INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/256

ICELAND

August 2013

2013 ARTICLE IV CONSULTATION AND THIRD POST-PROGRAM MONITORING DISCUSSIONS

In the context of the 2013 Article IV consultation and third post-program monitoring discussions with Iceland, the following documents have been released and are included in this package:

- The **Staff Report** for the 2013 Article IV consultation and third post-program monitoring discussions, prepared by a staff team of the IMF, for the Executive Board's consideration on August 1, 2013, following discussions that ended on June 14, 2013, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 16, 2013.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** including a statement by the Chair of the Executive Board, and summarizing the views of the Executive Board as expressed during its August 1, 2013 consideration of the staff report on issues related to the Article IV consultation and third post-program monitoring discussions.
- A **Statement by the Executive Director** for Iceland.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND THIRD POST-PROGRAM MONITORING DISCUSSIONS

July 16, 2013

KEY ISSUES

Context: Iceland's economy is on a path to recovery and the outlook is for continued gradual expansion, although legacy vulnerabilities weigh on growth. The newly-formed coalition government has stated its main policy priorities: creating an investment-friendly environment—including through tax cuts—and providing further household debt relief. The fiscal implications remain unclear, although the government has acknowledged the need to maintain fiscal discipline. In staff's view, the overarching policy challenge is to create a foundation for durable growth by resolving crisis legacy problems.

Capital controls: An orderly lifting of capital controls is needed to remove potential growth-hindering distortions while safeguarding the external position. This will require a comprehensive approach that addresses potential balance-of-payments drains stemming from the winding up of the old bank estates, from the liquid offshore krona overhang, and from portfolio rebalancing by residents.

Monetary policy: The central bank's monetary stance is appropriate. With the recent softening of economic activity, little change in the policy rate is needed to gradually bring inflation down to the 2½ percent target.

Fiscal policy: Adhering to the medium-term fiscal targets is key to ensure fiscal sustainability, preserve confidence, and cement market access—crucial for an orderly lifting of controls. Recognizing the fiscal slippages so far in 2013, the authorities signaled their intention to meet the 2014 target of a balanced budget. High quality measures will be important to ensure the durability of fiscal consolidation efforts.

Debt restructuring: Further reductions in household debt will require intensified efforts under existing restructuring frameworks. The authorities are also considering additional across-the-board debt relief. However, there is little fiscal space for additional relief. Any new measures should therefore be targeted on distressed households.

Financial sector policy: Safeguarding financial stability calls for heightened supervisory oversight and a stronger financial stability framework, including clear procedures for emergency liquidity assistance, a permanent legal framework for bank resolution, and a strong deposit insurance scheme. High bank capital and liquidity buffers should be maintained. A comprehensive plan to reform the Housing Financing Fund is critical.

Approved By
Ajai Chopra and Vikram Haksar

D. Zakharova (Head), R. Gregory and A. Bordon (all EUR), N. Belhocine (FAD), R. Bi (SPR), and O. Nedelescu (MCM) visited Reykjavik during June 4–14. The mission, joined by F. Rozwadowski and E. Karlsdóttir (Resident Representative Office), met with senior government, central bank and financial supervision officials, members of parliament, representatives from the trade unions and business community, and academics. R. Hjálmarsson, V. Boranova, and A. Ilagan assisted the mission. Mr. Groenn and Ms. Jónsdóttir (OED) participated in some of the policy discussions.

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ANNEXES

COMPLETING THE RECOVERY

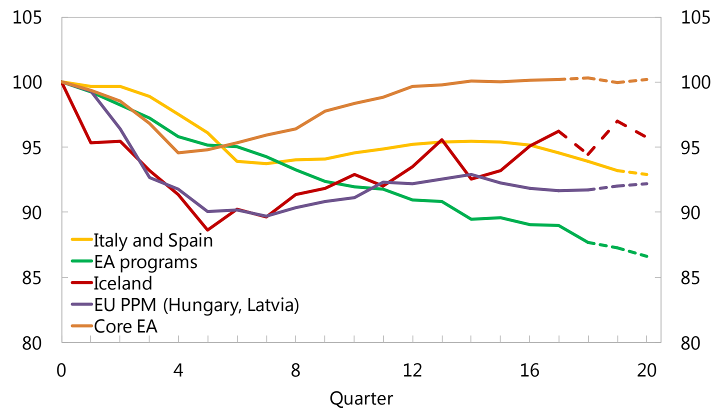
The authorities' decisive and comprehensive response to the 2008–09 crisis has put the Icelandic economy on a path to recovery. The prospect is for continued gradual expansion, but legacy vulnerabilities are creating headwinds.

A. The Crisis and Response

1. The global crisis hit hard in Iceland. Confidence, already sapped by asset bubbles and a risk-laden and vastly overextended banking sector, evaporated during 2008. The exchange rate and other asset prices went into freefall and in October, the banking system collapsed and the foreign exchange market froze up. Inflation rose above 18 percent, real GDP declined by 12 percent from peak to trough (see chart) and unemployment rose to a nearly unprecedented level. The primary fiscal balance moved from surplus to deficit which, together with the recapitalization of struggling financial institutions, propelled public sector debt from about 30 percent of GDP pre-crash to over 100 percent in 2011.

Post-Crisis Output: Recent Experiences

(Peak output at t=0)



Source: IMF WEO; and IMF staff calculations.

2. The authorities responded decisively. Their policies were characterized by strong ownership and were supported by a Stand-By Arrangement with the Fund. The key policies were:

- Halt the krona depreciation by imposing capital controls and tightening monetary policy.
- Put public finances on a sustainable path with a multi-year fiscal consolidation, phased so as to give rein to automatic stabilizers designed to provide a cushion for vulnerable groups.
- Rebuild the banking system and support private debt restructuring, while limiting the public sector's absorption of bank crisis costs. Strengthen supervision and prudential regulation.

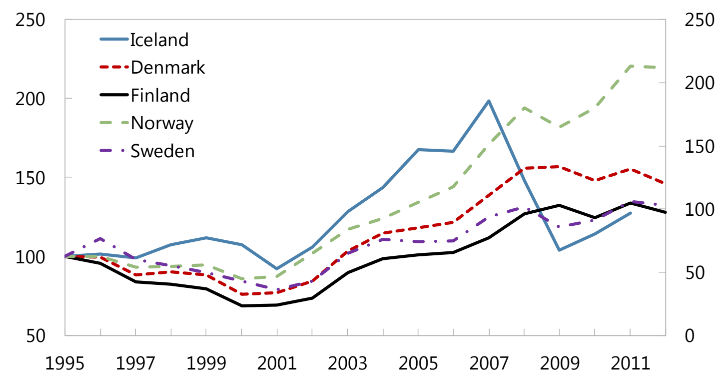
3. The newly-elected government is formulating its policies. The two-party coalition which took office in May has expressed support in principle for key elements of the previous government's macroeconomic and financial program, but also plans extensive tax cuts and large write-downs of household debt. The authorities are still working on developing measures that would render these policies consistent with the broader objective of maintaining economic stability and staying on course with fiscal consolidation.

B. Recovery in the Face of Headwinds

4. **Four years on, strong implementation is bearing fruit and the economy is gradually recovering** (Annex I). The capital controls ended a vicious depreciation-inflation spiral and helped stabilize the economy. The fiscal consolidation shifted the primary balance from deficit to surplus and has put public debt on a declining path. Iceland's new banks, subject to tougher supervision, are liquid and well capitalized and nonperforming loan ratios have declined. Household and corporate debt levels are falling. The external position has improved and gross international reserves exceed short-term debt. Growth turned positive in 2011, unemployment has declined, and inflation has come down. Iceland has benefitted from rating agency upgrades and regained market access.

5. **The policy adjustment was supported by a real depreciation, which boosted competitiveness.** The krona depreciated by 40 percent in real terms at the onset of the crisis and then stabilized. While the response of major goods exports (marine products, aluminum) was limited by supply constraints, tourism increased dramatically. The low krona also reduced unit labor costs, offsetting wage increases and helping to encourage FDI inflow to energy-intensive sectors. Iceland's labor productivity compares well with its peers (Annex II). Standard approaches point to a real exchange rate undervaluation in the range of 4–20 percent (Box 1). The authorities agree that the krona is undervalued, but note the uncertainty surrounding the size of the undervaluation and the speed at which it will unwind while private and public entities continue their FX deleveraging and capital controls are lifted.

Unit Labor Cost: Exchange Rate Adjusted Unit Labor Cost, 1995-2012
(Index, 1994=100)



Source: OECD.

6. **However, legacy vulnerabilities weigh on growth.** Real output is still 10 percent below its pre-crisis peak. GDP growth, which reached 2.9 percent in 2011, slowed to 1.6 percent in 2012 amid private sector deleveraging and weak external demand.

- **Deleveraging is constraining consumption and investment.** Private consumption weakened in the second half of 2012, as one-off supporting factors (early pension withdrawals and mortgage interest subsidies) waned and households and firms continued paying down debt (Box 2). Fiscal consolidation, while necessary to reduce high public debt, is limiting the public sector contribution to growth.

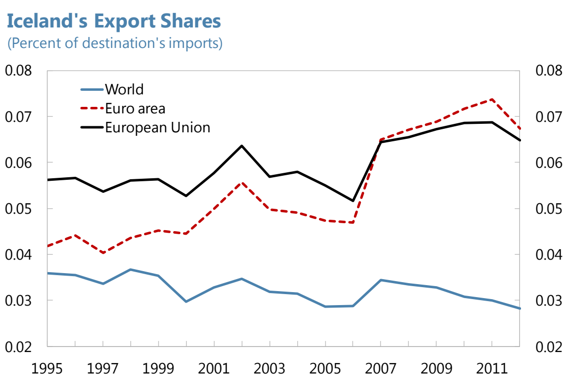
- **Slow progress in removing the capital controls is undermining confidence.** While the controls safeguarded external and financial stability during the crisis, slow progress in lifting them is undermining confidence and inhibiting investment. At the same time, uncertainty about exchange-rate developments following the lifting of controls has hindered the anchoring of inflation expectations.

- **Legacy risks in the financial sector are holding back credit expansion.** Banks are still burdened by bad assets and continue grappling with uncertain loan valuations and risks stemming from their reliance on captive funds locked in by capital controls.

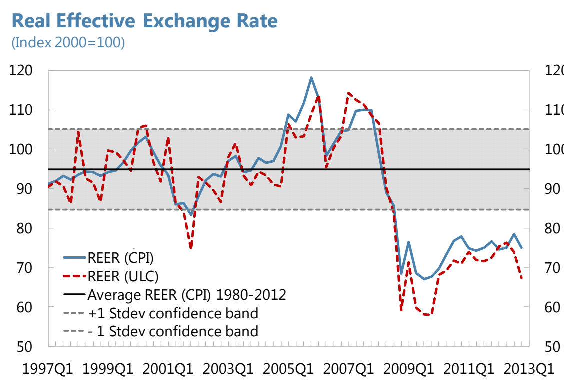
- **The challenging external environment is weighing on exports.** In 2012, less favorable terms of trade and weak external demand for real goods exports more than offset the improvement in services exports, notably tourism.

Box 1. Iceland: External Competitiveness

Iceland has maintained its post-crisis gain in external competitiveness. The krona depreciated by around 40 percent in real effective terms at the onset of the crisis and its value has stayed low. As a result, the trade balance has improved and export shares to European countries have increased. However, Iceland's share of world exports has remained flat, likely reflecting the sluggish demand, relative to the rest of the world, in its largely European trading partners.



Source: IMF's DTTS.



Source: Cental Bank of Iceland.

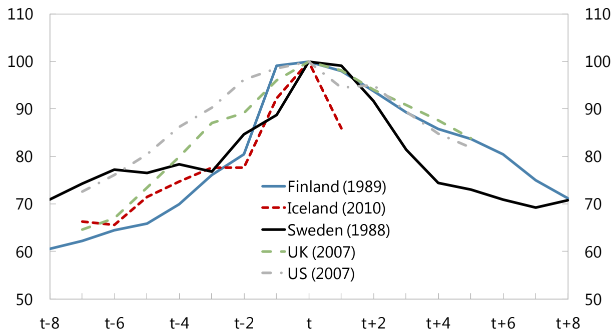
Staff analysis suggests that the REER is moderately undervalued relative to medium-term fundamentals. This assessment is unchanged from the 2012 Article IV. The three standard CGER methodologies point to a real undervaluation in the range of 4 to 20 percent. The macroeconomic balance (MB) approach points to a slightly greater undervaluation compared to 2012, reflecting Iceland's stronger growth relative to trading partners. The external stability (ES) approach estimates a current account deficit of slightly less than 3 percent of GDP to stabilize net foreign assets at the end-2012 level of -61 percent of GDP and a misalignment of 7 percent. The equilibrium exchange rate approach, which is influenced by the considerably more appreciated real exchange rate in the past, points to a bigger misalignment, some 20 percent.

The assessment is complicated by the capital controls. Despite the medium-term real undervaluation, pressures for nominal depreciation will likely emerge when the capital account is liberalized and as highly indebted companies continue to deleverage.

Box 2. Private Sector Deleveraging

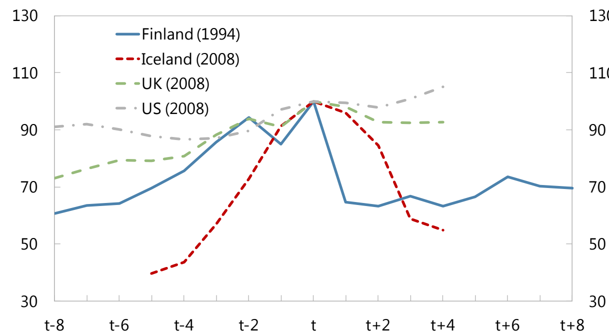
Debt has declined significantly, but further deleveraging should be expected. The restructuring of exchange rate-indexed loans (following a court ruling that such loans were illegal) and banks' voluntary restructuring of other loans have reduced household debt by 14 percent and corporate debt by 45 percent, larger reductions than in other countries during current and previous crises. International experience, however, suggests that further household adjustment should be expected. Peak-to-trough deleveraging of Swedish and Finnish households in the 1990s took as long as 8 years with debt declining by 30 percentage points.

Normalized Household Debt 1/
(Crisis peak household debt-to-disposable income ratio= 100)



Sources: IMF WEO; and Haver Analytics.
1/Peak year in parenthesis. Peak year=t.

Normalized Corporate Debt 1/
(Crisis peak corporate debt-to-GDP ratio= 100)

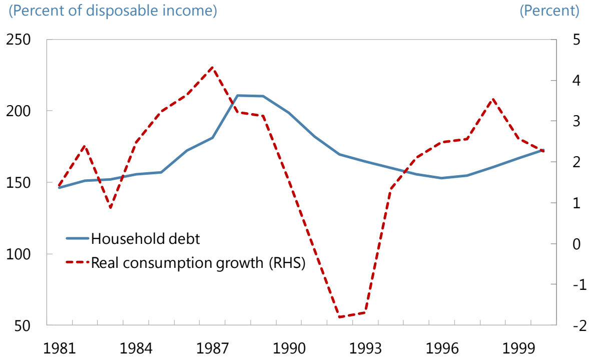


Sources: IMF WEO; and Haver Analytics.
1/ Peak year in parenthesis. Peak year=t.

Unique characteristics of Icelandic household debt complicate the deleveraging process. Household debt consists largely of home mortgages that are CPI-indexed, implying that the debt stock rises with inflation. Moreover, 85 percent of mortgages were issued in 2005–07 and have long maturities and back-loaded repayment profiles.

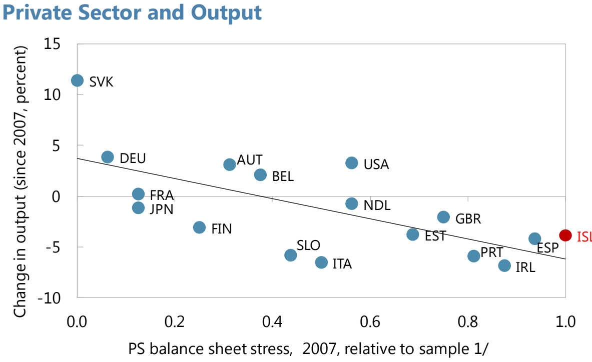
High private sector debt weighs on consumption and investment. Consumption is still 20 percent below its pre-crisis peak and 10 percent below trend, somewhat stronger than in euro area program countries but weaker than in other advanced economies. Domestic investment is about 20 percent below trend despite significant corporate debt deleveraging, likely reflecting factors such as capital controls. Growth will therefore likely remain modest for some time. To illustrate, average private consumption growth in Sweden and Finland hovered around 1 percent during the deleveraging period before rising to 2½ percent post-deleveraging. Cross-country comparisons also show a negative relationship between private sector balance sheet stress and growth.

Sweden and Finland: Deleveraging and Consumption
(Percent of disposable income) (Percent)



Sources: Statistics Sweden; Statistics Finland; and Haver Analytics.

Private Sector and Output



Source: OECD.
1/ Countries are ranked according to the level of private sector debt-to-GDP ratio and the change in the ratio to yield a measure of private sector balance sheet stress.

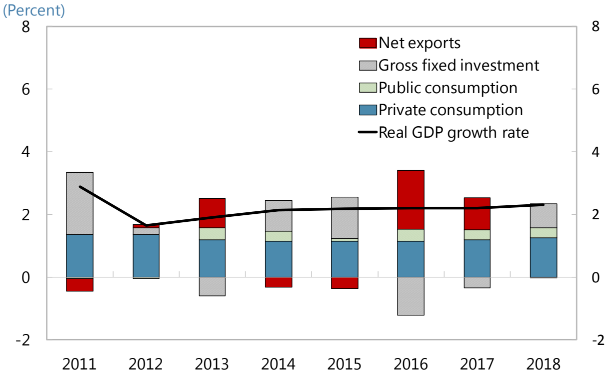
1/ Prepared by Anna Rose Bordon.

C. Overcoming Legacy Challenges

7. The outlook is for modest growth, declining inflation, and improving fiscal and external positions. The prospective drivers of demand are private consumption and investment, and, in the outer years, net exports. Growth is projected to remain moderate—around 2 percent a year over the next few years—as private sector deleveraging continues to weigh on the domestic sources of demand. Foreign investment in the energy-intensive sector will take up some slack in the near term and, by expanding capacity, raise net exports in the medium term. The output gap is projected to close in 2014, later than initially expected. Inflation is expected to converge to the target of 2½ percent by 2015, as the tight monetary stance helps anchor inflation expectations. Public and external debt ratios, though still high, are projected to decline as fiscal consolidation continues, although some fiscal slippage from 2012 and 2013 is built into the baseline.

Contributions to Growth, 2011–18

(Percent)



Sources: Statistics Iceland; and IMF staff estimates.

8. The external balance is expected to be dominated by the lifting of capital controls. Staff's baseline scenario is based on the authorities' capital account liberalization strategy and assumes that adequate reserve buffers are maintained. Liquid offshore kronas are released via the channels envisaged in the authorities' strategy by end-2016, one year later than in the previous staff report, reflecting weaker FDI and hence less foreign exchange available to help release offshore krona. Some easing of capital controls starts in 2017, with proper measures to contain outflows from residents as they rebalance their portfolios toward foreign assets. Starting in 2017, large foreign currency payments by the old banks' estates to foreign creditors are assumed to flow gradually and be partially offset by government external borrowing, helping to keep reserves at comfortable levels. Temporary inflationary pressures that may arise from the exchange rate volatility during the lifting of controls are expected to be contained by an appropriate monetary policy response.

9. The authorities are more optimistic on growth prospects than staff. They expect a rebound in growth from 1.8 percent this year to 3 percent next year as private consumption and investment return to trend. Staff acknowledged uncertainty surrounding the speed of private sector deleveraging and its impact on growth. In this context, employer groups drew a distinction between larger companies, which had made good progress restructuring their debt and might therefore be in a position to resume investing and smaller companies, many of which were still constrained by debt service payments, given that growth had turned out slower than expected.

10. Staff and the authorities see risks to the outlook as tilted to the downside. Slow progress in lifting capital controls could undermine confidence in an orderly liberalization while increasing the risk that prolonged controls will fuel asset bubbles, inhibit investment, and reduce productivity (see paragraph 13 for appropriate policy responses). Fiscal consolidation could be weakened by additional spending to meet the policy priorities of the new government and reliance on uncertain, one-off measures, putting at risk continued market access critical for capital account liberalization (see paragraphs 19–20 for appropriate policy responses). Further delays in energy-intensive-sector investments could reduce growth and damage confidence. While Iceland's direct exposure to a growth slowdown in emerging markets is limited, adverse euro area developments could have a significant impact on Iceland through trade and FDI channels. The authorities however emphasized that financial spillovers from the euro area will likely be muted by Iceland's capital controls.

Iceland: Risk Assessment Matrix 1/

Source of Main Threats	**Overall Level of Concern**	
	Relative Likelihood of Risk in the next 1–3 Years (High, medium, or low)	**Expected Impact if Risk is Realized** (High, medium, or low)
1. Disorderly or delayed capital account liberalization.	**Medium** • Lifting capital controls is complicated by large potential drains from liquid offshore krona holdings. • Uncertainty surrounds the resolution of the old bank estates and subsequent asset distributions. • Additional balance-of-payments pressures could stem from residents' pent-up demand for foreign assets and the risk of circumvention during liberalization.	**High** • Lifting controls too fast could weaken the krona, with knock-on effects on public and private sector debt. Reserve losses could affect international market access and the terms of public sector external borrowing. • Excessive delay in lifting controls could increase asset prices, discourage FDI, and inhibit market access. Controls are also increasingly costly to monitor and may lead to rent-seeking behavior.
2. Further weakening of fiscal consolidation.	**High** • The financing of new proposals—including tax cuts and additional household debt relief—remains uncertain. • The reliance on one-off and uncertain non-tax revenues weakens the quality of the fiscal adjustment. • The potential recapitalization needs of the Housing Financing Fund (HFF) pose fiscal risks.	**Medium** • Missing the fiscal targets could weaken market confidence and Iceland's access to capital markets, both critical to the successful lifting of capital controls.
3. Delays in investment in the energy intensive sector.	**High** • Technical, financing, and political constraints may continue to delay investments.	**Medium** • Protracted delays could lower growth, with knock-on effects on confidence and investments. • Public debt sustainability is sensitive to growth shocks.
4. Financial stress in the euro area re-emerges.	**Medium** • Financial stress in the euro area could re-emerge and bank-sovereign-real economy links could re-intensify as a result of stalled or incomplete delivery of policy commitments at the national or Euro area level, or adverse developments in some peripheral countries.	**Medium** • Icelandic banks have little direct exposure to European sovereign debt or wholesale funding. • Nonetheless, a sharp deterioration in conditions could affect Iceland through market access, trade, commodity price, and foreign direct investment channels.
5. Protracted period of slower European growth.	**Medium** • The adverse impact of public and private sector debt and deleveraging on the real economy may be larger than currently expected, spurring debt-deflation dynamics.	**Medium** • Slow growth in Europe could affect Iceland via trade, commodity price, and foreign direct investment channels.

