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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 08/79-2

11:05 a.m., September 10, 2008

2. Iceland—2008 Article IV Consultation

Documents: SM/08/273 and Correction 1, and Supplement 1, and Supplement 1, Correction 1, and Supplement 2; SM/08/274

Staff: Koeva-Brooks, EUR; Hoelscher, MCM; van der Willigen, SPR

Length: 1 hour, 49 minutes

Executive Board Attendance

J. Lipsky, Acting Chair

Executive Directors	Alternate Executive Directors
	S. Itam (AE)
	K. Assimaidou (AF)
	P. Pereira (AG), Temporary
	R. Moveni (AU), Temporary
	J. Prader (BE)
	M. Agudelo (BR)
H. Ge (CC)	
	C. Mira (CE), Temporary
	S. O'Sullivan (CO)
	B. Claveranne (FF)
	S. von Stenglin (GR)
	D. Mohanty (IN), Temporary
	M. Xafa (IT)
	H.Yamaoka (JA)
	M. Daïri (MD)
	S. El-Khouri (MI)
A. Bakker (NE)	
J. Henriksson (NO)	J. Bergo (NO)
	A. Lushin (RU)
	A. Al Nassar (SA)
P. Warjiyo (ST)	C. Sucharitakul (ST)
	A. Raczko (SZ)
M. Lundsager (UA)	
A. Gibbs (UK)	J. Talbot (UK)

P. Bradley, Acting Secretary
T. Orav, Assistant

Also Present
European Department: A. Chopra, P. Doyle, I. Ivaschenko, P. Koeva Brooks, M. Lutz, R. Luzio, D. Velculescu. External Relations Department: A. Gaviria. Monetary and Capital Markets: J. Fiechter, D. Hoelscher, L. Lian Ong, T. Olafsson, L. Zanforlin. Office of the Managing Director: O. Per Brekk. Strategy, Policy, and Review Department: D. Marston, T. van der Willigen. Secretary's Department: A. Blazejewski, M. Miller. Statistics Department: W.E. Alexander. Senior Advisors to Executive Directors: W. Abdelati (MI), A. Joseph (BR), B. Ólafsson (NO), J.Poulain (FF), N. Riad (Mi), S. Rouai (MD), M. Tanasescu (NE), Y. Tok (ST). Advisors to Executive Directors: A. Eng (ST), P. Gasiorowski (SZ), K. Harada (JA), R. Hills (UK), M. Leemets (NO), H. Li (CC), D. Mevis (BE), D. Muradnazarov (SZ), A. Rieck (GR), Y. Shinagawa (JA), E. Uanguta (AE), P. Wood (UA).

2. ICELAND—2008 ARTICLE IV CONSULTATION

Mr. Henriksson and Mr. Olafsson submitted the following statement:

The Icelandic authorities greatly appreciate the discussions with the Article IV and FSAP missions that visited Reykjavík this summer. My authorities also greatly value the Fund's advice and dedication and endorse the thrust of the main conclusions in both reports.

Historically, the growth of the Icelandic economy has been based on Iceland's renewable marine and energy resources while the service sector has contributed increasingly in recent years. As a result of its small size and openness, the economy has been prone to volatility. Economic policy has a history of responding to such changes. Iceland is noted for its resilience and adaptability. While the short term may present challenges, the medium-term outlook remains favorable, even enviable as has been noted by staff.

Growth and Trade

After a five year period of robust economic growth, the Icelandic economy has entered a period of adjustment. It became increasingly imbalanced as reflected in rising inflation and a large current account deficit, sustained by easy access to global credit. Forecasts imply that GDP growth in 2008 will be below trend and may even turn negative in 2009 and 2010 while internal and external balance is restored.

The economic upswing was fuelled by rapid growth in the financial sector and large scale investment in aluminum smelters and associated power plants. Annual aluminum production capacity has tripled to 800 thousand tons since 2003 and power generation capacity (hydro and geothermal) increased by 80 percent. The share of aluminum in total merchandise exports will increase from 20 percent in 2005 to 40 percent in 2009.

The trade deficit is set to disappear quickly as large-scale investment projects come on stream and imports contract as a result of the depreciation of the króna.

The authorities believe that the IIP may overstate Iceland's true level of external imbalances, as it seems likely that residents' foreign assets have been underestimated by current statistical methodologies. The findings of a recent study suggest that it is likely that the value of both FDI assets and liabilities is significantly underestimated in the official statistics. This discrepancy is due to different accounting treatments of portfolio equity investment vs. foreign direct investment, the former being valued at market prices but the latter at book value. Due to the scale in outward FDI investment over the past years, which has significantly outpaced the growing inward FDI, the proportion of FDI to total foreign assets is much higher than on the liability side.

The compilation of timely balance of payments figures has become much more complicated because of the scale of internationalization of Icelandic business, as reflected in most recent BoP figures. However, the figures that were published last Thursday show that the trade and service figures are moving toward balance.

Fiscal Policy

For the last four years the public sector has delivered a considerable surplus, which coincided with the growth in the economy. The Treasury surplus from 2005 to 2007 averaged 5.5 percent of GDP. The Ministry of Finance projects the surplus to be lower this year, as the economy slows down. More recent revenue and expenditure estimates indicate that the surplus will be larger than projected in the budget for 2008. While the fiscal surpluses have remained large, the stance of fiscal policy has recently turned more accommodative, as measured by the change to smaller surpluses. In 2008, this is linked to the automatic stabilization properties of fiscal policy as domestic demand contracts. The authorities believe that the executive summary description of a "highly expansionary fiscal policy" is therefore misleading. More so as it is based on further adjustment of the structural primary budget balance for the effects of the asset price boom. The increase in revenues due to asset price increases is in accordance with how the fiscal policy is structured and reflects the automatic stabilization of fiscal policy. Cancelling those revenues out, by adjusting for them, to determine the fiscal stance is a method that we do not agree with.

According to the macroeconomic forecast of the Ministry of Finance the public sector is expected to move into deficit in 2009 and 2010, amounting to about 1 percent of GDP each year. The deterioration can be traced primarily to the effects of the economic contraction on Treasury tax revenues, which are projected to decline considerably in real terms between 2008 and 2010. Revenues from taxes on personal financial income, corporate profits and consumption tax are also expected to contract, i.e. reflecting the adverse impact of the ongoing difficulties in international and domestic financial markets on economic activity. Fiscal policy is thus expected to remain counter-cyclical.

Even though the outlook for public finances is deteriorating it should be noted that record surpluses in recent years have been used to repay government debt and accumulate deposits with the Central Bank. Net Treasury debt has been reduced to zero and is set to move toward a net asset position of 4 percent of GDP at the end of 2008.

The key emphasis in budget management in Iceland is transparency, fiscal rules and discipline. There are two fiscal reforms in the pipeline, one relates to multi-year budgeting with the Treasury and the other is targeted at the local authorities requiring them to adopt expenditure rules to strengthen their medium-term fiscal framework.

Monetary Policy

Attaining the inflation target proved challenging in recent years, and inflation has remained above target since the second half of 2004. As a result of a sharp depreciation of the króna in early 2008, triggered by the global financial crisis, inflation has now reached an eighteen year high. To contain inflation expectations and bring inflation back to target over the medium term, the Central Bank of Iceland has maintained a tight monetary policy stance. Inflation is projected to fall during the winter months as the pass-through effects of the króna depreciation disappear and domestic demand contracts.

In August inflation measured 14.5 percent in terms of the 12-month rise in the CPI. To some extent the inflation stems from exogenous factors but the main contributing factors to the inflation performance are related to the depreciation of the króna and secondary effects from increasing food and energy prices. The monetary authorities fully realize the challenges brought on by the current situation. The policy rate is currently 15.5 percent and inflationary developments warrant a continued tight monetary policy. Economic indicators show that the economy appears to be cooling faster than previously anticipated. Declining demand could reduce inflationary pressures in the months to come.

At this juncture, there is a considerable uncertainty about the outlook in general but the Central Bank's priorities are clear. The inflation target takes precedence, not only because it is mandated by law, but also because the long-term cost of not anchoring inflation expectations is sizeable.

In order to increase the effectiveness of monetary policy and to remove distortions, the Government will promptly formulate and make public a credible plan for the restructuring and reform of the Housing Finance Fund system.

The Financial System

The Icelandic banking system has grown at an exceptional pace for the past several years. The bank's consolidated assets increased from 100 percent of GDP in 2004 to 900 percent in 2007. The contribution of the banking system to GDP has almost doubled in a decade. International acquisitions and internal growth have expanded the banks' combined balance sheets, and the commercial banks now have subsidiaries and branch offices in the UK, the US, Scandinavia and continental Europe.

The current environment in the global markets has proven challenging for many financial institutions and the Icelandic banks are no exception. Nevertheless, the three major banks showed profits in 2007, which has been sustained for the first half of 2008. As recognized by staff, liquidity ratios are high and capital levels are well above minimum levels. Also, the banks pass liquidity tests as required by the Central Bank and their capital ratios remain above required minimums in considerably stringent stress tests conducted by the Financial Supervisory Authority (FME).

My authorities concur with the assessment in the FSAP report that the main vulnerability in the Icelandic financial system relates to access to global international liquidity which has contracted significantly in the past year. As underlined by staff the banks have implemented various measures to manage their risks and increase market confidence. This inter alia includes diversification of funding resources, extension of maturities, enlargement of the deposit base, a contraction of loan books and the selling of noncore assets. Due to these measures, the banks estimated that they have at hand sufficient liquidity to meet their debt obligations through early 2009. The authorities cooperate closely on contingency planning and information sharing according to the Memorandum of Understanding on financial stability and crisis management by the Central Bank, Financial Supervisory Authority and the relevant Ministries.

The Financial Supervisory Authority (FME) monitors the banking system closely and has recently focused on credit risk in particular. The FME's scope of monitoring the Icelandic banks' operations extends to their overseas activities. While stress-testing methodologies have been significantly enhanced, my authorities agree with staff that improvements can still be made and they are working on further refinements.

The authorities continue to monitor carefully all new developments in the Icelandic financial system. Various measures have been undertaken by the authorities which inter alia include currency swap agreements between the Central Bank of Iceland and central banks of Denmark, Norway and Sweden, increased issuance of short-term instruments (CDs and T-notes), amended rules on eligible collateral and reserve requirements for banks at the CBI, aligning them with those of other central banks, and funding in the international market to buttress the foreign reserves of the Central Bank. In addition, the Financial Supervisory Authority has increased its cooperation with host authorities of the three major banks. Iceland will become a signatory to the Memorandum of Understanding (MoU) on cooperation between the Financial Supervisory Authorities, Central Banks and Financial Ministries of the European Union.

Other Issues

Iceland's pension system is virtually fully funded and the age distribution is favorable, making demographic trends easily manageable. At the end of last year the total assets of the pension system amounted to 133 percent of GDP. This situation creates added leeway for fiscal policy to be counter-cyclical and flexible in the face of rapid economic changes, more than offsetting tax cuts and measures to strengthen the welfare system.

The authorities have declared a target to increase ODA from 0.3 percent in 2008 to 0.35 percent of GDP by 2009. Iceland has the potential to make a purposeful contribution in certain fields, especially in the development of fishing industry and utilization of geothermal energy in the low-income countries.

Mr. Shaalan and Ms. Choueiri submitted the following statement:

We thank staff for a set of excellent papers which bring to the fore the necessary adjustment process facing the Icelandic economy, following several years of rapid expansion. The extraordinary foreign-funded boom entailed rising internal and external imbalances, contributing to a sharply higher level of inflation, a large current account deficit, overstretched private sector balance sheets, and a high dependence on foreign financing; all exacerbated by deteriorating global financial conditions.

Iceland's economic fundamentals are strong, reflecting the structural reforms of the 1990s, as well as sustainable public finances, including fully-funded pensions and a low level of government debt. These features, together with open and flexible labor and product markets, as well as continued significant growth potential in energy-intensive industries, will undoubtedly contribute to an improved economic environment. In light of the unusually large uncertainty surrounding the near-term outlook, Iceland's most immediate challenge is to ensure an orderly unwinding of internal and external imbalances. Additionally, attention needs to be focused on strengthening the policy framework in a way that would moderate macroeconomic volatility and prevent the re-emergence of major imbalances. Against this background, the staff report's focus on the coordination between monetary and fiscal policies, as well as actions to address vulnerabilities stemming from the banking sector, is well founded. At the same time, as rightly noted by Mr. Henriksson and Mr. Olafsson in their helpful statement, Iceland has a track record of resilience and adaptability, and the medium-term outlook remains favorable despite the short-term challenges.

While there is general agreement between the authorities and staff on the imminence of a recession, driven by a contraction in domestic demand, views on the nature of risks surrounding the outlook diverge considerably. The authorities emphasize the significant domestic risks stemming from the real estate market and the corporate sector. On the other hand, staff views external liquidity risks as a key concern, given the high foreign debt of the private sector, mainly related to the large funding needs of the banking sector. We would be grateful if staff could further elaborate on the reasons underlying this dissimilar assessment of prevailing risks, in view of the important implications this entails in terms of policy measures.

The central bank is to be commended for its response to intensifying external pressures, as evidenced in the tightening of policy rates and enhanced liquidity provision. With further króna depreciation susceptible of fueling inflationary pressures, we concur with staff that monetary policy should remain tight until there are clear signs that inflation is on a firm downward path. At the same time, careful management of domestic liquidity provision would ensure that the latter remains consistent with a tight monetary stance.

Improving the effectiveness of monetary policy hinges on a prompt reform of the Housing Financing Fund (HFF), which undermines the transmission of monetary policy and distorts the pricing of mortgage credit. We agree with staff that the HFF's 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. In our view, the social objectives of the HFF, i.e. equitable access to mortgage funding throughout the country, can be met in a more transparent and cost-effective fashion through the introduction of targeted transfers.

The fiscal stance entails a considerable easing in 2008–10, estimated at 3.5 percent of GDP, consistent with the authorities' view that fiscal policy should prevent a sharp economic downturn. However, given the considerable external risks and high leverage in the economy, we would favor a more neutral fiscal stance than suggested by the authorities. Further fiscal restraint would also be crucial in supporting the central bank's efforts to combat inflation. This is all the more important given the risk of a further króna depreciation. We therefore support the staff's recommendations to restrain expenditure growth. Staffs' suggestions to strengthen the fiscal policy framework, through more binding annual expenditure limits, a multi-year budgeting approach based on clear policy commitments, and mechanisms to better control local government finances, also deserve serious consideration.

We note that stress tests indicate that the banking system is resilient and that reported financial indicators are above the minimum regulatory requirements. Nonetheless, the timely FSAP update points to high and rising vulnerabilities in the financial sector, stemming from funding and credit risks and limited access to wholesale credit markets. Therefore, while the banks are adopting welcome steps to address these vulnerabilities, including diversification of funding and selected asset sales, staff's suggestions regarding stronger capital and liquidity buffers merit consideration. Such measures could indeed contribute to a slowdown in banks' balance sheet growth. Finally, we welcome the authorities' commitment to boost the central bank's foreign exchange reserves, given that they are still low relative to potential liabilities.

With these remarks, we wish the authorities success in their stabilization efforts.

Ms. Xafa and Mr. Crispolti submitted the following statement:

We thank staff for an exceptionally well-written report, focusing almost exclusively on the macro/financial sector linkages that dominate Iceland's economic outlook. In last year's board discussion we noted the meteoric rise in Iceland's gross external assets and liabilities to a multiple of GDP, and the risks that this high leverage—akin to a hedge fund—posed in the current global environment of tight credit. As global financial strains persist, we've probably only seen the tip of the iceberg as regards the impact of the necessary deleveraging on macro performance and financial stability.

Outlook and Risks

As discussed in Mr. Henriksson's and Mr. Olafsson's frank and informative statement, significant uncertainty surrounds Iceland's short-term outlook, as macro imbalances and financial sector risks are large and vulnerable to a disorderly unwinding. These risks appear to be increasing rather than receding as banks' credit default swap spreads are widening toward their March peaks. With risks clearly on the downside, GDP growth will likely enter into negative territory this year and record a marked contraction in 2009. The housing sector will be a drag on consumption, in view of the high sensitivity of household balance sheets to developments in the real estate sector (Box 2) and the potentially persistent negative wealth effects stemming from a substantial fall in house prices. Under the authorities' baseline forecast, it is expected that house prices will decline by about 30 percent in real terms during the 2008-10 and will remain depressed beyond that horizon[1]. If inflation stays significantly above the authorities' target during the projection period, as staff expects, downside pressures on the real income of households will compound the decline in consumption. Financial sector and corporate deleveraging will also be a drag on activity.

While macro prospects are admittedly poor, we agree with staff that policies should be geared to addressing external vulnerabilities stemming from large funding needs and liquidity risks. Although the banks seem well-protected against further króna depreciation, the same may not apply to corporate borrowers, much less to households with FX-denominated mortgage loans. Large amounts of glacier bonds maturing in late 2008 and early 2009 risk putting renewed pressure on the currency if, as appears likely, they are not rolled over. Against this background, macro policies should err on the side of caution to ensure that confidence is maintained and the currency stabilizes.

DSA and IIP

As regards the DSA, we wonder whether the published IIP figures understate external sustainability concerns. Both staff and authorities believe that Iceland's net IIP is undervalued, because outward FDI is much bigger than inward FDI and is recorded at book value. While we buy this argument, we still believe that the published IIP figures understate the deterioration in Iceland's IIP, because the market value of Iceland's external assets (which is not available) probably declined much more than their book value (on which the IIP figures are based). Since the expansion of Icelandic banks happened mainly through externally funded acquisition of financial institutions in other countries, the correction in global financial sector equity prices probably has wiped out a good portion of Iceland's foreign investment position. The point is that Icelandic banks are in effect leveraged holders of foreign assets whose value has declined sharply. While it is also true that the value of inward FDI in Iceland declined,

[1] Monthly Bulletin, 2008-2, Central Bank of Iceland.

net IIP measured in market prices must have declined significantly by virtue of the fact that outward FDI is bigger and more heavily weighted toward financial sector assets. We would welcome staff comments.

