INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/163

ICELAND

June 2017

2017 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 2017 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 12, 2017 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 12, 2017, following discussions that ended on March 28, 2017, 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 May 30, 2017.
- An **Informational Annex** prepared by the IMF staff.
- 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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

Press Release No. 17/240
FOR IMMEDIATE RELEASE
June 22, 2017

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Iceland

On June 12, 2017, the Executive Board of the International Monetary Fund (IMF) concluded its 2017 Article IV consultation[1] with Iceland.

Tourism continues to drive real GDP growth, which reached 7.2 percent in 2016 and is projected at almost 6 percent this year before tapering to around 2½ percent over the medium term. Bank credit to the nonfinancial private sector remains muted, growing by only 4.3 percent in 2016, yet is expected to gain pace going forward. Thus far, growth has been driven not by leverage but by exports, private consumption, and investment.

Inflation, at 1.7 percent in May, continues to be moderated by subdued import prices and currency appreciation. The continued strong appreciation of the króna reflects a market response to the strong increase in external demand for tourism—much of which is likely to be permanent—and should help guide output to its sustainable long-run growth path. Iceland's current account surplus is projected to shrink modestly over time, with some export sectors suffering while others thrive.

Executive Board Assessment[2]

Executive Directors welcomed the strong performance of the Icelandic economy with high growth, low inflation, rising reserves, fiscal and current account surpluses, and a decline in the level of public debt. These favorable outcomes were supported by sound economic management and, more recently, by a surge in tourism. Nevertheless, risks and challenges arise from a potential overheating of the economy, calling for vigilance with regards to credit growth and the real estate sector, labor market tightening, and

[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.

wage increases. Directors commended the authorities for the orderly removal of most capital controls, while noting that capital flows will bring risks as well as opportunities. Against this backdrop, Directors encouraged the authorities to maintain tight macroeconomic policies, take decisive steps to bolster financial sector oversight, and establish a supportive framework to manage the tourism sector.

Directors stressed that strengthening financial sector oversight should be a key priority. They urged a review of the Act on Official Supervision of Financial Activities to strengthen regulatory and supervisory arrangements, reduce gaps in financial sector oversight, and address coordination issues. Directors considered strong microprudential regulation and supervision of banks to be core elements of the financial stability toolkit, to be supported by well-targeted macroprudential measures. In the context of the ongoing market interest, Directors emphasized stringent vetting of investors seeking to acquire significant ownership positions in banks.

Directors emphasized the need to manage capital inflows carefully. Given Iceland's bitter past experience, most Directors were sympathetic to the current use of a special reserve requirement on selected debt inflows. In this regard, Directors underscored that the use of capital flow management measures (CFMs) should in general not substitute for warranted macroeconomic adjustment. Citing the IMF's Institutional View on the Liberalization and Management of Capital Flows, they emphasized that CFMs, when used, should be temporary and transparent.

Directors commended the Central Bank of Iceland for its prudent monetary policy stance, noting that the inflation targeting framework has helped anchor expectations and keeps inflation at low levels. The credibility of this framework could be enhanced by clear communication of the foreign exchange interventions policy and the introduction of a fine-tuning instrument to help sterilize the domestic liquidity impact of these interventions. Regarding the value of the Icelandic króna, should the pick-up in tourism be sustained, the real exchange rate could be allowed to appreciate while keeping an eye on competitiveness. To the extent that appreciation pushes inflation prospects lower, further interest rate cuts could be considered.

Directors recommended strict expenditure control to deliver a tighter-than-budgeted fiscal stance in 2017. Fiscal policy would also need to stand ready to tighten further if overheating risks materialized. Over the medium term, should fiscal space emerge under the Organic Budget Law, it could be used to support additional spending on infrastructure, healthcare, and education, guided by a comprehensive review of expenditures. Directors welcomed the recent public sector pension reform.

Directors underscored the need for structural reforms to protect competitiveness and foster sustainable tourism. They supported the authorities' efforts to revamp the wage bargaining framework, and recommended that a strategy be formulated to ensure adequate resources and coordination to develop the tourism sector in a sustainable manner.

Iceland: Selected Economic Indicators, 2013–17

	2013	2014	2015	2016	2017 Proj
	(Percentage change unless otherwise indicated)				
National Accounts (constant prices)					
Gross domestic product	4.4	1.9	4.1	7.2	5.8
Total domestic demand	0.7	5.2	5.9	8.7	6.4
Private consumption	1.0	2.9	4.3	6.9	6.4
Public consumption	1.0	1.7	1.0	1.5	1.3
Gross fixed investment	2.2	16.0	17.8	22.7	9.9
Net exports (contribution to growth)	2.7	-1.6	-0.4	-0.2	0.0
Exports of goods and services	6.7	3.2	9.2	11.1	6.9
Imports of goods and services	0.1	9.8	13.5	14.7	8.6
Output gap (percent of potential output)	-0.4	0.0	0.5	1.9	2.2
Selected Indicators					
Gross domestic product (ISK bn.)	1,891	2,006	2,214	2,422	2,632
GDP per capita ($ thousands)	47.5	52.2	50.5	59.6	67.6
Private consumption (percent of GDP)	52.3	52.2	49.8	49.0	49.1
Public consumption (percent of GDP)	24.3	24.2	23.6	23.1	23.1
Gross fixed investment (percent of GDP)	15.7	17.2	18.9	21.2	21.9
Gross national saving (percent of GDP)	21.5	21.3	24.6	29.3	28.5
Unemployment rate (percent of labor force)	5.4	5.0	4.0	3.0	3.0
Employment	3.3	1.6	3.4	3.7	3.3
Labor productivity	0.6	0.0	0.8	3.5	2.5
Real wages	0.9	1.9	6.2	8.1	3.7
Nominal wages	4.8	4.0	7.9	10.1	5.9
Consumer price index (average)	3.9	2.0	1.6	1.7	2.2
Consumer price index (end period)	4.2	0.8	2.0	1.9	2.4
ISK/€ (average) 1/	162	155	146	134	118
ISK/$ (average) 1/	122	117	132	121	109
Terms of trade (average)	-1.9	3.3	6.7	2.4	1.2
Money and Credit (end period)					
Base money (M0)	0.3	-17.6	27.8	3.0	8.7
Broad money (M3)	4.5	7.1	5.6	-4.6	7.8
Bank credit to nonfinancial private sector	-3.2	-2.4	3.5	4.3	4.8
Central bank 7 day term deposit rate 1/	5.75	4.50	5.75	5.00	4.75
	(Percent of GDP unless otherwise indicated)				
General Government Finances 2/					
Revenue	42.1	45.2	42.0	58.4	41.6
Expenditure	43.9	45.3	42.9	46.1	40.6
Overall balance	-1.8	-0.1	-0.8	12.4	1.0
Structural primary balance	1.7	2.1	1.2	2.9	2.3
Gross debt	84.7	82.4	68.1	54.0	41.1
Net debt	62.2	55.8	49.3	41.9	32.9
Balance of Payments					
Current account balance 3/	6.0	4.0	5.5	8.0	6.6
Capital and financial account (+ = outflow)	7.0	3.5	5.5	10.1	6.5
Gross external debt 4/	248.7	205.5	180.0	125.1	114.9
Central bank reserves ($ bn.)	4.1	4.2	5.0	7.2	6.2

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

1/ For 2017, rate as of June 7.

2/ Data for 2016 are preliminary.

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

4/ Data for 2013–14 use fund staff's calculated measure for the external debt of the bank estates; data from 2015 onward reflect the impact of the estates' compositions.

