Policy Brief

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Economic Survey of Iceland, 1999

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Summary

The Icelandic economy has expanded rapidly over the past five years, bringing output to well above its potential. Clear signs of overheating have emerged, with unemployment below 2 per cent, inflation picking up and a large current external deficit. These developments are projected to continue, raising the risks of a wage-price spiral and financial instability. To guard against such risks, a significant tightening of monetary policy is required, with less priority attached to the exchange rate as a target for policy. This should be complemented by a medium-term fiscal discipline aiming at achieving a structural budget surplus. Such a course would help cope with long-term care spending that will rise with ageing. On the other hand, except for government employees, pensions should not constitute a burden for public finances, as, for the main, they will be provided by the private sector. To enhance future growth prospects, it will be important to maintain and extend the fishing quota regime in the face of legal threats and to increase competitive forces, especially in the telecommunications industry. ■

This Policy Brief presents the assessment and recommendations of the 1999 OECD Economic Survey of Iceland. The Economic and Development Review Committee, which is made up of the 29 Member countries and the European Commission, is responsible for these Surveys. The starting point for the Survey is a draft prepared by the Economics Department, which is then modified following the Committee's discussions and issued under the responsibility of the Committee.

Organisation for Economic Co-operation and Development

What risks does Iceland's strong economy present?

Iceland's growth performance since 1994 has been one of the best in the OECD area, averaging 4½ per cent in real terms. In 1999, output should expand even faster, by around 6 per cent. The nature of the boom has changed in the past eighteen months, however, in a way that makes it less sustainable. The principal element feeding demand now is private consumption that, in the last two years, has increased at an annual average rate of close to 8½ per cent. Such a surge has followed generous three-year wage settlements, strong employment growth, tax cuts and buoyant borrowing. At the same time investment has remained flat, following the completion of large-scale projects, thereby slowing the growth in capacity. As a result, according to Secretariat estimates, the current pace of expansion is exceeding potential output growth by at least 3 percentage points.

Such developments have brought clear signs of overheating in the economy. The labour market has become extremely tight, with unemployment moving below 2 per cent recently and wages rising rapidly. Another indication of the pressure on resources has been the persistent current account deficit that, while expected to narrow in 1999 to around 4½ per cent of GDP, is still well above historical averages. These tensions already produced an upsurge in the growth of the GDP deflator to 5 per cent in 1998, even though consumer price increases were held back by the appreciation of the currency and weak world prices. Now that the latter factor has been reversed consumer price inflation has started to rise. Its expected increase in 1999, at close to 5 per cent, seems likely to be double the Central Bank's initial estimate, bringing a surge in financial markets' expectations of medium-term inflation.

Looking forward through 2000, the prospect is for some slackening in the pace of expansion. Public sector demand is likely to fall, following delays in investment projects announced in the budget for 2000. On the other hand, consumers are now benefiting from a pickup in the prices of houses that make up more than two-thirds of marketable household wealth. This is projected to lead to further increases in household indebtedness and falls in the savings ratio. While the prospects for nominal disposable income growth are uncertain, as the new wage contracts that will start in 2000 have not yet been negotiated, the continued low level of unemployment should ensure that pressures for real wage increases remain high. The strength of retail sales should sustain commercial investment. Overall, GDP growth seems likely to remain close to 3 per cent in 2000, perhaps bringing a slight increase in unemployment towards 2 per cent. As the growth of domestic demand slackens, the current account deficit should stabilise, but might still be above 4 per cent of GDP. Moreover, with the level of output remaining well above potential, consumer prices are projected to continue to rise rapidly in the next two years, though, if maintained, the renewed appreciation of the currency may help limit the extent of the increase.

The combination of strong output growth, low unemployment and wage pressure could make for a markedly worse inflation outcome than projected. As noted, the immediate outlook is already for faster price increases, but if the forthcoming wage settlements are made over an extended period of time, during which inflation expectations are ratcheting up, there is the risk that a wage-price spiral could develop. This risk is accentuated by the fact that bank credit is growing very fast, fuelled by foreign borrowing, so pushing up asset prices. Moreover, the money stock is currently expanding at a pace not seen since the introduction of the inflation stabilisation programme in 1990. Under such conditions, if confidence in the economy were to weaken, downward pressure on the exchange rate could emerge, which might adversely affect bank balance sheets and, in turn, private investment. In order to guard against such a risk of financial instability, the authorities have already pushed the banks to take steps to improve their overall liquidity, and further action is being considered, focusing on the maturity structure of assets and liabilities of the banking system. ■

Should monetary policy be tightened?