Exchange Rate Regime

Iceland is a clear example of an economy where exchange rate flexibility has compounded external shocks instead of helping deal with them. Far from promoting adjustment, the depreciation of the króna compounded the misery by adding inflation to it. Moreover, CGER estimates suggest that the exchange rate has overshot, as the REER now appears undervalued (Box 3). With 80 percent of household debt inflation-indexed and 13 percent FX-denominated, exchange rate overshooting has made the consumption cutback and growth slowdown more severe, fueling the negative feedback loop between currency depreciation, inflation and balance sheet deterioration.

We reiterate our skepticism about the choice of inflation targeting and a floating exchange rate in a tiny open economy like Iceland, where the pass-through of exchange rate movements is likely to be high. Staff calculates the pass-through to consumer prices at 40 percent (p. 9, ft 1), although second-round effects will likely emerge when wage contracts come up for renegotiation in early 2009. If labor and product markets are indeed open and flexible (¶33), it is not clear what purpose exchange rate flexibility serves. The country's size makes it a good candidate for a currency board or euro adoption. The current macro/financial turbulence would be much less severe if Iceland were part of a far larger and more liquid transactions area such as the Euro area. Staff comments on the above points are invited.

Monetary Policy

The authorities' concern in last year's consultation that monetary tightening would have perverse effects by attracting capital inflows has given way to concern about weakening economic activity. Although the CBI hiked its policy rate by 175 bps in March-April 2008 to shore up confidence in the currency, surging inflation since then has reduced the real policy rate and given rise to monetary easing that could eventually undermine confidence in the króna. Monetary tightening is also undermined by the downward pressure on mortgage rates caused by HFF lending and new measures to ease funding pressures. HFF reform thus appears essential to increase the effectiveness of monetary policy, and we welcome the authorities' efforts to formulate a HFF restructuring plan. The bilateral currency swap agreements of €1.5 billion concluded with three Nordic central banks have in effect increased FX reserves, giving time to the banks to reduce the size of their balance sheets. Still, the banks' foreign liabilities dwarf FX reserves, far exceeding the CBI's ability to act as a lender of last resort. These developments lend support to the staff's argument that confidence-boosting policies should take precedence over policy stimulus.

Fiscal Policy

At the current juncture, the stance of fiscal policy should be supportive of the central bank's efforts to contain inflation. While automatic stabilizers should be allowed to operate, additional stimulus should best be avoided. There seems to be disagreement between staff and authorities as to whether the deterioration of the fiscal position in 2008 reflects the normal working of automatic stabilizers or discretionary stimulus. In this connection, we would appreciate the staff's response to the points raised by Mr. Henriksson and Mr. Olafsson in their statement. If indeed discretionary stimulus is involved, we encourage the authorities to tighten the fiscal stance given the importance of confidence effects. In such a tiny economy the bulk of any discretionary stimulus is likely to leak abroad, widening the current account deficit and triggering a further weakening of the currency. These measures also tend to be difficult to reverse when circumstances change, leading to increased public expenditure rigidities. Looking ahead, we welcome the authorities plans to introduce multi-year budgeting and expenditure rules for local authorities.

Mr. Gakunu and Mr. Uanguta submitted the following statement:

We thank staff for a well focused report, and Messrs Henriksson and Olafsson for an insightful statement.

Iceland's economy is prosperous and flexible, with sound institutions and well managed natural resources. GDP growth output rose by over 25 percent during the last 5 years and inflation has been subdued until recently. It is also encouraging to note that the long-term prospects for the Icelandic economy remains promising, given sound institutions and bountiful renewable natural resources.

Notwithstanding these positive developments, the economy faces vulnerabilities and imbalances arising from this period of economic expansion including overstretched private sector balance sheets, high dependence on foreign financing and large current account deficit. Measures to facilitate an orderly rebalancing process, while mitigating mounting risks by shoring up confidence, remain a priority. In this regard, a tight monetary policy amid prevailing external risks and inflationary pressures is appropriate. The current central bank's policy stance with key policy rate at 15.5 percent should help to contain inflationary pressures, especially in the context of weakening economic activity. In the same vain, we encourage the authorities to act promptly to reform the publicly-owned Housing Financing Fund. Regarding the financial sector, improving the Icelandic financial sector should continue to remain a key priority in the medium-term. We, therefore, urge the supervisory authorities to strengthen the monitoring mechanisms, enhance cooperation between the home and host supervisors, and further develop contingency plans to manage risks and strengthen confidence.

While we understand the authorities' view to use fiscal policy to prevent a sharp slowdown of the economy, we, however, consider that a more prudent and cautious fiscal stance is needed to help build confidence and support monetary policy efforts. We also urge the authorities to remain committed to strengthening the medium-term fiscal framework, including multi-year budgeting and better public financial management control at all levels. We are encouraged to note that Messrs Henriksson and Olafsson in their statement provided a further assurance that these measures are already underway.

We note that the external sector may become more vulnerable as global liquidity tightens, which could reduce substantially net capital inflows. Furthermore, the significant amount of Glacier bonds expected to mature in the coming quarters could also pose a serious pressure on the exchange rate to depreciate. However, it is encouraging to note that the large current account deficit is expected to decline to a smaller and sustainable level over the medium-term.

With these comments, we wish the Icelandic authorities success in their future endeavors.

Mr. Kishore and Mr. Mohanty submitted the following statement:

We thank staff for their assessment and Mr. Henriksson and Mr. Olafsson for their informative statement. The Iceland economy is now passing through a difficult phase after a prolonged period of expansion. The current economic outlook remains uncertain with a decline in real GDP, high inflation and volatile exchange rate. While economic contraction is unavoidable, the policy priority should be to stabilize the economy and address the macroeconomic imbalances which have been building over time partly as a result of rapid expansion. We note that the authorities broadly agree with the staff assessment. We would focus our comments on a few areas.

External Stability

Persistence of a large of current account deficit led by private sector borrowings has raised the external indebtedness of the economy to a very high level. There is, therefore, a need to bring down the current account deficit to a more sustainable level. While the recent depreciation of the króna could have a favorable impact on trade balance, at the same time it could accentuate debt-servicing difficulties. The exchange rate of króna remains market determined, but as noted by staff its current value is judged to be below its equilibrium level. What are the policy options in the event of further depreciation pressures? Would it be desirable for the authorities to intervene in the foreign exchange market to stabiles the value of króna consistent with the fundamentals? Is the current level of reserves adequate for market confidence? Would a pegged exchange rate be more appropriate to stabilize a small open economy like Iceland? We would welcome staff comments.

Monetary Policy

The inflation rate is in double digits, way above the formal inflation target. As the growth momentum is slackening, a major factor that seems to have contributed to inflationary pressure is the depreciation of króna. In response, the Central Bank of Iceland (CBI) has tightened monetary policy and the real policy interest rate is positive. We agree that a tight monetary stance would be required to anchor inflationary expectations and to contain depreciation pressures on the currency. What has been the impact of high interest rates on capital inflows? We would welcome staff comments.

Fiscal Policy

We note that the stance of fiscal policy has turned more accommodative as a counter-cyclical measure. Given the magnitude of the current problems, a tight monetary stance by itself may not be adequate to contain aggregate demand without commensurate support from fiscal policy. The possible adverse impact of too tight a monetary policy on financial stability also needs to be kept in view. We, therefore, see merit in the staff's suggestion for fiscal restraints though the excess demand has emanated from the private sector.

Financial Stability

As noted in Mr. Henriksson's statement, there has been exceptional growth in the banking sector. Much of the expansion was facilitated by recourse to external borrowings taking advantage of benign international financial conditions. The vulnerability of the financial sector has, however, increased as the access to international liquidity becomes difficult. In this context, we welcome the recent steps taken by the authorities to strengthen financial stability. The tightening of prudential limit on the mismatch between banks' foreign currency assets and liabilities should prompt banks to diversify their funding sources. We note the preparedness of the authorities with contingency planning. The evolving situation in the financial sector needs close monitoring for a quick response.

With these comments, we wish the authorities success in their policy endeavors.

Mr. von Stenglin and Ms. Rieck submitted the following statement:

We thank staff for an interesting set of documents and Messrs. Henriksson and Olafsson for their concise statement. Indeed, the complexity of the current economic situation in Iceland makes an adequate assessment not an easy task and the information available is not always unambiguous. It is clear, however, that the coincidence of an imminent recession after a long period of strong growth and the high level of leveraging in the entire economy is a matter of strong concern. At the same time, the small size of the economy together with record-high financial and economic integration leave the authorities with limited policy options.

Risk assessment. Both staff and authorities rightly point at severe risks to financial stability and eventually the economy as a whole. While staff puts particular emphasis on the external side, the authorities focus more on domestic risks. However, instead of "hierarchizing" different sets or origins of risk, we would rather emphasize their interdependence. Via the channel of market reactions, external risks can well trigger domestic ones and vice versa.

- We agree with staff that the banking sector's short-term liquidity needs, notably in foreign currency, constitute a major challenge in the current environment. Banks have significant rollover needs within the next two years amidst stressed financial markets and strong scrutiny by investors. With consolidated assets surpassing 900 percent of GDP, a sudden stop or a significant reduction of capital inflows would have far-reaching consequences for the entire economy.

- Having said that, banks still appear financially healthy and credit quality has remained robust. Modest loan-to-value ratios in mortgage lending should limit the vulnerability of their credit portfolio to a sudden drop in house prices. As regards the external side, we understand that large parts of direct foreign exchange risk to the banking sectors are hedged – as are two thirds of domestic foreign currency borrowers more generally. Could staff provide more information about the quality of hedges in the banking sector, notably the counterparty risks arising from the use of derivates as hedging instruments? Does staff have an estimate of the overall volume of unhedged foreign currency exposure in Iceland? In this context we also note that the exchange rate does not seem to be misaligned, although further depreciation of the króna resulting from a loss in confidence cannot be excluded.

- Apart from potential effects on domestic demand, we would be interested to hear staff's opinion on the implications for price stability of inflation indexation of household debt.

- While linkages between the financial and the real sector of the economy played a significant role in driving economic growth in the past few years, the same interdependence now puts Iceland under pressure. As staff has pointed out convincingly, the balance sheets of households and non-financial corporations are highly vulnerable especially to a combination of shocks.

Policy action. This delicate state of the financial system and, in that regard, the Icelandic economy overall calls for strong confidence-building measures in order to avoid negative chain reactions such as outlined by staff in box 2.

- It is reassuring that both the public and private sector in Iceland seem to be well aware of looming banking sector risks. Banks have already made important efforts to reduce their vulnerabilities, such as diversifying their funding structure, increasing loan loss provisioning, and reducing non-core business. The deleveraging process will have to continue, although pressure on the market from a rigorous consolidation over a short time period should be avoided. Given the likelihood that international capital markets will remain strained for some time and access to wholesale markets difficult, we take comfort from the fact that banks hold liquidity and capital buffers somewhat above the current minimum requirements. Staff has a point in recommending to increase them further.

- The regulatory framework and operations by the central bank have been appropriate so far, even though it is less than ideal that the CBI has become the principal source of liquidity for Icelandic banks. The authorities' preparedness to boost international reserves is adequate and overreaction by the markets seems unlikely if it is done in a transparent way. We appreciate the measures taken to strengthen the supervisory authorities. Stress testing appears well advanced but would benefit from a better data base, including more precise information on banks' portfolios. Furthermore, test should take into account the interdependence of events as well as the persistence of shocks beyond the immediate time horizon. The quality of assessment of the financial system overall could be improved with data on the economy-wide foreign exchange position, including of non-financial corporations. We welcome the authorities' plans to accelerate the reform of the Housing Finance Fund, with an aim to strengthen the effectiveness of monetary policy. The recent increase in lending limits of HFF was not helpful in this regard.

- Sound macroeconomic policies might not be a panacea to immediately resolve the vulnerabilities in the banking sector. Still, stability-oriented adjustments would help to bolster confidence in the economy – with positive repercussions on financial stability. One has to admit that double-digit interest rates failed to prevent the current surge in inflation and two rate hikes earlier this year have not succeeded in anchoring inflation expectation. Nevertheless, we have sympathy for staff's call to tighten monetary policy further. Apart from any direct support for the króna, this can be an important signal to markets, including the labor market, underlining the central bank's commitment to dampening inflation.

- On the fiscal side, we support staff's recommendation to let automatic stabilizers operate fully but to refrain from additional fiscal stimulation at this time. Discretionary fiscal policy does not only tend to be less effective in a small economy such as Iceland; it would also put even more pressure on the monetary policy side. Moreover, a healthy limitation of expenditure growth can help to foster investor confidence, a crucial aspect given Iceland's dependence on international capital inflows. The fiscal reforms, the authorities are currently working on, go into the right direction.

Mr. Rutayisire submitted the following statement:

These are challenging times for Iceland. A number of economic fundamentals appear to have overshot their suitable levels, including inflation, the current account deficit and external debt. The rapid economic expansion experienced by Iceland over recent years seems to be coming to an end. Growth has slowed in the first quarter of 2008 and the housing prices have declined. The fiscal position is expected to deteriorate. The staff report, for which we are thankful, notes the worsening market and economic conditions under which it held policy discussions with the authorities a few months ago, with notably the volatility of the króna, the surge in inflation and the widening of bank and sovereign CDS spreads.

We thank Messrs Henriksson and Olafsson for their statement which provides welcome reassurances about Iceland's economic outlook. We concur that long-term prospects of the Icelandic economy are positive, given Iceland's low public debt and strong institutions. In light of the authorities' sound economic policies and the country's track record of responding to shocks, there is indeed a strong case for the economy to successfully cope with the turbulence it faces. The significant decline in the current account deficit which is projected over the medium-term is welcome. With regard to growth, both the authorities and staff concur that a recession is forthcoming even though they continue to differ with regard to its timing. For 2008, staff forecast a negative real GDP growth which contrasts sharply with the positive growth projections of the authorities, OECD, and the private sector. Could staff elaborate on why such a contrast continues to persist until this time of the year?

We note that there are significant risks to the economic outlook with staff emphasizing external ones and the authorities concerned about domestic ones. We would encourage the authorities to err on the side of caution and address both domestic and external risks. In particular, this would require containing risks emanating from the housing and corporate sectors on the one hand, and enhancing transparency and closely monitoring prudential ratios in the banking sector on the other hand.

The fact that inflation which has been above target over recent years is expected to return to target only around the second half of 2012 may raise concerns about the credibility of the inflation targeting framework. Staff's comments about how such concerns are being or could be addressed would be appreciated. The case for anchoring inflation expectations cannot be made strongly enough. In this connection, the CBI's recognition of the importance of anchoring inflation expectations is welcome. However, it is unfortunate that the reform of the Housing Financing fund (HFF) is not proceeding as steadfastly as expected. We urge the authorities to accelerate this reform with a view to improving the effectiveness of monetary policy. In this process, care will need to be taken to avoid implementing reform measures that would potentially run against this objective.

With the expected deterioration of the fiscal position, we regret that the authorities and the staff were not able to share similar views on the priorities and role of fiscal policy. While staff considers that fiscal policy should be supportive of monetary policy actions to contain inflation, the authorities see it as an instrument to counter a potential, sharp economic downturn. Though the authorities' efforts to prevent such a downturn are appropriate, it will be important to ensure that these do not undermine the measures being taken by the CBI to subdue inflation. We join staff in calling for the authorities to strengthen spending control mechanisms, notably by adopting a multi-year budgeting approach that is in line with policy commitments. In addition, improvements in the coordination between fiscal and monetary policies are warranted.

In the face of the recent financial sector turmoil, the authorities' emphasis on financial sector soundness is rightly warranted. In this regard, the steps taken by the Central Bank of Iceland to enhance banking supervision are appropriate, including the tightening of the rule on the mismatch between banks' foreign currency assets and liabilities.

The focus put by policy discussions between staff and the authorities on how to address financial sector vulnerability is appropriate. We encourage the authorities to promptly address the risks identified by the FSAP Update, particularly those associated with banks' liquidity, funding, operations, and quality of capital as well as the foreign currency and equity exposure and indebtedness of domestic borrowers.

With these remarks, we wish the authorities every success in implementing their policy and reform agenda.

Mr. Silva-Ruete and Mr. Pereira submitted the following statement:

Considering the size of accumulated macroeconomic imbalances, Iceland could undergo an uncertain transition with the chance of a steep economic contraction for a longer period that initially foreseen. Past financial excess will prove to be a high price to pay for this prosperous and flexible advanced economy. Given that the economy has proved enough flexibility and adaptability in the past, we concur that long-term promising prospects remain, as noted by Messrs. Henriksson and Olafsson in their comprehensive statement.

Iceland has traditionally been more volatile than its peers. The great unwinding now underway is the result of both a reversal of external benign environment and excessive financial liberalization. In the past decade, the country has attracted large foreign investment projects that have overwhelmed its economy, contributing to macroeconomic imbalances, despite prudent fiscal and monetary policies. This time, it seems that a worldwide financial liberalization process fueled a unique domestic economic boom (25 percent of real output increase between 2003 and 2007), promoting large foreign indebtedness and high-leverage households. The abundance of cheap, easily accessible global credit, aggressively exploited by Icelandic firms and banks, coincided with other favorable factors to further fuel growth. Macroeconomic imbalances and a large current account deficit were then prompted. Massive takeovers and the Icelandic purchases of companies in the U.K., Denmark, and elsewhere was a new critical factor. The process was perhaps envisaged as the unbeatable way to surpass the natural limits of this small, open economy.

Changes in the Icelandic financial system have been unprecedented. Before the year 2000, most banks were publicly owned and the ever-rising amount of debt relative to equity, low or negative real interest rates for long periods, and the longest working hours in Western Europe transformed the economy into one of the wealthiest in the world. Once the privatization process was completed around 2000, banks drastically extended their operations well beyond domestic deposits, financing their expansion largely from foreign borrowers. They were, indeed, a hybrid between commercial and investment banks for years, under a very lightly-regulated framework, with large exposure to market risk under complex financial instruments. The overall benign context promoted commensurable domestic asset bubbles fueled by extremely high credit growth. Funding in global wholesale markets also allowed them to take bets abroad, doubling their foreign debt. All in all, the Icelandic banking system has broadly operated like hedge funds, without separating the implicit guarantees they received as commercial banks from their operation as investment banks.