INTERNATIONAL MONETARY FUND

ICELAND

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

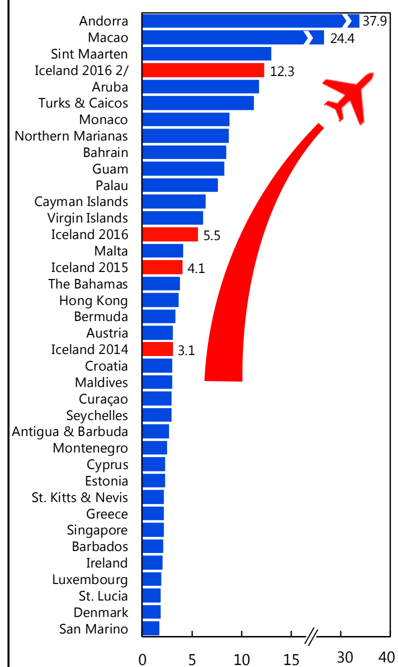
May 30, 2017

KEY ISSUES

Iceland is stepping into a new era of financial openness, with capital controls mostly gone. Reshaped by tourism, the economy is on a firmer footing than the last time it grew this fast. Current growth rates—more than 7 percent last year—are driven by tourism, private consumption, and investment, not leverage. Nonetheless, overheating risks are a clear and present concern.

Tourism has driven substantial króna appreciation, which serves as a dampening mechanism. If appreciation continues and drives inflation prospects lower, it could create room for further interest rate cuts. Fiscal policy should be tightened in the near term in response to demand pressures, with increases in public spending on infrastructure, health, and education supported by tax reforms. Efforts to reform the wage bargaining process should press on, and a tourism strategy should be formulated to ensure adequate resources and interagency coordination and sustainable development of the sector.

Tourists per Inhabitant 1/
(Number)



Sources: Statistics Iceland; World Bank; and IMF staff.
1/ Data for 2015 unless otherwise indicated. Figures for some countries reflect arrivals, and for others accommodation seekers. For Iceland, the latter applies.
2/ Including non hotel accommodations.

The top policy priority must be a decisive strengthening of financial sector oversight. Microprudential regulation and supervision are core elements of the financial stability toolkit. Macroprudential measures can help limit risks associated with capital flows, but should be well targeted. Capital flow management measures can be useful in some circumstances; they should not, however, substitute for warranted macroeconomic adjustment.

Approved By
Jörg Decressin (EUR)
Vikram Haksar (SPR)

Discussions took place in Reykjavík March 14–28, including with the new prime minister, new finance minister, central bank governor, and the Parliamentary Committee on Economic Affairs and Trade.

The team comprised A. Bhatia (head), M. Arena and U. Böwer (all EUR), R. Bhattacharya (FIN), N. Stetsenko (LEG), A. Qureshi (MCM), and S. Hassan (SPR), joined by G. Gunnarsdóttir (OED). V. Boranova, M. Maneely, and N. Veluz (all EUR) assisted.

CONTENTS

TABLES

ANNEXES

DEVELOPMENTS

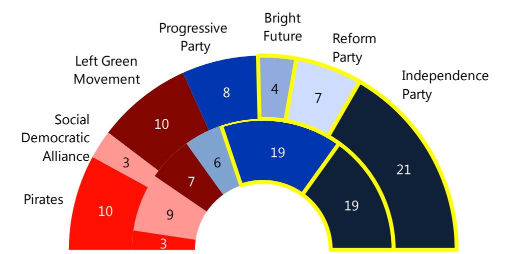
1. Iceland's new government offers some continuity. It centers on the Independence Party, which also sat at the heart of the previous government. The coalition is the outcome of two months of multi party talks that exhaustively explored other options. Yet it has a majority of only one seat, giving every coalition parliamentarian a veto.

2. Policy discipline has held thus far. Medium-term fiscal plans indicate commitment to debt reduction. Most capital controls are gone. In a concession to junior coalition partners, and reflecting calls for the Central Bank of Iceland (CBI) to curb króna appreciation and cut interest rates—many businesses in the traditional parts of the tradable sector are hurting while tourism booms, and real interest rates are at high levels—the government has commissioned a review of the "prerequisites of Iceland's monetary and currency policy." Findings are due by end 2017. Recommendations for big changes, however, are not a foregone conclusion.

3. Growth is at new heights. Tourist arrivals rose by 40 percent in 2016, lifting real GDP growth to 7.2 percent. Reykjavík is peppered with hotel building sites. Homebuilding is kicking in. Fixed investment grew by 22.7 percent in 2016, and private consumption by 6.9 percent, buoyed by wage growth, króna strength, and rising household net worth.

4. The goods balance has deteriorated while the current account surplus has grown. Goods exports fell by more than 6 percent in dollar terms in 2016, with a double digit contraction for aluminum and silicon. Goods imports rose by some 8 percent. Despite a growing deficit on goods, however, tourism earnings together with a 2½ percent of GDP one time improvement in the primary income balance related to the wind up of the bank estates (see the 2016 Article IV report) allowed the current account surplus to climb further, to 8 percent of GDP.

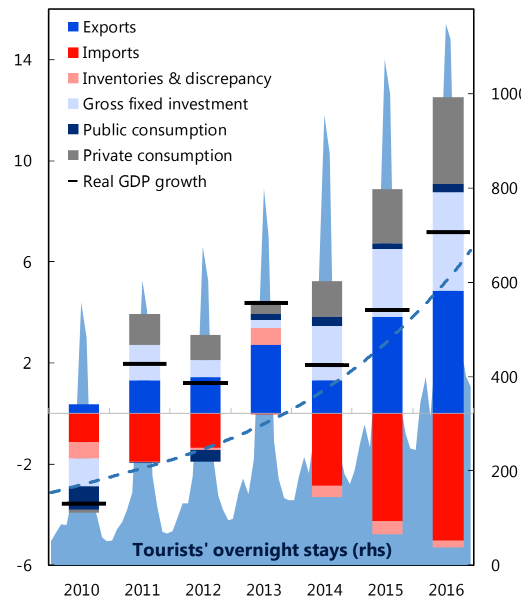
Figure 1. The Althing
2016 (outer) and 2013 (inner)
(Number of seats)



Source: Iceland Monitor.

Figure 2. Growth

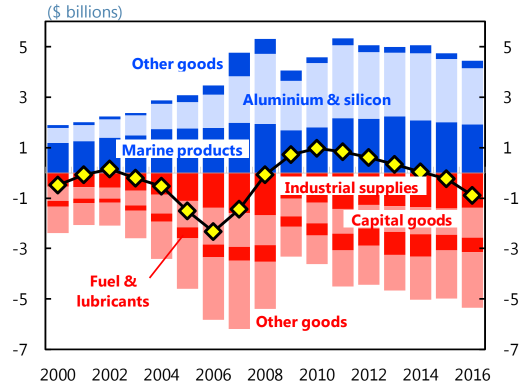
Real GDP and Tourism
(Percentage pt. contrib. to growth y/y) (Thousands)



Source: Statistics Iceland.

Figure 3. Balance on Goods

Balance on Goods
($ billions)



Sources: Statistics Iceland; and IMF staff calculations.

5. Capital account opening is mostly complete, and reserves continue to rise. First, the authorities eased outflow controls in two major steps, in October 2016 and January 2017. Then, on March 12, 2017, they announced an agreement with several of the largest offshore króna holders and the lifting of most remaining controls (Annex I). No pent up wave of outward FDI or household outflows followed.

