INTERNATIONAL MONETARY FUND

IMF Country Report No. 16/179

ICELAND

June 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ICELAND

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 20, 2016 consideration of the staff report that concluded the Article IV consultation with Iceland.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 20, 2016, following discussions that ended on April 12, 2016, 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 June 3, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Iceland.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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June 22, 2016

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IMF Executive Board Concludes 2016 Article IV Consultation with Iceland

On June 20, 2016 the Executive Board of the International Monetary Fund (IMF) concluded the 2016 Article IV consultation with Iceland.[1]

The outlook is positive. Growth is accelerating this year and is expected to exceed 4.5 percent, led by robust domestic demand and booming tourism. Growth will likely slow thereafter as policies to dampen excess demand and inflationary pressures take hold.

Inflation, at 1.7 percent in May, is being contained by falling import prices and króna appreciation. Given recent large wage awards, however, it is projected to breach the inflation target of 2.5 percent later this year, peaking next year before coming down gradually. Wage growth is expected to erode competitiveness over time, with the current account surplus shrinking steadily. These processes, if not sufficiently restrained by macroeconomic policies, could overheat the economy. This is the main risk for Iceland.

Executive Board Assessment[2]

Executive Directors commended the Icelandic authorities' progress in addressing crisis legacies, where recent milestones include the accords with the bank estates and the foreign exchange auction for offshore króna holders. This, coupled with the favorable macroeconomic conditions and outlook, should support the country's reintegration into global financial markets. Directors noted that, beyond uncertainties associated with the imminent U.K. referendum on EU membership, the main challenge for Iceland is to avoid a possible overheating of its economy and, in this regard, they also cautioned against any pre election fiscal easing. Directors called on the authorities to exercise caution as they scale back capital controls on residents, accompanying this with monetary and some fiscal

[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.

[2] 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.

tightening to cool demand, a framework to build reserves, and institutional reforms to anchor wage bargaining on competitiveness and to further strengthen financial sector oversight.

Directors welcomed the new Organic Budget Law, which creates a rules based, multi year fiscal planning framework, brings in the municipalities, and helps anchor fiscal discipline. They emphasized that compliance with the new fiscal rules will be essential to maintain credibility. Directors supported the authorities' commitment to save the one off fiscal receipts from the bank estates and the plans for a moderately tighter fiscal stance in 2017. They encouraged the authorities to revisit public spending priorities over the medium term, with a view to decompressing health, education, and capital spending, and to consider further reforms of value added taxes to mobilize additional revenues.

Directors supported the central bank's readiness to raise interest rates as needed. They encouraged the monetary authorities to further articulate their exchange market intervention policy, re emphasizing the primacy of the inflation target and distinguishing between reserve accumulation and market stability objectives. Directors recommended a conservative approach to reserve adequacy, especially while capital account liberalization is ongoing. They welcomed steps to strengthen the macroprudential toolkit, and took note of recent legislation laying the basis for a reserve requirement on specified debt capital inflows. Directors emphasized that capital flow management measures should be transparent, targeted, temporary, and preferably non discriminatory, and should not substitute for warranted macroeconomic adjustment.

Directors advised that capital flow liberalization for residents should be executed cautiously. They agreed that permitting more outward investment by pension funds is a logical first step, albeit one that should be matched by actions to strengthen the Pension Fund Act. At the same time, a comprehensive strategy should be drawn up to guide liberalization for households, firms, and banks, embedding concrete commitments to further improve banking regulation and supervision.

Directors underscored that with increased presence of the government in the banking system, prudent management of the state banks is crucial while suitable disposal arrangements are pursued. They recommended increasing the powers and independence of the financial regulator. Given the involvement of both the financial regulator and the central bank in banking oversight, Directors encouraged consideration of streamlining options, such as unifying all prudential oversight of banks at the central bank; other options also warrant study.

Iceland: Selected Economic Indicators, 2013–2016

	2013	2014	2015	2016 Proj
	(Percentage change unless otherwise indicated)			
National Accounts (constant prices)				
Gross domestic product	4.4	2.0	4.0	4.6
Total domestic demand	0.7	5.3	6.3	5.4
Private consumption	1.0	3.0	4.8	6.0
Public consumption	1.0	1.7	1.1	1.1
Gross fixed investment	2.2	16.0	18.6	10.0
Net exports (contribution to growth)	2.6	-1.6	-0.8	-0.3
Exports of goods and services	6.7	3.1	8.2	8.1
Imports of goods and services	0.1	9.8	13.5	11.2
Output gap (percent of potential output)	0.2	0.0	0.5	1.2
Selected Indicators				
Gross domestic product (ISK bn.)	1,889	2,004	2,205	2,402
GDP per capita ($ thousands)	48.0	52.7	50.9	57.8
Private consumption (percent of GDP)	52.3	52.2	50.1	49.8
Public consumption (percent of GDP)	24.3	24.2	23.6	24.3
Gross fixed investment (percent of GDP)	15.7	17.3	19.1	19.6
Gross national saving (percent of GDP)	21.2	21.0	23.5	23.6
Unemployment rate (percent of labor force)	5.4	5.0	4.0	3.5
Employment	3.3	1.6	3.4	3.3
Labor productivity	0.2	-0.2	0.8	1.3
Real wages	0.9	2.8	7.3	8.8
Nominal wages	4.7	4.9	8.9	11.0
Consumer price index (average)	3.9	2.0	1.6	2.1
Consumer price index (end period)	4.2	0.8	2.0	2.6
ISK/€ (average) 1/	162	155	146	139
ISK/$ (average) 1/	122	117	132	124
Terms of trade (average)	-1.9	3.3	6.8	2.0
Money and Credit (end period)				
Base money (M0)	0.3	-17.6	27.8	8.6
Broad money (M3)	4.5	7.1	5.6	-11.3
Bank credit to nonfinancial private sector	-3.2	-2.4	3.5	4.8
Central bank 7 day term deposit rate 1/	5.75	4.50	5.75	5.75
	(Percent of GDP unless otherwise indicated)			
General Government Finances				
Revenue	42.1	45.3	42.2	56.8
Expenditure	44.0	45.3	42.7	42.2
Overall balance	-1.8	-0.1	-0.5	14.6
Structural primary balance	1.4	2.1	1.4	0.9
Gross debt	84.8	82.5	67.6	55.1
Net debt	62.2	55.9	50.6	45.6
Balance of Payments				
Current account balance 2/	5.7	3.7	4.2	4.0
Capital and financial account (+ = outflow)	6.9	3.4	7.6	3.8
Gross external debt 3/	249.0	205.7	159.2	130.8
Central bank reserves ($ bn.)	4.1	4.2	5.0	6.0

Sources: Central Bank of Iceland; Ministry of Finance; Statistics Iceland; and IMF staff projections.
1/ For 2016, rate as of June 2.
2/ Actual data include accrued interest payments on intracompany debt held by a large multinational; projected data do not.
3/ Includes the effects of the compositions in 2015; projected data for the remaining debt of the bank estates calculated from their foreign currency claims on the domestic deposit money banks.

INTERNATIONAL MONETARY FUND

ICELAND

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

June 3, 2016

KEY ISSUES

Iceland wants to reintegrate into world financial markets. There is little precedent for adopting and abolishing full scope capital controls in the space of a decade, yet Iceland seeks to do precisely this. After the recent accords with the failed bank estates, economic conditions augur well for the liberalizing endeavor. Even so, what awaits is ultimately a leap into the unknown. Iceland is determined to press forward.

Staff pointed to risks and challenges. Free capital mobility will bring benefits yet risks also abound. In the very near term, there are the "Brexit" risks. Then there is the concern that surging wages could overheat demand. Compounding this will be the challenges of seeking to tailor local monetary policy to local conditions and of maintaining financial stability in the face of potentially large and volatile cross border capital flows.

The authorities know that opening up calls for prudence, firmness, and innovation: prudence in macroeconomic policy, in the determined pursuit of low debt and price stability; firmness in financial sector oversight, intrusive and uncompromising; and innovation in readying new macroprudential tools, including some to slow capital flows at the gates as needed. These were the main topics of the 2016 consultation.

Staff made the case that sailing this voyage safely calls for stronger institutions. The Organic Budget Law is an important step forward, introducing a rules based medium-term fiscal framework that brings in the municipalities. Structural changes are also needed in labor relations and in finance, to anchor wage bargaining on competitiveness and to give banking supervision real teeth and independence.

When the saga is written, hopefully, it will tell of a smooth transition. Iceland's new economic model should meld sustainable tourism and fisheries with investment in advanced technologies to harness and export its unique endowment of renewable energy. Banking and finance must be servant, not master, under the ever watchful eye of regulators that will not countenance a repeat of the boom-bust cycles of the past.

Approved By
Jörg Decressin (EUR)
Petya Koeva Brooks (SPR)

Discussions took place in Reykjavík and Akureyri, March 30–April 12, including with the new prime minister. The team comprised A. Bhatia (head), S. Antoshin, and M Arena (all EUR), J. McHugh (FAD), A. Qureshi (MCM), and G. Fayad (SPR), joined by G. Gunnarsdóttir (OED). M. Albertson (FAD) and T. Saadi Sedik (MCM) provided input from headquarters. V. Boranova and N. Veluz (both EUR) assisted.

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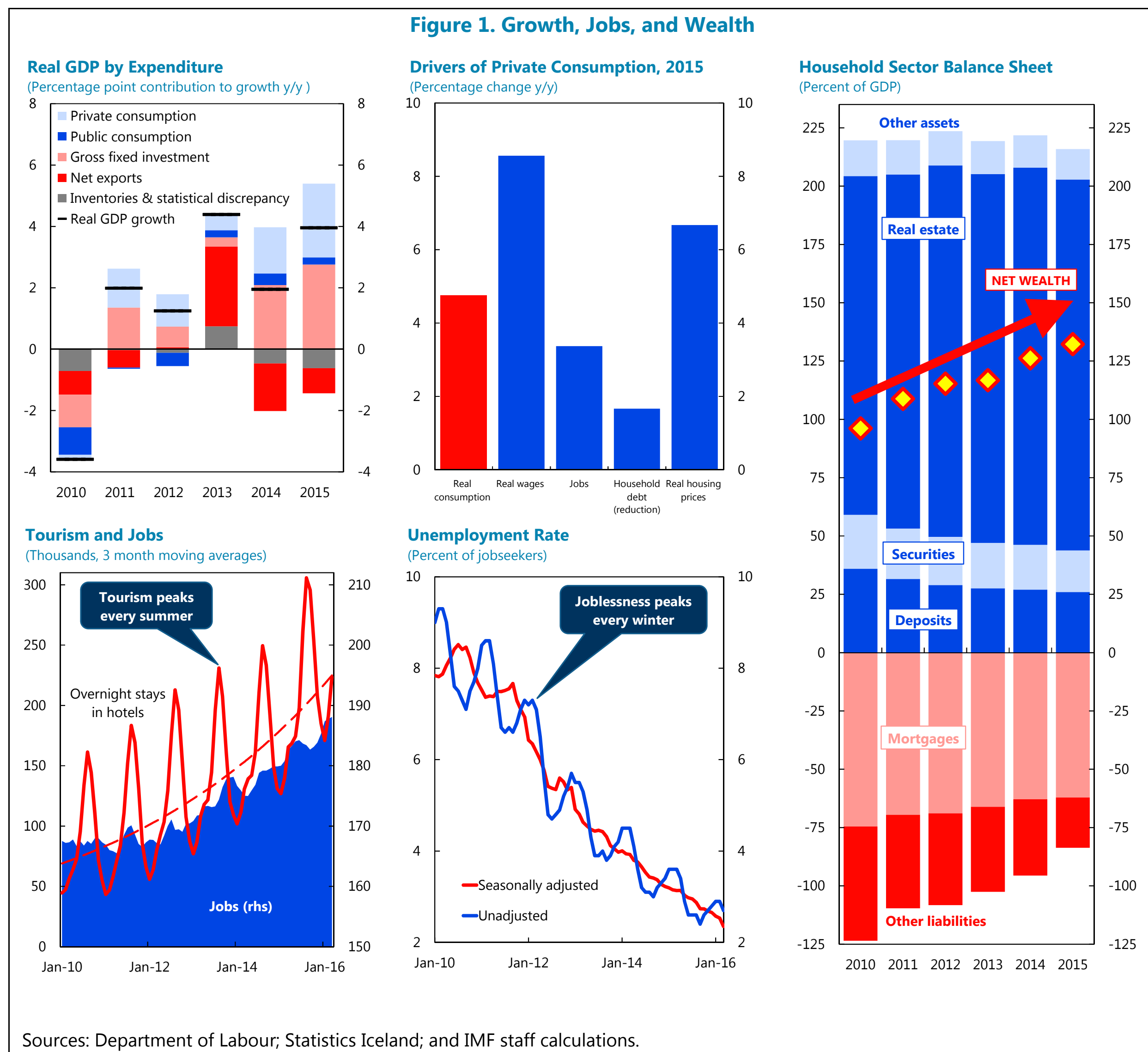
POLICY PRIORITIES AND RECENT INDICATORS

1. **Iceland wants to reintegrate into world financial markets**. There is a mounting sense that capital controls hurt growth prospects, repressing local financial markets, scaring foreign investors, and impeding savings diversification, and that it is time for them to go. Recent settlements with the bank estates are a huge step forward, improving already favorable macroeconomic conditions. Popular sentiment, to be voiced at the polls in the coming months, wants action.

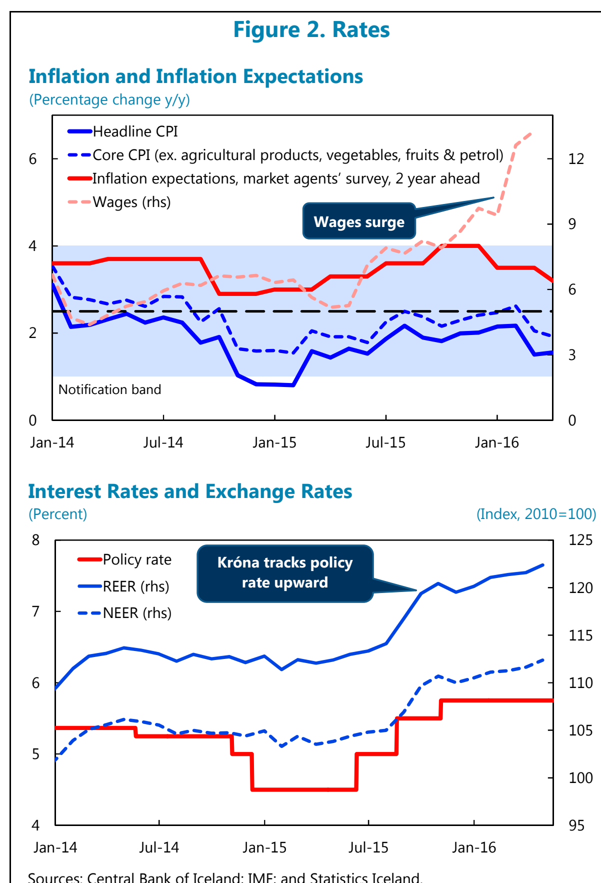
2. **Growth is strong**. At 4 percent in 2015 and gaining pace, real GDP expansion is among the fastest in Europe, opening up a positive output gap. The tourism boom goes on, with visitors outnumbering residents 7:1, spurring airline expansion, hotel projects, and hospitality jobs. Surging private consumption reflects growing employment, wages, and household net worth. Spirited investment activity includes new silicon plants, ship and aircraft purchases, and construction.

Figure 1. Growth, Jobs, and Wealth

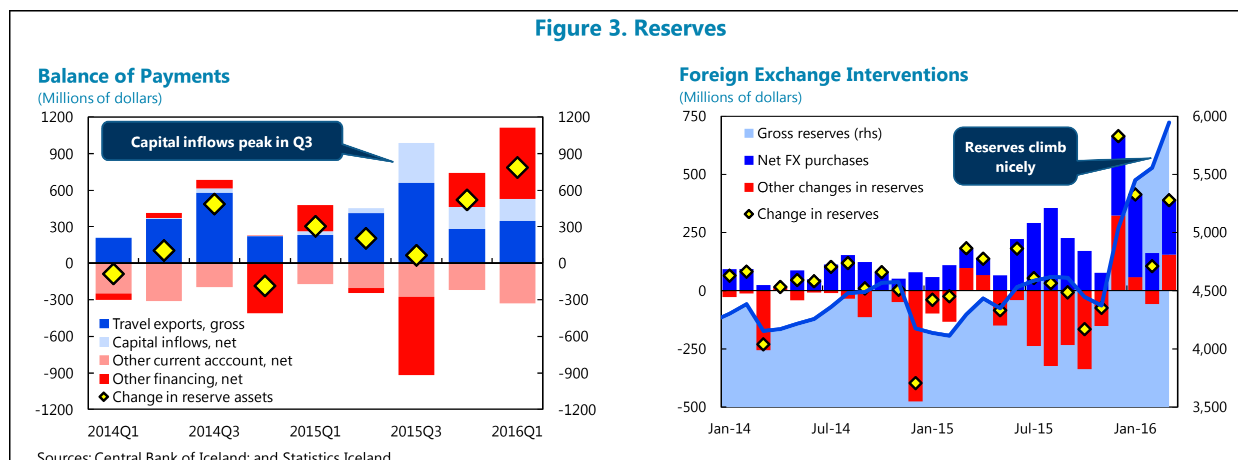


Sources: Department of Labour; Statistics Iceland; and IMF staff calculations.

3. Inflation remains controlled, helped by import prices and appreciation. The inflation rate is below the Central Bank of Iceland (CBI) target of 2½ percent. Falling import prices coupled with króna appreciation are cushioning the effects of negotiated wage awards of about 25 percent for 2015–18 which, including estimates for wage drift and pension contributions, could increase wage costs by 30–35 percent over the period. The CBI hiked its policy rate in June, August, and November by 125 basis points in total, to 5¾ percent, and has signaled readiness for further tightening. The króna appreciated by 8.4 percent in nominal and 10.1 percent in real effective terms in the 12 months to April 2016.



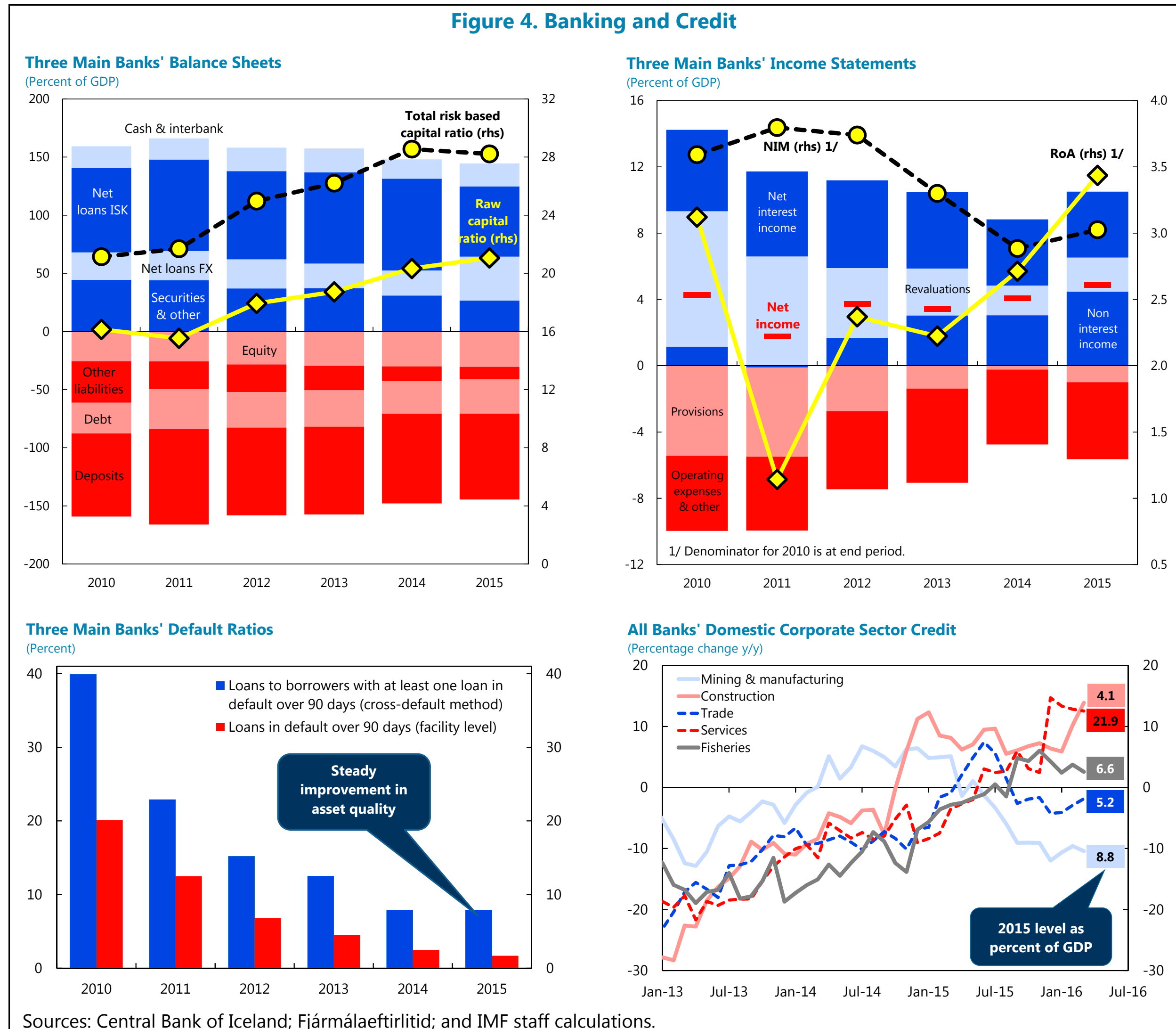
4. Tourism receipts and capital inflows have permitted debt prepayments and reserve accumulation. In October 2015, the CBI cleared Iceland's dues to the Fund with a single early repurchase of $334 million, bringing Post-Program Monitoring to an end. Flows into Treasury bonds spiked in Q3 2015, with net inflows of some $400 million over the year as a whole. CBI net foreign exchange purchases totaled $2.1 billion in 2015 and $800 million in Q1 2016, lifting reserves to $5.9 billion or 1.8 times the Fund's reserve adequacy metric (RAM, here calculated excluding restricted offshore krónur from external debt).



5. The general government recorded a deficit of ½ percent of GDP in 2015. Public sector wage growth and municipal borrowing were important drivers. The structural primary surplus contracted by some 0.7 percent of potential GDP, implying a substantial demand impulse. The Organic Budget Law, developed with significant input from Fund staff, was passed in December.

6. Strong bank results benefited from revaluations and cheap deposits given capital controls. The three main banks' raw capital ratios were 19–24 percent at end 2015, and the aggregate nonperforming loan ratio was near 8 percent. Credit is picking up from subdued levels. Funding is dominated by deposits with nowhere else to go, resulting in a rich margin. Loan values are still climbing from their deeply discounted original transfer levels, yielding valuation gains equivalent to half of net interest income in 2015. The return on assets was an enviable 3.4 percent.

Figure 4. Banking and Credit



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

SETTLEMENT OF THE FAILED BANK ESTATES

7. The recent settlements of the bank estates are a big achievement. The "composition" agreements signed in late 2015 haircut further bank claims in default since 2008–09 (many of which changed hands subsequently) as a *quid pro quo* for lifting capital controls on the estates. Back then, Iceland carved new banks from the rumps of the old, taking assets at deep discounts and, for two estates, providing equity in the successor banks as compensation. Now, one of those two banks is

given to the state, the other pledged, and more, with the estates forswearing lawsuits. A major crisis legacy is thus cleared, on terms beneficial to Iceland, even if damage to future flows cannot be excluded. Staff estimates the state has now gained on its direct crisis support to the banks (Box 1).

