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OECD Economic Surveys: Iceland

Assessment and recommendations

A decade of strong economic growth has lifted living standards but has fuelled imbalances

The Icelandic economy is prosperous and flexible. With its *per-capita* income growing at double the OECD rate since the mid-1990s, it is now the fifth-highest among member countries and more than a quarter above the OECD average. This impressive performance is attributable to extensive structural reforms that deregulated and opened up the economy, thereby unleashing entrepreneurial dynamism, as evidenced by an aggressive expansion of Icelandic companies abroad. Improved growth performance has been accompanied, however, by mounting tensions and imbalances in the economy. With financial-market liberalisation facilitating access to credit, and reducing its cost, aggregate demand has increasingly outstripped potential output, despite a substantial inflow of foreign workers. As a result, inflation and the external deficit have soared. Foreign indebtedness is the highest among OECD countries. This has made the economy vulnerable to changes in foreign investor sentiment, especially in the context of fragile global financial-market conditions.

Restoring economic stability remains the major challenge in the near term

With tightening macroeconomic policies and the maturing of major aluminium-related investment projects, economic activity slowed and growth came virtually to a halt in the year to the first quarter of 2007. However, it rebounded subsequently as wage developments, improved financial conditions and expansionary government measures rekindled demand and inflation pressures. In particular, previously announced cuts in personal income and consumption taxes, intended as a structural reform to enhance efficiency, were not helpful in terms of short-term economic stabilisation. Also, the Housing Financing Fund's credit conditions were eased in the run-up to the general election in May, but were reversed after the election. Financial-market conditions worsened again following the international turmoil in August 2007 and the monetary stance was tightened further in the autumn in response to a deteriorating inflation outlook. As a result, economic activity is expected to weaken again in the period ahead and to remain sluggish through 2009. By then, the emergence of a negative output gap should bring inflation down to near the official target while the current account deficit should narrow gradually. Yet there are considerable risks and uncertainties surrounding such a scenario of gradual adjustment relating, in particular, to the forthcoming wage round and the country's sensitivity to external shocks as manifested by the volatility of the exchange rate. Consequently, the key challenge for policymakers in the near term is to ensure that steady progress is being made in unwinding internal and external imbalances.

Monetary policy will have to bear the brunt of the work

Inflation has exceeded the official target of 2½ per cent since mid-2004. While housing policies have undermined the effectiveness of monetary policy (see below), it can be argued that the Central Bank has at times been too hesitant in raising interest rates. The Central Bank's communication strategy has greatly improved: now it publishes an interest rate path consistent with meeting the inflation target. With hindsight, however, it is clear that policymakers reacted too slowly to new information and were overly optimistic about the inflation outlook. Over most of 2007, monetary policy remained on hold before a renewed tightening late in the year. This reflected initial estimates that overstated the slowdown in activity as well as uncertainties related to substantial cuts in fishing quotas and the effects of international financial-market developments. Yet there were signs of a rebound in household demand and inflation from mid-year. International developments have contributed to a marked increase in long-term interest rates and real lending rates more recently. Still, *monetary policy will need to remain tight until inflation expectations are firmly anchored at the inflation target*. This is crucial to minimise second-round effects of wage increases or exchange-rate depreciation. *It would also be helpful if members of government respected the independence of Central Bank policymaking, as this would reinforce the credibility and effectiveness of policy.*

Although the financial system has withstood market stress, it needs to be monitored closely

The international liquidity crisis has increased uncertainty about economic prospects as markets are likely to remain volatile in the foreseeable future. So far, Iceland's financial institutions have weathered the storm well, although increased risk aversion has led to higher borrowing cost for Icelandic banks. While their rapid expansion has raised concerns about financial stability, supervisory and rating agencies consider that the financial system is broadly sound. Stress tests suggest that banks have adequate capital to withstand large credit and market shocks. However, these scenarios do not account for the second-round effects of such shocks. Hence, *the authorities should continue efforts aimed at improving the risk assessment and supervision of the financial system.*

Fiscal policy should be more supportive of monetary policy

With the benefit of hindsight, it is clear that the tax cuts in early 2007 eased the fiscal stance prematurely. Although the general government budget is still in substantial surplus, the latter is estimated to have narrowed by some 2 percentage points of GDP in 2007 (to around 4%). The 2008 budget proposal implies a further decline in the surplus (to around 1% of GDP), as expenditure is planned to increase by 8% in real terms. This reflects a rise in public investment by one-quarter, with central government investment virtually doubling. This rapid increase in spending risks reducing the cost-efficiency of these investments and would most likely exceed the absorptive capacity of the economy. *Hence, the planned increase in public investment should be moderated*. To the extent that higher expenditure is aimed at counteracting the effects of cuts in catch quotas on fishing communities, additional investment in human capital (such as retraining) would seem to be a more appropriate policy response. *It is important that public-sector wage growth be restrained in the upcoming round of negotiation and that new spending initiatives be avoided*.