6. Job creation has sucked in workers from abroad, letting steam out of the labor market. Arrivals have included locals who left during the crisis as well as Schengen immigrants (all subject to the same wage agreements), with many of the foreigners taking the lower end tourism jobs. The flexible labor supply puts a wide confidence interval around estimates of the output gap.

7. Inflation has surprised on the downside. The feared price surge from the wage awards of 2015 never materialized. Headline inflation has been below the CBI's 2½ percent target for three years. Inflation expectations are close to target. Króna appreciation, strong terms of trade, and some profit compression by firms have contained the pass through from wages to prices. Assessing that the monetary stance had tightened as real rates had risen while the natural rate might have fallen, the CBI has cut its policy rate by a total of 100 basis points since July 2016, to 4¾ percent.

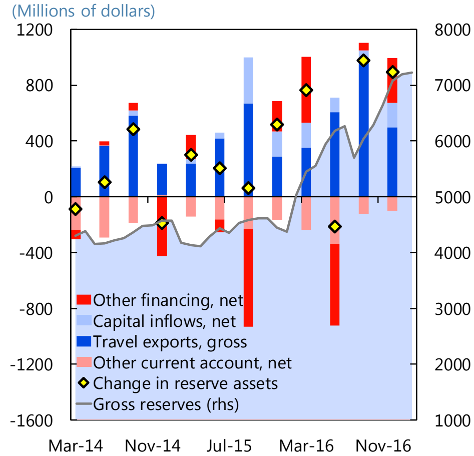
8. Króna appreciation in 2016 dwarfed that in 2015. The real effective exchange rate (REER) climbed almost 20 percent in 2016, fell back slightly in early 2017 as a fishing strike played out, and then resumed its ascent. Upward pressure has reflected the combination of the large current account surplus and limited capital outflows. Reserves climbed to over $7 billion or more than 2 times the Fund's reserve adequacy metric (RAM).

9. Iceland's capital flow management measure (CFM) has shaped the composition and perhaps the size of inflows. After the introduction in June 2016 of a 40 percent reserve requirement on selected debt inflows (with a 12 month holding period at an interest rate of nil), capital inflows saw a shift from debt to equity. It is not

Figure 4. Tourism and Reserves

Balance of Payments and Reserves

(Millions of dollars)

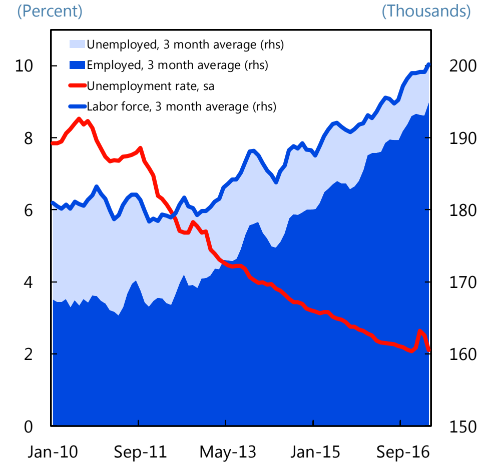


Sources: Central Bank of Iceland; Statistics Iceland; and IMF.

Figure 5. Labor

Labor Force and Unemployment

(Percent) (Thousands)

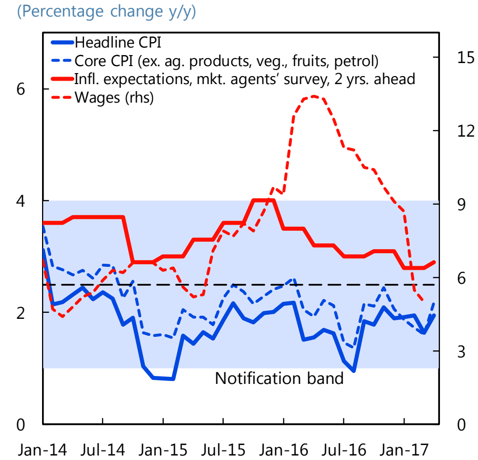


Source: Statistics Iceland.

Figure 6. Inflation

Inflation and Inflation Expectations

(Percentage change y/y)



Source: Statistics Iceland.

clear whether overall volumes were affected, with one view being that the equity flows would have come irrespective of the CFM.

10. Solid fiscal outturns have won rating upgrades. The general government balance came in at a surplus of 12.4 percent of GDP in 2016, after accounting for about 16 percent of GDP in one off receipts from the estates and nearly 5 percent of GDP in one off spending on a pension reform package passed in December. The structural primary balance is estimated to have improved by 1.7 percent of potential GDP. Below the line, the government acquired Íslandsbanki in 2016 as a "stability contribution" from the Glitnir estate, and net debt fell by 7½ percentage points, to 42 percent of GDP.

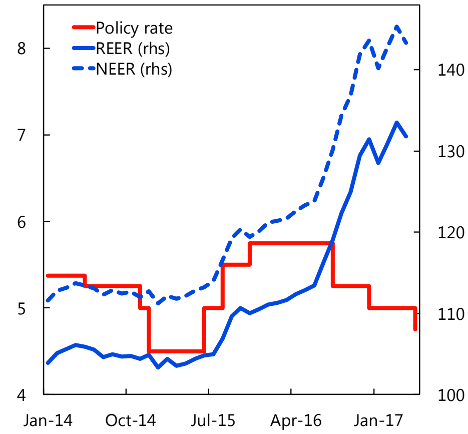
11. The banks remain profitable. The three main banks' "raw" total capital to total (unweighted) assets ratios were 17–23 percent at end 2016, with returns on assets at 1.4–1.8 percent. Funding is still dominated by domestic deposits, and net interest margins are improving on the back of recovering credit growth. Revaluation gains have run their course. Asset quality at one bank took a hit in Q1 2017. In the same quarter, three foreign funds and a U.S. investment bank acquired 29.1 percent of Arion Bank from the successor to the Kaupthing estate (in which they have a combined stake of about two thirds), with an option to take their stake in the bank to 51 percent ahead of an IPO this summer. The first leg of sales proceeds, amounting to just under 2 percent of GDP, flowed to the state as prepayment on a secured bond issued as part of Kaupthing's wind up. Net public debt fell accordingly, and reserves rose.

12. Housing prices have surged despite still moderate credit growth. Total credit to the private sector, including loans from pension funds which now account for about half of new mortgages, has been growing at close to 8 percent y/y. Despite the recent pick up in (mostly inflation indexed) mortgage lending, the ratio of household debt to GDP has fallen from a peak of some 120 percent in 2010 to below 80 percent in 2016. Housing prices climbed almost 10 percent in 2016,

Figure 7. Rates

Interest Rates and Exchange Rates

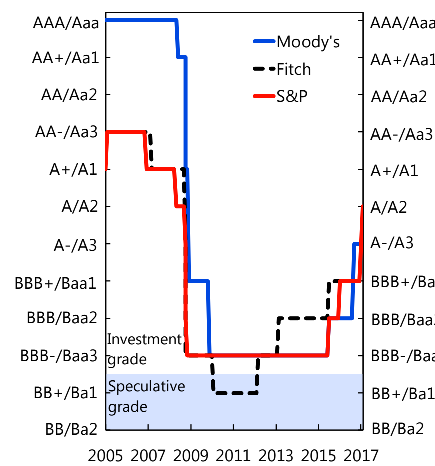
(Percent) (Index, 2010=100)



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

Figure 8. Sovereign Ratings

LT Foreign Currency Sovereign Rating

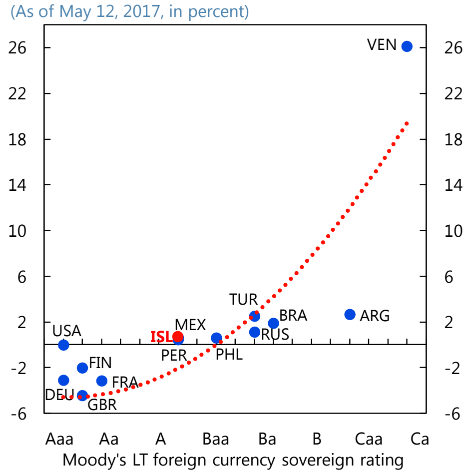


Source: Bloomberg Finance L.P.