Uncertainties on the outlook persist. Both external and domestic factors could play their role and mutually reinforce a downside cycle. On the one hand, external liquidity risks dominate the outlook. There is little doubt that the world economy is experiencing a full-blown financial crisis, encompassing severe stress in banking, securities and foreign exchange markets all at the same time. This global credit-crunch has torn down the Icelandic banks' funding model. Up until now, considerable skepticism has been built toward their market access and even the government's own borrowing capacity despite timely coordinated actions. Banks' liquidity has become highly dependent on central banks' liquidity facilities. The short-term maturity of sizeable funding needs (also known as Glacier bonds) is also of great concern, making it harder for banks to strengthen their capital buffers or to de-leverage in an orderly fashion in the short-term. On the other hand, the downturn in economic activity is typically higher the larger the initial financial imbalance. The strong reliance on external financing may produce a cycle of severe deleveraging, with banks sharply reducing their lending and then prompting an economic slowdown that feeds back into a further reduction in credit supply. Asset quality may already be under stress given the rapid loan growth and the increase of foreign currency borrowing negatively affected by the depreciation of the króna. The risk is that the financial accelerator could further erode credit availability and knock consumer confidence. It remains to be seen whether Iceland will turn out to be the first advanced country to fall into a protracted recession. We assign great importance to the role of net export contributions as an effective channel in supporting growth and narrowing the external imbalance. The staff's comments are welcome. We are also interested in hearing from the staff's regarding the level of external imbalances and the possibility of an underestimation of both residents' foreign assets and FDI flows given the scale of internationalization of the Icelandic economy.

A firmer lesson must be drawn from Iceland's experience. The authorities may have conceded that companies and households are borrowing like there is no tomorrow, perhaps putting too much faith in the self-healing power of market regulation. However, the strategy of pursuing a domestically driven foreign-funded boom was finite. Iceland may be naturally prone to considerable volatility given its size and openness, but the extent of this crisis could have been lessened under stronger regulatory and supervisory financial frameworks. We would welcome the staff's comments on this issue.

Turning to future policy stance, we agree with the authorities that containing a deep domestic recession is a key priority. An "orderly" rebalancing process critically lies on sustaining economic activity. In this regard, we support an active countercyclical fiscal policy to smooth the economic downturn, as suggested by Mr. Henriksson and Mr. Olafsson. This does not seem to be the right moment to shore up market confidence by ensuring a more cautious fiscal stance. As it was broadly recognized in the case of the U.S. economy, timely initial fiscal actions are vital. Targeted measures aimed at supporting labor markets and strengthening social spending are welcome; we ask the staff to describe the authorities' plans in this regard.

Considering the aforementioned financial and economic weaknesses, monetary policy would hardly be the first line of defense at this juncture. Admittedly, it remains to be seen if Iceland is facing a substantive liquidity – insolvency problem in a context of weakening economic activity. Tightening monetary policy will not necessarily ensure the needed foreign capital inflows to contain this crisis, neither bringing down inflation nor buttressing confidence in the króna. The risks of expanding domestic financial distress and promoting a more protracted slowdown are genuine. Overall, as the authorities, we favor keeping monetary policy on hold, taking a more accommodative stance if necessary.

Sounder regulation and supervisory frameworks must be instituted. We failed to perceive this clear message in the staff's policy advice. Despite weaknesses in the lightly regulated banking system, the staff states that either financial indicators were above minimum regulatory requirements or that the supervisory framework has been improved while the Financial Supervisory Authority's capacity enhanced. Of course, vulnerabilities are recognized and sound policy recommendations are now tabled (such as stronger capital buffers, enhanced liquidity facilities or adequate contingent plans). However, almost all of them are of limited applicability in the near term. The problem of procyclical capital positions, oversized and concentrated banking system, excess foreign indebtedness, and unsustainable high credit and liquidity risks are perhaps common elements in explaining this global financial crisis. Nevertheless, Icelandic Banks' complex ownership structure and the possibility of unclear funding mechanisms or a high concentration of exposure to large and connected parties were also part of the problem. Further co-operation among financial supervisory authorities, central banks and Financial Ministers is also critical and we welcome the authorities' intentions to move expeditiously in that area.

With these comments, we thank the staff for a very good set of papers and Mr. Henriksson and Mr. Olafsson for their informative buff Statement. We wish the authorities all the best in their endeavors.

Mr. Yamaoka and Mr. Harada submitted the following statement:

We thank the staff for their well-focused reports and Mr. Henriksson and Mr. Olafsson for their helpful statement. The economy of Iceland is at a critical phase, and prudent macroeconomic policy management and financial stability policies are required to recover market confidence.

Inflation, Economic Slowdown and Financial Vulnerability

The economic developments in Iceland typically show the difficulties in conducting inflation targeting under the current circumstances. Inflation has continuously stayed above the target over the last four years. Moreover, inflation has rapidly accelerated from around 6 percent in January 2008 to over 14 percent in August. Furthermore, developments in core inflation, which have been at almost the same level as that of headline inflation, indicate that the "second-round effects" of inflationary shocks have not been contained. The current wide divergence of actual inflation from the target (2.5 percent) might damage the credibility of the nation's inflation targeting framework. Indeed, as shown in the chart on page 24 of the Staff Report, inflation expectations have almost followed actual inflation, and such "adaptive" inflation expectations imply that the inflation target is unlikely to work as an effective "nominal anchor." In this regard, the authorities are required to take a decisive stance to fight inflation, so as to maintain the credibility of the nation's macroeconomic policies.

Additionally, we also recognize that the authorities have to deal with the economic slowdown and financial turbulence, which present them with a serious policy dilemma: Clinging to the inflation target at this juncture might intensify downside pressures on the real economy and destabilize the financial system. Alternatively, an expansionary economic policy and accommodative liquidity provisions might erode confidence in inflation targeting as well as in the external value of the currency. Frankly speaking, there is no panacea to such circumstances. (In hindsight, the policy response would have been much easier when the overshooting of inflation was accompanied by an overheated economy.) To this end, we must make a banal remark by stating that the authorities need to "strike a balance" between stabilizing inflation, real economic activities and the financial system.

Having said that, we encourage the authorities to tackle several challenges as a priority. First, we urge the authorities to utilize their fiscal room to establish an effective safety-net against financial shocks, and strengthen the capital base of banks. The banking sector's risk premium implies that market participants lack confidence in bank capital buffers against possible losses. Thus, the authorities should carefully examine whether the level of banks' loan-loss provisioning is sufficient or not. Moreover, if the increase in loan-loss provisioning were to reduce banks' capital, below necessary levels, banks would be required to restore their capital as soon as possible. If necessary, the authorities should not hesitate to intervene in the process of restoring capital. On the other hand, discretional fiscal expenditures would not be very effective in creating demand especially when the loss on credibility in the financial system impairs the confidence of firms and households.

Second, the authorities are required to make their monetary and fiscal policies consistent with the current economic environment, and to communicate their stance to the public in a clear-cut manner. The current monetary and fiscal policies may seem somewhat contradictory to the market, since some measures could be regarded as "tightening" while others may seem to be "easing." For example, recent measures facilitating the financing of the Housing Financing Fund (HFF) may hinder the effectiveness of monetary tightening. Thus, the authorities are encouraged to consider appropriate public sector interventions to housing financing, and restructure the HFF in line with such considerations. Lastly, the authorities are also required to improve their communications regarding inflation targeting, so as to prevent the target of 2.5 percent from being regarded as a "fictional target." Should the current communication problems remain unchecked, the situation could lead to further problems such as the inconsistency of public sector wage increases with the target.

Safety-Net Issues

While we understand the time constraints of the FSAP mission, we would have welcomed the staff's detailed assessment on the nation's financial safety net, especially on the deposit insurance scheme. Japan's banking crisis experience demonstrated that well-prepared safety nets, which include liquidity provision, public intervention and deposit insurance, play important roles toward containing banking crises. (Indeed, we have learned a lot from the experience of several countries in the Nord-Baltic constituency at the beginning of 1990s.) Since institutional and legal safety-net frameworks are not built in one day, the Fund is expected to examine whether the financial safety-net frameworks would work effectively or not, and to provide necessary advice and support at the earliest opportunity. (For example, it would be fruitful to examine whether the deposit insurance has sufficient financial and human resources to deal with shocks under various stress-scenarios.)

Moreover, in view of the scale of the banking sector compared to the nation's economic scale, international coordination might be required in order to implement any initiatives to strengthen the safety-nets against possible turbulence and in terms of carrying out contingency planning. We would welcome the staff's elaboration on this matter. Also, as a general topic, we are interested in the effectiveness of the Find's program under the cross-border financial crisis. (For example, would we be able to recognize "balance of payment needs" if external indebtedness were to arise largely on account of the banking sector?)

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Warjiyo and Mr. Eng submitted the following statement:

The staff report paints a somber picture of the Icelandic economy: the long boom has come to an end and the economy is entering into a difficult rebalancing process. The ongoing financial turmoil has brought to the fore vulnerabilities due to imbalances build up in the past. Growth has decelerated rapidly and forward looking indicators suggest no respite in the near term. Inflation has climbed to uncomfortably high levels well beyond the inflation target and there are signs that inflationary expectations have become unmoored. The current account deficit is projected to remain above 15 percent of GDP for the fourth year running even as the króna tumbles, and with external debt ballooning, reserves coverage has dipped to alarmingly low levels. Bank, corporate and household balance sheets are increasingly stretched as asset prices fall off their unsustainably high levels and liquidity conditions tighten.

The financing of the current account deficit could be a key source of risk for a possible dislocation of Iceland's adjustment process, given the still jittery financial markets. As the staff pointed out, a significant amount of glacier bonds, which is maturing in the coming quarters, could be subject to rollover risk. Clearly, the situation is still delicate, with the financial and macro outlook heavily contingent on investor sentiments. In the near term, policies will need to be appropriately geared toward shoring up confidence, and any policy misstep could penalize the economy heavily. In our view, the central theme of the staff's policy prescriptions, that is to shore up confidence through monetary tightening, fiscal restrain and addressing financial sector vulnerabilities, are appropriate. That said, the calibration of the specific policy responses is delicate given the unusually high uncertainties surrounding the baseline outlook. Consequently, some differences in views between the staff and authorities can be expected.

Exchange Rate Policy and External Stability

The staff assesses that the króna is broadly in line with long-term fundamentals, despite the large external imbalance that has shaken market confidence. At the same time, we note that there could be problems with the IIP estimate, as highlighted in Messrs. Henriksson and Olafsson's informative buff statement. Given that the IIP is used in calculating equilibrium exchange rate, could the staff comment on this and how it would impact the exchange rate assessment? Furthermore, the staff is quick to point out that the external imbalance is not a result of exchange rate policy, given that the króna is freely floating. However, like Ms. Xafa and Mr. Crispolti, we would like to underscore the point that staff could have taken a more enlightened view about the role of the exchange rate in the adjustment process and in the context of a small and open economy such as Iceland. We are very much interested in the staff's further elaboration on the underlying assumptions and the macroeconomic policy measures necessary to facilitate the adjustment of both the real exchange rate and current account norm back to their equilibrium levels as depicted in Box 3 on page 13.

Monetary Policy and Price Stability

On monetary policy, the staff favors a tighter policy stance than the authorities. While the authorities' concerns about the impact of higher interest rates on growth are clearly legitimate, we would agree with the staff that further hikes in the policy rate may be called for to secure price stability. Domestic price inflation has continued to rise, as updated by the staff, and thus the inflation trajectory needs to be quickly reversed to restore credibility to the inflation targeting regime and to ensure that rising inflationary expectations do not become entrenched. This is of particular importance since inflation expectations in Iceland have historically tracked inflation outcomes closely. With real interest rates still falling, a hike in the policy rate would send an important signal to markets demonstrating the CBI's commitment to rein in inflation. It would also help shore up confidence in the króna, which would not only alleviate imported inflation but also support the fragile balance sheets of the private sector. Like the staff, we urge the authorities to firmly resist pressures for rate cuts until there is compelling evidence that inflation is easing. We understand the difficulties of building consensus at a difficult and challenging time like this, but failing to do so could risk further growth set backs and a loss in output and wealth that could have more long-lasting effects going forward.

The effectiveness of the monetary transmission channel has been hampered by the lack of progress in reforming the Housing Financing Fund (HFF). The recent moves to raise the HFF lending limits and loan-to-value ratios could further limit its effectiveness, which would in turn circumvent the authorities' efforts to combat inflation. The growth of both credit and money supply remain relatively high, though declining somewhat recently, pointing to the need for further tightening of liquidity to restrain domestic demand. The authorities' reaffirmation of their pledge to reform the HFF is thus welcome, particularly that of separating the interest rate subsidy from the market-based element of their mortgage loans. We urge the authorities to pursue the reforms without delay.

Fiscal Policy

It was striking to note the differences between the staff and authorities on the fiscal priorities. The staff argues for a more cautious fiscal stance, including clawing back the planned stimulus, to support monetary policy and shore up confidence in view of the high external risks. The authorities, on the other hand, are more sanguine in their fiscal projections and believe that fiscal policy has an important countercyclical role in cushioning the economic slowdown. Clearly, there are merits in both sets of arguments. To the extent that the authorities have been prudent in the past in saving for "rainy days", it would appear to us that this is precisely the time to employ these savings. We can also empathize with the authorities' difficulties in reneging on the recent pledges and quickly adjusting social spending and wages, as called for by the staff. Nonetheless, we tend to agree with the staff that, despite the recent slowdown, restraining domestic demand is still in order to secure a sustainable adjustment process wherein fiscal policy could play its part. Having said that, we note that the fiscal multiplier in Iceland is low, which suggests that fiscal policy may not be as effective in stabilizing the broader economy. Beyond letting the automatic stabilizers operate, this would point to using more targeted measures to provide temporary relief to the most affected segments of the population. Staff comments are welcome.

Over the longer term, it will be important to strengthen the fiscal framework, including putting in place more binding spending limits, enhancing coordination with monetary policy, and better controlling local government finances. We welcome the authorities' commitment to that end and encourage them to vigorously pursue these reforms.

Financial Sector

We welcome the timeliness and quality of the FSAP Update. The Update clearly highlights the risks and vulnerabilities facing the Icelandic financial sector and puts forward useful recommendations. We urge the authorities to step up monitoring of the banks, enhance stress testing, strengthen their crisis management and bank resolution framework, and develop contingency plans. For their part, the banks should also put in train the necessary measures to fortify their capital positions, diversify their funding sources, boost liquidity and reduce currency mismatches on their balance sheets. We stress that it is the collective responsibility of all stakeholders to avoid any misstep that could lead to a full-blown financial crisis.

It would appear to us that the risk of contagion across banks and the potential for a spillover to neighboring countries (especially the Nordic countries and the UK where the banks have large exposures) are high. Could the staff comment on the level of preparedness of the various stakeholders in the event of a bank failure? For example, are the banks' contingency plans adequate? Do the home and host authorities have in place established procedures to manage such a fallout?

With these remarks, we wish the authorities well in the challenging period ahead.

Mr. Lushin submitted the following statement:

We thank the staff for a set of interesting and candid papers and Messrs. Henriksson and Olafsson for their helpful buff. While the long-term prospects of Iceland's economy are undoubtedly promising, the short-term challenges are formidable. The country's banking system got caught in the financial storm and banks' huge leverage makes them now feel like a ship forced to negotiate rough seas under full sail. While the crew is doing its best to steer away from trouble, the ship nevertheless is largely at the mercy of the forces of nature (or the ongoing financial crisis). Moreover, the analysis in the latest GFSR suggests that the challenging period for Iceland's economy (linked to the duration of global disturbances) is unlikely be over any time soon.

Under these circumstances, the authorities are doing what they can do – calibrating the macroeconomic policy mix to domestic factors (since external factors are beyond their control) and strengthening financial sector regulation and supervision to help it withstand any future crises. These measures, however, cannot guarantee a successful exit from the ongoing crisis and the landing for Iceland's economy will be as soft as it gets, depending mostly on luck rather than on policies.

Like the staff, we see external risks as prevailing and creating the largest uncertainty about the future course of the economy. Domestic risks, while also significant, are derived from and depend on the external ones (para 10). We, however, are less sure than the staff that measures of monetary and fiscal policies aimed at signaling and confidence-building could be effective in the present financial environment. The current crisis seems to have proved that in the periods of high distress as today, financial markets tend to discount fundamentals and policies with their decisions (especially in small countries) governed by herd behavior and/or events taking place elsewhere.

Specifically on monetary policy, we do not see how a further small increase in the policy rate could shore up confidence in the króna (para 13). This said, we think that the authorities were right to significantly increase interest rates in response to rising inflation and to keep policy interest rates positive in real terms. Right now, however, much larger forces are at play in determining the króna exchange rate to render it sensitive to a marginal increase in the interest rate differential. We agree with the staff that making the CBI the principal provider of liquidity in the domestic market is a risky strategy inconsistent with its tight monetary policy stance (para 14). Moreover, the prolonged shifting of risks from private banks to the

CBI may eventually undermine its balance sheet and "generate a need for future recapitalization" (FSSA Update, p.4).

Our views on the fiscal policy stance resemble those on monetary policy – we are not sure that a tighter stance per se could be of much help in confidence-building and combating inflation. This said, like Ms. Xafa and Mr. Crispolti, we are confused as to what extent fiscal projections for 2008-10 envisage discretionary fiscal stimulus. While both the staff and the authorities agree that automatic stabilizers should be allowed to operate (a position that we also share), their views seem to differ on the existence of discretionary stimulus. We would appreciate further clarification on this issue.

