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Chapter 2

Macro policies to maintain economic balance

This chapter discusses the factors driving the current expansion, the economic outlook and the macroeconomic policy settings in place to maintain economic stability. The recovery from the mild 2002 recession has been stronger than expected as the stimulatory effect of the large-scale aluminium-related investment projects has been reinforced by buoyant household demand. With the economy projected to continue to grow at a rapid pace over the next two years, there is a clear risk that tensions and imbalances – in particular inflation pressures and a large external deficit – of a magnitude similar to those that caused the previous downturn will re-emerge. Monetary policy has been tightened since mid-2004, but the new inflation-targeting regime will be put to a severe test in the period ahead. Budgetary policy has also become restrictive, following a substantial loosening in 2003. However, with tax cuts scheduled for 2005-07, the fiscal stance may not be tight enough to prevent a recurrence of the overheating episode that took place a few years ago.

The recovery from the mild 2002 recession has been much more vigorous than expected, as the stimulatory effect of the aluminium-related mega-projects has been reinforced by buoyant household demand. As a result, the same internal and external imbalances that caused the downturn have re-emerged, even though the economy has not yet entered the most intensive phase of the investments. Spending on consumption and housing has been boosted by surging stock and real estate prices, but an easy policy stance in the early stage of the upswing also contributed. Recent months have seen aggressive monetary tightening, however, as the authorities realised that they had possibly fallen "behind the curve" and that fiscal policy would be less supportive of monetary management in its stabilisation efforts than hoped for. Yet after a significant budget deficit in 2003, the fiscal stance has become restrictive, too. Nevertheless, the envisaged budget surpluses in the next two years (below 1½ per cent of GDP) are only about half those recorded during the overheating episode of the late 1990s, with tax cuts over 2005-07 bringing fiscal tightening nearly to a halt just when the construction projects peak. A better policy mix would be desirable, given the risk of a sharp retrenchment in growth so as to unwind accumulated internal and external disequilibria.

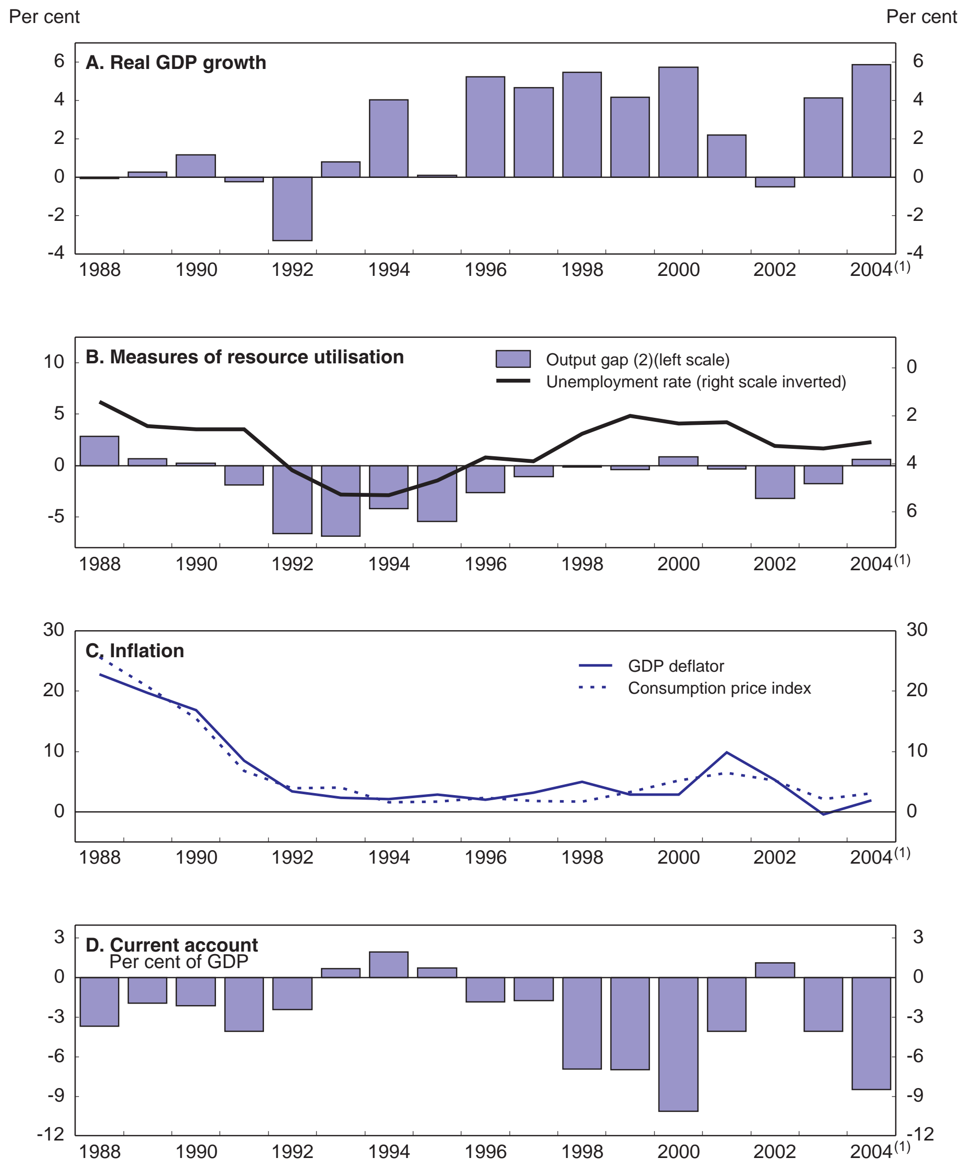
The economic situation and outlook

Current economic developments resemble in many respects those in the previous economic cycle (Figure 2.1). On that occasion, after a period of sluggish growth from the late 1980s to the mid-1990s, economic activity picked up strongly, assisted by a shift in policies toward achieving financial stability and market liberalisation. The expansion in the second half of the 1990s was initially investment-led, with renewed interest in the development of power-intensive industries, but soon became driven by booming household demand. While signs of overheating were increasingly apparent, interest-rate hikes and hesitant fiscal tightening failed to cool down the economy in time to ensure a soft landing. In the event, the currency depreciated sharply in response to a huge external deficit, and domestic demand contracted substantially after several years of rapidly accumulating corporate and household debt. Although further reforms, notably the adoption of an inflation targeting framework, mean that Iceland is now better prepared to face similar challenges, history could repeat itself if the lessons of the last upswing are not properly applied.

Recent developments

Following the downturn in the early part of the current decade, real GDP rebounded briskly in 2003 and gathered considerable momentum in 2004 (Table 2.1). The recovery initially relied solely on domestic sources, with exports contributing significantly to growth only in its second year (see below). With an expansion of around 8%, domestic demand in 2003 already recovered all the ground lost during its contraction over the preceding two years, and this rapid pace has been maintained since then. Business investment led the way, reflecting the beginning of the construction work on the Karahnjukar power plant but

Figure 2.1. **Aggregate economic indicators**



1. OECD projection.
2. Percentage difference between output and estimated potential output.
Source: OECD Economic Outlook 76 database.

also a partly-related improvement in confidence more generally. At the same time, the government launched a series of public works programmes in the run-up to the May 2003 general elections, thereby (temporarily) interrupting the decline in public investment, despite continued retrenchment at the municipal level. Historically low interest rates, the positive effect of falling inflation on real incomes and house price increases at double-digit rates rekindled residential investment, which had continued to expand during the recession. These factors combined with a surging equity market (which has doubled in value over the past year) also underpinned a consumption boom, to a large extent financed by increased borrowing in an increasingly competitive loan market.