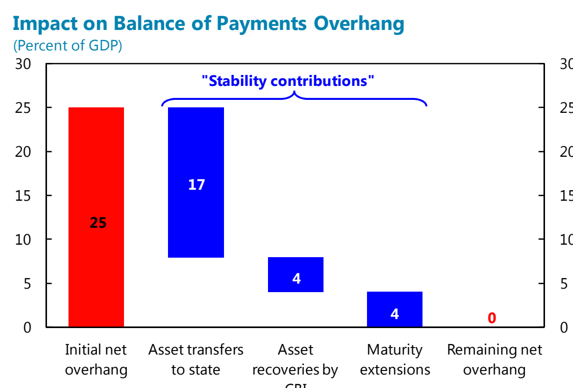
8. **The flow of funds is massive**. The estates assign most of their króna assets to the state (17 percent of GDP), distribute recoveries to the CBI as a claimant (about 4 percent), term out their domestic foreign currency deposits for seven years (4 percent), and dip into their external assets to refinance certain CBI and government claims on the banks (2½ percent of GDP). They agree to these actions so they may immediately distribute liquid foreign assets worth some 35 percent of Icelandic GDP to their predominantly foreign claimants, with more to follow over time.

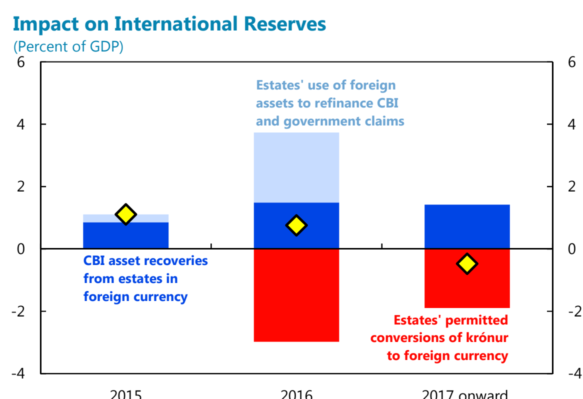
9. **In the external sector, reserves are protected and debt slashed**. Gross external debt is cut by more than 60 percent of GDP, to about 130 percent by end 2016, as the estates commit to transfer króna assets to the government and distribute recoveries to their claimants.

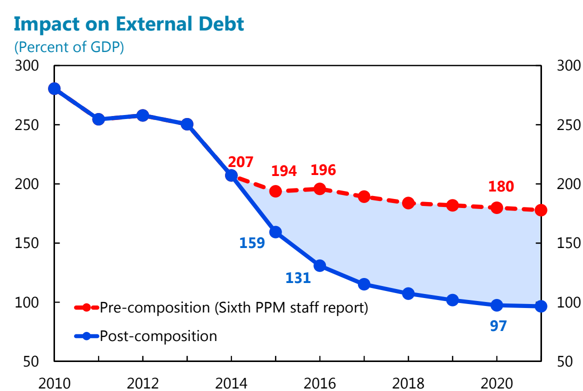
10. **In the fiscal sector, there is a windfall worth 17 percent of GDP**. The Glitnir estate transfers Íslandsbanki, Iceland's third largest bank with a book value of 8 percent of GDP, to the state. The Kaupthing estate commits (via bond contracts) to pay around 4½ percent of GDP when it divests Arion, the second largest bank, by 2018. Staff assumes Íslandsbanki's sale in 2020, taking net public debt below 30 percent of GDP, but is not averse to a slower disposal.

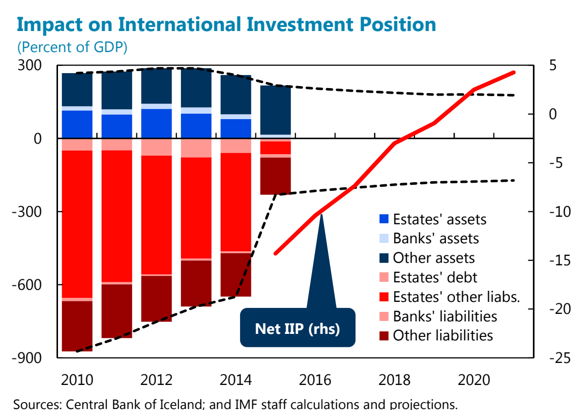
11. **In the banking sector, state ownership jumps and liquidity conditions adjust**. The state becomes controlling shareholder of two of the three main banks in the system, with a secured claim on the third. The terming out of the estates' foreign currency deposits improves the banks'

Figure 5. External Sector Impact of Composition









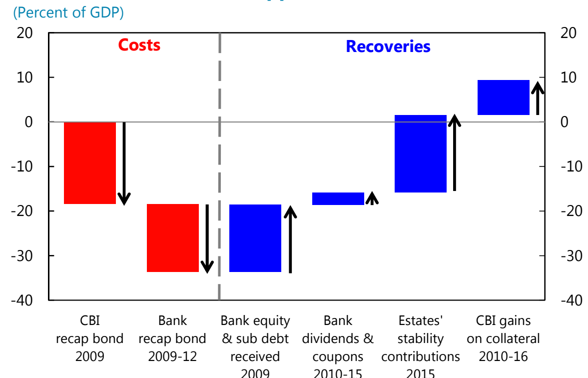
Sources: Central Bank of Iceland; and IMF staff calculations and projections.

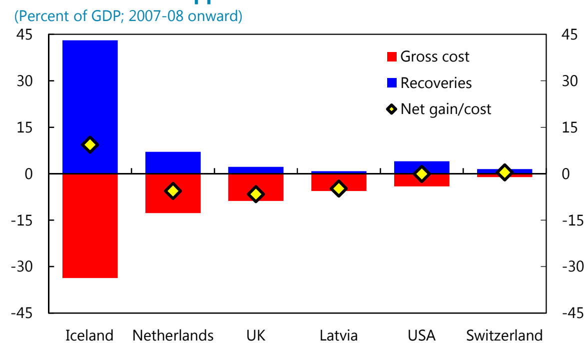
foreign currency liquidity coverage ratios (LCRs) and net stable funding ratios (NSFRs). Withdrawals of the estates' króna deposits lower total LCRs.

Box 1. Direct Costs of Iceland's Banking Crisis

Direct state support to the financial sector during the crisis amounted to some 34 percent of GDP. Both the CBI and the banks had to be recapitalized, with the former suffering large losses after its emergency liquidity assistance claims on the banks defaulted and collateral had to be written down. To cover these losses, in 2009 the government gave the CBI a bond worth 18 percent of GDP. In 2009–12 it provided the banks a separate bond worth 15 percent of GDP. Costs were limited by conservative valuations on assets transferred and steadfast refusal to socialize losses on the failed banks' foreign operations.

Recoveries are estimated at 43 percent of GDP. There are four parts: (i) bank equity and subordinated debt taken in 2009 as consideration for recapitalizations, the estimated value of which was 15 percent of GDP at end 2015; (ii) dividends and coupons on those claims, cumulating to around 3 percent of GDP in 2010–15; (iii) the stability contributions from the failed bank estates in the context of the compositions, valued on an accruals basis at 17 percent of GDP; and (iv) profits and interest payments to the CBI by the asset management subsidiary it established in 2009 to hold its seized collateral, cumulating to an expected 8 percent of GDP over 2010–16.





Sources: Central Bank of Iceland; Ministry of Finance; Laeven and Valencia (2012); Allan Sloan, *The Washington Post* (2015); and IMF staff calculations.

Iceland has thus fared remarkably well in terms of direct costs, with the state estimated to have made a net gain in excess of 9 percent of GDP. This compares favorably to many other crisis countries, a salutary feat given the enormity of Iceland's pre crisis banking system relative to its economy. Taxes lost or gained are not part of this analysis. Nor is any attempt made to quantify the vast economic costs of the crisis.

Figure 6. Recovery Rates for General Claimants on the Estates

(Percent of approved claims)

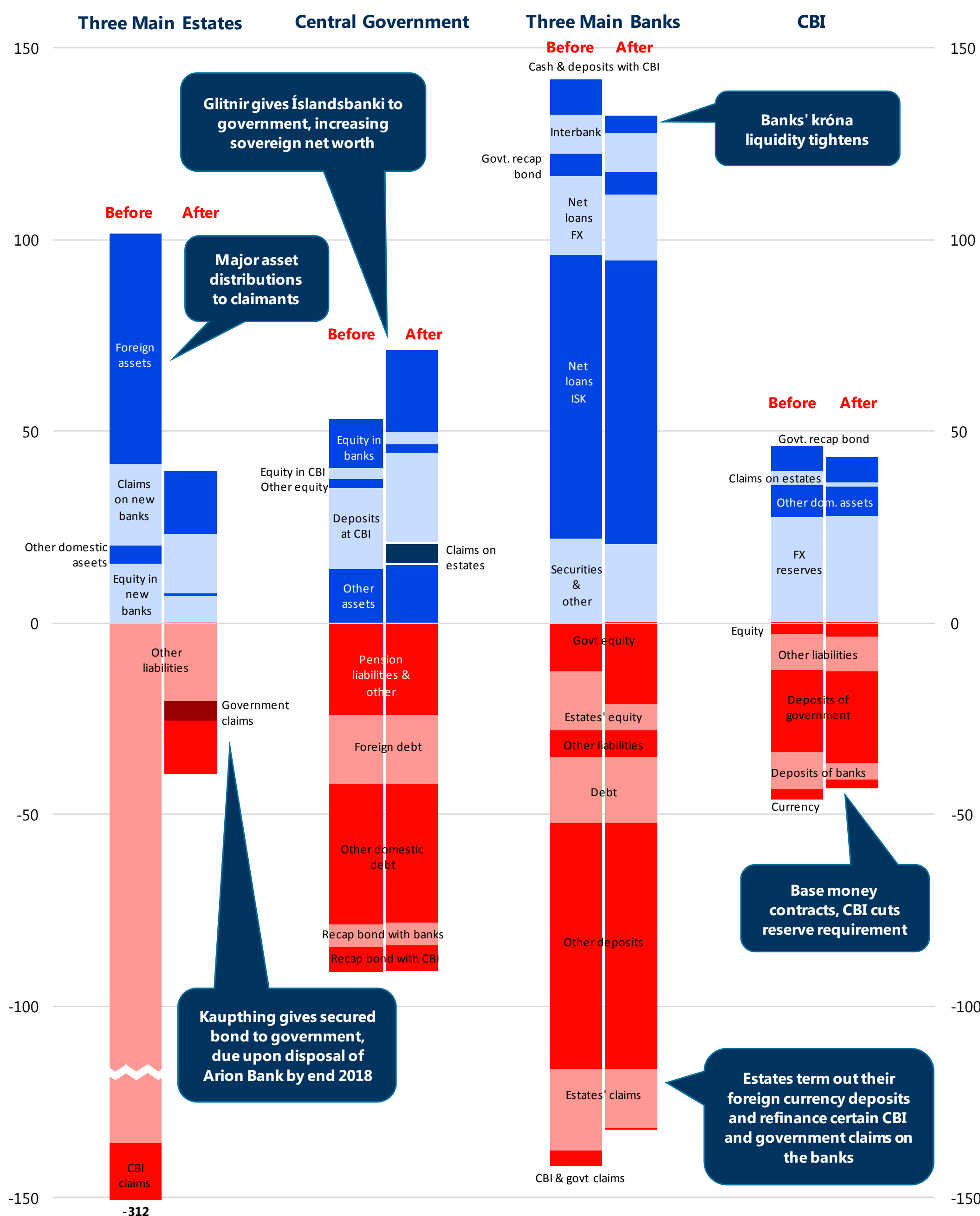
Sources: Capital Account Liberalisation Task Force; and IMF staff calculations.

12. The authorities view the settlements as a resounding success. Painstaking efforts paid off, achieving the core goals of neutralizing the balance of payments threat and minimizing legal risks. Public support was overwhelming. Claimholders got a fair deal, in their view, with not one of the thousands of claimants challenging the process in district court. Fiscal proceeds will be used

exclusively for public debt reduction, per statute. Following through on the successful lifting of capital controls on nonresidents with significant easing for residents is seen as a political imperative.

Figure 7. Balance Sheet Effects of Composition
(Percent of GDP)

West's Encyclopedia of American Law (edition 2, 2008) defines composition as "A contract made by an insolvent or financially pressed debtor with two or more creditors in which the creditors agree to accept one specific partial payment of the total amount of their claims, which is to be divided pro rata among them in full satisfaction of their claims." In Iceland's case, strictly, the recent compositions are voted and binding agreements among claimants, estate by estate.

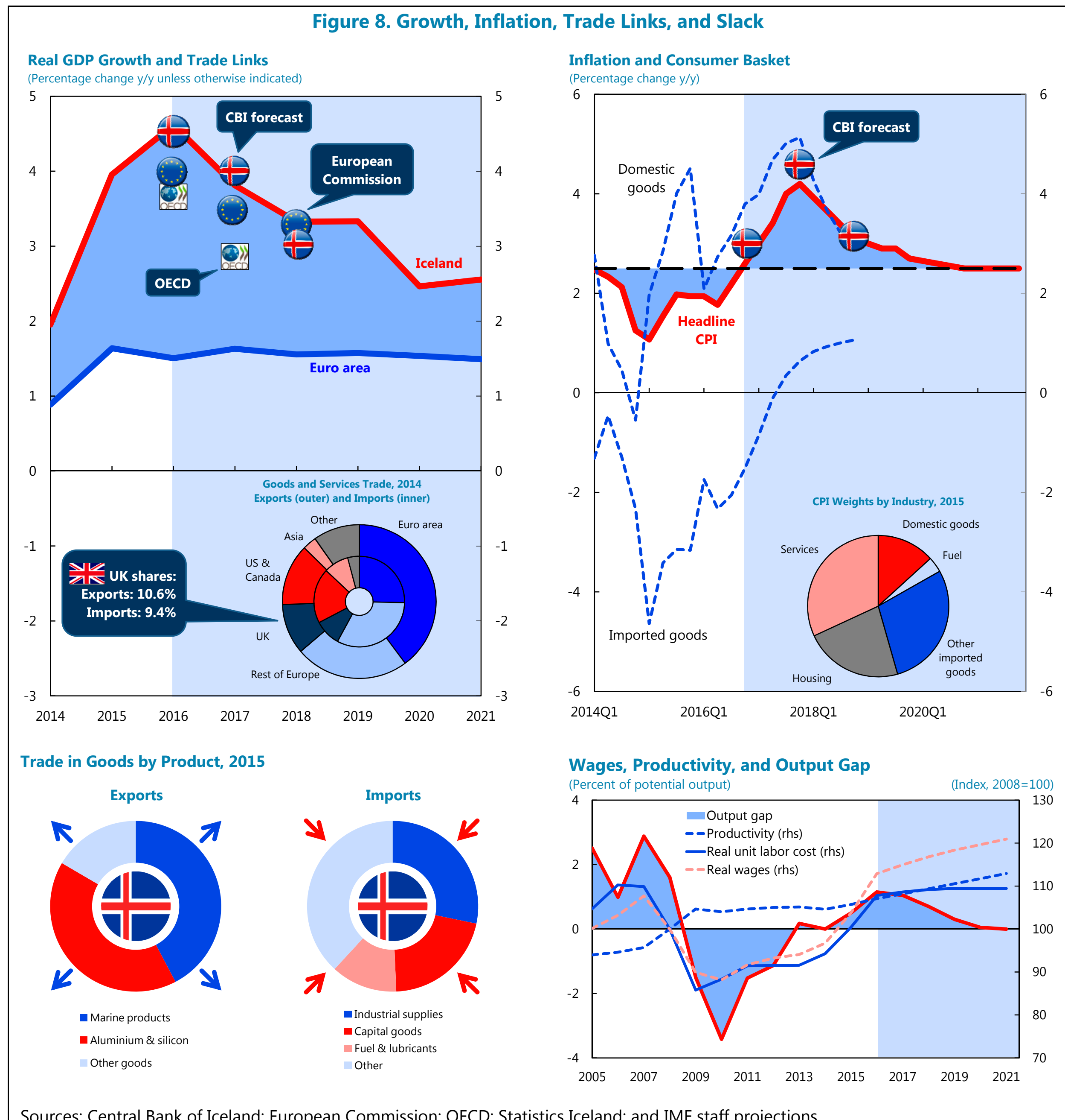


Sources: Central Bank of Iceland; and IMF staff calculations.

OUTLOOK AND RISKS

13. The baseline has growth and inflation gaining pace before easing back. Monetary tightening guides real GDP back to a potential growth rate of around 2½ percent. Private consumption and investments in energy intensive sectors, housing, and hotels remain the main drivers. With deleveraging having run its course and bank capital and liquidity supportive, credit recovers, its rate of growth converging to that of GDP over the medium term. Inflation breaches the target as wage increases feed through but does not break anchor. The CBI reacts with rate hikes, returning inflation to target after three years without forcing a hard landing.

Figure 8. Growth, Inflation, Trade Links, and Slack



Sources: Central Bank of Iceland; European Commission; OECD; Statistics Iceland; and IMF staff projections.

14. Falling competitiveness erodes the current account surplus. Commodity prices stabilize while some potential tourists are deterred by high costs. Staff views Iceland's external position as broadly consistent with fundamentals and desirable policy settings, but this changes going forward and the current account surplus is projected to shrink steadily (Box 2). Before factoring in flows relating to capital account opening, reserves climb to a healthy $10 billion by 2021.

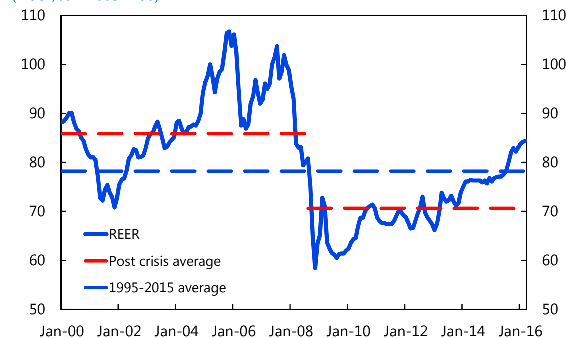
Box 2. Exchange Rate Assessment

The Fund's macro balance assessment method indicates modest exchange rate undervaluation. The regression suggests the current account surplus in 2015 exceeded the level consistent with fundamentals and desirable policies by about 2 percent of GDP. This, in turn, suggests a real effective exchange rate (REER) undervaluation of 5 percent, using a current account to REER elasticity of about 0.33. The model fit is poor.

The REER approach, in contrast, points to modest overvaluation, with a better fit. The regression suggests an overvaluation of 4 percent, with a tighter fit than in the macro balance approach.

Real Effective Exchange Rate

(Index, Jan-2005=100)



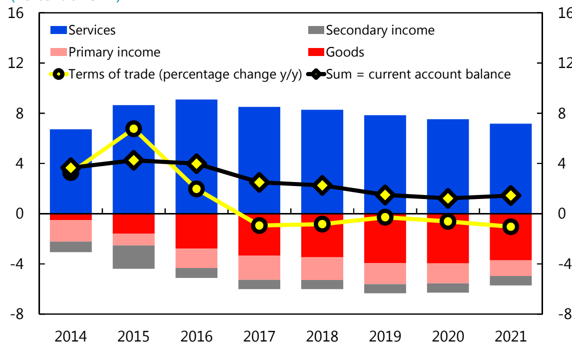
Sources: Central Bank of Iceland; and IMF staff calculations.

On balance, staff views Iceland's external position as broadly consistent with fundamentals and desirable policy settings. The various exercises do not fully capture the effects of capital controls, however, nor of structural breaks such as the tourism boom that followed the Eyjafjallajökull volcanic eruptions of 2010, nor of rising labor costs yet to be passed on to consumer prices. The sizeable real depreciation following the 2008 crisis appears to have shifted the equilibrium REER to a new (lower) normal as fundamentals also shifted to post crisis norms. These norms may shift again.

Figure 9. Balance of Payments

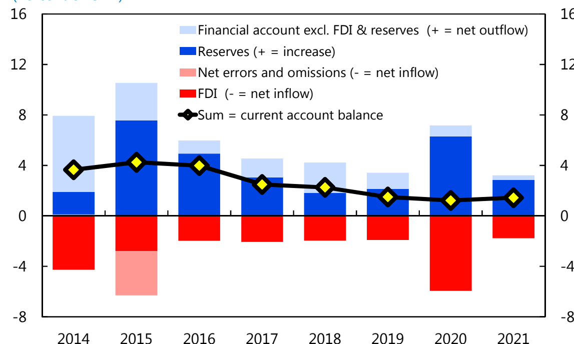
Current Account

(Percent of GDP)



Financial Account

(Percent of GDP)



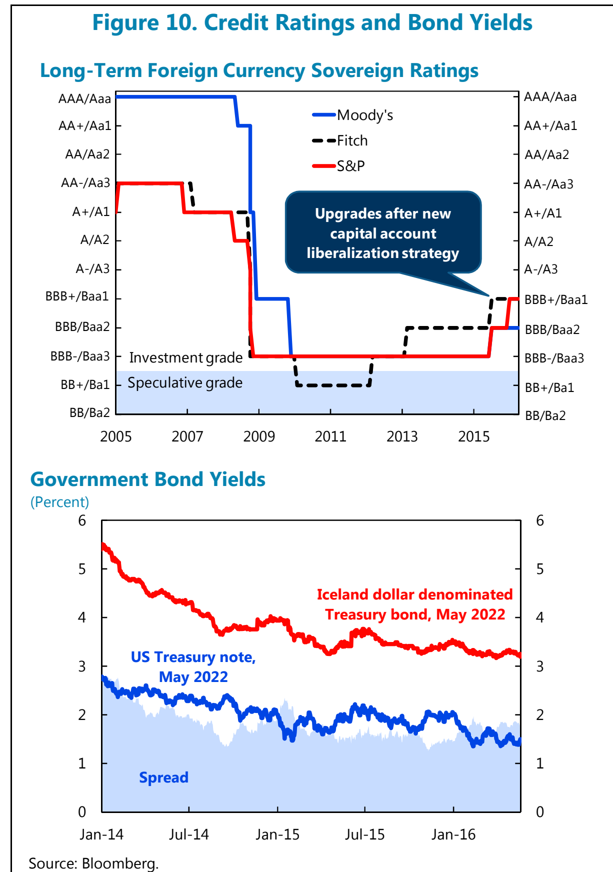
Sources: Central Bank of Iceland; and IMF staff calculations.

15. The biggest risk for Iceland is overheating. The large wage awards on top of already hot economic readings speak to Iceland's history of boom-bust. After years of expenditure restraint and with parliamentary elections approaching, spending pressures could build. A fiscal easing while wages surged would stoke domestic demand. If that were to coincide with rising import prices feeding inflation, interest rates herding in hot money, and credit inflating asset prices, Iceland would be left vulnerable to a sudden stop that itself could be triggered by outside factors.

16. Other risks range from policy errors to trade shocks to natural events. Missteps could occur in capital account opening, resulting in potentially large outflows by residents. Iceland could be hurt by trade, where the euro area for instance buys 40 percent of its exports. And there can always be shocks from disruptive volcanic activity or upsides such as the arrival, from 2006, of growing numbers of mackerel in national waters potentially linked to climate change.

