

## Chapter 1

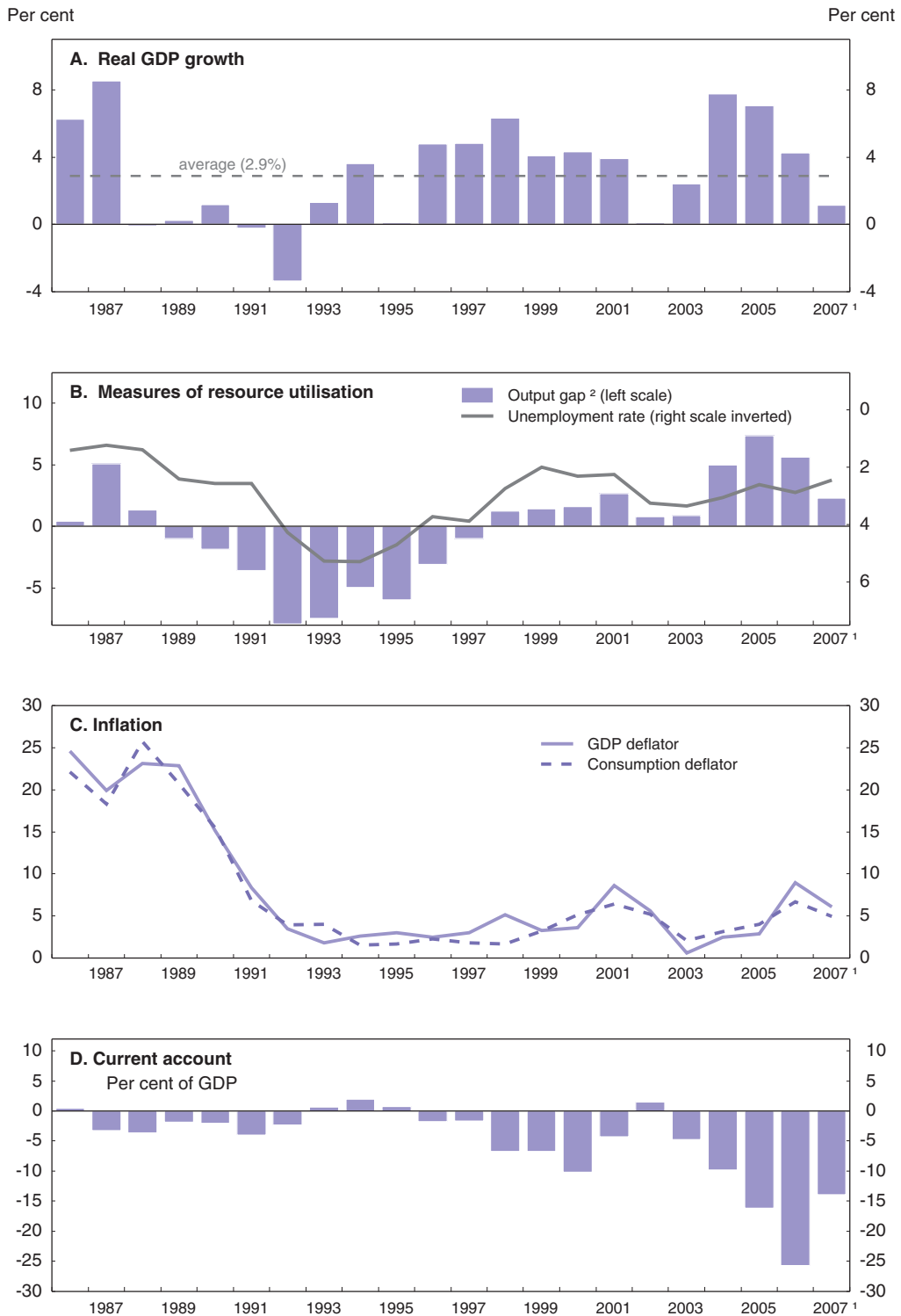

# Challenges facing the Icelandic economy

*Economic activity slowed through the first quarter of 2007, reflecting tight macroeconomic policies and the maturing of major aluminium-related investment projects. However, it revived subsequently as expansionary policy measures in the run-up to the general election in May rekindled demand and inflation pressures at a time when tensions and imbalances in the economy remained substantial. The further tightening of the monetary stance in the autumn should cool down the economy gradually in the period ahead. But the economy remains vulnerable to changes in foreign investor sentiment, especially in the context of fragile global financial-market conditions. Consequently, the key challenge for policy in the near term is to restore macroeconomic stability by ensuring that steady progress is made in unwinding both internal and external imbalances. In addition, with a view to sustaining Iceland's favourable growth performance, steps need to be taken to strengthen the ability of both monetary and fiscal policy to moderate macroeconomic volatility and prevent the re-emergence of such imbalances. In a longer-term perspective, a key challenge for policymakers is health-care reform. Although the overall fiscal position is better than in many other OECD countries, health care (which is largely government-funded) is a major source of public spending pressures. Health outcomes are very good, but there appears to be room for enhancing cost-effectiveness.*

## Longer-term economic performance

Extensive structural reforms that strengthened market forces, together with stabilisation policies that brought inflation under control and rebalanced the budget, laid the foundation for a period of robust growth from the mid-1990s (Figure 1.1). Membership of the European Economic Area opened up new markets to Icelandic companies, strong pension funds supplied capital needed for investments and the privatisation of the banking system provided new sources of financing. The increased dynamism of the economy has been most visible in the aggressive expansion of many Icelandic companies abroad. After strongly stepping up their foreign activities, the commercial banks also raised their profile in the domestic mortgage market by engaging in head-on competition with the state-run Housing Financing Fund from 2004, thereby greatly enhancing access to, and reducing costs of, credit for households. With strong household demand for both current consumption and housing adding to the substantial stimulus from large-scale investment in the aluminium and energy sectors, the expansion gained considerable momentum in the middle of the decade. Despite a slowdown thereafter, growth has averaged nearly 4% since the mid-1990s.