Decisions on investment projects are crucial

Large-scale aluminium-related investment projects are relevant both from a stabilisation and a longer-term prosperity perspective. They explain part of the current imbalances and there is a risk that new ones will be undertaken before economic stability is restored. The new government has promised to time such projects in a way that would promote economic stability. It has also announced that no new projects would be started before a "master plan" for future energy use has been completed. However, this moratorium does not apply to projects for which research and other permits have already been issued and only concerns "untouched land". A generally positive assessment of the National Planning Agency gives the impression that work on one project (which would involve investments equivalent to 10% of GDP) could start soon. To the extent possible, *new large-scale power-intensive investments should be phased in once macroeconomic imbalances have been corrected*. More generally, such large-scale public investments are inherently risky and, even though they appear to be profitable, they give rise to substantial contingent liabilities for the government. A lack of transparency makes it impossible to evaluate whether public utilities earn appropriate returns for the use of natural resources, the environmental costs and the risks they are taking on. *No major investments in energy-intensive projects, including those already in the planning phase, should proceed without prior evaluation within a transparent and comprehensive cost-benefit framework (including environmental impacts and inter-generational effects)*.

Housing policies also need reform

Housing policies have had a destabilising impact on the economy. Easing of lending criteria and changes to funding strategies at the publicly-owned Housing Financing Fund (HFF) sparked a competitive battle with the private banks in the middle of the decade, entailing a decline in real mortgage rates at the same time as the Central Bank was trying to tighten monetary conditions with hikes in the policy rate. In mid-2006, following market turbulence involving a sharp fall in the exchange rate, the HFF's lending conditions were tightened, but this move was reversed prior to the general election in 2007 through government decision, before being re-instated afterwards. *The Housing Financing Fund needs to operate free from government interference and to refrain from actions which complicate the stabilisation efforts of monetary policy*. More fundamentally, the presence of the HFF, which can borrow at lower rates because of its government guarantee, prevents fair competition and distorts the allocation of resources by subsidising housing activity. Reform of housing policies must not be delayed further. *To level the playing field, government backing for HFF bonds should be terminated or the HFF be charged a fee to cover the cost of the government guarantee*. The social objectives of the HFF can be addressed more transparently and cost-effectively through targeted transfers.

Once stability is achieved, adjustments to the inflation-targeting framework could be considered

The inflation-targeting framework adopted by the Central Bank of Iceland and its communication policy reflect in many ways best practice in this area. There are nonetheless some features of the framework which could be refined over time to better take account of the inherent volatility of the Icelandic economy and to contribute to avoiding unnecessary employment and output fluctuations. To be sure, changing the rules of the game before inflation has been durably brought back to target would probably be counterproductive. However, once this has been achieved, modifications to the framework could be beneficial. In particular, greater emphasis on inflation expectations, which are key to influencing long-term interest rates, is needed. *The Central Bank policy statements should further emphasise the importance of inflation expectations, which should always remain firmly anchored even if actual inflation deviates from target. Another change that would be desirable is a revision of the methodology used to impute the service flow of owner-occupied housing entering into the target measure of inflation.* The fact that the housing component of the targeted price index reflects mortgage rates has the unfortunate effect that monetary tightening tends to raise the target measure of inflation. Adopting a rental equivalence approach for owner-occupied housing is difficult because the rental market in Iceland is relatively small. Still, the issue needs to be addressed, perhaps in the context of related work at the European level. Changing the targeted index would obviously require a reconsideration of the targeted level of inflation.

