigating factors, such as Iceland's increased debt-servicing capacity (due to the expansion in the aluminum and energy sectors) residents' large foreign assets, as well as a very low level of government debt and a funded pension system.

Box 3. External Stability from an Exchange Rate Perspective

Results from a CGER-type analysis applied to Iceland suggest that the current level of the real exchange rate (REER) is broadly in line with long-term fundamentals, given the recent króna depreciation:

- According to the macroeconomic balance approach, the REER may be under/overvalued by some 5 to 9 percentage points, based on a gap of -1 to -2 percent of GDP between the underlying and the norm current account.
- According to the real exchange rate approach, the current and medium-term levels of the REER appear undervalued by 11 and 1 percent, respectively.
- According to the external sustainability approach, the REER appears to be undervalued by 9 percent, based on a gap between the underlying and the NFA-stabilizing CA of about -2 percent of GDP.





Results	Macroeconomic Balance	External Sustainability	Equilibrium REER
REER over/under valuation	-4.9% to-9.1%	-9.0%	-10.8% in 2008 -1.2% by 2013
CA	CA norm: -3.4 to -4.2 %of GDP Underlying CA: -2.5% of GDP	NFA-stabilizing CA: -4.2% of GDP	

This analysis builds on and updates the work in Tchaidze's paper "Estimating Iceland's Real Equilibrium Exchange Rate (2007). His results suggested that the REER was overvalued by about 15-25 percent at end 2007. Since then, however, the REER depreciated by more than 20 percent as of end-June 2008, the reference date for this analysis. Hence, results in this analysis are broadly consistent with those of Tchaidze, given the margins of error of this exercise.

[2] See FSSA (¶37) for a description of the Glacier bonds.

C. Monetary Policy

13. **Given prevailing external risks and strong inflationary pressures, staff favored a somewhat tighter policy stance than the authorities.**

- CBI officials viewed the current policy stance as appropriately tight to help bring inflation down in the context of weakening economic activity. While acknowledging the difficult inflation environment, they saw limited room for further rate hikes at this juncture, arguing that the rapid economic slowdown and binding foreign liquidity constraints were already slowing credit growth and making domestic interest rates increasingly important for private sector borrowers. Accordingly, the CBI kept its key policy rate unchanged at 15½ percent at its July 3 meeting—amidst enormous pressures for rate cuts from the business community, unions, and academics, among others.

- The mission agreed with maintaining a tight stance and emphasized that pressures to ease should be resisted until there are clear signs that inflation is on a firm downward path. In addition, staff noted that a further (small) increase in the policy rate could be useful to signal the CBI's commitment to achieving the target and shoring up confidence in the króna.[3] Mindful of domestic risks, staff nevertheless argued that failure to contain inflation could erode confidence in the króna, which could feed back into inflation and adversely affect balance sheets, ultimately requiring even higher policy rates.[4] Moreover, the direct impact of modestly higher interest rates on banks would appear limited (according to the authorities' stress tests), although there could be (hard-to-quantify) indirect effects stemming from the deterioration of corporate balance sheets—these, however, are also vulnerable to depreciation (Box 2).

14. **It was recognized that the central bank's liquidity provision posed new challenges**. The authorities explained that the recent issuance of short-term government debt and CBI paper was done to help restore normal functioning of the foreign exchange swap market,[5] while the alignment of the CBI's definition of repo-eligible collateral with that of the ECB was implemented to alleviate domestic liquidity pressures. Staff welcomed these measures, but cautioned that the CBI's level of liquidity provision may not be consistent with

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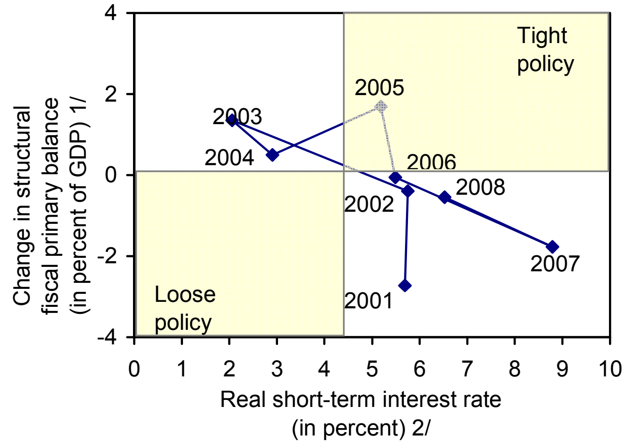
[3] See Box I-1 of the CBI's April *Monetary Bulletin* for a detailed discussion on the importance of anchoring expectations in Iceland, including on the rationale for a different monetary policy response than in the United States.