Box 3 of the staff report suggests that the real exchange rate is broadly consistent with long-term fundamentals according to the CGER methodology. At the same time, the staff speaks at length about capital-account based instability (para 12) stemming mostly from large foreign liabilities of the banking sector and possible difficulties with their refinancing. While this instability cannot be attributed to exchange rate policy (there have been no interventions), there may be a link between instability and the choice of exchange rate regime (see Ms. Xafa and Mr. Crispolti's statement), which can also be judged as leading to "misalignment". We believe that such an approach warrants further exploration by the staff, especially given that in case of Iceland the REER determined in line with the CGER-type analysis may have very little to do with the concept of external stability due to the prevalence of the capital account operations.

The financial sector in Iceland is unique in terms of its size in relation to GDP. The largest three banks can only formally be considered Icelandic, they are actually global with a hedge fund-type business model. They are facing considerable risks due to their high leverage, possible deterioration of asset quality (Supplement 2 to SM/08/273) and limited access to market liquidity (with the CBI lately being the principle provider of liquidity). The banks are doing their best to adjust to these challenging circumstances, but, as the staff rightly observes, "it remains uncertain whether these adjustments will be sufficient in today's difficult financial environment" (FSSA Update, p.6). We broadly agree with the main policy options suggested by the staff to address financial sector risks that draw on FSAP's recommendations (para 21). We wonder, however, what could be "more decisive steps to further deleverage," mentioned in the same paragraph, given that "there are limited options for quickly reducing the size of the banks" (FSSA Update, p.20). In this connection, we would also like to get more information on the banks' assets and, specifically, to find out whether they include any mortgage-based securities.

With these remarks we wish the authorities every success.

Mr. Prader and Mr. Mevis submitted the following statement:

We thank staff for the well-written set of papers and Messrs. Henriksson and Olafsson for their insightful buff statement. Iceland has experienced an extended period of prosperous development, as indicated by its high per capita output, strong productivity gains, low unemployment and a competitive products market. However, in recent years, in spite of the efforts being made by the authorities to stabilize growth, the Icelandic economy has shown signs of overheating which has culminated in severe imbalances. At present, the challenge for the authorities is to provide for an orderly unwinding of these imbalances while not putting too much strain on a slowing economy. This situation is further complicated by the slowing world economy, turmoil in international financial markets and rising commodities prices.

The authorities are facing a difficult trade-off between sustaining a cooling down of the economy and maintaining external financial stability. We are not fully convinced by the authorities' view that the factors impacting external stability are beyond their control. We agree with the staff that the central bank (CBI) should maintain a tight monetary policy to build investor confidence in the króna and that monetary policy should receive adequate support from a conservative fiscal policy stance. While such a policy mix may appear pro-cyclical and difficult in the short term, the authorities should be cautious that a sudden unwinding of the monetary imbalances may imply a much higher cost.

At the current juncture, in our view, the policy priority should be to lower inflation and to stabilize asset markets by avoiding any depreciating pressures on the króna. In addition, we believe that for an otherwise healthy economy like Iceland, the cost of a temporary slowdown should be easier to bear than a possible forceful unwinding of the monetary imbalances. Given the high levels of debt on household balance sheets and the leverage of non-financial corporations, such events could leave a considerable dent in consumer confidence and harm the institutional structure of the economy. Furthermore, a high rate of inflation threatens real wages, which in turn would further curb consumer confidence.

We agree with the staff that the authorities should take a cautious fiscal stance, keeping public sector debt low and restraining spending for now. An expansionary fiscal policy would unnecessarily fuel inflation and threaten the stability of the exchange rate. We also agree on the benefits of a rules-based, multi-year fiscal framework with better expenditure controls at all government levels. A multi-year expenditure plan may, if credible, improve confidence in the authorities' commitment to low inflation and contribute a great deal to the efforts of the CBI.

In addition, we would like to encourage the authorities to reform the Housing Financing Fund (HFF) to remove this impediment to a smooth and effective transmission of monetary policy. In this respect, we encourage the authorities to act sooner rather than later so as to give more control to monetary policy in this uncertain environment.

We welcome the useful information provided by the recent FSAP update and commend the authorities on the improvements that have been made in the supervisory powers and resources. We also welcome the frameworks established for cross-border stress testing and the measures suggested to further mitigate the risks to the financial sector. Especially, measures to increase capital cushions seem utterly appropriate in the current situation. Strengthening the bank resolution framework is also essential.

Given the uncertain condition of non-financial corporate balance sheets, we agree with the staff and the authorities about the importance of improved data collection and disclosure in this area. In particular, the strong increase in leverage of non-financial corporations and the potential repercussions an unwinding could have on banking sector stability make these data crucial.

Ms. Lundsager and Mr. Wood submitted the following statement:

We thank the staff for an informative report and FSAP that effectively lay out the challenges facing policymakers. Iceland's small, open, and financially integrated economy has proven vulnerable to external shocks, and the end of the massive investment and consumption boom has the country in the midst of a difficult period. Significant adjustment in asset prices and balance sheets is inevitable as part of a necessary rebalancing of the economy, and the risks for a disorderly unwinding remain high. Policy should stay focused on facilitating an orderly rebalancing process. In the long run, Iceland's low official debt, sizable endowments of renewable resources, and young well-educated population are consistent with favorable economic prospects.

Financial Sector

We agree with the staff's view that external liquidity risks remain a key concern for a banking system dependent on foreign funding. In the current situation, it is essential for policymakers and banks to reduce risks by taking actions that instill confidence in Iceland's financial system. Iceland's economic outlook will depend importantly on the quality of assets in the loan books of the commercial banks. We urge full transparency at the commercial banks, as timely disclosure of all risks is necessary to shore up confidence in the banking sector. This is particularly important with regard to the banks' lending to related parties and to holding companies.

We commend the authorities in their efforts to improve oversight of the banking sector, whose huge size relative to the country's economy should make continuous improvement in this area a top priority. Commercial banks have responded logically to the curtailment of foreign credit by raising deposits. However, many of these deposits are in online savings accounts at branches abroad. We urge greater transparency as to the relative roles of the Icelandic deposit guarantee fund and the home countries' deposit insurance schemes in the insurance of these deposits.

We support the government's move to authorize the CBI to borrow to expand its reserve base. We would stress the importance, however, of actually using this credit line to bolster the CBI's reserve position in advance of any potential crisis, even if the value of the króna and risk aversion in international capital markets makes this more expensive than in the past.

Exchange Rate and Monetary Policy

The staff analysis concludes that the sharp depreciation this year has eliminated the previous overvaluation of the króna and has left the currency near, and even somewhat below, its long-run equilibrium value. The depreciation has lifted inflation far above the inflation target and the staff indicates that inflation expectations have become unhinged. In this context, we agree with the staff recommendation that monetary policy remain tight, even as the economy weakens. We support the CBI's efforts to provide liquidity to the banking system, as long as those efforts are consistent with the monetary stance. We agree that plans to further increase the supply of short-term government debt would add a useful liquidity-management tool.

Fiscal Policy

The government piled up significant surpluses during the boom that have largely eliminated the government's net debt. Such countercyclical fiscal policy during good times should help prepare room for supportive policy when the economy turns down. With the economy expected to contract over the next two years, it is reasonable to let automatic stabilizers operate fully, but there is concern over the effectiveness of fiscal stimulus in such a small, open economy. Given the apparent disagreement between the staff and the authorities on adjustments of the structural primary budget balance for the effects of the asset price boom, we would like to hear an elaboration of the respective views on how to divide current fiscal stimulus between automatic stabilization and discretionary policy.

Ms. Agudelo and Mrs. Joseph submitted the following statement:

We thank staff for the detailed report and informative FSAP update and Mr. Henriksson and Mr. Olafsson for their insightful buff statement.

The Icelandic economy faces difficult and troubling challenges, which must be managed by the authorities with skill and caution in order to achieve a soft landing without major damage to economic growth. The international financial crisis and credit crunch exacerbated the economy's vulnerabilities, leading to significant threats to the country's external and domestic stability. The authorities have taken remedial action, tightening both monetary and fiscal policies and attempted to shore up the confidence of the economy's creditors. The economic outlook is very challenging, as the authorities must anchor inflation expectations, while seeking to turn around recessionary trends, which are fuelled in part by events in the financial system. At the same time, private sector external debt is high and the sector is faced with shrinking access to external financing, while the currency has depreciated, further swelling the debt stock. We believe that the criticality of external liquidity and domestic risks is equally balanced, and support the authorities in their efforts to mitigate these risks urgently.

We understand that when the international financial crisis arose, the Icelandic economy was under the wrong macroeconomic conditions to face it. For some years, the economy was growing above its potential, feeding increasing current account deficits and inflationary pressures. While we believe that the authorities should have taken the corrective actions at that moment, under the current circumstances, we believe that addressing concerns about a deep domestic recession is the priority. In that sense, we note that the staff's call for tighter monetary and fiscal policies is not fully shared by the authorities. The authorities need to carefully design monetary and fiscal policies to correct the macroeconomic imbalances while not exacerbating the economic recession.

Inflation stood at 14.5 percent in August 2008, far above the target rate of 2.5 percent, while core inflation hovers over 10 percent, indicating strong domestic pressures. Staff believes that monetary policy should be tightened further. However, we consider the authorities' current monetary policy stance gives the authorities the adequate balance to face economic growth worries. It allows them some room to move rates higher, if conditions warrant, without choking off growth and precipitating further króna depreciation. Moreover, a lower inflationary trajectory should be underpinned by sharply lower demand pressures, arising from declining real disposable income. A particular attention for future action should be given to wage negotiations, which are carded for 2009, as they could put further upward pressure on inflation if there are not concomitant productivity increases. On the other hand, given the need to secure current account financing, the authorities' plan to attract foreign investors is well placed and in that sense we also endorse their plans to augment the issue of government securities to support the inflow of foreign currency. We note that the central bank entered into a liquidity swap arrangement with three neighboring central banks. Could staff elaborate on whether the authorities have had recourse to this facility and in their opinion, has the existence of the facility been successful in bolstering confidence?

Staff and the authorities differ on the stance of fiscal policy. While staff favors tighter controls on spending, the authorities support the implementation of measures to slow the economic downturn, which seems inevitable. However, the authorities' intention to forestall a sharp correction, and perhaps an even greater outlay on measures to cushion the impact of a downturn in the future, has much merit, given that the fiscal balance is solid and the government's gross debt comfortable. In addition, as outlined by Mr. Henriksson and Mr. Olafsson, the favorable status of the pension system provides a further cushion for fiscal policy to be somewhat accommodative. With that said, we urge the authorities not to undertake these measures lightly in view of a projected budget deficit in 2009.

We note the vulnerability of the capital account and support the authorities' efforts to bolster confidence, in order to encourage the continued flow of foreign capital in the short term. In the medium term, both the central bank and staff expect the current account deficit to trend toward its equilibrium level. In the interim, the authorities are placing inter alia some reliance on the economy's increased debt-servicing capacity and residents' extensive holdings of foreign assets to act as a cushion. Could staff comment on the ability of the authorities to cope with the impact of such a crisis?

The financial sector is highly exposed and risks have been heightened in light of the global financial turmoil. The banks have taken concrete steps to consolidate their balance sheets and estimate that they can meet their debt obligations in the short term. It is worrying that the central bank has become the main source of liquidity, which increases the bank's potential risks. In view of the level of exposure of the system, we urge the authorities to commit to implementing the recommendations contained in the FSAP update, particularly in the areas of contingency planning and the strengthening of the bank resolution framework. Could staff comment on whether there are any plans to assess the deposit insurance framework in the near future in light of the number of vulnerabilities to the banking system and household and non-financial corporate balance sheets' sensitivity to financial conditions?

With these remarks, we wish the authorities all the best in weathering these difficult times.

Mr. Murray and Mr. Moveni submitted the following statement:

We thank staff for the excellent set of papers and Messrs. Henriksson and Olafsson for their informative buff statement. Rapid economic expansion that Iceland has enjoyed has swung sharply in recent years. Iceland's economy is now grappling with large macroeconomic imbalances, overstretched private sector balance sheets, and large external indebtedness. Meanwhile, the domestic economy is teetering on the brink of recession while CPI inflation is hovering above 10 percent. Given the significant downside risks, including an abrupt balance sheet adjustment, we broadly agree with the thrust of the staff's appraisal. We offer our comments only to a few areas.

We agree with staff that the policy priority should be put on facilitating an orderly rebalancing process and avoiding a possibility of the erosion of market confidence in the economy. In this regard, we concur with staff in recommending that the authorities should maintain a tight monetary policy stance to cope with prevailing external risks as well as strong inflationary pressures. Nevertheless, we note the diverging views between staff and the authorities regarding the appropriate pace of monetary tightening. In light of the differences in their views, can staff elaborate further on how tight they want the monetary policy to be, given the imminent recession, and what additional policy responses the authorities are contemplating to rein in inflationary expectations? We also note the low elasticity of the Housing Financing Fund (HFF) rates to policy rates. Considering the dominant role that the HFF plays in Iceland's financial market and the need to enhance the responsiveness of HFF rates to policy rates, we support staff's recommendation that the authorities need to redefine the role of HFF in the financial market by separating its social components from its market-based elements.

We commend the authorities for their sound fiscal policies, as illustrated by a fiscal surplus of about 5 percent of GDP on average since 2005 and the expected higher-than-projected fiscal surplus in 2008. While we note the need to fight inflation and bolster market confidence, we warn against a significant tightening, as it could exacerbate the economic downturn, adversely affecting market confidence. Nevertheless, we encourage the authorities to remain cautious and maintain a broadly balanced fiscal position over the business cycles. To this end, we take comfort in what Messrs. Henriksson and Olafsson said in their buff statement that "key emphasis in budget management in Iceland is transparency, fiscal rules and discipline." We also welcome the authorities' intention to introduce a multi-year budgeting framework and to improve fiscal transparency and accountability at the local government level. These measures should contribute to creating fiscal space for undertaking other priority spending over the medium-term.

We commend the authorities for maintaining a resilient financial system. However, the recent FSAP Update has indicated rising financial sector vulnerabilities due to limited access to wholesale credit markets and funding and credit risks. In light of the need to mitigate these financial sector risks, we encourage the authorities to strengthen banking supervision and to fully implement the FSAP recommendations. Measures that need to be implemented include raising capital cushions for operational, credit and quality-of-capital risks; reviewing the robustness of liquidity coverage under various stress scenarios; and enhancing transparency and accountability of financial institutions. To this end, we see the recent reforms undertaken by both banks and the authorities as important stepping-stones to strengthening the financial sector's resilience going forward, which include diversification of funding sources, increasing of supervisory powers, and enhancement of supervisory framework.

With these remarks, we wish the Icelandic authorities success in their future endeavors.

Mr. Alazzaz submitted the following statement:

I thank the staff for a clear and candid report and Mr. Henriksson and Mr. Olafsson for their informative buff statement. Following the strong economic expansion in Iceland over the 2003-2007 period, growth slowed down markedly this year, while inflation increased further. Moreover, the exchange rate depreciated and the financial markets faced severe turbulence. The outlook for the next two years is also unfavorable with the economy expected to fall into a recession.

Against this background, the authorities' tight monetary policy stance is appropriate. However, in view of the sharp decline in commodity prices over the past month as well as the downside risks to growth, the authorities rightly note the limited room for additional interest rate hikes. Moving forward with a credible plan for restructuring and reforming the Housing Finance Fund should further enhance the effectiveness of monetary policy. Here, it is important to ensure that the reforms are done in a fashion that does not aggravate the weakness in the housing market and thus worsen the expected economic decline.

Turning to the external sector, the depreciation of the exchange rate coupled with the expected increase in Aluminum exports should help reduce the current account deficit. However, the staff rightly points out the presence of capital account based vulnerabilities reflecting the high level of private sector external debt and the rise in the share of short-term debt. These vulnerabilities are accentuated by the current difficult global financial environment.

On the financial sector, I am reassured that Iceland's banking sector is well-capitalized and profitable. That said, the challenge now is to guard against the high and rising vulnerabilities that are detailed in the FSAP update. To this end, I welcome the measures taken by the banks and the authorities, which are detailed in the buff statement of Mr. Henriksson and Mr. Olafsson, to address those risks. However, further efforts are still needed in line with the FSAP's recommendations.

In the fiscal area, the authorities deserve credit for their prudent policies. Indeed, the large surpluses of the past few years have not only reduced the general government net debt, but also provided the space to allow the automatic stabilizers to fully operate and to increase investment spending to help cushion the expected downturn in the economy.

With these comments, I wish the authorities further success.

Mr. Gibbs and Mr. Hills submitted the following statement:

We thank staff for a comprehensive set of papers and Mr. Henriksson and Mr. Olafsson for their helpful buff statement.

Staff's view of Iceland's short-term macroeconomic prospects, in the Article IV report, is broadly in line with ours. In the central case, the level of GDP falls by around 3 percent between now and 2010, concentrated in 2009. This adjustment is necessary after a period of excessive domestic demand growth and large current account deficits. We would be interested to hear whether staff concur with the views expressed in the Mr. Henriksson's statement about mismeasurement of Iceland's external imbalances, and about the most recent balance of payments data. In addition, staff could usefully clarify exactly what assumptions are made in the central projection about feedback mechanisms between the macroeconomy and the banking sector (i.e. the mechanisms discussed in Box 2 for the recent past).

We agree with staff that there are significant downside risks to economic activity and asset prices. In particular, there is a risk of a large net capital outflow and a currency crisis. This, in turn, may lead to much higher inflation and policy interest rates, and a more marked fall in domestic demand and asset prices. This suggests, as staff also advise, that the Icelandic authorities should err on the side of tighter monetary, and especially, fiscal policies (or, at a minimum, do not loosen policy). We are concerned, though, at staff's judgment that no significant progress has been achieved in reforming the public-owned Housing Finance Fund (HFF), which still tends to weaken the transmission mechanism from policy to market rates.