1/ The RAM shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with authorities.

POLICY DISCUSSIONS—ADDRESSING LEGACY VULNERABILITIES TO REINVIGORATE GROWTH

11. Discussions with the authorities focused on policies that support strong and sustainable growth by dealing with legacy vulnerabilities. A clear and comprehensive roadmap for capital account liberalization is needed to remove potential growth-hindering distortions while safeguarding Iceland's external position. The monetary policy stance and framework should be geared toward bringing inflation down to target. Fiscal consolidation needs to be completed in order to reduce debt and protect growth. Debt restructuring needs to be concluded to strengthen domestic demand and support growth. And financial sector risks must be addressed so as to safeguard financial and economic stability.

A. Putting in Place a Credible Roadmap to Lift Capital Controls

Progress in removing capital controls has been limited. A comprehensive approach is needed that begins with resolving the old bank estates, sets a clear time-bound strategy to deal with offshore krona, and prepares for the lifting of capital account restrictions.

Background

12. Progress in lifting capital controls has been limited. Key steps remain to be taken to set the stage for orderly liberalization by addressing potential balance of payments drains related to the winding up of the old bank estates, the liquid offshore krona overhang, and potential portfolio rebalancing by residents. Furthermore, maturing external foreign currency loans by financial and non-financial corporations could also add to the foreign exchange outflows.

- **Old bank estates.** The winding-up of the estates will distribute a large stock of domestic assets (40–50 percent of GDP) to nonresidents. In the process, the servicing of the Landsbanki compensation bond could put additional pressure on the balance of payments. Legislative changes in March 2012 and subsequent amendments gave the authorities tools to contain the reserve drain from the distributions: the old banks will need to seek exemptions to the capital controls in order to proceed.
- **Liquid offshore kronas.** Under the current strategy, liquid offshore kronas are to be released through auctions, swaps of krona securities into long-term Eurobonds, and an exit levy. Two years into the strategy, only the auction channel has been opened and the uptake has been limited—the stock of offshore kronas remains at 22 percent of GDP. To strengthen incentives to participate in the strategy, recent legislation scrapped the terminal date for the capital controls. Although this initiative was a necessary step, on its own it did not accelerate the release of offshore kronas, suggesting that incentives are still not sufficient.
- **Lifting of restrictions on capital account transactions.** A more general easing of controls will begin only when the above two issues have been addressed and the appropriate

financial and macroeconomic conditions are in place. Design of the macroprudential measures to support lifting restrictions is still at an early stage.

Policy Discussion

13. **Staff and the authorities agreed on the need for a comprehensive approach to lifting the controls.** The new government supports the principle of a conditions-based strategy. Staff emphasized the need to lay out a clear and credible roadmap, with the building blocks elaborated and properly sequenced, to set appropriate incentives, build confidence in the strategy, and minimize circumvention.

- **Resolution of old bank estates.** The first step will be to develop a plan to handle old banks' domestic asset distribution in a manner consistent with external stability.
- **Release of liquid offshore krona.** Staff supported the authorities' intention, once the old banks estates have been resolved, to publish a strategy that sets a clear implementation timeline, clarifies the treatment of holdouts, and ensures enforcement.
- **Lifting the restrictions on capital account transactions.** Staff estimates that following the lifting of controls, resident outflows from portfolio rebalancing could be in the order of 20 to 40 percent of GDP over a number of years.[1] To prepare for this, staff encouraged the authorities to explore options to protect external and financial stability while capital controls are lifted. These could include "speed limits" on outflows, as is already foreseen for pension funds, and a phased liberalization that takes into account the different types and maturities of outflows. The authorities thought that staff's estimates of potential resident outflows were too pessimistic, in particular because they did not sufficiently account for possible offsetting inflows. The authorities were therefore skeptical about the need for "speed limits" on non-pension-fund resident outflows. All agreed, however, that strong prudential regulations and supervision would be needed to mitigate risks.

B. Securing Progress on Inflation

Decisive action from the central bank, including through foreign exchange intervention, has helped bring inflation down towards the target. Foreign exchange purchases now need to resume in order to build up non-borrowed reserves.

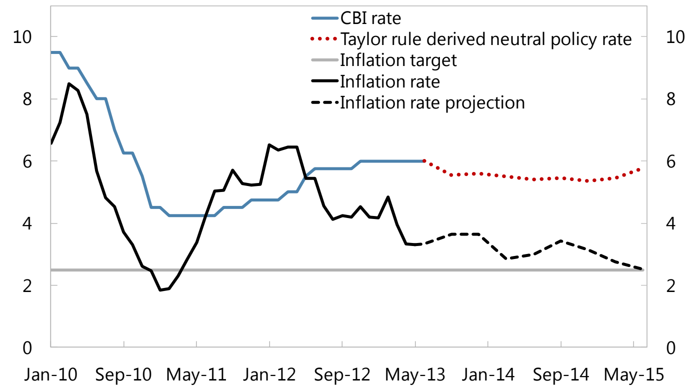
Background

14. **With inflation stubbornly above target, the central bank has taken action**. It raised policy rates by a cumulative 125 basis points in 2012 before pausing in November. During the winter, the CBI also intervened in the foreign exchange market, reversing a depreciation that resulted

[1] See Selected Issues Paper, "Lifting Capital Controls, the Effect of a Potential Rebalancing of Residents' Investment Portfolios."

from temporary factors but threatened to pass through to prices. Inflation—at 3.3 percent in June—has been moving back toward the CBI's 2½ percent target. Monetary transmission remains weak, however. Banks hold large excess reserves, market interest rates hover at the bottom of the policy interest rate corridor, and inflation expectations have not yet converged to the target rate of inflation (Figure 3).

Inflation and Monetary Policy
(Percent)



Sources: Central Bank of Iceland; and IMF staff calculations and projections.

Policy Discussion

15. Staff supported the central bank's monetary stance. With the recent softening of economic activity, model-based projections suggest that little change in the policy interest rate is needed to gradually bring inflation to the 2½ percent target. Staff encouraged the authorities to take advantage of the recent seasonal appreciation of the krona to resume foreign exchange purchases in order to build up nonborrowed reserves. The authorities explained that while this was their medium-term objective, their priority was to reduce inflation as much as possible and promote benign wage dynamics. The central bank agreed that more could be done through liquidity management operations to position the interbank rate in the middle of the policy interest rate corridor. They nevertheless highlighted structural issues with the interbank market—arising from, for example, market dominance and capital controls—that weaken monetary transmission.

C. Ensuring Sustainable Fiscal Consolidation

Iceland has made significant progress with fiscal consolidation since the crisis. The challenge now is to complete the process in order to bring the public debt ratio down to a prudent level, cement market confidence, and support durable market access.

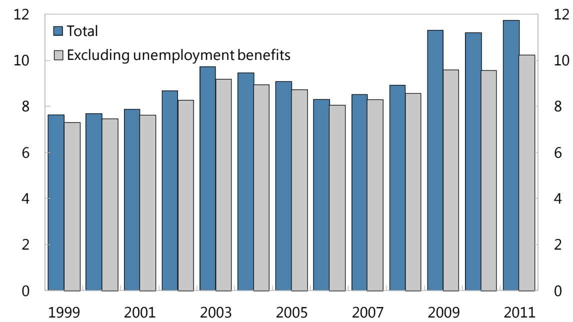
Background

16. Iceland's post-crisis fiscal consolidation has been impressive. The adjustment program was well designed and effectively implemented: it was large enough to put Iceland's public finances on a sustainable footing, gradual enough to not undercut the recovery, and credible enough to reassure markets. The consolidation was also designed in way that preserved the Nordic welfare model and protected vulnerable groups (see panel). All in all, the primary general government balance swung from a deficit of 6.5 percent of GDP in 2009 to a surplus of 0.6 percent in 2012, putting the public debt ratio on a declining path. Iceland has regained market access with two successful U.S. dollar-denominated bond issuances in 2011 and 2012, and has benefited from ratings upgrades and a significant reduction in sovereign bond spreads (Figure 4).

Iceland: Protecting Vulnerable Groups in the Face of Fiscal Consolidation

Fiscal consolidation sheltered social protection spending…

General Government Spending on Social Protection
(Percent of GDP)



Source: Statistcs Iceland.

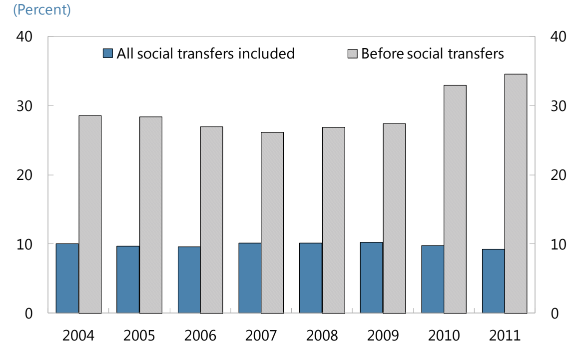
…supporting continued increase in social assistance.

Households Receiving Income Support
(Thousands)

Source: Statistics Iceland.

Poverty incidence held steady through the crisis…

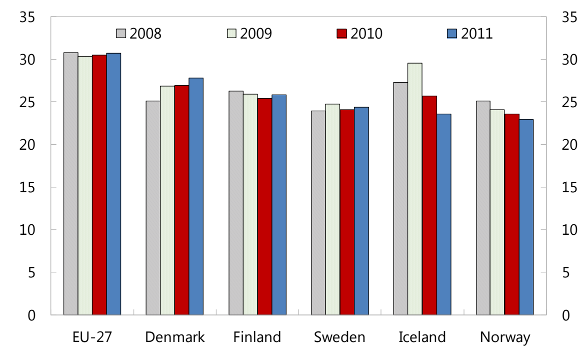
At-risk-of-poverty Rate Before and After Social Transfers
(Percent)



Source: Statistics Iceland.

…while inequality has steadily declined.

Gini Coefficients



Source: Eurostat.

17. This consolidation has, however, increasingly relied on one-off or uncertain revenues, while fiscal risks persist.

- **2013 budget implementation**. Fiscal outcomes in 2013 have been significantly weaker than expected. On current trends, the 2013 budget deficit target (1.3 percent of GDP) will be missed by about 1½ percent of GDP, driven primarily by expenditure overruns (0.6 percent of GDP), the materialization of fiscal risks (0.5 percent of GDP)—including lower-than-budgeted dividend receipts and asset sales—and slower than projected growth (0.2 percent of GDP).
- **2014 budget preparation.** The existing target for 2014, a balanced budget, may come under pressure from costly electoral promises—including those to lower taxes and to increase household debt relief—the financing of which remains uncertain. Additional risks stem from uncertain revenues from asset sales and dividend payments, amounting to 1 percent of GDP.

- **Medium term**. The medium-term adjustment plan, which targets a 5 percent of GDP primary surplus in 2016—compared to 0.6 percent of GDP in 2012—relies in part on uncertain asset sales and unidentified fiscal measures. Furthermore, in the absence of restructuring, the Housing Financing Fund (HFF) requires yearly transfers of about 0.2 percent of GDP to cover its losses and may require further capital injections to bring its capital adequacy in line with the target of 5 percent.

Policy Discussion

18. The new government is still formulating its medium-term fiscal plan. Staff expressed concern about the sizeable fiscal slippage in 2013 and risks for 2014 and stressed that adhering to the existing fiscal targets for 2014 and 2016 was critical. They strike a good balance between supporting growth, ensuring that debt is on a downward trajectory, and increasing fiscal buffers in the face of new risks, including from the HFF. Conversely, unless fiscal slippages are addressed, Iceland's public debt and debt service will remain high (see Annex III, Annex Figure 1). Staying on course will also support market confidence, which will contain borrowing costs and facilitate continued market access, crucial for a successful lifting of capital controls. Moreover, as controls are lifted, and captured funds are released, the government's interest costs could increase, underscoring the need to make progress now. Staff also advocated a swift passage of the draft Public Finances Act—which the authorities plan to submit to parliament in the fall—to strengthen budget discipline and accountability.

19. The 2014 target, a balanced budget, is still within reach. Staff highlighted that the target (adjusted marginally to account for slower-than-anticipated growth) could be reached with measures of 1½ percent of GDP over the next 18 months. Measures could include reducing agricultural subsidies, better targeting social transfers, and raising the lowest VAT rate (with offsetting subsidies to the most vulnerable groups). These measures could generate over 2 percent of GDP in fiscal adjustment, helping to address past slippages and additional fiscal risks in 2014. The authorities said that they would strive to meet the target, but noted that this would be challenging given the fiscal slippages in 2013 and the policy priorities of the new government. Nevertheless, they signaled that they would consider rolling back some initiatives implemented by the previous government and identifying new measures.

Iceland: Potential Fiscal Measures

Measure	Yield (in percent of GDP)
Reducing agricultural subsidies	0.7
Better targeting social transfers	>0.2
Raising the lowest VAT rate (with offsetting subsidies)	1.1
Total	>2.0

Sources: Ministry of Finance; and IMF staff estimates.

20. For the medium term, staff encouraged the authorities to identify more durable sources of fiscal consolidation. In this regard, cross-country analysis suggests that savings can be achieved in health and education without compromising the quality of outcomes. In these sectors, bridging half of the efficiency gap between Iceland and countries on the efficiency frontier could generate 3 percent of GDP in expenditure savings.[2] The authorities acknowledged the need to improve efficiency in these sectors and have been working on implementing the relevant OECD recommendations, particularly in health. They also emphasized that their planned policies—including tax cuts and a more welcoming investment environment—would boost revenues, spur growth, and help bring down deficit and debt ratios. While supporting the overall goal of improving investment environment, staff noted that lowering tax rates is unlikely to generate higher revenue—since cross-country studies suggest that Laffer curve effects occur at higher tax rates than present in Iceland—and will likely have only a limited near-term impact on growth given the relatively low multipliers.

D. Bringing Debt Restructuring to a Conclusion

Progress has been made with corporate and household debt restructuring, but the pace is slowing. Efforts therefore need to be intensified to complete the remaining cases. There is little fiscal space for additional household debt relief.

Background

21. There has been progress with corporate and household debt restructuring. Banks finalized the bulk of corporate debt restructuring in 2012 and the still outstanding cases are taking time because of ongoing legal disputes or their inherent complexity. By end-2012, corporate debt had reached 170 percent of GDP, down 205 percentage points from its 2008 peak (Figure 7). Household debt restructuring has also advanced, albeit at a slower pace, with debt still high at 109 percent of GDP, 24 percentage points below the 2009 peak.

22. The pace of resolving remaining cases has been slow. Still-pending Supreme Court rulings on foreign currency-related financial contracts are delaying the resolution of many cases. In the absence of legal clarity, banks have been reluctant to pursue collections or use the threat of legal action to bring noncurrent borrowers to the negotiation table. The relevant government agencies have also been slow in addressing cases, citing as reasons their lack of legal authority under the existing framework and the inadequacy of resources. The HFF has only seen a limited decline in its NPLs, reflecting weak effort in collection and debt restructuring.

Policy Discussion

23. The new government reiterated its commitment to additional household debt relief, a key electoral promise. The Prime Minister will oversee preparation of proposals (to be available by November 2013) for further relief—which will likely include a reduction in the principal of inflation-

[2] See Selected Issues Paper, "Assessing Efficiency of Public Spending on Health and Education in Iceland."

indexed mortgages. Staff emphasized that there is little fiscal space for new measures and that across-the-board measures are costly and may not provide sufficient relief to households in most distress. The authorities are of the view that this is not a fiscal issue since the initiative would most likely be financed by a windfall obtained through haircuts on the asset distribution of the old banks to their foreign creditors. Staff noted that such a windfall is uncertain and, in any case, if it does materialize a better use for it would be to reduce still-high public debt.

24. Staff instead urged the authorities to intensify efforts to complete the existing restructuring process. This would address the problems of households in distress and support a healthy resumption of credit. Within the existing framework, government agencies should be able to match the progress made by the banks. Staff therefore encouraged the authorities to identify and address bottlenecks, including by revising legislation and regulations where needed. In a welcome development, the authorities have passed legislation to accelerate court procedures clarifying the status of foreign-exchange-indexed loans. Accelerating resolutions by reducing the backlog of appeals under the Debtors Ombudsman´s framework should also be a priority. Staff emphasized that any new measures should be targeted on distressed households falling through the cracks of the existing programs—including households with deeply-underwater guarantor or HFF mortgages, and those who bought their first home during the boom years.

E. Reducing Legacy Risks in the Financial Sector

Financial sector conditions have improved, but legacy risks still need to be addressed. A comprehensive plan is needed to deal with the loss-making HFF. And while there have been welcome improvements, the financial stability framework needs further strengthening.

Background

25. The condition of the banking system has improved, but legacy risks remain high. The three largest banks' average capital adequacy ratio (CAR) is 25.5 percent. Nonperforming loans on a facility basis declined from the peak of 18.3 percent at end-2010 to 6.4 percent at end-2012. Loan valuation uncertainty is magnified by the possibility of legal challenges related to FX-linked loans. Liquidity is strong, but banks are still reliant on captive and on-demand deposits (Figure 5).

26. The HFF is in a difficult financial position. Losses are mounting (ISK 52 billion since 2008), capital adequacy is weak (3.2 percent at end 2012), and the level of non-performing loans remains high (14.8 percent at end-April). The fund faces significant prepayment risk, high asset impairments, and elevated operating costs. Maintaining capital adequacy at the current level would likely require annual capital injections of at least ISK 3-4 billion (0.2 percent of GDP).

27. Financial supervision is being strengthened. The authorities are setting up a Financial Stability Council, tasked with identifying and containing systemic risks. The Financial Supervisory

Authority (FME) is advancing its reform agenda to improve risk-based supervision, reporting by supervised entities, and its internal organizational structure.

Policy Discussion

28. Staff emphasized that still-substantial risks call for heightened supervisory oversight. Banks' profitability is increasingly challenged by declining revenues from asset revaluations, weak credit demand, and high operating costs (Figure 6). A new round of household debt restructuring would also likely have adverse implications for the banks, as they may have to further write down loan values, and borrowers may suspend payments in anticipation of restructuring. Staff therefore argued that banks should conserve capital and build more stable sources of funding to address liquidity risks. Staff encouraged the introduction of uniform rules for loan classification, including a conservative prudential treatment for restructured loans, and noted that this would need to be backed by intensive onsite supervision, requiring enhanced supervisory resources. A Basel Core Principles ROSC assessment planned for March 2014 should help identify and address supervisory gaps.

29. There was broad agreement that the HFF requires an overhaul. Staff argued that given the fiscal and financial stability risks emerging from the fund, its mandate and institutional set-up need to be reviewed from the ground up, preferably by independent experts. Further recapitalization should wait until a permanent and financially viable solution is agreed. The FME indicated that it plans a supervisory review (SREP) of HFF's capital adequacy this fall but noted that it does not have sufficient legal powers to require corrective action; the HFF is under the auspices of the Ministry of Welfare.

30. Staff welcomed plans to strengthen the financial stability framework. The planned capital account liberalization underscores the need for reinforcing regulations that limit maturity and currency mismatches. The draft liquidity rules implementing the Basel III framework, strengthened to reflect local risks (such as the reliance on captive and on-demand funds), go in the right direction. In addition, the authorities shared staff's views on the need to enhance financial safety nets in advance of the capital controls removal. This would require introducing clear procedures for emergency liquidity assistance, establishing a permanent legal framework for bank resolution, and strengthening funding arrangements for the deposit insurance scheme. All agreed that implementing the proposed inter-agency framework for tackling systemic risks should be a priority.

POST-PROGRAM MONITORING

31. Iceland's reserve position is comfortable. The baseline balance of payments outlook—which incorporates gradual capital account liberalization and deleveraging of highly indebted companies—shows reserves as staying above 100 percent of short-term debt for the projection horizon. External debt is also projected to continue declining. Iceland's contingent liabilities—and economic uncertainty more broadly—have been reduced by the European Free Trade Association

(EFTA) court judgment that Iceland did not breach its obligations under the European Economic Area (EEA) treaty in the so-called Icesave case.

32. But risks remain. As set out in paragraph 10, risks arise from: the uncertainty surrounding capital account liberalization; a weakening of fiscal consolidation; delays in investment in the energy intensive sector; and adverse Euro area developments. Strong policy implementation would help mitigate these risks. Taking a comprehensive approach to lifting the capital controls will safeguard external and financial stability. Staying on course with fiscal consolidation will maintain market confidence and support continued market access. Buttressing non-borrowed reserves through foreign exchange purchases—taking advantage of seasonal krona appreciation—would help support reserve adequacy.

STAFF APPRAISAL

33. The recovery is continuing, but crisis legacies are restraining growth. Unemployment is still declining but growth has slowed amid private sector deleveraging and weak external demand. Financial conditions have improved but legacy risks are still holding back credit expansion. Uncertainty about the lifting of capital controls is weighing on confidence and investment. Competitiveness gains have been sustained, which should help attract investment and support the recovery. In this regard, the authorities' intentions to create a more inviting investment environment are welcome.

34. Legacy vulnerabilities need to be addressed. A clear and comprehensive roadmap is needed to safely lift capital controls and remove potential growth-hindering distortions. The monetary policy stance and framework should be geared toward bringing inflation down to target. Fiscal consolidation needs to be completed in order to reduce public debt and protect growth. Financial sector risks must be tackled so as to safeguard stability.

35. An orderly lifting of capital controls requires a comprehensive approach. First, the winding up of the old banks should be handled in a manner consistent with external and financial stability. Second, incentives to participate in the authorities' capital account liberalization strategy to release liquid offshore krona need to be strengthened by publishing a well-defined strategy with a clear implementation timeline. Third, potential resident outflows following the easing of controls can be contained by imposing "speed limits" on outflows or by phasing liberalization by asset type. This should be supported by strong prudential regulations and supervision.