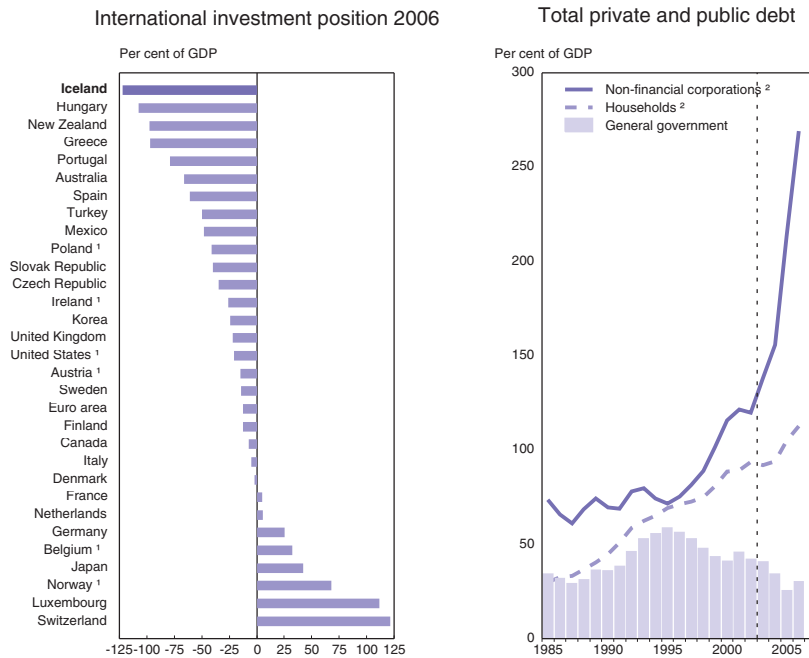
Improved growth performance has been accompanied, however, by mounting tensions and imbalances in the economy, with a mild recession in the early part of the decade providing only a temporary reprieve. Activity has increasingly outstripped potential output despite strong growth of the latter, entailing substantial pressures in goods and labour markets, despite a sizeable inflow of foreign workers. As a result, inflation has exceeded the official target by a large margin in recent years and the external deficit has widened dramatically. At the same time, foreign and domestic indebtedness have soared. Iceland's total foreign debt is about five times its annual GDP. Although foreign assets have also grown strongly, its (negative) international investment position, at 122% of GDP at the end of 2006, is the weakest among OECD countries (Figure 1.2). As foreign liabilities have risen fast, net interest and dividend payments abroad have soared and weigh heavily on the current account, a recent turnaround notwithstanding. With the government retiring a substantial amount of its foreign debt over the past decade, total foreign debt is now largely private, reflecting low savings since the financial-market liberalisation of the mid-1990s. The increase in corporate debt has been particularly steep, with a significant amount lying with companies that have been expanding their operations overseas. Household debt has grown more gradually. While it is high by international comparison, the asset position of households has also strengthened and, if pension fund assets are included, so has their net worth. Still, even an only partial reversal of the sharp rise in asset prices in recent years would have a marked adverse effect on the equity of indebted households. As for corporations, the main concern is the impact of their large indebtedness on their resilience to economic shocks.


Figure 1.1. **Aggregate economic indicators**StatLink  <http://dx.doi.org/10.1787/276206462773>

1. Estimate.

2. Percentage difference between output and estimated potential output.

Source: OECD Economic Outlook 82 database.

Figure 1.2. **Indebtedness**

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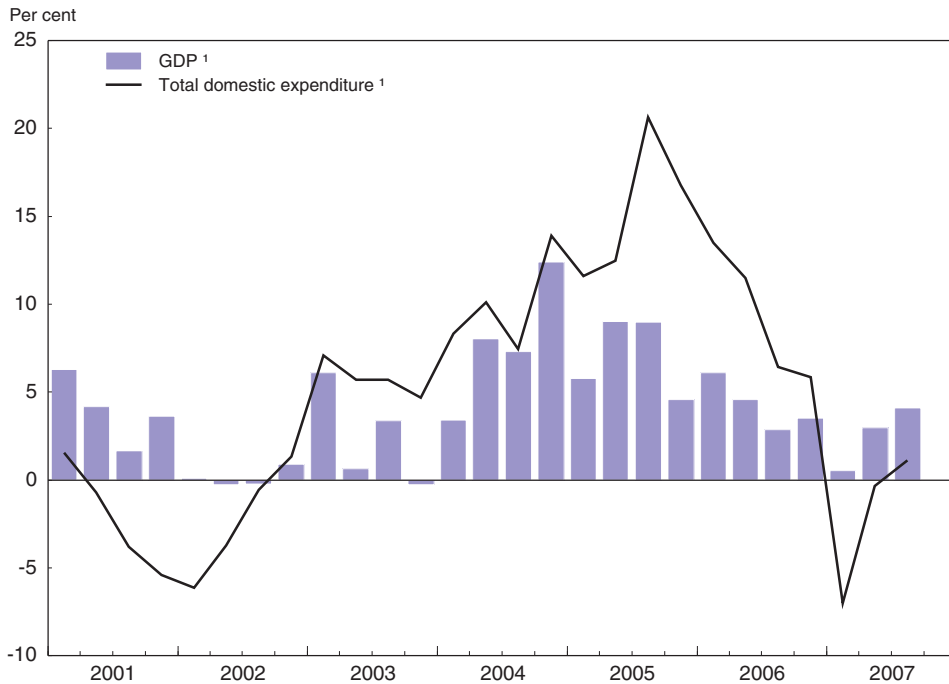
1. Figures are for 2005.


2. Classification of lending from 2003.

Source: Central Bank of Iceland and OECD Economic Outlook 82 database.

## The economic situation

After expanding at torrid rates in the middle of the decade on the back of soaring domestic demand, economic activity slowed and growth came virtually to halt in the year to the first quarter of 2007 (Figure 1.3). Domestic demand even contracted over that period, as work on the large-scale investment projects that were launched in 2003 peaked and monetary policy tightening started to weigh down on household spending. Lagged effects of the turmoil in financial markets in 2006 apparently also played a role. Private consumption, in particular, which has been traditionally very volatile by international comparison, decelerated sharply, and much more so than households' real disposable income (Box 1.1). Subsequently, however, consumer spending rebounded as financial conditions improved and wage developments along with direct and indirect tax cuts (in January and March, respectively) boosted real disposable income. Moreover, the exchange rate strengthened during that period, underpinning household purchasing power abroad (the bulk of consumer durables is imported). Finally, households' financial position improved due to rising equity prices and a re-acceleration of property prices. The latter was associated with strengthening housing market activity as the Housing Financing Fund eased its credit terms and private banks followed suit in an environment of diminishing liquidity constraints. Household demand remained robust during the summer, although leading indicators suggest some softening following the financial-market turmoil in August. This had adversely affected the exchange rate and entailed higher borrowing costs. Even so, the renewed surge in household spending rekindled activity and delayed the closing of the sizeable positive output gap.

Figure 1.3. **Growth has resumed**

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1. Year-on-year increase at constant prices.

Source: Statistics Iceland.