Table 2.1. **Demand, output and prices**

Per cent change in volume terms, 1990 prices

	Average 1988-96	Average 1997-2003	2000	2001	2002	2003	2004[1]
Private consumption	0.2	3.7	4.0	–3.8	–1.0	6.6	6.7
Government consumption	2.4	3.9	4.4	3.1	4.2	3.3	2.2
Gross fixed investment	–0.5	5.3	14.8	–7.6	–15.1	17.6	15.7
Residential	–1.1	8.6	15.2	17.8	5.2	13.3	n.a.
Business	0.0	4.6	14.9	–15.1	–22.6	25.9	n.a.
Government	–1.5	3.7	14.0	–1.7	–12.3	–0.4	n.a.
Final domestic demand	0.5	4.1	6.4	–3.4	–3.2	8.1	7.7
Change in stockbuilding[2]	–0.1	–0.1	0.5	–0.9	0.4	–0.1	–0.1
Total domestic demand	0.4	4.0	6.9	–4.2	–2.8	8.0	7.6
Exports of goods and services	2.2	3.8	5.0	7.7	3.6	0.3	7.5
Imports of goods and services	0.5	5.1	8.0	–9.0	–2.5	9.7	11.7
Change in foreign balance[2]	0.6	–0.7	–1.6	6.7	2.3	–3.6	–1.7
GDP	1.0	3.5	5.7	2.2	–0.5	4.3	5.9
GDP deflator	7.0	4.2	2.8	9.9	5.3	–0.3	1.7
Private consumption deflator	7.2	3.5	4.4	8.9	3.7	0.7	2.2

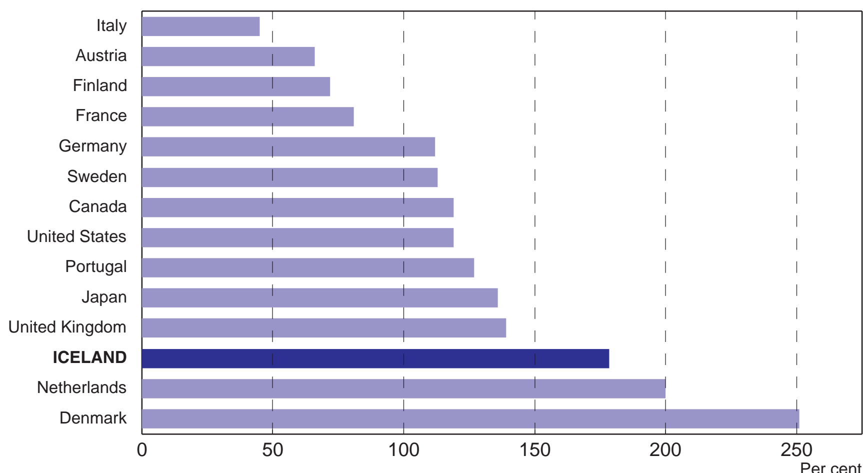
1. First three quarters of 2004 over first three quarters of 2003.
2. As a percentage of GDP in the previous period.

Source: Statistics Iceland and OECD calculations.

Although it has shown continuous increases over almost a quarter of a century, household debt rose exceptionally fast in 2003, reaching around 180% of disposable income at the end of the year. This ratio is one of the highest among OECD countries (Figure 2.2). Its strong rise has meant that household debt service is approaching 40% of disposable income. The high level of owner-occupancy explains Iceland's high debt ratio to some extent: more than 80% of housing is owner-occupied, twice the rate in Germany, for example. This implies that households own considerable assets to sustain their debt. Most

Figure 2.2. **Household debt in selected countries**

Percentage of disposable income, 2003 or latest available year



Source: Central Bank of Iceland, Monetary Bulletin 2004/3.

household equity is held within pension funds, however, and normally cannot be used to pay off arrears. Nonetheless, it is a guarantee for future income flows and allows a higher level of indebtedness, especially for those approaching retirement age. The countries where households are most heavily indebted all have strong pension fund systems. The main risk entailed by aggregate debt accumulation is probably not that large-scale household arrears could end up as loan losses in the financial system but that they increase volatility in the economy (Central Bank, 2004a). Heavy losses are more commonly caused by lending to businesses.[1] However, although a large part of household debt has a very long maturity and is mostly secured with good collateral, according to unofficial sources, personal loans tied to the exchange rate have tripled over the past year, reaching about 10% of all such loans. Hence, if the currency weakens significantly or should real household income drop due to a rise in unemployment or inflation, high debt levels could amplify the resulting contraction in demand.

Household debt accumulation slowed in the first half of 2004, but it has rebounded since the summer, with year-on-year growth back to 14% at the end of September, and innovations in financial markets and proposed changes in housing finance legislation seem likely to stimulate it even further. In particular, the private banks and some pension funds recently began offering favourable housing loans which are not conditional on the purchase of housing, and the government intends to raise the mortgage ceiling for ordinary loans offered by the Housing Financing Fund (see below for more details). These developments are facilitating households' ability to finance consumption by mortgage equity withdrawal. They also raise the risk of future negative net housing equity for recent purchases, given the potential volatility of house prices.

While the surge in activity appears to have eliminated the output gap that opened up in 2001, it is not clear whether labour market slack has already disappeared. Unemployment seems to have fallen little from its cyclical peak of just under 3½ per cent in 2003, remaining above the OECD estimate of the natural rate of 2¾ per cent. Seasonally adjusted registered unemployment has edged up again after an initial decline (Table 2.2). No seasonally adjusted data are available from the quarterly labour market survey since it was introduced only in 2003, but the raw data also show no clear downward trend in unemployment. Available employment data show an extreme case of a "jobless recovery".

Table 2.2. **Labour market indicators**

	2003	2004 Q1	2004 Q2	2004 Q3
Unemployment rate				
Registered	3.4	3.6	3.3	2.8
S.a.	. .	2.9	3.1	3.4
Survey-based	3.4	3.1	4.0	2.6
Employment				
Survey-based	156 900	152 300	158 000	158 100
Y-o-y % change	. .	0.3	–1.1	–2.9
Tax-based	155 680			
Y-o-y % change	–0.2			
Average working hours				
Survey-based	41.8	40.9	42.2	43.7
Y-o-y % change	. .	0.0	0.7	1.9

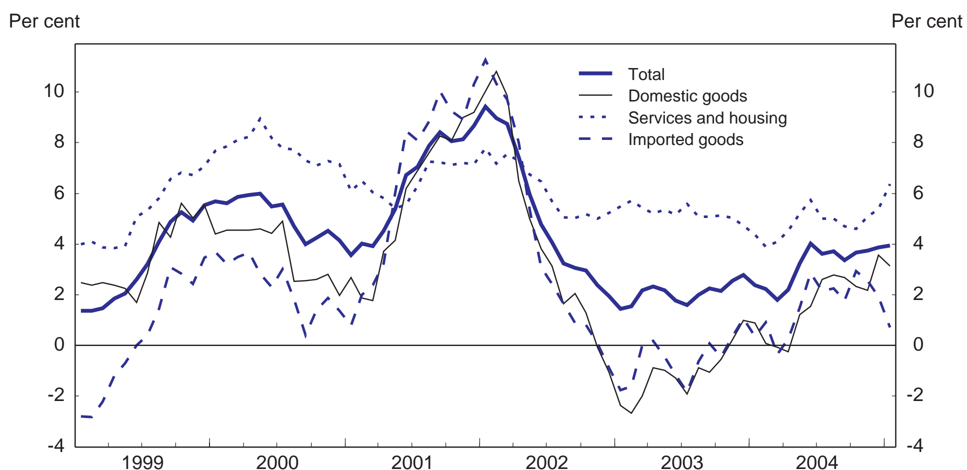
Source: Statistics Iceland.