36. The monetary policy stance is in line with the central bank's inflation objectives. With the recent softening of economic activity, little change in the policy interest rate is needed to gradually bring inflation to target. The foreign exchange interventions conducted in the winter helped smooth a depreciation stemming from temporary factors. Looking forward, foreign exchange purchases to build up nonborrowed reserves should resume.

37. Recent slippages highlight the importance of adhering to Iceland's existing fiscal targets and improving the quality of the adjustment. The targets strike a good balance between supporting growth, ensuring that debt is on a downward trajectory, and increasing fiscal buffers in the face of new risks. The authorities' intention to maintain the 2014 target of a balanced budget is therefore welcome. However, the adjustment should be supported by durable measures. Consideration could be given to improving expenditure efficiency in health and education, reducing agricultural subsidies, and better targeting social transfers. Fiscal discipline and governance would also be strengthened by enacting the proposed framework budget law.

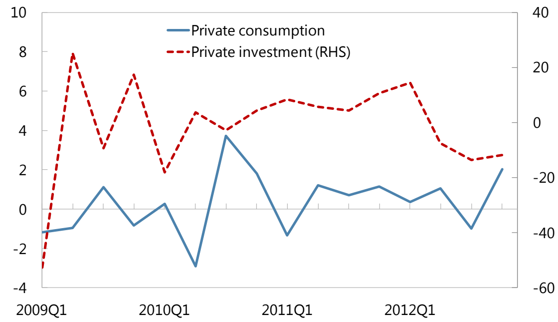
38. There is little fiscal space for additional household debt relief. Any new measures should thus be targeted on distressed households falling through the cracks of existing programs. There is scope, however, to improve existing restructuring processes and to intensify debt restructuring efforts at the HFF. In this context, the government's initiative to accelerate court procedures clarifying the status of foreign-exchange-indexed loans is welcome. In addition, the authorities should identify and address bottlenecks in order to speed up resolution within the Debtors' Ombudsman framework.

39. Still-substantial risks call for strengthening financial sector oversight. Banks should continue to maintain strong capital and liquidity buffers, improve their funding profile, and address nonperforming loans. Plans to strengthen the financial safety net need to be advanced, and the proposed inter-agency framework for tackling systemic risks should be implemented. The HFF should be reformed, after a comprehensive review of its mandate and institutional set-up.

Figure 1. Iceland: Recent Developments in Demand and Labor

Domestic demand growth is decelerating.

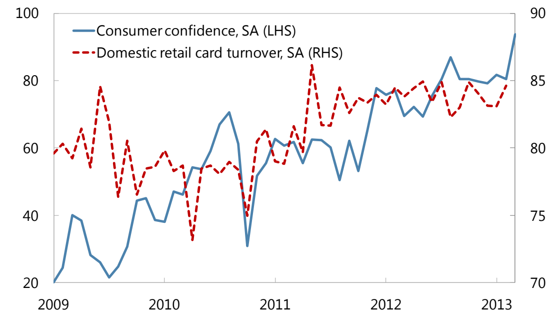
Consumption and Investment Growth
(Quarter-on-quarter percentage change, SA, annualized)



Sources: Statistics Iceland; and IMF staff calculations.

Retail turnover is stagnating, but confidence is improving.

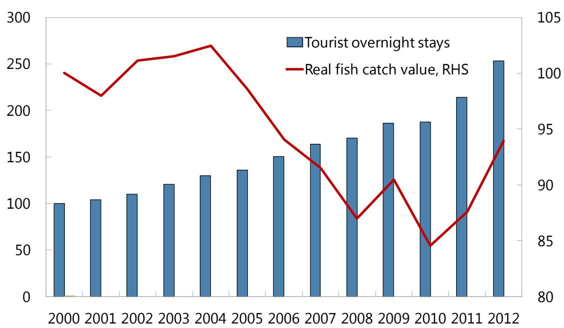
High Frequency Indicators
(Percent) (Index, 2007=100)



Source: Statistics Iceland.

Tourism and marine products are supporting exports…

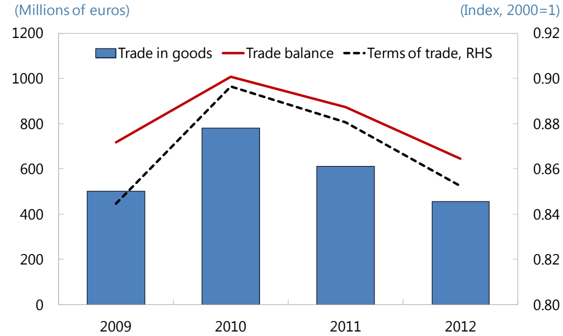
Key Exports
(Index, 2000=100)



Sources: Statistics Iceland; and IMF staff calculations.

…but declining terms of trade weigh on the trade surplus.

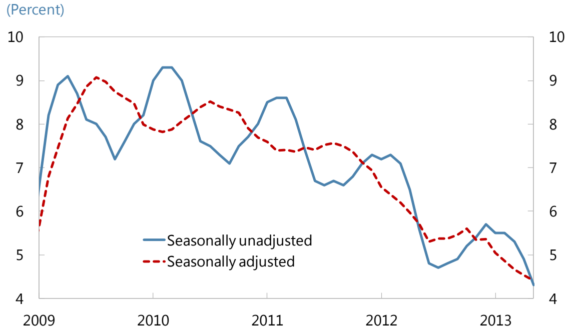
Trade Balances and Terms of Trade
(Millions of euros) (Index, 2000=1)



Sources: Statistics Iceland; Central Bank of Iceland; and Haver Analytics.

The unemployment rate is trending down…

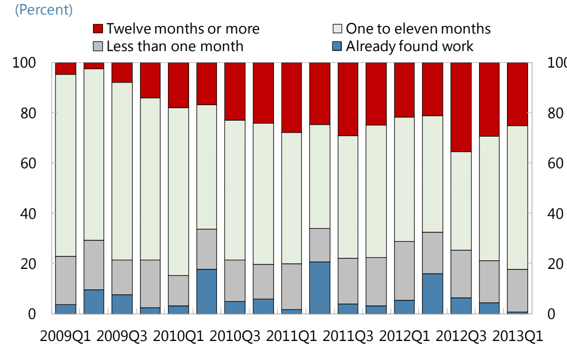
Unemployment Rate 1/
(Percent)



Sources: Department of Labor; and Haver Analytics.
1/ Refers to registered unemployment.

…but long-term unemployment remains high.

Unemployment Duration
(Percent)

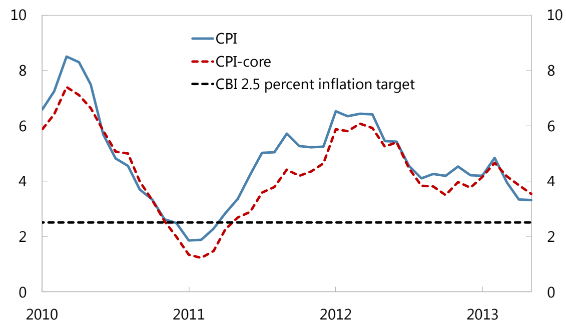


Source: Statistics Iceland Labor Market Survey.

Figure 2. Iceland: Price and Exchange Rate Developments

Inflation is easing, but is still above the CBI's target…

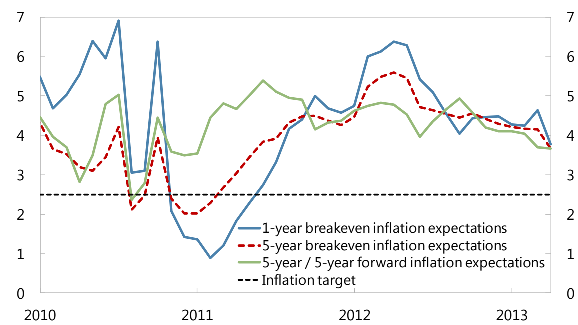
Inflation Rates
(Percent)



Sources: Central Bank of Iceland; and Statistics Iceland.

…while inflation expectations are coming down slowly…

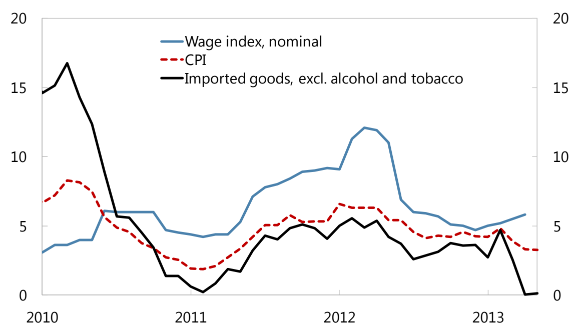
Inflation Expectations
(Percent)



Source: Central Bank of Iceland.

…helped by lower import prices.

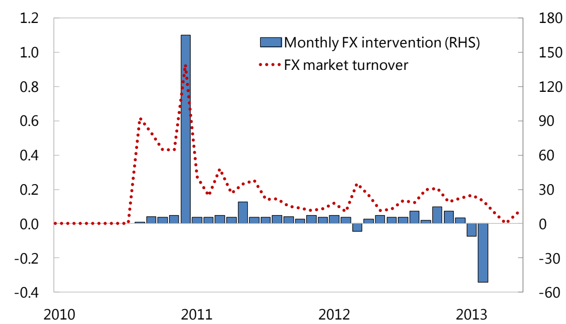
CPI, Wages and Import Prices
(Percent, 12-month growth)



Source: Statistics Iceland.

The CBI sold foreign currency early this year…

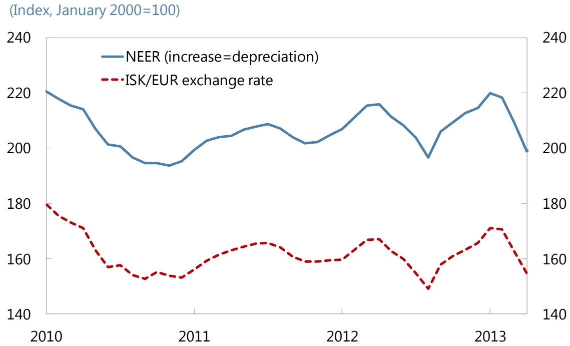
Foreign Exchange Transactions
(Percent) (Millions of euro)



Sources: Central Bank of Iceland; and IMF staff calculations.

…successfully stemming depreciation pressures…

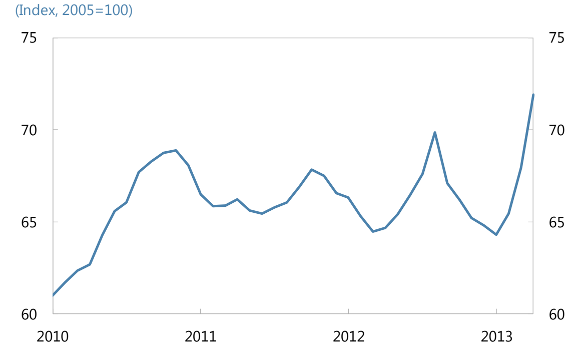
Effective Exchange Rates
(Index, January 2000=100)



Sources: Central Bank of Iceland; and Haver Analytics.

…and resulting in a real appreciation.

Real Effective Exchange Rate
(Index, 2005=100)

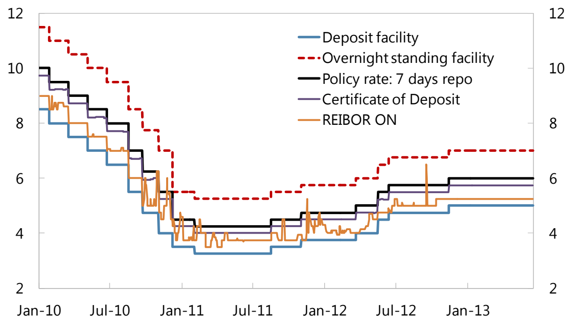


Source: IMF's INS database.

Figure 3. Iceland: Monetary Policy

Monetary policy has been tightened …

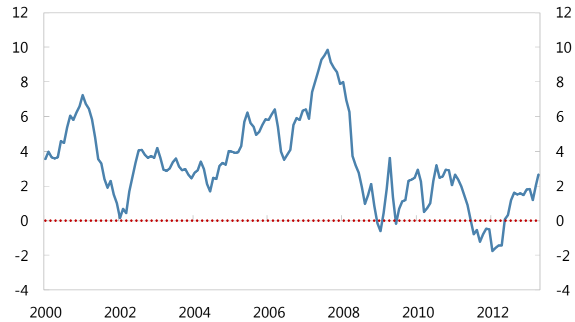
Policy and Interbank Rates
(Percent)



Source: Central Bank of Iceland.

…and real policy rates have turned positive…

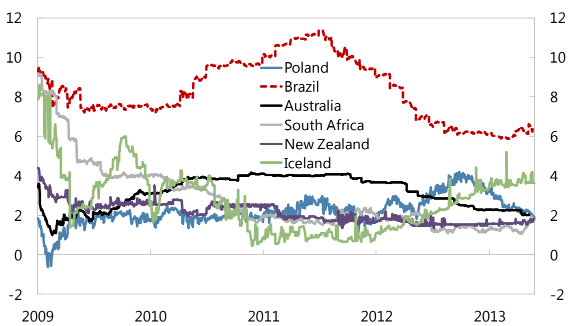
Real CBI Policy Rate
(Percent)



Sources: Central Bank of Iceland.

…while risk-adjusted rates increased.

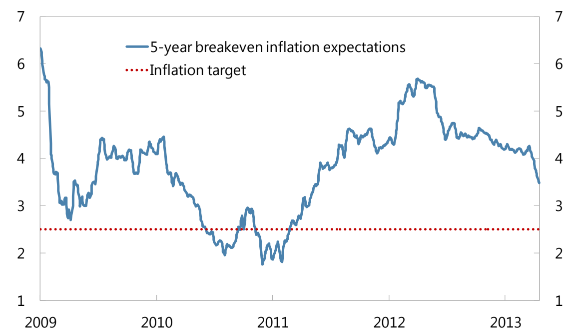
Risk-adjusted Policy Rates
(Percent)



Sources: National Authorities; Thomson Reuters; and IMF staff calculations.

Expectations remain high, but are coming down slowly.

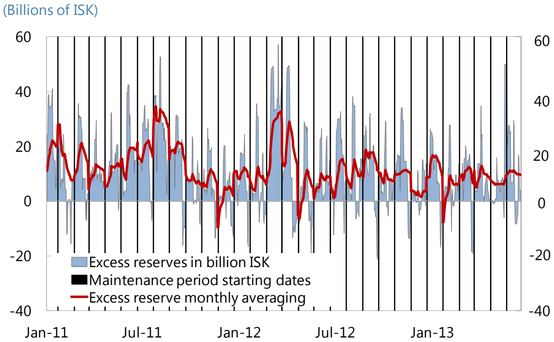
Breakeven Inflation Expectations
(Percent)



Sources: Central Bank of Iceland.

Banks continue to keep high excess reserves…

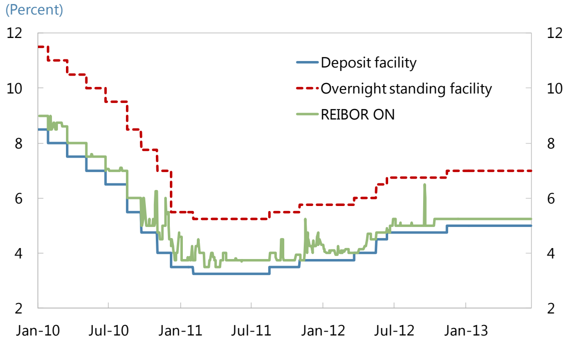
Excess Reserves
(Billions of ISK)



Source: Central Bank of Iceland.

…leaving the policy rate near the bottom of the corridor.

The Interest Rate Corridor
(Percent)

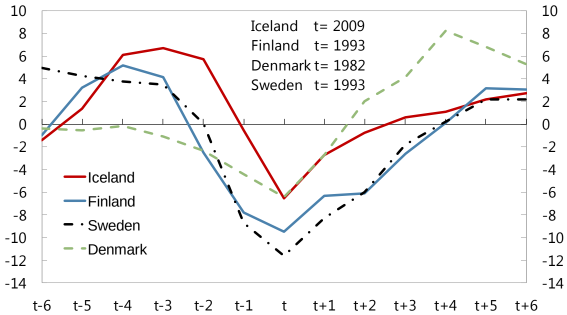


Source: Central Bank of Iceland.

Figure 4. Iceland: Fiscal Policy Developments and Outlook

The fiscal targets set in line with the Nordics' experience ...

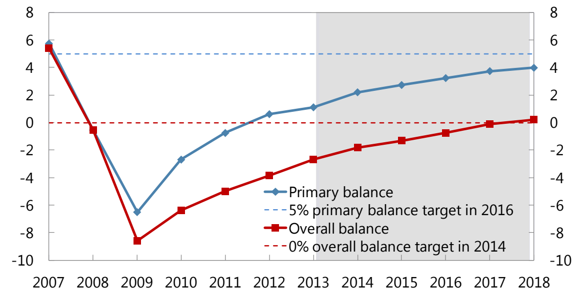
Primary Balances
(Percent of GDP, t=primary balances trough)



Source: IMF WEO; and IMF staff estimates.

... remain within reach...

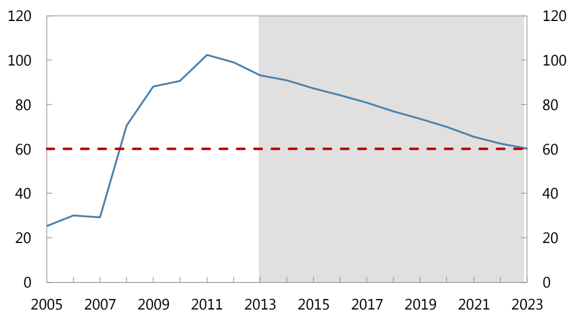
Primary and Overall Balances in Relation to the Goverment's Fiscal Targets
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates (shaded area).

...with public debt on a declining path.

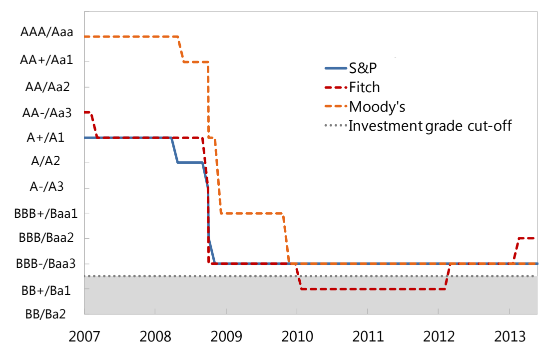
Debt to GDP Ratio
(Percent)



Sources: Ministry of Finance; and IMF staff estimates (shaded area).

Iceland enjoyed rating upgrades ....

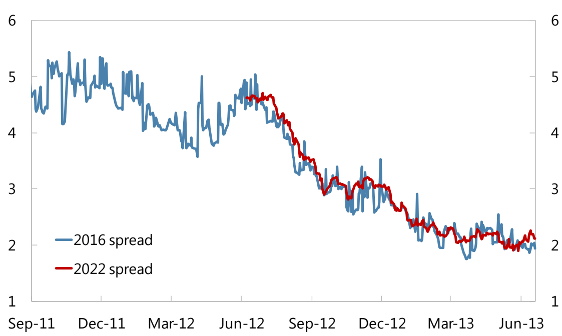
Long-Term Sovereign Credit Ratings



Source: Bloomberg.

... and sovereign spreads have come down...

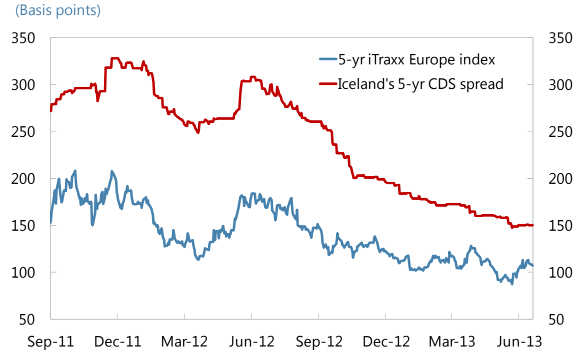
Spread on Icelandic USD-bonds against US Treasuries
(Percent)



Source: Thompson Reuters.

...in parallel with a fall in CDS spreads.

Iceland's CDS spread and the ITRAXX Europe Index
(Basis points)



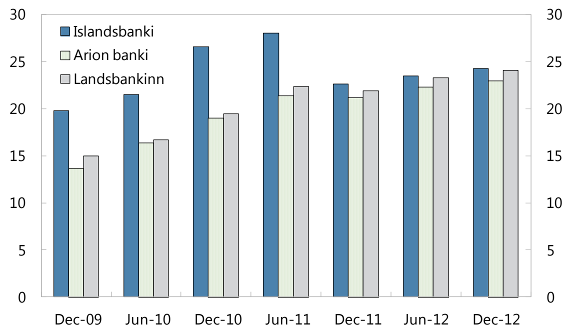
Source: Thompson Reuters.

Figure 5. Iceland: Banking Sector Developments

Capital buffers remain high...

Capital Adequacy Ratios of Commercial Banks

(Percent)

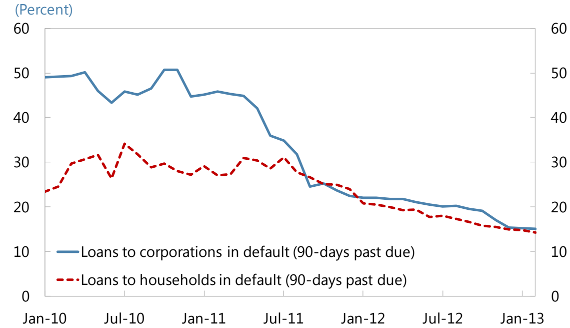


Source: Central Bank of Iceland.

...and asset quality is improving.

Loans to corporations and households in default 1/

(Percent)



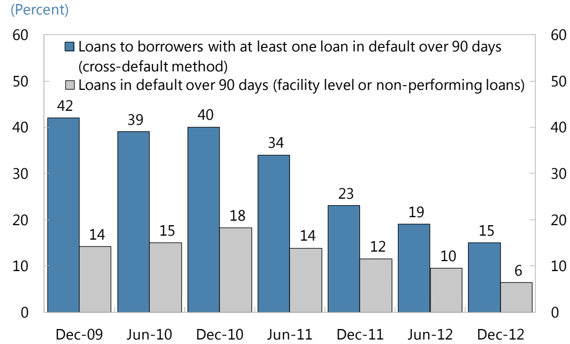
Source: Central Bank of Iceland.