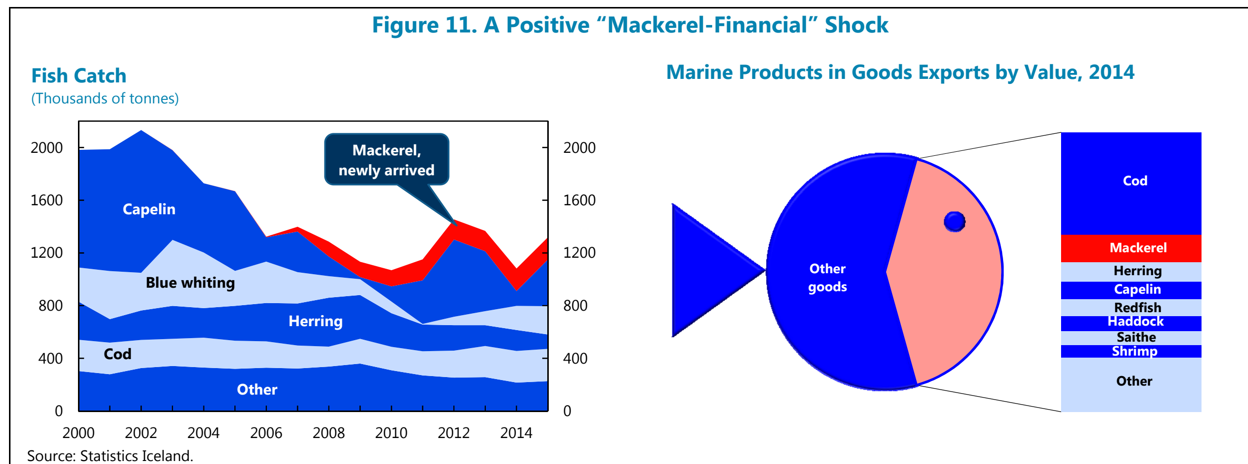
17. A U.K. vote to leave the EU would likely dent Iceland's exports. The United Kingdom accounts for a tenth of Iceland's service exports, two thirds of which is tourism, and London is a global financial center. If sterling depreciates significantly and U.K. growth slows in a "leave" scenario, tourist arrivals and other demand for Iceland's exports from the United Kingdom could weaken, while spillover effects could dent demand from other countries. A "Brexit" vote could also result in increased volatility in asset prices.

Figure 10. Credit Ratings and Bond Yields



Source: Bloomberg.

Figure 11. A Positive "Mackerel-Financial" Shock



Source: Statistics Iceland.

18. The authorities share staff's views on the outlook and risks. They concurred current conditions are positive. The CBI projects growth of 4½ percent this year, with a widening positive output gap and inflation exceeding target at year end. Falling import prices and króna appreciation are expected to continue to contain inflation until wage increases feed through more strongly in 2017. The authorities agree higher unit labor costs relative to trading partners will hurt the trade balance. Like staff, the CBI shows the current account surplus shrinking steadily over the medium term. There was strong agreement that overheating is the main risk.

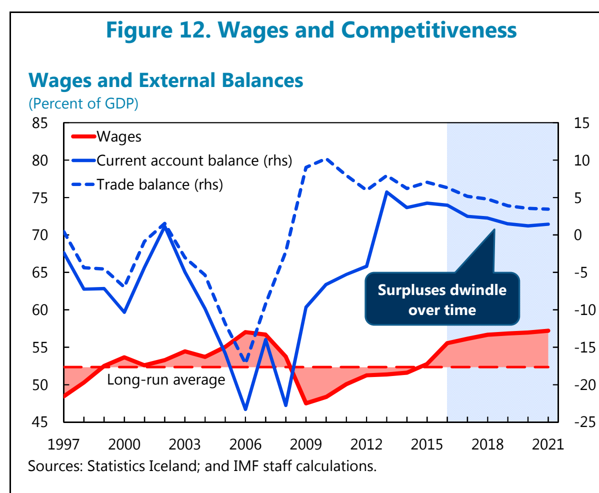
POLICY DISCUSSIONS

19. Staff advised a cautious approach to capital account liberalization with supporting institutional reforms. The wage framework should be revamped to prevent a replay of the recent wage rounds. Lifting capital controls on residents will be delicate, calling for credibility, reserves, and resilience. Staff suggested the right mix includes monetary and some fiscal tightening to cool demand, a framework to build reserves, and a careful sequencing by sector, supported by steps to build a solid microprudential foundation and an overlay of macroprudential tools.

A. Wage Bargaining

20. Staff supported efforts to reform wage setting. The share of compensation of employees in GDP by factor cost has already reached its long-run average. Pointing out that the ratcheting wage awards since early 2015 pose a challenge, it supported efforts to anchor wage bargaining on competitiveness and welcomed the new Macroeconomic Council as a forum to bring together social partners and policy makers.

Figure 12. Wages and Competitiveness



Sources: Statistics Iceland; and IMF staff calculations.

21. The authorities view revamping the wage bargaining framework as critical. They flag a risk that if price stability is maintained despite the wage hikes—as they resolutely intend—the unions may downplay the external effects and again push hard in the 2018 wage round. Seeking to head off such an outcome, the authorities have signed an agreement with the unions and employers aiming to reach a labor market accord by end 2017. This will center on a new approach to wage settlement where the scope for changes in wages will be determined by the competitive position of the export oriented manufacturing industries. The authorities are cautiously optimistic that the Macroeconomic Council will help achieve consensus.

B. Fiscal Policy

22. The Organic Budget Law is an important step forward. General government net debt, conservatively defined as gross debt less deposits, may not exceed 30 percent of GDP; if it does, the annual improvement in the net debt ratio may not be less than 1/20 of the excess. The rolling 5 year sum of overall balances should never be less than zero, and the overall deficit may not exceed 2½ percent of GDP in any year. An escape clause allows the Minister of Finance to go to parliament in the event of an extreme shock to seek authorization to deviate from the rules.

23. The new fiscal rules are transparent and introduce a medium-term planning process. Coupled with reforms underway that will lower taxes, they imply real spending growth well below that of potential GDP. Consistent with saving the windfall from the estates and liquefying it over time, a late amendment to the bill lowered the net debt ceiling from a previously envisaged

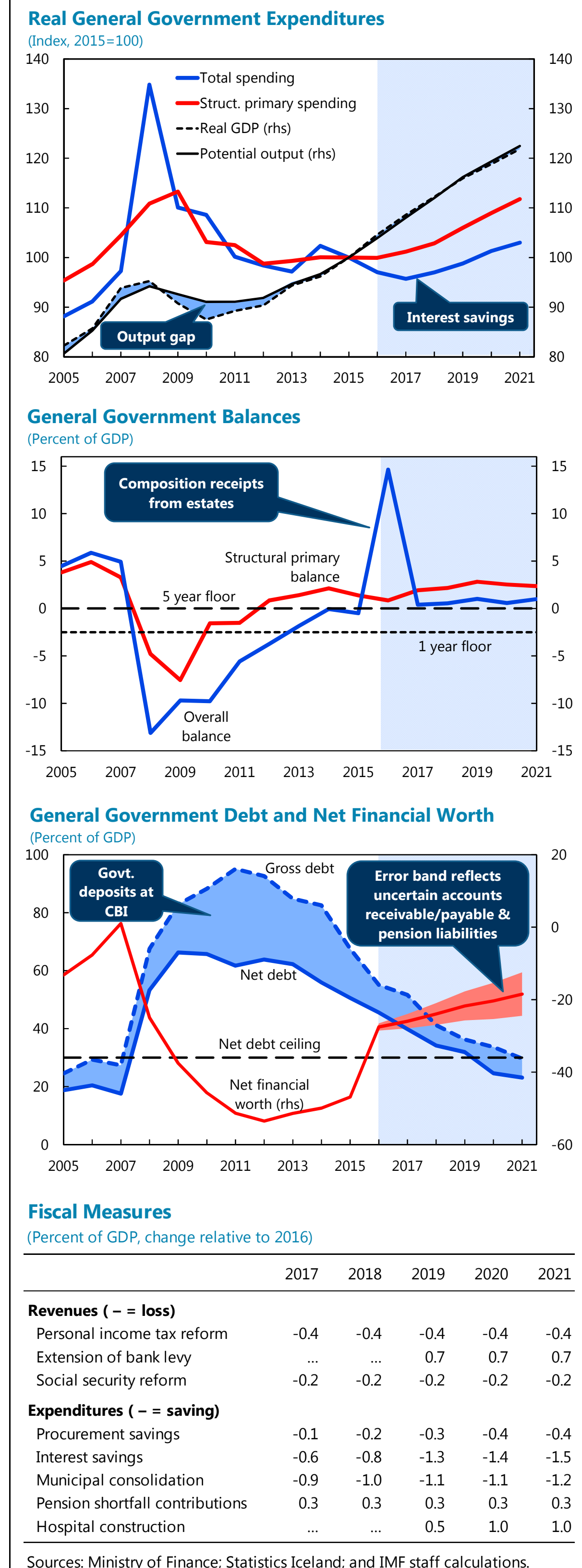
45 percent of GDP. The objective is sound, yet an adjustor might have provided greater flexibility.

24. Staff advised that the rules be respected. Compliance will build credibility. The authorities' intention to use cash receipts from the estates to pay down the CBI recapitalization bond, with a remaining principal amount equivalent to 4 percent of GDP, is consistent with saving the windfall. Noting that there is no calendar deadline for meeting the net debt rule, staff cautioned against any undue sense of haste in liquefying state assets, especially the banks.

25. The 2016 budget includes an important reform of the personal income tax system. The main objectives of the reform are to increase labor force participation and recalibrate the relative importance of direct and indirect taxes. Personal income tax rates will be reduced and the current three rate bands harmonized into two, for an annual revenue loss of about ½ percent of GDP.

26. Staff called for firm budget execution in 2016 and a moderately tighter budget for 2017. Restraint is warranted from a cyclical standpoint given the growing positive output gap. The 2016 budget envisages a reduction in the structural primary surplus relative to 2015 given wage growth. A moderately tighter stance is needed for 2017, where at a minimum the impulse should not again be positive. While personal income taxes fall, dividends from the state banks and energy company climb and interest savings should cumulate to about 1 percent of GDP in 2016–17. Room to cut spending is limited, but further reforms of value added taxes could be considered, including to increase the revenue take. Iceland's value added tax regime is among the least efficient in the Nordic countries. The fiscal plan for 2017–21, yet to be approved by parliament, is broadly consistent with staff advice.

Figure 13. Fiscal Policy



Fiscal Measures

(Percent of GDP, change relative to 2016)

	2017	2018	2019	2020	2021
Revenues (– = loss)					
Personal income tax reform	-0.4	-0.4	-0.4	-0.4	-0.4
Extension of bank levy	...	...	0.7	0.7	0.7
Social security reform	-0.2	-0.2	-0.2	-0.2	-0.2
Expenditures (– = saving)					
Procurement savings	-0.1	-0.2	-0.3	-0.4	-0.4
Interest savings	-0.6	-0.8	-1.3	-1.4	-1.5
Municipal consolidation	-0.9	-1.0	-1.1	-1.1	-1.2
Pension shortfall contributions	0.3	0.3	0.3	0.3	0.3
Hospital construction	...	...	0.5	1.0	1.0

Sources: Ministry of Finance; Statistics Iceland; and IMF staff calculations.

27. Staff stressed the need for growth enhancing expenditure reforms (*Selected Issues*). These should seek to decompress education, health, and capital spending by rationalizing disability outlays, which have risen steadily, and spending on social protection, which jumped during the crisis and stays elevated despite job creation. Education, health, and capital spending remain below their real pre boom levels. Discontent with medical service provision suggests healthcare will be an election issue.

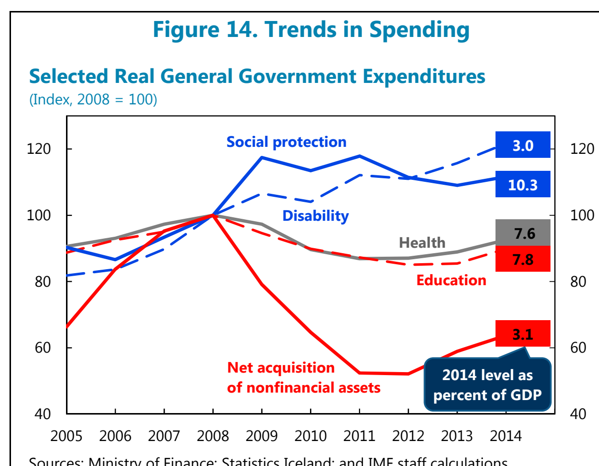


Figure 14. Trends in Spending

Sources: Ministry of Finance; Statistics Iceland; and IMF staff calculations.

28. The authorities broadly agreed with staff views. They regard the Organic Budget Law as a game changer, bringing the municipalities into the planning framework and insulating fiscal policy from the political cycle. They assured there is a political consensus to use the windfall from the estates for debt reduction. There is no rush to sell the state banks, and dividend policy will be set at arm's length. They agreed fiscal policy should support monetary policy and suggested this is reflected in the medium-term plan, which has a surplus of about 1 percent of GDP in 2017.

29. The authorities acknowledged the need to reprioritize expenditures. The medium-term fiscal plan has health and education expenditures rising, but not capital spending, where a new hospital costing some 5 percent of GDP is to be offset by ambitious savings elsewhere. They were also broadly in favor of further reforms of value added taxes, especially to limit exemptions, but stressed there was little political appetite for further increases in the lower value added tax rate.

C. Monetary and Exchange Rate Policy

30. Staff supported readiness for further rate hikes. Inflation expectations are elevated, inflation is likely to breach target this year, the positive output gap is growing, and wages are ratcheting upward. Falling import prices could prove transitory. With scope for countercyclical fiscal policy limited by tax reforms and spending rigidities, and with CBI credibility at stake, more monetary tightening will probably be needed. This should be done in measured, data driven steps. The goal should be to keep inflation near target while finding a smooth glide path for the economy.

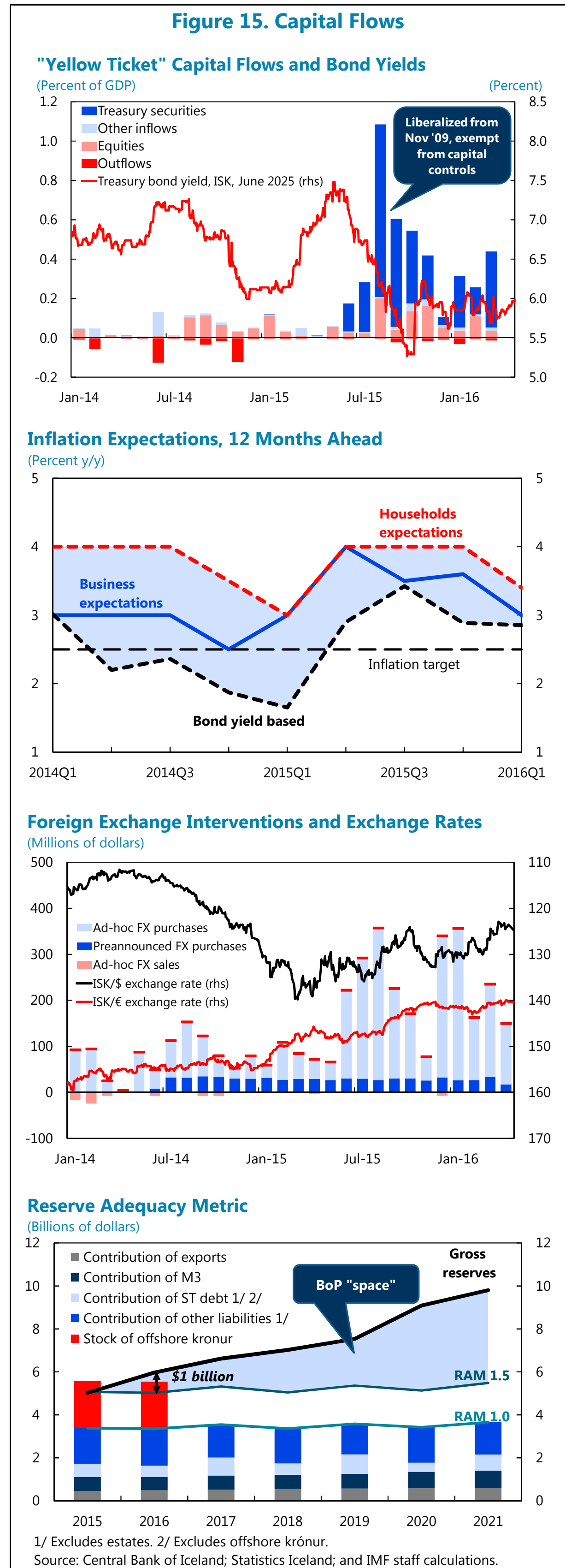
31. Staff suggested the CBI develop an exchange market intervention policy consistent with the inflation targeting (IT) framework. This should re-emphasize there is no exchange rate objective, and distinguish between the separate goals of accumulating reserves and countering disorderly market conditions. With further capital account opening high on the agenda, staff advised a conservative approach to reserve adequacy, targeting perhaps around 1.5 times RAM, as before.

32. Circumstances could arise where new capital flow management measures form part of an efficient policy response. Capital flows into the long end of the (thin) Treasury bond market have weakened policy transmission to long-term rates, distorting bond based measures of inflation expectations and prompting concerns about a new carry trade. Staff pointed the authorities to the

Fund's *Institutional View*, which takes the position that capital flow management measures should be transparent, targeted, temporary, and nondiscriminatory and should not substitute for warranted macroeconomic adjustment.

33. The authorities stressed the primacy of the price stability objective. The CBI Governor describes a strengthened regime where IT coexists with some foreign exchange intervention and macroprudential policies. This framework, which he calls "IT+", will at some point formally succeed the 2001 concordat on IT. The Governor sees foreign exchange intervention as an instrument to dampen excess volatility but not to target any exchange rate level. The authorities regard recent interventions as opportunistic and characterize them as risk mitigating steps ahead of further capital account liberalization. They acknowledged a potential role for clearer communication on the separate objectives of smoothing excess volatility and building reserves, where developing a long-term policy on reserve accumulation remains a work in progress. At the technical level, the CBI subscribes to the IMF's RAM methodology.

34. The authorities are working to develop tools aimed at giving monetary policy more room for maneuver while helping safeguard financial stability. In particular, they seek to ready capital flow management measures as a "third line of defense" to help dissuade carry trade inflows that interfere significantly with the domestic interest rate channel of monetary policy transmission. Unremunerated reserve requirements and direct levies on inflows were mentioned as two options under the microscope of a working group tasked with instrument design taking into account Iceland's international obligations. The authorities want to have tools operational this year.



1/ Excludes estates. 2/ Excludes offshore krónur.
Source: Central Bank of Iceland; Statistics Iceland; and IMF staff calculations.

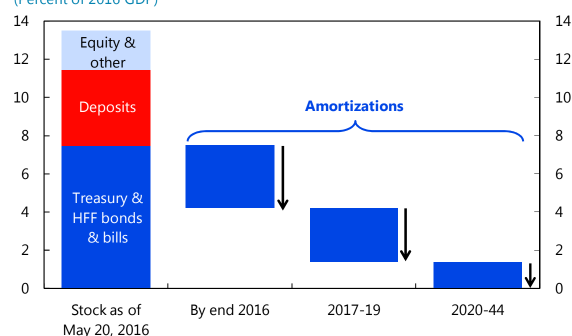
D. Capital Account Liberalization and Financial Sector Policies

35. Staff advised that steps to unlock restricted offshore krónur are best kept simple. These blocked holdings, a legacy of the glacier bond era, are worth some 13 percent of GDP or about 40 percent of reserves. Today, they mostly comprise bank deposits, Treasury securities, and equity interests. The authorities plan one final offer to clear the overhang, with holdouts to be left in special blocked accounts (Box 3). Estimating the balance of payments "space" available for both offshore króna holders and residents by comparing projected reserves to levels consistent with 1.5 times RAM, staff pointed out tradeoffs but did not advise on parameters of the offer.

Box 3. One Final Offer to Offshore Króna Holders

The CBI has announced a final euro auction for offshore króna holders, to be held on June 16, 2016. All accepted bids will be offered to investors at the same price. The auction exchange rate will be on a sliding scale by size of total bid, with a best rate of ISK 190:€1, implying a euro premium of roughly 27 percent over the current onshore market rate. Participation is voluntary. Settlement will be on June 29.

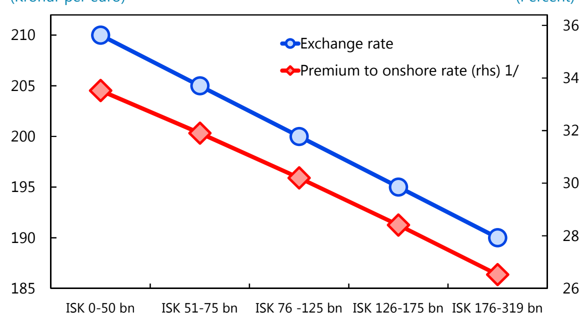
Offshore Króna Assets
(Percent of 2016 GDP)



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

Announcement of the auction terms followed passage of an Act stipulating the ground rules. This law defines eligible offshore króna assets and lays out the treatment of nonparticipating assets. Eligible assets not exiting are to be transferred to "accounts subject to special restrictions." Essentially this formalizes in law the *status quo ante* where offshore investors could retain their legacy holdings of króna securities and generally convert and transfer out interest receipts, but could not do the same with principal amounts, which could be reinvested subject to CBI investment authorizations (limited since early 2015 to Treasury bills only). Under the new law, the investment authorizations are expanded to include CBI certificates of deposit. Nonparticipating assets shall remain in the special accounts until "resident investors' asset portfolios become better balanced." Such assets shall until November 1 be eligible, however, for exit at ISK 220:€1 (about the weighted average rate of the auctions held in 2011–15, a premium to the current onshore market rate of about 37 percent).

Exchange Rates Offered at Auction
(Krónur per euro) (Percent)

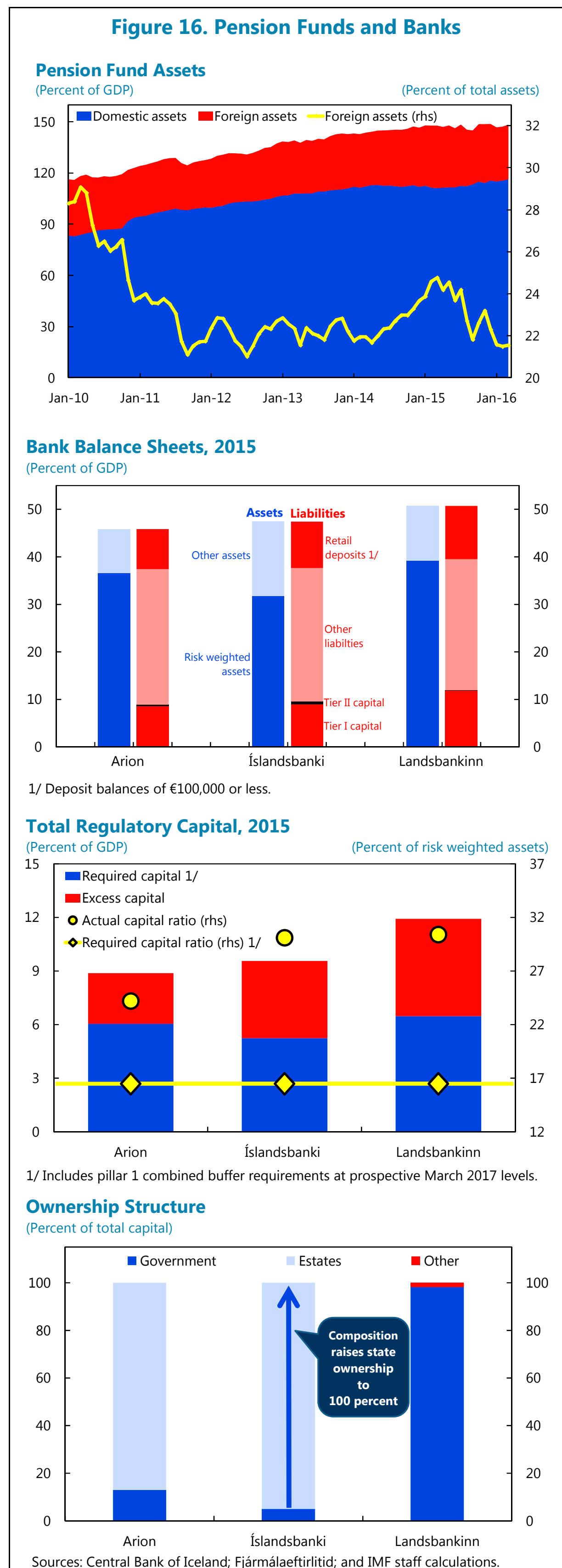


Sources: Central Bank of Iceland; and IMF staff calculations.
1/ Premium for euros relative to onshore rate as of May 25, 2016.