According to the survey, employment fell significantly below the levels recorded a year earlier in the first three quarters of 2004. At the same time, working hours per employee rose markedly compared to the levels reported 12 months earlier, albeit not sufficiently to offset the drop in the number of people employed. Although the investment projects are capital intensive, these data are difficult to reconcile with output developments (real GDP expanded by 7½ per cent in the year to the third quarter of 2004) and surging job offers (vacancies registered with employment agencies were up by more than 40% year on year over the first ten months of 2004). One explanation of their surprising weakness is that the survey does not account for the increasing number of foreigners working on the large-scale investment projects. Observers have therefore relied on information from tax collection data to assess labour-market conditions. Such information points to an increase in employment in 2004, following a slight decline in the preceding year. Nonetheless, productivity gains appear to have remained robust, although it is difficult to gauge their precise extent.

With moderating nominal wage increases, healthy productivity growth dampening unit labour costs and a strong exchange rate weighing on import prices, inflation remained benign until spring 2004 (Figure 2.3). In the middle of the year, however, the 12-month increase in consumer prices suddenly doubled to just below 4% and has been running in the 3½ to 4% range since. The surge in inflation was due to both cost and demand pressures. The former reflected mainly the rise in oil prices, which account for the bulk of imported inflation. Higher fuel prices pushed up prices for domestic goods, which have closely followed import price developments in recent years. Demand pressures have been felt in the housing market in particular. House prices in the Reykjavik area have been growing at annual rates of 10 to 15% since 2003. The 12-month increase in the housing component of the consumer price index approached 10% in mid-2004 and, after some subsequent slowdown associated with decreasing mortgage interest rates, exceeded this mark most recently. It now accounts for more than one-half of overall inflation while the

Figure 2.3. **Consumer prices**

12-month per cent change



Source: Statistics Iceland and OECD calculations.

contribution of imported goods prices has declined markedly due to a renewed strengthening in the exchange rate.

Stronger growth than abroad and a marked deterioration in Iceland's terms of trade have entailed the re-emergence of a sizeable current account deficit after a temporary surplus during the 2002 recession (Table 2.3). The sharp turnaround in the external balance was amplified by developments in the marine products sector, where both the fish catch and prices declined in the early stages of the recovery, depressing export revenues just when imports were surging. Although increased fishing quotas and rising sales abroad of pharmaceuticals and other manufactured goods lifted exports in 2004, this has not sufficed to arrest the widening in the trade deficit because the torrid growth of imports of consumer and investment goods has shown little sign of tailing off. While the merchandise trade balance accounts for the major part of the deterioration in the current account, the services balance has also moved back into deficit. Services exports have been boosted by a strong performance from the tourism sector, but travel expenditure by Icelanders abroad has also increased considerably. Indeed, a growing share of Icelandic household spending takes place overseas. The traditional deficit on the investment income balance has been curbed by lower debt service costs due to the strength of the krona and lower market interest rates abroad, as well as by the strong rise in reinvested earnings from companies located overseas.[2]

Table 2.3. **Current account**

Per cent of GDP

	1999	2000	2001	2002	2003	2004[1]
Trade balance	**–3.7**	**–5.7**	**–0.8**	**1.8**	**–2.0**	**–4.0**
Merchandise exports f.o.b.	23.9	22.5	26.4	26.2	22.5	23.3
of which:						
Marine products	16.0	14.3	16.4	16.5	14.0	14.0
Aluminium and ferro-silicon	4.2	4.8	6.0	5.6	5.0	5.1
Other industrial products	1.9	2.3	2.6	1.9	2.7	3.2
Merchandise imports f.o.b.	27.5	28.3	27.2	24.4	24.5	27.3
of which:						
Consumption goods[2]	9.6	9.0	8.2	7.6	8.2	8.8
Investment goods	6.8	6.7	6.0	5.0	5.7	6.2
Non-factor services	**–1.1**	**–1.4**	**0.2**	**0.2**	**–1.0**	**–0.6**
Exports	11.0	12.4	14.3	13.4	13.0	14.3
Imports	12.2	13.9	14.1	13.2	13.9	14.9
Factor income, net	**–2.1**	**–2.9**	**–3.4**	**–0.8**	**–2.0**	**–0.9**
Transfers net	**–0.1**	**–0.1**	**–0.1**	**0.2**	**–0.1**	**–0.1**
Current balance	**–7.0**	**–10.1**	**- 4.0**	**1.4**	**–5.0**	**–5.7**
Memorandum items:						
International investment position	–49.4	–63.7	–75.7	–79.0	–69.5	–72.6
Net external debt[3]	68.6	91.2	101.4	101.7	101.2	117.5
External debt position[4]	82.5	102.5	120.2	123.7	143.7	172.0
of which: Long-term debt	67.1	83.6	97.5	94.7	109.2	135.8

1. First three quarters at annual rate, except first ten months at annual rate for the components of merchandise exports.
2. Excluding food and beverages.
3. International investment position excluding net investment in equities.
4. Total debt (total liabilities minus equities).

Source: Central Bank of Iceland, *Monetary Bulletin* and *Economic Indicators*.

Gross external debt has continued to rise rapidly, reaching 172% of GDP at the end of September 2004. The net external debt position (excluding equities), which has been in excess of 100% of GDP since the beginning of the decade, has tended to expand more slowly but has jumped recently largely due to increased foreign debt of the banking sector. By contrast, Iceland's negative international

investment position has actually improved since end-2002, despite the rising current account deficit, owing to exchange rate appreciation and the increased market value of foreign portfolio investments. However, at above 70% of GDP, it still compares unfavourably with most other advanced economies. Credit rating agencies have expressed concern for some while and highlighted the need for Icelandic banks and companies to lengthen their foreign debt maturity structure in order to lessen the risk to the economy in the event of an external shock, and recent developments show a move in this direction.