### Box 1.1. What drives private consumption?

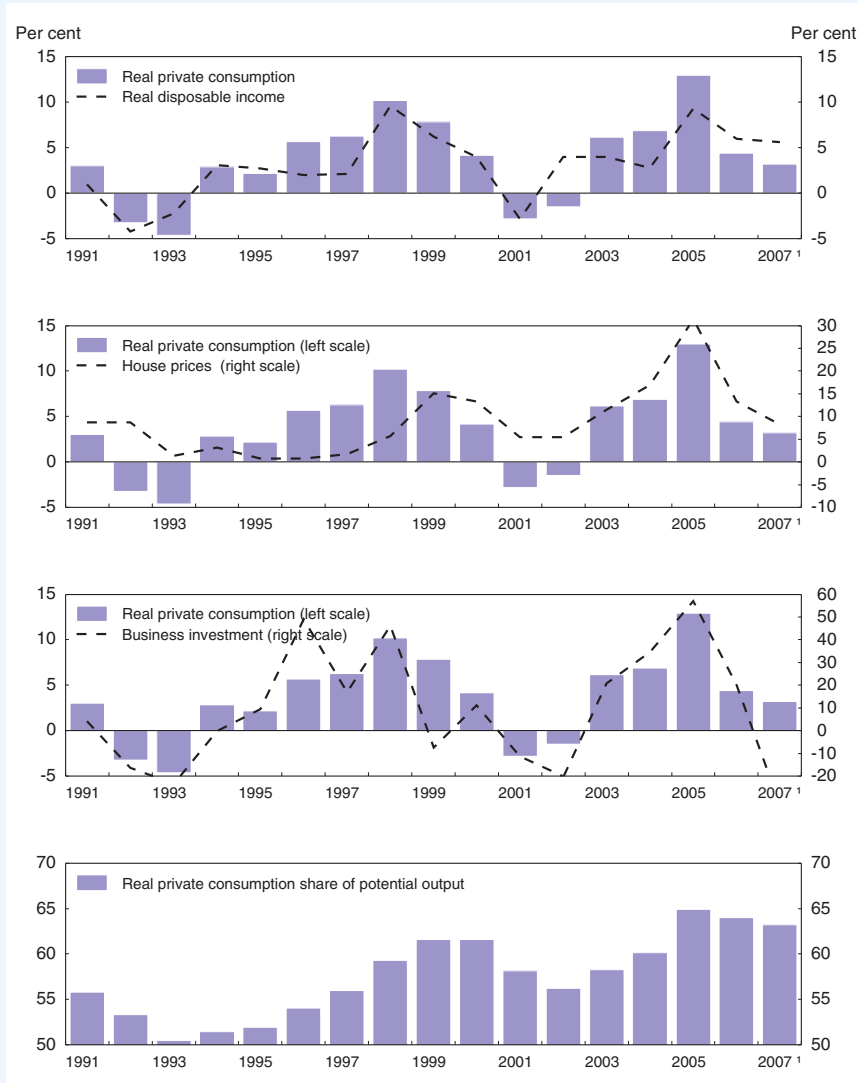

As shown in the previous *Economic Survey*, an outstanding feature of the Icelandic economy is the volatility of private consumption, which is unusually high, even if account is taken of the fact that economic fluctuations tend to be the more pronounced the smaller and more open the economy. Moreover, over time, the instability of internal demand has become relatively more important as a source of overall output volatility and economic imbalances.

As generally elsewhere, the major determinant of private consumption growth in Iceland is the development of households' real disposable income (Figure 1.4). However, in the short run, divergences can be enormous. For instance, in 2003-2005, the growth in private consumption was more than double that of disposable income. This is a significantly higher differential than during the cyclical upturn in the late 1990s. One explanation for this is the development of household wealth. While the latter had little impact on the pace of consumption in the previous decade, the recent surge and subsequent moderation in consumer spending has been closely associated with the movement of house prices. The unprecedented increase in asset prices (the stock market also boomed) enabled households to increase their consumption by collateralising expected future income to a greater extent than before. At the same time, as noted, the privatisation of the banks and developments in the mortgage market facilitated households' access to credit. Moreover, the strengthening exchange rate had a positive impact on consumption both by increasing real disposable income and improving consumer confidence. Finally, there has been a close relationship between private consumption and major power-intensive investment projects that have dominated fixed capital formation over the last decade or so. Consumer spending picked up sharply when the latest projects were launched five years ago, perhaps in anticipation of future disposable income growth.

## Box 1.1. What drives private consumption? (cont.)

Figure 1.4. Determinants of private consumption

Annual changes

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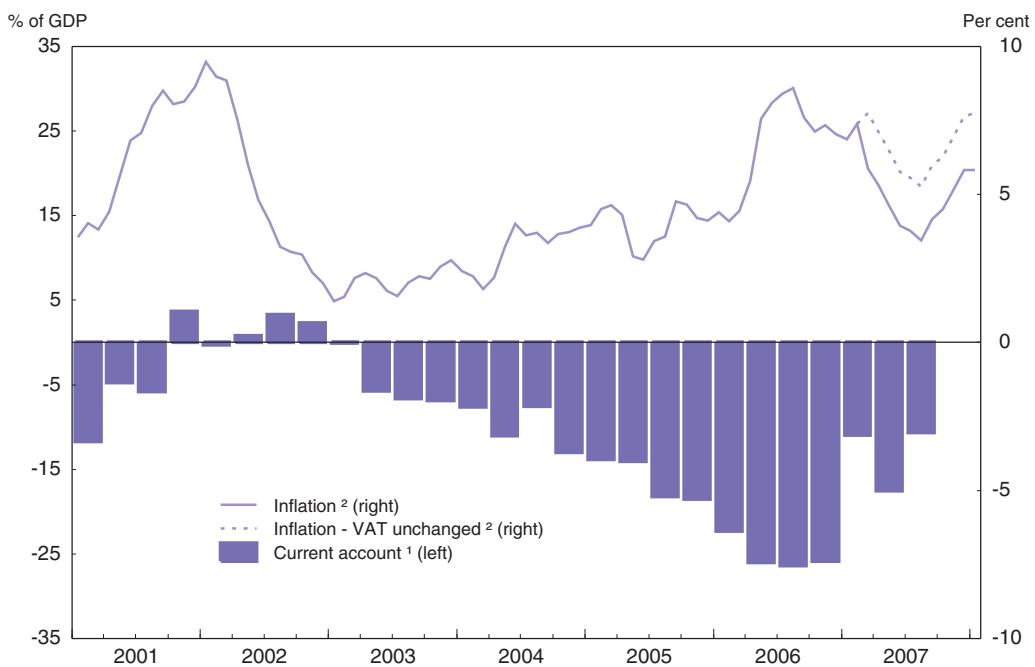
1. Projection.


Source: Central Bank of Iceland and OECD Economic Outlook 82 database.

As a share of potential output, private consumption in Iceland is high by international comparison and has displayed an upward trend. This may be related to factors such as declining public debt, rising pension savings and Iceland's relatively young population. Even so, the current level of the consumption/output ratio suggests that further adjustments are needed to return consumer demand to a more sustainable level and thereby reduce macroeconomic disequilibria. Indeed, compared to previous adjustment episodes, the recent fall in the ratio has been very slow as cuts in income and consumption taxes (intended as a structural reform to enhance efficiency) have strengthened households' purchasing power and, along with renewed house price appreciation, have underpinned consumer confidence.

As a result, tensions and imbalances persist. Although a strong inflow of foreign workers has boosted the labour force, whose growth has averaged 4% since 2005, labour-market conditions have remained tight. The unemployment rate is around 2½ per cent, according to Survey data, and at a historical low of 1% in terms of registered unemployed. With a tight labour market putting upward pressure on wages and a re-acceleration of housing costs, inflation has edged up again, after easing due to the effects of a stronger exchange rate and reduced consumption taxes (Figure 1.5). Excluding the temporary impact of the VAT cuts, it has again exceeded 7½ per cent. This is not much lower than in mid-2006, when a temporary collapse of the exchange rate pushed up the price level and compares with the official target of 2½ per cent. At the same time, the unwinding of the huge current account deficit, which reached 26% of GDP in 2006, has slowed after a sharp decline in early 2007. It has been argued that official statistics overstate the size of the external deficit, but even after some adjustments it may still be too large to be sustainable (Box 1.2).

Figure 1.5. **Tensions and imbalances persist**



StatLink  <http://dx.doi.org/10.1787/276266707534>

1. As a percentage of gross domestic product.
2. Annual increase in the consumer price index and constant tax-rate consumer price index.

Source: Statistics Iceland.

### Box 1.2. How big is the external deficit?

Iceland's current account has been in deficit for all but a handful of years in the past half century. There have been several occasions when deficits exceeded 10% of GDP, but these were usually quickly corrected. Yet, deficits of the order recorded recently (more than a quarter of GDP in 2006) will be more difficult to reverse. The Central Bank has estimated that about one-third of that imbalance derived from investments in the power and aluminium sectors and one-fifth reflected re-invested earnings of foreign companies in

**Box 1.2. How big is the external deficit? (cont.)**

Iceland (which have grown enormously in recent years). Taking this into account still leaves an external deficit that is probably too high to be considered sustainable. Reliance on volatile short-term capital inflows to finance such deficits would be a source of economic fragility and instability. However, doubts have been raised about the reliability of the data underlying estimates for the current account deficit, and hence the validity of such an assessment.