Ownership of the offshore króna assets, as now defined, has become more concentrated over time. The four largest holders, all of which are major international asset managers, together own almost half of the total. The auction terms are explicit that this "will be the last auction in which owners of offshore krónur will be invited to purchase foreign currency before the authorities begin lifting controls on residents."

36. Staff urged a comprehensive plan be developed to guide capital account liberalization for residents. Capital controls have been enforced exceptionally effectively. Their prolonged use, however, is increasingly amplifying distortions, including for instance commercial real estate lending by domestic pension funds via special purpose vehicles. Permitting significantly more outward

investment by pension funds for portfolio rebalancing purposes seems a logical first step, including because such a quantity based approach can be calibrated and controlled. Such exemptions should be matched, however, by steps to strengthen governance and risk management provisions in the Pension Fund Act. A well calibrated and comprehensive strategy should be drawn up to sequence the subsequent easing of restrictions on households and firms. One option for households could be to allow outward portfolio investments via mutual funds, where overall amounts could be adjusted in light of balance of payments conditions, mirroring the approach applied to pension funds.



37. Banking policies must animate the plan, starting with the state banks. Strong bank results will be tested as competitive pressures intensify, with capital account liberalization permitting alternatives to domestic deposits and thus compressing net interest margins. The government, with its overarching presence in the system, must be a responsible steward. With the state banks reporting sizable excess capital relative to the regulatory capital floors, temptations to extract large dividends will arise and must be resisted, including to ensure that the liquidity rules are respected. Bank disposal plans must look beyond near-term fundraising, or even value maximization, to finding the right owners. Reputable foreign banks would be best, and patience will be of the essence. In the interim, arm's length arrangements to ensure commercially oriented management should be maintained.

38. Concrete commitments are needed to further improve microprudential oversight. The IMF's integrated approach to capital flow liberalization ascribes considerable importance to strengthening prudential regulation and supervision. Iceland's recent partial adoption of the latest EU laws on bank supervision is a positive

step, albeit from a weak starting point. A 2014 assessment of Iceland's observance of the Basel Committee's *Core Principles for Effective Banking Supervision* found Fjármálaeftirlitid (FME, the banking, securities, and insurance regulator) lacking teeth and independence (Box 4). Noting the forward steps taken since 2014, staff nonetheless urged the Act on Official Supervision of Financial Activities be amended to increase supervisory powers and independence, even as work advances to enhance the quality of risk based supervisory processes.

39. **A fundamental reform of the regulatory architecture could be considered**. While the primary reform objective must be to ensure that bank regulation and supervision have the requisite legal powers and independence, there are also issues around the potential for conflicts, gaps, or coordination failure given the involvement of two bodies in bank regulation—FME, responsible for safety and soundness oversight, and the CBI, which applies the LCR and NSFR rules. Two earlier official reviews, in 2009 and 2012, proposed centralizing safety and soundness oversight of banks at the CBI. The 2012 review detailed a "twin peaks" model leaving regulation of nonbanks and markets, as well as conduct of business oversight of banks (including consumer protection), at FME.

Box 4. Some Identified Challenges in Banking Oversight

Iceland's banking crisis prompted calls, rightly, for a critical examination of bank regulation and supervision. The first post crisis review, in 2009, made a number of far reaching recommendations, including to reduce the number of ministries involved in financial market legislation; give more discretionary powers to FME; and merge the CBI and FME. Some recommendations were implemented, yet many were not.

Persistent institutional weakness was confirmed by the Basel *Core Principles* assessment in 2014. Among other things, the assessment identified several important legislative deficiencies.

The assessment pointed to insufficient rulemaking powers: "FME … is only allowed to issue rules if explicitly commanded to do so by the legislation. This has seemingly led to the situation where FME relies on the issuance of guidelines not only to clarify to the banks its supervisory expectations, but to detail and interpret where law and regulation is too general. However, such guidelines are not legally binding."

The assessment gave little comfort on regulatory and supervisory independence: "FME depends on the Minister of Finance to put forward prudential legislation and regulation," which "undermines the timeliness of regulatory updates, and in practice may prevent FME from responding adequately if there are conflicting interests between the government and prudential supervision."

It also flagged a risk of coordination failure, especially in liquidity oversight: "While there is strong cooperation between the CBI and FME, there are still gray areas regarding responsibilities … Whatever the institutional arrangement decided by the authorities, it is important FME has the power … to supervise individual banks' liquidity risk compliance and management and apply adequate corrective actions early on."

40. **One solution in the Icelandic context might be to unify safety and soundness oversight of banks at the CBI**. This, by placing prudential regulation and supervision of banks alongside the lender of last resort function at the independent central bank, would limit the potential for conflicts, gaps, or coordination failure and amount to a significant streamlining arguably well suited to a country as small as Iceland. By leaving oversight of nonbanks, markets, conduct of business, and consumer protection at FME, it would allow the CBI to focus on risks related to leveraged maturity transformation while FME specialized in compliance and conduct. Staff acknowledged, however, that change can be disruptive and that other solutions also warranted further study.

41. Other priorities include a stronger bank safety net. The recent Icesave settlement opens the door to reforms of deposit insurance and bank resolution. Elements would include adopting the EU guarantee limit of €100,000 per head (giving an insured deposit base of 40 percent of GDP), clarifying emergency backstops, and ensuring the insurance fund is available to help finance bank resolutions. The resolution statute should include early intervention powers, authority to replace management and abrogate contracts, and the full range of intervention tools.

42. Finally, staff encouraged further work on macroprudential policies and mooted somewhat greater delegation of powers by parliament (*Selected Issu*es). Systemic risks should be understood to inform targeted use of tools, where resilience to exchange rate shocks should be a core objective (Box 5). The CBI's foreign currency LCR and NSFR floors are welcome steps, as are recently adopted capital buffer requirements for banks. With loan to value caps for mortgages and limits on unhedged foreign currency lending pending in parliament, staff suggested it could be efficient if authority to introduce new instruments was delegated to the CBI and FME.

Box 5. Building a Macroprudential Toolkit

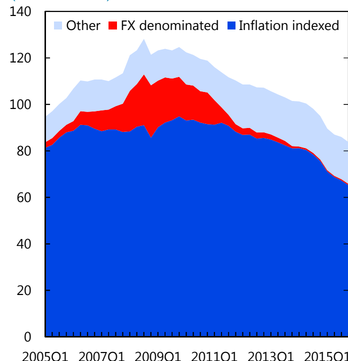
In Iceland, several macroprudential measures have already been adopted:

- **Liquidity rules, by the CBI**. LCR floors, both total and in foreign currency, took effect in December 2013, followed by an NSFR floor, in foreign currency only, in December 2014. The LCR focuses on ensuring adequate unencumbered liquid assets to fund liquidity drains over a 30 day horizon. The NSFR seeks to encourage longer-term financing of long-term assets.
- **Capital add ons, by FME**. Phase ins are in train for a capital conservation buffer, a systemically important financial institution buffer, a systemic risk buffer, and a countercyclical capital buffer. For the three main banks, these will add up to 6 percent of risk weighted assets commencing April 2016, rising to 8½ percent by March 2017. This is in addition to the basic pillar 1 risk based regulatory capital floor of 8 percent and some of the (non public) pillar 2 supervisory capital requirements.

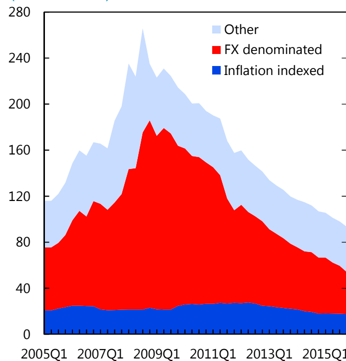
Work is ongoing to further augment the toolkit. Draft legislation currently before parliament proposes to authorize loan to value and, possibly, debt service to income ceilings, as well as authority for the CBI, on the recommendation of the Financial Stability Council, to limit foreign currency lending to unhedged parties. Such instruments would help to address potential systemic risks arising from excessive credit growth and asset price appreciation as well as credit risks specific to foreign currency lending.

Indexation and Dollarization

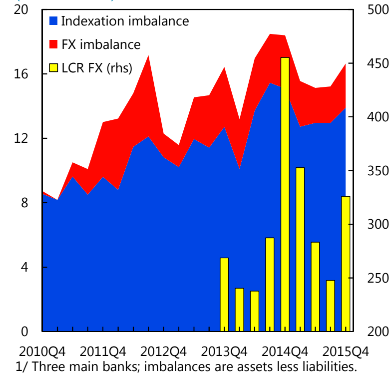
Household Debt
(Percent of GDP)



Corporate Debt
(Percent of GDP)



Banking System Imbalances 1/
(Percent of GDP)



1/ Three main banks; imbalances are assets less liabilities.

Sources: Sources: Central Bank of Iceland; Fjármálaeftirlitid; and Statistics Iceland.

43. The authorities are offering offshore króna holders a last chance to exit. Agreeing with staff on the merits of simplicity, they shall hold a targeted foreign exchange auction on June 16, 2016, after which their attention will resolutely turn to easing capital controls on residents. Preparations, which include legislating a modified blocked accounts regime, were accepted as one reason to not call parliamentary elections before the autumn. The authorities embrace a conservative approach to reserve adequacy, which shapes the terms of their offer.

44. There is commitment to lifting capital controls on residents. The authorities agree liberalization should start with the pension funds, where exemptions would not require legislation and significant easing could be effected over the summer. This could be followed by liberalizing steps for households and firms starting in the autumn, although here Iceland would step beyond the "comfort zone" of controllable processes, calling for a cautious strategy. Confidence will be central.

45. The authorities agreed with staff on the importance of the financial sector legislative agenda. They flagged that recent amendments to the Act on Financial Undertakings adopt most of the new EU prudential rules for banks, with work underway to introduce provisions on supervisory review and evaluation, authority to impose a leverage ratio, and definitions of related parties and regulatory capital. It is hoped that the EU Bank Recovery and Resolution Directive can be transposed by end 2016. FME thanked staff for advice to strengthen the Pension Fund Act and the Act on Official Supervision of Financial Activities. It welcomed further study of options to reorganize the architecture, reminding that until 1999 bank, market, and fund (but not insurance) oversight had been in the CBI. FME opposed separating oversight of banks from that of funds, markets, and insurance, however, arguing that keeping all under one roof offered synergies that would not be available under a twin peaks structure.

STAFF APPRAISAL

46. The outlook is for continued good performance, with growth accelerating initially, then converging to around 2½ percent. Wage growth will probably lift inflation above target. Further monetary tightening is assumed, striking a balance that keeps inflation in check and puts the economy on a gently decelerating glide path. With eroding competitiveness and less favorable terms of trade, the current account surplus shrinks steadily.

47. The biggest risk is of another boom-bust. Popular demands for more fiscal spending are becoming louder after years of restraint, and election season has arrived early. If the newly reshuffled government, or indeed any successor administration, were to seek popularity through spending, this would come on top of burgeoning wages and further stoke domestic demand at a time when demand already risks being too strong. This would necessitate even larger interest rate hikes than already envisaged. High interest rates, in turn, could attract carry trade inflows.

48. Revamping the wage bargaining framework is important. The "dolphin leap" of ratcheting wage awards since early 2015 increases the risk of overheating. The new Macroeconomic Council, as a forum for discussions among social partners and policy makers, is a welcome step. Reform efforts appropriately seek to anchor wage bargaining on competitiveness.

49. It is timely that the Organic Budget Law is in place to help maintain fiscal discipline. Commitment to saving the receipts from the estates must remain firm. The new fiscal rules create a multi-year guiding framework for fiscal policy, bringing in the municipalities. Compliance will build credibility. Demand pressures call for a moderately tighter fiscal stance next year. Further reforms of value added taxes should be considered to mobilize revenues and help adjust spending priorities.

50. More monetary tightening will probably be needed. Iceland is enjoying an unusually long period of price stability, giving the CBI increasing credibility. Irrespective of opposition from many quarters, it is entirely correct that the Monetary Policy Committee should stand ready to raise interest rates and consolidate this credibility. The economy is growing rapidly, wage growth will likely push inflation above target, and ever-falling import prices cannot be assumed.

51. The monetary policy framework would benefit from a clearly articulated intervention policy. This should stress the primacy of the inflation target and re-emphasize there is no exchange rate objective. Resisting appreciation can, perversely, generate market expectations of further appreciation, so the best course is to focus squarely on inflation. It should also distinguish between the separate goals of building reserves and countering disorderly market conditions. A conservative approach to reserve adequacy is needed, especially while capital account liberalization is ongoing.

52. Further capital account liberalization should be executed cautiously. The final effort to resolve the offshore króna overhang is appropriate before attention turns to residents. Permitting significantly more outward investment by pension funds is a logical first step for residents, and should be matched by steps to strengthen governance and risk management provisions in the Pension Fund Act. A strategy should be drawn up to calibrate the easing of restrictions on households and firms. This should embed concrete commitments to further improve bank oversight.

53. Policies need to adjust to the increased state presence in the banking system. It is vital that the government be a responsible steward. Dividends should not unduly drain bank liquidity. Privatization efforts should focus on finding high quality buyers. Legislative amendments should be considered to strengthen FME. The involvement of two official bodies in bank regulation could be revisited to address potential overlaps and gaps, bank liquidity and solvency being two sides of the same coin. One solution in the Icelandic context might be to unify all safety and soundness regulation and supervision of banks at the CBI, leaving oversight of nonbanks, markets, conduct of business, and consumer protection at FME. This and other options warrant further study.

54. Efforts to strengthen the macroprudential toolkit should press forward. Ideally bills before parliament to establish loan to value caps on mortgages and limit unhedged foreign currency lending would be passed soon. Work to develop effective capital flow management tools should also proceed apace. In future, a more integrated approach could be considered where the CBI and FME are given delegated authority to introduce new instruments by regulation.

55. Staff recommends approval of the retention of Iceland's exchange restrictions subject to Fund jurisdiction under Article VIII, Section 2(a). The restrictions arise from the capital controls regime Iceland continues to maintain which includes rules affecting the conversion and transfer of

(i) interest on bonds whose transfer the foreign exchange rules apportion depending on the period of the holding, (ii) amortized principal on bonds, and (iii) the indexed portion of the principal on bonds. Retention of the three restrictions was first approved by the Board on April 6, 2012 (Decision No. 15133-(12/35)), with approval subsequently extended, most recently on March 3, 2016 (Decision No. 15957- (16/19)). The authorities are of the view that retention of the measures is essential to the continued success of their capital account liberalization strategy. Staff, finding these restrictions necessary for balance of payments reasons, temporary, and nondiscriminatory, recommends their retention be approved for a period of 12 months or until the completion of the next Article IV consultation with Iceland, whichever is earlier.

56. Staff recommends the next Article IV consultation with Iceland be held on the standard 12 month cycle.

Table 1. Iceland: Selected Economic Indicators, 2013–21

	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Proj	Proj	Proj	Proj	Proj	Proj
	(Percentage change unless otherwise indicated)								
National Accounts (constant prices)									
Gross domestic product	4.4	2.0	4.0	4.6	3.8	3.3	3.3	2.5	2.6
Total domestic demand	0.7	5.3	6.3	5.4	4.4	3.3	4.0	2.5	2.2
Private consumption	1.0	3.0	4.8	6.0	5.5	4.6	3.8	3.1	2.7
Public consumption	1.0	1.7	1.1	1.1	1.0	1.1	1.1	1.0	1.1
Gross fixed investment	2.2	16.0	18.6	10.0	5.5	2.0	8.4	2.6	2.2
Net exports (contribution to growth)	2.6	-1.6	-0.8	-0.3	-0.2	0.3	-0.4	0.1	0.5
Exports of goods and services	6.7	3.1	8.2	8.1	3.0	3.3	3.0	2.2	2.2
Imports of goods and services	0.1	9.8	13.5	11.2	4.3	3.1	4.7	2.3	1.3
Output gap (percent of potential output)	0.2	0.0	0.5	1.2	1.0	0.7	0.3	0.1	0.0
Selected Indicators									
Gross domestic product (ISK bn.)	1,889	2,004	2,205	2,402	2,576	2,743	2,914	3,055	3,198
GDP per capita ($ thousands)	48.0	52.7	50.9	57.8	63.1	66.5	69.6	71.3	72.2
Private consumption (percent of GDP)	52.3	52.2	50.1	49.8	50.8	51.7	51.9	52.4	52.7
Public consumption (percent of GDP)	24.3	24.2	23.6	24.3	24.2	23.9	23.5	23.3	23.0
Gross fixed investment (percent of GDP)	15.7	17.3	19.1	19.6	19.8	19.6	20.7	20.8	20.8
Gross national saving (percent of GDP)	21.2	21.0	23.5	23.6	22.3	21.9	22.2	22.0	22.3
Unemployment rate (percent of labor force)	5.4	5.0	4.0	3.5	3.7	3.8	3.9	4.0	4.0
Employment	3.3	1.6	3.4	3.3	2.8	2.3	2.3	1.4	1.5
Labor productivity	0.2	-0.2	0.8	1.3	1.1	1.1	1.1	1.1	1.1
Real wages	0.9	2.8	7.3	8.8	1.8	1.6	1.3	1.1	1.1
Nominal wages	4.7	4.9	8.9	11.0	5.5	5.1	4.2	3.6	3.6
Consumer price index (average)	3.9	2.0	1.6	2.1	3.7	3.5	2.9	2.6	2.5
Consumer price index (end period)	4.2	0.8	2.0	2.6	4.2	3.1	2.7	2.5	2.5
ISK/€ (average) 1/	162	155	146	139	…	…	…	…	…
ISK/$ (average) 1/	122	117	132	124	…	…	…	…	…
Terms of trade (average)	-1.9	3.3	6.8	2.0	-0.9	-0.8	-0.3	-0.6	-1.0
Money and Credit (end period)									
Base money (M0)	0.3	-17.6	27.8	8.6	-11.6	-13.2	-15.2	-17.9	16.6
Broad money (M3)	4.5	7.1	5.6	-11.3	2.9	1.3	4.3	12.7	6.1
Bank credit to nonfinancial private sector	-3.2	-2.4	3.5	4.8	4.6	3.8	3.8	3.8	3.9
Central bank 7 day term deposit rate 1/	5.75	4.50	5.75	5.75	…	…	…	…	…
	(Percent of GDP unless otherwise indicated)								
General Government Finances									
Revenue	42.1	45.3	42.2	56.8	41.5	41.2	41.3	41.0	41.2
Expenditure	44.0	45.3	42.7	42.2	41.1	40.7	40.3	40.4	40.2
Overall balance	-1.8	-0.1	-0.5	14.6	0.4	0.5	1.0	0.6	1.0
Structural primary balance	1.4	2.1	1.4	0.9	1.9	2.2	2.8	2.5	2.3
Gross debt	84.8	82.5	67.6	55.1	51.6	41.2	36.2	33.7	29.7
Net debt	62.2	55.9	50.6	45.6	39.8	34.2	31.9	24.6	23.1
Balance of Payments									
Current account balance 2/	5.7	3.7	4.2	4.0	2.5	2.3	1.5	1.2	1.4
of which: services balance	7.5	6.7	8.6	9.1	8.5	8.3	7.8	7.5	7.2
Capital and financial account (+ = outflow)	6.9	3.4	7.6	3.8	2.4	2.1	1.4	1.1	1.3
of which: direct investment, net (+ = outflow)	0.3	-4.3	-2.8	-2.0	-2.1	-2.0	-1.9	-5.9	-1.8
Gross external debt 3/	249.0	205.7	159.2	130.8	115.2	107.3	101.7	97.4	96.5
Central bank reserves ($ bn.)	4.1	4.2	5.0	6.0	6.6	7.0	7.5	9.1	9.8

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

1/ For 2016, rate as of June 2.

2/ Actual data include accrued interest payments on intracompany debt held by a large multinational; projected data do not.

3/ Includes the effects of the compositions in 2015; projected data for the remaining debt of the bank estates calculated from their foreign currency claims on the domestic deposit money banks.

Table 2. Iceland: Money and Banking, 2012–17

(Billions of krónur unless otherwise indicated)

	2012	2013	2014	2015	2016 Proj	2017 Proj
Central Bank						
Net foreign assets	-28	-30	47	295	374	443
Assets	540	488	530	653	745	814
Liabilities	568	517	483	358	371	371
of which: central government foreign currency deposits	347	315	368	301	333	333
of which: bank estates' foreign currrency deposits	23	23	24	18	0	0
Net domestic assets	126	128	34	-209	-261	-344
Central government, net	43	89	7	7	-16	-16
Assets	185	180	153	98	8	8
of which: recapitalization bond	171	172	146	91	0	0
Liabilities (current account)	142	90	146	91	23	23
Credit institutions (incl. nonbanks), net	-99	-95	-82	-216	-256	-325
Assets	21	56	59	58	4	4
Liabilities	120	151	142	274	260	329
of which: term deposits and CDs	105	133	106	242	228	297
Others items, net	183	134	109	-1	10	-3
ESI (asset management company)	324	276	210	116	93	69
Capital	98	90	75	79	77	67
Base Money	98	99	81	104	113	100
Currency issued	45	47	50	56	56	56
Deposit money banks' deposits at the central bank	53	52	31	48	57	44
Deposit Money Banks						
Net foreign assets	245	294	244	68	-178	-281
Assets	366	438	395	351	235	232
Liabilities	122	144	151	283	414	514
of which: bonds	0	18	37	175	306	406
Net domestic assets	1,174	1,189	1,344	1,606	1,658	1,805
Central bank, net	142	131	82	238	288	344
Assets	160	184	139	295	290	346
Liabilities	18	54	57	56	2	2
General government, gross	233	227	237	231	240	234
of which: bonds	214	213	217	210	219	213
Private sector, gross	2,428	2,275	2,192	2,217	2,307	2,404
Nonfinancial	2,088	2,022	1,973	2,043	2,142	2,239
Corporations	1,291	1,157	1,079	1,128	1,190	1,249
Households	797	865	894	915	952	990
Financial	341	253	219	174	165	165
Other items, net	-1,630	-1,444	-1,168	-1,080	-1,176	-1,176
Domestic deposits	1,418	1,483	1,588	1,674	1,479	1,524
Krona deposits	1,205	1,180	1,295	1,393	1,351	1,408
Foreign currency deposits	213	303	293	281	129	116
Consolidated Banking System						
Net foreign assets	217	264	291	363	196	162
Net domestic assets	1,242	1,260	1,341	1,342	1,332	1,410
General government, net	276	317	245	238	224	218
Private sector, gross	2,428	2,275	2,192	2,217	2,307	2,404
Other items, net	-1,462	-1,331	-1,096	-1,113	-1,199	-1,212
Broad money	1,459	1,524	1,632	1,723	1,528	1,573
of which: currency in circulation	41	42	44	49	48	48
Memorandum item:						
Bank estates' deposits at deposit money banks 1/	0	0	230	205	28	28

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

1/ Deposits of successor holding companies to the bank estates from 2016.