On the Icelandic banking sector, we broadly agree with the diagnosis in the FSAP of the risks that the banks face. The FSAP highlights the funding risk to Icelandic banks, given limited access to wholesale markets, and notes the marked step-up in króna liquidity provided by the central bank. It also highlights the increased credit risk given the ongoing slowdown in GDP growth in Iceland and in the banks' European markets. Uncertainties over the amount of credit risk are compounded by a lack of transparency. The bank ownership structure is complex, the amount of related party lending is unclear and the information on the financial strength of corporate borrowers is limited.

However, we are concerned that the liquidity and credit risk stress tests undertaken by the Icelandic authorities do not fully capture the impact on the banking system of the most severe downside risk scenarios discussed in the Article IV report. Staff comments would be appreciated.

In terms of policy options, the FSAP report emphasizes the need for the major banks to: (i) further diversify their funding base, (ii) increase local and foreign currency liquidity, (iii) increase their capital to meet the expected decline in asset quality and (iv) further reduce non-core activities. And only if these are not sufficient do they recommend that a more aggressive downsizing should be considered.

We would argue that there is a need for Icelandic banks to limit their expansion, and, over the medium term, there may be a need for more aggressive downsizing (we accept that, in the near term, a marked downsizing would be difficult given current market conditions and may, in any case, accentuate the economic downtown). The three major banks have expanded rapidly in recent years and their combined assets are now more than ten times Iceland's annual GDP. And given the difficulties in wholesale markets, Icelandic banks are increasingly funding via raising retail deposits from abroad via the internet, which could turn out to be short-term in nature.

Given the size of the largest three banks and their vulnerability, we strongly agree with staff's recommendation that the Icelandic authorities should focus urgently on further developing their crisis management planning framework, in particular contingency planning and closer cooperation with foreign supervisors. We would also like staff to monitor, on an ongoing basis, the risks to the Icelandic economy, and especially to the largest banks, including carrying out their own liquidity and credit stress tests of the vulnerabilities of the banks to severe but plausible adverse scenarios.

Mr. Ge and Ms. Li submitted the following statement:

We thank staff for the well-written and concise papers and Mr. Henriksson and Mr. Ólafsson for their helpful buff statement. We have the following comments for emphasis.

Driven by expanding domestic demand and robust investment, the Icelandic economy has experienced fast growth over the past several years, yet it is regrettable that its strong economic growth has declined sharply over the last two years, mainly due to a deteriorating external environment and weak domestic demand. We recognize that the uneven economic expansion was emerging as early as 2006, with higher-than-targeted inflation and a large current account deficit. Regrettably, the authorities have not achieved a successful soft landing for growth; currently, their main challenge is to mitigate potential risks while gradually recovering steady economic growth.

We note that the authorities and staff have different opinions concerning Iceland's economic risks. While staff emphasizes external liquidity risks and the authorities stress domestic risks, their interdependence cannot be ignored. If the external situation continues to deteriorate, this will have a further negative effect on Iceland's domestic demand and external investment.

Monetary Policy

As Iceland's inflation has exceeded its target since mid-2007, and was recently around 14.5 percent, we believe it is a priority for the authorities to bring it back near target. While we understand the authorities' cautious stance in holding its key policy rate unchanged, it is uncertain whether the economic growth slowdown will have sufficient dragging impact to bring inflation back to target. We encourage the authorities monitor price developments closely and take timely measures, if necessary. We also call on staff using its comparative advantage to conduct in-depth research on monetary policy operations under stagflation circumstances, and provide recommendations to member countries. As the authorities and the staff agree, we believe reforming the Housing Finance Fund could improve the transmission mechanism of monetary policy and encourage the authorities to consider staff's recommendation carefully.

Fiscal Policy

On the fiscal front, we commend the authorities on their previous efficient measures and the improved fiscal position in recent years; it is difficult to decide whether to implement an expansionary or a tightened fiscal policy in the current uncertain environment. The different views of the authorities and staff on their preferred fiscal position seem fairly reasonable. We understand the authorities' position on using past fiscal savings in some specific sectors to smooth the economic downturn, and encourage them to exercise strict control of expenditure in other sectors. We do not think an overperformance of the fiscal budget is a good choice at the current juncture. Staff's recommendation for a more rules-based fiscal framework is welcome, and we encourage its implementation at the earliest possible opportunity.

Financial Sector

We welcome the recent FSAP update on Iceland's banking sector and although it has weathered the global financial turmoil and its performance overall is sound, some potential risks remain. We thank Mr. Henriksson and Mr. Olafsson for the updated information in their buff statement and while we welcome the measures introduced by banking supervisors and the improved supervisory framework, the high share of foreign currency loans is a source of concern, exposing the banking sector to global financial market developments. In this regard, we strongly encourage banking supervisors to continue to strengthen cross-border cooperation with host supervisors. On page 28, table 3, we note the lack of relevant loan data on its key sector—the real estate loans in past several years—and encourage supervisors to strengthen the timely collection of data to improve its financial analysis.

We appreciate the authorities' increase in their ODA from 0.3 percent in 2008 to 0.35 percent of GDP by 2009 and wish them every success in their future reform endeavors.

Mr. Raczko and Mr. Gasiorowski submitted the following statement:

We would like to thank staff for a set of interesting papers and Mr. Henriksson and Mr. Olafsson for their explanatory buff statement.

There is a substantial risk that Iceland could face severe financial strains over the next twelve months. The development of the situation heavily depends on the improvement of the global capital markets and the policy measures which authorities will take to implement corrections of monetary and fiscal policies. In our opinion the authorities are facing a difficult choice between an immediate and painful recession or further increase of inflation and deterioration of financial markets' confidence. On the one hand, tightening of the monetary and fiscal policies will bring lower inflation, stronger currency and reduced risk premia in the banking sector, but may in result increase a risk of a protracted recession. On the other hand, the lack of action may lead to a medium-term contraction with a possibly sharp depreciation of the currency, accelerating inflation rates and illiquidity of the banking sector. In our opinion, for the sake of a sustainable recovery, the authorities should rather concentrate on the measures that build confidence. Such measures must bear in mind strong interdependence of the real economy and the banking sector rightly described in the staff report.

Managing the risks of the banking sector has become a crucial task. Given the systemic importance of a number of banks for Iceland's financial sector, we fully side with staff that to further mitigate financial sector risks, capital cushions will need to be raised, the robustness of liquidity coverage improved, and banks' transparency increased. We also fully support staff recommendation on the reform of the HFF and enhancement of the financial supervision.

With regard to the financial supervision, we wonder what data is missing on the non-financial corporate sector. Does it mean that the banks were financing the corporate sector without sufficient information about their client's activities or is it the financial regulator who does not have sufficient information about the foreign assets of the Icelandic banks? In the same vein we would also like to ask the staff how big the funding needs of the banking sector over the next 12 months are? Are private sector estimates of around 30 percent of GDP realistic? It would also be important to know at least approximately the "true" value of the IIP, especially in case that it is undervalued by 60 percent of GDP (see Annex 1, page 2). By how much could Iceland's external sustainability be improved?

The CBI's moderately tight stance has been commendable, though staff rightly argues that more should be done, especially as some of the confidence building measures have expansionary effects. However, we share Mr. Lushin's skepticism how further small increases, in real terms, in the policy rate could increase confidence in the króna and help in limiting inflation. What is the staff's opinion on the strength of the interest and exchange rate transmission channels in the case of Iceland?

The currency swap arrangement with other Nordic central banks as well as the alignment of the CBI's definition of repo-eligible collateral with that of the ECB are reasonable measures to shore up confidence in financial markets. They will increase liquidity in the distorted and risk averse markets. But they must be monitored cautiously for inflationary side-effects. Furthermore, while they make sense as ad hoc measures, they should be backed by economic policies that demonstrate the authorities' determination to address the rebalancing process. Could staff comment on whether the ECB's recently announced changes in the terms of its bank liquidity operations also affect the CBI's operations? Also, more information on the currency swap arrangements with three other central banks would have been appreciated.

In regard to economic policies, addressing the problem of the highly vulnerable capital and financial accounts is of utmost importance. Staff rightly points out that in the current environment the rollover risks for the Glacier bonds could be substantial and might even trigger a liquidity crisis. Although measures such as the swap arrangement provide a certain buffer, other contingency measures must be lined up. Are the mitigating factors mentioned by authorities in §12 sufficient? And if not, what additional short-term measures would be at hand? The readiness to increase the CBI's reserves "at the right time" is quite vague and surely not sufficient in this regard.

Finally, the end of Iceland's stellar economic performance is particularly unfortunate because of the plentiful early indications for the build-up of financial stress. Macroeconomic and financial system indicators should have given Iceland's authorities sufficient time and reason to address problems early on. Now it is important that the right lessons are learned so that economic policies are geared to supporting a prosperity that is sustainable in the long term.

Mr. Daïri submitted the following statement:

We thank staff for the well-written papers and Mr. Henriksson and Mr. Olafsson for their helpful statement.

Recent developments in Iceland point to the limits of the "home-grown, foreign-funded" model, despite strong policy and institutional framework. Excessive credit growth, in particular, fueled by easy access to borrowing from abroad, has led to overheating and large imbalances and has exposed the country disproportionately to the international financial turbulence. Iceland has now to face high inflation, which has been exacerbated by the króna depreciation, a possible recession resulting from contraction in private consumption following tighter credit conditions and the decline in housing prices, and increased financial sector vulnerabilities. While the budget situation per se is sustainable, contingent liabilities may be large, in view of downside risks in the banking sector, and could threaten fiscal sustainability. Beyond the adjustments necessary to bring the situation under control, it is important to reflect on the lessons that could be drawn for other countries, although situations may vary significantly. In this regard, we agree with Mr. Shaalan and Ms. Choueiri that Iceland's strong fundamentals and track record of policy implementation could help bring the situation under control.

As indicated by staff, an appropriate policy mix combining monetary tightening and fiscal adjustment, together with measures aimed at reducing financial sector vulnerabilities, is essential for restoring confidence and mitigating downside risks to growth and inflation. In response to the rising inflationary expectations, the central bank has increased the policy rate recently and has kept it unchanged despite enormous pressures from the business community and trade unions for a policy easing. While staff see scope for further tightening, Mr. Henriksson and Mr. Olafsson indicate that the economy seems to be cooling faster than anticipated, which calls for caution. We welcome their assurances about the Central Bank's key priority of controlling inflation and avoiding anchoring inflation expectations, as well as the authorities' intention to reform the Housing Financing Fund (HFF), which is essential to enhance the efficiency of monetary policy. We agree with staff that the real exchange rate is broadly in line with fundamentals, although we share Ms. Xafa's misgivings on the appropriateness of a floating exchange rate and inflation targeting in a small open economy.

Fiscal policy has been exemplary, supported by fiscal rules and transparency, leading to large surpluses. Staff call for a tighter policy stance in 2008 beyond the full operation of automatic stabilizers, by reducing fiscal stimulus as a means of supporting monetary policy, strengthening confidence, and easing pressures on the króna. The authorities and staff seem to disagree, however, on the extent of the fiscal stimulus and the definition of the structural primary balance. Staff elaboration will be helpful. The very low level of public debt, which is more than offset by government deposits with the Central Bank, provides a buffer against potential shocks and loss of confidence. Nevertheless, the authorities are encouraged to follow the situation closely and to stand ready to adjust policies as needed, including in response to any further currency depreciation. Adherence to a binding multi-year budgeting approach, as envisaged, will help improve the effectiveness of fiscal policy.

Mitigating the risks faced by the banking sector is crucial. With an extremely large financial sector in terms of GDP and a significant amount of debt maturing over the next two years, securing adequate liquidity at appropriate cost could be a major challenge in this unfavorable international credit environment. We welcome the measures taken by the Icelandic banks to manage risks and strengthen confidence, as elaborated by Mr. Henriksson and Mr. Olafsson. The authorities are appropriately strengthening bank supervision and risk monitoring, including overseas activities. Cross-border cooperation in areas of supervision, early warning and crisis management are also being enhanced. The authorities' positive response to the FSAP Update recommendations aimed at further strengthening supervision and the crisis prevention and resolution framework is encouraging. Further increasing the CBI's reserves, as intended, is important, and the currency swap agreed recently with Nordic central banks will be helpful.

We welcome the authorities' intention to increase their ODA assistance and encourage them to move further toward the UN target. We wish the authorities every success in their endeavors.

Mr. Fayolle submitted the following statement:

We thank staff for an excellent and well focused set of papers including a timely FSAP update. We also thank Mr. Henriksson and Mr. Olafsson for their candid and insightful buff statement. We broadly concur with the staff appraisal and would like to highlight the following:

Economic Outlook

The strong economic performance of the last five years was driven by a domestic boom mainly funded by external borrowing. This remarkable growth has therefore been accompanied by growing internal and external imbalances: the current deficit has grown to unsustainable levels, banks balance sheets have dramatically expanded since 2004 and core inflation is on an uptrend.

Consequently, Iceland's situation has dramatically weakened given the protracted international financial turmoil. In spite of Iceland's strengths, the economy is facing important challenges in the near term. We agree with staff that Iceland should experiment a recession as soon as in 2008 and that it should worsen in 2009.

Monetary Policy and Exchange Rate

To tackle these challenges, we agree with staff that policies should aim at addressing in priority external imbalances. On the monetary policy side, the tightening has been adequate as both CPI and core inflation have risen to double digits levels and are far beyond the central bank's target. Higher interest rates could also contribute to stabilize the króna. An appreciation of the króna would also mitigate risks by improving the situation of companies and households whose borrowings in foreign currencies is sizeable. Furthermore we agree that inflation should somewhat decrease as activity contracts and pass-through effects of the recent depreciation vanish.

Considering its importance for a better transmission of monetary policy, we regret that a plan for the reform of the Housing Finance Fund (HFF) system has not been adopted yet, when it had been highlighted as a priority action in May. Nevertheless, we note that the authorities commit to deal with this promptly. In addition, longer term actions should aim at purging the system from borrowings in foreign currency. This is a long but much needed process.

Fiscal Policy

Fiscal policy needs to support monetary policy much more. Indeed the fiscal stance has been rather accommodative since 2007 even though there should still be a positive balance in 2008. Fiscal tightening seems all the more relevant as the past excess demand was driven by the private sector. Efforts should primarily aim at better controlling spending growth and local government finances.

Financial Sector

We note that the banking sector meets prudential requirements. However, we consider these cushions could prove not be sufficient in case of protracted difficult access to global capital markets as the amount of external short term debt needed to be rolled over by end 2009 is significant and much higher than the country's international reserves. A high scale deleveraging or banks will therefore be key. This indeed is an ongoing process but Icelandic banks should be more firmly engaged in:

(i) asset sales, especially in non core sectors. More specifically, the recent huge widening of the investment income deficit raises the question of the profitability of the important investments abroad by Icelandic residents and should be an incentive to larger scale sales of assets to avoid bankruptcies;

(ii) diversification of funding resources and enlargement of deposit base. But this should not be done at the cost of too aggressive returns offered to depositors: it would be counterproductive as it increases the volatility of resources and the current account deficit.

At end-2007, almost 50 percent of bank assets were held abroad and 75 percent of liabilities vis-à-vis non-residents. Staff comments on ways to rebalance the mismatch between assets and liabilities would be appreciated. Moreover, although we recognize the complexity of the issue, related-party transactions and concentrated lending should be reduced.

Last, given the highlighted risks, we strongly support staff recommendation to enhance the bank resolution framework by establishing a bankruptcy regime.

External Stability

Economic imbalances and banks balance sheets raise the issue of Iceland's external stability. In a context of weakening confidence, we note that after a period of overvaluation, the króna seems to have undershot its equilibrium level as assessed by the CGER. Beyond, there will be a need to closely monitor the banks rollover needs given their potential sizeable impact on the country's financial needs and on the króna exchange rate.

To conclude, we should be cautious in our communication on these matters in order not to contribute to trigger a self-fulfilling crisis with strong capital outflows and bank runs from foreign depositors

Mr. O'Sullivan submitted the following statement:

We thank the staff for the analytical quality of the report and for the clarity of its policy prescriptions. The report is complemented by the additional analysis and insights provided in Mr. Henriksson's and Mr. Olafasson's statement. Together, these papers should stimulate a useful discussion.

The Policy Environment

While there is broad agreement on the factors which have led to the current economic situation and that fundamental adjustments are required, there is not a consensus on how to manage the adjustment process. Views on the depth and duration of the coming contraction in output differ, though there is agreement that the risks are very much on the downside and that the expected contraction could prove to be deep and durable. Views also diverge on the true size of the external imbalances. There also would appear to be some disagreement about the current thrust of fiscal policy. The staff sees a deterioration in the cyclically-adjusted budget balance of 0.7 percentage points in 2008 and a cumulative deterioration of 4 percentage points between 2007 and 2010 whereas the authorities place considerable emphasis on the role of automatic stabilizers in explaining the decline in the unadjusted budget balance. The staff calls for a tight monetary policy stance in order to bear down on inflation and help restore the rate of inflation to low single digits by 2012 but of course the capability of conventional monetary policy instruments to deliver low inflation in a very small very open economy with a freely floating exchange rate regime is obviously open to question.

The forthcoming round of wage negotiations adds a further layer of complexity and uncertainty. The stance of the partners in the discussions which are scheduled to take place next year will be conditioned by the evolution of price trends in the run-up to the negotiations. Much will also depend on their expectations about inflation rates over the period of the agreement. Actions taken by the authorities to help embed expectations of a steady decline in inflation, as indicated in the staff report, could prove crucial.

Fiscal Policy

If the adjustments which lie ahead are to be smoothly managed, the authorities will need to pursue a well-coordinated set of credible stability-oriented policies consistently over a period of time and to communicate these policies clearly to domestic and external stakeholders. Iceland's track record in these matters will be an important asset in this regard. So also would acceleration in the on-going fiscal reforms around multi-year budgeting and medium-term expenditure rules. Can the staff say whether the potential value of adopting an explicit set of fiscal rules centered on the cyclically-adjusted budget balance featured in the discussions with the authorities?