The criticism has focused on the income account, which has swollen following the liberalisation of capital movements. With expenditures outstripping strongly growing receipts, the reported deficit on investment income accounted for roughly one-third of the total current account deficit in 2006 (Table 1.1). Some observers regard Iceland's investment income deficit as greatly overestimated. While admitting that there may be an underreporting of assets while liabilities may be more accurately reported, the Central Bank has argued that measuring the income balance differently would not affect the current account as drastically as sometimes imagined. For example, if changes in the portfolio value were included in the balance of income, the current account deficit for 2006 would have been significantly smaller than under the current methodology, but it would have been much larger in 2005 and in 2000-2003. Since positive and negative deviations have so far tended to be offsetting, it cannot be taken for granted that a change in methodology would give a more favourable picture of the external position. Taking full account of market value would, however, introduce much more volatility in the income account that would be unrelated to actual payment flows.

Even so, communication might be enhanced by regularly presenting estimates both using the conventional and the market value method. This is also true for foreign direct investment (FDI). A lack of reliable data has hitherto hindered Iceland, like most other countries, from recording it at market value. With the proportion of outward FDI that is entered at book values much bigger than that of inward FDI, it might well be that Iceland's negative international investment position is overstated, at least recently. Any official estimates in this respect would inform and focus the public debate.

**Table 1.1. Balance of payments**

	2006	
	ISK billion	% of GDP
Balance of goods	-156.5	-13.7
Balance of services	-49.7	-4.4
Income balance	-90.0	-7.9
Current account	-298.7	-26.2
Capital and financial account	421.0	36.9
<i>of which:</i>		
Direct investment net	-70.4	-6.2
Portfolio investment net	771.9	67.6

Source: Central Bank of Iceland.

**Near-term prospects and risks**

Recent information suggests that real GDP growth in 2007 could have significantly exceeded the estimate shown in Table 1.2, even if it dropped sharply in the final quarter of the year. Looking ahead, activity is projected to remain sluggish through 2009. This growth



Table 1.2. **Short-term projections**  
Percentage change, volumes

	2007	2008	2009
Private consumption	3.2	-1.1	-1.6
Government consumption	2.5	3.3	3.0
Gross fixed capital formation	-21.1	-13.9	-1.3
Final domestic demand	-3.9	-3.0	-0.4
Change in stockbuilding <sup>1</sup>	0.0	-0.6	0.0
Total domestic demand	-3.9	-2.6	-0.4
Exports of goods and services	8.2	9.9	6.9
Imports of goods and services	-8.7	-2.6	-0.4
Change in foreign balance <sup>1</sup>	7.0	4.4	2.0
<b>GDP</b>	<b>1.2</b>	<b>1.0</b>	<b>1.6</b>
GDP implicit price deflator	6.1	4.0	3.3
Consumer price index	4.9	4.4	2.8
Unemployment rate (per cent)	2.5	3.2	3.3
Current account balance <sup>2</sup>	-13.9	-11.1	-9.9
General government financial balance <sup>2</sup>	4.2	0.8	-1.3
Short-term interest rate	14.3	13.6	9.9
Long-term interest rate	9.7	9.0	7.8

1. As a percentage of GDP in the previous year.

2. As a percentage of GDP.

Source: OECD Economic Outlook 82.

path reflects countervailing forces. Household demand contracts in response to high interest rates, coupled with record high personal debt; business investment drops sharply as aluminium-related investment projects are completed; the adverse effect of lower fish catch quotas on exports is outweighed by the strong increase in aluminium-production capacity; and government investment is soaring (see below). With such factors depressing activity overall, the emergence of a negative output gap should help bring inflation down to the official target towards the end of the projection period while the current account deficit is projected to narrow gradually.

There are, however, considerable risks and uncertainties surrounding such a benign scenario of gradual re-equilibration of the economy and the adjustment process might well be more uneven than projected. In the context of a still tight labour market, it remains to be seen whether the major wage agreements (both in the private and public sectors) due in the first half of 2008 are compatible with the projected decline of inflation towards the official target. As well, renewed sharp downward pressure on the exchange rate (which is assumed to remain constant) cannot be excluded. The still high current account deficit leaves the economy highly dependent on developments in international financial markets and the willingness of foreign investors and creditors to fund it. This sensitivity towards external shocks has been manifested by the volatility of the exchange rate in recent years. In both cases, interest rates would need to be higher to counter the inflationary effects of such developments (the projections assume that the closing of the positive output gap allows interest-rate reductions from the second half of 2008). Moreover, the projections do not include the effects of possible new large-scale aluminium-related investment projects, which could delay disinflation and the unwinding of the external deficit. One project will likely begin in 2008 and additional ones are under consideration (Box 1.3). Even before construction starts, household expectations could be supported by such new projects drawing closer, as occurred five years ago. Although such investments would underpin the exchange rate in the short run, higher interest rates

### Box 1.3. **New investment projects**

There are plans to build three new aluminium smelters in the next few years. The projects are of similar size and would again double Iceland's aluminium production capacity. The preparation for the Century Aluminum smelter at Helgúvík in the southwest of the country is the most advanced and construction work could begin in 2008. New ideas concerning an expansion of the Alcan smelter in Straumsvík in the capital area or the construction of a new facility are under scrutiny in the wake of the narrow defeat of the expansion proposal in a local referendum. Preparatory work on a new Alcoa smelter near Husavík in the north of the country is underway; the project seems likely to go ahead, but not in the current decade. The National Power Company has recently announced that it would not supply energy to any new aluminium projects in the southwest of the country as it intends to diversify and reap higher margins on energy sales. This will not affect the Century project, which relies on geothermal power from other providers, or the Alcoa project in the north.

In October, the National Planning Agency published an opinion on the environmental impact assessment for the Helgúvík smelter, stating that the proposed plant would not have any significant negative externalities. The Agency expressed some reservations concerning the environmental impact of related construction (such as energy procurement, transmission lines and harbour construction), but the publication of the generally positive opinion has considerably increased the likelihood that the project will go forward. The municipalities involved have yet to issue the required development and construction permits, however, and the proposed operations are dependent on the granting of greenhouse gas emission allocations. Energy procurement is guaranteed by contracts with municipal utilities in the area for the first stage of the project that would allow production to begin in mid-2010. The cost of both smelter construction and energy procurement during the first stage is estimated to be around two-thirds of the total cost of the project, which is about 10% of GDP.

than otherwise would probably be required to achieve the inflation target within an acceptable timeframe and maintain price stability thereafter.

