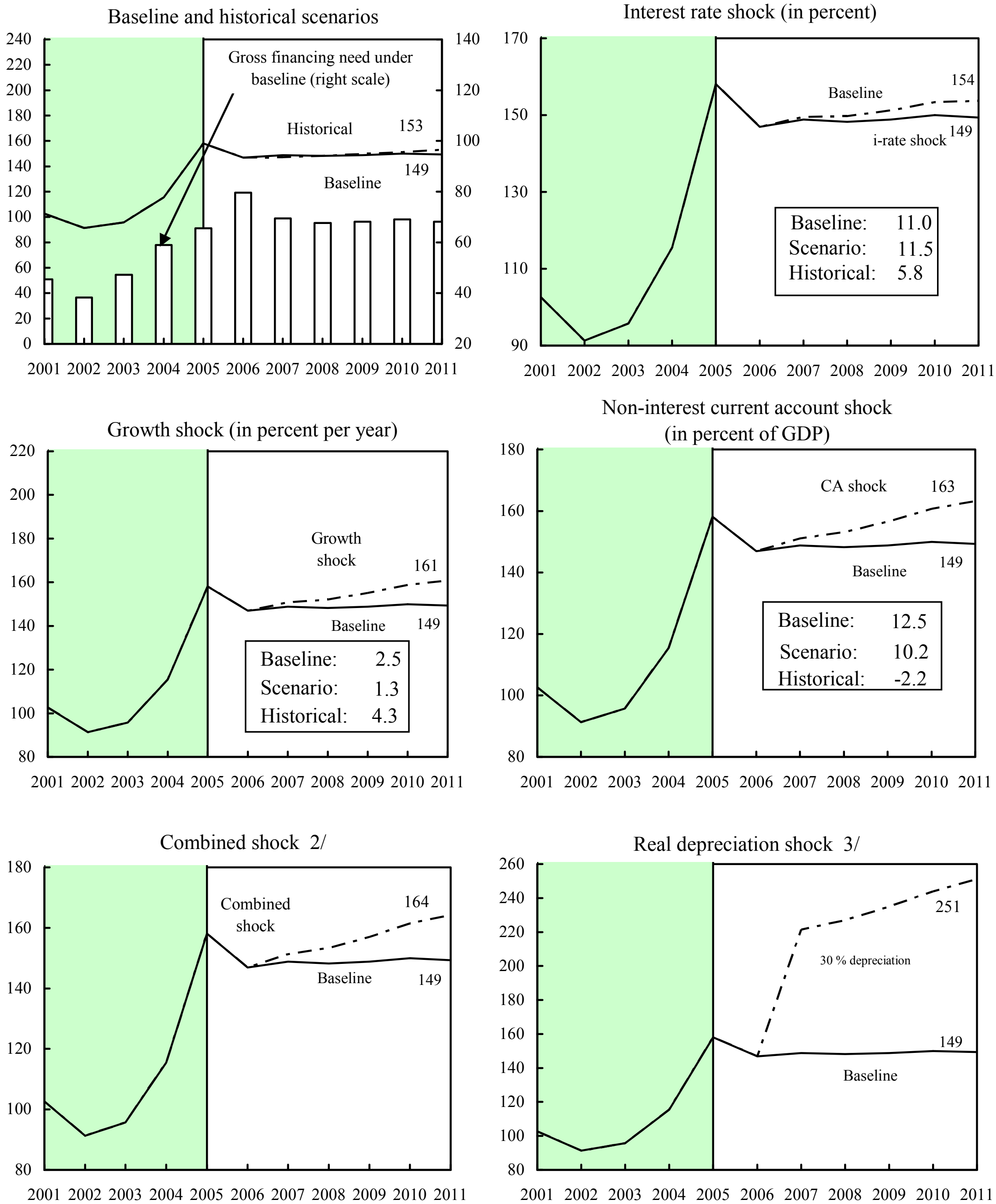
Figure 1. Iceland: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

Statement by the IMF Staff Representative
August 4, 2006

1. This statement provides an update on developments in Iceland since the circulation of the staff report to the Board. The new information does not change the thrust of the staff appraisal, but developments in the external accounts and inflation heighten the risks and strengthen the case for a more restrictive fiscal stance.

2. **Iceland's external imbalance continues to widen and inflation has accelerated further.** In 2006Q1, imports grew by 17.5 percent while exports shrunk by 7.5 percent, doubling the current account deficit with respect to a year earlier. Monthly trade data suggest that this trend continued in the second quarter with June's trade deficit reaching a record level. Annual CPI inflation reached 8.4 percent in July, while wages posted 8.8 percent year-on-year growth in June. However, the housing market, which had been a key driver of inflation, has started to cool. Reykjavik's housing price index rose by 0.6 percent in June bringing the 3-month rate of change down to 1.6 percent from 4.3 percent the previous three months.

3. **The Central Bank responded by raising its policy rate.** The policy interest rate was increased by 75 basis points to 13 percent on July 6 and an additional policy setting meeting has been announced for August 16. Market participants expect the policy rate to rise following the meeting and possibly reach 14.5 percent by the end of the year. Exchange rate movements since the issuance of the staff report have been more contained: as of August 2, the ISK nominal effective exchange rate index had appreciated by slightly under 3 percent relative to the last observation of June 12 presented in the staff report.

4. **The government has announced planned measures to reduce demand pressures in the economy.** The maximum loan-to-value ratio on loans issued by the Housing Finance Fund (HFF) has been temporarily decreased from 90 to 80 percent and the HFF's loan limits have been temporarily reduced from ISK 18 to 17 million. Tenders and commencement of new central government investment projects will be postponed and discussions are underway with local governments to reduce investment this year and next. Some local governments have announced plans to do so. This is being done against the background of an improving fiscal position. In the first quarter of 2006, the general government financial balance rose to a surplus of 1.5 percent of annual GDP (against 0.7 percent a year ago).

5. **The Government, trade unions, and the employers' confederation reached a consensus to maintain the current wage agreement which could have been canceled in November 2006 owing to high inflation.** To maintain the current wage agreement, the government has committed to increase the tax-free income threshold by 14 percent starting in 2007, index this threshold to inflation thereafter, and increase the minimum wage by 15.7 percent. To finance these changes, the reduction in the income tax rate set to occur in January 2007 has been reduced to 1 percentage point rather than the previously planned 2 percentage points.