Given the apparent divergence of view on the extent to which the current deterioration in the fiscal balance reflects the operation of automatic stabilizers, it is difficult to formulate a view on whether fiscal tightening is called for at the present moment. Indeed, the clear risk that the coming recession could prove deeper than forecast by both the staff and the authorities counsels caution in that respect.

Monetary Policy

As indicated in the buff statement, monetary policy needs to remain tight and needs to focus on anchoring inflation expectations. It is noted that the real exchange rate is currently within a range consistent with the long-term fundamentals. Indeed, there is a possibility that the nominal exchange rate has already overshot. A more basic question, however, is whether monetary policy can effectively deliver low inflation in Icelandic circumstances. Can the staff indicate whether the nature of Iceland's exchange rate regime was discussed in the course of the recent mission?

Medium-Term Outlook

The medium-term prospects for Iceland are very favorable. The combination of abundant renewable natural resources, the underlying profitability of the financial sector and the exceptionally low exposure of Iceland's public finances to the cost of aging (due in large measure to the funded nature of the pension arrangements) augur well for the future, once the period of adjustment which now lies ahead is over.

With these comments, we comment the authorities for their efforts and wish them well in their endeavors.

Mr. Bakker and Mr. Tanasescu submitted the following statement:

We thank staff for a well-written set of papers and Mr. Henriksson and Mr. Olafsson for their informative statement. We broadly share the staff analysis and recommendations and have a few comments about the significant risks ahead.

Following a period of rapid growth, the Icelandic economy has shown signs of overheating, followed by cooling down and an ongoing recession. The financial turbulence since August 2007 contributed to this turning point and has had a major impact on the Icelandic economy and its financial markets. This impact finds its origin in a number of macroeconomic external and internal imbalances. Iceland has a large current account deficit, high inflation and a large external debt of the private sector. More than 80 percent of the increase in external debt is the result of Icelandic banks' international activities. The interaction between external and internal imbalances has led to a sharp depreciation of the króna and high levels of the CDS spreads of banks. We note the differences between staff and the Central Bank on the one hand, and the fiscal authorities on the other hand regarding the priorities and role of fiscal and monetary policy, but addressing these imbalances requires continuing efforts on both sides, better coordination between the Finance Ministry and the Central Bank, and pro-active actions and measures to address the vulnerabilities in the banking sector.

Fiscal Policy

Fiscal policy played an important role in supporting macroeconomic stability, and the fiscal stance has improved during the upswing from a deficit in 2003 to a comfortable surplus of 5.5 percent of GDP in 2007, which is expected to fall to 2.2 percent in 2008. We noted that the authorities believe that the domestic risks prevailed, that fiscal policy should shift the focus toward preventing a sharp economic downturn, and that the fiscal stimulus should continue to be implemented. In this context the fiscal deficit would reach around 3 percent of GDP in 2009.

We agree with staff that a more restrictive fiscal policy is not only important for an effective fight against inflation and support of the króna, but also to improve the public's resilience to the possible cost of government intervention in the banking sector. At the same time, we support staff's recommendations to restrain expenditure growth, to make multi-year targets more binding and to increase control of local government finances.

Monetary Policy

Despite the sharp monetary tightening measures made by the Central Bank of Iceland (the interest rate was increased from 5.2 percent in 2004 to 15.5 percent in July 2008), inflation is above the target since 2004. This fact suggests that various factors may be blocking the effectiveness of monetary policy. First, an important explanation is the fact that Icelandic banks easily could rightly go abroad for their financing at low interest rates. Second, the competition between the Housing Financing Fund (HFF), which is controlled by the state, and is offering interest rates that do not respond quickly to policy rates, and commercial banks plays a negative role and distorts the pricing of mortgage credit. Thirdly, the commercial banks have introduced new products that made it possible for households to spend excess money on new loans. In this respect, we urge the authorities to address these problems and improve the effectiveness of the monetary policy through a reform of HFF which would imply separating the social component that provides targeted support from the market-based element that should not benefit from state aid, and by tightening the monetary policy until there are signs that inflation is on a firm downward path. At the same time, we concur with staff that to help restore normal functioning of the foreign exchange swap market, the Central Bank of Iceland should manage carefully the domestic liquidity provision in line with its tight monetary stance.

Banking Sector

The banking sector in Iceland has a high degree of concentration, and about 90 percent of the total banking assets are concentrated in three main banks. In the last years the banking sector grew very fast in relation with the Icelandic economy, mainly through acquisition of banks abroad. The current environment in the financial markets has proven challenging for many banks in Iceland, and despite reported financial indicators of the banking sector being in line with regulatory requirements, there are several risks. We agree with Mr. Henriksson and Mr. Olafsson that the main vulnerability in the Icelandic financial system relates to access to global international liquidity, and that a significant portion of loans are denominated in foreign currencies. In addition, high exposure to the UK and Danish housing markets, increased 'related party loans', and an increase in non-performing loans are a source of concern. We note that the banking sector made important efforts to reduce their vulnerabilities, including diversification of funding and selected asset sales, but we agree with staff's recommendation that further measures, such as strengthening financial buffers and increasing transparency, are needed to mitigate financial sector risks. Finally, we welcome the progress made by the authorities in enhancing cross-border collaboration to strengthen the quality of supervision.

Mr. Guzmán and Ms. Mira submitted the following statement:

We thank staff for a very useful set of papers, and Mr. Henriksson and Mr. Olafsson for their insightful statement.

Iceland's economic performance has proved impressive in the past years, with rapid economic expansion and a long transformation process. Nonetheless, the growth process gave rise to significant macroeconomic imbalances and relied increasingly on foreign financing. The current global financial crisis and the increase in commodity prices have now made these weaknesses apparent and have put the economy in a very challenging situation. We concur with the staff's assessment that the key objective now should be to facilitate an orderly rebalancing process, while mitigating risks.

Despite the very difficult current circumstances, it is reassuring to learn that long-term prospects in Iceland remain positive, given the flexibility of the economy and its strong productivity, the soundness of the institutions, the sustainability and good position of the government's accounts and Iceland's wealth in terms of natural resources.

The authorities' and staff's recommendations to face the coming slowdown differ given their diverse interpretations and expectations as to which risks are most likely to materialize. While it is difficult to make a clear judgment, we tend to see merit in the staff's assertion that external risks should take center stage. Furthermore, we are convinced that if these risks were to unfold, their consequences on the economy would be far more damaging. Therefore, and given the significant uncertainties arising from the international turbulences, it remains crucial to start by enhancing confidence and stabilizing the currency through the combination of a tight monetary policy and a non-expansionary fiscal policy.

Thus, on monetary policy, we believe the central bank's actions have so far been adequate, firstly raising and now maintaining a tight stance designed to rebuild confidence and to avoid a further króna decline. Ultimately, this will also contribute to bringing inflation down to its target. While the staff calls for a further tightening, it is reasonable to think that weaker demand should also contribute at some point to lowering inflation. Given the high degree of uncertainty, authorities would be well-advised to monitor developments closely and act as needed, resisting pressures to ease, at least until the inflation rate starts to fall.

As we have claimed in the past, the challenges the publicly-owned mortgage institution Housing Financing Fund (HFF) poses to the transmission to consumption of monetary policy make the need to reform the HFF a priority. There seems to be disagreement between staff and the authorities about the impact of the already-implemented measures to raise HFF lending limits and loan-to-value ratios. Could staff provide further information on this issue? We find reassuring Mr. Henriksson and Mr. Olafsson's statement that the government will address this issue promptly.

On fiscal policy, we also concur with staff that a more cautious fiscal stance would contribute to supporting the central bank's anti-inflationary efforts and enhance confidence. We also concur that the strengthening of the fiscal framework would be useful looking forward, and thus welcome Mr. Henriksson and Mr. Olafsson's statement that the reforms toward establishing a multi-year budgeting framework and toward strengthening the medium-term fiscal framework for local authorities are in the pipeline.

On financial stability, the very timely FSAP update illustrates that vulnerabilities and risks are increasing in the context of a deteriorating international environment. Thus, we welcome the recent measures undertaken by banks to manage their risks and address these deficiencies and by the supervisors to improve the supervisory framework. We also see merit in the recommendation to build stronger capital and liquidity buffers. Contingency planning should also be enhanced, and thus we welcome recent steps to improve the crisis prevention and resolution framework and enhance cooperation with foreign supervisors.

With these remarks, we wish the authorities success in their endeavors.

Extending his remarks, Mr. Prader noted Mr. Yamaoka's question on the possible need for international coordination, and wondered whether the issue has arisen during the Fund's consultations with Iceland, or if the issue of Fund involvement was considered taboo given its status as an advanced economy. He also noted that a number of internationally well known academics the previous links to the Icelandic governments had played a role in reassuring markets; why was not the Fund involved in such activities? Finally, did the FSAP team think there was a case for Fund involvement?

The Acting Chair (Mr. Lipsky) asked Mr. Prader to clarify his understanding of 'Fund involvement.'

Mr. Prader, recalling the Fund's previous experience with international crises, asked that staff make clear if there had been discussions with the authorities on possible Fund assistance. If so, what kind of engagement was considered? If not, did Iceland intend to augment its reserves with the assistance of friendly Nordic neighbors, or by borrowing from the markets?

Mr. Henriksson made the following statement:

I think I can answer some of the questions. First, there was some IMF involvement in the sense that during a period of turmoil the authorities approached the IMF, which responded very quickly with an assessment letter. This was a great help to Iceland, so there was IMF involvement in that sense.

Second, when it comes to the swap arrangements that have been agreed with friendly neighbors, then that measure was based on recommendations made in a report by the Financial Stability Forum. Iceland continues to have access to capital markets, and the IMF is the lender of last resort. With these neighboring countries willing to participate in these swap arrangements and access to capital markets, there was no need to discuss a program for borrowing IMF money.

As far as academics are concerned, this is a country that really pays a great deal of attention to what the IMF says. Directors often say in this Board room that, "I will convey this to my authorities." Honestly, in the case of Iceland, I do not need to. This information has already have been conveyed. They read Directors' statement through the night; they have already talked to the Governors. Although I do not come from a large country, it is a 'less small' country, and the level of interest in what the IMF has to say is not always high in the absence of a problem. However, Iceland is a country that has some problems and they follow what is said very carefully. All Directors' statements have been read and analyzed. Iceland cares a great deal about what professors say, about what the staff says, and what the Board says.

Extending his earlier remarks, Mr. Gibbs made the following statement:

I just wanted to emphasize a couple of areas that we already picked up in our preliminary statement. One is on the question of cooperation between supervisors across borders. Given the FSAP estimate that over half of Icelandic banks' assets are now held overseas through branches and subsidiaries, it seems to us that this is an absolutely critical area. I was very pleased to see in Mr. Henriksson's statement that the authorities are taking steps in that direction, which we welcome. At the same time, there are some quite specific and constructive proposals in the FSAP itself on page 29 that I would strongly encourage the authorities to consider further. One possibility is the report's call for home and host supervisors to come to a common understanding about the overall condition of banks, and how responsibilities would be allocated both in terms of crisis prevention and resolution. There may also be promise in the notion of a regulatory college as long as it does not override existing bilateral agreements between supervisors. More generally, we strongly support the mission's recommendation that the authorities should develop their contingency planning for the possible failure of a major bank. We think it might also be useful for them to review the adequacy of deposit protection, which I believe was outside the scope of the FSAP Update.

> The second point I would just like to make concerns the question of banks diversifying their foreign currency funding. One concern that we still have is that quite a bit of this diversification consists of raising deposits from overseas via the Internet. While this is an appropriate strategy, I suspect that in practice these deposits are not diverse geographically, and they may prove to be quite volatile—much as they have grown rapidly, they could probably be withdrawn rapidly as well. For us, this points to the need for stress testing to encompass the implications of a rapid withdrawal of those sorts of deposits.

Mr. von Stenglin agreed with Mr. Henriksson that Fund financial assistance was not an option for Iceland given that it continued to have access to capital markets. Recalling that the Central Bank of Iceland had established currency swap arrangements with Nordic central banks in response to the intensifying external pressures, he wondered what kind of collateral had been offered by the CBI to secure those commitments.

Ms. Xafa said that she had received a bilateral response from staff with regard to her question on Iceland's international investment position, but still looked forward to a discussion of the issue during the Board session. She also noticed from the Debt Sustainability Analysis that Iceland's gross external financing requirement amounted to about 250 percent of GDP, which had likely risen as a result of a recent currency depreciation. In that light, she wondered how bank's would be able to roll over their external obligations under tight credit conditions.

Mr. Daïri noted that staff had responded to several questions bilaterally, and suggested in the future any information that might be of general interest should be shared with other Directors. He also pointed out that the staff paper identify both external and domestic risks and wondered if, during discussions with the authorities, staff had gone over the relative magnitude of those risks.

The Acting Chair (Mr. Lipsky) noted that staff sought to exercise some judgment in their response to Directors' questions in order to differentiate issues of general interest from those that were more specific and best addressed bilaterally. Directors were certainly free to request staff's response on issues raised by other Directors, but the intention was to avoid unduly burdening staff and to focus the Board's time to the issues of the greatest importance.

Mr. Daïri reiterated that it was not his suggestion that staff should respond to all questions, rather that it should share information that could prove useful to other Directors.

Extending his earlier remarks, Mr. O'Sullivan made the following statement:

> My intervention is very much on the theme that the last two speakers have raised. I, too, received a bilateral response from staff to a question that I asked in my preliminary statement, and am very grateful to the staff for that response. Just by way of informing colleagues, I asked whether, given the need for the Icelandic authorities to pursue a consistent set of stability-oriented policies over a period of time, had staff discussed with the authorities whether the reforms that are ongoing in relation to medium-term fiscal framework might perhaps be accelerated and strengthened with a focus on an explicit set of rules around the cyclically adjusted budget balance. Staff's response, which I found interesting, was that, yes, a certain amount of discussion had taken place. However, they did not recommend framing fiscal policy in this way due to the lack of an completely reliable method of defining a cyclically-adjusted budget balance, as well as other problems of transparency and credibility. I did actually write back to staff that this policy seems to have worked reasonably well in the European Union and that there is both transparency and credibility to such an approach. That is by way of just informing colleagues in the spirit of the last point about the response I received to that particular question. I do think it is a question of general interest, and I would look forward to further elucidation on the part of the staff to my question here in this open forum.

The staff representative from the European Department (Ms. Koeva Brooks), in response to Directors' questions and comments, made the following statement:

> At the start, let me thank Directors for a very frank and thoughtful set of statements. We were heartened to see that the preliminary statements suggest a shared viewpoint between staff and Directors about the complex challenges facing the economy as well as the policies needed to help facilitate an orderly adjustment and reduce financial sector vulnerabilities.
>
> Mr. Chairman, we have addressed several technical questions bilaterally, and so my remarks will focus on three topics that we thought would be of broader interest. These topics include the challenges for monetary and exchange rate policy, the estimation of the fiscal stance, and the assessment of external stability and issues related to contingency planning.

Directors inquired on how to rein in inflationary expectations and improve the credibility of the inflation targeting (IT) framework in the currently very challenging inflationary environment. There was also a question on the strength of the exchange rate and interest rate channels.

There is no doubt that the central bank is faced with a very difficult task of re-anchoring inflation expectations and improving credibility in the context of rising inflation, slowing growth, and a very volatile exchange rate. Complicating matters further is the fact that the exchange rate channel of monetary transmission is very strong in Iceland, while the power of the interest rate channel has been somewhat constrained and uncertain. In this context, while there is no silver bullet on how to improve credibility, above-target inflation and high inflationary expectations leave little choice for an inflation targeter like Iceland but to keep policy tight until there are clear signs of improvement. In fact, staff's argument for a small interest rate hike is precisely that it could be useful to signal the central bank's commitment to attaining the target, which should also help improve credibility and rein in inflation expectations.

There was also a question whether the current monetary and exchange rate regime is appropriate in light of Iceland's small and open economy. The choice of the monetary and exchange rate regime, and, in particular, the effectiveness of inflation targeting in a small open economy, has been the subject of wide ranging debate in policy and academic circles. While there are numerous theoretical arguments for and against a particular choice of regime, in the absence of a counterfactual, it is always difficult to assess the true effect of the exchange rate regime on economic outturns. That said, the benefits of inflation targeting, including in a small open economy, are relatively well documented in the empirical literature, which shows that IT tends to reduce macroeconomic volatility. In fact, Iceland turned from a fixed exchange rate regime to inflation targeting and a floating currency in 2001 precisely because of these expected benefits. In Iceland's case, it is difficult to establish exactly how the recent expansion would have played out in a hypothetical alternative scenario under a different exchange rate regime. Considering the ample global liquidity during that period, domestic and external imbalances might have been even larger under a fixed exchange rate regime, especially given the somewhat weak incentives in this case to hedge foreign exchange exposures. Moreover, looking to the period ahead, a freely floating króna is a plus, as it is expected to play a key role in helping the economy rebalance quickly. Its effect is projected to work both through improving the net external position, through the trade effect, as well as compressing domestic demand for balance sheet effects.

Turning to fiscal policy, Directors asked about the extent to which the fiscal projections by staff and the authorities envisage discretionary fiscal stimulus in 2008 and beyond. On this issue, let me offer the following points. There is no doubt that assessing the fiscal position poses significant challenges, especially at a turning point in the economic cycle. Indeed, evaluating the effect of the cycle while using different measures of the output gap is extremely difficult in real time, especially at the end of an economic expansion. These difficulties are also compounded by changes in tax buoyancy over time, which could be partly driven by cyclical upswings in asset prices, especially in some revenue categories, e.g. corporation and capital gains taxes. Given all these difficulties and uncertainties surrounding the computation of the underlying or structural fiscal balance, the staff's and the authorities' estimates of the discretionary fiscal stimulus, which is the change in the underlying structural balance, are actually very similar. To be more precise, for the period between 2007-2010, staff projects a discretionary stimulus of 4.1 percent of GDP, compared with the Ministry of Finance estimate of 4.5 percent. Let me also clarify in this context the staff's reference to the 'highly expansionary fiscal policy' pertains exactly to this estimated stimulus for the period. It is also worth noting that the staff projections for the overall worsening of the nominal fiscal balance—not the structural—is indeed larger than the one forecast by the authorities in the same period. However, it is also important to note that this difference is not due to divergent estimates of the stimulus itself, but differences in macroeconomic assumptions.

