

Assessment and recommendations

Economic performance has improved, but tensions and imbalances remain

Iceland's growth dynamics have vastly improved since its policies changed course in the 1990s, shifting towards financial stabilisation and market liberalisation. Economic expansion since the middle of the last decade has considerably bettered that in the OECD and in particular in other European countries. With productivity growth picking up, Iceland's per capita income has risen faster than abroad, partly reversing its previous decline relative to an OECD benchmark, and is now, in level terms, among the highest in the area. However, while output variability has declined, it remains high, with a history of overheating requiring corrective policy actions that induced a sharp retrenchment in domestic demand. But alongside volatility, the Icelandic economy now exhibits a substantial degree of resilience, reflecting in part the improved policy framework. The recession in 2002 was quickly overcome, and the most recent rebound in activity has been quite vigorous, as buoyant household demand has reinforced the stimulatory effect of large-scale aluminium-related investment projects (averaging nearly 6% of GDP over 2003-07, including power plants). As a result, the economy is entering the most intensive phase of those investments with higher inflation and a larger external deficit than expected, implying a risk of imbalances similar to those of the last overheating episode.

Preserving stability will be a demanding task for policymakers

The structural reforms of the 1990s have enhanced the economy's capacity to adjust in the face of numerous large shocks to which it is subject, as has the more recent adoption of an effective macroeconomic policy framework featuring a floating exchange rate and an inflation targeting regime. The result is that output growth has strengthened and become less volatile, and imbalances can be reduced more rapidly. At the same time, however, the economy still faces several challenges. Growth remains more variable than in larger economies, raising the cost of capital. Furthermore, households and corporations are highly indebted by international comparison, and foreign-currency borrowing of short-term duration has grown rapidly. Given a prevalence of current account deficits, Iceland's external debt is one of the highest in the OECD, heightening the risks associated with sharp exchange-rate swings brought about by exogenous shocks or policy slippages. Moreover, there has been a massive rise in equity and property prices, which may be followed by a sharp downward correction, with all the attendant difficulties for investors. Finally, persistent spending overruns have complicated the use of fiscal policy for demand management. Against this backdrop:

- The major challenge to policymakers in the short run is to maintain economic stability in the face of the current investment boom through sufficiently tight macroeconomic policies and appropriate accompanying structural policies.

Greater diversification would probably give rise to increased productivity growth

In a longer-term perspective, the question arises as to what further changes to the structure of the economy and to policy settings would be conducive to maintaining a high standard of living by international comparison. Since the scope for raising (already high) labour utilisation is limited, policies need to be mainly focused on productivity. Despite higher productivity growth in recent years, the level of GDP per hour in Iceland is below the OECD average. Apart from diseconomies of scale and scope and high labour utilisation, possible reasons for that include an undiversified economic structure and unfinished business in the areas of education and competition policy. The current strategy is directed at attracting additional investment in power-intensive projects, capitalising on Iceland's supply of renewable energy resources. However, besides the question as to what impact this would have on economic volatility, in the absence of a comprehensive framework for evaluating such projects, the resulting economic returns are unclear (see below). High-technology manufacturing and knowledge-intensive services began to develop in the 1990s and have enjoyed rapid growth since then, but the most recent data show that their sectoral shares are still small by international comparison. Human capital formation is crucial to the expansion of such industries, as is the elimination of impediments to their development (such as implicit subsidies to the electricity sector – in the form of tax advantages and government guarantees – and agricultural protection). Accordingly:

- The major challenge to policymakers in the long run is two-fold: to ensure that any future power-intensive projects yield transparent net benefits, and to sustain faster productivity growth through human capital development and the removal of barriers that are inhibiting diversification away from low-technology sectors towards knowledge-intensive activities.