Figure 9. Ratings and Spreads

Five Year Sovereign Dollar Spreads

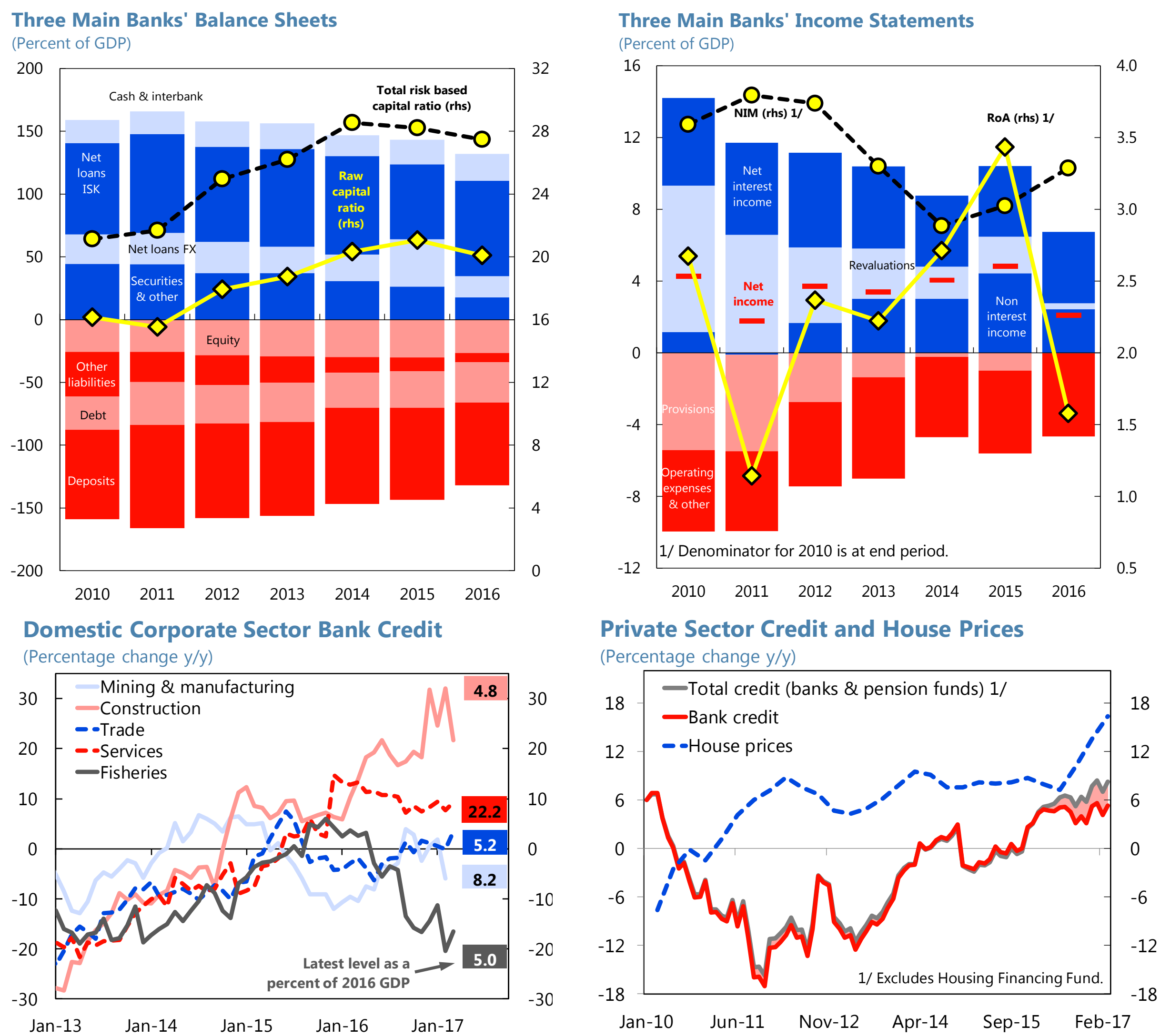
(As of May 12, 2017, in percent)



Source: Bloomberg Finance L.P.

centered on Reykjavík where the crowding out of homebuilding by hotel construction, and of rentals to residents by rentals to tourists, is most acute. A supply response appears to be kicking in, however, with residential investment expanding by 34 percent in 2016. For now, investment financing has a large element of retained earnings.

Figure 10. Bank Financials, Credit, and Housing



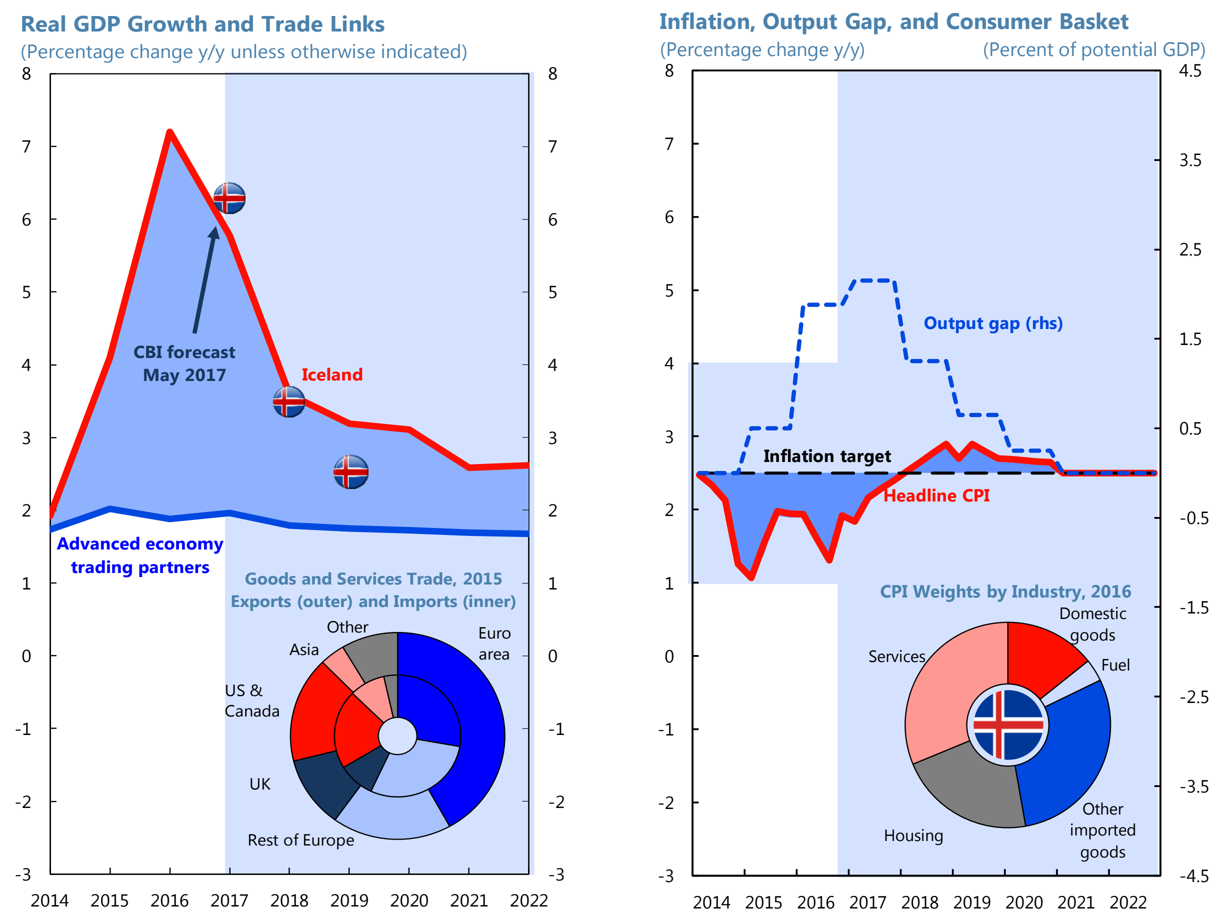
Sources: Central Bank of Iceland; Statistics Iceland; and IMF staff calculations.