As the limits of non-inflationary growth seem to have been reached, a significant tightening of monetary policy is needed to preserve the notable progress in disinflation achieved this decade. Since the end of 1997, the authorities have raised interest rates five times, by a total of 210 basis points to 9 per cent in September 1999. Nonetheless, given the rise in inflation expectations, real short-term interest rates are only slightly higher than at the end of 1997 when the economy was broadly in equilibrium. Since the magnitude of the restriction so far has proved insufficient to prevent economic overheating from building up, additional monetary restraint is therefore required before confidence deteriorates. Such a move would help avoid a further pickup in inflation by sending, in advance of the new wage agreements, a clear message to financial markets and the social partners that the monetary authorities are determined to maintain stable prices in the future.

Aggregate economic indicators

1. Projected based on available data.
2. Percentage difference between output and estimated potential output.

Source: OECD.

Focusing on inflation control requires giving less priority to exchange rate stability, which, in current circumstances, could imply leaving the exchange rate to appreciate in the period ahead. Indeed following the last increase in official rates and the subsequent tightening in money markets, the exchange rate has appreciated to within 2 per cent of the upper limits of its target range. A flexible approach to exchange rate policy would seem to be consistent with the fundamental characteristics of the Icelandic economy which is subject to important supply shocks, as a result of its dependence on fish and energy-intensive products. These shocks are markedly different from those facing its trading partners. While such disturbances could be overcome with increased labour mobility and real wage flexibility, this may be difficult to achieve if past downward rigidity of nominal wages persists. Greater exchange rate flexibility would not only provide a means for ensuring stabilisation of the domestic economy in the short run, but it would also help cope with increased capital mobility in the context of the ongoing financial liberalisation.

It would therefore seem appropriate to consider an alternative to the exchange rate as an anchor for monetary policy. The money stock could be one such anchor as the demand for money has been stable over the past decade. However, in the future, continuing financial deregulation could result in fluctuations in the behaviour of money aggregates. This points instead to targeting inflation in the conduct of monetary policy. Experience in other countries in this regard would suggest setting a time frame of between two and three years to achieve such a target, in order to avoid excessive short-term output fluctuations, especially as import prices have a significant direct impact on consumer price inflation in Iceland. It also suggests that the Central Bank would need to have a large degree of autonomy for setting interest rates, subject to transparently explaining its decisions to the public and the markets. ■

What about fiscal policy?

Public finances have benefited from the expansionary environment, although not as much as might have been expected. In the past four years, they have improved substantially with the general government budget balance moving from a deficit of 4¾ per cent of GDP in 1994 to a surplus of around 1 per cent of GDP in 1998 -- a move that is projected to continue in 1999. The fall in public debt may be even greater than suggested by the budget surplus, thanks to privatisation receipts, with net and gross debt projected to drop by 10 and 17 percentage points of GDP between 1994 and 1999, respectively, to reach 27 and 40 per cent of GDP. However, despite the fiscal "bonus" generated by rapid economic growth, recent stimulatory policy measures have limited the extent of these budgetary improvements. In 1999, tax cuts and expenditure increases resulted in a slight worsening in the structural budget balance of around ¼ per cent of GDP, a not uncommon experience during upswings. Moreover, the structural deficit would be slightly greater if the increase in civil service pension liabilities were taken into account.