1/ If a single loan is overdue for more than 90 days the entire credit position of the borrower is considered nonperforming.

However NPLs remain relatively high...

Default Ratios of the Three Largest Commercial Banks 1/

(Percent)



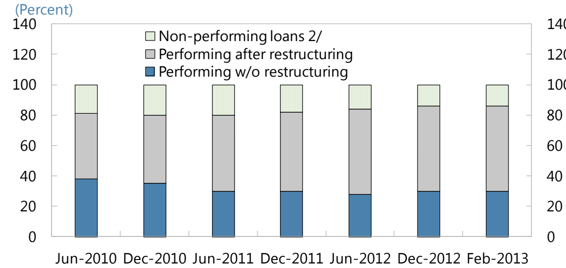
Sources: Financial Supervisory Authority; and Central Bank of Iceland.

1/Parent companies; book value.

...which calls for continuing loan restructuring efforts..

Status of Loans to Households From Three Largest Banks and Housing Financing Fund 1/

(Percent)



Sources: Financial Supervisory Authority; and Central Bank of Iceland.

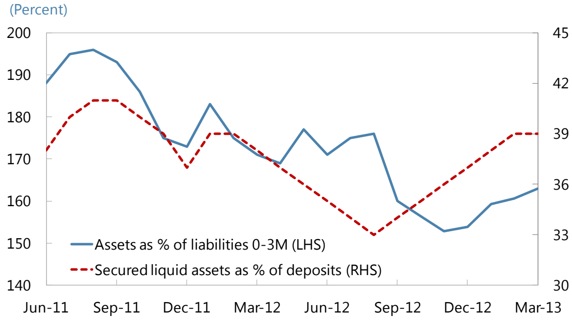
1/Parent companies; book value.

2/ Non performing loans are defined as loans in default for over 90 days or deemed unlikely to be paid.

Liquidity has been improving...

Liquidity Of The Largest Commercial Banks 1/

(Percent)



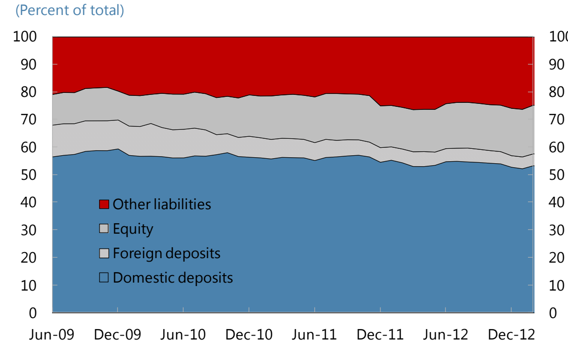
Sources: Financial Supervisory Authority; and Central Bank of Iceland.

1/ Parent companies.

...but banks continue to rely on captive deposits.

Banks Funding

(Percent of total)

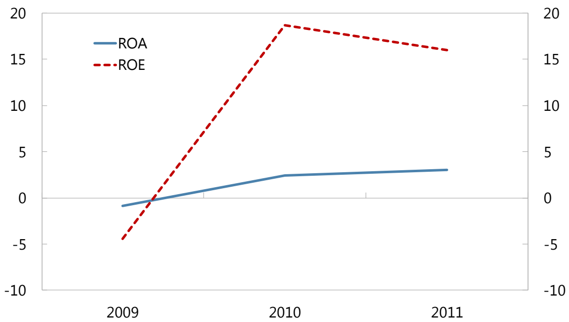


Source: Central Bank of Iceland.

Figure 6. Iceland: Financial Sector Developments

Banks are profitable...

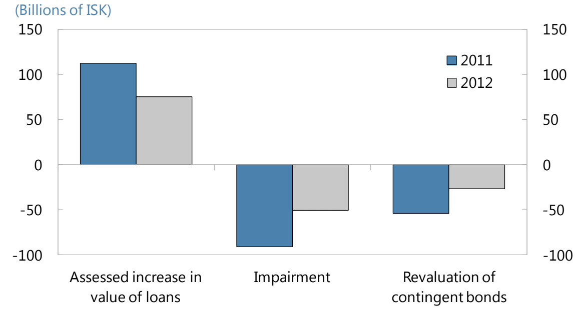
Profitability
(Percent)



Source: IMF.

...but the potential for exceptional revenues is shrinking.

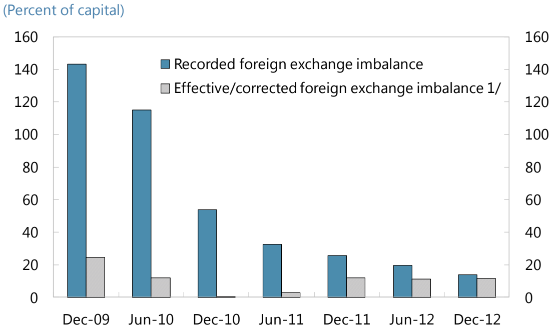
Three Largest Banks' Income and Expenses due to Revaluation of Loans and Receivables 1/
(Billions of ISK)



Source: Central Bank of Iceland.
1/ Consolidated banks' accounts.

Net open positions in FX remain positive...

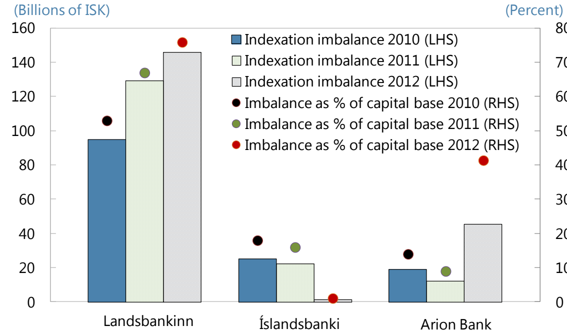
Exchange Rate Imbalance
(Percent of capital)



Source: Central Bank of Iceland.
1/ Excluding foreign exchange loans taken by borrowers with income in krona.

...while indexation imbalances are rising.

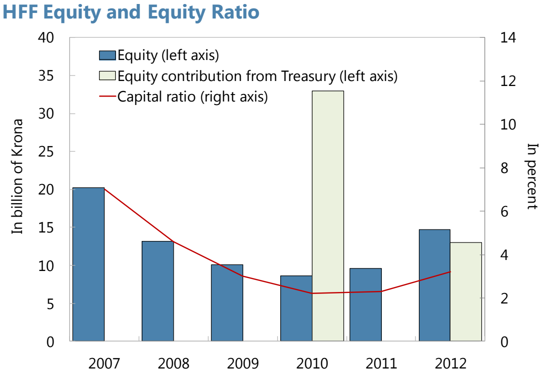
Indexation imbalances of the three largest commerical banks 1/
(Billions of ISK) (Percent)



Source: Central Bank of Iceland.
1/ Indexation imbalance reflects the difference between CPI-indexed assets and liabilities.

The HFF is undercapitalized...

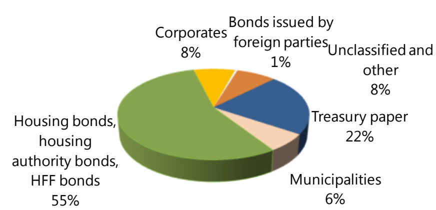
HFF Equity and Equity Ratio



Source: Housing Financing Fund.

...while pension funds are strongly interconnected through substantial holdings of HFF bonds.

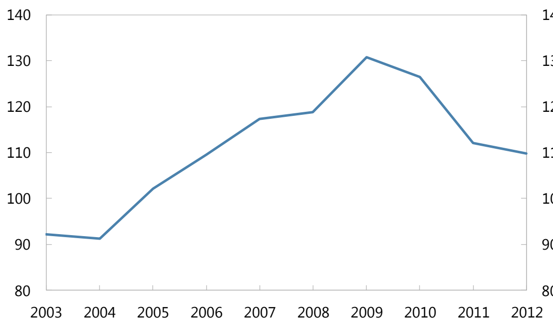
Pension Funds' Market Bonds, 2012 1/
(Percent)



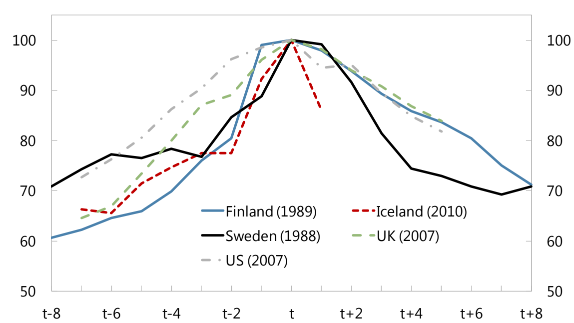
Source: Central Bank of Iceland
1/Year-end figures based on monthly reports for December are revised as soon as annual financial statements are received. The funds' final results are not available and the figures are therefore provisional and may change.

Figure 7. Iceland: Private Sector Deleveraging

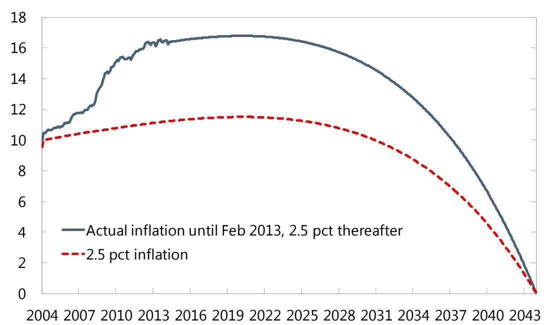
Household debt is declining...



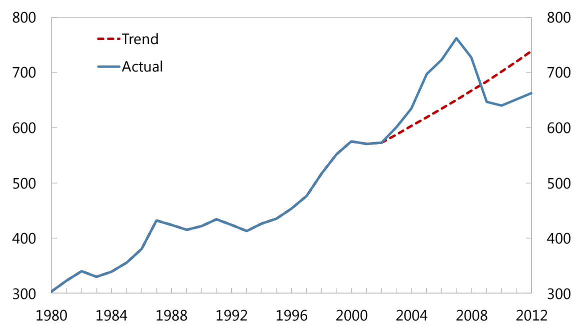
...but further deleveraging should be expected.



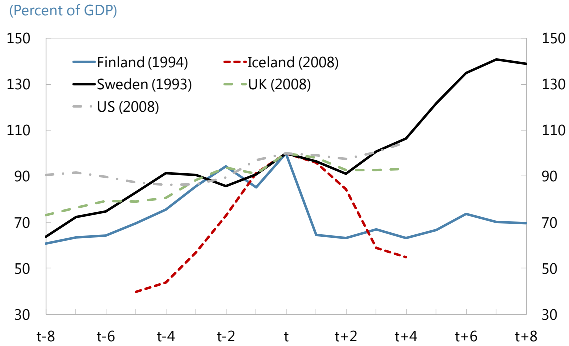
Household deleveraging is complicated by inflation-indexed mortgages...



...and weighs on consumption.



Corporate debt deleveraging has progressed further...



...but investment remains low.

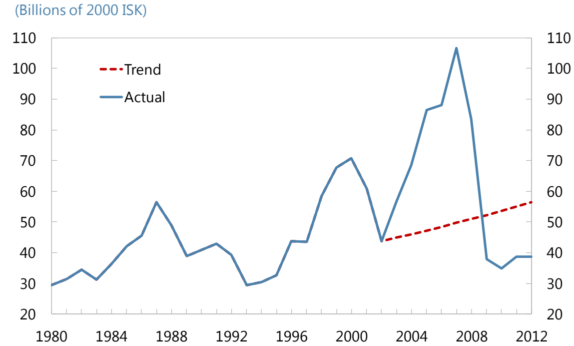


Table 1. Iceland: Selected Economic Indicators, 2007–14

	2007	2008	2009	2010	2011	2012	2013 Proj.	2014 Proj.
	(Percentage change, unless otherwise indicated)							
National Accounts (constant prices)								
Gross domestic product	6.0	1.2	-6.6	-4.1	2.9	1.6	1.9	2.1
Total domestic demand	0.0	-8.6	-20.3	-2.2	3.4	2.1	1.2	3.8
Private consumption	5.7	-7.8	-14.9	0.0	2.6	2.7	2.3	2.2
Public consumption	4.1	4.6	-1.7	-3.4	-0.2	-0.2	1.7	1.5
Gross fixed investment	-12.2	-20.4	-51.4	-9.4	14.3	4.4	-3.9	15.3
Export of goods and services	17.7	7.0	7.0	0.6	4.1	3.9	3.5	4.0
Imports of goods and services	-1.5	-18.4	-24.0	4.5	6.8	4.8	2.0	6.2
Output gap 1/	3.6	1.7	-2.8	-5.9	-3.5	-1.0	-0.8	0.0
Selected Indicators								
Nominal GDP (bln ISK)	1,308.5	1,480.3	1,497.9	1,535.9	1,632.0	1,708.2	1,790.5	1,902.5
Unemployment rate 2/	1.0	1.6	8.0	8.1	7.4	5.8	5.1	4.6
Consumer price index	5.0	12.4	12.0	5.4	4.0	5.2	3.7	3.1
Nominal wage index	8.9	7.5	2.8	7.9	7.0	8.5	5.2	6.3
Nominal effective exchange rate 3/	2.5	-40.4	-34.2	2.9	-0.1	-2.4	...	...
Real effective exchange rate 3/	6.0	-20.7	-18.7	6.4	0.9	0.6	3.5	-0.3
Terms of trade	0.2	-9.3	-6.7	6.0	-1.8	-3.2	-1.8	1.5
Money and Credit								
Base Money	190.7	-31.5	1.3	-19.4	-20.7	32.0	-17.6	...
Deposit money bank credit (end-period)	56.6	-28.3	-17.8	-3.5	1.9	0.2	0.0	...
Broad money (end-period)	56.4	36.3	1.2	-9.9	8.7	-2.8	0.6	...
CBI policy rate (period average)	13.8	15.4	13.7	7.8	4.4	5.4	...	...
	(Percent of GDP, unless otherwise indicated)							
Public Finance								
General government 4/								
Revenue	47.7	44.1	41.0	41.5	41.7	43.1	43.8	43.8
Expenditure	42.3	44.7	49.6	47.9	46.7	46.9	46.4	45.6
Balance	5.4	-0.5	-8.6	-6.4	-5.0	-3.8	-2.7	-1.8
Primary balance	5.7	-0.5	-6.5	-2.7	-0.8	0.6	1.1	2.2
Balance of Payments								
Current account balance	-15.7	-28.4	-11.6	-8.4	-5.6	-4.9	-1.2	-1.9
Trade balance	-10.1	-2.3	8.6	10.1	8.5	6.3	6.4	5.6
Financial and capital account	18.1	-66.9	-30.7	52.2	17.6	-7.5	-2.0	-0.1
Net errors and omissions	-1.0	-19.5	36.2	-25.5	7.6	-9.7	0.0	0.0
Gross external debt 5/	605.9	564.7	269.8	295.2	254.7	222.2	207.6	191.3
Central bank reserves (US$ billion)	2.6	3.6	3.5	5.8	8.5	4.2	3.7	3.4

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and IMF staff estimates.

1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ A positive (negative) sign indicates an appreciation (depreciation).
4/ National accounts basis.
5/ Including face value of old banks debt before 2009. Related interest transactions are not included from Q4 2008 on.

Table 2. Iceland: Money and Banking, 2010-13

(Billion of Krona, unless otherwise indicated)

	Dec-10	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13 Proj.	Sep-13 Proj.	Dec-13 Proj.
Central Bank													
Net foreign assets 1/	-177	-116	-73	-42	90	-39	-37	-31	-18	-31	-19	-7	5
Assets	715	766	831	917	1,052	982	856	537	545	505	497	489	480
Liabilities	892	882	904	959	962	1,022	893	569	564	537	516	496	475
Net domestic assets	271	192	145	113	-16	123	113	102	117	116	105	86	76
Net claims on the public sector	28	17	21	75	47	31	33	68	42	44	56	56	58
Net claims excluding recap bond	-142	-156	-149	-97	-145	-163	-164	-125	-142	-145	-143	-142	-140
Recapitalization bond	171	173	170	172	192	194	197	193	185	189	199	198	198
Net claims on banks 2/	-19	-55	-104	-170	-244	-90	-94	-126	-93	-91	-90	-90	-93
Others Items, net	262	231	228	209	182	183	174	161	167	163	139	120	111
Base Money 3/	94	76	72	71	74	83	76	71	98	85	85	79	81
Currency issued	35	32	33	34	39	37	37	37	41	39	39	33	35
DMB deposits at the central bank	59	44	39	37	35	47	39	34	57	46	46	46	46
Banking System													
Net foreign assets	77	108	117	145	205	220	159	217	254	267	267	270	269
Net domestic assets	1,338	1,310	1,291	1,402	1,331	1,306	1,363	1,304	1,237	1,216	1,223	1,229	1,237
Net claims on the central bank	76	96	122	176	121	134	131	156	147	134	136	136	139
Credit to private sector	1,785	1,762	1,735	1,715	1,820	1,828	1,830	1,806	1,823	1,825	1,827	1,829	1,827
Credit to government	222	225	228	230	233	236	239	242	245	248	251	255	262
Other items, net	-745	-773	-794	-719	-843	-892	-837	-900	-978	-991	-991	-991	-991
Domestic deposits	1,414	1,418	1,408	1,547	1,536	1,526	1,522	1,521	1,491	1,483	1,490	1,499	1,506
Local currency	1,327	1,333	1,335	1,445	1,462	1,435	1,434	1,422	1,391	1,374	1,380	1,389	1,396
Foreign currency	87	84	72	102	74	91	88	99	100	110	110	110	110
Consolidated Financial System													
Net foreign assets	-101	-8	43	103	295	180	122	186	235	236	248	263	274
Net domestic assets	1,550	1,458	1,397	1,478	1,280	1,382	1,437	1,372	1,296	1,286	1,282	1,269	1,267
Net claims on the public sector	250	242	249	305	280	267	272	310	287	292	307	311	320
Net credit to private sector	1,785	1,762	1,735	1,715	1,820	1,828	1,830	1,806	1,823	1,825	1,827	1,829	1,823
Other, net	-486	-546	-588	-541	-820	-713	-664	-743	-814	-831	-852	-871	-876
Broad Money (M3)	1,449	1,450	1,440	1,581	1,575	1,562	1,559	1,552	1,532	1,522	1,529	1,532	1,541
Memorandum items:													
Base money (y-o-y percentage change)	-19.4	-31.9	-17.8	-1.0	-20.7	10.0	5.4	-0.7	32.0	1.7	12.1	11.5	-17.6
Broad money (y-o-y percentage change)	-9.9	-8.2	-5.0	5.5	8.7	7.8	8.3	-1.8	-2.8	-2.6	-2.0	-1.3	0.6
Credit to private sector	-3.5	-7.1	-7.0	-5.6	1.9	3.8	5.5	5.3	0.2	-0.2	-0.2	1.3	0.0
Money velocity (GDP/base money)	16.4	21.2	22.7	22.5	21.9	19.9	22.1	23.6	17.4	20.9	21.6	24.4	24.9
Broad money velocity (GDP/M3)	1.1	1.1	1.1	1.1	1.0	1.1	1.1	1.1	1.1	1.2	1.2	1.3	1.3
Multiplier (M3 / base money)	15.4	19.1	20.0	22.2	21.1	18.7	20.6	22.0	15.6	17.9	18.0	19.4	19.0

Sources: Central Bank of Iceland; and Fund staff estimates.

1/ Foreign liabilities include fx deposits of domestic banks and the government.

2/ Net claims on banks is the difference between CBI's lending to banks and banks' holding of certificates of deposits.

3/ Base money includes currency in circulation (ex cash in vault) and DMBs deposits at the central bank in krona.

Table 3. Iceland: Medium-Term Projections, 2010–18

	2010	2011	2012 Prel.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.
				(Percentage change)					
Real economy									
Real GDP	-4.1	2.9	1.6	1.9	2.1	2.2	2.2	2.2	2.3
Real domestic demand	-2.2	3.4	2.1	1.2	3.8	3.1	0.2	1.5	2.9
Private consumption	0.0	2.6	2.7	2.3	2.2	2.2	2.2	2.3	2.4
Public consumption	-3.4	-0.2	-0.2	1.7	1.5	0.4	1.8	1.4	1.4
Gross fixed investment	-9.4	14.3	4.4	-3.9	15.3	11.2	-8.9	-1.6	7.5
Net exports 1/	-1.1	-0.4	0.1	0.9	-0.3	-0.4	1.9	1.0	0.0
Exports of goods and services	0.6	4.1	3.9	3.5	4.0	3.8	5.2	4.8	3.8
Imports of goods and services	4.5	6.8	4.8	2.0	6.2	5.9	1.9	3.7	5.1
Output gap 2/	-5.9	-3.5	-1.0	-0.8	0.0	0.3	0.0	0.0	0.0
Potential output	-1.0	0.3	0.3	0.5	1.1	2.0	2.5	2.2	2.3
Unemployment rate 3/	8.1	7.4	5.8	5.1	4.6	4.5	4.3	4.1	4.0
Real wages	2.4	2.9	3.2	1.4	3.1	2.1	2.1	2.1	2.1
CPI inflation	5.4	4.0	5.2	3.7	3.1	2.5	2.5	2.5	2.5
CPI inflation (excl. effect of ind. taxes)	4.4	3.8	5.0	3.6	3.1	2.5	2.5	2.5	2.5
CPI inflation (end of period)	2.5	5.3	4.2	3.6	2.9	2.4	2.5	2.5	2.5
Nominal ISK/EUR exchange rate	161.7	161.0	160.5	…	…	…	…	…	…
Real exchange rate (+ appreciation)	6.4	0.9	0.6	3.5	-0.3	-0.4	-0.4	-0.6	1.0
Terms of trade	6.0	-1.8	-3.2	-1.8	1.5	2.2	0.9	1.5	1.2
Nominal GDP (bln ISK)	1535.9	1632.0	1708.2	1790.5	1902.5	2017.9	2125.3	2245.8	2365.2
				(Percent of GDP, unless otherwise indicated)					
Balance of Payments									
Current account	-8.4	-5.6	-4.9	-1.2	-1.9	-1.6	0.8	1.8	1.7
Underlying current account 4/	8.3	6.6	1.9	-0.4	-1.2	-0.9	1.5	2.4	2.3
Trade balance	10.1	8.5	6.3	6.4	5.6	5.8	8.1	9.6	9.6
Net income balance 5/	-17.9	-13.6	-10.6	-7.0	-7.0	-6.9	-6.8	-7.3	-7.4
Capital and financial account	52.2	17.6	-7.5	-2.0	-0.1	1.9	-1.3	1.4	-2.0
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	21.8	7.5	28.7	1.1	2.4	2.8	1.9	1.8	0.6
Portfolio investment, net	-4.0	-1.5	5.4	3.5	1.0	5.6	0.3	-2.8	-0.7
Other investment, net	34.5	11.5	-41.5	-6.6	-3.5	-6.4	-3.5	2.4	-1.8
Accumulation of arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	8.3	14.7	-9.7	0.0	0.0	-3.2	-1.3	0.0	0.0
Gross external debt 6/	295.2	254.7	222.2	207.6	191.3	178.0	160.0	150.9	144.6
Underlying gross external debt 7/	275.3	228.4	203.7	189.8	173.9	162.8	147.6	139.2	132.9
Net external debt 8/	187.2	173.6	102.5	96.4	86.9	81.4	69.9	63.1	62.8
Central bank reserves (US$ billion)	5.8	8.5	4.2	3.7	3.4	2.9	2.6	3.2	3.1
General government accounts									
Revenue	41.5	41.7	43.1	43.8	43.8	43.0	43.7	42.8	42.5
Expenditure	47.9	46.7	46.9	46.4	45.6	44.3	43.6	42.9	42.3
Overall balance 9/	-6.4	-5.0	-3.8	-2.7	-1.8	-1.3	-0.7	-0.1	0.2
Primary balance	-2.7	-0.8	0.6	1.1	2.2	2.7	3.2	3.7	4.0
Gross debt	90.6	102.3	99.1	93.2	90.9	87.2	84.2	80.7	77.0
Net Debt	59.9	66.7	68.2	64.1	63.6	62.4	60.3	58.3	56.2

Sources: CBI; and IMF staff estimates.