Prospects

After approaching 6% in 2004, economic growth is projected to average 5% in the next two years, with a marked deceleration towards the end of this period (Table 2.4). This reflects a gradual cooling of household demand, as the assumed substantial rise in interest rates begins to bite, as well as a more pronounced slowdown in investment activity when the mega-projects begin to gear down, although the retrenchment in public investment is likely to come to an end by then. On the other hand, export growth is expected to remain robust, given the projected solid expansion of Iceland's markets abroad and the likelihood of a continued moderate rise in marine exports. With a significant positive output gap projected, inflation is likely to temporarily overshoot 4%, on the assumption of constant exchange rates at early November levels. The current account deficit could approach 12%

Table 2.4. **Short-term projections**

Percentage change, volumes (1990 prices)

	2004	2005	2006
Private consumption	7.3	4.8	4.6
Government consumption	1.9	2.4	2.2
Gross fixed capital formation	16.9	17.7	10.0
Final domestic demand	8.2	7.3	5.5
Change in stockbuilding[1]	0.3	0.0	0.0
Total domestic demand	8.5	7.4	5.5
Exports of goods and services	6.3	5.1	6.8
Imports of goods and services	12.5	11.0	8.1
Change in foreign balance[1]	–2.5	–2.6	–1.0
GDP	**5.9**	**5.2**	**4.8**
GDP implicit price deflator	1.9	3.6	3.2
Consumer price index	3.1	3.9	3.9
Unemployment rate (in per cent)	3.1	2.9	2.6
Current balance[2]	–8.5	–11.0	–11.6
General government financial balance[2]	0.1	1.2	1.0
Short-term interest rate	6.2	8.7	8.8
Long-term interest rate	7.5	9.0	9.0

1. As a percentage of GDP in the previous year.
2. As a percentage of GDP.
Source: OECD Economic Outlook 76.

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of GDP, more than seen even at the end of the last economic boom, even though the deterioration in the real foreign balance is projected to diminish and that in Iceland's terms of trade to come to an end.

Further oil price increases pose a risk to the economic outlook. However, less than a quarter of energy used in Iceland comes from oil (Ministry of Finance, 2004). While higher oil prices have a significant effect on profitability in the fisheries, their estimated impact on output is much smaller than in other countries, given the less widespread use of hydrocarbons for heating and electricity production (Central Bank of Iceland, 2004b). The major risk to the outlook is that budget restraint will be insufficient to prevent severe overheating and the development of a wage/price spiral. According to OECD estimates, fiscal tightening – as measured by the change in the cyclically adjusted primary balance – will decrease to ½ percentage point of GDP in 2005 and go into reverse thereafter. The private-sector multi-year wage settlements concluded in March 2004 contain trigger clauses, whereby they can be revoked (both in late 2005 and again in late 2006) if the premises on which they are based fail to hold. This could happen if inflation deviates from the Central Bank's inflation target (although the required deviation is confidential) or other settlements do not entail broadly the same wage increases (the risk being higher wage increases as the result of current labour conflicts in the public sector, in particular the teachers strike). Such developments would necessitate even higher interest rates, could amplify exchange-rate movements and might ultimately entail another hard landing of the economy.

Monetary management

Guarding against a hard landing will require appropriate macroeconomic policies with monetary policy likely to be severely tested, even though a new policy framework is now in place. Experience with inflation targeting since its inception in 2001 has been largely positive, with 12-month consumer price increases remaining within the Central Bank's tolerance limits since mid-2002. While some modifications to policy implementation might be useful, the major challenge will be to establish the credibility of the framework by a firm response to demand pressures. This is central to anchoring long-term inflation expectations and avoiding the wage/price spirals that have haunted Iceland in the past.

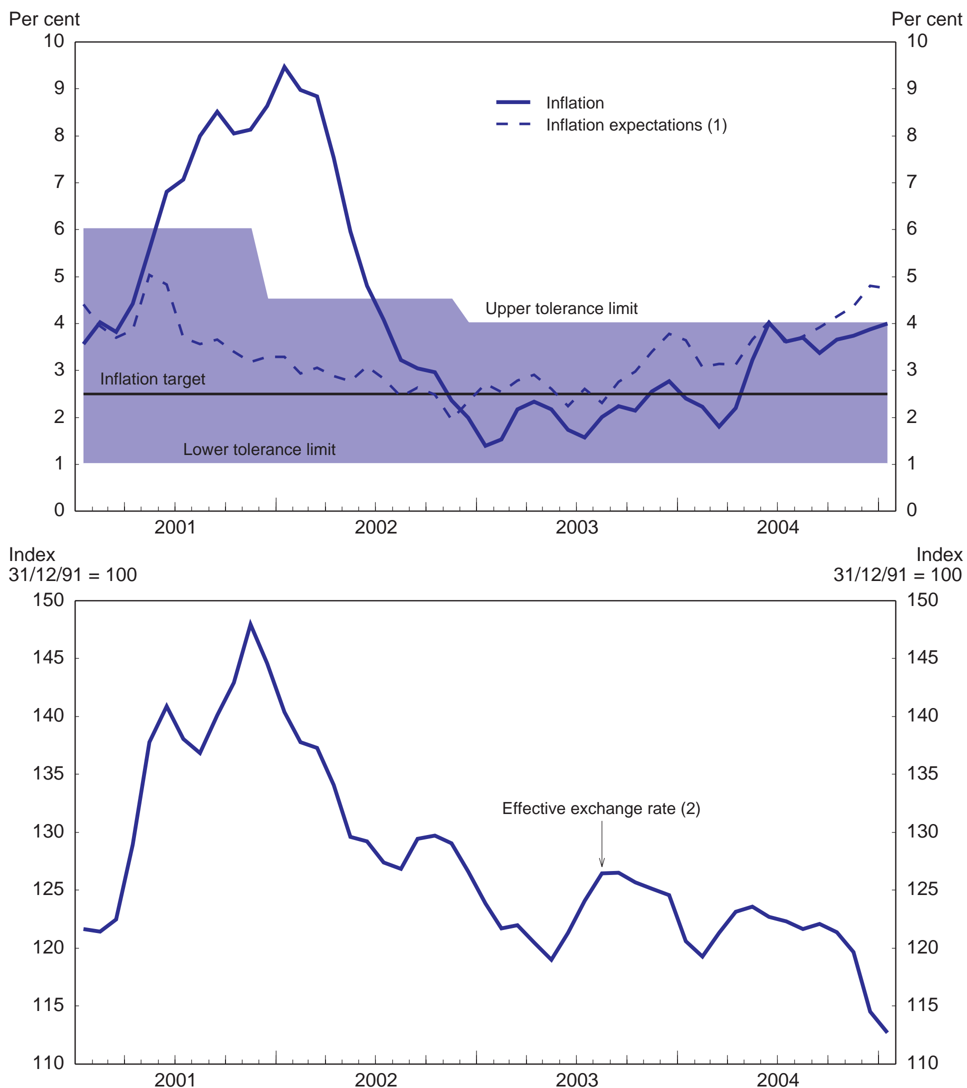
Experience with the new policy framework

Although monetary policy has been oriented towards maintaining low inflation since the early 1990s, the nominal anchor through early 2001 was an exchange-rate target. The adoption of inflation targeting reflected the recognition of the fact that, in an overheating economy with a surging external deficit, maintenance of a nominal exchange-rate target was both incompatible with internal balance and contributing to the mounting burden of foreign-currency-denominated debt (Petursson, 2000). The Central Bank of Iceland's main objective is price stability, defined as a 12-month rise in the consumer price index of 2½ per cent. Its aim is to keep the rate of inflation on average as close to the target as possible. Deviations from the target by more than 1½ percentage points in either direction – before 2003 the band had been wider – oblige the Bank to present the government with a report, which would be made public, explaining the reasons and the Bank's policy response. The Bank's main instrument for attaining the target is the interest rate on its repurchase agreements with credit institutions, but it can also buy or sell currency in the inter-bank market with the aim of influencing the exchange rate and thereby domestic

inflation.[3] The inflation target takes priority over other economic objectives, such as achieving external balance or full employment, which are to be pursued only if they do not conflict with the achievement of price stability.