Mr. Chairman, there were also a number of questions related to the external position and contingency planning. Let me start by addressing the issue of the valuation of Iceland's international investment position (IIP) and its implication for staff's assessment of external stability. Indeed, the magnitude of the IIP in Iceland is subject to considerable measurement uncertainty, chiefly related to the valuation of FDI. However, there is no currently well established and universally accepted method to assess FDI at market prices, mainly because it is extremely difficult to assess market prices for nontraded entities. The OECD and the Fund have been working to develop a number of alternative methodologies to better reflect the value of FDI at market prices. Unfortunately, these different methodologies can produce vastly different results. Therefore, in the absence of a well established methodology and data on alternative measurements of FDI at market value in Iceland, staff has no choice but to base its analysis on official data, noting the caveats that were just mentioned. Moreover, while valuation adjustments are likely to result in a reduction in the overall level of Iceland's IIP, the magnitude of these adjustments is somewhat unclear. Of course, staff stands ready to make use of a methodology should such become available. Let me also mention that the uncertainties surrounding the stocks of the international investment position translate into perhaps somewhat smaller uncertainty surrounding the flows that are the basis for staff's exchange rate analysis.

Regarding Iceland's external vulnerabilities more generally, staff believes that the use of alternative methodologies for the calculation of the FDI would not have affected its assessment in a fundamental manner. Let me elaborate on this point, which ultimately relates to the fragile structure of Iceland's external balance sheet. Gross and net private sector external debt are very high. Short-term debt is substantial, and its reserve coverage is relatively low. The large liquidity needs of the private sector give rise to vulnerabilities, as also illustrated by the heightened króna volatility. In fact, given the current turbulent global environment, one could argue that what matters for external stability is the availability of liquidity. In this context, it is unclear whether different valuation methodology for FDI would affect this in a meaningful way. In reality, FDI positions tend to be somewhat illiquid, and therefore cannot be expected to affect availability of liquidity in the short term.

Finally, there was a question about the authorities' preparedness in the event that risks to external stability materialize. Recognizing a number of mitigating factors mentioned by the authorities, staff nevertheless pointed to these liquidity risks, mostly but not exclusively related to the financial sector. In this context, contingency planning featured was a very prominent theme in the consultation—not only in our reports, which pointed not only to the progress that is made in this area, but also stressed that efforts in this area should continue in full force. The rationale behind this is simple;

given the heightened risks, the demands on how prepared one should be have increased as well. Thank you, Mr. Chairman.

The staff representative from the Monetary and Capital Markets Department (Mr. Hoelscher) , in response to Directors' questions and comments, made the following statement:

> Directors asked a number of questions about the adequacy of the supervisory framework. They asked whether the current difficulties could have been mitigate by a stronger supervisory framework. It is important to point out that the regulatory and supervisory framework in Iceland has improved sharply over the last five years. Prudential rules have been brought into line with international practice, and the staffing and funding of the supervisory agency, the FMA, has increased. It is also useful to note that banks' financial indicators, e.g. capital adequacy, liquidity levels, and nonperforming loans, remained quite good throughout that period. That said, banks' expansion was extraordinarily fast and concentrated abroad, and those conditions would have posed monitoring challenges for any supervisory agency. This points to the importance of strengthening and deepening cooperation among supervisors in both home and host countries.
>
> Several Directors asked about the adequacy of international coordination among supervisors. Certainly, as the banks expanded their balance sheets, cooperation among supervisory agencies has increased. The Icelandic supervisors participated in some on-site inspections in host countries, and the supervisory authorities in Iceland visited a number of supervisory agencies to discuss both the shared diagnosis of the issues and what might be done. However, as we suggest in the report, there is greater scope for such cooperation. Stronger efforts to agree on a common diagnosis of the bank's conditions, efforts to evaluate firms' global risks and vulnerabilities, and efforts to monitor common prudential issues would be welcome. As has been suggested in the report and around the table this morning, there may well be merit in trying to develop some common formats for such supervision, e.g., a college or forum of supervisors, so that a group of people from different jurisdictions could work together to monitor the banks.
>
> Some Directors have also asked about contingency planning for addressing bank problems. Certainly work has been done. The Icelandic authorities have signed memoranda of understanding a

number of other supervisory agencies on information sharing, but collaboration on contingency planning is an area where certainly more intensive work would be helpful. The resolution of a cross-border bank is extremely difficult, and it raises a number of very complex issues, both institutional and legal. The better prepared the home and the host supervisors are for addressing these kinds of problems, the smoother and less costly the resolution process.

Several Directors also indicated that they would have welcomed an evaluation of Iceland's financial safety net, particularly the deposit insurance system. We certainly agree that a full FSAP Review needs to look at the detailed assessment of the safety net framework, especially deposit insurance. This exercise was an FSAP Update, and it was conducted under fairly tight time constraints and some fairly severe resource constraints. As these updates are less extensive than a full-fledged FSAP, the focus of the mission was to try to focus on those risks that we thought were the most important. We focused on identifying the conditions and financial pressures of the banks, on the ability of the authorities to respond, the strength and effectiveness of their stress testing framework, and the framework for resolving problems. I would think that a fuller evaluation of the safety net certainly should occur, possibly within the context of the next Article IV mission or as part of any follow-up work to the FSAP that the authorities might suggest.

As has been discussed around the table this morning, some Directors raised some technical questions that have been dealt with on a bilateral basis.

The staff representative from the Strategy, Policy, and Review Department (Ms. van der Willigen), in response to Directors' questions and comments, made the following statement:

I wanted to pick up a general question raised by Directors about whether Fund facilities are well suited for the kind of cross-border financial sector problems to which Iceland is exposed. Furthermore, Directors have asked if hypothetically these problems would qualify as a balance of payments need in the sense required for Fund financing. This is an especially timely question in view of the upcoming broad review of Fund facilities. It is true that there are important questions that are raised in the chapeau paper for that review that need to be discussed about the concept of balance of payments need, in particular in dollarized economies or economies that may for other reasons be subject to a sudden increase in resident demand for foreign exchange, where there may be a need for a lender of last resort function in foreign exchange even in the absence of a balance of payments need which is relative to nonresidents. However, fortunately from this morning's point of view, these complications do not apply in Iceland. The kind of problems that Iceland is experiencing fall more under the traditional definition of balance of payments need—outflows to nonresidents. We were reminded this morning of the very large numbers with respect to gross financing need. Thus, I think there would be no doubt that this could be described potentially as a balance of payments need. The bottom line in such cases where there is a balance of payments need: The availability of Fund financing does not depend on whether the origin of the need is in the fiscal sector, the financial sector, or some other source, rather only on the appropriateness of the measures being taken to tackle the source of the need.

Mr. Bakker made the following statement:

I think this is a very interesting case. Earlier this morning, we had a discussion on Kenya, and Ms. Lundsager said that Kenya would be a case for the textbooks. I am quite sure that Iceland will also make it to the textbooks, if it has not already given all these professors commenting on the country. I have basically two or three questions or comments.

First, on exchange rate policy, I am very grateful for the open and frank answers of staff. It struck me that staff was very much in favor of the current exchange rate policy with the argument that it would help rebalance the economy. That may be true, and I am not arguing for another exchange rate policy, but it seems that exchange rate policy could have played a more helpful role in promoting financial stability. The interaction may have been less fortuitous and where the interaction between sharp volatility of the exchange rate, very large household financing in foreign currency, and the problems of the banks in financing themselves may actually have not been helpful. In light of the high level of exchange rate volatility, could staff elaborate further on whether this is really the way forward?

My second comment relates to an apparent disconnect between the staff appraisal and the authorities' views, and I would appreciate if

> Mr. Henriksson could comfort me whether that is still there. It seems to me that staff and a lot of Directors feel that more drastic measures are needed to address the external and financial stability vulnerabilities, whereas the authorities seem to be more focused on getting the economy and growth back into shape. I think this may be something where it would be very helpful to have a clear view also in the message we will sending through our summing up.
>
> My last question would be on the issue of a possible Fund financing involvement. I think Ms. van der Willigen rightly said that this could be considered a balance of payments need, which could be accommodated by one of the Fund's existing facilities. On the other hand, the fact that Iceland is a very small economy with a very large financial sector creates legitimate questions on the ability of the authorities to serve as a backstop for the banking sector. In that light, I would venture that Iceland might be an ideal candidate for the liquidity instrument that we will hopefully discuss in the coming weeks. It is a country that is in the process of strengthening regulation; it continues to be an open economy; and at the same time it may be facing acute liquidity needs, given the very large size of the financial sector in relation to the GDP. As such, it seems to me that if you are looking for candidates for the liquidity instrument, this may be such a case.

Mr. Claveranne, in light of the high quality of the report and the important issues under discussion, agreed with other Directors that staff's responses to specific questions should be circulated to all Directors. He had raised a question on the banking sector concerning the mismatch between the sectoral assets and liabilities, which staff had replied to bilaterally, saying that Icelandic banks were aware of the importance of deposits held by retail banks. In that context, he wondered if staff had data on recent trends with respect to foreign deposits of Iceland banks' branches. As Mr. Gibbs rightly pointed out, foreign branch deposits represented a volatile source of financing, and it was important to get a sense of the strength of this sector. He also wondered if the ongoing measures being taken by the Iceland banks to reduce the size of their balance sheets were, in staff's view, consistent with the extraordinary challenges facing that sector.

Ms. Xafa made the following statement:

> First, I would like to completely agree with Mr. Bakker on the question of the exchange rate and its role in the financial system. Iceland is a clear example of a case where exchange rate flexibility has compounded the external shock instead of facilitating resolution, and

as we said in our preliminary statement. We also note that wage growth is now approaching double digits, so we fail to see how exchange rate flexibility will help reduce the current account deficit. In a country as small as Iceland, with a population of 300,000 people, a big chunk of the population would be engaged in writing or reading inflation reports, whereas a fixed exchange rate much easier to manage.

As far as the staff's argument that the fixed exchange rate might have reduced incentives to hedge, this is an argument that I see frequently in staff reports. I just do not buy it because having a fixed exchange rate carries the caveat that one must accept the discipline inherent to the arrangement. If you do, then there is no reason why the peg will break, as is assumed in statements of the kind that incentives to hedge are weakened.

Coming to the international investment position, I thank staff again for further clarification this morning. I do understand that the valuation of FDI is undervalued because the published figures are expressed in terms of the book value of FDI rather than the market value of FDI. As such, I understand that because outward FDI is so much bigger than inward FDI, the published figures based on book value present a picture that is worse than the real one. At the same time, the point that we raised in our statement is that the published figures likely underestimate the deterioration in the international investment position since the market value certainly has declined more than the book value, which is a historical cost. In the bilateral response that I received from staff, there is a study quoted that confirms this point. However, even the simulations presented in this study comparing a 30 percent decline in equity prices on both inward and outward investment do not take into account the sectoral composition of this investment. Presumably, outward FDI is much more heavily weighted toward the financial sector and must have corrected much more than the inward FDI. I suspect that this study from the monetary bulletin of the central bank understates the deterioration in the international investment position, even taking market prices into account.

Mr. Prader agreed with Mr. Bakker that, in instances where there was some doubt on the course of action, it would be preferable for the authorities to adopt measures that would enhance confidence, and therefore fiscal policy needed to be tightened. Unfortunately, the academics that had been quoted extensively in the

Financial Times had taken a more complacent view of the risks facing Iceland, arguing that it had been unfairly attacked by the financial markets. He also hoped that the follow-up recommended by the FSAP mission to evaluate the financial safety net would be undertaken in the context of the next Article IV consultation or an FSAP Review.

Mr. Daïri remarked on the large gap between the staff report's very positive assessment on the fundamentals of the economy, the strength of the policy stance, and the quality of supervision on the one hand, and the magnitude of the difficulties facing the country on the other. He felt that not enough had been done to determine previous missteps in policy-making, since global market developments could not be the exclusive cause of the current difficulties. The financial sector could not expand indefinitely; at some point in time supervisors need to step in to assess the inherent limits and risks. It would be important to determine what lessons could be drawn from Iceland's experience.

Mr. El-Khouri agreed with other Directors that the authorities should pursue a more cautious fiscal stance. Noting Mr. Bakker’s earlier reference to the Fund as lender of last resort, he asked staff to clarify how fast the Fund could respond to a financial request in the event that market access becomes restricted and there are no alternative sources of financing.

Mr. Mohanty supported Ms. Xafa remarks on exchange rate volatility. Iceland represented a textbook example of a flexible exchange rate with inflation targeting, which appeared to work well. However, was such a framework best for stabilizing the country in a time of crisis? With the interest rate already high by European standards; how much higher could it go to defend the inflation target? If rates are raised too high, what would be the implications for the financial sector, which was not in the best shape. In that context, there was merit in considering the role of exchange rate policy, at least to stabilize the economy.

Ms. Lundsager made the following statement:

> There have been a number of questions from around the table on the interaction between exchange rate policy with monetary and fiscal policy, although mainly monetary policy in this instance, and what is the best approach. I think the one conclusion that comes out clearly in looking at Iceland and the Central and East European transition countries, the latter tending toward fixed exchange rate regimes, is that anywhere you go you can still borrow money. Furthermore, regardless of the system, you can over-borrow and that can get you into trouble. It seems clear that having a flexible exchange

rate, having a fixed exchange rate, or even moving toward euro zone does not guarantee that institutions in your country are not going to borrow too much in one form or another. The authorities need to try and have enough information so they know what is going on and have the ability to talk with home regulators and within the European Union regulators. It would be helpful for the Fund as the institution that is looking at all these countries in a very detailed way to try and come up with some sense of what is the best advice we can give countries in terms of how to manage their exchange rate, including on the choice of exchange rate policy. I agree you cannot really change exchange rate policy in the middle of a crisis, because that can contribute to the crisis, but we should have some sense of what is the best way to go in different situations and country circumstances in order to achieve the best results for the short run as well as for long run growth and the health of the economy. I think this is an area where the Fund should be the number one institution. A lot of the good advice is given regardless of the exchange rate system that is in place, but is there something beyond that that the Fund can draw upon as well?

Mr. von Stenglin remarked that several Directors seemed to be engaged in interesting bilateral exchanges of views with staff, and he would be happy to participate more in that exchange of views. For instance, he had asked staff about the potential implications of the high proportion of inflation indexed domestic debt, particularly with respect to price stability. What was staff's advice to the authorities in this area?

Mr. Warjiyo made the following statement:

I also thank the staff for their answers both bilaterally and also during this session. I agree with the previous speakers, particularly Mr. Bakker, Ms. Xafa, and also Ms. Lundsager, that Iceland is an interesting case—not only for the particulars of the case, but also in terms of the Fund's engagement. I would echo what has been said by previous speakers for documentation and also a case study of this country for future reference, e.g. on the Fund's policy advice and the financing aspect. I have three follow-up questions relating to the exchange rate policy and its effectiveness for facilitating the adjustment process.

First, I agree with Mr. Bakker and Ms. Xafa that we have to look carefully on the role of the exchange rate in the adjustment process, especially with respect to the effectiveness of monetary policy at this juncture. It seems to me that reading the paper and listening what staff has said, I have significant doubts on the effectiveness of interest rate policy facilitating the adjustment process. The pass-through of the exchange rate is very, very high, but at the same time the impact of the interest rate on the exchange rate is quite low. As such, the transmission mechanism of interest rate to inflation and price stability will be very weak.

Second, the country's foreign debt level is quite high, and a large portion of domestic debt is inflation indexed, as Mr. von Stenglin indicated. In that respect, I could imagine that the bulk of the adjustment will be coming through the exchange rate to real economic activity, meaning that a high degree of depreciation in the króna will be transmitted into high inflation and a significant reduction in output volatility. If I look carefully on the staff's September 8 update, I see the indicators are already showing that pattern. We are seeing a very slight decline in economic activity, while domestic price inflation has continued to rise. The question being raised by Ms. Xafa and others concerns doubts on how the exchange rate can achieve the expected outcome. It seems to me that the exchange rate will play a negative role in this respect, given the low response to changes on interest rates. If that is the case, and with the countries being susceptible to high external debt both on the short term and long term, I am just wondering whether there is some thought on the measure that is in the literature being referred to 'sending on the wheel' in order to dampen the negative impact of the exchange rate in the process of economic adjustment.

Third, we also need to look at how this exchange rate impacted the financial sector. Again, the financial sector external debt exposure is high. Also, the share of foreign exchange-denominated loans is high. In that respect, the exposure of the financial sector to exchange rate risks is very high. I am sure that the staff has already done the risk assessment for the financial sector. In the event of a continuous depreciation of the króna, what might be the impact in terms of financial sector losses? How much might the capital cushion be strengthened to help the financial sector withstand exchange rate volatility.

Having said all this, some of the recent developments seem comforting. I look forward to staff's and Mr. Henriksson's assessment of the latest developments. The króna and sovereign spreads appear to be stabilizing, and risk premia have eased in recent weeks. Is this an early sign of a stabilization, or should we remain cautious? Of course, that will depend on what policy measures are taken and the adjustment on the real sector side, including inflation and economic activity, in the coming months. Any update on this aspect would be appreciated.

Mr. Yamaoka made the following statement:

I just would like to make two remarks. First, and related to the point raised by Mr. Claveranne, I think that Iceland's case offers a very interesting example of the nexus of macroeconomic and financial stability, an issue that central banks have been analyzing over recent years. One of the major challenges, even for the central bank, is how to use the banking sector to stabilize the economy. I think that the banking industry is possibly the most transparent industry; we have information of the balance sheet of the banks. Of course, the financial market is more and more complicated. The idea behind Basel II was that large banks should have their own model to evaluate the market, and supervisory or regulatory agencies were responsible for determining whether that internal model is correct or not.