[4] Moreover, given the price indexation of most household debt, high inflation would hurt households disproportionately by reducing purchasing power and increasing debt burdens.

[5] See Box III-1 of the April *Monetary Bulletin* for a detailed discussion of the impact of the financial turmoil on Iceland's foreign exchange swap market.

Fiscal and Monetary Stance



Source: IMF estimates.
1/ Structural balance adjusted for the effect of asset price boom.
2/ CBI's target rate minus inflation expectations.

- In contrast, the authorities believed that domestic risks prevailed, and hence the policy focus should shift toward preventing a sharp economic downturn. In addition, rolling back the implementation of the recent pledges and quickly adjusting other spending (especially social spending and wages) were seen as politically unfeasible, or very difficult. More generally, the authorities argued that fiscal policy should play a countercyclical role, using past fiscal savings to smooth the economic downturn. In the event of a much sharper-than-expected downturn, the authorities noted that with little public tolerance for high unemployment, the government would be called upon to support labor markets and help affected groups.

- Staff saw a more active stabilizing role for fiscal policy only if such a scenario were to materialize, considering that monetary policy would still need to shore up confidence in the króna and keep inflation expectations under control. In this context, targeted and temporary measures could be used, with additional positive distributional effects (e.g., housing support, unemployment benefits).

18. **Looking forward, staff stressed the benefits of a more rules-based fiscal framework to help improve macroeconomic stabilization**. The authorities agreed that the current medium-term framework lacked effective, binding spending controls. To achieve better expenditure control, one reform objective was to develop a multi-year budgeting approach consistent with policy goals. However, with no other specific plans in the near term, the authorities saw fiscal reform as a slow-moving process. Staff reiterated the need to make multi-year targets more binding and increase control of local government finances.

E. Financial Sector Policy

19. **A recent FSAP Update points to high and rising vulnerabilities in the financial sector.** Despite reported financial indicators of the banking system being fully compliant with regulatory requirements (Figure 4), there are several key risks:

- ***Liquidity and funding risks***, associated with the banks' reliance on market funding and sizeable funding needs due to a significant amount of debt maturing over the next two years. Given the difficult market situation, challenges in securing adequate liquidity coverage at acceptable price could also reduce bank profitability.
- ***Credit and market risks***, stemming from the foreign currency and equity exposures and high levels of debt of domestic borrowers,[9] as well as from collateralized lending,[10] connected lending and large exposures (mostly related to holding companies);
- ***Operational risks***, associated with the banks' rapid expansion in recent years, including in new markets and business lines, which could strain risk management capacity and internal controls;
- ***Quality of capital risks***, related to complex ownership structures, perceived substantial related-party lending, and uncertainty about the financial strength of shareholders following the decline in equity markets.[11]

20. **Despite efforts to address market concerns, managing these risks remains a challenge for the banking sector**. The three largest banks have responded by slowing lending growth, consolidating funding needs, withdrawing from marginal markets, mobilizing retail deposits abroad, and reducing costs. As a result, they reported adequate liquidity to meet debt obligations over the next 12 months. But banks' ability to de-leverage has been limited by global risk aversion, and their market and credit risk have increased, pointing to significant risks going forward. Hence, as highlighted by the FSAP Update, it remains unclear whether these adjustments are sufficient in today's financial environment. Access to foreign liquidity remains severely limited, and banks' CDS spreads have been rising toward their March peaks. Some smaller banks have reportedly come under liquidity pressures as well. In this environment, the central bank is now the key liquidity provider to the banking system.

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[9] As noted in FSSA (¶19), some indications of a slippage in credit quality have already appeared.

[10] See FSSA (¶20).

[11] The large banks protected their capital against foreign currency fluctuations by hedging with derivatives.