After an initial burst associated with currency depreciation, inflation receded swiftly in 2002, reflecting high real interest rates helped by recessionary conditions and a renewed strengthening of the exchange rate. Monetary policy then succeeded in stabilising inflation at close to its target level until its recent up-tick (Figure 2.4). On average, other countries adopting an inflation-targeting regime (especially industrial countries) have seen a faster convergence towards their targets (Petursson, 2004). Such countries have in general experienced both lower inflation levels and fluctuations than before, as well as reduced

Figure 2.4. **CPI inflation**



1. Inflation expectations defined as difference between nominal and indexed five-year Treasury bond yields.
2. Increase means depreciation.

Source: Statistics Iceland and Central Bank.

growth variability. This is not yet manifest in Iceland. However, as noted, inflation performance had already improved considerably in the 1990s, and hence the new regime should rather be viewed as a method to institutionalise a previous move towards price stability. Moreover, the time since the introduction of the new framework is too short to draw firm conclusions. A crucial test of its success will be whether it can definitively anchor inflation expectations. The shift to inflation targeting and greater independence for the Central Bank did not immediately confer credibility on the new regime. Inflation expectations initially rose, apparently driven by exchange rate weakness. But they remained below the 6% upper tolerance limit temporarily set for the first year of the regime and started to decline as the Bank maintained a restrictive level of real interest rates and the exchange-rate turned the corner. By late 2002, inflation expectations had fallen to around 2½ per cent, the official target, where they remained until mid-2003. Yet, since then, they have drifted upwards again, with both short- and medium-term expectations (derived from the difference between nominal and indexed bond yields) rising beyond 4%, the Bank's upper tolerance limit. Apparently, agents are not convinced that the Central Bank will be able or willing to achieve inflation outcomes close to the 2½ per cent target.

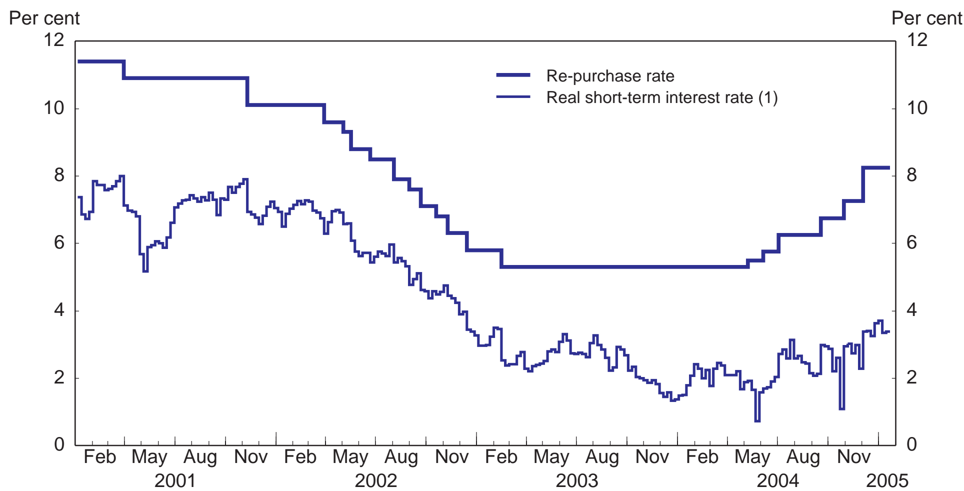
By international comparison, Iceland's inflation target is relatively high and the tolerance band comparatively wide. This seems to be appropriate, given that external shocks can have significant exchange-rate effects that lead to sizeable temporary inflation fluctuations. While others, notably the first inflation-targeting country (New Zealand), have de-emphasised the mid-point, this appears to be premature so long as inflation expectations are not firmly anchored. Iceland is the only inflation targeter that does not schedule regular policy meetings and announce decisions at such times. Without ruling out such an approach in the future, the authorities point out that policy decisions are explained in the Central Bank's Monetary Bulletin. This is a quarterly publication, though, and transparency would be enhanced by holding more frequent pre-announced rate-setting meetings and publishing their minutes, even with a lag. Even a decision to leave interest rates unchanged can be informative, since it is driven by the outlook and has important implications for prices and activity.

Maintaining price stability in the face of strong growth fluctuations

As inflation came down, the Central Bank cut the policy rate gradually through February 2003, when it was set at 5.3%, the lowest level since the mid-1990s. Subsequently monetary policy remained on hold for more than a year. Although the authorities indicated that the large-scale investment projects over the next few years implied that monetary decisions needed to take into account a longer horizon than usual and that it would thus be appropriate for the Central Bank to raise its policy rate even with current inflation below the official target, they hesitated in the light of benign inflation outcomes that bettered expectations. Moreover, it was not before spring 2004 that the strength of the economic recovery in the year before became clear, implying that the output gap would be closed earlier than expected. With increasing signs of inflation pressures and revised projections indicating that inflation would not only surge in the short run but exceed the official target over the entire two-year forecast horizon, the Central Bank finally began to lift its policy rate in May (Figure 2.5).

At first, interest rates were raised very gradually, as the authorities considered that, although core inflation had also increased, a considerable part of the rise in overall inflation was attributable to (temporarily) surging oil and commodity prices in world

Figure 2.5. **Central bank's policy rate**



1. Defined as re-purchase rate minus inflation expectations from five-year Treasury bonds.
Source: Central Bank of Iceland.

markets, which did not warrant the same response. Subsequently, however, the Bank moved to boost the policy rate more aggressively, at first in 50 basis-point steps and then by 100 basis points in early December. This was motivated by several developments. *First*, rising inflation expectations following unexpectedly fast demand growth limited the rise in *real* interest rates. *Second*, developments in financial markets, which brought about a considerable reduction in mortgage interest rates, counteracted the Central Bank's tightening moves (see Box 2.1). *Finally*, the Bank considered that a tighter fiscal stance would have been desirable in the budget proposal for 2005 and the associated medium-term fiscal programme (see below), so that a strong monetary policy response was unavoidable. Altogether, the policy interest rate has been raised by almost 3 percentage points so far, but further hikes will be needed to bring both inflation and inflation expectations back to the target over the medium term. Real official rates remain at levels that are probably only mildly restrictive and only half of what was seen leading up to the last overheating episode. Although increases in inflation arising from temporary shocks such as oil price surges call for a measured monetary policy reaction, focused on ensuring that second-round effects do not ensue, mounting domestic demand pressures require a persistently vigorous response.[4]

The fiscal stance

Iceland's fiscal position is sound. Fiscal consolidation in the 1990s re-established broad budget balance. As a result, the public-debt-to-GDP ratio has declined to low levels by international comparison, and Iceland is well prepared to face demographic pressures, which are relatively benign, the more so since the pension system (based on compulsory fully-funded defined-contribution private schemes) limits their impact on government budgets. No recent generational accounts are available, but earlier studies also concluded that Iceland's public finances were in good shape (Benediktsson *et al.*, 2000). However, rapid expenditure growth associated with deviations from budgeted levels was only temporarily halted in the mid-1990s so that public spending approached half of GDP subsequently,