1/ Contributions to growth.
2/ In percent of potential output
3/ In percent of labor force.
4/ Excludes old banks transactions and accrued interest payments on intra-company debt held by a large multinational.
5/ Includes interest payments due from the financial sector and income receipts to the financial sector.
6/ Excluding old banks' total liabilities, but external debt includes TIF's deposit liabilities, and accumulated recovered assets from both external and domestic sources before being paid out to foreign creditors. Once recovered, these assets are recorded as short-term debt.
7/ Excluding short-term debt that are covered by external assets.
8/ Gross external debt minus debt securities and other investment assets.
9/ Excludes write-offs recorded as capital transfers and revenues from the exit tax.

Table 4. Iceland: Balance of Payments, 2010–18

(U.S. Dollar billions)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
			Prel.	Proj.	Proj.	Proj	Proj	Proj	Proj
Current Account	-1.1	-0.8	-0.7	-0.2	-0.3	-0.3	0.1	0.3	0.3
Trade Balance	1.3	1.2	0.9	0.9	0.9	0.9	1.4	1.7	1.8
Balance on Goods	1.0	0.8	0.6	0.5	0.5	0.6	0.8	0.8	0.9
Merchandise exports f.o.b.	4.6	5.3	5.0	4.9	5.2	5.5	6.1	6.5	6.9
Merchandise imports f.o.b.	-3.6	-4.5	-4.4	-4.4	-4.7	-4.9	-5.3	-5.6	-6.0
Balance on Services	0.3	0.4	0.3	0.4	0.4	0.4	0.6	0.9	0.9
Exports of services, total	2.5	3.0	3.0	3.4	3.6	4.0	4.2	4.5	4.7
Imports of services, total	-2.2	-2.6	-2.8	-3.0	-3.2	-3.6	-3.6	-3.6	-3.8
Balance on Income 1/	-2.3	-1.9	-1.4	-1.0	-1.1	-1.1	-1.2	-1.3	-1.4
Receipts	0.5	1.2	0.7	0.7	0.8	0.8	0.9	0.9	1.0
of which dividends and reinvested earnings	0.2	0.9	0.5	0.5	0.5	0.5	0.6	0.6	0.7
of which interest receipts	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.3	0.3
Expenditures	-2.7	-3.1	-2.2	-1.7	-1.8	-1.9	-2.1	-2.3	-2.4
of which dividends and reinvested earnings	-0.9	-1.0	-0.8	-0.7	-0.7	-0.8	-0.8	-0.8	-0.9
of which interest payments	-1.8	-2.1	-1.3	-1.0	-1.1	-1.1	-1.3	-1.4	-1.5
Current transfer, net	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Cap and Finan. Acct	6.6	2.5	-1.0	-0.3	0.0	0.3	-0.2	0.3	-0.4
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	6.6	2.5	-1.0	-0.3	0.0	0.3	-0.2	0.3	-0.4
Direct investment, net	2.7	1.1	3.9	0.2	0.4	0.5	0.3	0.3	0.1
Portfolio investment, net	-0.5	-0.2	0.7	0.5	0.1	0.9	0.1	-0.5	-0.1
Assets	0.2	-0.9	-0.6	0.2	-0.1	-0.1	0.0	-0.6	-0.3
Liabilities 2/	-0.7	0.7	1.4	0.3	0.2	1.0	0.1	0.1	0.2
Net borrowing	-0.7	0.7	1.4	0.2	0.1	0.9	0.0	-0.1	0.1
Equities	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Other investment, net 3/	4.3	1.6	-5.7	-1.0	-0.5	-1.1	-0.6	0.4	-0.4
Assets	2.4	4.1	-2.4	-1.2	-0.8	-1.5	-0.9	0.7	-0.1
Liabilities 2/	1.9	-2.5	-3.3	0.2	0.2	0.4	0.3	-0.3	-0.3
Net errors and omissions	-3.2	1.1	-1.3	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	2.3	2.8	-3.0	-0.5	-0.3	0.0	-0.1	0.6	-0.1
Overall financing	-1.6	-2.8	3.0	0.5	0.3	0.0	0.1	-0.6	0.1
Change in gross reserves ("-" = increase)	-2.6	-4.8	4.3	0.5	0.3	0.5	0.3	-0.6	0.1
Accumulation of arrears ("-" = paydown)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 4/	1.0	2.1	-1.3	0.0	0.0	-0.5	-0.2	0.0	0.0
Fund ("+" = net disbursement)	0.3	0.9	-1.3	0.0	0.0	-0.4	-0.2	0.0	0.0
Bilateral (earmarked/ non-cash)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other identified new financing 5/	0.7	1.2	0.0	0.0	0.0	-0.1	0.0	0.0	0.0
Financing Gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Level of gross reserves (eop)	5.8	8.5	4.2	3.7	3.4	2.9	2.6	3.2	3.1
Level of gross reserves (eop) excluding old bank deposits	4.5	5.8	4.2	3.7	3.4	2.9	2.6	3.2	3.1
Memo									
GDP $ bln	12.6	14.1	13.7	14.6	15.4	16.4	17.3	18.1	19.1
Underlying balance of income 6/	-0.2	-0.2	-0.5	-0.9	-1.0	-1.0	-1.1	-1.2	-1.3
Underlying current account balance 6/	1.0	0.9	0.3	-0.1	-0.2	-0.2	0.3	0.4	0.4
Reserves (months of imports of G&S)	9.7	14.2	6.7	5.6	4.8	4.0	3.4	3.9	3.8
Reserves/S-T debt (residual basis, in percent) 7/	56.6	90.0	125.3	102.0	152.8	118.8	163.2	159.4	147.5
Reserves (in percent of GDP)	46.0	60.7	30.7	25.6	22.1	17.9	15.2	17.7	16.5

Sources: CBI; and IMF staff estimates.

1/ Actual data include old banks' incomes.

2/ Unlike in the 2012 Article IV staff report, where claims on Kaupthing and Glitnir are assumed to be transformed into equity, these now assumed to remain as debt (see Annex III for details).

3/ Includes inflows and outflows related to non-Icesave depositor obligations of Old Landsbanki.

4/ Debt service payments on extraordinary financing appear in the financial account, except for Fund repurchases.

5/ Excludes Polish loan (assumed to be converted into holding of Polish treasuries in zloty, which do not qualify as reserves assets).

6/ Excludes old banks transactions and accrued interest payments on intra-company debt held by a large multinational.

7/ Excludes resolution committee deposits at the central bank.

Table 5. Iceland: General Government Operations, 2009–18

(GFS, modified cash, percent of GDP 1/)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue	**41.0**	**41.5**	**41.7**	**43.1**	**43.8**	**43.8**	**43.0**	**43.7**	**42.8**	**42.5**
Taxes	**30.7**	**30.9**	**31.7**	**33.0**	**33.1**	**33.2**	**32.8**	**33.6**	**32.8**	**32.9**
Taxes on income and profits	16.0	15.6	16.3	16.9	17.2	17.3	17.4	17.5	17.6	17.8
Personal Income Tax	12.8	12.8	13.5	14.0	14.0	14.2	14.2	14.4	14.5	14.5
Corporate Income Tax	1.8	1.0	1.8	1.9	2.3	2.3	2.3	2.3	2.3	2.4
Capital gains tax, rental income	1.4	1.8	1.0	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Taxes on payroll and workforce	0.2	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Taxes on property	2.1	2.3	2.3	2.5	2.7	2.8	2.4	2.3	2.3	2.3
Taxes on goods and services	11.7	12.0	12.0	12.3	12.0	12.0	11.8	11.7	11.7	11.6
VAT	8.0	8.0	8.0	7.9	8.0	8.0	7.9	7.9	7.9	7.9
Other taxes on goods and services	3.6	4.0	4.0	4.4	4.0	4.0	3.9	3.8	3.8	3.7
Taxes on international trade	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other taxes	0.4	0.4	0.4	0.5	0.4	0.4	0.4	1.2	0.4	0.4
Social contributions	**3.1**	**4.1**	**4.1**	**3.9**	**3.8**	**3.8**	**3.8**	**3.9**	**3.9**	**3.9**
Grants	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Other revenue	**7.1**	**6.3**	**5.7**	**6.0**	**6.7**	**6.6**	**6.2**	**6.0**	**5.8**	**5.5**
Property income	3.6	2.6	2.1	2.6	2.7	2.3	2.0	1.9	1.7	1.7
o/w Interest income	3.1	2.1	1.5	1.3	1.4	1.2	1.1	1.0	1.0	0.9
Total expenditure	**49.6**	**47.9**	**46.7**	**46.9**	**46.4**	**45.6**	**44.3**	**43.6**	**42.9**	**42.3**
Current expense	**48.2**	**47.1**	**47.0**	**47.2**	**46.6**	**45.9**	**44.6**	**44.0**	**43.2**	**42.5**
Compensation of employees	15.0	14.8	14.5	14.8	15.1	14.9	14.6	14.6	14.5	14.4
Use of goods and services	12.5	12.2	11.7	11.4	11.6	11.4	11.1	10.9	10.6	10.5
Consumption of fixed capital	2.1	2.2	2.1	2.2	2.2	2.2	2.2	2.1	2.1	2.0
Interest	5.2	5.8	5.7	5.8	5.2	5.2	5.1	5.0	4.9	4.7
Subsidies	1.9	1.8	1.8	1.7	1.7	1.7	1.7	1.6	1.6	1.6
Grants	0.4	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social benefits	8.1	7.9	8.5	8.0	8.1	8.0	7.8	7.8	7.7	7.6
Other expense	3.0	2.3	2.4	3.1	2.6	2.3	2.0	1.8	1.6	1.4
Nonfinancial assets	**1.4**	**0.7**	**-0.3**	**-0.3**	**-0.2**	**-0.2**	**-0.3**	**-0.4**	**-0.3**	**-0.2**
Non-financial assets, acquisition	3.5	2.9	1.8	1.8	2.0	2.0	1.9	1.7	1.8	1.8
Consumption of fixed capital (-)	-2.1	-2.2	-2.1	-2.2	-2.2	-2.2	-2.2	-2.1	-2.1	-2.0
Net lending/borrowing (augmented) 2/	**-8.6**	**-6.4**	**-5.0**	**-3.8**	**-2.7**	**-1.8**	**-1.3**	**-0.7**	**-0.1**	**0.2**
Net lending/borrowing 3/	**-10.9**	**-10.3**	**-6.2**	**-3.8**	**-2.7**	**-2.2**	**-1.7**	**-0.3**	**-0.4**	**0.2**
Financial assets, transactions	**5.2**	**2.2**	**-1.6**	**-5.1**	**-0.3**	**-0.1**	**-0.7**	**0.5**	**0.0**	**-0.3**
Currency and deposits	3.0	7.2	-1.9	-5.5	-0.7	-0.3	-1.0	0.2	-0.3	-0.6
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	-7.7	-6.0	0.4	0.3	0.4	0.2	0.3	0.3	0.3	0.3
Shares and other equities	9.3	2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	0.6	-1.8	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, transactions	**16.1**	**12.5**	**4.5**	**-1.3**	**2.5**	**2.2**	**1.0**	**1.2**	**0.2**	**-0.5**
Securities other than shares	21.9	6.6	4.4	0.6	2.5	2.1	0.1	1.4	0.2	-0.3
Loans	-6.2	3.9	-0.1	-2.3	0.0	0.1	1.0	-0.1	-0.1	-0.2
Domestic loans	-7.5	1.7	0.7	0.1	0.4	0.1	-0.1	-0.1	-0.1	-0.2
Foreign loans	1.3	2.2	-0.8	-2.4	-0.4	0.0	1.0	0.0	0.0	0.0
Insurance technical reserves	0.1	0.1	0.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.2	2.0	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Stock of debt										
General government gross debt	88.0	90.6	102.3	99.1	93.2	90.9	87.2	84.2	80.7	77.0
Domestic	61.0	66.0	72.9	72.3	63.7	57.4	54.5	52.9	51.0	48.5
Foreign currency 4/	27.0	24.6	29.4	26.8	29.4	33.5	32.6	31.2	29.7	28.4
of which:										
Bilateral loans to support CBI reserves	3.1	7.4	13.5	6.2	5.5	5.2	4.8	4.5	4.3	3.8
Other	23.9	17.2	15.8	20.6	23.9	28.3	27.9	26.7	25.5	24.7
General government net debt 5/	55.7	59.9	66.7	68.2	64.1	63.6	62.4	60.3	58.3	56.2
Structural Balances 6/										
Structural balance	-7.5	-3.7	-3.7	-2.6	-2.8	-2.6	-2.1	-1.3	-0.5	0.1
Structural primary balance	-5.4	-0.2	0.4	1.8	1.0	1.4	1.9	2.7	3.3	3.8
Memo Items										
Nominal GDP (billion ISK)	1498	1536	1632	1708	1791	1902	2018	2125	2246	2365
Primary revenue	37.9	39.4	40.2	41.7	42.4	42.6	41.9	41.9	41.7	41.5
Primary expenditure	44.4	42.1	41.0	41.1	41.2	40.4	39.2	38.6	38.0	37.6
Primary balance	-6.5	-2.7	-0.8	0.6	1.1	2.2	2.7	3.2	3.7	4.0

Sources: IceStat; Ministry of Finance; and IMF staff estimates.

1/ Historical data are semi-accrual; projections are modified cash.

2/ Excludes write-offs recorded as capital transfers and revenues from the exit tax. Write-offs in 2008 are the result of CBI recapitalization and securities lending contracts that failed following the banks' collapse. Write-offs in 2009 reflect the retroactive interest paid to new banks to compensate for late capitalization. Write-offs in 2010 reflect called guarantees of the State Guarantee Fund and HFF recapitalization. Write-offs in 2011 reflect recapitalization of the savings bank and does not include the state's revaluation of its equity holdings in the Regional Development Institute and the NSA Ventures since these are valuation changes recorded in the balance sheet of the government. Write-offs in 2012 reflect the recapitalization of the HFF.

3/ Excludes asset sales.

4/ Includes bilateral loans and international bond issuance to support foreign currency reserves at the Central Bank of Iceland (CBI). The loan from the Norwegian government directly to the CBI is excluded from general government debt. Does not include Fund liabilities.

5/ Gross debt minus liquid assets at the CBI (including assets to support CBI reserves, which are assumed to be liquid).

6/ In percent of potential GDP. Structural estimates for 2008-2009 account for the impact of the asset bust price cycle.

Table 6. Iceland: Central Government Operations, 2009–18

(GFS modified cash basis, percent of GDP)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Cash receipts from operating activities	**27.7**	**30.1**	**28.8**	**29.6**	**30.3**	**30.2**	**29.4**	**30.1**	**29.1**	**28.8**
Tax revenue	21.3	22.3	22.2	23.3	23.1	23.1	22.6	23.4	22.6	22.6
Taxes on income, profits, and capital gains	9.3	9.0	9.1	9.2	9.1	9.1	9.1	9.2	9.2	9.4
Personal income tax	5.5	5.8	5.7	5.9	5.9	5.9	6.0	6.0	6.1	6.1
Corporate income tax	1.2	1.2	1.8	2.2	2.3	2.3	2.3	2.3	2.3	2.4
Other taxes on income and profit	2.6	1.9	1.6	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Taxes on payroll and workforce	0.2	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Taxes on property	0.4	0.6	0.7	0.9	0.9	0.9	0.5	0.5	0.5	0.5
Taxes on sales and services	10.8	11.8	11.4	11.9	12.0	11.9	11.8	11.6	11.6	11.5
Taxes on international trade and transactions	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Other tax revenue	0.4	0.4	0.4	0.5	0.4	0.4	0.4	1.2	0.4	0.4
Social contributions	2.8	4.0	4.1	3.8	3.8	3.8	3.8	3.9	3.9	3.9
Grants	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Other receipts	3.5	3.7	2.5	2.4	3.2	3.2	2.9	2.7	2.5	2.2
Of which:										
Interest income	2.9	1.8	1.2	1.0	1.1	0.9	0.8	0.8	0.8	0.7
Total spending	**36.8**	**34.6**	**32.4**	**32.7**	**32.8**	**32.2**	**31.1**	**30.4**	**29.5**	**29.0**
Cash payments for operating activities	**34.3**	**32.9**	**31.4**	**31.9**	**31.8**	**31.1**	**30.1**	**29.5**	**28.7**	**28.1**
Compensation of employees	8.6	8.3	8.0	8.1	8.0	8.1	7.9	7.9	7.8	7.7
Purchases of goods & services	6.0	6.2	5.6	5.5	5.9	5.6	5.3	5.2	5.0	4.9
Interest 1/	5.3	4.8	4.0	4.4	4.7	4.7	4.5	4.4	4.2	4.1
Transfer payments	14.4	13.6	13.8	13.9	13.3	12.8	12.3	12.1	11.7	11.4
Net cash inflow from operating activities	**-6.6**	**-2.8**	**-2.5**	**-2.3**	**-1.5**	**-0.9**	**-0.6**	**-0.3**	**0.4**	**0.7**
Investments in NFAs	2.5	1.7	1.0	0.8	1.1	1.0	1.0	0.9	0.8	0.9
Of which: road construction projects	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Augmented balance (incl. adjustment to cash) 2/	**-10.0**	**-4.5**	**-3.5**	**-3.1**	**-2.5**	**-2.0**	**-1.6**	**-1.1**	**-0.4**	**-0.2**
Write-offs	2.3	3.6	1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Of which:										
Recapitalization related write-offs	0.0	2.1	1.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Securities lending related write-offs	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Guarantees	0.5	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Retro-active interest on bank capitalization	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance 3/	**-12.3**	**-8.1**	**-4.7**	**-3.1**	**-2.6**	**-2.4**	**-2.0**	**-0.6**	**-0.7**	**-0.2**
Memorandum Items:										
Nominal GDP	1,498	1,536	1,632	1,708	1,791	1,902	2,018	2,125	2,246	2,365
Primary revenue	24.8	28.3	27.6	28.6	29.2	29.3	28.6	28.4	28.4	28.1
Primary expenditure	31.5	29.8	28.4	28.3	28.2	27.5	26.6	26.0	25.3	24.9
Primary balance	-6.7	-1.5	-0.8	0.3	1.0	1.8	2.0	2.5	3.1	3.2

Sources: IceStat; Ministry of Finance; and IMF staff estimates.

1/ Interest paid cash. Excludes accrued interest from inflation indexed bonds.

2/ Excludes write-offs recorded as capital transfers and revenues from the exit tax. Write-offs in 2008 are the result of CBI recapitalization and securities lending contracts that failed following the banks' collapse. Write-offs in 2009 reflect the retroactive interest paid to new banks to compensate for late capitalization. Write-offs in 2010 reflect called guarantees of the State Guarantee Fund and HFF recapitalization. Write-offs in 2011 reflect recapitalization of the savings bank and does not include the state's revaluation of its equity holdings in the Regional Development Institute and the NSA Ventures since these are valuation changes recorded in the balance sheet of the government. Write-offs in 2012 reflect the recapitalization of the HFF.

3/ Excludes asset sales.

Table 7. Iceland: Indicators of Fund Credit, 2008–16

(Millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Existing and prospective Fund credit									
Disbursements	560	105	210	525	0	0	0	0	0
Stock	560	665	875	1400	512	512	512	171	0
Obligations	0	13	18	29	914	11	10	348	172
Principal (repurchases)	0	0	0	0	888	0	0	341	171
Charges and interest	0	13	18	29	26	11	10	6	1
Stock of existing and prospective Fund credit									
In percent of quota	476	565	744	1190	435	435	435	145	0
In percent of GDP	5	9	11	15	6	5	5	2	0
In percent of exports of G&S	11.5	16.3	19.0	25.9	9.7	9.2	8.8	2.7	0
In percent of gross reserves	24.3	26.9	23.2	24.7	11.8	18.4	20.2	7.2	0
Obligations to the Fund from existing and prospective Fund arrangements									
In percent of quota	0.0	11.1	15.2	25.0	777.5	9.2	8.5	295.7	146.0
In percent of GDP	0.0	0.2	0.2	0.3	10.3	0.1	0.1	3.2	1.5
In percent of exports of G&S	0.0	0.3	0.4	0.6	17.3	0.2	0.2	5.6	2.6
In percent of gross reserves	0.0	0.5	0.5	0.5	21.0	0.4	0.4	14.7	15.2

Source: IMF staff estimates and projections.