The international liquidity crisis has increased uncertainty about economic prospects (Box 1.4). So far, Iceland's financial institutions have weathered the storm well. There has been no need for the Central Bank to take special action and commercial banks have continued to borrow heavily abroad. Still, higher risk aversion has led to a surge in credit default swap (CDS) levels for Icelandic banks, which have been only partly corrected, and a

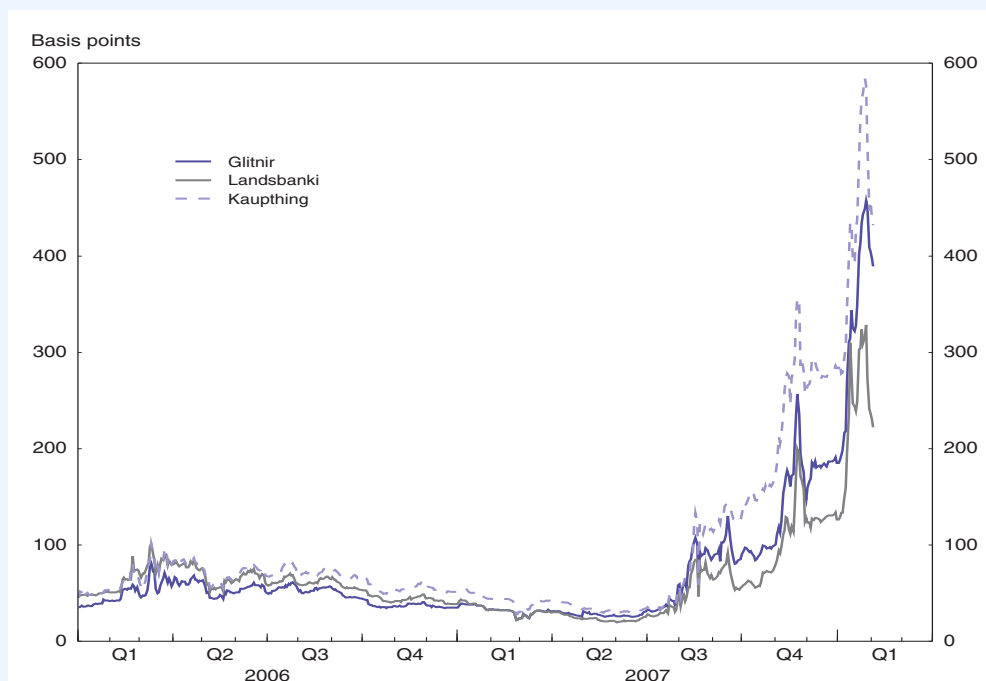
### Box 1.4. **Financial market developments**

Icelandic financial markets were the subject of a special chapter of the previous *Survey*. The chapter noted the vitality of the financial system, reflecting to a significant extent financial liberalisation policies. The *Survey* also noted the guarded assessment of financial supervisors and rating agencies that the financial system was broadly sound. Over the past two decades the financial system has been transformed from being highly regulated by international standards to one where the authorities' role is largely supervisory. The financial sector is now a bigger part of the Icelandic economy than high-profile industries such as fishing, electricity and aluminium. The expansion of financial institutions into foreign markets has been particularly dynamic so that the three major banks are now huge relative to the size of Iceland's financial markets and the economy.

#### Box 1.4. Financial market developments (cont.)

The fast growth of the Icelandic banks has been accompanied by growing pains. In 2006, large and growing imbalances in the Icelandic economy raised concerns about the viability of the banks and the stability of the Icelandic financial system. Many observers became worried about high levels of debt and potential exposure of financial institutions to asset prices. Despite a sharp fall in the exchange rate and share prices and a rise in the Credit Default Swap (CDS) spreads of the major Icelandic banks in the first half of 2006, the banks have continued to perform well and the financial system has remained stable. Several observers have concluded that the funding problems of the banks at that time reflected a lack of transparency concerning their business model and activities, as the concerns about *market risk* were shown to be exaggerated. The confidence returned and refunding problems of financial institutions were resolved as investor concerns were addressed. The international financial turmoil since August 2007, triggered by problems in the US subprime mortgage market, has been accompanied by widespread information problems creating uncertainty about the pricing of risk in financial intermediation. This situation has prompted renewed concerns about financial stability, reflected in increased asset price volatility also in the Icelandic financial market. More recently the CDS spreads have surged once again and are now considerably larger than those of foreign banks with similar credit ratings (Figure 1.6). This has been linked to the collapse of a small Icelandic investment fund raising concerns about a wider systemic fragility. While these may be misplaced, the continuing rapid growth of the banks has remained a source of concern, which is consistent with CDS spreads declining somewhat (but remaining elevated) for all major banks after the recent decision by the largest bank (Kaupthing) to abandon plans to acquire a foreign bank (NBIC).

Figure 1.6. Credit Default Swap (CDS) spreads for major banks<sup>1</sup>



StatLink  <http://dx.doi.org/10.1787/276287837767>

1. Senior five-year Credit Default Swap.

Source: Thomson Datastream.

**Box 1.4. Financial market developments (cont.)**

Despite investor concerns, most criteria suggest that the Icelandic banks are sound, as reflected in their consistently good ratings: The main banks run a surplus of foreign-currency assets over liabilities and their fourth-quarter results showed healthy net interest income, while their capital ratios look solid. All of them have recently passed a comprehensive stress test of the Icelandic Supervisory Authority. The test implies that a financial institution must be in a position to take on considerable simultaneous setbacks in the value of shares, market bonds, non-performing loans and appropriated assets, and the exchange rate without having its capital adequacy ratio drop below 8%. Recently, Moodys has placed the ratings for Icelandic banks on review, while pointing to their growing reliance on foreign deposits as a possible source of fragility. At the same time, Moodys confirmed the (Aaa) sovereign rating of the Icelandic government finding it to have ample access to foreign exchange denominated liquidity to handle any *contingent liabilities* associated with a “low probability worst case scenario”. In summary, while most observers consider the Icelandic banks fundamentally healthy and to follow sound business models, uncertainty remains about the future development due to the ongoing adverse conditions on international financial markets.

slide in the stock market. This diminishes companies’ growth potential, especially their plans for expansion abroad. Households face higher financing costs and tighter access to credit as well as lower levels of wealth. So far, these effects have been limited, but markets are likely to remain volatile. Thus, more pronounced business and household retrenchment than projected cannot be excluded, especially if falling house prices added to the negative wealth effect of lower share prices.

**Immediate policy requirements**

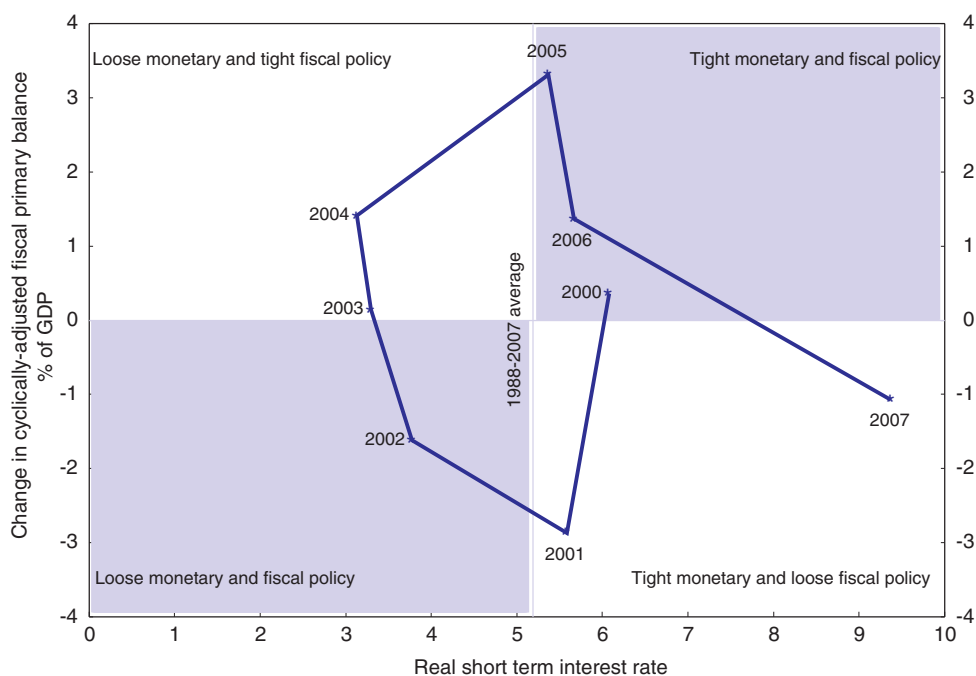
Inflation has exceeded the official target of 2½ per cent since mid-2004. From that time, the Central Bank gradually raised its policy rate until late 2006 (by almost 8 percentage points). This had little effect on long-term rates and real lending rates, which actually were lower at the end of 2006 than three years earlier (Table 1.3). This partly reflected a competitive battle between the publicly owned Housing Financing Fund and the private banks, which depressed interest rates and tended to loosen credit criteria. While this undermined the effectiveness of monetary policy, it can be argued that the Central Bank was at times too hesitant in raising interest rates. In real terms, the policy rate hardly exceeded its long-term average until 2006, as the rise in inflation kept pace with interest-rate hikes (Figure 1.7). Over most of 2007, monetary policy remained on hold before a