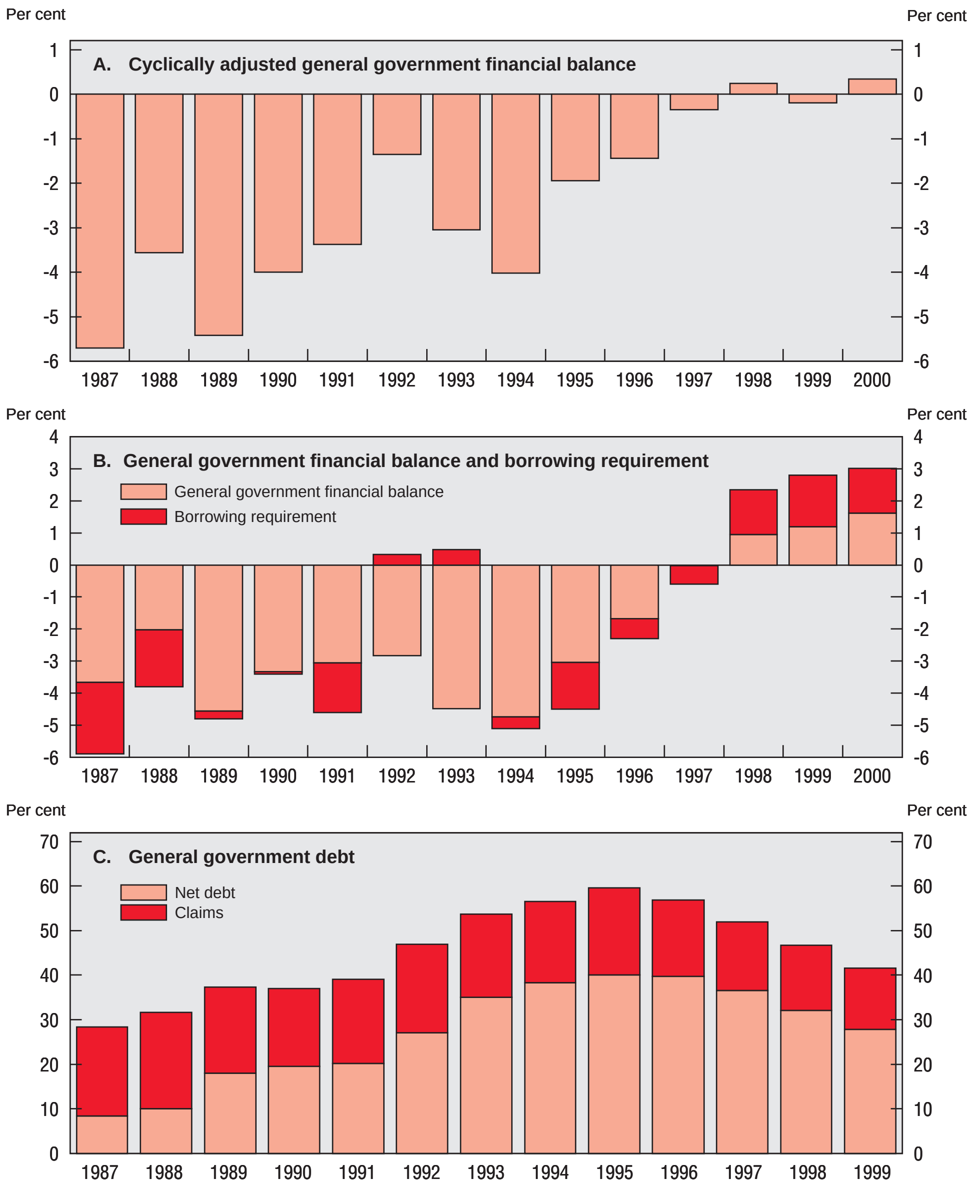
Compensating for these developments, the draft 2000 central government budget envisages limiting the growth of expenditure in order to achieve a budget surplus of the order of 1 per cent of GDP on a structural (i.e. cyclical adjusted) basis. In particular, the government will restrain the growth of income-support programmes and tighten the controls over government agencies in order to ensure that they stick to agreed budgets. Moreover, a significant portion of investment projects will be delayed, while public sector wages will be reined back, after the large increases of the past two years. The resulting decline in government indebtedness will be accentuated by the proceeds from privatisation. Building on such a course, fiscal stability would be best served by the introduction of a medium-term plan that aims for a continued central government structural budget surplus. Such a plan would provide the resources for meeting the unfunded pension liabilities for existing government employees, that have accumulated in the past. It would also help to reduce pressure for spending at the wrong time and better limit commitments being taken in one year that have their full budgetary consequences only subsequently. ■

How will population ageing affect Iceland?

Sound public finances should allow private saving and capital inflows to be used productively, so helping to maintain growth in the face of an ageing population. However, Iceland will need to transfer fewer resources to the elderly than other European countries. Among people aged between 65 and 74, fully 40 per cent are economically active. In addition, although the proportion of elderly in the population is likely to increase at a similar pace to other countries, the working population is not expected to fall as the birth rate has stayed close to its replacement level.