Table 8. Iceland: Financial Soundness Indicators (in percent, unless otherwise indicated)

	2009	2010	2011
Capital adequacy			
Total regulatory capital to risk-weighted assets	12.6	19.3	24.3
Tier I regulatory capital to risk-weighted assets	11.8	17.4	21.9
Capital to assets	13.4	16.1	17.4
Asset composition 1/			
Sectoral distribution of loans to total loans (percent of total)			
Business credit	45.9	44.7	42.3
Industry (excluding energy sector)	8.8	7.3	6.7
Energy Sector	0.4	0.4	0.4
Agriculture (including fisheries)	6.3	5.8	6.1
Construction	4.4	3.5	2.9
Transport and communication	0.5	1.1	1.5
Trade/commerce	25.5	26.7	24.7
Consumer credit (trade and services)	8.3	8.3	8.4
Mortgage credit	32.1	33.6	33.8
Loan portfolio to GDP	187.7	184.1	174.3
Total asset to GDP	250.8	234.6	233.8
Asset quality			
Nonperforming loans (billions of kronur)	241.4	319.7	244.8
Non-performing loans (percent of book value) 2/	42.0	40.0	23.0
Provisions to non-performing loans (book value)	82.0	48.0	50.0
Asset liability management 1/			
CPI-indexed assets to total assets	34.1	35.0	36.8
FX-indexed assets to total assets	47.0	42.9	31.8
CPI-indexed liabilities to total assets	32.1	32.7	33.7
FX-indexed liabilities to total assets	26.0	25.3	28.1
Earnings and profitability 3/			
ROA (profits to period average assets)	-0.3	2.4	3.0
ROE (profits to period average equity)	-4.4	18.7	16.0
Interest margin to gross income	61.3	36.4	55.8
Net interest margin	...	3.1	2.5
Cost to assets	...	2.2	1.8
Liquidity 4/			
Liquid assets to total assets	18.0	18.0	20.0
Liquid assets to total short-term liabilities	195.0	210.1	201.4
Loan-to-deposit ratio (non-interbank liabilities only)	113.0	126.0	126.0
Liquid assets to foreign exchange liabilities to nonresidents	938.0	6857.0	6591.0
Foreign exchange liabilities to nonresidents to total liabilities	4.2	0.6	0.6
Sensitivity to market risk			
Gross open positions in foreign exchange to capital	605.3	417.4	346.7
Net open position in FX to capital	174.4	107.7	21.4

Source: Central Bank of Iceland; FME

1/ Including Housing Finance Fund (HFF).
2/ Cross-default criteria for NPLs: If one single loan is overdue for more than 90 days, the entire credit position of the borrower is nonperforming.
3/ For 2011, based on non-audited financial statements Q3 or Q4, 3 largest banks, excluding HFF.
4/ For all Deposit Money Banks (DMBs), does not include HFF.

Annex I. Authorities' Response to Past IMF Policy Recommendations

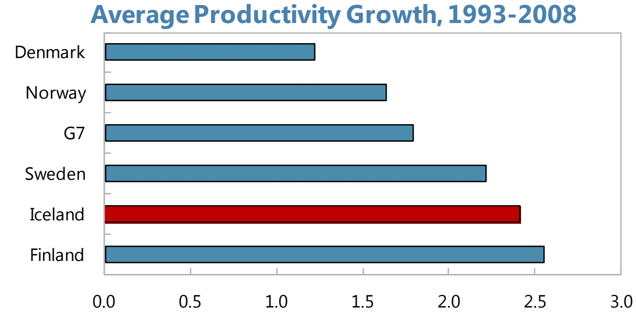
IMF 2012 Article IV Recommendations	Authorities' Response
Fiscal Policy Complete fiscal adjustment in line with the authorities' medium-term fiscal objectives. Contingency measures should be identified in case implementation risks materialize in 2012. Submit to parliament new legislation on an organic budget law.	**Broadly Consistent** There were slippages relative to the medium-term plan because uncertain one-off revenues did not materialize—there were no contingency measures—and expenditures rose in an election season. The new government aims to maintain the 2014 target but its proposed tax cuts and spending hikes risk producing less ambitious medium-term fiscal outcomes. The draft Public Finances Act will be submitted to parliament in the fall of 2013.
Monetary Policy With inflation and inflation expectations above the central bank's inflation target, policy interest rates should rise.	**Consistent** The central bank took decisive action—raising policy rates by a cumulative 125 basis points in 2012 before pausing in November.
Capital Controls A gradual approach remains essential. The speed of liberalization will have to be adapted to the strength of the balance of payments outlook, reserve adequacy, and the need to safeguard financial stability. The conditions for lifting the controls may well take additional time (beyond end-2013) to be fully met.	**Broadly Consistent** The 2013 legislative deadline for lifting the controls was removed. The authorities are maintaining a conditions-based approach.
Private Sector Debt Restructuring Debt restructuring must be brought to completion as soon as possible, and new calls for across-the-board writedowns of household debt should be resisted.	**Partly Consistent** There has been progress with corporate and household debt restructuring but the pace of resolving the remaining cases is slowing. Plans for additional relief have been announced.
Financial Sector Additional efforts needed to reduce vulnerabilities. The HFF still needs to be fully recapitalized. Financial sector supervision must be further strengthened.	**Broadly Consistent** Banks are liquid and well-capitalized, but legacy risks remain. The HFF was partially recapitalized but remains in a difficult financial condition. Financial supervision is being strengthened.

Annex II. Assessing Labor Productivity[1]

Iceland's economy is recovering but its longer-term prospects depend on its ability to remain competitive. The krona depreciation during the crisis has more than offset rising unit labor costs. However, with continuing wage pressures and the possibility of an exchange rate appreciation in the medium term, increasing labor productivity is critical. This annex assesses Iceland's productivity by decomposing total factor productivity into technology and efficiency—or how effectively a country uses its factors of production. The annex concludes that Iceland's efficiency compares well with its peers.

1. Iceland's labor productivity growth does well in comparison with other Nordic countries. During 1993-2008, the growth of labor productivity—defined as GDP per hour worked—averaged 2.4 percent, second highest among the Nordics. Labor productivity growth was driven by financial services and the electricity and gas sectors. Financial services experienced impressive growth in value added, explained by both rising labor input as well as increasing labor productivity. Electricity and gas, manufacturing, and agriculture, in contrast, experienced losses in labor input, but made up for it with higher labor productivity. Labor productivity growth remained positive during the crisis, as hours worked declined, and turned negative only in 2010–11 when hours worked recovered faster than output.

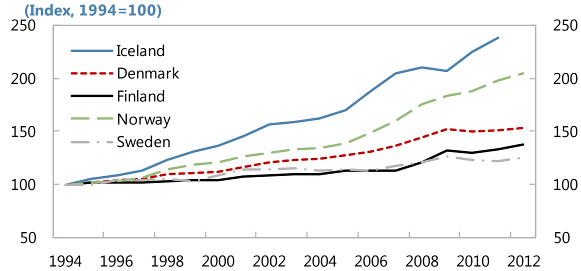
Average Productivity Growth, 1993-2008



Source: OECD

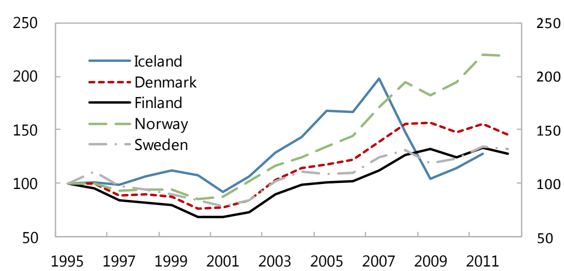
2. Wages have increased faster than productivity, pushing unit labor costs up. Despite increasing labor productivity, unit labor costs grew by 5½ percent from 1998 to 2011, more than twice the Nordic average of 2½ percent. The sectors that saw the highest growth were construction (7.8 percent)—which saw very little productivity growth—and financial services (7.4 percent). Both sectors also grew strongly in other Nordic countries although growth rates were lower than Iceland's.

Iceland: Unit Labor Cost, 1994-2012
(Index, 1994=100)



Source: OECD

Iceland: Exchange Rate Adjusted Unit Labor Cost, 1995-2012



Source: OECD

[1] Prepared by Anna Rose Bordon.

3. Nonetheless, competitiveness was restored at the time of the crisis when exchange-rate-adjusted unit labor costs dropped significantly. During 1994–2007, unit labor costs adjusted for the exchange rate grew on average by more than 6 percent annually before declining by some 40 percent during 2008–09, as a result of the krona depreciation. In 2010–11, rising wages and an appreciating krona reversed the decline.

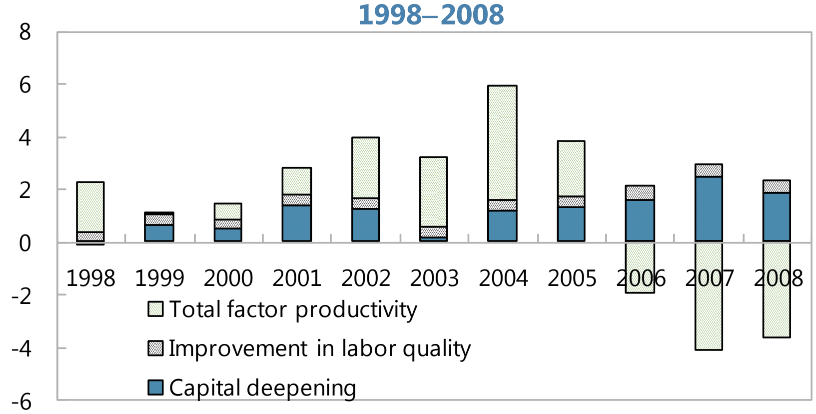
4. Capital deepening contributed to the growth of labor productivity before the crisis. A standard growth accounting approach shows that more than half of labor productivity growth came from capital deepening from 1998–2008. This reflects the high rate of investment in the energy-intensive sector and construction. In contrast, Finland and Sweden's labor productivity growth is accounted for largely by rising total factor productivity. However, growth accounting over time shows that the contribution of capital deepening became more pronounced in the run-up to the crisis, while that of total factor productivity (TFP) declined, reflecting growing resource misallocation in the economy.

Table 1. Growth Accounting

	Total labor productivity growth, 1998–2008	of which: Capital deepening	Labor quality improvement	Growth in total factor productivity
Iceland	2.0	1.1	0.4	0.5
Denmark	1.3	1.1	0.1	0.1
Finland	2.4	0.7	0.4	1.4
Norway	1.2	0.7	0.4	0.1
Sweden	1.9	0.5	0.2	1.1

Source: IMF staff calculations.

Iceland: Contributions to Productivity Growth, 1998–2008



Sources: OECD, and IMF staff calculations.

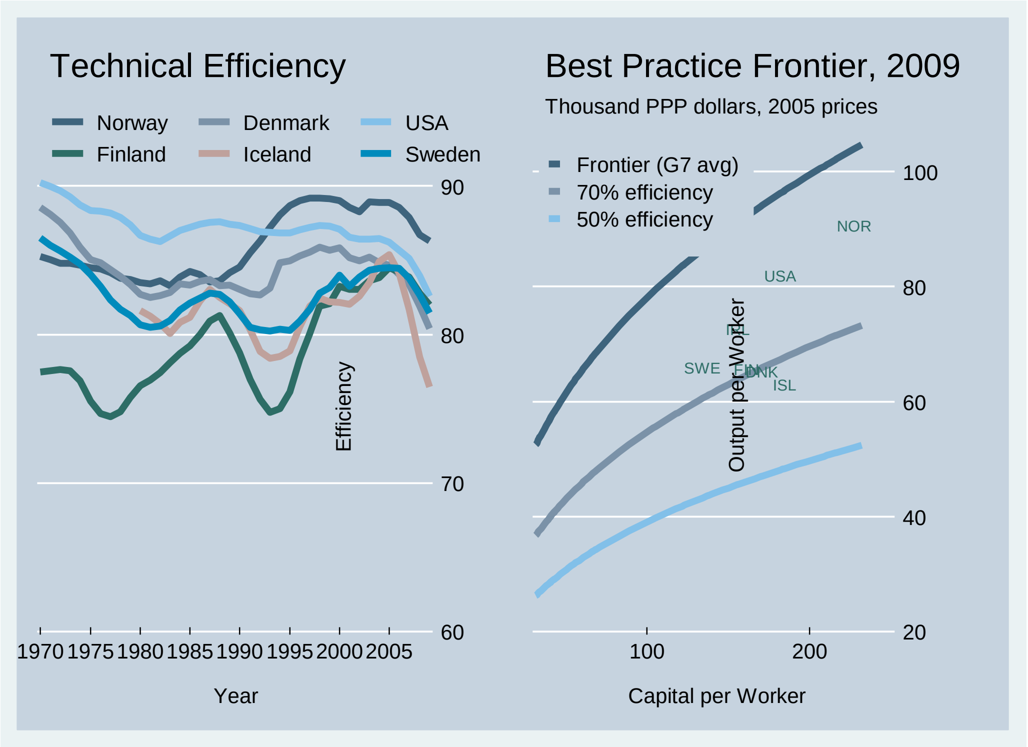
5. A stochastic frontier model is used to estimate the components that drive TFP. TFP is decomposed into 2 drivers: technology and efficiency (see box for details). With technology diffusing more easily across countries, efficiency—or how effectively a country uses its factors of productions—accounts for most of the variation of TFP over a cross-section of countries. Factors such as governance, competition policy, labor market policies, ease of doing business, and regulatory burden affect a country's efficiency. An index that summarizes some of these factors—in this case, the Fraser Institute's economic freedom index—is used in the model to estimate the efficiency rating of a cross section of countries.

6. Estimates using a stochastic frontier model suggest that Iceland's efficiency exceeds that of European countries and lags only slightly behind its Nordic neighbors. In 2009, Iceland's efficiency is estimated at around 76 percent, compared to 80 (Denmark) to 86 percent (Norway) for the other Nordics. The crisis has reduced these ratings significantly for all countries, especially for Iceland where the recession was more severe. Despite the decline, Iceland and other Nordic countries enjoy some of the highest efficiency ratings in the sample.

Table 2. Technical Efficiency Estimates, 1990–2009

Iceland average	0.81
G7 average	0.84
Nordic average	0.83
Euro area average	0.81
EU average	0.75
World average	0.50

Source: IMF staff calculations.



If we assume that the G7 countries have an efficiency rating of 1, we can use their (mean) level of human capital to graph a best practice frontier for the world. Relative to that best practice frontier, Iceland is just below the 70 percent band in 2009. Note that the best practice frontier represents a specific efficiency and human capital level. Thus, the distance between Iceland and the best practice frontier captures not only the small divergence in efficiency but also the human capital gap between Iceland and the G7 countries.

7. Nevertheless, efficiency ratings have declined in the last few years, underscoring the need to improve resource allocation and address legacy vulnerabilities. For Iceland, the rating fell from a peak of around 85½ percent in 2005 to 82 percent in 2007 and 76 percent in 2009. Falling efficiency ratings in the run-up to the crisis point to resource misallocations, not only in Iceland but also in many advanced economies. In Iceland, this was reflected in a rapidly expanding financial sector, rising asset prices, and widening imbalances. Crisis legacies, including the imposition of capital controls and a weak banking system, have further exacerbated the decline in the last two years of the sample.

Stochastic Frontier Analysis

To evaluate total factor productivity growth more closely, a stochastic frontier approach is used. To illustrate how efficiency enters the model (see Tiffin, 2006 for a more in-depth discussion), define output as:

$$Y = f(Z)\xi e^{v}$$

Output is determined by a production function, *f(Z),* where *Z* are inputs (labor, capital, labor quality, technology), an efficiency term, ξ, and a random term, e^{v}. The efficiency term is assumed to fall between 0 and 1. For a country producing at the optimal level, ξ=1, output collapses to the standard production function with random term. The production function, *f(Z)*, follows a Cobb-Douglas specification:

$$f(Z) = Ae^{\eta t}K^{\alpha}(hL)^{\beta}$$

where $Ae^{\eta t}$ is technology that varies over time, *t*, *K* is the capital stock, *L* is the labor force, and *h* is a measure of human capital. Dividing by *L* and taking logs yield:

$$\log\frac{f(Z)}{L} = constant + \alpha k + \beta h - (1 - \alpha - \beta)L + \eta t$$

Let *u* = -log(ξ) be the inefficiency term. Defining *y* and *k* as log output per worker and log capital per worker, respectively, the regression model is

$$y = c_0 + c_1 k + c_2 h + c_3 L + c_5 t + v - u$$

The inefficiency term, *u*, is assumed to be truncated positive normally distributed, with mean, μ:

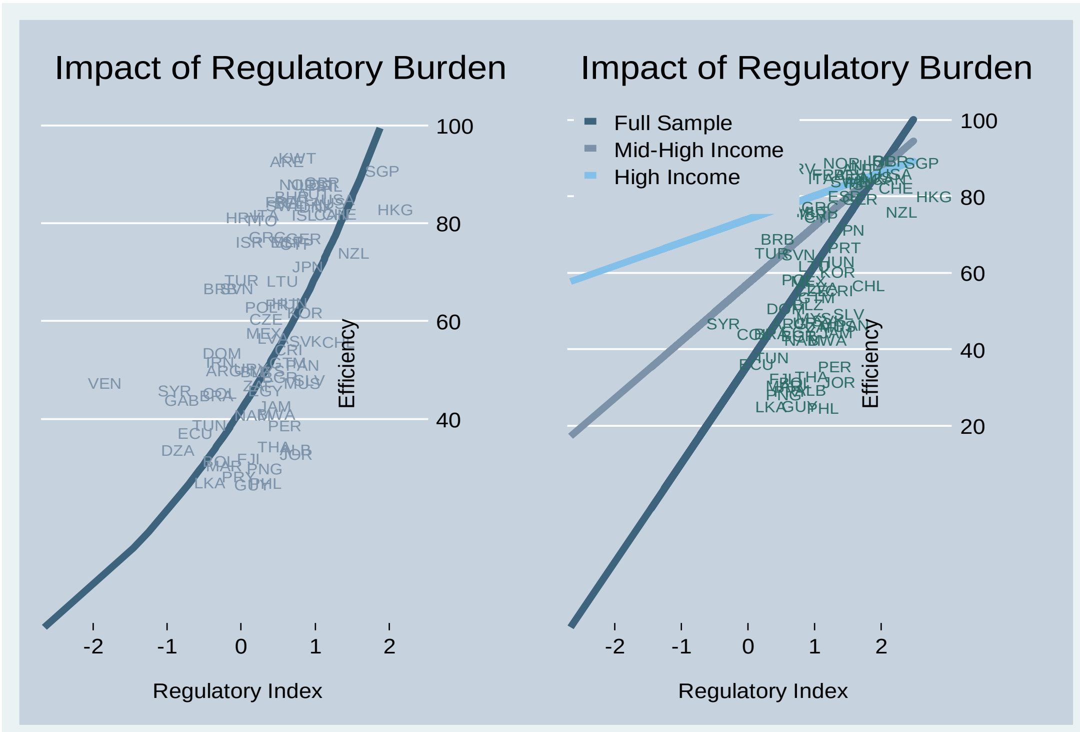
$$\mu = \delta z$$

where *z* is the economic freedom index.

Estimation is conducted on an unbalanced panel of 178 countries over the period, 1950-2007. Data for the production function are from the Penn World Tables, except for human capital which uses the Barro-Lee dataset. Real output and capital are measured in 2005 U.S. dollars, using purchasing power parity exchange rates. Human capital takes into account not only the average education of the workforce but also the average level of workplace experience. Estimation uses the one-step estimator for stochastic frontier models discussed in Wang and Schmidt (2002).

Efficiency is identified in the model by structural indicators. We use the summary rating of the Fraser Institute's economic freedom index, which is the broadest panel data (144 countries, 1970–2010 with gaps) among available structural indicators. The economic freedom index looks at 5 areas, namely size of government, legal system and property rights, sound money, freedom to trade internationally, and regulation (Gwartney, etal, 2012). The size of government criterion measures the extent of countries' reliance on the political process to allocate resources. Legal system and property rights refer to the protection of persons and their property. Sound money refers to the absence of high and volatile inflation and access to alternative forms of currency. Freedom to trade internationally captures the absence of trade barriers and controls in the movement of capital and people. Lastly, regulation measures freedom to engage in voluntary exchange in business and credit and labor markets.

Efficiency and the economic freedom index are positively related, as shown by the charts below. Countries with a low economic freedom index tend to have lower efficiency. The relationship is weaker for high income countries, reflected by the flatter slope of the high income sample.



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Annex III. Debt Sustainability Analysis

1. Public and external debt are on sustainable paths, but risks remain elevated (Annex Tables 1–2; Annex Figures 1–2). Although both public and external debt are projected to decline, the still high debt ratios remain a challenge.

A. Public Debt Sustainability Analysis

2. Iceland's public debt sustainability analysis (DSA) is based on the government's existing medium-term fiscal plan, adjusted for recent fiscal developments, including the following:

- The primary balance in 2013 is expected to be about 1½ percent of GDP lower than projected in the Second Post-Program Monitoring Discussion report, owing primarily to expenditure overruns (0.5 percent of GDP), the non-materialization of expected revenues (0.4 percent of GDP) and capital transfers to HFF (0.2 percent of GDP). The overall deficit is expected to reach 2¾ percent of GDP.
- The 2014 target of a zero balance will likely be missed by about 1¾ percent of GDP, owing to the 2013 overruns and to the reversal of some planned revenue increases (0.2 percent of GDP). Over the medium term, the primary balance is expected to reach 3.7 percent of GDP by 2017, which is lower by 1 percentage point of GDP than the latest DSA projections. The overall deficit is not expected to close until 2017, following which the overall balance will record a surplus of 0.2 percent of GDP by the end of the projection period.
- The baseline scenario includes yearly capital transfers of 0.2 percent of GDP to cover projected HFF losses. HFF may also require equity injections to bring its capital adequacy ratio in line with the target of 5 percent. Due to uncertainty over the equity needs, no equity injection assumption has been made in the baseline projections.

3. General government debt is estimated to reach 93¼ percent of GDP at end-2013 (Annex Table 1, Annex Figure 1). Because of the capital injection into HFF (0.8 percent of GDP), a larger than projected deficit in 2013, and lower than expected nominal GDP, the debt-to-GDP ratio in 2013 is higher by 3 percentage points of GDP than was projected in the Second Post-Program Monitoring Discussion report. In light of this, and given the weaker primary balance profile, the debt-to-GDP ratio is higher by 4 percent of GDP in the medium-term than in the Second Post-Program Monitoring Discussion report. Nonetheless, as in the previous DSA, debt remains on a declining path throughout the forecasting period.