13. Staff sees a positive but still limited output gap. Investment spurred by growing demand for tourism services boosts actual and potential output. Very strong growth, full employment, still brisk wage increases, the deteriorating merchandise trade balance, and firming house prices point to risks of overheating. But there are also mitigating factors: flexible labor supply, low inflation and falling inflation expectations, the large tourism driven current account surplus, and still moderate credit growth. Some bottlenecks, notably those linked to tourism infrastructure, may be more lasting. These are being buffered by the appreciation of the real exchange rate. Should wages accelerate again, however, that would point to greater cyclical pressures than currently estimated.

OUTLOOK AND RISKS

14. Staff's baseline assumes a smooth glide path for the economy. With bookings at Keflavík airport foreshadowing a 27 percent increase in foreign travelers in 2017, another year of unusually strong real GDP growth is expected. Staff sees this followed by a gentle convergence to a potential growth rate of around 2½ percent over the medium term. Inflation marginally exceeds target in 2018–19. This baseline builds on the authorities' current plans and frameworks. It embeds a continued tight monetary policy, and an easing fiscal impulse in 2017 followed by a correction in 2018–19. Other assumptions include slowing yet still strong tourism growth, a pause in lumpy spending on aircraft and ship purchases, and a further acceleration of housing construction.

Figure 11. Growth and Inflation



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

15. Staff continues to view Iceland's external position as broadly in line with fundamentals. The judgement that the external position remains broadly consistent with fundamentals and desirable policy settings hinges on the presumed permanence of the tourism boom. Evidence from other countries suggests tourism surges—unlike many nonrenewable commodity booms—tend to be durable (Annex II). If the shock is permanent, then it follows that the equilibrium exchange rate needs to find a higher level (Box 1).

Box 1. External Sector Assessment

The króna has risen fast and by a lot, yet the current account remains in large surplus. Iceland's nominal effective exchange rate appreciated by 18 percent in 2016, and its REER by 19 percent, to close to the pre crisis apex. An REER based on unit labor costs shows a similar pattern. Yet the current account is projected to remain strongly in surplus.

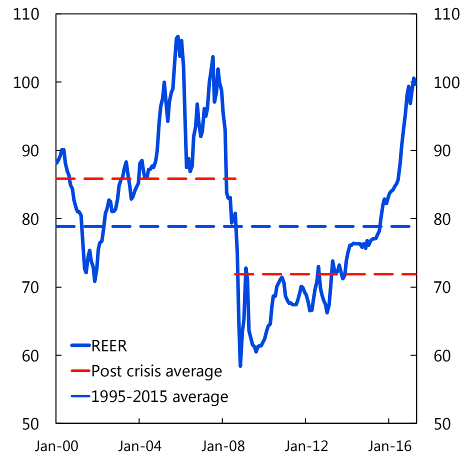
Arguably, Iceland's exchange rate is adjusting to a permanent shock. If the tourism shock is permanent, then it follows that the exchange rate needs to find a higher equilibrium level. Such adjustment will help guide tourism to a plateau, and output to its sustainable long-run growth path.

Iceland's external position was assessed to be broadly in line with fundamentals and desirable policies. Two "EBA-lite" methodologies are used. Both assume a current account to REER elasticity of one third, and both reflect staff's judgement that desired policy settings include a significantly positive medium-term full employment fiscal balance. The current account model indicates a current account norm of 6½ percent of GDP and thus a current account gap of +1½ percent of GDP relative to the actual surplus of 8 percent of GDP in 2016. With the tourism shock likely to be permanent, staff considers it appropriate to adjust the current account norm upward by some 1½ percent of GDP, implying a cyclically adjusted norm of close to 8 percent of GDP; this narrows the current account gap to +½ percent of GDP and yields an estimated undervaluation of 1½ percent. The REER approach, in contrast, points to overvaluation of 7 percent.

Iceland's external balance sheet has improved dramatically. With the bulk of the bank estates' external debts cleared in 2015–16, Iceland has become a net external creditor country. As detailed in the 2016 Article IV report, the wind ups of the bank estates involved large distributions of accumulated recoveries to nonresident claimants, and write offs, slashing external debt. The maturity structure of the remaining debt is comfortably long, with short-term debt comprising only about one tenth of the total at end 2016. Iceland's net international investment position is now positive for the first time since its measurement began. Given a projected current account surplus of 5–6 percent of GDP through 2022, it is expected grow more positive going forward.

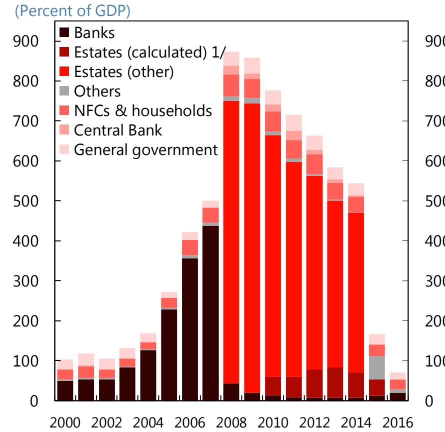
On balance, reflecting a judgement that the tourism shock is permanent, staff's overall assessment is that Iceland's external position remains broadly consistent with evolving fundamentals. If the tourism shock is permanent, then much of the recent króna appreciation must reflect a reassessment of its intrinsic value.

Real Effective Exchange Rate
(Index, Jan-2005=100)



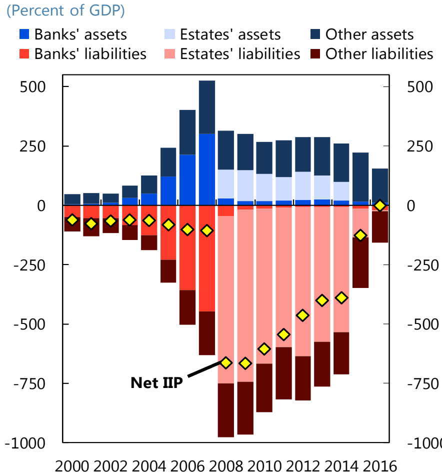
Sources: Central Bank of Iceland; and IMF staff calculations.

Gross External Debt
(Percent of GDP)



Sources: Central Bank of Iceland; IMF staff calculations.
1/ As used in past debt sustainability analyses; liquid assets apportioned to nonresidents claimants.