Strengthening the fiscal policy framework could reduce macroeconomic volatility

Since the early 1990s, Iceland has been using a top-down "frame-budgeting" approach and, in recent years, it has also published medium-term budget projections and guidelines for expenditure growth in real terms. However, this has not arrested a tendency towards expenditure drift, which has limited the potential stabilisation role of fiscal policy. There is thus a clear need for strengthening the framework. The government has recognised this and intends to present proposals to Parliament in its spring session. According to the National Audit Office, a number of ministries and agencies have repeatedly overspent their annual budgets with few consequences, despite existing regulations. One reason for insufficient spending discipline is that "frame-budgeting" is not implemented for a multi-year period, which would address the problem of expenditure base drift. To the extent that medium-term plans exist, they have in practice been more a forecasting exercise than a means of budgetary restraint. Moreover, the real expenditure targets are very global and allow large overruns in nominal terms, often related to wage increases. *Moving towards a fiscal framework with binding nominal medium-term expenditure ceilings for each ministry would increase spending discipline, improve the counter-cyclical impulse from fiscal policy and be more consistent with the inflation-targeting framework*. Nominal ceilings consistent with the Central Bank's inflation target would enhance transparency and thus increase the enforceability of fiscal rules; as well, they would increase the public ownership of the objective of controlling inflation. *While automatic stabilisers should be allowed to run their course (at least on the revenue side), public investment seems to be an instrument which is ill-suited for demand*

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management. Instead, public investment should be geared to enhancing the growth potential of the economy. Both international and Icelandic experience suggest that timing and implementation problems make investment a poor means of stabilisation policy. Rather than trying to fine-tune public investment according to perceived cyclical requirements, expenditure should be implemented on the basis of medium-term plans derived from careful and independent cost-benefit analysis. *Future direct tax cuts that are desirable for efficiency reasons (but not reductions in indirect taxes) should also be part of a medium- to long-term strategy, which should include quantified objectives for the budget balance (such as a surplus over the medium term) or appropriate government debt levels relative to GDP.*

Fiscal rules should be extended to local governments

Fiscal rules at the local government level also need to be strengthened. Municipalities account for one-third of total public spending and more than one-half of total government investment. While the local government income-tax rate is capped, equalisation payments rise automatically with central government revenues and municipalities have shown even less restraint than the central government in using windfall revenues during the economic boom for additional expenditure. The government has begun negotiations with the local authorities to address these problems, offering debt relief and increased equalisation payments in exchange for the adoption of ceilings on debt and real expenditure growth (including investment). In principle, *the same fiscal rules that apply to the central government should also be introduced for local governments in order to achieve national expenditure and stabilisation objectives*. The diversity of municipalities, especially their very different demographics, needs to be taken into account, however, as well as costs arising from new central government legislation.

Longer-term fiscal pressures call for reforms to the health-care system

Notwithstanding a secular increase in public expenditure, government finances are in better shape than in many other countries. Public indebtedness is low by international comparison (although the government has very high contingent liabilities in international comparison) and fully-funded occupational and public-employee pension funds limit the effects of population ageing. Still, there are some areas where spending pressures will remain strong, in particular health care, which is largely government-funded, suggesting that the authorities should aim at achieving budget surpluses. Per capita expenditure on health care has risen more than on average in other OECD countries and its growth has exceeded that of Iceland's per capita income by an even higher margin. Although long-term projections are surrounded by considerable uncertainties, they suggest that, as a result of population ageing and medical cost pressures, public health-care spending could reach 15% of GDP by 2050 if no restraining measures are taken. Certainly, Iceland is a rich country and can afford to spend a lot on health care. But while Iceland's GDP per capita betters the OECD average by about one quarter, given low private health care spending, its public per capita expenditure on health care already now, when its demographic structure is still very favourable, exceeds the OECD benchmark by 40%. *Given the outlook for public* *health-care spending and its implications for government finances, the authorities need to explore the scope for, and take measures aimed at, raising cost-effectiveness.*

The good health status of the population…

To be sure, care has to be taken to maintain the high-quality health services and the enviable health status of the Icelandic population. Life expectancy is among the highest in the world. Perinatal and infant mortality are the lowest, and maternal mortality virtually non-existent. Icelanders can expect to be healthy for about 90% of their (long) lives. Recent indicators of the quality of care (for instance, survival rates for certain illnesses and in-hospital case-fatality rates) also show Iceland in a very favourable light. However, empirical estimates, which take into account a wide range of health determinants, suggest that, reflecting declining returns to scale, every further health gain may come at a very high price, while maintaining the present excellent health status should be possible at lower levels of resource use and expenditure. Indeed, although the geography and population distribution of the country probably justify an above-average share of health-care workers, staffing ratios seem excessive by international comparison.