**Table 1.3. Interest rates**

Per cent, year end

	2003	2004	2005	2006	2007
Policy interest rate	5.30	8.25	10.50	13.00	13.75
Three month money market yield	5.1	7.9	10.1	13.3	14.1
Long-term treasury bond yield	7.7	7.8	7.7	8.4	12.4
HFF bond real yield	4.0	3.5	4.3	5.1	6.4
Average bank lending rate	11.7	12.8	15.7	19.3	19.5
Average bank lending rate, indexed loans	8.7	7.5	6.7	7.7	9.9

Source: Central Bank of Iceland.

Figure 1.7. **Monetary and fiscal stance**

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Source: OECD Economic Outlook 82 database.

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 effect of financial-market developments. Yet there were signs of a rebound in household demand and inflation from mid-year. On the other hand, international developments contributed to a marked increase in long-term interest rates and real lending rates more in late 2007 that exceeded the rise in the policy rate. Nonetheless, with long-term rates easing more recently, further hikes in the policy rate may be necessary. Certainly, it is unfortunate that housing policy counteracts the stabilisation efforts of monetary policy and, as recommended in previous *Surveys*, reforming the Housing Financing Fund should be a priority since its operations require a higher policy rate than otherwise. But, in any case, interest rates will have to remain high until inflation expectations have been firmly anchored at the inflation target.

Fiscal policy tightened appropriately during the economic upswing, moving towards restraint even earlier than monetary policy (Figure 1.7). The recent easing in the fiscal stance, however, occurs at a time when monetary policy is still going in the other direction and record high interest rates are necessary to curb inflation. More than half of the projected narrowing in the general government budget surplus in 2007 (from above 6% to above 4% of GDP) can be traced to discretionary measures, in particular cuts in income and consumption taxes. The 2008 budget proposal implies a further decline in the general government budget surplus (to around 1% of GDP), as expenditure is planned to be raised by 8% in real terms. This reflects a rise in public investment by as much as one-quarter, with central government investment virtually doubling. As a share of GDP, public

investment is projected to rise by 1 percentage point, with very cautious assumptions regarding local government outlays (Table 1.4). This would bring the public investment ratio to 4½ per cent, above the long-term average of just below 4%. This compares with a long-term average of 2½ per cent in the euro-area; usually only emerging economies have such high public investment ratios. The planned sharp expansion in government investment risks reducing the cost-efficiency of these investments and would most likely exceed the absorptive capacity of the economy (although part of it is for building a coast guard vessel abroad). Instead, as argued in Chapter 3, projects should be carefully planned and evaluated, and not rushed through. 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 response.

Table 1.4. **Public investment**  
% of GDP

	Local government	Central government	Total
2004	2.1	1.8	3.9
2005	1.8	1.3	3.1
2006	2.6	1.4	4.0
2007	1.6	2.0	3.6
2008	0.9	3.7	4.5
Average 1996-2006	2.1	1.9	3.9

Source: Ministry of Finance.

## Longer-term challenges

While rebalancing the economy is the priority in the near term, there are a number of policy issues that need to be addressed to sustain good economic performance in the longer run. There is scope for adjusting the monetary and fiscal policy frameworks with a view to moderating macroeconomic volatility and preventing the re-emergence of major imbalances. There is room for enhancing cost-effectiveness in the health-care sector, which is a major source of public spending pressures. And there are other areas where little progress has been made in structural reform (Annex 1.A1).

### **Refining the monetary policy framework**

The implementation of monetary policy has greatly improved recently (Chapter 2). In particular, the Central Bank now publishes an interest-rate path that it considers optimal for bringing inflation to the official target within an acceptable timeframe, thereby providing an anchor for inflation expectations. Nonetheless, further refinements to the inflation-targeting framework should not be discarded. They could concern, for instance, the target variable, so as to avoid unnecessary employment and output fluctuations. The fact that the housing component of the targeted price index reflects mortgage rates has the undesirable effect that monetary tightening raises the targeted index. Adopting a rental equivalence approach for owner-occupied housing is difficult because the rental market in Iceland is very small. Still, the issue should be addressed, ideally 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, but this new target should not be adopted until inflation is under control. However, once inflation expectations have been

permanently reduced and reforms to the Housing Financing Fund's operations have re-enforced the interest-rate channel, modifications of the inflation-targeting framework could be considered.

### **Strengthening the fiscal policy framework**

Government finances have been in substantial surplus in recent years and public indebtedness is low by international comparison. Together with fully-funded occupational and public-employee pension funds, this means that Iceland is relatively well prepared for longer-term spending pressures stemming from population ageing. This does not mean that there are no fiscal risks. Besides the debt on the books of government entities, the state guarantees the debts of certain enterprises and institutions. The largest part of this represents government backing of residential mortgages through the Housing Financing Fund. The other important state guarantee concerns the debt of the National Power Company. Compared to the figure shown in Table 1.5, this debt guarantee has broadly doubled with the recent takeover of the local authorities' stakes by the state. It may now account for about one-fifth of total Treasury debt guarantees, which are likely to have risen to 70% of GDP. This, together with a high level of estimated contingent liabilities from the financial sector, explains somewhat less favourable assessments by credit agencies despite the low level of public debt in a narrower sense.