Box 2.1. **Housing finance**

Until recently, the vast majority of residential mortgage lending was done by the state-owned Housing Financing Fund (HFF), whereas commercial banks were largely absent from the mortgage market. The situation has changed dramatically since August 2004, when the banks began offering primary mortgages. Their decision to enter the market and offer mortgage loans at interest rates below the HFF rate (which was subsequently adjusted) seems to have been a consequence of changes in the HFF's refinancing operations, allowing them to exploit a widening of the HFF's margins (and possibly their access to capital at lower cost). Following the government's notification to the EFTA Surveillance Authority (ESA) of its planned changes to the operating conditions for the HFF, the Bankers' and Securities Dealers' Association of Iceland lodged a complaint with the ESA, alleging that the changes violated EEA rules on state aid. In early August, the ESA ruled that the changes, which had taken effect at the beginning of July, were permitted under the provisions of the EEA agreement. Two weeks later, the first commercial bank decided to offer mortgage loans at a rate below that offered at the time by the HFF, and within a day the other two major banks followed. The commercial banks extended about ISK 11 billion in mortgage loans in September and about ISK 20 billion more in October. This compares with the total volume of new housing loans in 2003 of ISK 50 billion and the HFF's volume of housing loans outstanding at the end of 2002 of ISK 388 billion. It appears that so far a large proportion of these loans has been used by households to refinance existing mortgages, judging from pre-payments of HFF mortgages relative to mortgage lending by the commercial banks. It is uncertain how much of the interest saving will be used for spending (renovations, non-housing consumption) and how much to build assets.

One key difference between the HFF's mortgage loans and those of the commercial banks is that the HFF extends loans only to a maximum amount, whereas there is no ceiling on commercial banks' mortgage loans. This amount was ISK 11½ million ($173 000 at the current exchange rate) until the end of 2004, having been raised over the past year from ISK 8 million for the secondary market and ISK 9 million for new housing. With house prices in the Reykjavik area rising rapidly in recent years, many single-family units are more than twice as expensive as the HFF's current ceiling. The HFF also applies a maximum loan-to-value (LTV) ratio, which was 70% of the purchase price for first-time home buyers and 65% for other purchases, except in the case of social housing where the maximum LTV ratio was 90%. By contrast, the commercial banks initially lent up to 80% of the purchase price, a ratio that was recently raised to 100%. When the government notified the ESA about its intended changes to the operating conditions of the HFF, it also asked for approval to increase the maximum LTV ratio on all HFF loans to 90%, which was given by the ESA. This change was implemented at the beginning of 2005, together with an increase in the maximum loan amount to ISK 15 billion. These moves are likely to exacerbate the already heavy demand pressure on the housing market in the Reykjavik area and would thus further complicate the Central Bank's efforts to prevent the economy from overheating. Given the prospect that commercial banks will capture a large share of the residential mortgage market, public discussions are taking place on how to re-define the HFF's role, possibly as a mortgage lender to low-income households and those in remote locations who are likely to be underserved by commercial banks.

meaning that both the use of fiscal policy for stabilisation purposes is impaired and the tax burden has moved above the OECD average. This creates a dilemma because tax reductions in Iceland are in principle desirable and affordable in the long run but at variance with demand management requirements in the next few years.

Reinforcing expenditure control

Despite significant reforms since the early 1990s – notably the introduction of "frame budgeting" (that is, setting expenditure ceilings) – recurrent overruns of spending targets have remained a problem. Although the "frame method" has improved planning and decision-making during the budget formulation phase, its effectiveness has been undermined by several factors. *First*, control over expenditure targets has been eroded by the fact that expenditure targets have tended to be modified during the parliamentary phase of the budget process, with the bulk of the changes at this stage being initiated by the government itself. During 1998-2003, voted central government expenditure surpassed the level of initial budget proposals by about 2% on average. This problem has been addressed by changes to Parliamentary procedures and, as a result, this gap was less than 1% in 2004-2005. *Second*, the execution of the voted budget has compounded this loosening. During 1998-2003, central government spending exceeded budgeted levels by around 11% on average, with no clear improvement over time (Table 2.5). If estimated pension liabilities and lost tax claims, items that arguably are not relevant to budget implementation, are excluded, this percentage is halved but still substantial. In a recent report, the National Audit Office was highly critical of budget implementation, noting that from 1999 to 2002 revenues bettered budget forecasts cumulatively by ISK 38 billion (representing 5% of GDP

Table 2.5. **Proposed, voted and realised central government spending**

	ISK billion					Per cent	
	Budget bill	Voted budget	Outcome	Difference	Difference	Budget bill	Voted budget
	(A)	(B)	(C)	B-A	C-B	(A)	(B)
A. Accruals basis							
1998	163.0	165.7	189.6	2.7	24.0	1.7	14.5
1999	179.2	182.4	199.0	3.2	16.6	1.8	9.1
2000	190.0	193.2	229.0	3.2	35.9	1.7	18.6
2001	210.0	219.2	228.7	9.2	9.5	4.4	4.4
2002	239.3	239.4	267.3	0.1	27.6	0.0	11.7
2003	253.3	260.1[1]	280.0	6.8	20.6[2]	2.7	7.9[3]
2004	273.0	275.3	284.6[4]	2.3	–	0.8	–
B. Accruals basis, excluding pension liabilities and lost tax claims							
1998	155.3	159.3	164.1	4.0	4.8	2.6	3.0
1999	167.4	170.6	181.6	3.2	11.0	1.9	6.4
2000	179.4	183.1	192.8	3.7	9.7	2.1	5.3
2001	199.5	208.6	220.2	9.2	11.6	4.6	5.5
2002	229.1	230.6	241.0	1.5	10.4	0.7	4.5
2003	244.5	251.6	265.7	7.1	14.1	2.9	5.6
2004	264.3	266.6	–	2.3	–	0.9	–

1. 264.8 including March supplementary budget.
2. 15.2 from March supplementary budget.
3. 5.7 from March supplementary budget.
4. Estimate.

Source: Ministry of Finance.

in 2002), since GDP growth was much higher than assumed, but that more than double that amount was used for extra spending (Rikisendurskodun, 2004). At year-end 2003, 108 of the 530 central government budget line items had accumulated a deficit overstepping the 4% reference limit, which is stipulated by the Regulation on the Implementation of the Government Budget. Although this is a lower proportion than in the late 1990s, the Office observed that many ministries and public bodies have even far outspent their budgets year after year, a practice it found unacceptable, as it both violates existing regulations and undermines stated government objectives. The government is aiming to reduce budget overruns by changes to the mentioned Regulation. An issue that needs to be addressed is the fact that public managers can withdraw funds from the Treasury in excess of budgets without any penalty and have insufficient incentives to keep expenditures within budgeted amounts.