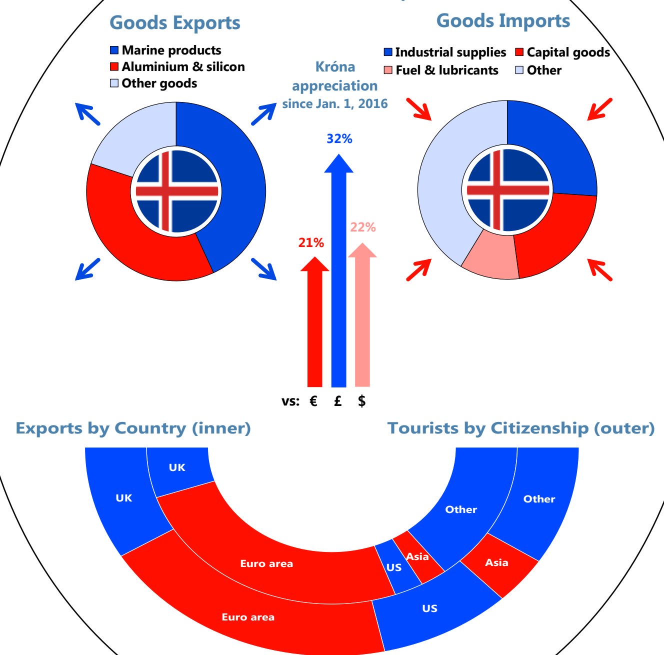
International Investment Position
(Percent of GDP)



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

16. Challenges posed by króna appreciation are significant, yet should be manageable for the largest export earners. Exports of knowledge intensive services from the so called innovation sector, which is an important provider of higher skilled jobs, are hit hard. Impacts are less pronounced for marine products, aluminum, and silicon, which together contribute over 70 percent of Iceland's goods exports. For fish, prices are set internationally, catch sizes closely match quotas, crew pay is linked to catch value, balance sheets of the large firms are strong after several good years, and recent fleet modernization underpins efficiency. For aluminum and silicon, import content is high and comparative advantage rests on Iceland's abundance of hydro and geothermal energy, which remain cost competitive despite appreciation.

Figure 12. The Face of Trade, 2016

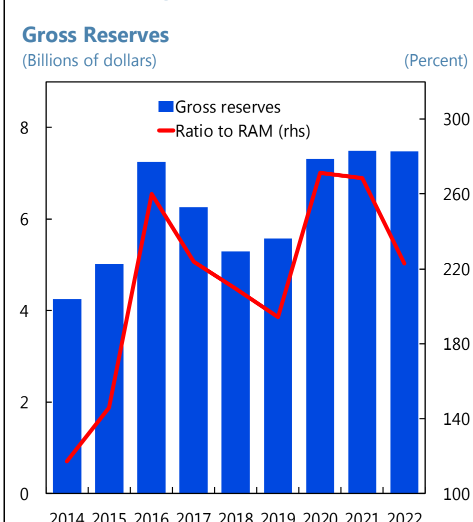


Sources: Central Bank of Iceland; Statistics Iceland; and IMF staff.

17. The current account is expected to remain in large surplus. The arrival from the Barents Sea of a vast and previously untracked shoal of capelin gave an early boost to the 2017 fish catch, while cod stocks at their strongest since at least 1985 suggest the bounty is set to continue. Weighing against this, however, is some softening of fish prices, notwithstanding long-run support from evolving world food tastes. In tourism, although there are no signs of Iceland losing its appeal, króna strength will create some drag, slowing exponential growth rates of arrivals and shortening stays. Goods imports should remain firm, linked to investment and consumption, enlarging the goods deficit.

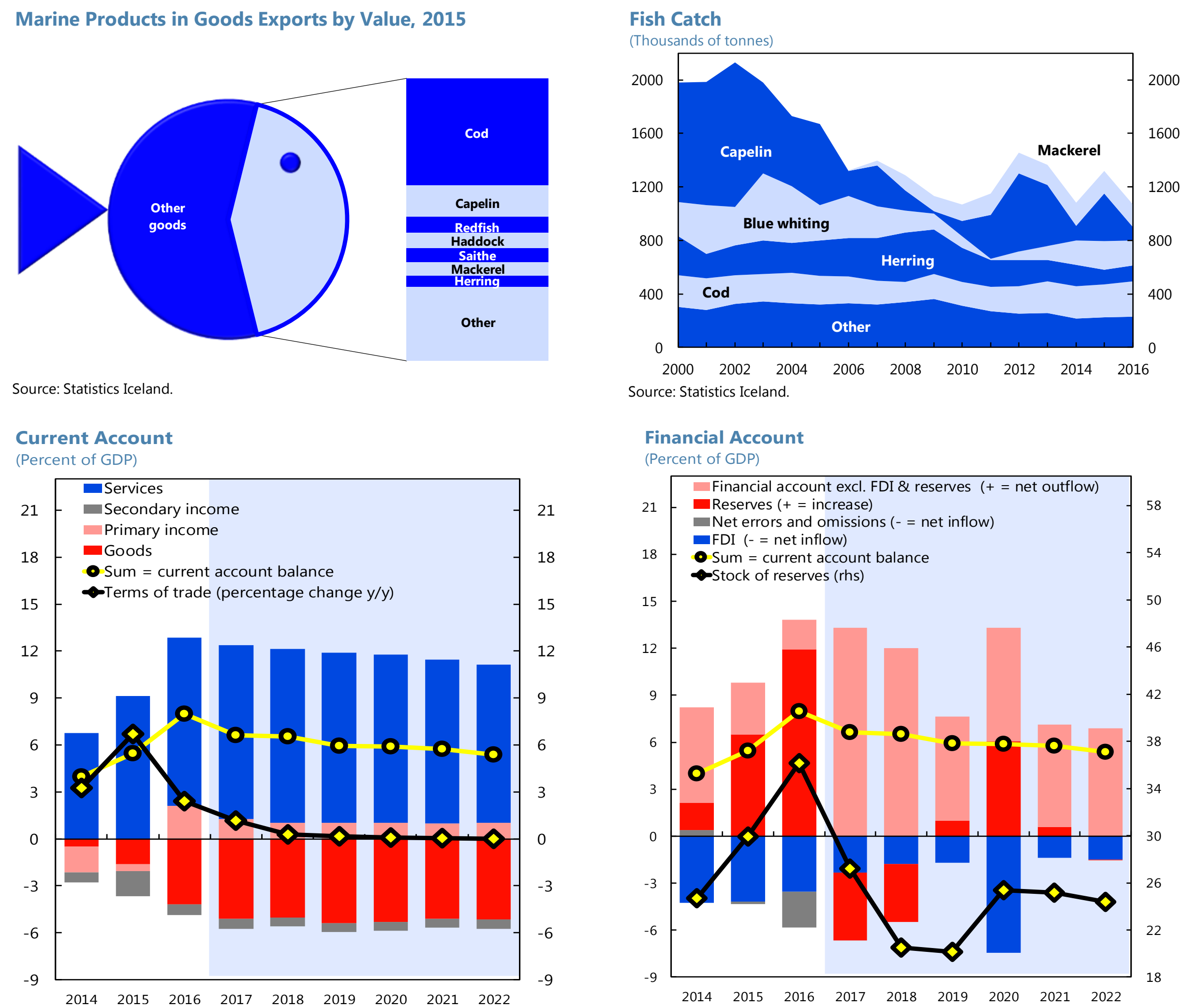
18. Reserves look to remain adequate. Foreign exchange reserve levels will reflect both capital flows and asset sales. Net annual outflows through the financial account (excluding changes in reserves and FDI) are put at about 6 percent of GDP, and net FDI inflows at perhaps 1½–2 percent. Added to these flows, however, are the assumed exit of the remaining offshore krónur in 2017–18, taking a big bite out of reserves; the assumed sale of Arion Bank to nonresidents in 2017, partly offsetting the drain; and the assumed sale of Íslandsbanki to foreign buyers in 2020—which would take reserves back above $7 billion.

