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CONFIDENTIAL

February 13, 1992

The Acting Chairman's Summing Up at the Conclusion of the
1991 Article IV Consultation with Iceland
Executive Board Meeting 92/15, February 7, 1992

Directors commended the authorities on their success in reducing inflation. All speakers agreed that the authorities' strategy of using the exchange rate as a nominal anchor could only succeed if financial policies were more disciplined than they had been in the past. Indeed, the large fiscal and external imbalances in 1991 underlined the critical need for tight policies in 1992 and beyond, especially given that medium-term prospects did not indicate that those imbalances would be largely temporary in nature. Moreover, tight financial policies would need to be complemented with structural reforms, including reforms to liberalize and develop the financial markets.

Directors praised the determination of the authorities to reduce the fiscal deficit substantially in 1992, despite the bleak economic prospects for the year. In their view, that determination provided a strong signal of the commitment of the authorities to a stable exchange rate, and would help guide the ongoing wage negotiations. It would be important to follow up that commitment with a strict implementation of the budget.

Directors observed that excessive public borrowing had created problems for the implementation of monetary policy in 1991, and had contributed to relatively high real interest rates. Directors stressed that the only way to lower interest rates to the level prevailing abroad was through a more disciplined fiscal policy and by securing market confidence in the exchange rate.

Against that background, Directors noted that the authorities intended to use the planned revision of the Central Banking Act to strengthen the independence of the monetary authorities, which they welcomed. With currency stability as its primary responsibility and with its independence from political pressures firmly established in the legislation, the Central Bank should be able to focus on safeguarding the exchange rate anchor, and thereby secure a low rate of inflation. Some Directors encouraged the authorities not to wait--as planned--until 1993 to move to a European Currency Unit (ECU) peg. Some Directors also cautioned that, in the future evolution of exchange rate policy, excessive reliance should not be placed on using a fluctuation band around a central rate as a way of adjusting to economic shocks.

Directors underlined the importance of the authorities' efforts to strengthen the operation of the financial markets. In addition to providing important feedback for macroeconomic policy, deeper and more efficient financial markets were critical to boosting the medium-term growth prospects of the economy. Directors commended the authorities on the important steps that had been taken to liberalize long-term capital flows, and encouraged them to eliminate in the near future controls on direct investment and short-term capital flows. Directors stressed that there was a need to move swiftly with reform of the domestic financial system. The subsidy element in Government financing of housing had been reduced, and portfolio restrictions channeling much of the pension fund investment to the housing sector had been abolished, but more needed to be done. In particular, Directors suggested that the Government should privatize public sector banks, withdraw from its dominant role as a provider of finance for home purchasers, and promote greater competition among private pension funds.

A few Directors urged the authorities to increase their assistance to developing countries, as the ratio of official development assistance to GDP in Iceland was below the OECD average.

The Executive Board has placed Iceland temporarily on the 24-month consultation cycle. The next Article IV consultation will be completed within 24 months.