Furthermore, the future path of public finances should be largely insulated from the consequences of increasing social security pension payments thanks to a decision taken in 1969 by the social partners to set up private pension funds. This system, which has become mandatory, now covers all workers including the self-employed. By 1998, private funds operating under this scheme had accumulated assets amounting to 69 per cent of GDP and these

Fiscal indicators
Per cent of GDP



Source: *Statistical Yearbook of Iceland* and OECD.

should continue to build up, as all individuals will not receive maximum pensions until around 2025. There is still, nonetheless, a small state basic pension and means-tested supplementary benefits that provide a "safety net" to most of the retired people as yet without a full occupational pension. As private pensions increase, entitlements to supplementary state pension payments should gradually decline given current income limits, largely offsetting the growth in basic pension outlays caused by the rising number of elderly people. ■

What is the agenda for pensions?

Although fiscal pressure is, thus, unlikely to arise from state pensions in general, growing claims on public resources are expected from the increased cost of pensions of government employees. The authorities have taken steps to limit the growth of this liability by recognising the cost of the new rights that accrue each year in the budget, but nonetheless such claims remain significantly underfunded. there is also a risk of growing demands to raise the thresholds at which social security pension benefits are withdrawn. Recent changes to the disability pension that increased the eligibility ceilings for some benefits should not be taken as a precedent for changes to supplementary pension benefits. Were this to occur, spending pressures on the government budget could intensify. In this regard, it is important that the transitory nature of the means-tested component of public pension benefits for most of the population be respected. Spending growth should also be limited by linking the value of state pension benefits to wages, rather than to the faster of either wages or prices as this would allow any drop in real wages to be reflected in pension payments. In addition, the government will have to make sure that all people do join the occupational pension system for which they are eligible, by using the powers it obtained from the new legislative framework for pension funds introduced in 1997.

The government is committed to review the current legislation governing occupational pensions in 2001, looking especially at the provisions for freedom of choice between different savings schemes. At present, people are given limited possibilities to divert part of their total pension contributions to individual accounts. as in other countries, the bulk of such contributions is used to generate a pension that is proportional to life time earnings. But individual accounts, now on offer, generate greater final benefits for the young generation than for older people as their contributions will have a longer time to accumulate interest. Thus the young are more likely to opt for such accounts, so potentially worsening the financial position of existing funds that will have to rely on a reduced flow of interest payments to pay benefits. When reviewing the current system, the government will, therefore, need to ensure that any further extension of individual accounts is not destabilising. One option would be to couple any extension of individual accounts with changes in benefit accumulation rules of pension funds in order to link the size of benefits to the age at which contributions are made At the same time, the government should consider raising the limits on both equity and foreign investment, so allowing a greater diversification of pension fund portfolios and an improved return on their assets.

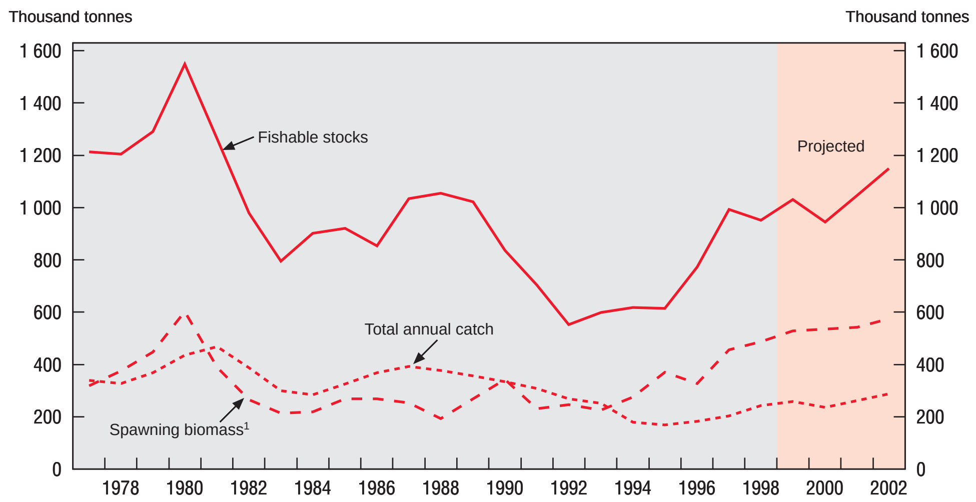
Although direct government expenditure on pensions is low, relative to other OECD countries Iceland spends a significant amount on services for the elderly, notably in the areas of housing, home-care and long-term institutional care. The cost of such a system appears to be higher than necessary, and the goal of maintaining the elderly independent is not being met as well as it could, with a higher proportion of them living in institutions compared with other Nordic countries. Excessive supply of institutions providing long-term care in the more rural parts of the country results in pressures to fill these retirement-home beds. At the same time, there is a short supply of nursing care beds in the capital area, that results in elderly people staying in costly hospital beds for long periods. A better geographic distribution of facilities would ease this problem and, in the long run lower costs. In addition, there are wide differences in the unit costs of providing services in different homes, suggesting that a pricing policy that set uniform tariffs for given levels of care at the level of the costs of the most efficient homes would generate significant savings. The government is attempting to increase the information on patient needs that could be used to determine the appropriate level of care and its associated cost. Such data should be used to improve the cost-effectiveness of the less efficient institutions, helping to lower spending. Moreover, in case the recent experiment to finance municipally-provided residential care by a block grant from central government, rather than through per-diem payments, proves successful in lowering spending, it should be quickly generalised.