Figure 13. Reserves



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

Figure 14. Fish and the Balance of Payments



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

19. Risks center on overheating and capital flows. If homebuilding continues to lag demand while mortgage lending gains pace, house price pressures could keep foreign workers away. This would cause labor market conditions to tighten. Another round of large wage increases, then, would tip the economy into overheating. A vicious and complex interplay could also develop between macroeconomic overheating and a carry trade, with excessive króna appreciation hurting competitiveness and a credit fueled asset boom (likely centered on real estate) turbocharging domestic demand and hurting bank soundness. Alternatively, policy mistakes or misstatements, or a global shock, could trigger capital outflows (Annex III).

20. Iceland also remains vulnerable to natural events. The risk of a volcanic *force majeure* is ever present. *In extremis*, impacts could be felt continents away—the eruption of Laki in 1783 is claimed as the most fatal eruption in human history, having caused famines worldwide. Not far from Reykjavík, the volcano Katla buried deep beneath Mýrdalsjökull glacier is recorded erupting every 13–95 years, yet is now at 99 years and counting. An eruption of Katla could eclipse that of nearby

Eyjafjallajökull in 2010—yet, ominously, every eruption of the latter in the last millennium has triggered a much larger eruption of Katla. Further from the capital, beneath Vatnajökull lurks Bárdarbunga, another restless giant. Vulcanology aside, the glaciers themselves are receding while, in the oceans, species come and go. The herring famously left in the 1960s. Mackerel arrived more recently. In nature as in economics and finance, Iceland is prone to shocks.

21. The authorities broadly share staff's views on the outlook and risks. After incorporating national accounts data for Q4 2016, CBI projections for 2017 were close to those of staff, with strong growth, a widening positive output gap, and inflation still below target. Like staff, the CBI expects soft import prices and a strengthening króna to contain inflation until a new wage round gets underway in 2018. The authorities agree that higher unit labor costs and currency appreciation will hurt the merchandise trade balance, causing the current account surplus to shrink over time. Consistent with staff's views, they too see overheating and capital flow volatility as the main risks. The latter, and fears of a new carry trade especially, inform their views on policy.

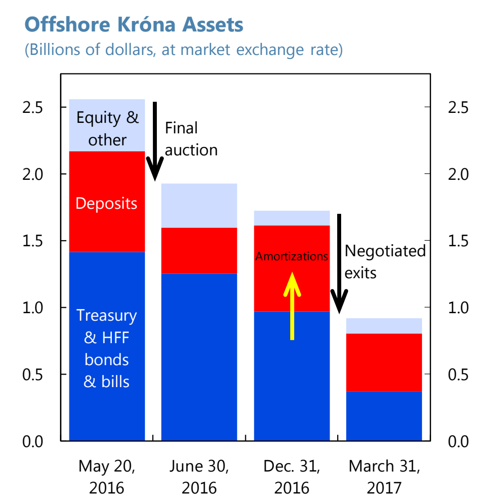
POLICIES

22. Staff stressed that Iceland's bold embrace of financial openness adds urgency to the need to improve financial sector oversight. Pointing to the Arion Bank transaction as a case in point, staff warned that opening the capital account without concomitant improvements in supervision can engender more risk taking in the system. It therefore urged that concrete steps to strengthen microprudential regulation and supervision be the top policy priority. Staff noted the need for deft macroeconomic management of strong demand conditions, where the right mix in the near term should include strict expenditure control—ideally to underspend relative to the 2017 budget—and, potentially, further rate cuts, if inflation developments so warrant. Macroprudential policies have an important role to play, targeted at specific financial stability risks. CFMs can be useful in some circumstances, but should not substitute for warranted macroeconomic adjustment.

A. Capital Controls

23. The recent lifting of capital controls seized an opportune moment. First, the economic omens were propitious, with output growing robustly, the tourism shock looking to be permanent, inflation low, and the current account in surplus. Second, the reserve dynamics were supportive, taking reserves to over 2 times RAM vs. a target ratio of perhaps around 1.5 as advised by staff last year. Third, the initial experience with lifting controls had been encouraging, with the major steps taken in October and January proving orderly.

Figure 15. Offshore Krónur



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

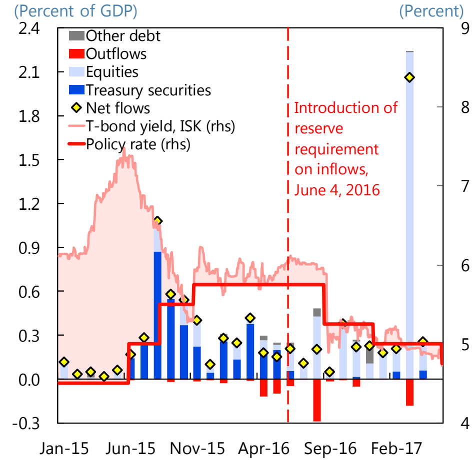
24. Staff saw the latest agreement with offshore króna holders as positive. One result has been the dropping by several large foreign investors of plans to pursue legal action against the state. The smaller foreign exchange premium paid by investors in 2017—20 percent, vs. 37 percent in 2016—reflects Iceland's improving economic conditions and reserve position. Staff advised that the approach to the remaining restricted offshore krónur, estimated to fall to about 3 percent of GDP as a result of the ongoing purchase operation, from 25 percent of GDP a few years ago, should continue to follow agreed high level principles: all steps to be transparent and well communicated; to be shaped by prevailing conditions and based on credible analysis; to give preference to nondiscriminatory measures where possible; and to emphasize a cooperative approach, with incentives.

25. Staff advised the reserve requirement on selected debt inflows be rolled back to zero. Absent an inflow surge, staff saw no compelling reason to activate the CFM last year. With lower nominal interest rates at home and global interest rates trending higher, it sees even less reason to keep the CFM in effect now. Based on the Fund's *Institutional View*, macroeconomic policies should play a leading role in managing challenges associated with capital flows, backed by strong microprudential oversight and macroprudential measures to limit systemic risks. Staff counseled that CFMs, if used, should be transparent, targeted, temporary, and preferably nondiscriminatory. Importantly, CFMs should not substitute for warranted macroeconomic adjustment—where at present staff assesses scope for tighter expenditure control this year, some further currency appreciation, possible additional interest rate cuts, and more reserve accumulation. Nonetheless, in the event of a future inflow surge, re-imposing a CFM could form part of a comprehensive policy response, provided the above conditions are met.

26. The authorities questioned staff's call to set the special reserve ratio to zero. In their view, the measure had (i) affected the size of inflows, not just their mix, thus helping prevent an upward overshoot of the króna and helping limit the growth of reserves and the attendant cost of carry; and (ii) restored the link between short- and long-term interest rates, repairing the domestic interest rate

Figure 16. Capital Flows and Yield Curves

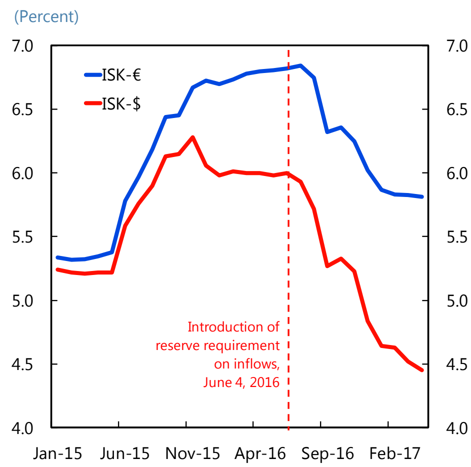
"Yellow Ticket" Flows and Interest Rates



Source: Central Bank of Iceland.