4. The baseline debt trajectory is sensitive to growth shocks (Annex Figure 1). A standard growth shock would reverse the downward path of public debt and keep it above 100 percent of GDP in the absence of offsetting measures. An interest rate shock, a combined macro shock, and an interruption of fiscal consolidation would flatten the debt path and stabilize debt in the 87-90 percent of GDP range. A 30 percent depreciation of the exchange rate would raise the debt ratio to 106 percent of GDP in 2014, leaving debt at 93 percent of GDP in 2018. Finally, a 30 percent contingent liability shock could raise public debt above 120 percent of GDP in 2014. Under this last scenario, public debt is expected to decline to 108 percent of GDP in the medium term.

B. External Debt Sustainability Analysis

5. The baseline external debt path takes into account the following assumptions:

- Available data on the three old banks' asset recovery up to March 2013 suggest that recovery has been in line with previous estimates. The split between domestic and foreign claims, however, has been updated based on a recent analysis of the Central Bank of Iceland (CBI).[2] According to the analysis, foreign claims account for about 95 percent of total claims (compared to 86 percent assumed in the previous staff report). With a larger share of foreign claims, the old banks' external debt is higher than previously projected by about 2 percent of GDP over the medium term.

- The sale of Actavis (a large domestic multinational) to a nonresident company in October 2012 reduced Iceland's external debt by about 200 billion krona (about 11 percent of GDP).[3] This debt reduction was largely accounted for in the staff report for the Second PPM, where part of Actavis' debt was assumed to be transformed into equity. Therefore, this update does not materially change the external debt ratio from the previous staff report.

- The sale also prompted a downward revision of Actavis' accrued interest payments, which in turn reduces interest payments projection. As a result, the non-interest current account surplus needed to stabilize the external debt-to-GDP ratio reduces from 3.8 percent of GDP in the previous DSA to 1.2 percent of GDP in this DSA.

- Interest rates for new borrowing throughout the projection period are assumed to be slightly lower than in the last DSA, reflecting reduced global funding costs.

- As before, external borrowing by the central government (aside from that from bilateral official creditors) is assumed to be fully rolled over, and additional bonds are assumed to be issued to cover 30 percent (on average) of the CBI's external debt falling due between 2012 and 2016.

- External debt rollover for the rest of the economy is assumed to be lower than in the previous report, reflecting continued deleveraging. Central government corporations, local

[2] *Iceland's Underlying External Position and Balance of Payments*, Special Publication of the Central Bank of Iceland, March 2013. This special publication is based on an examination of the underlying and actual owners of the old banks' claims.

[3] However, following the transaction, there remains an Icelandic (resident) part of the multinational, which still holds external debt of more than 40 percent of GDP. This amount remains Icelandic external debt.

municipalities, and local government corporations are assumed to roll over about 40 percent (on average) of maturing principal during the next three years (compared with an average of 70 percent in the previous report). As before, corporations under financial stress are assumed to be unable to roll over external debt. Lower rollover assumptions help bring down Iceland's external debt ratios more rapidly than in previous DSAs.

- The easing of capital controls is assumed to start in 2017, one year later than in the previous DSA. As part of its program to address the liquid offshore krona overhang, the government is assumed to issue two long-term Eurobonds, one in 2014 and one in 2015, both amounting to $0.8 billion. The Eurobonds will be exchanged for short-term krona assets held by nonresidents. This will not affect the level of external debt, but will increase the government's foreign exchange exposure.

- The final EFTA ruling on the Icesave dispute early this year eliminates the associated contingent risks to the external debt path.

6. External debt is expected to decline substantially over the medium term. External debt is estimated at 222 percent of GDP at end-2012, and is expected to fall to around 145 percent of GDP by 2018 (Annex Table 2). Around one-third of the 2012 debt stock is nonresident claims subject to capital controls, although this ratio declines as offshore kronas exit and old banks' liabilities are paid out.

7. Stress tests suggest that the downward trajectory is relatively robust. Standard shocks, except in the historical scenario, would not disturb the downward trajectory of the external debt ratio (Annex Figure 2). The historical scenario, however, would put the external debt ratio on an upward trend because it assumes large capital outflows (as suggested by the 10-year historical average of non-debt creating capital flows). With the assumption that capital controls would be in place for most of the medium term, this scenario is highly unlikely. Nevertheless, this tail risk scenario highlights the importance of an orderly lifting of the controls.

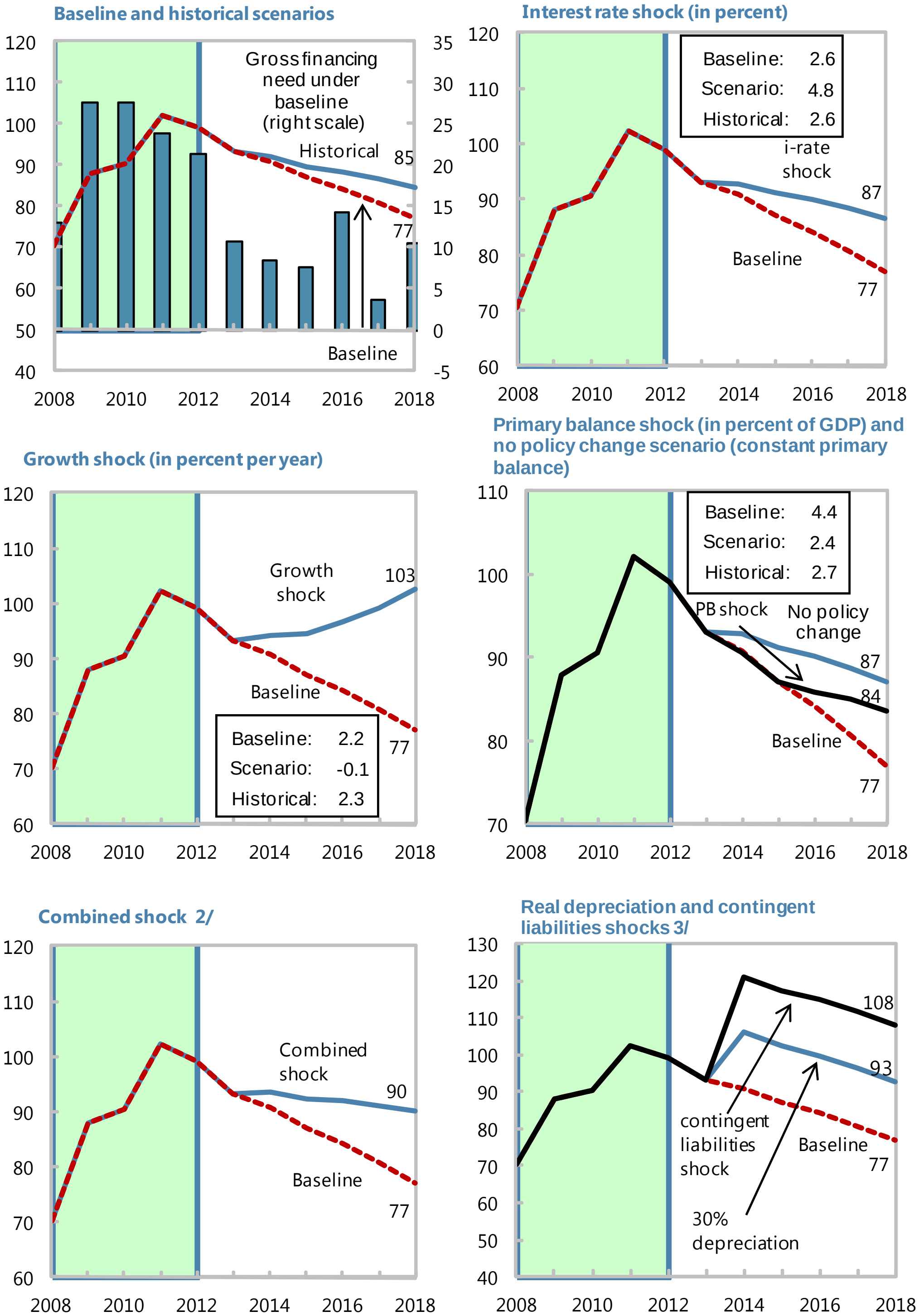
Annex Table 1. Iceland: Public Sector Debt Sustainability Framework, 2008–18

(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	70.4	88.0	90.6	102.3	99.1	**93.2**	**90.9**	**87.2**	**84.2**	**80.7**	**77.0**	**0.6**
o/w foreign-currency denominated	24.6	27.0	24.6	29.4	26.8	31.0	34.0	34.6	32.6	30.7	29.0	
Change in public sector debt	41.3	17.6	2.6	11.7	-3.2	-5.9	-2.3	-3.7	-3.0	-3.5	-3.7	
Identified debt-creating flows (4+7+12)	28.0	25.4	11.9	6.1	2.4	-1.9	-3.7	-2.8	-4.4	-4.4	-4.3	
Primary deficit (including interest income)	-2.8	3.4	0.6	-0.8	-1.9	-2.5	-3.4	-3.8	-5.1	-4.7	-4.9	
Revenue and grants	44.1	41.0	41.5	41.7	43.1	43.8	43.8	43.0	43.7	42.8	42.5	
Primary (noninterest) expenditure	41.3	44.4	42.1	41.0	41.1	41.2	40.4	39.2	38.6	38.0	37.6	
Automatic debt dynamics 2/	12.6	4.1	3.3	-0.8	3.5	0.6	-0.3	-0.1	0.6	0.3	0.6	
Contribution from interest rate/growth differential 3/	0.0	4.4	3.6	0.4	1.2	0.6	-0.3	-0.1	0.6	0.3	0.6	
Of which contribution from real interest rate	0.3	-0.2	0.1	2.9	2.8	2.4	1.6	1.8	2.4	2.1	2.4	
Of which contribution from real GDP growth	-0.3	4.6	3.5	-2.5	-1.6	-1.8	-1.9	-1.9	-1.8	-1.8	-1.8	
Contribution from exchange rate depreciation 4/	12.6	-0.3	-0.3	-1.2	2.3	...	...	...	...	...	...	
Denominator = 1+g+p+gp	1.1	1.0	1.0	1.1	1.0	1.0	1.1	1.1	1.1	1.1	1.1	
Other identified debt-creating flows	18.2	17.9	8.1	7.7	0.9	0.0	0.0	1.1	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities 5/	0.0	0.0	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (capitalization of banks, support of international reserves) 6/	18.2	17.9	6.6	7.7	0.9	0.0	0.0	1.1	0.0	0.0	0.0	
Residual, including asset changes (2-3) 7/	13.3	-7.8	-9.4	5.5	-5.6	-4.0	1.4	-1.0	1.4	0.9	0.5	
Public sector debt-to-revenue ratio 1/	159.5	214.6	218.3	245.2	230.1	212.9	207.5	202.6	192.7	188.8	181.2	
Gross financing need 8/	13.1	27.6	27.6	23.8	21.4	10.7	8.4	7.5	14.2	3.6	10.5	
in billions of U.S. dollars	2.2	3.3	3.5	3.3	2.9	1.6	1.3	1.2	2.5	0.6	2.0	
Scenario with key variables at their historical averages 9/						**93.2**	**92.0**	**89.5**	**88.4**	**86.7**	**84.7**	**0.2**
Scenario with no policy change (constant primary balance) in 2013-2018						**93.2**	**90.6**	**87.1**	**85.9**	**85.0**	**83.7**	**0.7**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	1.2	-6.6	-4.1	2.9	1.6	1.9	2.1	2.2	2.2	2.2	2.3	
Average nominal interest rate on public debt (in percent) 10/	13.0	7.5	6.7	6.7	5.9	5.5	6.0	6.0	6.1	6.1	6.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.2	-0.8	-0.2	3.5	2.9	2.6	1.9	2.2	3.0	2.7	3.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-48.7	1.0	1.1	5.3	-7.2	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	11.8	8.3	6.9	3.3	3.0	2.9	4.0	3.8	3.1	3.4	2.9	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.4	0.3	-9.0	0.1	2.1	2.2	0.1	-0.9	0.7	0.6	1.1	
Primary balance (including interest income)	2.8	-3.4	-0.6	0.8	1.9	2.5	3.4	3.8	5.1	4.7	4.9	
Net public sector debt	41.8	55.7	59.9	66.7	68.2	64.1	63.6	62.4	60.3	58.3	56.2	

1/ General government gross debt (including borrowing by the central government to support central bank reserves; excludes IMF loans).
2/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
5/ Reflects called guarantees of the State Guarantee Fund.
6/ Includes capitalization of new banks, savings banks, and bilateral loans and international bond issuance to support CBI reserves.
7/ For projections, this line includes exchange rate changes. In 2009-17, the residual also reflects use of deposits at the central bank and sale of financial assets obtained during the financial crisis.
8/ Defined as general government deficit, plus amortization of medium and long-term general government debt, plus short-term debt at end of previous period.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.
10/ Derived as nominal interest expenditure divided by previous period debt stock.

Annex Figure 1. Iceland: Public Debt Sustainability under Current Projection 1/
(Public 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 primary balance.
3/ One-time real depreciation of 30 percent or 30 percent of GDP shock to contingent liabilities occur in 2013, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Annex Figure 2. Iceland: External Debt Sustainability Framework, 2008 – 2018
(In percent of GDP, unless otherwise indicated)

	Actual							Projections							
	2008	2009	2010	2011	2012			2013	2014	2015	2016	2017	2018		**Debt-stabilizing non-interest current account 6/**
Baseline: External debt (including old banks)	564.7														
Baseline: External debt	188.7	269.8	295.2	254.7	222.2			**207.6**	**191.3**	**178.0**	**160.0**	**150.9**	**144.6**		**1.2**
Change in external debt	16.9	81.1	25.4	-40.5	-32.4			-14.7	-16.3	-13.2	-18.1	-9.1	-6.3	0.0	
Identified external debt-creating flows (4+8+9)	34.2	99.5	-30.7	-29.9	-18.8			-5.4	-4.3	-4.5	-5.9	-6.5	-5.2	0.0	
Current account deficit, excluding interest payments	12.5	1.4	0.4	-4.7	-6.4			-5.7	-5.2	-5.3	-8.3	-9.8	-9.7	-1.2	
Deficit in balance of goods and services	2.3	-8.6	-10.1	-8.5	-6.3			-6.4	-5.6	-5.8	-8.1	-9.6	-9.6		
Exports	44.1	52.7	56.5	59.1	59.2			57.5	57.3	57.7	59.3	60.9	61.1		
Imports	46.4	44.2	46.4	50.6	52.9			51.2	51.7	51.9	51.2	51.2	51.5		
Net non-debt creating capital inflows (negative)	-30.9	26.3	-29.9	-5.8	-28.5			-2.7	-2.0	-2.2	-1.4	-1.3	-0.2	0.9	
Automatic debt dynamics 1/	52.6	71.8	-1.2	-19.4	16.1			2.9	2.9	3.0	3.8	4.6	4.7	0.4	
Contribution from nominal interest rate	15.9	10.3	8.0	10.2	11.3			6.9	7.1	6.9	7.5	8.0	8.0	7.6	
Contribution from real GDP growth	-2.5	17.2	10.7	-7.6	-4.3			-4.0	-4.2	-3.9	-3.7	-3.4	-3.3	-3.2	
Contribution from price and exchange rate changes 2/	39.2	44.4	-19.8	-22.0	9.1			...	...	...	...	...	...	-4.1	
Residual, incl. change in gross foreign assets (2-3) 3/	-17.3	-18.4	56.0	-10.7	-13.7			-9.2	-12.1	-8.7	-12.2	-2.6	-1.1	0.0	
External debt-to-exports ratio (in percent)	427.9	511.8	522.1	430.8	375.6			360.9	333.8	308.8	269.8	247.9	236.7		
Gross external financing need (in billions of US dollars) 4/	13.5	6.6	9.6	14.0	16.8			9.3	9.2	8.2	7.7	4.5	4.1		
in percent of GDP	80.4	54.7	76.6	99.4	123.0	10-Year	10-Year	63.6	59.4	50.2	44.6	24.6	21.3		
Scenario with key variables at their historical averages 5/								**207.6**	**213.5**	**223.1**	**227.0**	**239.3**	**253.2**		**4.3**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							For debt stabilization	
Real GDP growth (in percent)	1.2	-6.6	-4.1	2.9	1.6	2.3	4.7	1.9	2.1	2.2	2.2	2.2	2.3	2.3	
GDP deflator in US dollars (change in percent)	-18.6	-23.0	8.1	8.8	-4.5	2.8	14.9	4.8	3.5	4.1	3.1	2.7	2.9	2.9	
Nominal external interest rate (in percent)	7.6	3.9	3.1	3.9	4.3	4.4	1.8	3.3	3.6	3.8	4.4	5.2	5.6	5.6	
Growth of exports (US dollar terms, in percent)	5.4	-13.9	11.2	17.0	-2.8	9.9	12.5	3.8	5.3	7.0	8.3	7.7	5.7		
Growth of imports (US dollar terms, in percent)	-14.1	-31.6	9.0	22.0	1.5	10.5	20.8	3.4	6.7	6.8	3.9	5.0	5.8		
Current account balance, excluding interest payments 7/	-12.5	-1.4	-0.4	4.7	6.4	-6.4	9.2	5.7	5.2	5.3	8.3	9.8	9.7		
Net non-debt creating capital inflows	30.9	-26.3	29.9	5.8	28.5	-6.1	29.4	2.7	2.0	2.2	1.4	1.3	0.2		

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes, inflows of extraordinary financing (and Fund repurchases), and external asset recovery and repayments of the old bank estates.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

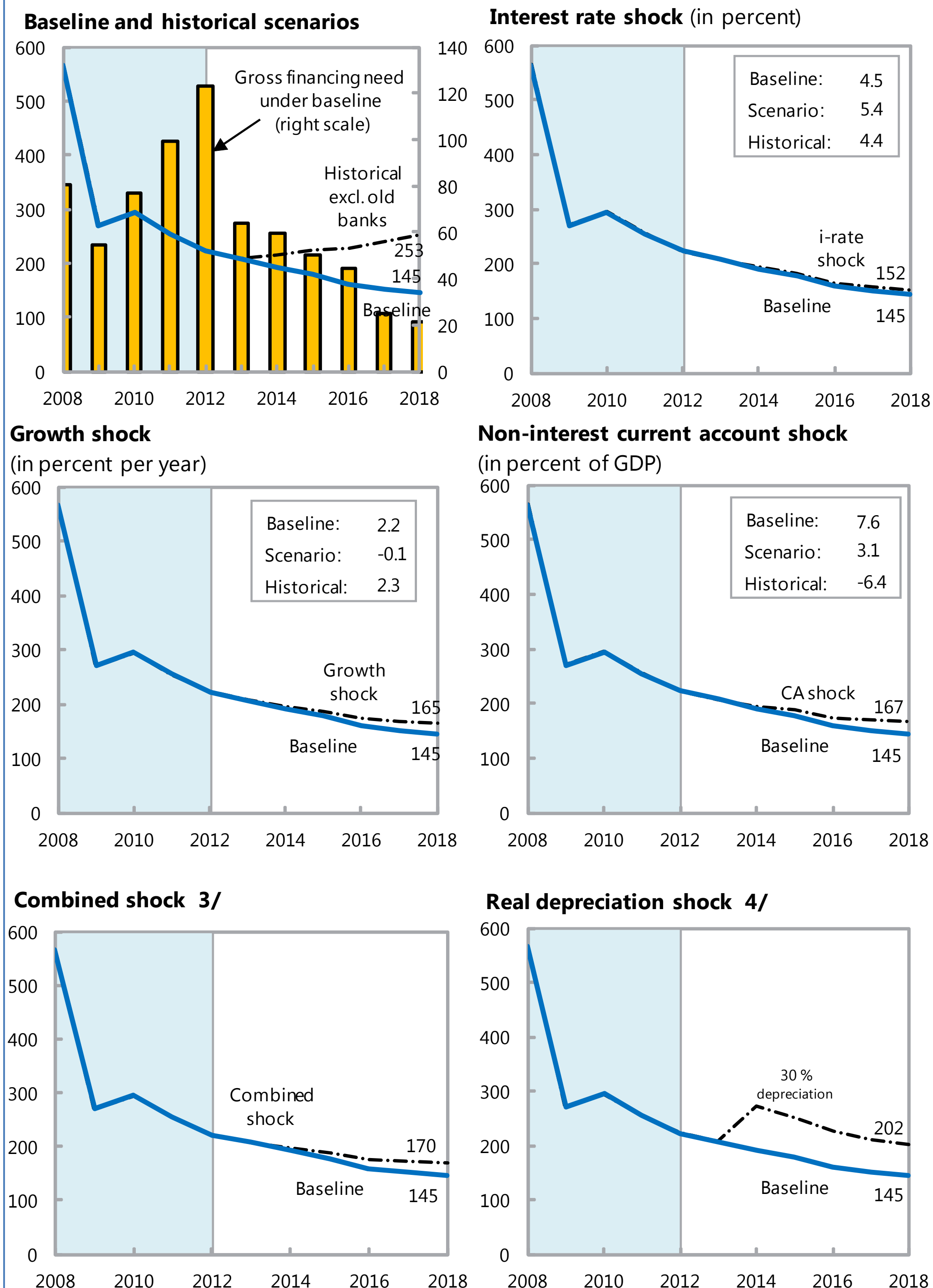
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year. This estimate excludes old bank-related asset recovery in 2017, and large one-off projected liquidation of assets abroad, to service lumpy debt payment.

7/ Historical debt and interest data exclude old bank data (based on staff and Central Bank estimates).

Annex Figure 2. Iceland: External Debt Sustainability: Bound Tests 1/ 2/

(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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2014.