Table 1.5. **Treasury guarantees**

End of 2006

	EUR million	% of total
Housing Financing Fund	6 158	81
Regional Development Institute	117	2
National Power Company	881	12
Landsbanki	211	3
Other	234	3
Total Treasury guarantees		63
Per cent of GDP		
Treasury gross debt		
Per cent of GDP		24

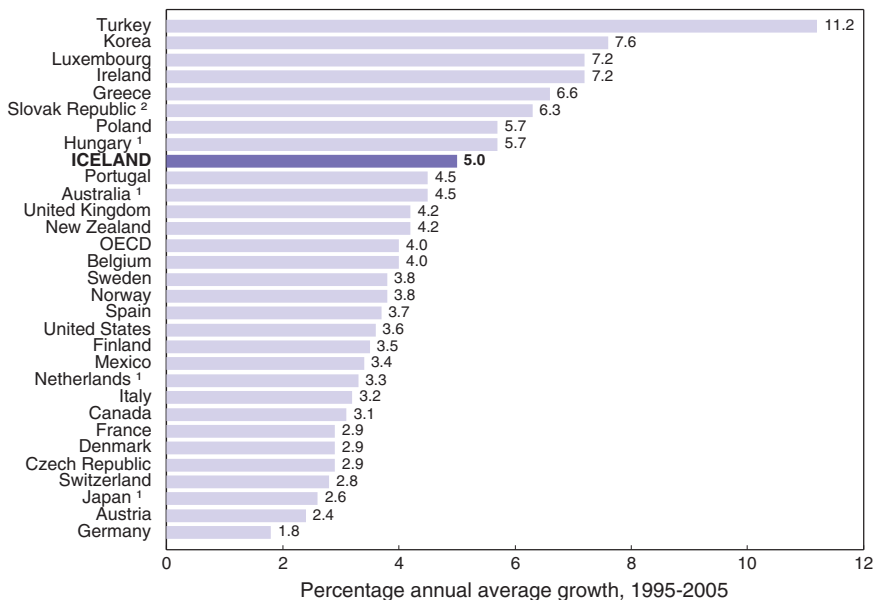
Source: Treasury Accounts.

Fiscal risks notwithstanding, the long-term sustainability of public finances would not seem to be a cause of major concern. However, there are two – interrelated – issues that need to be addressed. What can be done to arrest a tendency toward expenditure drift and to enhance the stabilisation role of fiscal policy in a country with unusual macroeconomic volatility? Although this might seem ambitious by Icelandic standards, moving towards a fiscal framework with binding nominal medium-term expenditure targets for each ministry would increase spending discipline, improve the countercyclical impulse from fiscal policy and be more consistent with the inflation-targeting framework (Chapter 3). While automatic stabilisers on the revenue side should be allowed to run their course, experience (both in Iceland and abroad) has shown that public investment is an ill-suited instrument for demand management. Such fiscal rules would need to be extended to local governments, which account for a large share of public expenditures (especially investment) and hence have the potential to offset developments at the central level.

### Reforming health care

Health care, which is largely government funded, is a major source of public spending pressures. The increase in real health expenditure *per capita* averaged 5% in 1995-2005, which is 1 percentage point more than in the OECD and almost double the growth of per capita GDP in Iceland (Figure 1.8). Although long-term projections are surrounded by considerable uncertainties, they indicate 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. This highlights the importance of raising cost-effectiveness and spending efficiency more generally (Chapter 4). To be sure, care has to be taken to maintain the high quality of health services. But there are estimates suggesting that the excellent health outcomes in Iceland could be achieved at lower cost. A number of measures could be helpful in this regard. They include: opening up the sector to competition and increasing (relatively limited) private provision; introducing cost-sharing where it does not exist, both to avoid overconsumption and as a source of public revenue; more reliance on cost-efficiency and activity-based funding arrangements; and reducing the high cost of pharmaceuticals by re-enforcing competition and the use of inexpensive generic drugs.

Figure 1.8. Real health expenditure per capita



1. 1995-2004.

2. 1997-2005.

Source: OECD Health Data 2007.

StatLink  <http://dx.doi.org/10.1787/276320407488>

### Other structural policy areas needing attention

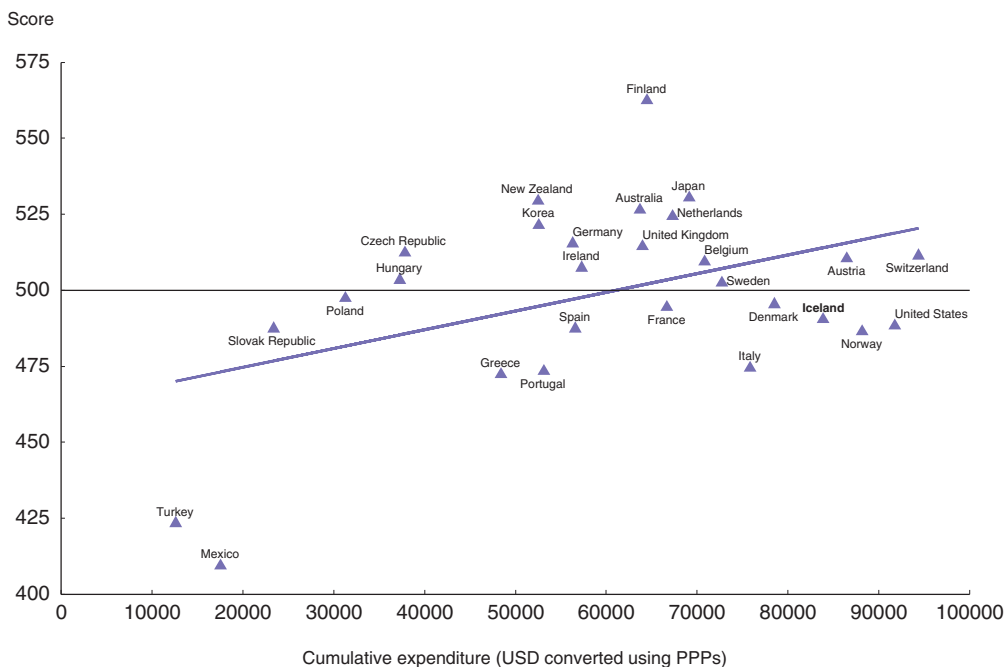
The major outstanding reform in the *financial* sector concerns housing finance. The publicly owned Housing Financing fund (HFF) has advantages over other housing lenders




that prevent fair competition, distort the allocation of resources and impede innovation. As mentioned above, the Fund's operations also reduce the effectiveness of monetary policy. Given its government guarantee, it can fund its mortgage lending at lower interest rates than the commercial banks. The latter nevertheless match HFF rates to maintain their share of the mortgage market, even if this means that they are lending at rates below their cost of funds. Previous *Surveys* have argued that, 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 Fund could be addressed more transparently and cost-effectively through targeted transfers.

Recent PISA test scores highlight the importance of additional *education* reforms. Given that Iceland spends more per student than most other OECD countries, educational achievement at the end of compulsory education is disappointing (Figure 1.9). Moreover, it has generally deteriorated since 2000 relative to an OECD benchmark. Only on the mathematics scale is it still slightly above the OECD average. The deterioration has been most pronounced on the reading scale, where Iceland has moved from a little above to significantly below the OECD benchmark. The relative decline in reading performance was particularly pronounced for males, although females have also lost ground. The previous *Survey* has argued that education policy needs to focus on teacher quality rather than quantity. Indeed, since responsibility for compulsory education was transferred to the municipalities in the mid-1990s, the number of teachers – and hence spending per student – has increased strongly without leading to better educational achievements. The government has just introduced legislation that would tighten qualification requirements

Figure 1.9. **Student performance on the science scale<sup>1</sup> and spending per student<sup>2</sup>**



StatLink  <http://dx.doi.org/10.1787/276324267232>

1. Average OECD score is 500.

2. Cumulative expenditure on educational institutions per student between the ages of 6 and 15 years.

Source: OECD PISA 2006 database.

for teachers. But this will take time to be implemented while changes in the economic structure are increasing the demand for a skilled workforce.