Table 3. Iceland: Financial Soundness Indicators, 2014–15 1/

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4
Regulatory capital to risk-weighted assets	25.3	27.2	27.2	28.5	25.5	26.6	26.9	28.2
Regulatory tier 1 capital to risk-weighted assets	23.1	25.0	25.1	26.2	23.8	25.4	25.7	27.6
Return on assets	2.1	3.2	2.7	2.7	3.5	2.8	2.8	3.4
Return on equity	11.7	17.5	14.6	14.1	19.3	14.8	15.0	17.2
Net interest income to total income 2/	53.5	46.5	49.2	45.8	42.3	48.8	48.8	46.8
Noninterest expense to total income 2/	77.6	66.4	68.1	70.0	59.4	66.5	66.4	68.8
Liquid assets to total assets 3/	21.5	24.3	25.2	21.2	22.9	24.0	23.5	22.8
Net open foreign exchange position to capital	4.9	4.5	5.2	6.1	4.1	3.7	5.5	2.2
Total nonperforming loans (NPLs), facility level 4/	4.3	3.2	3.2	2.5	2.1	2.1	2.0	1.7
Household NPLs, cross default basis 5/ 6/	12.6	12.0	11.1	10.1	8.8	8.7	8.1	7.2
Corporate NPLs, cross default basis 6/	11.6	10.8	10.1	7.2	6.1	6.7	6.8	9.0
Household and corporate NPLs, cross default basis 6/	11.6	10.8	10.0	7.9	6.7	7.0	6.7	7.9
Allowances to household loans in default	50.2	49.3	49.7	48.9	52.1	51.4	52.7	50.4
Allowances to corporate loans in default	62.6	47.3	44.6	42.7	45.3	44.8	41.3	36.5
Allowances to total loans in default	58.5	48.1	46.8	45.7	48.6	47.8	46.3	41.8

Source: Central Bank of Iceland.

1/ Three largest deposit money banks unless otherwise indicated.

2/ Total income is sum of net interest income and noninterest income.

3/ Data for 2014–15 data are based on a new definition of liquid assets (LCR liquid assets, money market loans, and nostro accounts).

4/ Over 90 days in default.

5/ Includes loans from the Housing Financing Fund.

6/ Over 90 days in default or deemed unlikely to be paid.

Table 4. Iceland: General Government Operations, 2013–21

(Percent of GDP)

	2013	2014	2015	2016 Proj	2017 Proj	2018 Proj	2019 Proj	2020 Proj	2021 Proj
Total revenue	**42.1**	**45.3**	**42.2**	**56.8**	**41.5**	**41.2**	**41.3**	**41.0**	**41.2**
Taxes	**32.1**	**35.0**	**33.3**	**31.5**	**32.2**	**32.2**	**32.4**	**32.4**	**32.4**
Taxes on income and profits	16.7	18.0	17.4	16.7	16.7	16.7	16.7	16.7	16.7
Personal income tax	13.7	13.5	13.2	13.2	13.3	13.3	13.3	13.3	13.4
Corporate income tax	2.1	3.3	2.9	2.3	2.2	2.2	2.2	2.2	2.2
Capital gains tax and rental income	0.9	1.2	1.2	1.3	1.2	1.2	1.2	1.2	1.1
Taxes on payroll and workforce	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Taxes on property	2.5	2.5	2.0	2.0	2.0	2.0	2.0	2.0	1.9
Taxes on goods and services	11.7	11.7	11.5	11.3	11.4	11.5	11.7	11.8	11.9
Value added tax	7.9	8.0	8.1	7.8	7.8	7.8	8.0	8.1	8.1
Other taxes on goods and services	3.8	3.6	3.3	3.5	3.6	3.7	3.7	3.7	3.8
Taxes on international trade	0.3	0.3	0.3	0.2	0.3	0.3	0.3	0.2	0.2
Other taxes	0.6	2.2	1.8	1.0	1.5	1.4	1.4	1.3	1.3
Social contributions	**3.7**	**3.7**	**3.6**	**3.6**	**3.6**	**3.4**	**3.5**	**3.5**	**3.5**
Grants	**0.2**	**0.1**	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Other revenues	**6.2**	**6.5**	**5.2**	**21.5**	**5.5**	**5.4**	**5.3**	**4.9**	**5.2**
of which: interest income	1.1	1.1	0.7	1.0	0.8	0.8	0.5	0.4	0.6
Total expenditure	**44.0**	**45.3**	**42.7**	**42.2**	**41.1**	**40.7**	**40.3**	**40.4**	**40.2**
Current expenses	**43.1**	**44.2**	**41.6**	**42.0**	**41.0**	**40.6**	**39.7**	**39.3**	**39.1**
Compensation of employees	13.6	13.8	13.8	14.4	14.3	14.1	13.8	13.7	13.6
Use of goods and services	11.8	11.5	10.8	10.8	10.7	10.6	10.5	10.4	10.3
Consumption of fixed capital	2.0	2.0	1.8	2.0	2.0	2.0	2.0	2.0	2.0
Interest	4.6	4.7	4.4	3.5	2.9	2.7	2.2	2.1	2.0
Subsidies	1.6	1.5	1.3	1.5	1.5	1.5	1.5	1.5	1.5
Grants	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social benefits	7.1	7.0	6.4	7.0	7.3	7.3	7.3	7.3	7.3
Other expense	2.2	3.6	2.8	2.6	2.2	2.2	2.2	2.2	2.2
Nonfinancial assets	**0.9**	**1.1**	**1.1**	**0.2**	**0.1**	**0.1**	**0.6**	**1.1**	**1.1**
Nonfinancial assets, acquisition	2.9	3.1	2.9	2.2	2.1	2.1	2.6	3.1	3.1
Consumption of fixed capital (-)	-2.0	-2.0	-1.8	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Net lending/borrowing 1/	**-1.8**	**-0.1**	**-0.5**	**14.6**	**0.4**	**0.5**	**1.0**	**0.6**	**1.0**
Financial assets, transactions	**-2.0**	**2.6**	**-7.8**	**9.1**	**0.1**	**-6.8**	**-1.7**	**-0.5**	**-1.4**
Currency and deposits	-2.8	4.4	-7.2	-6.1	2.9	-4.0	-2.3	4.9	-2.1
Securities other than shares	0.0	0.0	0.0	6.8	-0.6	-3.4	0.0	0.0	0.0
Loans	0.3	0.0	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Shares and other equities	2.1	-0.1	0.0	7.7	-2.9	0.0	0.0	-6.0	0.0
Other accounts receivable	-1.6	-1.8	-0.9	0.5	0.4	0.3	0.3	0.3	0.3
Liabilities, transactions	**-0.2**	**2.7**	**-7.3**	**-5.5**	**-0.3**	**-7.4**	**-2.7**	**-1.1**	**-2.4**
Securities other than shares	-0.2	1.7	-4.3	-7.2	-0.7	-7.6	-2.9	-1.2	-2.5
Loans	-1.0	-1.4	-4.1	1.1	0.3	0.2	0.1	0.1	0.0
Krona denominated	-0.3	-1.2	0.5	1.2	0.3	0.2	0.1	0.1	0.0
Foreign currency denominated	-0.7	-0.1	-4.6	-0.1	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.2	0.2	0.2	0.2	-0.3	-0.3	-0.3	-0.3	-0.3
Other accounts payable	0.8	2.2	0.9	0.4	0.4	0.3	0.4	0.3	0.3
Gross debt	**84.8**	**82.5**	**67.6**	**55.1**	**51.6**	**41.2**	**36.2**	**33.7**	**29.7**
Krona denominated	64.2	61.8	53.7	43.0	40.5	30.7	26.2	23.9	20.3
Foreign currency denominated	20.6	20.7	13.9	12.1	11.2	10.5	10.0	9.8	9.5
Net debt 2/	**62.2**	**55.9**	**50.6**	**45.6**	**39.8**	**34.2**	**31.9**	**24.6**	**23.1**
Memorandum items:									
Primary revenue	41.0	44.2	41.5	55.8	40.7	40.4	40.8	40.6	40.7
Primary expenditure	39.4	40.6	38.3	38.6	38.3	38.0	38.1	38.4	38.2
Primary balance	1.6	3.6	3.2	17.1	2.5	2.4	2.7	2.3	2.5
Structural balance	-2.0	-1.5	-2.3	-1.6	-0.2	0.3	1.2	0.8	0.9
Structural primary balance	1.4	2.1	1.4	0.9	1.9	2.2	2.8	2.5	2.3
Gross domestic product (ISK bn)	1,889	2,004	2,205	2,402	2,576	2,743	2,914	3,055	3,198

Sources: Ministry of Finance; Statistics Iceland; and IMF staff projections.

1/ The 2014 outturn was lowered by 1.3 percent of GDP due to reclassification of a large one off item.

2/ Gross debt less currency and deposits.

Table 5. Iceland: General Government Financial Balance Sheet, 2005–21
(Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016 Proj	2017 Proj	2018 Proj	2019 Proj	2020 Proj	2021 Proj
Financial assets	**38.0**	**48.4**	**52.1**	**73.1**	**75.4**	**73.0**	**75.4**	**70.2**	**63.4**	**64.4**	**50.8**	**55.7**	**52.1**	**42.1**	**38.0**	**35.7**	**32.7**
Currency and deposits	5.8	8.9	9.8	14.2	16.6	22.5	33.4	28.8	22.6	26.6	17.0	9.5	11.8	7.0	4.3	9.1	6.6
Other assets	32.1	39.6	42.3	58.9	58.7	50.5	42.0	41.5	40.8	37.8	33.7	46.2	40.3	35.1	33.6	26.7	26.1
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	6.8	5.7	2.0	1.9	1.8	1.7
Loans	8.6	15.4	14.4	32.3	25.0	16.8	10.4	10.8	10.4	9.8	9.2	8.8	8.5	8.3	8.1	8.0	8.0
Shares and other equities	12.5	12.5	16.6	15.0	23.2	23.4	21.6	20.3	21.2	19.2	17.5	23.7	19.2	18.0	17.0	10.2	9.7
Other accounts receivable	11.0	11.6	11.3	11.7	10.6	10.3	9.9	10.3	9.2	8.8	7.0	6.9	6.9	6.8	6.7	6.7	6.8
Liabilities	**51.2**	**56.1**	**51.1**	**98.1**	**112.9**	**118.7**	**126.7**	**123.7**	**114.8**	**114.4**	**97.6**	**83.3**	**78.0**	**66.1**	**59.7**	**56.1**	**51.2**
Gross debt	24.6	29.3	27.3	67.6	82.9	88.3	95.1	92.6	84.8	82.5	67.6	55.1	51.6	41.2	36.2	33.7	29.7
Securities other than shares	10.1	9.4	9.2	20.0	39.3	44.6	46.4	47.2	44.6	43.8	40.1	33.7	30.8	21.3	17.1	15.2	12.0
Loans	14.5	19.9	18.1	47.5	43.6	43.6	48.7	45.4	40.2	38.7	27.4	21.3	20.9	19.9	19.1	18.5	17.7
Krona denominated	4.4	3.5	5.4	23.9	18.1	20.1	20.6	19.7	18.9	17.8	13.5	9.2	9.7	9.4	9.1	8.7	8.3
Foreign currency denominated	10.1	16.4	12.8	23.6	25.5	23.5	28.2	25.7	21.3	20.9	13.9	12.1	11.2	10.5	10.0	9.8	9.3
Other liabilities	26.6	26.8	23.7	30.5	30.0	30.5	31.6	31.1	30.0	31.9	30.0	28.2	26.4	24.9	23.5	22.4	21.5
Insurance technical reserves	23.2	22.8	19.6	24.8	23.8	23.7	24.5	24.7	24.2	24.5	22.4	20.8	19.0	17.6	16.3	15.2	14.2
Other accounts payable	3.4	4.0	4.1	5.8	6.2	6.8	7.1	6.4	5.8	7.4	7.6	7.4	7.4	7.3	7.2	7.2	7.2
Net financial worth	-13.2	-7.7	1.0	**-25.0**	**-37.5**	**-45.7**	**-51.4**	**-53.5**	**-51.4**	**-49.9**	**-46.9**	**-27.5**	**-26.0**	**-23.9**	**-21.7**	**-20.4**	**-18.5**
Memorandum item:																	
Net debt 1/	18.7	20.4	17.6	53.3	66.3	65.7	61.7	63.8	62.2	55.9	50.6	45.6	39.8	34.2	31.9	24.6	23.1

Sources: Ministry of Finance; Statistics Iceland; and IMF staff projections.

1/ Gross debt less currency and deposits.

Table 6. Iceland: Balance of Payments, 2013–21

	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Proj	Proj	Proj	Proj	Proj	Proj
				(Billions of dollars)					
Current account 1/	**0.9**	**0.6**	**0.7**	**0.8**	**0.5**	**0.5**	**0.4**	**0.3**	**0.4**
Trade balance	1.2	1.1	1.2	1.2	1.1	1.1	0.9	0.9	0.9
Balance on goods	0.1	-0.1	-0.3	-0.5	-0.7	-0.8	-0.9	-1.0	-0.9
Merchandise exports f.o.b.	4.6	4.9	4.7	4.8	5.0	5.2	5.5	5.7	5.8
Merchandise imports f.o.b.	4.5	5.0	4.9	5.3	5.7	6.0	6.5	6.7	6.8
Balance on services	1.2	1.2	1.4	1.7	1.8	1.9	1.9	1.9	1.8
Exports of services, total	4.0	4.3	4.3	5.0	5.4	5.7	5.9	6.1	6.1
Imports of services, total	2.8	3.1	2.8	3.2	3.6	3.8	4.0	4.2	4.3
Primary income balance 1/	-0.2	-0.3	-0.2	-0.3	-0.4	-0.4	-0.4	-0.4	-0.3
Receipts	1.1	0.9	0.8	0.7	0.7	0.7	0.8	0.8	0.8
of which: interest receipts	0.6	0.5	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Expenditures	1.3	1.2	1.0	1.0	1.1	1.1	1.2	1.2	1.1
of which: interest payments	1.5	1.8	1.5	0.9	0.9	0.9	1.0	1.0	0.9
Secondary income balance	-0.1	-0.1	-0.3	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Capital and financial account (+ = outflow)	**1.1**	**0.6**	**1.3**	**0.7**	**0.5**	**0.5**	**0.3**	**0.3**	**0.3**
Capital account balance (+ = inflow)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account (+ = outflow)	1.1	0.6	1.3	0.8	0.5	0.5	0.3	0.3	0.3
Direct investment (+ = outflow)	0.0	-0.7	-0.5	-0.4	-0.4	-0.4	-0.5	-1.5	-0.4
Portfolio investment ("+" = outflow)	1.1	-1.2	3.9	0.2	0.3	0.2	0.2	0.2	0.2
Assets (+ = outflow)	1.2	-0.1	-2.9	0.2	0.3	0.3	0.3	0.3	0.3
Liabilities (+ = inflow)	0.1	1.1	-6.8	0.0	0.0	0.0	0.1	0.1	0.1
of which: net borrowing (+ = inflow)	...	...	-6.7	0.0	0.0	0.1	0.1	0.1	0.1
Other investment (+ = outflow)	-0.1	2.2	-3.4	-0.1	0.0	0.3	0.1	0.0	-0.1
Assets (+ = outflow)	-0.9	-3.2	-0.5	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Liabilities (+ = inflow)	-0.9	-5.4	2.9	-0.1	-0.1	-0.4	-0.2	-0.1	0.0
of which: net outflows related to bank estates' compositions	...	...	0.2	0.1	0.0	-0.3	0.0	0.0	0.0
Change in reserve assets (+ = increase/outflow)	0.0	0.3	1.3	0.9	0.6	0.4	0.5	1.6	0.7
Net errors and omissions (+ = inflow)	**0.2**	**0.0**	**0.6**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
				(Percent of GDP)					
Current account 1/	**5.7**	**3.7**	**4.2**	**4.0**	**2.5**	**2.3**	**1.5**	**1.2**	**1.4**
Trade balance	7.9	6.2	7.0	6.3	5.2	4.8	3.9	3.6	3.4
Balance on goods	0.4	-0.5	-1.6	-2.8	-3.3	-3.5	-3.9	-4.0	-3.7
Merchandise exports f.o.b.	29.7	28.4	27.8	24.9	23.8	23.3	23.2	23.1	23.2
Merchandise imports f.o.b.	29.3	28.9	29.5	27.7	27.1	26.7	27.1	27.1	26.9
Balance on services	7.5	6.7	8.6	9.1	8.5	8.3	7.8	7.5	7.2
Exports of services, total	25.8	24.9	25.5	25.9	25.5	25.2	24.8	24.6	24.4
Imports of services, total	18.2	18.2	16.9	16.8	17.0	16.9	16.9	17.0	17.2
Primary income balance 1/	-1.3	-1.7	-0.9	-1.5	-1.9	-1.8	-1.7	-1.6	-1.3
Receipts	6.8	5.3	5.0	3.6	3.3	3.3	3.2	3.2	3.3
of which: interest receipts	3.6	3.1	2.5	2.0	1.9	1.9	1.9	1.9	1.9
Expenditures	8.2	7.0	5.9	5.1	5.3	5.1	4.9	4.8	4.5
of which: interest payments	10.0	10.2	8.8	4.5	4.4	4.2	4.0	3.9	3.4
Secondary income balance	-0.9	-0.8	-1.9	-0.8	-0.7	-0.7	-0.7	-0.7	-0.8
Capital and financial account (+ = outflow)	**6.9**	**3.4**	**7.6**	**3.8**	**2.4**	**2.1**	**1.4**	**1.1**	**1.3**
Capital account balance (+ = inflow)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Financial account (+ = outflow)	7.0	3.5	7.7	3.9	2.4	2.2	1.4	1.1	1.4
Direct investment (+ = outflow)	0.3	-4.3	-2.8	-2.0	-2.1	-2.0	-1.9	-5.9	-1.8
Portfolio investment ("+" = outflow)	7.0	-7.0	23.1	1.2	1.4	1.0	0.9	0.9	0.8
Assets (+ = outflow)	7.8	-0.5	-17.6	1.3	1.2	1.2	1.2	1.2	1.3
Liabilities (+ = inflow)	0.8	6.5	-40.6	0.1	-0.1	0.2	0.3	0.3	0.5
of which: net borrowing (+ = inflow)	...	...	-40.0	0.2	-0.1	0.3	0.4	0.4	0.6
Other investment (+ = outflow)	-0.4	13.1	-20.2	-0.3	0.0	1.2	0.2	-0.2	-0.5
Assets (+ = outflow)	-6.0	-18.5	-3.1	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6
Liabilities (+ = inflow)	-5.6	-31.6	17.1	-0.4	-0.6	-1.8	-0.8	-0.4	0.0
of which: net outflows related to bank estates' compositions	...	...	1.2	0.7	0.2	-1.4	0.1	0.1	0.0
Change in reserve assets (+ = increase/outflow)	0.1	1.8	7.6	4.9	3.0	1.8	2.1	6.3	2.8
Net errors and omissions (+ = inflow)	**1.3**	**-0.1**	**3.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Central bank reserves ($ bn)	**4.1**	**4.2**	**5.0**	**6.0**	**6.6**	**7.0**	**7.5**	**9.1**	**9.8**
(Percent of GDP)	26.8	24.7	30.0	31.1	31.3	31.2	31.6	36.8	38.9
(Percent of reserve adequacy metric)	110.1	117.1	148.6	178.3	186.7	208.9	210.7	265.5	268.2
Memorandum item:									
Gross domestic product ($ bn)	15.5	17.2	16.7	19.2	21.2	22.6	23.8	24.7	25.2

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

1/ Actual data include accrued interest payments on intracompany debt held by a large multinational; projected data do not.

Table 7. Iceland: International Investment Position, 2005–15

(Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Assets	**242.6**	**401.6**	**524.9**	**316.0**	**300.7**	**267.9**	**274.1**	**287.9**	**289.3**	**261.9**	**217.8**
Central bank	6.4	14.1	12.0	27.9	30.5	41.1	61.6	30.4	26.0	26.7	29.7
Deposit taking corporations	120.5	213.5	300.3	29.9	17.2	17.6	21.2	21.4	25.8	19.8	15.9
General government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposit money banks undergoing winding up proceedings	0.0	0.0	0.0	121.6	131.3	114.2	98.2	120.9	101.9	79.7	0.0
Other financial corporations 1/	40.8	52.1	38.3	32.7	35.2	31.0	30.5	33.9	34.6	37.5	70.3
Nonfinancial corporations, households, etc.	10.9	32.2	40.0	23.0	19.4	13.0	11.4	11.6	11.0	14.7	10.5
Unallocated: direct investment excl. estates	63.6	89.3	133.9	80.4	66.5	50.5	50.8	69.2	89.5	83.2	90.9
Unallocated: other investment, other equity	0.3	0.4	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.4
Liabilities	**324.4**	**503.9**	**631.2**	**983.6**	**967.9**	**873.8**	**819.3**	**752.8**	**693.3**	**653.9**	**232.1**
Central bank	0.2	0.2	0.1	22.7	12.8	17.3	23.4	10.9	9.1	4.5	1.7
of which: SDRs	0.1	0.1	0.1	0.2	1.4	1.2	1.2	1.3	1.1	1.0	0.9
Deposit taking corporations	228.0	356.8	446.2	44.8	19.1	12.8	9.1	6.9	7.8	7.5	13.1
General government	14.6	20.4	17.8	34.5	40.5	34.7	38.9	35.8	29.6	29.2	24.8
Deposit money banks undergoing winding up proceedings 2/	0.0	0.0	0.0	710.3	726.9	654.4	589.4	558.0	495.8	466.5	89.6
Other financial corporations 1/	4.8	8.6	11.2	14.1	16.3	12.3	13.1	9.1	7.7	7.2	72.5
Nonfinancial corporations, households, etc.	23.2	36.4	34.9	52.8	45.6	47.4	43.1	45.8	38.3	34.4	23.9
Unallocated: direct investment, excl. estates	31.4	51.6	94.4	103.5	103.1	92.0	99.4	83.4	101.7	101.1	91.9
Unallocated: portfolio investment, equity	…	…	…	…	3.6	2.9	2.9	3.0	3.2	3.6	4.2
Unallocated: portfolio investment, equity and investment fund share	22.2	29.9	26.5	0.8	…	…	…	…	…	…	…
Net international investment position	**-81.8**	**-102.3**	**-106.4**	**-667.6**	**-667.2**	**-606.0**	**-545.2**	**-464.9**	**-404.0**	**-392.0**	**-14.4**

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

1/ Deposit money banks and nonbank financial corporations.