INTERNATIONAL MONETARY FUND

ICELAND

July 16, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION AND THIRD POST-PROGRAM MONITORING DISCUSSIONS—INFORMATIONAL ANNEX

Prepared By

The European Department
(in consultation with other departments)

CONTENTS

FUND RELATIONS

(As of May 31, 2013)

Membership Status: Iceland became a member of the Fund on December 27, 1945

General Resources Account:

	SDR Million	Percent Quota
Quota	117.60	100.00
Fund holdings of currency		
(Exchange Rate)	610.73	519.33
Reserve Tranche Position	18.75	15.95

SDR Department:

	SDR Millions	Percent Allocation
Net cumulative allocations	112.18	100.00
Holdings	3.87	3.45

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
Stand-by Arrangements	511.88	435.27

Latest Financial Arrangements:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Nov. 19, 2008	Aug 31, 2011	1,400.00	1,400.00

Projected Payments to the Fund [1] (SDR Million; based on existing use of resources and present holdings of SDRs):

			Forthcoming		
	2013	2014	2015	2016	2017
Principal			341.25	170.63	
Charges/Interest	4.97	9.85	6.31	1.06	0.07
Total	4.97	9.85	347.56	171.69	0.07

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not applicable

Implementation of Post-Catastrophe Debt Relief (PCDR): Not applicable

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section

Exchange Rate Arrangements: The Icelandic krona is floating effective October 2008. Iceland accepted the obligations under Article VIII, Sections 2(a), 3, and 4 but maintains exchange restrictions arising from limitations imposed on the conversion and transfer of (i) interest on bonds (whose transfer the FX rules apportion depending on the period of the holding), (ii) the principal payments from holdings of amortizing bonds, and (iii) payments on the indexation of principal from holdings of amortizing bonds. In addition, Iceland has in place measures that constitute exchange restrictions imposed for security reasons related to financial transactions based on UN Security Council Resolutions. The Executive Board has approved these restrictions until March 18, 2014.

Safeguards Assessment: The 2009 assessment concluded that the CBI's overall control environment was broadly appropriate for a small central bank, with good controls in the accounting and financial reporting area. The CBI's external and internal audit procedures practices were not found to be in line with international practices, however, and the foreign reserves management area would benefit from development. The authorities have already taken steps to implement safeguard recommendations, notably by appointing an international audit firm under the auspices of the Auditor General to conduct annual external audits of the CBI in line with international standards, starting with financial year 2009. Internal audit was also outsourced. Work on other recommendations, such as the reserves management guidelines, is in progress.

Last Article IV Consultation: Discussions for the 2012 Article IV Consultation were held in Reykjavik during February 21–March 22, 2012. The Staff Report (country report No. 12/89) was considered by the Executive Board on April 6, 2012. Article IV consultations with Iceland are currently held on a 12-month cycle.

Technical Assistance:

Department	Purpose	Date
MCM	Capital account liberalization	March 2010
MCM	Reserves building and liquidity management	June 2010
MCM	Public debt management	July 2010
FAD	Fiscal framework issues	August 2010
MCM	Capital Control Liberalization	November 2010
MCM	Liquidity management	March 2011
FAD	Tax policy	March 2011
STA	External Sector Statistics	April 2011
FAD	Organic Budget Law	October 2011
FAD	Follow up on Organic Budget Law	May 2012

Resident Representative: Mr. Franek Rozwadowski assumed the position in March 2009.

STATISTICAL ISSUES

Data provision to the Fund is adequate for surveillance purposes. Iceland subscribed to the Special Data Dissemination Standard (SDDS) in 1996, and is in observance of the SDDS specifications for coverage, periodicity, and timeliness, but uses a flexibility option on the timeliness and periodicity for the production index and the producer price index (PPI). The Statistics Department (STA) prepared a data module of the Report on the Observance of Standards and Codes (data ROSC) that was published on November 22, 2005.

Data on a wide range of economic and financial variables are provided to the Fund in a timely manner during and between consultations. In addition to periodic press releases, statistical information is disseminated to the public through a range of monthly, quarterly, and annual publications by three main institutions (The Central Bank of Iceland (CBI), the Ministry of Finance, and Statistics Iceland), and is increasingly available on their internet sites. Provision of electronic data in English has improved substantially in recent years, especially from Statistics Iceland.
As regards the national accounts data, the authorities shifted to ESA95 in August 2000 and revised the corresponding time series back to 1990. Another revision was carried out in 2002. A breakdown is disseminated by industry back to the beginning of the production approach in 1973. Data on GNP and national income, in current and constant prices, as well as data on net savings for the economy as a whole, are also disseminated. The quarterly data are seasonally adjusted.
The authorities publish a Treasury cash flow statement on a monthly basis, quarterly data on the general government operations, and annual data on the general government operations and financial assets and liabilities. Iceland reports government finance statistics in accordance with the GFSM 2001 framework in the GFS Yearbook, and is an up-to-date contributor to the International Financial Statistics (IFS). Balance of payments data deviate from the IMF's Balance of Payments Manual, fifth edition (BPM5) in certain respects. In particular, the CBI follows the methodology applied by the European Central Bank (ECB) for the calculation of income payable by collective investment institutions (e.g., mutual funds).

The CBI made good progress in improving external sector statistics based on 2011 TA mission's recommendations. Particularly, (i) the coverage was expanded by including the data on portfolio investment in equity capital, as well as in securities on secondary market; (ii) data on FDI and on other investment income are compiled in line with balance of payments methodology; (iii) remittances data were improved based on information from money transfer operators; and (iv) the old banks' transactions are recorded broken down by instruments.

On monetary and financial statistics, the concepts and definitions broadly conform to the guidelines of the Monetary and Financial Statistics Manual (MFSM). Departing from the MFSM, M3/Broad Money measure includes deposits of the central government, positions of commercial banks with private nonfinancial corporations include some positions with public nonfinancial corporations, and the latter include some positions with private nonfinancial corporations. Beginning in February 2010, the CBI reports for publication in IFS monetary data for central bank and other depository corporations using the Standardized Report Forms (SRFs).

Iceland: Table of Common Indicators Required for Surveillance

(As of June 21, 2013)

	Date of latest observation	Date received	Freq. of Data	Freq. of Reporting	Freq. of publication	Memo Items: Data Quality – Methodological soundness	Data Quality – Accuracy and reliability
Exchange Rates	Jun. 21, 13	Jun. 21, 13	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities	May 2013	Jun. 7, 13	M	M	M		
Reserve/Base Money	May 31, 13	Jun. 7, 13	M	M	M	LO, O, LO, LO	LO, O, O, O, O
Broad Money	Apr. 2013	May 27, 13	M	M	M		
Central Bank Balance Sheet	May 2013	Jun. 7, 13	M	M	M		
Consolidated Balance Sheet of the Banking System	Apr. 2013	May 27, 13	M	M	M		
Interest Rates	Jun. 21, 13	Jun. 21, 13	D	D	D		
Consumer Price Index	May 2013	May 29, 13	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing – General Government	Q1, 2013	Jun. 2013	Q	Q	Q	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing– Central Government	Apr. 2013	May 2013	M and Q	M and Q	M and Q		
Stocks of Central Government and Central Government-Guaranteed Debt	May 2013	Jun. 2013	M	M	M		
External Current Account Balance	Q1, 2013	Jun. 3, 13	Q	Q	Q	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	Q1, 2013	Jun. 7, 13	Q	Q	Q		
GDP/GNP	Q1, 2013	Jun. 7, 13	Q	Q	Q	O, LO, O, LO	LO, O, LO, LO, O
Gross External Debt	Q1, 2013	Jun. 3, 13	Q	Q	Q		

Press Release No.13/300
FOR IMMEDIATE RELEASE
August 7, 2013

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation and Third Post Program Monitoring Discussions with Iceland

On August 1, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation and third Post Program Monitoring discussions with Iceland.[1]

Iceland's economy is on a path to recovery, but legacy vulnerabilities are weighing on growth. GDP growth—which reached 2.9 percent in 2011—slowed to 1.6 percent in 2012 amid private sector deleveraging and weak external demand. Unemployment has continued to decline however, standing at 5.1 percent in May, down from a peak of 9.2 percent in September 2010.

Progress in lifting capital controls has been limited. Modest amounts of offshore krona have been released through the channels opened up by the authorities' liberalization strategy. But the stock of liquid offshore krona remains high and could rise significantly as the estates of "old banks" are wound up. Additional foreign exchange outflows could also arise from potential resident portfolio rebalancing as capital controls are lifted.

Inflation has come down to 3.3 percent in June from a peak of 18.6 in January 2009, but remains above the central bank's target of 2½ percent. The central bank responded by raising policy rates by a cumulative 125 basis points in 2012 before pausing in November. During the winter, the CBI also intervened in the foreign exchange market, reversing a depreciation that resulted from temporary factors but threatened to pass through to prices.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Fiscal consolidation is facing headwinds. On current trends, the 2013 budget deficit target will be missed owing to slower than projected growth, expenditure overruns, and lower-than-budgeted dividend payments and asset sales. The existing target of a balanced budget in 2014 may also come under pressure from costly electoral promises—including those to lower taxes and to increase household debt relief—the financing for which remains uncertain. Medium-term fiscal adjustment relies in part on one-off or uncertain measures.

The condition of the banking system has improved, but legacy risks remain. Banks are well capitalized, liquid, and profitable. Nonperforming loan ratios have also declined. But banks are still reliant on short-term funding and deposits captured by capital controls, and face continued loan valuation uncertainty. There has been progress with corporate and household debt restructuring, but the pace of resolving remaining cases has been slow. The Housing Financing Fund (HFF) is in a difficult financial position.

Reserves remain at comfortable levels, with the ratio of gross reserves to short-term debt projected to remain well above 100 percent over the medium term. The outlook is for modest growth, declining inflation, and improving fiscal and external position. However, downside risks prevail, including from disorderly or delayed capital account liberalization, weaker fiscal consolidation, and possible adverse euro area developments.

Executive Board Assessment

Executive Directors welcomed the progress made by Iceland on the recovery path from the 2008 crisis and noted that the outlook points to a continued expansion, further disinflation, and additional improvements in the fiscal and external positions. Nonetheless, Directors agreed that the legacies of the crisis continue to pose challenges that must be addressed to reinforce the foundations for durable growth.

Directors emphasized the importance of a comprehensive approach to lifting capital controls. They urged the timely publication of a well-defined strategy to release the stock of liquid offshore krónur—a key condition for removing the controls. Prudential regulations and supervision would need to be strengthened in the run-up to full liberalization, and additional measures, such as speed limits on outflows, could be considered.

Directors expressed satisfaction with the central bank's actions to bring down inflation. They encouraged the authorities to continue improving liquidity operations given the still weak monetary transmission mechanism. Directors supported the central bank's intention to purchase foreign currency in the open market as opportunities arise, to boost foreign exchange reserves.

Directors welcomed the progress in fiscal consolidation, but expressed concern over recent slippages. They emphasized the importance of adhering to the fiscal targets to reduce public debt, preserve confidence, and bolster market access. Accordingly, they encouraged the authorities to take measures to meet the balanced budget target for 2014, and to rely on more durable sources of fiscal consolidation over the medium term. Directors also welcomed the creation of a parliamentary committee to review public spending and looked forward to enactment of the draft Public Finances Act to strengthen budget discipline and accountability.

Directors agreed that there is little fiscal space for additional household debt relief. In this regard, they considered appropriate the authorities' intentions not to undertake further household debt relief unless fiscal space is created. Any new measures should be targeted to distressed households not captured under existing programs. Directors also noted scope to improve existing debt restructuring processes.

Directors welcomed improvements in the banking system. Nonetheless, they urged the authorities to address legacy risks through heightened supervisory oversight and a strengthened financial stability framework. They also recommended a comprehensive reform of the Housing Financing Fund.

Iceland: Selected Economic Indicators, 2007–14

	2007	2008	2009	2010	2011	2012	2013	2014
	(Percentage change, unless otherwise indicated)							
National Accounts (constant prices)								
Gross domestic product	6.0	1.2	-6.6	-4.1	2.9	1.6	1.9	2.1
Total domestic demand	0.0	-8.6	-20.3	-2.2	3.4	2.1	1.2	3.8
Private consumption	5.7	-7.8	-14.9	0.0	2.6	2.7	2.3	2.2
Public consumption	4.1	4.6	-1.7	-3.4	-0.2	-0.2	1.7	1.5
Gross fixed investment	-12.2	-20.4	-51.4	-9.4	14.3	4.4	-3.9	15.3
Export of goods and services	17.7	7.0	7.0	0.6	4.1	3.9	3.5	4.0
Imports of goods and services	-1.5	-18.4	-24.0	4.5	6.8	4.8	2.0	6.2
Output gap 1/	3.6	1.7	-2.8	-5.9	-3.5	-1.0	-0.8	0.0
Selected Indicators								
Nominal GDP (bln ISK)	1,308.5	1,480.3	1,497.9	1,535.9	1,632.0	1,708.2	1,790.5	1,902.5
Unemployment rate 2/	1.0	1.6	8.0	8.1	7.4	5.8	5.1	4.6
Consumer price index	5.0	12.4	12.0	5.4	4.0	5.2	3.7	3.1
Nominal wage index	8.9	7.5	2.8	7.9	7.0	8.5	5.2	6.3
Nominal effective exchange rate 3/	2.5	-40.4	-34.2	2.9	-0.1	-2.4	...	...
Real effective exchange rate 3/	6.0	-20.7	-18.7	6.4	0.9	0.6	3.5	-0.3
Terms of trade	0.2	-9.3	-6.7	6.0	-1.8	-3.2	-1.8	1.5
Money and Credit								
Base Money	190.7	-31.5	1.3	-19.4	-20.7	32.0	-17.6	...
Deposit money bank credit (end-period)	56.6	-28.3	-17.8	-3.5	1.9	0.2	0.0	...
Broad money (end-period)	56.4	36.3	1.2	-9.9	8.7	-2.8	0.6	...
CBI policy rate (period average)	13.8	15.4	13.7	7.8	4.4	5.4	...	...
	(Percent of GDP, unless otherwise indicated)							
Public Finance								
General government 4/								
Revenue	47.7	44.1	41.0	41.5	41.7	43.1	43.8	43.8
Expenditure	42.3	44.7	49.6	47.9	46.7	46.9	46.4	45.6
Balance	5.4	-0.5	-8.6	-6.4	-5.0	-3.8	-2.7	-1.8
Primary balance	5.7	-0.5	-6.5	-2.7	-0.8	0.6	1.1	2.2
Balance of Payments								
Current account balance	-15.7	-28.4	-11.6	-8.4	-5.6	-4.9	-1.2	-1.9
Trade balance	-10.1	-2.3	8.6	10.1	8.5	6.3	6.4	5.6
Financial and capital account	18.1	-66.9	-30.7	52.2	17.6	-7.5	-2.0	-0.1
Net errors and omissions	-1.0	-19.5	36.2	-25.5	7.6	-9.7	0.0	0.0
Gross external debt 5/	605.9	564.7	269.8	295.2	254.7	222.2	207.6	191.3
Central bank reserves (US$ billion)	2.6	3.6	3.5	5.8	8.5	4.2	3.7	3.4

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and IMF staff estimates.
1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ A positive (negative) sign indicates an appreciation (depreciation).
4/ National accounts basis.
5/ Including face value of old banks debt before 2009. Related interest transactions are not included from Q4 2008 on.

Statement by Audun Groenn, Executive Director for Iceland and Ragnheidur Jonsdottir, Advisor to Executive Director July 29, 2013

The Icelandic authorities appreciate the constructive and fruitful discussions during the Article IV mission in June and welcome the Article IV report and Selected Issues Paper.

Our authorities broadly agree with the staff appraisal and recommendations. Substantial progress has been made in some areas, as real disposable income has increased, unemployment has come down to around 5½ percent, inflation has declined to below 4 percent, and there has been strong growth in several areas, including tourism, in recent years. However, although economic growth has resumed, investment and growth rates have been somewhat lower than expected in 2012 and 2013. The targets set for a balanced fiscal budget in 2014 and surpluses thereafter are unchanged but will require some fiscal rebalancing, as the outlook for the 2013 outcome is somewhat less favorable than planned. At present, reducing uncertainties regarding the winding-up of the failed banks' estates, refining and implementing the strategy for lifting capital controls, and providing an environment conducive to higher private sector investment and economic growth are considered the key challenges.

Fiscal policy

Staff points out that, in order to reach the 2014 balanced budget target, additional measures equivalent to 1.5 percent of GDP must be undertaken over the next 18 months. The authorities are in the process of formulating their fiscal plans, and the 2014 budget proposal will be put before Parliament in early October. The fiscal measures suggested by staff will be taken into consideration. In addition, the authorities will now focus on increased efficiency in public spending. An *ad hoc* Parliamentary committee has been established to look into every aspect of public spending and is mandated with presenting realistic proposals in coming months, including in the health and education sectors, aimed at increasing efficiency and providing savings, thus bringing public finances back towards the previously targeted path. In terms of design and implementation, potential tax cuts will be made consistent with that path and will not necessarily be predicated on Laffer curve effects.

The electoral promise of household debt relief aiming to reduce the principal of indexed household mortgages will not be undertaken unless fiscal space is created to allow such a move. The purpose is to mitigate the large financial shock sustained in the 2008 crash as a result of mortgage loan indexation. This shock jeopardized the financial plans of even the most prudent households. Otherwise, the existing restructuring process will be strengthened, as suggested by staff.

A recent report on the status of the pension system in Iceland points to significant strength in the system and the ability to cover its future obligations given the demographic trend. An exception is the State Pension Fund, which is not fully funded and faces a significant deficit if nothing is done. This situation, in addition to the high debt and Housing Financing Fund problems, places an additional constraint on public finances, signifying the need for extremely prudent fiscal management by the newly elected government.

Our authorities welcome the European Free Trade Association Court's recent ruling that Iceland was not in breach of its obligations under the EEA Agreement in the so-called Icesave dispute. This conclusion reduced the uncertainty regarding large potential contingent liabilities of the sovereign.

Monetary policy

Inflation has declined in recent months and has been moving towards the inflation target. Underlying inflation and inflation expectations have also declined. The Monetary Policy Committee therefore kept the policy rate unchanged at its June meeting.

In several recent publications, the Central Bank has argued that an inflation target coupled with a managed float, rather than the free float prevailing prior to the crisis, might be better suited for Iceland, given its small size and volatility of capital flows. Recent changes in the Central Bank's foreign exchange market intervention policy that are consistent with this view appear to have contributed to greater exchange rate stability and provided a firmer anchor for inflation expectations. This should facilitate more rapid disinflation than would otherwise have occurred. Consistent with the goal of reducing exchange rate volatility around the current exchange rate level, the Central Bank will take advantage of foreign currency inflows during the peak tourist season to buy foreign currency to strengthen its foreign reserves. The seasonal pattern of currency flows is far from stable, however, as the exchange rate is subject to various forces at the current juncture, not least the variable pace of FX deleveraging.

The MPC has indicated that it will pay close attention to the upcoming wage negotiations this autumn and will respond accordingly if it appears that wage increases will exceed the level that is consistent with the inflation target. In addition, the Committee has emphasized that monetary policy must at all times take account of fiscal policy and other factors that affect demand.

Capital controls

Staff notes that progress in abolishing the capital controls has been limited, and the authorities agree with the need to expedite the process. However, it should be noted that the auctions held by the Central Bank have been rather successful in reducing the most volatile part of the offshore krona overhang. Króna-denominated deposits held by non-residents in Icelandic commercial banks have fallen from more than ISK 200 billion, which was approximately 13.5 percent of GDP at the time the controls were introduced, to the current balance of ISK 50 billion, or 3 percent of GDP. In addition, as of end-June 2013, the foreign currency auctions had brought into Iceland foreign investments equivalent to roughly 9 percent of year-2012 GDP. These auctions are scheduled to continue until end-2013 and may be continued into 2014. Despite this progress, Iceland's balance of payments situation remains vulnerable, as liquid króna assets held by non-residents still amount 22 percent of GDP and the failed banks' estates hold substantial domestic assets. Most of the failed banks' creditors are non-residents.

This situation could potentially create disorderly capital outflows in the absence of capital controls. It is clear that resolution of the failed banks' estates in a manner consistent with financial stability is a prerequisite for further progress towards lifting the capital controls.

The Act on the Central Bank of Iceland was amended in July so as to expand the Central Bank's authority to impose prudential rules, including rules on liquidity and the banks' foreign currency balance. In addition, the amended Act empowers the Central Bank to compile more detailed information on certain financial activities carried out by banks, and it contains specified provisions on fines for violation of rules regarding financial activities under the Central Bank Act. Prudential regulation and strengthened financial supervision will be needed to control financial risks and reduce uncertainties in asset prices and exchange rates as capital controls are lifted. Moreover, prior to lifting controls on domestic resident outflows, there are plans to impose speed limits on pension fund investments abroad. Other resident outflows will be liberalized as conditions allow. It should be stressed that the various measures taken to prepare for the lifting of controls aim at reducing and mitigating the risks of resident outflows following liberalization. The likelihood that such risks will materialize depends on domestic and international economic and financial conditions at the time and cannot be easily predicted based on simple models, especially if home bias and endogeniety of the exchange rate are excluded from the analysis.

Financial sector

Structural reforms under the Stand-By Arrangement were aimed primarily at the financial sector. In that area, work continues to be focused on strengthening supervision and regulation. A draft bill of legislation for a Financial Stability Council is currently under review, and work towards implementing Basel III, additional macroprudential rules, and more comprehensive financial supervision in general is ongoing. A recent report on the Housing Financing Fund reveals a difficult financial and operational situation with non-negligible fiscal risks. The authorities will further investigate the situation before taking decisive action to define its role and put its finances on a sound basis.

The authorities agree with staff that the banks need to maintain high levels of capital adequacy and liquidity. During the last year, the commercial banks' capital ratios rose from 22 percent to 25 percent. Non-performing loans at the three largest commercial banks remain high; however, they have dropped from 23 percent of total lending to 15 percent in the past year and are expected to fall still further this year.

The banks rely heavily on deposits for their funding. However, the banks operate behind capital controls and have limited foreign market access thus far. Although this shields them from spillover effects from adverse swings in global and European financial markets, it also curtails their ability to provide FX financing for business investments. There is scope for streamlining and efficiency gains in the financial sector. The authorities foresee the emergence of a sound banking system capable of supporting investment and growth when the capital controls have been lifted and financial conditions have normalized.

Structural reforms

The role of the authorities is to create an environment conducive to growth and development, while the private sector must be the source of new employment opportunities and new enterprises. A small economy with a limited domestic market must have access to foreign capital and foreign markets. To this end, new capital inflows and associated future outflows are unrestricted, but capital controls still create various impediments for cross-border activities of Icelandic companies. The removal of capital controls is therefore important if Icelandic companies are to grow beyond their limited domestic market, which in turn is important for future growth. Economic growth potential would benefit from further diversification and strengthening of secondary and tertiary activities. The tourist sector has been growing rapidly, and there are no signs of a slow-down. There are many other opportunities related to utilization of both natural resources and human capital. The authorities will do their utmost to support new investments opportunities while increasing efficiency in public services, education, and health.