Monetary policy will soon be put to the test

As noted, the new monetary policy regime should help limit the build up of imbalances over the near term. Following the adoption of inflation targeting in 2001, the Central Bank succeeded in bringing both 12-month consumer price increases and inflation expectations (as implicitly gauged by bond investors) down to the official objective of 2½ per cent. However, with the recent pick-up in inflation, expectations have also risen, drifting up to the Central Bank's upper tolerance limit of 4%. This suggests that the new framework's credibility is not yet fully established, which is not unusual in view of its recent adoption. Anchoring inflation expectations to the target is particularly important because the March 2004 multi-year wage agreements in the private sector were based on the twin assumptions of inflation near the official objective and similar settlements in the public sector and can be reopened in late 2005 if these assumptions are not satisfied. The Central Bank has strived to enhance confidence in and understanding of the new monetary policy framework through outreach activities and its publications, but there would seem to be room for further strengthening it. In particular:

- The Central Bank should consider moving to regular rate-setting meetings so as to increase transparency and improve communications with financial markets, with decisions announced immediately thereafter (as is done by all other inflation-targeting central banks).

As it will have to bear most of the forthcoming stabilisation burden

As the recent hike in the inflation rate reflected not only international oil price developments but also domestic demand pressures, the Central Bank appropriately began to raise its policy interest rate in mid-2004. By year-end the policy rate was almost 3 percentage points higher than it had been in the spring, though, with the rise in inflation expectations, the rise in real interest rates has been much smaller. In addition, developments in financial markets counteracted the Bank's initial tightening moves. Stock market and property prices have surged, and – more recently – commercial banks and subsequently the public Housing Financing Fund (HFF) have offered mortgage loans at much lower interest rates than hitherto. The banks' entry into the mortgage market, which facilitates equity withdrawal, is adding to household demand and inflation. Similarly, the latest relaxation of HFF lending limits risks further stimulating demand in the housing market. Finally, the recently legislated reductions in personal income taxes could begin to stimulate spending even before they have been fully implemented. In these circumstances:

- Further interest-rate increases will be needed in 2005 to prevent consumer price inflation from significantly overshooting the authorities' upper tolerance limit and to forestall a wage/price spiral.

Fiscal tightening is also crucial in the near term

A tight stance of fiscal policy during the investment boom would alleviate the burden on monetary policy to safeguard price stability without the need for excessively high interest rates, which are already putting upward pressure on the real exchange rate and squeezing the exposed sector of the economy. Regrettably, in 2003, when economic activity rebounded, the general government budget moved into substantial deficit, reflecting fiscal loosening due to a number of discretionary spending measures as well as recurring expenditure overruns. Helped again by stronger-than-assumed economic growth, the budget appears to have returned to broad balance in 2004. While fiscal tightening – in particular a cutback in public investment – contributed, expenditure restraint seems to have fallen short of intentions. Nonetheless, the withdrawal of the sharp fiscal stimulus imparted in 2003 is welcome. But it needs to be sustained so long as excess demand conditions prevail. The latest budget calls for general government surpluses in 2005 and 2006. However, these surpluses – both in actual and cyclically adjusted terms – are projected to be modest compared to those recorded during the overheating period of the late 1990s, which were 1 to 2 percentage points of GDP higher. The tax cuts for 2005-07 will slow fiscal tightening in the near term and, in the absence of further measures, are projected to bring it nearly to a halt in 2006, just when the construction projects peak. Hence:

- Now that the tax cuts have been passed, the authorities should aim at budget surpluses higher than those currently planned to ensure a better policy mix, by rigorously avoiding spending overruns (especially in the form of high public-sector pay rises), implementing additional spending restraint and reducing tax expenditures favouring the housing sector.

Better expenditure control and greater restraint would facilitate demand management and enhance the scope for tax reductions

With the exception of a brief period in the 1990s when radical austerity policies eliminated the budget deficit, expenditure growth has been rapid. Moreover, despite reforms to the fiscal framework, especially the introduction of “frame-budgeting” (setting expenditure ceilings), and, more recently, of medium-term budget projections, public spending has tended to exceed not only the “frames” but also the ultimately voted (and usually higher) authorisations. Sometimes, as in 2003, supplementary budgets raise expenditure during the year; yet even discounting that, deviations from budgeted levels have remained substantial. According to the National Audit Office, a large number of government bodies exceed the permitted annual budget overrun (which is limited by regulation), and some have done so for many years. Apart from complicating the use of fiscal policy for economic stabilisation purposes, this puts upward pressure on taxation. Whereas from 1978 to 2003 the public-expenditure-to-GDP ratio rose by about 4 percentage points in the OECD area, it rose by 16 points in Iceland, and the revenue-to-GDP ratio increased accordingly. Such a steep rise in tax pressure is bound to have a negative impact on the growth of output and real income mainly through the associated higher marginal tax rates which distort incentives to save, work and invest. In this perspective, the recent tax cuts are likely to have favourable supply-side effects on economic performance. In order to address these issues:

- Public expenditure control needs to be strengthened by stricter enforcement of existing regulations and the rigorous observance of medium-term spending ceilings, in order to make fiscal policy more effective and create room for the sought-after substantial reduction in the tax burden.