Developments in 2003, an election year, are a vivid and extreme example of these problems. Not only were expenditures raised significantly in the voted budget as compared to the budget proposal, but they were then increased in a supplementary budget in March and rose further due to spending overruns. Altogether, the level of central government expenditure in 2003 outstripped the initial budget proposal by 10½ per cent (8½ per cent excluding pension liabilities and lost tax claims), with "fiscal slippage" in a narrower sense contributing more than one-half (that is, not counting the changes to spending targets made in the voted budget and the March 2003 supplementary budget). The March supplementary budget brought forward public investments (mainly road building) to 2003-04 from the two subsequent years. It was justified by the fragility of the incipient recovery and the healthy long-term condition of public finances, in spite of the risks that the resulting construction activity would overlap with the gearing-up of the power-intensive projects. Deviations from the March supplementary budget reflected, as usual, public-sector wages, but above all transfer payments. Despite higher-than projected revenues (partly reflecting privatisation receipts), substantial spending overruns meant that the central government budget moved into deficit in 2003, instead of remaining in comfortable surplus, as initially envisaged (Table 2.6). The budget for 2004 aimed at reversing this fiscal loosening, in

Table 2.6. **Central government budget**

ISK billion

	2003	2003	2004	2004	2005	2005
	Budget	Outcome	Budget	Estimate	Budget proposal	Budget
Current expenditure	114.1	110.1[1]	126.1	129.1	137.7	137.8
Transfer payments	106.5	128.8[1]	113.8	120.1	122.3	123.7
Interest payments	15.5	15.3	15.1	15.1	15.5	15.5
Capital expenditure	24.0	25.9	20.2	20.2	19.1	19.4
Total expenditure	260.1	280.0	275.3	284.6	294.6	296.4
Tax revenue	237.0	238.9	254.6	265.4	280.6	281.2
Other revenue	34.6	35.0	27.4	25.9	25.2	25.2
Total revenue	271.6	273.9	282.0	291.3	305.8	306.4
Budget balance	11.5	–6.1	6.7	6.7	11.2	10.0
Per cent of GDP	1.4	–0.8	0.8	0.8	1.2	1.0
Memorandum item:						
Revenue from asset sales	10.3	12.0	0.5	0.5	0.5	0.5

1. Current expenditure is understated by ISK 4 billion and transfer payments are overstated by the same amount due to changes in the presentation of some payments.

Source: Ministry of Finance.

Table 2.7. **General government fiscal situation**[1]

Per cent of GDP

	1998	1999	2000	2001	2002	2003	2004[2]
Revenues	42.9	45.9	45.6	44.3	45.3	46.3	46.2
Expenditures	42.4	43.5	43.1	44.1	45.8	48.0	46.0
Financial balance	0.5	2.4	2.5	0.2	–0.4	–1.6	0.1
Structural balance[3]	0.6	2.6	2.2	0.3	0.9	–0.8	–0.1
Structural primary balance[3]	2.1	4.0	3.3	1.4	0.6	–0.4	0.5
Net debt	31.7	24.1	24.0	26.9	23.4	23.4	22.7
Gross debt	49.3	44.5	41.9	47.4	43.6	41.4	37.1
Memorandum items:							
Central government							
Financial balance	1.1	2.6	2.6	0.6	–0.6	–1.8	. .
Net debt	26.5	19.4	19.2	22.9	19.1	19.2	. .
Gross debt	41.5	36.1	33.7	38.3	35.6	33.6	. .
Local government							
Financial balance	–0.7	–0.5	–0.4	–0.5	0.2	0.2	. .
Net debt	5.3	4.7	4.6	4.1	4.2	3.8	. .
Gross debt	7.6	7.6	7.5	7.6	7.7	7.4	. .

1. National accounts basis.
2. OECD projections.
3. Per cent of potential GDP.

Source: *OECD Economic Outlook 76*; Ministry of Finance; Central Bank of Iceland; Statistics Iceland.

recognition of the need for restraining domestic demand. Latest estimates indicate that central government finances have indeed moved back into surplus. However, this is attributable to substantially higher tax revenues than anticipated, thanks to real GDP growth that is likely to have beaten the 3½ per cent budget estimate by more than 2 percentage points. While capital expenditure appears to have declined substantially, as planned, expenditure restraint in other areas again seems to have fallen short of intentions, with transfer payments and current expenditure overshooting budgeted levels by 5 and 2½ percentage points, respectively, according to latest estimates.

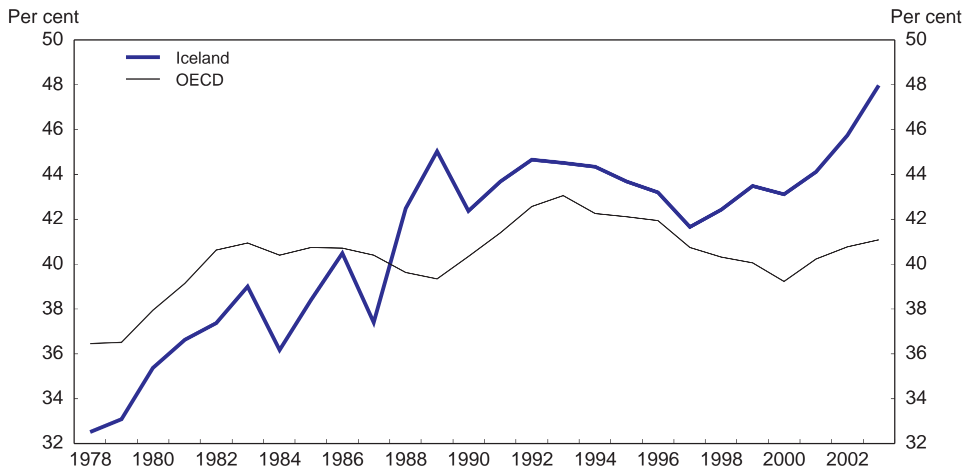
Developments in general government finances in recent years have been dominated by movements at the central government level (Table 2.7). The local government sector, which had been in a deficit position since the early 1990s, moved to budget balance in 2002 and appears to have realised a slight surplus since then. This reflected both higher central-government appropriations to the Local Authority Equalisation fund and the freedom given to municipalities to raise their income tax rates (to just over 13%). Spending has been growing much less than at the central level. Indeed, municipalities' expenditure-to-GDP ratio remained broadly stable in 2003, while that of the central government jumped by almost 2 percentage points, lifting the general government expenditure-to-GDP ratio to a record level of 48%. Over the quarter century to 2003, the ratio rose by 16 percentage points, while it increased by only about 4 points in the OECD area (Figure 2.6). Indeed, the rise was the second largest of the 21 OECD countries for which data are available.

Facilitating the central bank's stabilisation task by appropriate demand management

The government's draft budget for 2005 and its medium-term fiscal programme call for surpluses over the next two years. However, at somewhat above 1% of GDP, the projected surpluses for the entire government sector (on a national accounts basis) will be

Figure 2.6. **Public expenditure**

Per cent of GDP



Source: OECD Economic Outlook 76 database.

about 1½ percentage points lower than those achieved in the overheating episode of the late 1990s. The contrast is particularly pronounced in terms of the cyclically adjusted primary surplus, which rose by 2 percentage points of GDP in 1999 to reach 4%, while it is now estimated to increase by ½ percentage point in 2005, to around 1% of GDP, before edging down. This reflects tax cuts over 2005-07 which, though back-loaded, will bring fiscal tightening to a halt, despite continued planned restraint on current spending.