There is also unfinished business in the area of *public sector reform*, such as the introduction of output-based budgeting, performance measurement and management reforms. Output-based budgeting is used in the funding of secondary schools, universities and nursing homes, and there are plans to extend it to hospitals (see Chapter 4). However, the authorities have been hesitant in introducing it more widely. It is thought to provide incentives for higher spending, to be difficult to model accurately and too often, lack necessary auditing. While this is sometimes true (an example being higher education), the National Audit Office feels that these problems should be fairly easy to overcome. In any case, output-based budgeting at least provides more transparency on how agencies and programmes are funded.

*Agricultural support* is an impediment to structural change and represents a heavy burden on consumers and taxpayers. Total on-budget transfers to farmers amount to about 1% of GDP, almost as much as the percentage contribution of agriculture to GDP. After declining in the 1990s, producer support has changed little and was the highest in the OECD by 2006 (Table 1.6). Prices received by farmers are about 2½ times higher than those in the world market. The share of the most distorting payments (based on output or input use) is still nearly 80%. It is the major form of support for dairy producers, but will gradually decrease in this sector until 2012 under an agreement between the government and the farmers' association. Further efforts are required to reduce market protection, although import tariffs on meat products have been lowered recently along with the abolition of excise taxes on most imported food.

Table 1.6. **Agriculture: Producer support estimate**<sup>1</sup>  
As a per cent of gross farm receipts

	2004	2005	2006
Australia	4	4	6
Canada	21	22	23
European Union	36	33	32
<b>Iceland</b>	<b>65</b>	<b>67</b>	<b>66</b>
Japan	56	55	53
Korea	63	63	63
Mexico	11	14	17
New Zealand	1	1	1
Norway	67	66	65
Switzerland	68	67	63
Turkey	26	27	20
United States	16	16	11
OECD	30	29	27

1. The monetary value of transfers from consumers and budgetary payments to producers.

Source: *Agricultural Policies in OECD Countries: Monitoring and Evaluation*, 2007.

Another exception to the trend towards market liberalisation is the *energy sector*, which is still predominantly publicly owned. As a member of the European Economic Area, Iceland has implemented some deregulation under an EU directive relating to the separation of transmission, generation, distribution and sale of electricity. The legislation does not call, however, for incorporation of power companies or any changes regarding the

state or municipal guarantees they currently enjoy. Of the main producers, the National Power Company (Landsvirkjun) is now fully state-owned after acquiring the stakes held by municipalities, and Orkuveita Reykjavíkur is owned by the city of Reykjavík and other municipalities. By 2006, the National Power Company already accounted for more than 80% of Iceland's total electricity production, and this share will increase further when the Karahnjúkar power plant, which supplies energy to the new Alcoa aluminium plant, reaches full capacity. Any plans to eventually start privatising the energy sector suffered a setback when a joint venture between Orkuveita Reykjavíkur and a private company met strong resistance and collapsed. Still, divestiture of the National Power Company's electricity generation activities would be desirable both to create a level playing field and reduce taxpayers' exposure to the risks surrounding large-scale investment projects. The National Power Company's recent announcement that it would not supply energy to any new aluminium projects in the southwest of Iceland and instead diversify to reap higher margins on energy sales in other sectors may support some doubts about the profitability of power projects. 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.

There are important *environmental issues*, even though, by international comparison, Iceland is relatively unpolluted due to sparse population and high reliance on renewable energy resources. Developing the country's huge exploitable electric power potential requires the building of dams and reservoirs that affect nature and the landscape. Hence, power-intensive investment projects have faced growing criticism for their impact on the environment. While they are using renewable energy sources, emissions of aluminium plants are not negligible. The emission limit for greenhouse gases in Iceland according to the Kyoto Protocol for the period 2008-2012 allows a 10% increase from the 1990 level. In addition, emissions from single large projects can be reported separately and are not included in the above limit, provided they use renewable energy and adhere to certain criteria. As a result, Iceland is likely to remain within its Kyoto limits, although emissions of greenhouse gases have already grown by more than 10% since 1990s. Much will depend, however, on the speed with which new investment projects are undertaken. There have been conflicting signals whether the government would have to, or would want to, ask for additional exemptions if a continuation of the Kyoto Convention is agreed. In any case, as emphasised in previous *Surveys*, future expansions of energy-intensive industries should not go ahead without being evaluated on the basis of a broad, transparent cost-benefit framework that takes into consideration their environmental impact.

## ANNEX 1.A1

*Progress in structural reform*

This annex reviews actions taken to follow policy recommendations made in the 2006 *OECD Economic Survey of Iceland* and, where indicated, still outstanding from earlier *Surveys*. Recommendations that are new in the Survey are shown in the boxes at the end of each relevant chapter.

Recommendations in previous Survey	Actions taken and current assessment
<b>A. Financial markets</b>	
Charge the Housing Financing Fund (HFF) a fee reflecting the cost of the government guarantee, explore the possibility of the HFF wholesaling mortgages or restructure it as a limited liability company, subject to tax, with a view to future privatisation.	Reforms have been considered, including limiting the HFF's role to that of a wholesaler, but there has been no progress in implementing them.
<b>B. Educational and training</b>	
Focus on teacher quality rather than quantity and increase class size to reduce cost pressures. Increase the focus of teaching on sciences and languages. Encourage potential drop-outs to select vocational programmes.	Legislation has been introduced recently that tightens teacher qualification requirements, obliges the state to educate everybody up to the age of 18, and promotes vocational training.
Boost fees for public tertiary education to reduce completion times and budget pressures.	No action.
<b>C. Public sector management</b>	
Strengthen the "frame budgeting" process and tighten budget execution, limiting the use of supplementary budgets. Consider the introduction of multi-year budget plans with spending limits made binding in nominal terms.	The government has announced that it will adopt official budget frames for a four-year period, with details of the new approach to be presented to Parliament in its spring session.
Make the co-operation between central and local levels of government effective through binding annual agreements.	Negotiations are underway between the central government and the municipalities with a view to introducing fiscal rules for local governments.
Accelerate the introduction of outcome-based budgeting, performance measurement and management reforms in the public sector.	Progress in these respects has remained slow.
<b>D. Taxation</b>	
Match income tax cuts with spending restraint and increase user fees, in particular in the education and health-care sectors.	Not only income but also consumption taxes have been reduced, without a spending offset.
<b>E. Product market competition</b>	
Consider whether divestiture of the National Power Company's generation activities would help create a level playing field in power generation by avoiding cost-of-capital differentials between the incumbent and entrants.	No action.

Recommendations in previous Survey	Actions taken and current assessment
Reduce agricultural support, especially in the area of policies that provide incentives to increase production. Eliminate administered prices for dairy products.	Excise taxes on food have been abolished and import tariffs for imported meat have been cut.
Reduce the remaining ownership restrictions, notably in the energy and fisheries sectors.	No action.

#### F. Environment

Make explicit use of cost-benefit analysis to improve policy effectiveness and coherence; especially in deciding on the merits of major power-intensive investments.	The government has announced a partial moratorium for new investment projects, but a comprehensive framework for their evaluation is still lacking.
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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.*

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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	<i>of which:</i>	
<i>of which:</i>		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

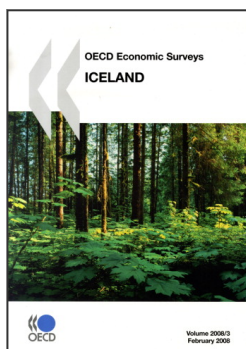
Gross domestic product in 2006		Gross fixed capital formation in 2006	
ISK million	1 162 930	ISK million	387 992
Per head, US dollars	54 764	Per cent of GDP	33.4

### 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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