Maintaining a flexible immigration policy would help to avoid labour-market pressures

Official efforts to achieve stabilisation should also be extended beyond the domain of macroeconomic policies. For example, decisions regarding the labour market are crucial. Labour demand associated with the large-scale investment projects is already significant in relation to Iceland’s workforce, and unemployment is not much above its structural rate, although it has fallen little from its cyclical peak recorded two years ago. This highlights the importance of facilitating the employment of foreigners at the construction sites. Conditions for granting work permits to foreigners are numerous, and, although EEA nationals do not need a permit, this is not yet the case for the new EU members. The fact that the proportion of foreigners involved in the investment projects has exceeded expectations suggests that immigration policy has so far shown remarkable flexibility. But project-related labour demand has not yet peaked, and some tightening in labour-market conditions is likely. Therefore:

- The entry of foreign workers should continue to be handled flexibly during the construction of the large-scale projects to minimise labour-market and hence inflation pressures.

Limiting damage to the environment from the large-scale investment projects will remain a key objective

The power-intensive investment projects are challenging to handle not only because of their large macroeconomic effects but also for their impact on the environment. Iceland has generally given substantial weight to environmental concerns in its planning. The design of the power plants and aluminium smelters has been changed, sometimes significantly, following environmental impact assessments, lowering planned output and associated emissions. However, it remains to be seen whether these modifications will be sufficient to address all environmental concerns satisfactorily. Moreover, some possible problems (such as erosion) will become apparent only over time, possibly affecting the country's vegetation and fauna as well as the developing industry of (eco-)tourism. While the design changes should allow Iceland to comfortably meet its Kyoto Protocol stage-one targets, given its special quota for single projects, this would probably not be the case for a further significant expansion of the aluminium sector, which may also have more severe effects on the environment than those previously. For these issues to be properly addressed:

- It is important that the authorities continue to monitor the environmental impact of the power-intensive investment projects to ensure the fulfilment of commitments and minimise damage that could become apparent only with some delay.

A framework for the transparent evaluation of further expansions of energy-intensive industries needs to be developed

In a longer-term perspective, as noted above, an important issue is what further changes to the economic structure would be conducive to enhancing the country's prosperity. The current enormous expansion of the aluminium sector reflects the authorities' view that Iceland should diversify its export base by reducing its reliance on fisheries while at the same time taking advantage of its wealth of renewable energy resources. Past and current developments of power-intensive industries have involved foreign companies building and operating plants, with public utilities providing the necessary electricity under bilateral long-term contracts. While considerable efforts have been made to evaluate the profitability of these long-term agreements, a transparent overall framework for assessing the costs and benefits of the expansion of the energy-intensive sector has so far been missing. The authorities have now begun to develop such a framework. Having it in place before deciding about further expansions is essential. In particular, it is important to identify: i) the implicit rent demanded for the use of scarce natural resources; ii) the-site specific charge for negative environmental externalities; iii) the marginal cost of providing the power itself; and iv) the amount of risk borne by Icelandic taxpayers. One possible model would have the government explicitly set the first two as a sort of reservation price and then allow private companies to bid for the right to supply electricity to large industrial users; projects would go ahead only if this threshold were met. The government would then be absolved from dealing with the users, and the bids would reveal the value of power provision. Hence:

- Future expansions of energy-intensive industries should be evaluated on the basis of a broad, transparent cost-benefit framework, taking into consideration factors such as the

appropriate rent for the use of natural resources, the environmental impact, the allocation of risks and implications for macroeconomic performance.