2/ Authorities' methodology. Calculated based on face value of claims plus accrued interest. Following the composition agreements, the write off of claims on the bank estates was as large as 323 percent of GDP, which explains the step improvement in the net international investment position in 2015. In the IMF staff's methodology as used in the debt sustainability analysis, the bank estates' external debt is calculated based on the assets of the estates (i.e., the write off is implicit in the external debt calculations).

Annex I. Risk Assessment Matrix[1]

Risks	Relative Likelihood	Impact if Realized	Policy Response
DOMESTIC RISKS			
1. Overheating of the economy	**High** • Greater than estimated effects from the wage hikes • Political pressures to raise public spending	**High** • Inflation above target • Upward spiral of credit, asset prices, and collateral values • Re emergence of external imbalances	• Raise interest rates • Observe fiscal rules • Strengthen microprudential oversight • Deploy macroprudential tools to address threats to financial stability
2. Missteps in capital account liberalization	**Medium** • Political pressures to accelerate opening for residents trigger ill planned actions	**High** • Premature and disorderly release of residents' savings destabilizes balance of payments	• Ensure resilience and reserve adequacy • Pursue phased release of residents based on economic needs by sector, consistent with macro stability and supported by decisive strengthening of bank oversight
3. Realization of contingent liabilities	**Low** • Large losses at Housing Financing Fund	**Medium** • Guarantees called, raising public debt levels and costs	• Leave Housing Financing Fund in run off • Identify fiscal measures to restore budget balance and gradually reduce debt
GLOBAL RISKS			
4. Tighter or more volatile global financial conditions	**Medium** • Sharp asset price decline and blowout of credit spreads	**Medium** • Privatization of the state owned banks and related debt reduction are delayed	• Ensure macroeconomic policies support investor confidence, delivering price stability and falling public debt • If capital outflows occur, allow exchange rate to absorb the shock
5. U.K. voters elect to leave the EU	**High** • Possible period of elevated financial volatility and heightened uncertainty, with potential contagion and long-run hits to performance in affected countries due to increased barriers	**Medium** • Potential weak export demand especially if there is contagion to other EU countries • Privatization of the state owned banks and related debt reduction are delayed	• Ensure macroeconomic policies support investor confidence, delivering price stability and falling public debt • If capital outflows occur, allow exchange rate to absorb the shock
6. Sharper than expected global slowdown	**Medium** • Structurally weak growth in European trading partners	**Medium** • Weak export demand and persistently low import prices	• Accelerate structural reforms to increase competitiveness, including new wage bargaining framework

[1] Shows events that could materially alter the baseline path most likely to materialize in the view of staff). The relative likelihood of risks listed is staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability of 10–30 percent, and "high" a probability of over 30 percent). Reflects staff views on the sources of risks and overall level of concern at the time of discussions with the authorities. Non mutually exclusive risks may interact and materialize jointly.

Annex II. External Debt Sustainability Analysis

Iceland's external debt path has improved sharply since the debt sustainability analysis (DSA) in the Sixth Post-Program Monitoring review. The composition agreements among estate claimants, which became binding in December 2015, eliminate the bulk of the old bank estates' external debt.

1. **Prior to the recent lifting of capital controls on the estates, debts attributed to them formed about one third of Iceland's external debt**. The estates' debts were calculated by formula, apportioning their liquid assets (irrespective of location) as well as the "LBI compensation bond" (a foreign currency claim of LBI on Landsbankinn) to their foreign creditors. As of Q3 2015, the estates' main remaining illiquid assets were Kaupthing and Glitnir's shares in Arion and Íslandsbanki, respectively. Staff's previous baseline scenario assumed the disposal of these holdings by 2016, increasing liquid assets and therefore external debt.

2. **The late 2015 composition agreements of the estates embedded write offs of about 80 percent of the face value of general claims**. These write offs improve the net international investment position by about 323 percent of GDP, but do not affect staff estimates of the estates' external debt which are based, as noted, on the value of the estates' assets. The "haircuts" for this analytical concept of external debt are the "stability contributions" or the transfer of the estates' domestic assets to the Icelandic state. As a share of the estates' total assets, such haircuts were in a range of 5–24 percent.

3. **The haircuts and asset distributions by the estates slash debt**. With most of the estates' króna assets going to the government in 2016 and most of their foreign currency assets abroad to be distributed to their predominantly foreign claimants in 2015 and 2016, the bulk of their external debt is eliminated by 2017. What remains from 2017 on are the amortizing LBI bond (issued in 2009) and two new bullet euro medium term notes (EMTNs) issued by Arion Bank and Íslandsbanki to Kaupthing and Glitnir, respectively. The EMTNs reflect these two estates' decisions to refinance for up to seven years both their own foreign currency deposits in the two banks and certain foreign currency claims of the state and the CBI on the banks.

4. **The balance of payments and external debt statistics record the impact of the compositions based on the distribution profile of each of the estates**. In practice, Glitnir received its capital control exemption in December 2015 while Kaupthing and LBI received theirs in January 2016. Impacts are best understood by asset type:

- **Króna assets**. Asset transfers from the estates to the government are worth about 15½ percent of GDP, in addition to which there are domestic costs and expenses incurred by the estates during 2015 (including some 1.3 percent of GDP in financial levies paid to the government). These so called stability contributions are recorded in Q1 2016 and are transactions that cut external debt but have no corresponding balance of payments outflows (explaining the large residual in 2016). In addition, two of the estates are permitted to exchange some 5½ percent of GDP worth of króna for foreign exchange

to distribute abroad (the so called "foreign exchange credits"). These latter transactions do show as balance of payments outflows.

- **Foreign assets**. The release of liquid foreign assets to foreign claimants cuts debt without any matching net outflow in the balance of payments. Some 95 percent of Glitnir's foreign assets were in liquid form when composition was agreed, that share being closer to two thirds for Kaupthing and LBI. Only Glitnir actually distributed its liquid foreign assets in 2015. Distributions by Kaupthing and LBI, including LBI's final payment to its priority creditors of about $1.6 billion, take place in 2016 (explaining the large residual in 2016). The estates' remaining illiquid foreign assets are assumed to be liquefied and distributed (contemporaneously) to claimants over the medium term with no further effect on external debt.

5. **Changes in the baseline debt path relative to the previous DSA are also driven by**:

- **Prepayments of government debt during 2015**. In Q3 2015, the Treasury bought back almost half of the outstanding stock of its dollar denominated bond maturing in June 2016, equivalent to about $0.4 billion. In Q4, the CBI prepaid its outstanding obligations to the IMF, about $0.3 billion, consolidating 11 separate repurchases that would otherwise have fallen due October 2015–August 2016.

- **Improvements in macro assumptions**. Relative to the Sixth Post-Program Monitoring review, real growth over 2015–20 has been revised up by about 1 percentage point on average. The path for the current account surplus over the same period is broadly unchanged, reflecting strong service exports and broadly unchanged competitiveness effects from the recent wage rounds. The projected króna–dollar exchange rate path reflects a stronger króna compared to the previous report.

6. **The noninterest current account balance needed to stabilize Iceland's external debt ratio is now a surplus of 1.6 percent of GDP, down from 5.1 percent of GDP previously**. External debt is thus expected to decline faster than previously projected, from 207 percent of GDP at end 2014 to less than 100 percent of GDP by 2021. The debt structure is favorable, with about 60 percent of the external debt of private debtors other than the failed bank estates estimated to be FDI related as of end 2015.

7. **Stress tests suggest the projected downward path of total external debt is relatively robust, although risks remain**. With the exception of the depreciation scenarios, standard shocks do not materially alter the trajectory. Remaining risks relate primarily to the ongoing liberalization of capital controls and to any additional wage negotiations, where larger than expected wage increases would hurt competitiveness, growth prospects, and debt sustainability.

Table 1. External Debt Sustainability Framework, 2011–21

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						Debt-stabilizing
	2011	2012	2013	2014	2015			2016	2017	2018	2019	2020	2021	non-interest CA 7/
Baseline: External debt (including old banks) 1/	254.6	257.6	249.0	205.7	159.2			**130.8**	**115.2**	**107.3**	**101.7**	**97.4**	**96.5**	**1.6**
Change in external debt	-25.8	3.0	-8.6	-43.3	-46.5			-28.4	-15.6	-7.9	-5.5	-4.3	-0.9	
Identified external debt-creating flows (4+8+9)	-27.8	-19.9	-25.9	-30.7	-0.7			-11.5	-8.2	-6.9	-5.9	-8.8	-4.8	
Current account deficit, excluding interest payments	-6.1	-5.4	-11.5	-8.9	-9.2			-8.5	-6.8	-6.4	-5.5	-5.1	-4.9	
Deficit in balance of goods and services	-8.0	-6.0	-7.9	-6.2	-7.0			-6.3	-5.2	-4.8	-3.9	-3.6	-3.4	
Exports	56.6	57.0	55.5	53.3	53.3			50.8	49.3	48.5	47.9	47.7	47.5	
Imports	48.6	51.0	47.5	47.1	46.3			44.5	44.1	43.7	44.0	44.1	44.1	
Net non-debt creating capital inflows (negative)	-7.4	-29.5	1.0	-3.5	0.7			-1.1	-1.2	-1.1	-1.1	-5.2	-1.0	
Automatic debt dynamics 2/	-14.2	15.1	-15.3	-18.4	7.7			-1.9	-0.2	0.6	0.6	1.5	1.0	
Contribution from nominal interest rate	11.4	9.6	4.9	5.2	4.9			4.5	4.4	4.2	4.0	3.9	3.4	
Contribution from real GDP growth	-5.0	-3.3	-10.4	-4.4	-8.4			-6.4	-4.5	-3.6	-3.4	-2.4	-2.4	
Contribution from price and exchange rate changes 3/	-20.6	8.8	-9.8	-19.2	11.1			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	2.0	22.8	17.3	-12.6	-45.8			-16.9	-7.5	-0.9	0.4	4.5	4.0	
External debt-to-exports ratio (in percent)	449.8	451.8	449.0	386.2	298.4			257.7	233.7	221.4	212.3	204.2	203.0	
Gross external financing need (in billions of US dollars) 5/	14.6	17.9	6.9	9.7	9.2			6.4	4.4	6.4	4.0	6.3	3.3	
in percent of GDP	99.5	126.0	44.8	56.8	54.8	10-Year	10-Year	33.3	20.7	28.5	17.0	25.5	13.2	
Scenario with key variables at their historical averages 6/								**130.8**	**130.0**	**131.9**	**134.2**	**140.0**	**143.8**	
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
								2016	**2017**	**2018**	**2019**	**2020**	**2021**	
Real GDP growth (in percent)	2.0	1.2	4.4	2.0	4.0	2.0	4.0	4.6	3.8	3.3	3.3	2.5	2.6	
GDP deflator in US dollars (change in percent)	8.6	-4.3	4.2	8.8	-6.3	-1.2	12.3	9.7	6.2	3.2	2.3	1.0	-0.3	
Nominal external interest rate (in percent) 8/	4.5	3.7	2.1	2.3	2.3	3.2	0.9	3.3	3.7	3.9	3.9	4.0	3.6	8/
Underlying external interest rate (in percent)	5.8	4.5	3.0	3.4	3.3	3.6		4.4	4.1	4.2	4.3	4.3	3.9	
Growth of exports (US dollar terms, in percent)	16.7	-2.4	5.8	6.6	-2.4	6.4	12.5	9.2	7.1	4.8	4.5	3.0	2.0	
Growth of imports (US dollar terms, in percent)	23.8	1.7	1.3	9.9	-4.1	2.2	16.1	10.1	9.4	5.5	6.5	3.7	2.2	
Current account balance, excluding interest payments	6.1	5.4	11.5	8.9	9.2	0.7	9.9	8.5	6.8	6.4	5.5	5.1	4.9	
Net non-debt creating capital inflows	7.4	29.5	-1.0	3.5	-0.7	3.5	21.2	1.1	1.2	1.1	1.1	5.2	1.0	

1/ External debt includes recovered domestic and foreign assets of old banks.

2/ 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.

3/ 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).

4/ For projection, line includes the impact of price and exchange rate changes, inflows of extraordinary financing (and Fund repurchases), and external asset recovery of the old bank estates. Unlike the last report, we no longer make assumptions on repayments to the old banks until we gain further clarity on the strategy to lift capital controls.

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

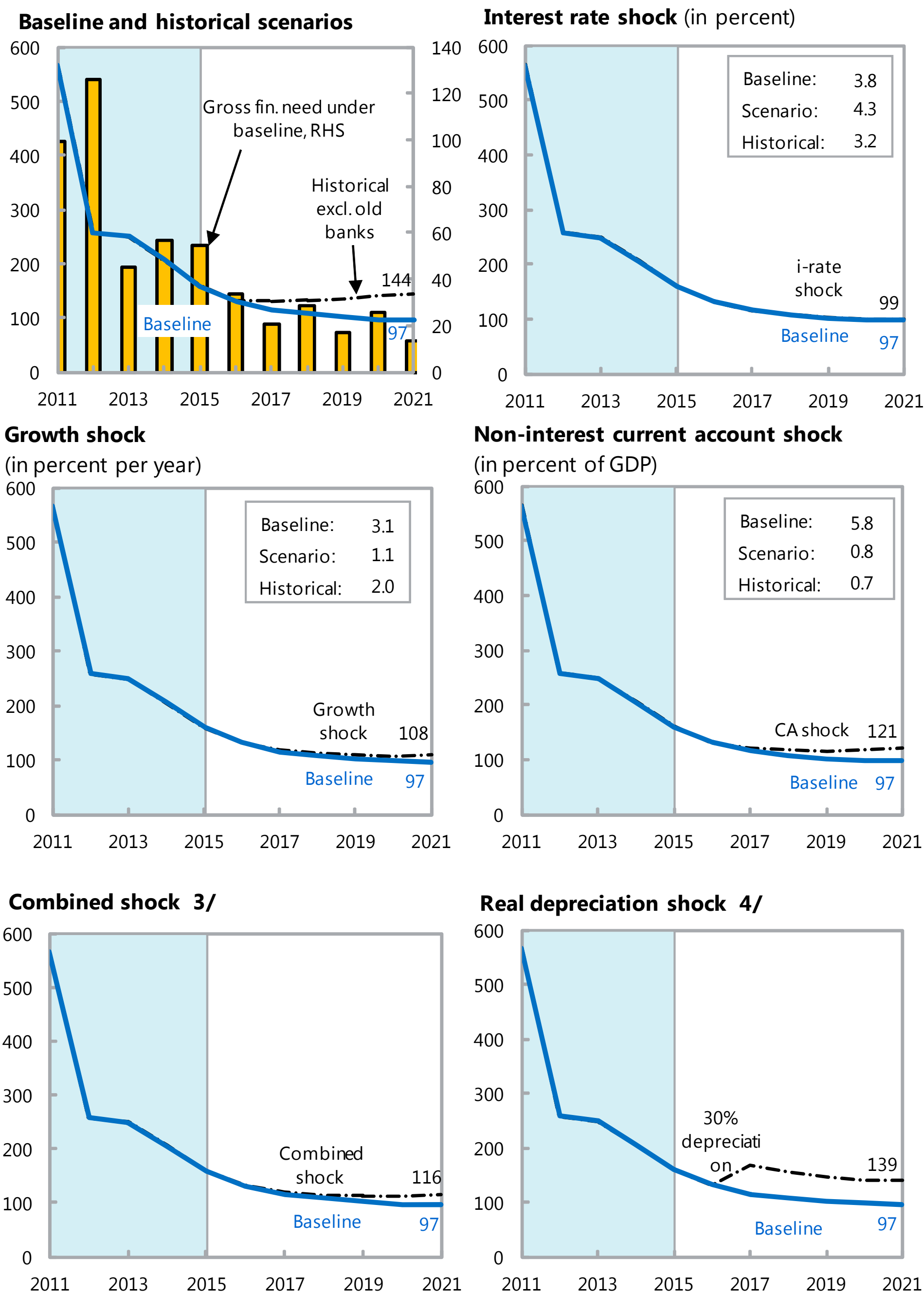
6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ 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.

8/ Since interest payment projections exclude old bank related interest payments while the external debt stock includes old bank debt, this results in an understatement of the external interest rate. Hence, for the computation of debt stabilizing current account we use the 2020 underlying interest rate that would exclude old bank debt stock as well.

Figure 1. External Debt Sustainability – Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund; country desk data, and IMF staff projections.
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.

Annex III. Public Debt Sustainability Analysis

Iceland's public debt sustainability is projected to improve rapidly. The authorities are receiving significant resources from the estates and are committed to saving them. With asset sales, net debt should fall below the new statutory ceiling of 30 percent of GDP by around 2020. The debt trajectory is robust to most shocks. In the case of a combined macroeconomic and contingent liabilities shock, the debt ratio deteriorates in the short run before resuming its downward path.

1. **Iceland's debt sustainability indicators are projected to improve considerably over the medium term**. During the early part of 2016, the authorities expect to collect just over 16 percent of GDP from the bank estates, which will be used to reduce public debt. This will take time, however, as a large share of these assets is illiquid. Iceland's net debt ratio should fall below the new statutory ceiling of 30 percent of GDP before the end of the projection period.

2. **Even excluding the large one off receipts from the estates, Iceland has in recent years made impressive progress in unwinding liabilities accrued during the financial crisis**. Since the peak year of 2011, the gross debt ratio has fallen by around 30 percentage points of GDP. At end 2015, the gross general government debt ratio was estimated to be just below 68 percent of GDP, compared to a pre crisis ratio of just below 29 percent in 2007.

3. **A significant share of recent government bond issuance has been used to build foreign exchange reserves**. Placing issuance proceeds at the CBI, the government has built up a sizable stock of deposits. This is reflected in the widening difference between the gross and net debt ratios over the last five years. At end 2015, net general government debt amounted to 51 percent of GDP. Going forward, the compositions of the failed bank estates will permit the government to prudently reduce its deposits and thus accelerate the reduction of gross debt.

4. **During 2015, the government began to use its deposits to finance early repayment of crisis related bonds**. It accelerated the repayment of a large nonmarketable instrument that was issued during the crisis to recapitalize the CBI. As of end 2015, the remaining balance on this bond was ISK 90 billion (4 percent of GDP). It is expected that this will be paid in early 2016. Separately, there is another nonmarketable bond, issued in 2009–12 to recapitalize financial institutions. At end 2015, the balance on this bond was ISK 212 billion (10 percent of GDP). This is projected to be paid in 2018 using government deposits and divestment proceeds.

5. **The structure of the public debt helps minimize fiscal risks**. Around three quarters is held domestically, mostly by banks and pension funds. Less than 2 percent is short term. Around three quarters of central government debt is denominated in krónur, with most of the rest in dollars or euros. About 85 percent of the stock carries fixed rates. The weighted average time to maturity on central government debt is 6.7 years, or 4.4 years for the portion in foreign currency.

6. **However, a significant fiscal risk is posed by the large stock of government guarantees issued to state owned enterprises**. As of November 2015, the stock of state guarantees was equivalent to about 50 percent of GDP, which is down from a peak of 81 percent

of GDP in 2009. Heightening fiscal vulnerabilities, around 84 percent of these guarantees are to two entities, the Housing Financing Fund and Landsvirkjun (the national power company). Landsvirkjun has been able to borrow without government guarantees.

7. **The recently published medium term fiscal strategy has highlighted the importance of addressing legacy pension issues**. Iceland reformed its pension framework in 1997, establishing a fully funded system for private sector workers and public sector workers hired after 1997. Serving public sector workers were given the option of moving to the newly established fully funded system or remaining with the old pay as you earn system. The authorities estimate that the old system has an unfunded liability of around 24 percent of GDP, which will need to be met from 2030 onward. This liability, published annually by Statice and recorded as insurance technical reserves in the general government balance sheet, is not included in debt

Baseline and Realism of Projections

8. **This DSA uses staff's macro framework and makes the following assumptions**:

- **Fiscal outlook**. In line with the new Medium Term Economic Program, the authorities aim for a general government surplus of around 1 percent of GDP over the medium term. This implies primary surpluses averaging 2½ percent of GDP in 2017–21. Coupled with asset sales, drawdowns of government deposits, and a negative interest rate–growth differential in most years, this puts the gross debt ratio on a firm downward trajectory.
- **Housing Financing Fund**. The government makes sizable allocations to cover capital shortfalls here, amounting to about 1 percent of GDP over four years.
- **Tax reform**. In line with the 2016 budget, personal income tax reforms are assumed to cost about ½ percent of GDP annually. The scenario also assumes modest cuts in social security contributions and increased collections of excise revenues.
- **Debt management**. Substantial divestment proceeds in 2016–21 are assumed to reduce liabilities, with no rollover of outstanding domestic bonds as they come due.

9. **The realism of staff's baseline assumptions has improved over time**. The median forecast error for growth over 2005–13 was 0.3 percent. Staff tended to be overly pessimistic about growth during the early years of this period and slightly optimistic during the crisis years. More recent growth forecasts have been close to outturns. Inflation forecasts have been subject to larger errors, particularly before and during the crisis. Again, recent forecast accuracy has improved. The median forecast error for the primary balance shows a similar pattern of pessimism turning to optimism with forecast accuracy improving in recent years.

10. **The heat map indicates that Iceland's current debt levels do not pose high levels of risk**. The only potential area of concern is the external financing requirement, which shows considerably above the upper threshold of the early warning benchmark. A large external bond maturity in 2016 is assumed to be rolled over.

Shocks and Stress Tests

11. The DSA stress tests indicate a highly favorable medium-term outlook. Under all shock scenarios, debt sustainability indicators recover relatively quickly. This is heavily contingent, however, on the commitment to reduce liabilities using both government deposits and the resources from the estates. This assessment also assumes that the commitment to fiscal adjustment is sustained and the macroeconomic and external environment is relatively benign.

12. Based on an asymmetric restriction of the shocks, the debt ratio peaks at around 80 percent of GDP with a 95 percent confidence interval. Six scenarios were considered:

- **Growth shock**. Real GDP growth is subjected to a one standard deviation negative shock. Inflation is assumed to decline in line with lower growth, dropping ¼ percentage point for every 1 percentage point decrease in growth. Reflecting higher risk premiums, nominal interest rates rise by 25 basis points for every 1 percent of GDP worsening of the primary balance. Under this scenario, the debt to GDP ratio remains broadly flat in 2017 but declines sharply thereafter as the authorities' debt reduction strategy accelerates.

- **Interest rate shock**. A 200 basis point increase in spreads is applied throughout the projection period. The decline in the debt ratio decelerates modestly in 2017 relative to the baseline but returns rapidly to its downward trajectory thereafter.