The current outlook argues for a tighter fiscal stance than envisaged in the budget proposal. Instead, in light of past experience, there is a risk of fiscal slippage, which needs to be avoided by decisive measures and stricter implementation than hitherto. Recent initiatives should be helpful in this respect. In addition to those mentioned above, beginning with the 2004 budget, the government began publishing a medium-term fiscal programme. The role of medium-term projections, which had existed before, was reinforced by the fact that the government passed a formal resolution on a programme for the years 2004-07, based on its post-election Policy Statement for its parliamentary term. This initiative is welcome, as it enhances transparency, but there is room for the government to strengthen its medium-term fiscal strategy by increasing enforceability. But, while avoiding expenditure overruns is crucial, consideration should be given to going beyond that and further increasing spending restraint in 2005 and 2006, for instance by delaying investments. It is therefore regrettable that the revised medium-term programme increases funding for public investment in 2005. Although this is to be compensated by savings in other areas – through cost-efficiency demands upon government agencies – it risks adding to the pressures emanating from private demand.

But expenditure measures alone will probably not be sufficient to achieve an appropriate fiscal stance. Fiscal tightening thus also needs to come from the revenue side. The government's tax reduction programme, voted in December 2004, extends primarily to reductions in the personal income tax, the abolition of the net wealth tax and an increase in child benefits. The cut in the personal income tax takes place in three stages from 2005 to 2007. The abolition of the net wealth tax on individuals and companies will be

implemented in 2006 (together with the complete elimination of the personal income surtax, which was decided already in 2003). The rise in child benefits is scheduled for 2006 and 2007. Abstracting from the current macroeconomic situation, the announced tax measures would be welcome. Latest international comparisons show that Iceland's tax burden moved above the OECD average in the second half of the 1990s and that action in recent years has only temporarily interrupted its upward trend (Table 2.8). However, in the current economic context, the tax cuts are ill-timed and should at least be accompanied by other measures, such as cuts in tax expenditures favouring the housing sector, and the development of a more comprehensive tax reform programme with a structural policy

Table 2.8. **Total tax revenue**

Percentage of GDP

	1975	1985	1990	1995	2000	2001	2002	2003 Provisional
Canada	31.9	32.5	35.9	35.6	35.6	35.0	33.9	33.9
Mexico	n.a.	17.0	17.3	16.7	18.5	18.8	18.1	19.5
United States	25.6	25.6	27.3	27.9	29.9	28.9	26.4	25.4
Australia	26.5	29.1	29.3	29.6	31.8	30.4	31.5	n.a.
Japan	20.8	27.4	30.2	27.8	27.1	27.4	25.8	n.a.
Korea	14.5	16.0	18.1	19.4	23.6	24.1	24.4	25.5
New Zealand	28.5	31.3	37.7	37.0	33.4	33.3	34.9	34.8
Austria	37.4	41.9	40.4	41.6	43.4	45.2	44.0	43.0
Belgium	40.6	45.6	43.2	44.8	45.7	45.9	46.4	45.8
Czech Republic	n.a.	n.a.	n.a.	39.8	39.0	38.5	39.3	39.9
Denmark	40.0	47.4	47.1	49.4	49.6	49.9	48.9	49.0
Finland	36.8	40.2	44.3	46.0	48.0	46.0	45.9	44.9
France	35.9	43.8	43.0	43.9	45.2	44.9	44.0	44.2
Germany[1]	35.3	37.2	35.7	38.2	37.8	36.8	36.0	36.2
Greece	21.8	28.6	29.3	32.4	38.2	36.6	35.9	n.a.
Hungary	n.a.	n.a.	n.a.	42.4	39.0	39.0	38.3	n.a.
Iceland	**29.7**	**28.5**	**31.5**	**31.8**	**39.4**	**38.1**	**38.1**	**40.3**
Ireland	29.1	35.0	33.5	32.8	32.2	30.1	28.4	30.0
Italy	26.1	34.4	38.9	41.2	43.2	43.0	42.6	43.4
Luxembourg	37.5	45.1	40.8	42.3	40.2	40.7	41.8	41.6
Netherlands	41.3	42.8	42.9	41.9	41.2	39.8	39.2	38.8
Norway	39.3	43.1	41.5	41.1	43.2	43.4	43.5	43.9
Poland	n.a.	n.a.	n.a.	37.0	32.5	31.9	32.6	n.a.
Portugal	20.8	26.6	29.2	33.6	36.4	35.6	33.9	n.a.
Slovak Republic	n.a.	n.a.	n.a.	n.a.	34.0	31.6	33.1	n.a.
Spain	18.8	27.8	33.2	32.8	35.2	35.0	35.6	35.8
Sweden	42.0	48.2	53.2	48.5	53.8	51.9	50.2	50.8
Switzerland[2]	27.0	25.8	26.0	27.8	30.5	30.0	30.3	29.8
Turkey	16.0	15.4	20.0	22.6	32.3	35.1	31.1	32.9
United Kingdom	35.3	37.7	36.5	35.0	37.4	37.2	35.8	35.3
Unweighted average:								
OECD Total	**30.3**	**33.6**	**34.8**	**35.9**	**37.2**	**36.8**	**36.3**	–
OECD Europe	32.1	36.6	37.4	38.5	39.9	39.4	38.9	–
EU 15	**33.2**	**38.8**	**39.4**	**40.3**	**41.8**	**41.2**	**40.6**	–

1. Unified Germany beginning in 1991. Starting in 2001, Germany has revised its treatment of non-wastable tax credits in the reporting of revenues to bring it into line with the OECD guidelines.
2. The source for the 1975 figure is Swiss authorities, due to a change in the methodology which is only implemented in OECD Revenue Statistics from 1985 onwards.

Source: OECD Revenue Statistics 1965-2003 and Swiss authorities.

focus, which should include the expansion of user fees and co-payments to enhance the overall efficiency of the public sector.

Corporate taxation has been reduced substantially and is now among the lowest in Europe. By contrast, personal income taxation is still relatively high, although over the past decade or so the central government has pursued a policy of gradually reducing its standard marginal tax rate. This is because these cuts have been offset to a large extent by the increasing revenue needs of the municipalities, which were repeatedly authorised to raise their tax rates to improve their financial position. The combination of a uniform basic tax credit, which has fallen in value over time, and a high standard income tax rate has resulted in increasing average tax rates. Moreover, the relative simplicity of the Icelandic regime is partly offset by the existence of two benefits that are paid through the tax system – the child benefit and the mortgage interest rebate – which entail a steep rise in the marginal effective tax rate when they are phased out with rising income or net worth. Although the recent reform of the child benefit system has addressed this problem, the marginal tax rate schedule is still very erratic. The tax credit for mortgage interest payments has been reduced somewhat, but this process should be accelerated and the tax credit removed. The benefit tilts incentives toward home ownership and high household indebtedness and biases investment decisions away from productivity-enhancing business capital spending.

Notes

1. The risk is especially acute when lending is denominated in foreign currency (at lower interest rates), even though the borrower has no foreign-currency revenues. Such lending accounts for 20 to 30% of all foreign currency lending. Foreign currency lending in October 2004 was ISK 232 billion, equivalent to 19% of total credit and about 25% of GDP.
2. Recent large-scale foreign investment by Icelandic residents has meant that direct investment overseas has reached around 25% of GDP and accounts for almost one-quarter of foreign assets.
3. Over 2003-04, the Central Bank bought foreign currency on a regular basis to build reserves. At the time of the latest interest rate increase in early December, the Bank announced that it would discontinue such purchases at the end of the year.
4. Private-sector forecasters have recently adjusted their predictions up to a peak of 10% for the repurchase rate and warned of the need to reach that point fairly quickly so as to head off much higher inflation.

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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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