- Allowing private (including foreign) electricity generators to bid for electricity supply contracts would both enhance transparency of the contract terms and potentially reduce taxpayers' exposure to the risks resulting from these arrangements.

Educational outcomes have yet to respond to higher spending

Recognising the importance of human capital formation for Iceland's ability to diversify and its future economic performance, the government has considerably raised spending on education in recent years. As a result, by international comparison Iceland has moved from being a low spender to becoming a high spender in this area relative to GDP, although the country's young population means that expenditure is less outstanding on a per capita basis. These developments have understandably yet to translate into better scores on standardised international tests. Iceland's latest average PISA test-score is only just above the OECD average. This reflects good results in mathematics but a slightly below-average performance in both scientific and reading literacy. The relatively low share of teachers with a degree in the subjects that they teach may be a reason. In addition, Icelandic students continue to show less inclination to choose natural science-related subjects than is the case generally elsewhere in the OECD. To improve this situation:

- The authorities should continue efforts to enhance teacher qualifications and increase the focus of teaching on sciences as well as foreign languages.

Further reforms are needed to address the drop-out issue and raise educational attainments

Graduation rates have picked up markedly last year. However, until 2002, the last year for which international comparisons are available, educational attainment in Iceland had improved less than in other member countries, so that young people were even less qualified relative to the OECD average than older ones; and the share of the working-age population that has no more than compulsory education is still high. Iceland's relatively poor record regarding educational qualifications is not the result of low initial enrolment rates but of high drop-out rates, especially (albeit not only) from upper-secondary institutions. The country's economic structure implies that there are unusually good job opportunities for workers with few formal educational qualifications. But there are also shortcomings in the education system that need to be addressed. Today's low-skilled jobs may not survive through possible further expansion of power-intensive industry, and a preponderance of low-skilled labour is not conducive to the development of new higher-technology activities. The government has begun to take measures that should be helpful in reducing drop-out rates, notably broadening the variety of courses and making schools' financial allocations dependent on pupils' sitting exams. It is also considering shortening the duration of upper-secondary education following a lengthening of the school year. No major reforms are intended at the tertiary level, although the merger of a private university

with a public one will make the recourse to user fees a bit more widespread. To sustain the very recent improvement in educational attainment:

- Measures to reduce drop-out rates should be continued, in particular curriculum reform and incentives for schools to focus on attainment, and the planned shortening of the duration of post-secondary education should be implemented speedily together with a restructuring of study programmes.

The institutional structure of competition law enforcement has proved efficient

The economy's good performance, and in particular the step-up in productivity over the past decade, reflects in part the fundamental changes to competition and regulatory policies beginning in the early 1990s. Combined with the wide-ranging reduction in government ownership, these changes have strengthened competitive forces both from within and without, unleashed a surprising degree of entrepreneurial dynamism and raised efficiency in many sectors of the economy. In the area of legislation, the adoption of a new competition law in 1993 marked a turning point. The current institutional structure of competition law enforcement, which has evolved further since then, is on the whole efficient, although perhaps too cumbersome. Recent proposed changes aim to simplify the enforcement structure and to strengthen the Competition and Free Trade Authority's (CFTA) powers and resources for monitoring activities while removing consumer affairs from its portfolio so as to focus its resources on competition issues. These revisions would probably have positive effects. In addition, however:

- The authorities should ensure close cooperation between the CFTA and the new entity dealing with consumer affairs so as to preserve existing synergies between the two areas of surveillance.
- They should also resist *de facto* and legal exemptions of agricultural producers from certain aspects of the competition law.

Competition has taken hold in most segments of the telecommunications market

The current legal and regulatory framework in the telecommunications sector, which with some modifications has been in place since the year 2000, has been conducive to strengthening competition, notably in the sector's mobile phone and broadband segments. An initial wave of entry was followed by consolidation, leaving the market for both fixed-line and mobile telephony divided between the still state-owned incumbent and one private competitor. The emergence of competition in telecommunications has probably contributed to the decline in prices for such services relative to overall consumer prices. Since the late 1990s, this decline has been of similar magnitude to that in the United States, a country regarded as being at the technology frontier and enjoying strong competition in this sector. Nonetheless, more needs to be done to facilitate entry in some market segments. In particular:

- The regulator should consider widening the margins between fixed-line subscription fees and leasing fees for the local loop so as to promote more entry into the fixed-line segment and reduce the incumbent's present dominance.