21. **Accordingly, discussions focused on policy options to further mitigate financial sector risks**. Staff welcomed the progress made over the past few years by the Financial Supervisory Authority (FME) and the CBI to boost monitoring, analysis, and stress-testing of liquidity, credit, and market risks. Staff stressed, however, that a successful policy going forward will require strengthening financial buffers and increasing transparency as regards banks' ownership and lending relations ~~the condition of the banks~~.[12] Accordingly, drawing on the FSAP's recommendations, staff outlined possible options to mitigate risks further, including by: (i) raising capital cushions, including for operational, credit, and quality-of-capital risks; (ii) reviewing the robustness of liquidity coverage under different stress scenarios that take into account the interlinkages among banks and boosting liquidity buffers appropriately; (iii) improving overall transparency concerning progress in reducing related-party transactions and concentrated lending. There was broad agreement that, if successfully implemented, these policies could contribute to a significant slowdown in banks' balance sheet growth. However, as mentioned in the FSAP's findings, more decisive steps to further deleverage may become necessary.

22. **The mission also covered other issues related to financial stability.** Specifically, staff welcomed the progress made to enhance the **quality of supervision**, including by boosting the supervisory powers and resources of the FME and advancing the work on high-frequency monitoring and modeling. At the same time, the mission stressed that **lack of the timely and comprehensive data on the non-financial corporate sector** (especially non-listed companies) impedes the analysis of the sector's financial situation and its potential implications for the banks. Therefore, staff urged boosting the enforcement of disclosure requirements for all corporations—a recommendation that the authorities welcomed.

F. Contingency Planning

23. **Given the large vulnerabilities of the system, discussions also focused on key elements of contingency planning**. In recent years, supervisory powers and resources have been boosted, formal frameworks for coordination between domestic agencies and across the Nordic region established and tested,[13] and the task force on liquidity crisis management (established in late 2007) advanced its work on high-frequency monitoring and modeling.

- Noting the progress already made, staff stressed that these efforts should continue in full force,[14] including by **compiling all existing elements of contingency planning into a single framework**—a recommendation welcomed by the authorities.
- There was general agreement that **the bank resolution framework** should be strengthened to provide the FME with additional legislative powers.

[12] On transparency, see FSSA (¶18, ¶27, and Key Recommendations).

[13] An MOU was signed between the Nordic countries to deal with cross-border crises in 2003.

[14] See FSSA, Section III, B and C on cross-border policy coordination and crisis management and bank resolution, respectively.

- The CBI clarified that **the liquidity swap agreement with other Nordic banks** was only a precautionary, confidence-building measure.

- With **foreign exchange reserves** still low relative to potential liabilities, the authorities confirmed (and staff welcomed) their commitment to increase the CBI's reserves "at the right time."

- In response to a query~~ about possible enhancements to **the domestic deposit insurance scheme** and its **LOLR capacity**~~, CBI officials mentioned no specific plans or intentions to boost the CBI's LOLR capacity. A review of deposit insurance is underway~~these facilities~~.

III. Staff Appraisal

24. **Iceland's prosperous and flexible economy is now starting a difficult and highly uncertain adjustment process.** Its long expansion has come to an end. Its legacies are overstretched private sector balance sheets, large macroeconomic imbalances, and high dependence on foreign financing. As liquidity constraints are becoming more binding, economic activity is expected to slow significantly from unsustainably high levels, inflationary pressures to persist, and the current account to normalize. Uncertainties surrounding the outlook are unusually large, with significant downside risks dominated by external factors. Although the current level of the (freely-floating) króna is estimated to be somewhat below its equilibrium level, the external balance sheet structure remains fragile—mainly due to the large funding needs of the banking sector—raising concerns about capital account-based external instability. If risks were to materialize in full, Iceland could face severe financial strains.

25. **Against this backdrop, policies will have the challenging task to facilitate an orderly rebalancing process, while mitigating risks by shoring up confidence**. Close coordination between monetary and fiscal policies, along with actions to address financial sector vulnerabilities, will be key in this respect.

26. **A continued tight monetary policy stance is needed to return inflation to target and maintain confidence in the króna**. A further króna decline would fuel inflationary pressures, squeeze private balance sheets, and erode households' purchasing power. In turn, such developments could further undermine confidence, feeding back into currency weakness. To prevent this, monetary policy should remain tight until there are clear signs that inflation is on a firm downward path, while domestic liquidity provision should be carefully managed. Pressures to ease prematurely should be resisted.

27. **Promptly acting on the pledge to reform the publicly-owned HFF is crucial to increase the effectiveness of monetary policy**. Its role in the financial market could be redefined by separating the social component that provides targeted support from the market-based element that should not benefit from state aid.

28. **The highly stimulative fiscal policy needs to be restrained**. Given the prevailing external risks and high leverage in the economy, a more neutral fiscal stance is warranted to