The cost of care for the elderly to the Treasury could be contained by increased user charges. At present, residents of institutions pay little more than their low basic state pension for care. Although payments should rise as the occupational pensions increase, costs are unlikely to be fully covered in nursing or geriatric homes. Some scope exists for raising charges by lowering the amount of occupational pensions that individuals are allowed to keep. But, in the light of the level of assets of the elderly, the government should also consider requiring residents to use part of their wealth to pay for the services received, if only by building up a debt to the government that would eventually be repaid. In this context, regulations would need to be carefully set to limit the risk of individuals running down their assets early or transferring them to their children. ■

What about the fisheries sector?

Securing a sustainable growth of incomes over time, as the population ages, will depend as well on a successful fisheries management policy. The scientific establishment of total catch limits for cod has restored stocks in areas around Iceland sufficiently to allow a relatively high level of fishing. Moreover, by allowing the transfer of quotas nationally, it also ensures that the catch is made efficiently. Recent and pending court cases could pose a threat to this system, however. Against this, it is essential that such a system be retained and even expanded, bringing in smaller fishermen and widening the range of species for which there are automatic quota rules. Public acceptance of the system might, nonetheless, be improved by the introduction of an auction mechanism for allocating increases in quotas, as this might be seen as fairer than the current regime where rights depend on historical catch levels. Moreover, if revenue from this source were used to reduce tax distortions in other sectors, the economy would become more productive. However, now that the quotas have been capitalised both into the market values of quoted companies and by sales between individuals, any change in the system will have to be gradual. Finally, the trade in fish should be made more transparent to ensure that the fishermen can continue to be compensated by receiving a share of the value of the catch. ■

Icelandic cod



1. The spawning biomass refers to the average number of newly born fish multiplied by their estimated weight at maturity.
Source: The Icelandic Marine Institute.

And structural reform?

Elsewhere, recent structural reforms should be extended. In particular, the government should complete its withdrawal from the financial sector quickly by selling its holdings in the commercial banks and the government-owned housing fund. Moreover, privatising the national telephone company would help improve competition. Before this is done, however, an independent regulatory agency should be established that should develop a competitive pricing system for network access. Those branches of the national company that operate in competitive markets should be placed in arms-length subsidiaries. Finally, a new mobile phone operator should be licensed, provided it agrees to use new high capacity technology. A competitive telecommunications environment would clearly help lessen the barrier of Iceland's geographic isolation, thus contributing to boost its nascent high-tech industries. Finally, in the area of mergers, the government needs to introduce a pre-notification system in order to ensure adequate time for considering the merits of a particular case. ■

For further information

Further information on the *Survey* can be obtained from Richard Herd who can be reached by e-mail at richard.herd@oecd.org or by telephone (33) 1 45.24.87.00. ■

For further reading

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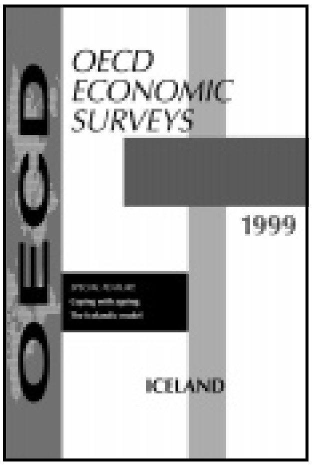

- **Additional Information**: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco/eco/.

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