- Universal service objectives should be financed through income support out of general tax revenues rather than universal service charges, and there should be an investigation of whether such objectives could be achieved more efficiently through technologies other than fixed-line telephony.
- The privatisation of Iceland Telecom should be completed as soon as possible so as to remove uncertainty about an important aspect of the future industry structure.

But competition has yet to emerge in the electricity sector

One sector that has remained entirely in public ownership is the electricity sector. Natural factors create substantial barriers to entry: virtually all electricity is generated from hydropower and geothermal energy, exploitation of which is characterised by high fixed and extremely low variable cost in comparison to electricity generated from carbon fuels. The current legal framework, adopted in 2003, designates generation and sales as competitive activities and imposes accounting separation between transmission and other activities for the monopoly provider of transmission services. In practice, the National Power Company (Landsvirkjun) remains dominant in generation and is the majority owner of a newly established transmission operator, while the municipal utility serving the Reykjavik area is the only potential competitor of significant size in generation and dominates in distribution. The complex ownership structure, which involves cross holdings between these two companies, makes competition between them even less likely. Several measures would improve the prospects for viable competition in generation and sales:

- The authorities should consider whether divestiture of Landsvirkjun's generation activities would help create a level playing field in generation by avoiding cost-of-capital differentials between the incumbent and potential entrants.

There remains room for policies in other sectors to promote stronger competition

Although the generally pro-competitive stance of regulatory policies over the past decade has increased competitive pressures, some sectors of the economy remain excessively protected. The most obvious case is agriculture, where support remains very high by international standards and is heavily skewed towards output-distorting measures. Outside agriculture, barriers to trade are low, but there are a few sectors in which foreign ownership is still restricted, and administrative and screening requirements in connection with inward direct investment stipulated by the law are generally high, although actual practice is considerably more liberal. Competitive pressures could also be strengthened further in the areas of public procurement and publicly funded services. A number of initiatives could improve efficiency in the sheltered sectors:

- Agricultural support should be reduced, especially in the area of policies that provide incentives to increase production, and administered prices for dairy products should be eliminated.
- The market for agricultural products should be exposed to foreign competition by raising quotas and reducing tariffs on quota-exceeding imports.

- The remaining restrictions on foreign ownership – notably in the energy and fisheries sectors – should be reduced and the remaining administrative requirements in the law should be removed.
- The competition authority should be especially vigilant against bid-rigging in public tenders, in view of the small number of domestic competitors in many Icelandic markets.

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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, December 2003	290 490	Occupational distribution, 2003 (per cent)	
Net increase 1993-2003, annual average (per cent)	0.9	Agriculture	2.7
		Fishing and fish processing	7.6
		Other manufacturing	10.9
		Construction, total	6.8
		Trade	13.6
		Transport and communication	6.8
		Other services	50.7

PARLIAMENT AND GOVERNMENT

Present composition of Parliament :	2003
Independence Party	22
The Alliance Party	20
Progressive Party	12
The Left-Green Movement	5
The Liberal Party	4
Last general election: 10th May 2003	

PRODUCTION AND CAPITAL FORMATION

Gross domestic product in 2003:		Gross fixed capital formation in 2003:	
ISK million	810 844	ISK million	172 430
Per head, US dollars	36 519	Per cent of GDP	21.3

FOREIGN TRADE

Exports of goods and services in 2003, per cent of GDP	35.5	Imports of goods and services in 2003, per cent of GDP	38.4
Main exports in 2003 (per cent of merchandise exports):		Imports in 2003, by use (per cent of merchandise imports):	
Fish products	62.3	Consumer goods	29.2
Aluminium	18.8	Capital goods and transport equipment	35.8
Other manufacturing products	15.1	Industrial supplies	27.3
Agricultural products	1.9	Fuels and lubricants	7.4
Miscellaneous	2.0		

THE CURRENCY

Monetary unit: Krona		Currency unit per US dollar, average of daily figures:	
		Year 2004	70.19
		December 2004	62.71



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