… could be achieved at lower costs

There are a number of options for enhancing spending efficiency in the health-care sector. Impediments to private provision, which accounts for only one quarter of publicly financed health services, should be removed and the sector opened up to competition. But when services are sourced out to the private sector, the authorities need to have the necessary expertise and resources to design appropriate service contracts and monitor the outcomes. To avoid that increased patient choice overly stimulates demand for services, cost-sharing should be introduced where it does not exist and reformed where it does not provide sufficient incentives for cost-savings (for instance, pharmaceuticals). This would also relieve the pressure on public finances. In addition, or alternatively, consider a form of gate-keeping system in which patients are directed to the most appropriate level of care. Activity-based funding in hospitals, which account for a high share of health-care spending in Iceland, should be accelerated and carefully implemented. Within a robust regulatory framework, output-related prospective payment systems can encourage providers to minimise costs without hurting patient care if associated prices are set correctly and there is appropriate control of quality. The authorities do not always make use of the scope provided by a high degree of centralisation to increase efficiency. What is clearly needed is a prioritisation of public health-care spending based on cost-benefit analysis of different kinds of services. Also, the government has to make more use of its power as the main buyer of health services to reduce costs, by putting downward pressure on prices or shifting care to less expensive services. Reforms along these lines should go a long way towards eliminating the apparent efficiency gap of the Icelandic health-care system.

Other policy areas also need attention

Another area where there is scope for getting better value for money is education. Given that Iceland spends more per student than most other OECD countries, educational achievement in terms of PISA test scores is disappointing. Moreover, it has rather tended to deteriorate over time relative to an OECD benchmark. As argued in the previous *Survey, education policy needs to focus on teacher quality rather than quantity.*

In addition, there are some exceptions to the general trend of market liberalisation, in particular the agricultural and energy sectors. Agricultural support is the highest among OECD countries and an impediment to structural change. *To reduce the heavy burden on consumers and taxpayers, agricultural support should be lowered, focusing on the most distorting payments to farmers, and market protection should be reduced further.*

The state-owned National Power Company accounts for the bulk of the country's electricity production and the energy sector is subject to foreign ownership restrictions. *Divestiture of the National Power Company's generation activities would be desirable both to create a level playing field and reduce taxpayers' exposure to risks surrounding large-scale investment projects.* As noted, power-intensive investments have a significant impact on the environment and, even though they are using renewable energy, emissions from aluminium plants are not negligible. Hence, *it should be carefully considered whether Iceland should ask for additional exemptions for large projects if a continuation of the* Kyoto Convention *is agreed*.

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The Secretariat's draft report was prepared for the Committee by Hannes Suppanz and Andrea de Michelis under the supervision of Patrick Lenain.

The previous Survey of Iceland was issued in August 2006.

BASIC STATISTICS OF ICELAND

THE LAND

Area (1 000 sq. km)	103	Unproductive area (1 000 sq. km)	82
Productive area (1 000 sq. km)	21	*of which:*	
of which:		Glaciers	12
Cultivated area	1.1	Other area devoid of vegetation	67
Rough grazings	20		

THE PEOPLE

Population, 31 December 2007	312 872	Occupational distribution, 2007 (per cent)	
Net increase 1997- 2007, annual average, %	1.4	Agriculture	3.8
		Fishing and fish processing	4.7
		Other manufacturing	11.5
		Construction, total	10.1
		Trade	16.3
		Transport and communication	7.1
		Other services	59.6

PARLIAMENT AND GOVERNMENT

Present composition of Parliament	2007
Independence Party	25
The Alliance Party	18
Progressive Party	7
The Left-Green Movement	9
The Liberal Party	4
Last general election: 12th May 2007	

PRODUCTION AND CAPITAL FORMATION

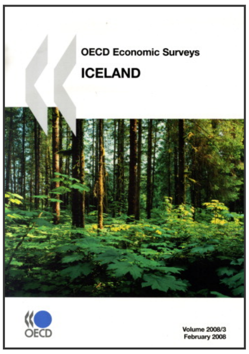
Gross domestic product in 2006		Gross fixed capital formation in 2006	
ISK million	1 162 930	ISK million	387 992
Per head, US dollars	54 764	Per cent of GDP	33.4

FOREIGN TRADE

Exports of goods and services in 2006, % of GDP	32.2	Imports of goods and services in 2006, % of GDP	38.4
Main exports in 2006 (% of merchandise exports)		Imports in 2006, by use (% of merchandise imports)	
Fish products	51.2	Consumer goods	20.2
Aluminium	23.5	Capital goods and transport equipment	46.2
Other manufacturing products	14.8	Industrial supplies	25.1
Agricultural products	1.8	Fuels and lubricants	8.4
Miscellaneous	8.7		

THE CURRENCY

Monetary unit: Króna		Currency units per USD, average of daily figures:	
		Year 2007	64.1
		December 2007	62.4



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