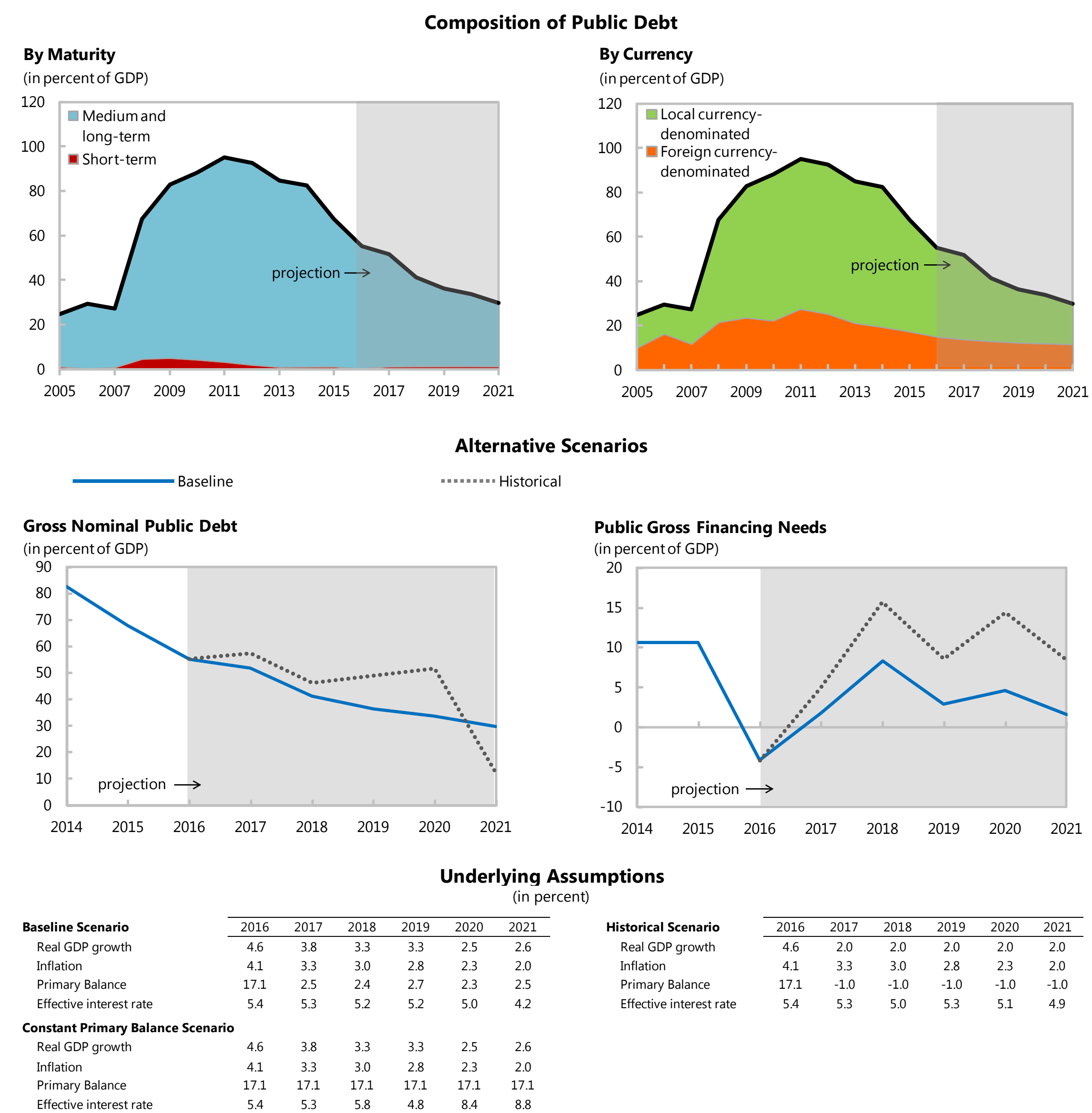
- **Real exchange rate shock**. A 25 percent real exchange rate devaluation is applied in the first year, coupled with a 25 basis point increase in interest rates for each 1 percent of GDP reduction in the primary balance. The debt ratio increases slightly in 2017 but returns to its downward trajectory thereafter. Overall, the impact of the shock is very limited due to the large share of króna denominated debt.

- **Primary balance shock**. A 2 percent of GDP decline in revenues is applied over two years, coupled with a rise in nominal interest rates over the same period. The debt to revenue ratio deteriorates but recovers quickly, with little deterioration in the debt ratio relative to the baseline.

- **Combined macro fiscal shock**. This scenario combines the shocks to real growth, the interest rate, the real exchange rate, and the primary balance while eliminating double counting of the effects of the individual shocks. The gross debt ratio spikes in 2017, peaking at 72 percent of GDP, with the downward trajectory reestablished thereafter as asset sales and privatizations go ahead as envisaged in the baseline.

- **Contingent liabilities shock**. The assumption is that 10 percent of state guarantees are called in 2016, with interest rates increasing by 25 basis points for every 1 percent of GDP worsening in the primary balance. The primary balance deteriorates to a deficit of almost 7 percent of GDP in 2017 and interest rates increase by over 210 basis points, taking the debt ratio to about 66 percent of GDP before it resumes its downward path thereafter.

Figure 1. Public Debt Sustainability – Composition of Public Debt and Alternative Scenarios



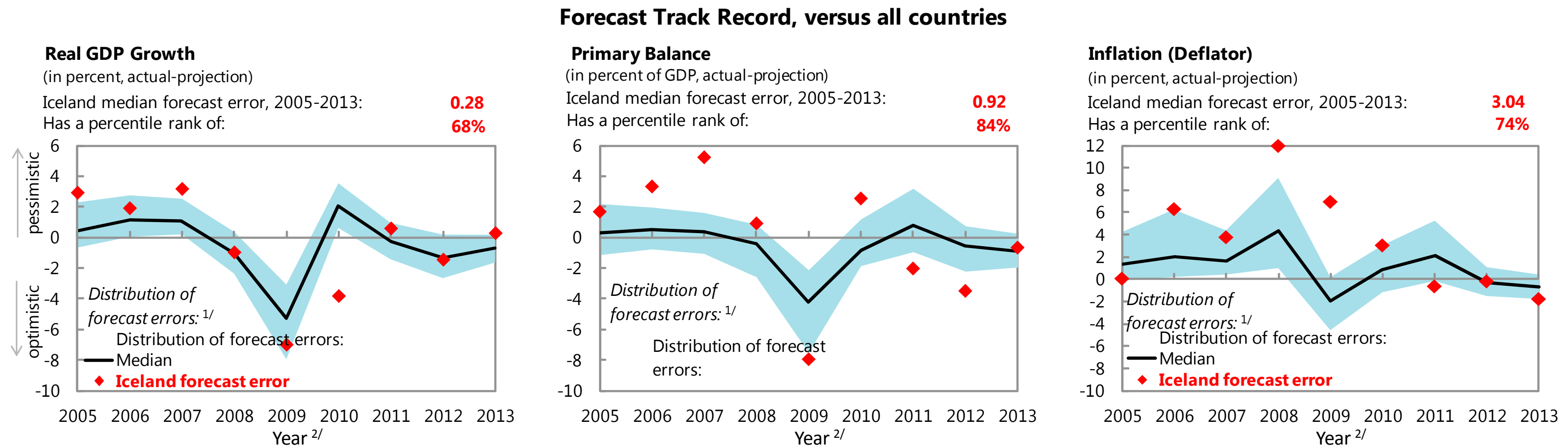
Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	4.6	3.8	3.3	3.3	2.5	2.6
Inflation	4.1	3.3	3.0	2.8	2.3	2.0
Primary Balance	17.1	2.5	2.4	2.7	2.3	2.5
Effective interest rate	5.4	5.3	5.2	5.2	5.0	4.2
Constant Primary Balance Scenario						
Real GDP growth	4.6	3.8	3.3	3.3	2.5	2.6
Inflation	4.1	3.3	3.0	2.8	2.3	2.0
Primary Balance	17.1	17.1	17.1	17.1	17.1	17.1
Effective interest rate	5.4	5.3	5.8	4.8	8.4	8.8

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	4.6	2.0	2.0	2.0	2.0	2.0
Inflation	4.1	3.3	3.0	2.8	2.3	2.0
Primary Balance	17.1	-1.0	-1.0	-1.0	-1.0	-1.0
Effective interest rate	5.4	5.3	5.0	5.3	5.1	4.9

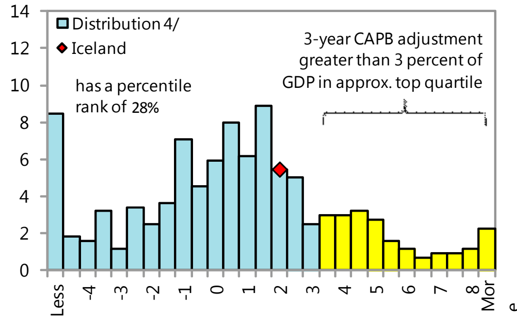
Source: IMF staff.

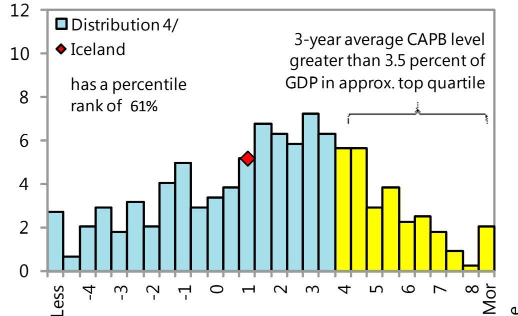
Figure 2. Public Debt Sustainability – Realism of Baseline Assumptions

Forecast Track Record, versus all countries

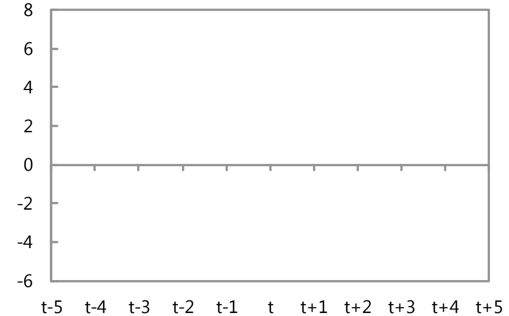


Assessing the Realism of Projected Fiscal Adjustment





Boom-Bust Analysis 3/



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Iceland.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Public Debt Sustainability – Baseline Scenario

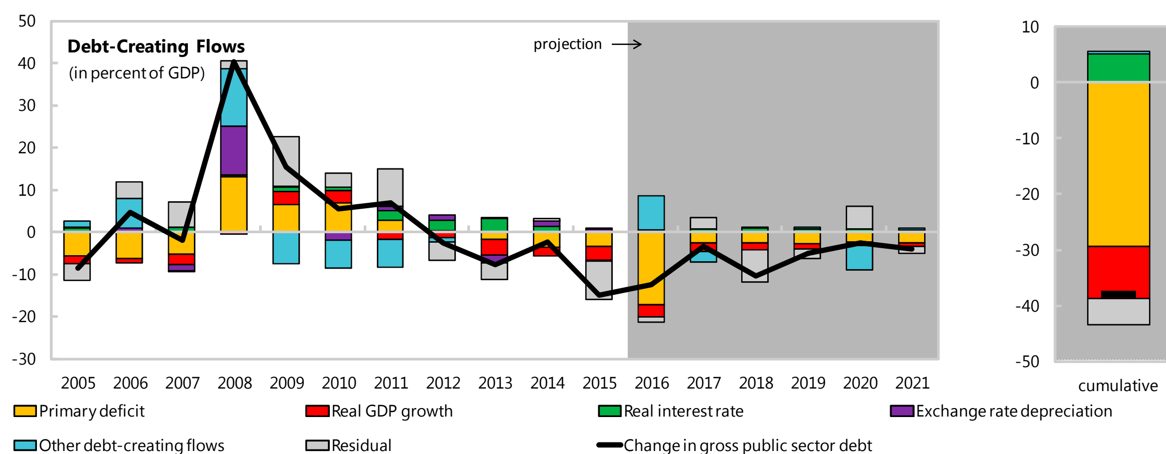
Debt, Economic and Market Indicators [1/]

	Actual		Projections					
	2014	2015	2016	2017	2018	2019	2020	2021
Nominal gross public debt	82.5	67.6	55.1	51.6	41.2	36.2	33.7	29.7
Public gross financing needs	10.6	10.6	-4.1	1.7	8.2	2.8	4.6	1.6
State guarantees	66	56						
Unfunded pension liabilities	24.3	24.1						
Real GDP growth (in percent)	2.0	4.0	4.6	3.8	3.3	3.3	2.5	2.6
Inflation (GDP deflator, in percent)	4.0	5.9	4.1	3.3	3.0	2.8	2.3	2.0
Nominal GDP growth (in percent)	6.1	10.1	8.9	7.3	6.4	6.2	4.9	4.6
Effective interest rate (in percent) [4/]	5.9	5.9	5.4	5.3	5.2	5.2	5.0	4.2

As of June 02, 2015		
Sovereign Spreads		
Spread (bp) 3/		174
CDS (bp)		102
Ratings	Foreign	Local
Moody's	Baa2	Baa2
S&Ps	BBB+	BBB+
Fitch	BBB+	A-

Contribution to Changes in Public Debt

	Actual		Projections							
	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-2.3	-14.9	-12.5	-3.5	-10.4	-5.0	-2.6	-4.0	-37.9	
Identified debt-creating flows	-2.9	-5.9	-12.2	-6.3	-2.7	-2.6	-7.7	-2.2	-33.8	
Primary deficit	-3.6	-3.2	-17.1	-2.5	-2.4	-2.7	-2.3	-2.5	-29.4	0.3
Primary (noninterest) revenue and grants	44.2	41.5	55.8	40.7	40.4	40.8	40.6	40.7	259.0	
Primary (noninterest) expenditure	40.6	38.3	38.6	38.3	38.0	38.1	38.4	38.2	229.5	
Automatic debt dynamics [5/]	0.7	-2.9	-3.0	-1.2	-0.6	-0.3	0.3	0.0	-4.9	
Interest rate/growth differential [6/]	-0.6	-3.6	-2.2	-1.0	-0.6	-0.4	0.0	-0.2	-4.3	
Of which: real interest rate	1.4	-0.2	0.7	0.9	1.0	0.9	0.9	0.7	5.1	
Of which: real GDP growth	-2.1	-3.5	-2.9	-2.0	-1.6	-1.3	-0.9	-0.8	-9.4	
Exchange rate depreciation [7/]	1.3	0.8	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.2	8.0	-2.6	0.3	0.3	-5.7	0.3	0.5	
General government net privatization proceeds (negative	0.0	-0.1	7.7	-2.9	0.0	0.0	-6.0	0.0	-1.3	
Net lending for policy purposes	0.0	0.3	0.3	0.3	0.3	0.3	0.3	0.3	1.8	
Residual, including asset changes [8/ 10/]	0.6	-9.1	-0.3	2.9	-7.7	-2.3	5.1	-1.8	-4.1	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ 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).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ For projections, this line includes exchange rate changes during the projection 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/ The residuals in 2015-21 reflects the draw-down of government deposits held at the central bank, asset sales, and the subsequent repayment of domestic and external debt

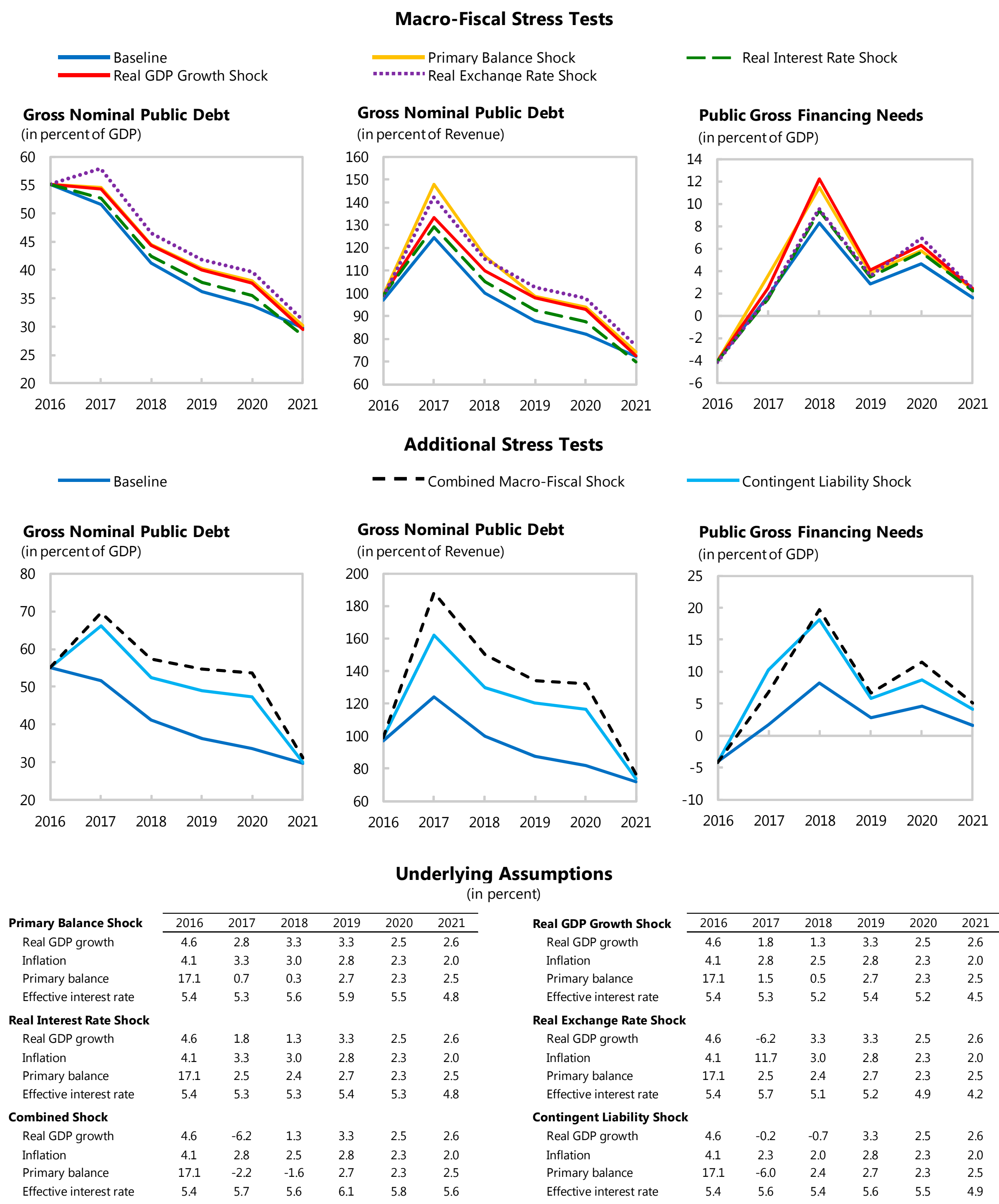


Figure 4. Public Debt Sustainability – Stress Tests

Underlying Assumptions
(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	4.6	2.8	3.3	3.3	2.5	2.6
Inflation	4.1	3.3	3.0	2.8	2.3	2.0
Primary balance	17.1	0.7	0.3	2.7	2.3	2.5
Effective interest rate	5.4	5.3	5.6	5.9	5.5	4.8
Real Interest Rate Shock						
Real GDP growth	4.6	1.8	1.3	3.3	2.5	2.6
Inflation	4.1	3.3	3.0	2.8	2.3	2.0
Primary balance	17.1	2.5	2.4	2.7	2.3	2.5
Effective interest rate	5.4	5.3	5.3	5.4	5.3	4.8
Combined Shock						
Real GDP growth	4.6	-6.2	1.3	3.3	2.5	2.6
Inflation	4.1	2.8	2.5	2.8	2.3	2.0
Primary balance	17.1	-2.2	-1.6	2.7	2.3	2.5
Effective interest rate	5.4	5.7	5.6	6.1	5.8	5.6

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	4.6	1.8	1.3	3.3	2.5	2.6
Inflation	4.1	2.8	2.5	2.8	2.3	2.0
Primary balance	17.1	1.5	0.5	2.7	2.3	2.5
Effective interest rate	5.4	5.3	5.2	5.4	5.2	4.5
Real Exchange Rate Shock						
Real GDP growth	4.6	-6.2	3.3	3.3	2.5	2.6
Inflation	4.1	11.7	3.0	2.8	2.3	2.0
Primary balance	17.1	2.5	2.4	2.7	2.3	2.5
Effective interest rate	5.4	5.7	5.1	5.2	4.9	4.2
Contingent Liability Shock						
Real GDP growth	4.6	-0.2	-0.7	3.3	2.5	2.6
Inflation	4.1	2.3	2.0	2.8	2.3	2.0
Primary balance	17.1	-6.0	2.4	2.7	2.3	2.5
Effective interest rate	5.4	5.6	5.4	5.6	5.5	4.9

Source: IMF staff.

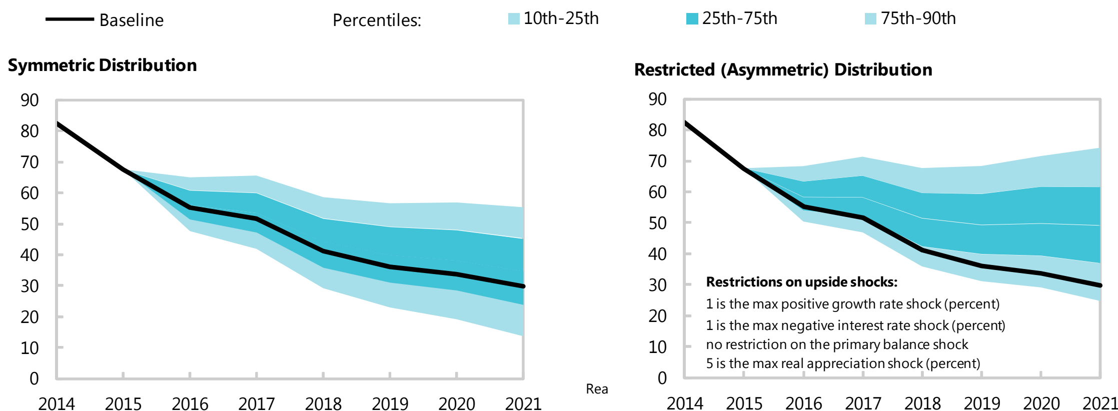
Figure 5. Public Debt Sustainability – Risk Assessment

Heat Map

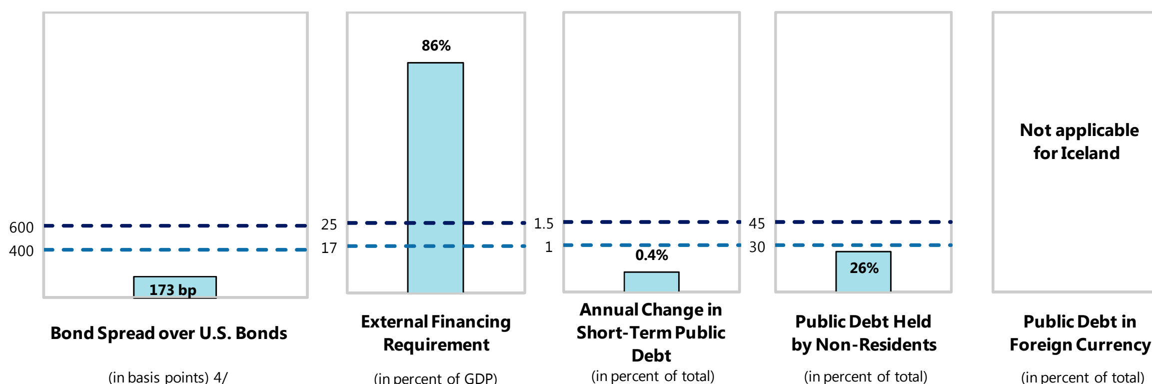
Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ An average over the last 3 months, 04-Mar-15 through 02-Jun-15.