The dramatic expansion of the balance sheets of Icelandic banks of course involves significant risks related to the macro stress scenario and exchange rate risks. It is important that each bank should have their own model and allocate capital, and that kind of capital burden may increase the opportunity cost for enlarging their businesses. This kind of mechanism might help to automatically stabilize the macro economy. I am heartened by the explanation that Iceland's regulatory framework has improved sharply in these five years, but actually I feel there is still a little bit of room to make improvements, especially with regard to the internal modeling of the large banks and integrated risk management, as well as on macro stress testing. This kind of improvement could contribute to stabilizing the economy in the future.

My second point is on the exchange rate. I broadly agree with the opinions expressed by Mr. Bakker. I am also interested in the remarks by Ms. Xafa on the burden of the macroeconomic policy framework, specifically the cost of preparing the inflation report. I think this is an important issue for small countries.

With regard to the inflation targeting regime versus a pegged exchange rate regime, I think that in the current situation in Iceland the actual policy reaction by the central bank might be similar under either arrangement. Under the inflation targeting regime, to maintain the inflation rate or to reduce the inflation rate, the central bank needs to raise the interest rate. If they choose a pegged exchange rate regime, they also have to raise the interest rate to maintain the value of the currency. I think an important consideration concerns whether it is easier to communicate decision-making under one of these policy frameworks. For example, given global inflationary pressure, many inflation targeting countries have allowed a temporary deviation of the inflation rate from the target and promised to achieve the target at a certain date in the future. Is this explanation easy to understand or not? I broadly agree with the current framework by Icelandic central bank; at the same time, given the current situation, they have to allow for a substantial deviation from the target. Moreover, they have to negotiate with labor unions on public sector wages, while the market is seeking a consistent macroeconomic policy. In this scenario, which is easier for the market and outside investors to understand policy-making, under a pegged exchange rate or, under an inflation targeting regime? As a broad issue, it would be an interesting topic for future discussion. Thank you very much.

Mr. Lushin wanted to return briefly to the discussion on fiscal policy. He felt there was broad agreement on the need for a cautious fiscal policy, with no discretionary stimulus going forward. While that was understandable, he wondered if too much was being asked of fiscal policy as a means for confidence-building, given the scale of the financial sector and the fact that the private sector was driving current account dynamics. It did not seem that a one or two percent change in the fiscal stance would have a major impact on investors when they decided on when and on what terms to roll over the liabilities of Icelandic banks.

Mr. Pereira made the following statement:

Unfortunately, we believe that Iceland will be the first advanced country that will be falling into a recession, and considering the magnitude of the macroeconomic imbalances and the stress in the domestic financial system, this could be a very protracted recession. The core of the problem is financial sector surveillance, which has been existent in the domestic financial system. In our statement, we point out to the sudden change from a publicly-owned to a privatized banking system, which staff acknowledges was problematic and possibly overdue. We also face some governance problems that are picked up in the Financial Stability Forum study. So we are concerned that this issue is not that Iceland is subject to vulnerabilities in terms of this assessment, it is a small advanced open economy that is in a reversal of banking and international financial conditions, so now in fact the country has some problems. There were problems within the regulatory and supervisory framework that need to be addressed. When I heard the staff say that there was improvement in the regulatory and supervisory framework, but there is little that can be done because cross-border flows, that is a sign of alert. At the same time, we are proposing more cooperation between financial institutions as a solution. We know it will be limited solution, as it will take time to implement, and that there are legal impediments. As such, we are still somehow not convinced about the fact that we did everything that was possible to reduce the extent of this crisis.

Turning on the policy stance, given this picture of a likely recession, we are somehow puzzled to hear that all we have to do is try to keep credibility of the current policy framework. It is not about the market buying a small hike of interest rate just to keep inflation under control, or about being careful with fiscal policy. In fact, we may produce signals that will make things worse in terms of the capital inflows. We really do not understand the logic. The crisis is here, and the recession is there. What we have is more likely a banking system that would have a liquidity problem and will most likely move into insolvency problems. So monetary policy will not be very useful. In fact, it could make things worse given further strains on households' balance sheets and an even longer adjustment process.

We do think that fiscal policy will help, and we concur with the authorities that a timely fiscal stimulus will help to reduce the sting of the adjustment of the recession. I am very glad to hear also from the staff in bilateral answers that there were very interesting fiscal measures in terms of social targeted actions that the authorities have already taken since February to try reduce the impact of what is somehow inevitable. Again, our aim is to emphasize the need to draw stronger lessons from Iceland's experience rather than try to establish whether the inflation targeting scheme works for Iceland or not; there are stronger lessons to be learned in terms of regulatory and supervisory frameworks, while keeping an open mind in terms of the policy stance. Credibility will not help markets that are working in the panic mode. We have to think out of the box. Fiscal policy helped

> U.S.; it could help Iceland as well. A timely fiscal stimulus will be in our understanding a very good start.
>
> Finally, I was wondering if the Fund can learn a lesson as well from this experience on whether growth exceeded what is reasonable. I think this is a very interesting case. We have to approach it with a more open mind in terms of the future policy stance. I know we will also look forward to hearing from the staff what would be the role of the exchange rate policy for Iceland. In our view, in the case of such a flexible and open economy, the contribution of net exports will be very important in the rebalancing process.

The Acting Chair (Mr. Lipsky) asked Mr. Pereira for clarification whether he was suggesting that staff's base case analysis should have assumed financial system insolvency.

Mr. Pereira did not believe that insolvency should be a base case, but given the clear liquidity problems, an insolvency problem could not be ruled out. There needed to be a franker discussion of the possibilities and the alternative paths for adjustment.

Mr. Raczko felt that Board was approaching Iceland like a good group of doctors examining a very interesting case. In medical parlance, an interesting case implied a very seriously ill patient, and a very seriously ill patient needed a prescription. In that light, he associated himself with Mr. Bakker's advice about the tightening of the fiscal policy and Ms. Xafa's comments on monetary policy.

Ms. Agudelo made the following statement:

> I agree that this Board meeting has been very interesting and all the participation here by the different Board members showed that it is not easy for the authorities to find the right way for the country. I have three brief comments on fiscal policy, monetary policy, and exchange rate policy.
>
> With respect to fiscal policy, I see that there is a call for prudence around the table, and I think it is well placed. I feel that there is agreement between the staff and the authorities on letting automatic stabilizers work. I still do not understand the real differences between staff and the authorities on the extra policy inputs. In particular, I understood from Ms. Koeva Brooks that there are differences in the assumptions on the macro variables that create difficulties for assessing

the fiscal stance. I would tend to agree with Mr. Lushin that the level of the public debt provide scope room to the authorities to allow fiscal stabilizers to operate.

In terms of monetary policy, I have one question with respect to the role of domestic demand. I understand that right now the Central Bank of Iceland should send a correct signal in terms of the commitment to meet or to keep inflation under control, but I note that domestic demand has been on the negative side since last year and is expected even to decline 5 percent next year, so it has to play a role in terms of what the authorities should do in terms of the signal or interest rates.

With respect to exchange rate policy, I find that the whole debate has been very interesting, but I can see that this debate has two different points of view—a short-term point of view and a long-term point of view. I do not see if the flexible exchange rate, as Ms. Xafa has been saying, has compounded the effects of the vulnerabilities of the economy. However, in a more long-term view, I do not know if we have now a total view that this particular country should have another system exchange rate policy. In particular, it would be very interesting to see why at the beginning of this decade the authorities decided to change their exchange rate policy from one of a more fixed exchange rate to this current policy. I can imagine that at that moment there were some vulnerabilities that they wanted to address with a more flexible exchange rate.

The staff representative from the European Department (Ms. Koeva Brooks), in response to Directors' questions and comments, made the following statement:

Let me try to address as many of the questions again by grouping them in several topics. I think a lot of the questions on the exchange rate and the monetary framework just underscore the challenges that a very small and a very open economy with a very large financial sector faces. As I mentioned before, it is very difficult to assess the precise impact of the exchange rate regime by itself. However, we have seen examples in the recent past of other countries that had other exchange rate regimes that also underwent a fairly substantial build-up of imbalances. I agree that one could make the argument that the exchange rate was not helpful for financial stability. However, one could make the opposite argument that, in the absence of this exchange rate policy, perhaps financial institutions would have taken even more risk in terms of providing more loans and foreign exchange, which was a problem in a lot of other countries. At least in Iceland, what we could see is that the banks hedged their foreign exchange exposure, which was one of the reasons why in the first two quarters their results were actually quite positive. The bottom line is that it is a very complicated question; we have been on it thinking, as have academics and policymakers, and there are no easy answers. However, we do feel that the current framework provides a channel through which an exchange rate adjustment is possible. In a way, there is a trade-off. With a floating exchange rate, you are likely to get an adjustment that is quite quick. At the sane time, there is the risk of an overshooting. The problem with an alternative exchange rate regime, however, is that any sort of adjustment would have to occur over a long period of time, as we have seen in many other countries. This trade-off definitely needs to be considered.

Going back to the issue of the effectiveness of monetary policy, in a small open economy, it is indeed very difficult to conduct monetary policy, with an important factor being this abovementioned issue of the indexation of debt. In terms of what type of recipe we could give, there is a simple answer and a not-so-simple answer. The simple answer is one of the actions that we have been recommending—reform of the publicly-owned housing corporation, which actually provides a lot of these indexed loans. The more complicated answer for reducing inflation involves moving the private sector away from the use contracts with indexation.

There were also a number of questions on fiscal policy. I would like to underscore that we place a very important role on the coordination between the monetary and fiscal policy. Beyond reinforcing the credibility of the policy mix, we do believe that a less expansionary fiscal policy would help the monetary authority bring inflation down. In that sense, it would also have a confidence building effect because of the impact of inflation on the exchange rate.

To clarify the issue in terms of our position on the automatic stabilizers, we are very much in favor of allowing their full operation. This is the position that we have taken in the staff report.

There was also a question about the most recent update to recent developments. Our supplement shows how quickly things can change in Iceland, and even over the last couple of days the króna actually has been depreciating. We make sure that we keep an eye on develops on a daily basis, but I think the stabilization of the króna is something that we are going to be looking forward to and see what happens in the coming weeks and months.

With your permission, Mr. Chairman, if I could respond to some of the other questions bilaterally after the meeting, if that is acceptable. Thank you.

The staff representative from the Monetary and Capital Markets Department (Mr. Hoelscher), in response to Directors' questions and comments, made the following statement:

There were a couple questions about the stability of banks' funding models. These banks have evolved over time. They started off expanding very rapidly in 2005-06 when access to wholesale markets was extraordinarily easy. They used unusually low interest rates to grow very rapidly. A year or so ago, the banks began to realize that model was probably unsustainable and was in fact going to have to be revised, with a shift to attracting retail deposits. Thereafter they have been trying to build up their retail base. Retail deposits have grown very rapidly—something like 30 percent over the last year—as banks have reached out to other jurisdictions. The ability to mobilize that level of deposits in Iceland is limited, so they are in some sense forced offshore to raise those deposits. The authorities and the bank owners recognize that these could be potentially very volatile sources, and so even the effort to establish a more durable funding model carries risks. In response to those risk, they have done a couple of things. First, they recognize the stability of these retail deposits depend a great deal on the soundness of banking practices, so the banks are trying to ensure that they have adequate liquidity buffers to meet withdrawals. They are also trying to introduce longer maturities. To that end, several of the banks now have quite successfully introduced term deposits. This does not mean these problems will go away—there continues to be a problem on the potential volatility of the retail deposits, but it does mean that the banks view this as their only option because the wholesale market really is no longer a viable source of resources over the next period of time.

What is the likelihood that they will be able to roll over their debt as it comes due? The big three banks have about \$3 billion coming due this year, and about another \$18.8 billion coming due next

> year. When we talked to the banks, they said the chances of rolling over that debt is minimal, if not zero, so their policies are geared toward building up adequate liquidity to meet the payments as they comes due. One of the banks that has a very large debt obligation coming due in October sold a subsidiary in Europe and is using those funds to be able to pay off that obligation in October. Similarly, the banks that have the March and April amortizations have shown that they have already built up adequate liquidity to meet those needs. Thus, the banks are not trying to roll over. I think they recognize that the market is much too difficult for that at this point, so their policy is to deleverage to the extent they can: sell the noncore assets; use those funds to meet debt obligations; and then try to adopt banking policies that are sound and safe.
>
> There was also a question about whether the banks' policy on deleveraging is adequate or not. In some sense, that somewhat depends on what happens in the market. Certainly, their ability to meet debt obligations over the next 12 months, possibly 18 months, is fine. If the situation stabilizes and then improves, then it will probably be possible to deal with those problems. Were the market to continue to deteriorate, they would be in a much more difficult position. At that point, they would have to be looking at the sale of core assets and a significant downsizing. I know they are looking at those options as a worst case scenario. I know the supervisory authorities are working with the banks to consider the worst case scenario, but everyone is hoping that that it remains only a worst case scenario.

The Acting Chair (Mr. Lipsky) asked whether it is correct to assume that the big banks' balance sheet had been shrinking, or whether one should expect it to decline in the context of upcoming actions.

The staff representative from the Monetary and Capital Markets Department (Mr. Hoelscher) replied that the balance sheet of one bank was clearly shrinking, and the others had plans to shrink their balance sheets if necessary.

The staff representative from the Strategy, Policy, and Review Department (Ms. van der Willigen), noting the question on how quickly the Fund could respond to a request for financial support, regretted that she could not provide an exact answer. A possible reference point was the seven-day timeline for Korea a decade earlier. One might suppose that improvements in communications technology, as well as the advent of more continuous and comprehensive monitoring, e.g. through the Financial

Sector Assessment Program, could speed processes further. That said, the international financial system had arguably become more complex.

The Acting Chair (Mr. Lipsky) remarked that the speed of the Fund's response to a financial request was a broader consideration that would be reflected in the discussion of the chapeau paper on the future of the Fund's financing facilities.

Mr. Claveranne asked staff for the figures on deposits of Icelandic banks in offshore markets, particularly the United Kingdom. He also asked about recent trends with respect to deposits.

The staff representative from the Monetary and Capital Markets Department (Mr. Hoelscher) replied that Icelandic banks' consolidated accounts distinguished between resident and nonresident, but did not differentiate between deposits between branches and subsidiaries. Staff had been in discussions with the central bank and supervisors in order to disentangle the branch versus subsidiary deposits, which was necessary from a stability or resolution perspective. He note that over the last year, deposits into the system had grown by slightly more than 30 percent, with almost all occurring at branches or subsidiaries outside of Iceland.

Mr. Henriksson made the following concluding statement:

> Let me once again thank Ms. Brooks and Mr. Hoelscher and their teams for excellent work and a fruitful dialogue during the missions in June. I also thank my colleagues in the Board for their candid and indeed very useful input that I will faithfully convey to my authorities. I can be very brief as staff has already provided useful information in answer to your questions and comments.
>
> The authorities are as before in agreement with staff on most issues. By and large the fiscal stance has been the only root of some divergence in views. The question is to what extent fiscal policy should be restrained and supportive to monetary policy in the face of a possible domestic recession. We acknowledge that there is room for different views on this issue, and we welcome the views offered on the Fund's surveillance about the consequences of possible policy actions.
>
> The financial sector continues to be an issue of concern. At first sight it seems odd that such a small economy has been so prominent in the financial limelight for several years. But the rapid transmission of the turmoil in financial markets on the domestic economy has turned out to be an accurate barometer for what to expect

in other economies. Also, the "wakeup call" in 2006 was timely, but the rapid deterioration in the global financial environment since then was not anticipated. Intense scrutiny by the financial authorities as well as the market, exposed weaknesses - but has also triggered remedial actions in the banks. This process has helped to strengthen the banks, but more needs to be done as detailed in several Grays and the staff report.

However, the emphasis on the lack of transparency in the Gray statements on the Icelandic banking system is not necessarily fair. The level of transparency is on par with what you will find in most of the EU countries. The banks follow international accounting standards and are subject to surveillance based on EU standards in Iceland and in their host countries. In addition to official surveillance, the Icelandic banks undergo regular monitoring by the rating agencies and their ratings remain strong. The banks have also been subject to intense scrutiny from international market analysis. Finally, the institutional framework in Iceland has been noted for its transparency and efficiency as reflected in topping the league tables of commentators such as Transparency International and World Bank Doing Business.

Inflation has been above target despite high nominal policy rates in recent months, and we can assure you that the authorities have no intention of holding back in the fight against inflation and will use all available tools to bring inflation within the target range and anchor inflation expectations going forward. I wish to repeat here that to increase the effectiveness of monetary policy and to remove distortions, the Government will promptly formulate and make public a credible plan for the restructuring and reform of the Housing Finance Fund system.

As we have seen the CDS spreads for the Icelandic banks, albeit still higher than in comparable rated banks, have been narrowing. Also the Central Bank has continued to strengthen foreign reserves, and access to credit has been increased. The credit ratings of the Republic remain strong and access to markets has been demonstrated.

The outlook for the Icelandic economy is highly dependent on the global environment and unfortunately dark clouds remain on the horizon. In this situation it is prudent to batten down the hatches and the authorities are working with contingency plans for the financial sector and preparing other measures to promote macro stability in a cooling economy.

Despite some headwinds, we should not forget what has been achieved. Just over two hundred years ago an evacuation of the island was contemplated as volcanic eruptions and resulting in cooling of the climate had made the country almost uninhabitable. The magnitude of the eruptions was such that crop failures in Europe in the following years are believed by some historians to have sparked the French revolution. The Icelanders stayed on and since then, the population has grown tenfold and enjoys living standards among the highest in the world, with a comprehensive welfare system and fully funded pension system. In the last decade we have seen not only a rapid expansion of the financial sector, but also diversification in other areas of the economy including medical goods, software and services. Abundant hydro and geothermal resources add further to the growth potential of the Icelandic economy. As noted by staff the long-term economic prospects for the Icelandic economy remain enviable.

The Acting Chair (Mr. Lipsky) made the following summing up:

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.

APPROVAL: December 22, 2008

SHAILENDRA J. ANJARIA
Secretary