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Annex IV. Responses to Past Policy Recommendations

IMF 2014 Article IV Recommendations	Authorities' Responses
Fiscal Policy Maintain Iceland's core objectives of a balanced budget and debt reduction. Proceed with value added tax and personal income tax reforms. Enact the proposed Organic Budget Law. Boost public investment.	**Consistent** The government recorded a small surplus in 2015. Large receipts from the compositions of the estates will dominate the fiscal position in 2016. However, small deficits will open up in the outer years. The first of two stages of the value added tax reform was completed in the 2015 budget. The personal income tax reform will unfold in 2016–17. The Organic Budget Law was passed in December 2015.
Monetary Policy Stand ready to cut interest rates if imported deflation persists. Conversely, be prepared to hike rates if wage increases are larger than expected. Continue reserve accumulation as conditions allow. Maintain central bank independence.	**Consistent** The CBI raised rates in response to the large wage hikes, which, together with significant imported deflation and currency appreciation, has kept inflation below target. The CBI has continued to build reserves amid favorable external conditions. Proposed amendments to the CBI legislation as submitted by an experts committee would preserve the current governance structure and improve checks and balances.
Capital Controls The updated liberalization strategy should be comprehensive, conditions based, and with an emphasis on a cooperative approach with appropriate incentives.	**Consistent** The updated liberalization strategy released in June 2015 takes a staged approach. The bank estates were resolved first, in a cooperative manner, which minimized legal and reputational risks and won credit rating upgrades. The authorities are now working to release offshore króna investments via an auction. Residents will be addressed thereafter.
Financial Sector Gaps in bank supervision and safety nets must be addressed. Banks should continue to maintain strong capital and liquidity buffers. The deposit insurance, bank resolution, and emergency liquidity assistance frameworks should be strengthened. The Housing Financing Fund should be put in run off.	**Partly Consistent** The authorities are stepping up efforts to improve supervisory processes. However, major weaknesses persist, as detailed in the 2014 Basel *Core Principles* assessment, with many rooted in FME's dependence on the Ministry of Finance. Banks are liquid and well capitalized, although large dividends payouts are a risk. The loss making Housing Financing Fund continues to lend and draft housing bills propose it remain operational.
Structural Follow through on plans to support productivity and competitiveness.	**Partly Consistent** Work by the *Growth Forum* continues to improve productivity. However, the large wage hikes undermine competitiveness, calling for a revamp of the wage bargaining framework.

INTERNATIONAL MONETARY FUND

ICELAND

June 3, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The European Department
(In consultation with other departments)

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FUND RELATIONS

(As of April 30, 2016)

Membership Status: Joined December 27, 1945

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	321.80	100.00
Fund holdings of currency	252.00	78.31
Reserve tranche position	69.80	21.69

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	112.18	100.00
Holdings	111.72	99.58

Outstanding Purchases and Loans: None.

Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Nov. 19, 2008	Aug. 31, 2011	1,400.00	1,400.00
Stand-By	Mar. 22, 1962	Mar. 21, 1963	1.63	0.00
Stand-By	Feb. 16, 1961	Dec. 31, 1961	1.63	0.00

Projected Payments to the Fund [1] (SDR Million; based on existing use of resources and present holdings of SDRs): None.

Implementation of HIPC Initiative: Not applicable.

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

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

Exchange Rate Arrangement and Exchange Restrictions:

The *de jure* exchange rate arrangement is free floating. In 2015, the Central Bank of Iceland (CBI) continued to follow the strategy of increased foreign exchange market intervention as set forth by the Monetary Policy Committee in May 2013. CBI transactions accounted for about 55 percent of total market turnover in 2015, up from 43 percent in 2014, and total turnover increased by around 80 percent y/y. The objective of the intervention strategy is to mitigate short-term exchange rate

[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.

volatility and expand the CBI’s reserves as much as conditions allow. Exchange rate volatility diminished significantly after the strategy was announced. The *de facto* exchange rate arrangement is classified as a floating arrangement. The CBI publishes monthly data on its interventions in the foreign exchange market. Iceland has 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 foreign exchange rules apportion depending on the period of the holding, (ii) amortized principal on bonds, and (iii) the indexed portion of principal on bonds. The retention of the three exchange restrictions was last approved by the Executive Board on March 3, 2016 (Decision No. 15957-(16/19)). Iceland also has in place measures that constitute exchange restrictions imposed for security reasons based on UN Security Council Resolutions.

Safeguards Assessment:

The 2009 Safeguards Assessment concluded that the overall control environment for the CBI was broadly appropriate for a small central bank, with good controls in the areas of accounting and financial reporting. The CBI's external and internal audit procedures were not found to be in line with international practices, however, and the assessment noted that the foreign reserves management area would benefit from further development. The authorities have since taken steps to implement the recommendations, notably by appointing an international audit firm to conduct annual external audits of the CBI in line with international standards, establishing an internal audit function, and appointing a Chief Audit Executive per the board approved charter. New reserve management guidelines were approved in 2012. Work on the remaining recommendation—amendments to the Central Bank Act—remains in progress.

Last Article IV Consultation:

Discussions for the 2014 Article IV Consultation were held in Reykjavik during December 8–18, 2014. The Staff Report (Country Report No. 15/72) was considered by the Executive Board on March 9, 2015. 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 controls liberalization	November 2010
MCM	Converging to EU regulations-credit bureaus	January 2011
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

MCM	Capital account liberalization	March 2013
FAD	IPSAS in Iceland: Towards Enhanced Fiscal Transparency	December 2013
FAD	VAT reform	February 2014
MCM	Capital controls liberalization	May 2014
MCM	Banking supervision	February 2015
MCM	Banking supervision	March 2015
MCM	Stress testing	April 2015
FAD	Workshop on Distributional Effects of Tax Reforms and Expenditure Measures	April 2015
MCM	Banking supervision	September 2015
MCM	Banking supervision	March 2016
FAD	Organic Budget Law implementation	April 2016

STATISTICAL ISSUES

A. Assessment of Data Adequacy for Surveillance

General. 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, although it uses a flexibility option on the timeliness and periodicity for the production index and the producer price index. 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 in English is disseminated to the public through a range of monthly, quarterly, and annual publications by three main institutions (the CBI, the Ministry of Finance and Economic Affairs, and Statistics Iceland), and is available on their internet sites.

The composition agreements reached by the bank estates in late 2015 had large impacts on the fiscal, monetary, and external sectors. The estates' "stability contributions" are recorded in the general government data on an accruals basis in 2016. The monetary data have been affected in both 2015 and 2016. In the external sector, the compositions entailed a large step reduction in the estates' foreign liabilities in December 2015, and a reclassification of their remaining foreign assets and liabilities from "deposit money banks in winding up proceedings" (which no longer exists as a category) to "financial holding companies"—both classified in the balance of payments (BOP) and international investment position (IIP) under "Other sectors – other financial corporations".

National accounts. The existing methodological framework for producing national accounts data was replaced in September 2014 with the new European System of Accounts (ESA) 2010 and the data starting in 1997 were revised. The expenditure based GDP data are available by component on a quarterly basis. Nonetheless, there is still scope for improvement of the national accounts data:

- Income accounts by sector are not sufficiently detailed and available only on an annual basis with a significant lag; and
- Production based GDP or gross value added by industry are available only on an annual basis in nominal terms with a considerable lag.

Collection of the data on construction can be improved, because as of now the data is subject to substantial data revisions, which complicates assessment of quarterly growth.

Price statistics. Data provision is adequate for surveillance.

Government finance statistics. The authorities publish a Treasury cash flow statement on a monthly basis, quarterly data on general government operations, and annual data on general government operations and financial assets and liabilities. Iceland reports government finance statistics in accordance with the Government Financial Statistics Manual (GFSM) 2014 framework in the Government Financial Statistics (GFS) Yearbook, and is an up to date contributor to the International Financial Statistics (IFS).

Monetary and financial statistics. The concepts and definitions broadly conform to the guidelines of the Monetary and Financial Statistics Manual (MFSM). The CBI reports detailed monetary (CBI and deposit money bank) balance sheet data promptly on a monthly frequency.

Financial sector surveillance. Iceland does not report financial soundness indicators to STA.

External sector statistics. Since 2014, the CBI has compiled BOP and IIP data according to the 6th edition of the Balance of Payments and International Investment Position Manual (BPM6). The BoP data do not provide a breakdown of services before 2013.

B. Data Standards and Quality

Subscriber to the SDDS since June 1996. Uses SDDS flexibility options on the periodicity and timeliness of the industrial production index.	A data ROSC was disseminated in November 2005.

Iceland: Table of Common Indicators Required for Surveillance

(As of June 3, 2016)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memorandum Items:[8]	
						Data Quality – Methodological Soundness[9]	Data Quality – Accuracy and Reliability[10]
Exchange Rates	June 3, 16	June 3, 16	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr. 2016	May 9, 16	M	M	M		
Reserve/Base Money	Apr. 2016	May 23, 16	M	M	M	LO, O, LO, LO	LO, O, O, O, O
Broad Money	Apr. 2016	May 23, 16	M	M	M		
Central Bank Balance Sheet	Apr. 2016	May 9, 16	M	M	M		
Consolidated Balance Sheet of the Banking System	Apr. 2016	May 9, 16	M	M	M		
Interest Rates[2]	June 3, 16	June 3, 16	D	D	D		
Consumer Price Index	May 2016	May 27, 16	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4, 2015	Mar. 15, 16	Q	Q	Q	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Feb. 2016	May 10, 16	M and Q	M and Q	M and Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Apr. 2016	May 9, 16	M	M	M		
External Current Account Balance	Q1, 2016	June 2, 16	Q	Q	Q	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	Q1, 2016	June 2, 16	Q	Q	Q		
GDP/GNP	Q4, 2015	Mar. 10, 16	Q	Q	Q	O, LO, O, LO	LO, O, LO, LO, O
Gross External Debt	Q1, 2016	June 2, 16	Q	Q	Q		
International Investment Position[6]	Q1, 2016	June 2, 16	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.
[9] This reflects the assessment provided in the data ROSC or the Substantive Update (published in November 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[10] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

ICELAND

June 17, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—SUPPLEMENTARY INFORMATION

Prepared by European Department

This supplement updates the staff report (SM/16/126) and appraisal.

On June 2, 2016, the Althing legislated to permit the imposition of a reserve requirement on selected capital inflows. Amendments to the Foreign Exchange Act vest such authority in the Central Bank of Iceland (CBI). Selected flows may be subject to a reserve ratio of up to 75 percent, with the resulting reserve amount to be deposited, for a holding period up to five years, in a deposit institution in Iceland. The deposit institution, in turn, shall deposit such amount in a reserve account at the CBI.

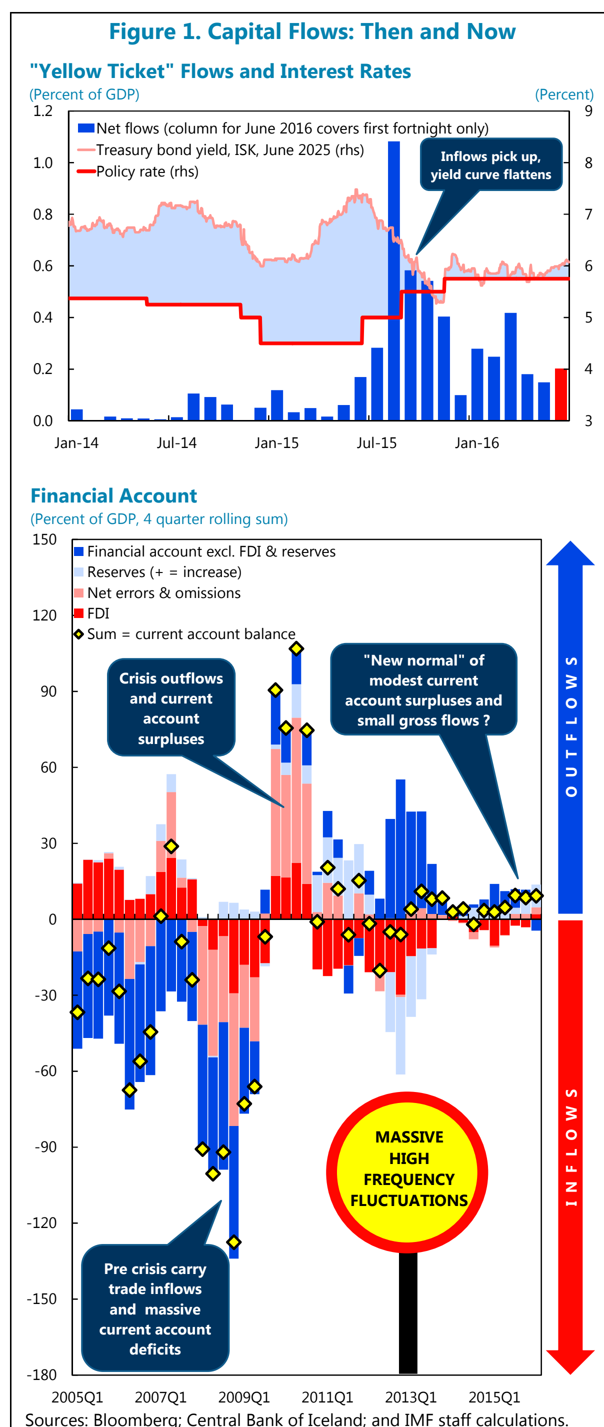
On June 4, the CBI issued rules activating the tool, which was announced as a capital flow management measure (CFM). The reserve base, as further detailed, comprises foreign currency debt flows entering Iceland after June 4, most of which come through the New Investment Route introduced in late 2009 (these inflows are issued with "yellow tickets" exempting them from capital controls). The special reserve ratio is set at 40 percent, the holding period at 12 months, and the interest rate on the reserve accounts at the CBI at nil. FDI, investments in listed and unlisted equities and in real estate, and flows restricted under the capital control regime are unaffected.

The stated purpose of the action is to curb incentives for a new carry trade. By taxing inflows, in effect, the authorities seek to temper them and influence their composition, thereby reducing risks to macroeconomic and financial stability. Iceland has telegraphed that, while it remains committed to lifting capital controls, it shall do so on its terms—its priority is not foreign investment in a shrinking stock of public debt, but rather steps to let out bottled up domestic savings, consistent with the current account surplus. Seeing no sign of overlap between yellow ticket and FDI investors, the authorities assess the impact on TFP enhancing inflows to be limited.

On timing, the authorities point to bitter past experience and argue an ounce of prevention is better than a pound of cure. Characterizing recent inflows as significant, they apprehend also that legacy offshore króna investments that exited via the CBI's auction could return using the yellow ticket route, replacing an immobilized overhang with a dynamic and potentially flighty one, complicating the liberalization of capital controls on residents. The auction has thus been one factor driving their timing.

The authorities have also been candid that there is a monetary policy dimension. The recent capital inflows have hurt transmission to long-term rates. The CBI Governor has argued for tools aimed at giving monetary policy more room for maneuver,

informing that work was underway to ready measures to temper inflows that, *inter alia*, interfere significantly with the domestic interest rate channel of monetary policy transmission.



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

Staff also considers the reserve requirement a CFM as defined in the Fund's *Institutional View*. Staff had noted circumstances could arise where CFMs form part of an efficient policy response in Iceland, and had pointed the authorities to the *Institutional View*. The guidance therein emphasizes the central role of macroeconomic policies in managing the risks associated with inflow surges, yet notes CFMs can be useful in certain circumstances. Such measures, if used, should be transparent, targeted, temporary, and nondiscriminatory and should not substitute for warranted macroeconomic adjustment.

With the *Institutional View* envisaging the use of CFMs in the context of inflow surges, staff sees no compelling reason for having activated the tool now. Although the policy objectives are clearly communicated, fundamentally, there is no inflow surge at present. Recent inflows have been modest and centered on the Treasury bond market. With credit growth subdued and with no obvious signs of credit fueled asset price pressures, serious financial stability risks are not currently in evidence. In the absence of an inflow surge, it is difficult to form a definitive assessment of the room to adjust macroeconomic policies, not least because the macroeconomic outlook may change with inflows. While it is clear that inflationary pressures argue against any lowering of the policy rate at the current juncture, there may be some room for further appreciation of the króna given an external position that is broadly consistent with fundamentals, and for further reserve accumulation in tandem with the planned liberalization of outflow controls on residents. Staff also notes that the tool, with its long holding period, looks to be a permanent part of the toolkit, and advises greater clarity on the exit strategy.

Separately, the latest national account and price data are consistent with staff's baseline projections. Real GDP expanded by 4.2 percent y/y in Q1, with domestic demand surging 8.3 percent y/y, led by private consumption (up 7.1 percent) and fixed investment (up 24.5 percent). CPI inflation was 1.7 percent in May, with inflation excluding housing coming in at 0.3 percent.

Statement by Kimmo Tapani Virolainen, Alternate Executive Director for Iceland and Gudrun Soley Gunnarsdottir, Advisor to Executive Director
June 20, 2016

The Icelandic authorities appreciate the candid and constructive discussions during the 2016 Article IV Mission in Reykjavík and Akureyri.

My authorities broadly agree with the staff appraisal and recommendations. The economic recovery has gained momentum in recent years. The economic slack created during the deep recession that came in the wake of the financial crisis has disappeared and possible overheating of the economy has become an important risk. The fiscal accounts are in surplus territory and public debt as a share of GDP has been reduced substantially, helped by economic growth, fiscal consolidation, and lately, stability contributions from the bank estates that were intended to mitigate potential negative balance of payments effects. The economy is relatively well balanced with a sizeable current account surplus and inflation somewhat below target for over two years. However, inflation expectations, although falling, are not yet anchored at the target. This partly reflects forecasts that indicate inflation might rise above target next year as sizeable wage increases and a positive output gap have their effect and international deflationary forces might be on the wane. As a result of the sizable current account surpluses in the post-crisis period and the compositions of the bank estates, the NIIP has greatly improved, towards about minus 6 percent of GDP at end 2015. The NIIP will turn positive in the near future if current account surpluses continue to persist as forecast.

Economic growth is projected to be between 4 and 5 percent this year and easing slightly next year. A rapid increase in tourism has been the main engine of growth, also fueling consumption and investment in hotels and tourist facilities. At the same time, the important fishing sector enjoys high external demand and good catches, the tech sector enjoys robust growth and investment in the energy sector continues at a measured pace. Financial system resilience has continued to increase in tandem with private sector deleveraging and banks' strengthening their capital positions. Downside risks to the outlook include, as staff points out, effects from wage increases far in excess of the sum of productivity growth and the inflation target, the impact of potential premature capital account liberalization, financial imbalances, and weaker demand for exports in trading partner countries. However, the authorities intend to manage the downside risks with planned reforms and prudential policies.

Fiscal policy

Fiscal easing in 2015 and 2016 calls for some tightening in 2017 and balance onwards in accord with the newly introduced Organic Budget Law (OBL). Reforms of the personal income tax system will continue and there remains scope to make the indirect tax system, including the VAT, more efficient. Public investment is just below 3 percent of GDP and has not reached the levels seen before the banking collapse. There is a need for infrastructure investments, including in transport and the health care system. Some of this need arises from the sharp increase in tourism and must be undertaken to build capacity to accommodate the

projected growth of the tourism sector. However, the authorities stand firm on not departing from the policy to use the windfall from the settlement of the failed bank estates to lower public debt. Consequently, the debt ceiling in the OBL was lowered from 45 percent of GDP to 30 percent prior to the legislation being passed, which seems well within reach.

Staff mentions the rise in disability outlays and social protection spending. The Organic Budget Law will in a way act as a ring fencer in this regard alongside actions to target spending to those most in need. The largest municipality, Reykjavik, has already made significant progress in reducing outlays for social protection, including through successful rehabilitation programs. Sales of the state owned banks will proceed but the lessons from the privatization of the banking system at the turn of the century are still in memory and the lessons learned will be applied to ensure that the banks will be responsibly managed. The Parliament has recently passed a new law that will help to remove bottlenecks in the housing market where young people have been hard pressed to obtain suitable accommodation, whether by renting or purchasing. The associated fiscal cost will be acceptable as more choices for new entrants in the housing market will help to lower the risk of house price imbalances, inter alia due to demand from the tourist sector.

Monetary policy and financial stability

Inflation expectations have become better aligned with the inflation target as inflation has been at or below the target for over two years. Nevertheless, work is still needed to anchor them more firmly. This is not surprising given the legacy of high and volatile inflation in Iceland. The Central Bank of Iceland (CBI) will use the necessary means to achieve such anchoring as it is a pre-requisite for successfully keeping inflation at target over the medium term. The CBI has already signaled that a policy rate increase might be in the cards later this year if inflation starts to rise.

There have been significant inflows of short term capital to take advantage of relatively high interest rates in Iceland. Such flows proved to be very destabilizing in the period leading up to the banking crisis, also interfering with the interest rate channel of monetary policy. Recently passed legislation has given the CBI the power to apply a special reserve requirement on specific capital inflows. From June 4th portfolio debt inflows, most of which are registered as new domestic investment and receive a so-called "yellow ticket" making them exempt from the capital controls, will be subject to a 40 percent one-year unremunerated reserve requirement (max. 75 percent for five years according to the legislation). This is structured to dampen the return on speculative short term investments without deterring capital inflows directed into long term investment. The policy measure is also intended to support other aspects of domestic economic policy, including monetary policy, thereby contributing to economic stability.

The authorities agree with staff on the need to strengthen financial system regulation and supervision. Capital requirements should be proportionate to the risk profile of individual banks and take into account systemic risk factors through appropriate macro-prudential policies. The macro-prudential toolkit is still being developed and staff´s suggestions are

welcome in this context. The implementation of the EU Capital Requirements Directive IV and Capital Requirements Regulation is an ongoing process and capital buffers were introduced into Icelandic legislation last winter. In January, the Financial Stability Council (FSC) issued a recommendation to the Financial Supervisory Authority (FSA) regarding imposing the Systemic Risk Buffer, the Buffer on Systemically Important Institutions and the Countercyclical Capital Buffer. The FSA made a decision in accordance with the Council's recommendation and this will increase capital requirements for systemically important financial institutions by up to 6.5 percentage points. Last year the FSA obtained new supervisory powers, e.g. with regard to risk management, and bills of legislation have been introduced before Parliament which would allow the FSA to set caps on loan-to-values for mortgages and the CBI to set limits on unhedged foreign currency lending. Additionally, a working group consisting of representatives from the Ministry of Finance, the FSA and the CBI has been established to review the Law on Financial Undertakings with the objective of reducing systemic risk resulting from universal banks and systemically important financial institutions.

Capital account liberalization

Capital account liberalization is proceeding according to plan. The offshore króna overhang from the glacier bond era now constitutes around 13 percent of GDP. To prevent destabilizing rapid outflow of these assets, offshore króna assets were ring-fenced with special legislation. Tomorrow, the CBI will hold one final auction to give the offshore króna holders the option of an exit before the Icelandic authorities turn to lifting capital controls on domestic residents. Offshore króna holders who choose not to participate in the auction will continue to face limited investment options consisting of bank deposits, Central Bank certificates of deposits and treasury bills. Following the demarcation of the offshore krónas and the containment of the overhang, the process towards full liberalization of capital controls on domestic parties will be executed in carefully measured steps. The authorities welcome the discussion in the Selected Issues paper that gives consideration to some of the problems related to capital flows, financial stability, and monetary policy.

The labor market and structural reforms

Staff correctly associates the very high wage increases last year with possible overheating and inflation pressures. A new Macroeconomic Council with labor market participants and fiscal and monetary authorities represented will help to create consensus on rational wage setting based on competitiveness in the future.

With the progress made towards lifting capital controls through the composition agreements of the estates of the fallen banks and by containing the offshore króna overhang the authorities can turn to structural reforms in various sectors of the economy. These include the educational and health systems as well as the rapidly growing tourist sector where environmental considerations and capacity developments must go hand in hand. The authorities welcome the discussion and proposals in the Selected Issues paper covering expenditure policies related to the above issues.