Figure 17. Rate Differentials

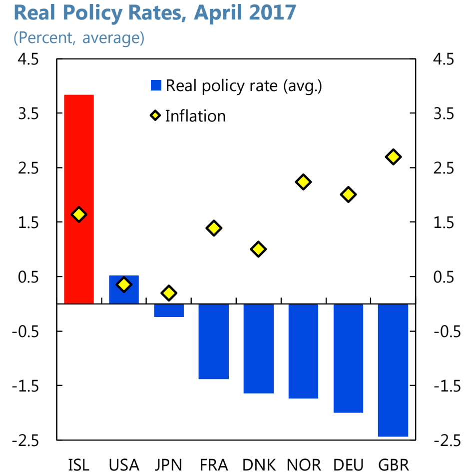
3 Month Interbank Rate Differentials



Sources: CBI, FRB, Tullett Prebon, and IMF staff.

Figure 18. Real Rates Compared

Real Policy Rates, April 2017



Sources: Haver Analytics; and IMF staff calculations.

channel of monetary policy. Fundamentally, they are convinced Iceland faces a "wall of money" waiting to flood in and that a new carry trade must be stopped at the gates. This, they stress, is an area of strong national consensus born of bitter experience. If Iceland's rate differential with the rest of the world continued to narrow, they would consider dialing back the CFM in small steps—although it was not clear to them that it had caused harm. More broadly, they expressed their intention to review the legal basis for the current CFM framework to ensure that they have the option to continue to use such instruments when deemed necessary.

B. Prudential Policies

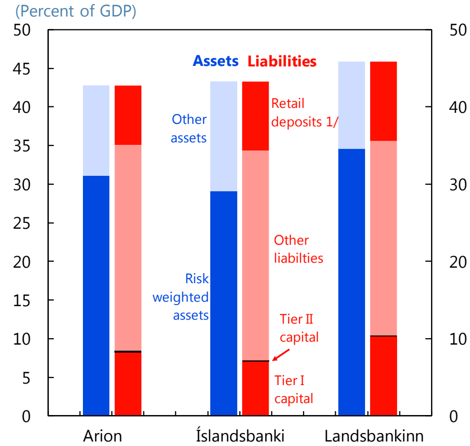
27. Staff warned that swift capital account opening without adequate strengthening of the prudential framework could spur excessive risk taking. Agreeing that the main banks appear sound at this time, it stressed that this can change fast. Together the three main banks hold some 6 percent of GDP in excess capital above their regulatory floors including combined buffers and pillar 2 requirements. More importantly, they are subject to a maximum net open foreign exchange ratio (set at 15 percent of capital) as well as minimum foreign currency liquidity coverage and net stable funding ratios (both set at 100 percent), and comfortably meet all of these. Their capital and liquidity cushions and relatively strong profitability serve as bulwarks against risk. Nonetheless, the removal of capital controls will fundamentally alter the operating environment.

28. The recent Arion Bank transaction is an example of the forces that will drive competition. The risk appetite of the foreign investors concerned is illustrated by their previous acquisitions, at distressed prices, of claims on the Kaupthing estate. Now, should they achieve management control over Arion, they could aggressively pursue dividends, divestments, and restructuring. More broadly, increasing competition for deposits will bid up funding costs in the system, incentivizing more risk taking. Capital inflows will tend to inflate banks' foreign currency liabilities, leading to larger

Figure 19. Bank Funding

Bank Balance Sheets, 2016

(Percent of GDP)

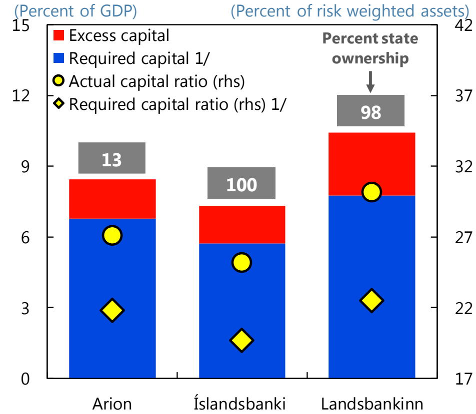


Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.
1/ Deposit balances of €100,000 or less.

Figure 20. Capital Adequacy

Total Regulatory Capital, 2016

(Percent of GDP) (Percent of risk weighted assets)

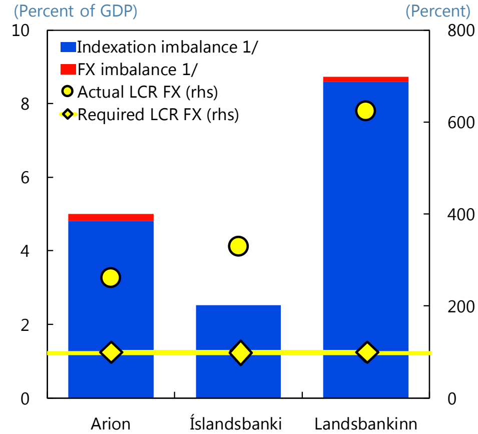


Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.
1/ Includes pillar 1 combined buffer requirements at March 2017 levels, plus pillar 2 requirements.

Figure 21. Currency Risk

Banking Sector Imbalances, 2016

(Percent of GDP) (Percent)



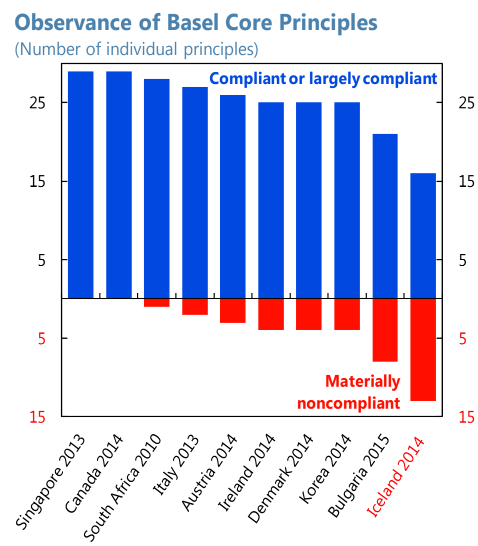
Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.
1/ Imbalances are assets less liabilities.

foreign currency exposures, including exposures abroad. Currency and credit risks will mount, with the latter potentially amplified by slipping underwriting standards.

29. As competition intensifies, policies to ensure high quality bank ownership will be critical. Privatization of the two state owned banks should be pursued patiently, with a focus on finding strategic buyers with track records of conservatism and a long-term commitment to Iceland. In all cases, the quality of new bank owners should take priority over transaction speed or price. The Arion transaction poses a test for Fjármálaeftirlitid (FME, the banking, securities, and insurance regulator), which must ensure its fit and proper assessments are stringent and evenhanded.

30. Improving financial sector oversight must be a top priority. Staff reminded that strong and nimble microprudential oversight is a basic building block to which macroprudential rules are a supplement not a substitute—and that this is doubly true in a system with three main banks. Iceland scored poorly in the 2014 assessment of its observance of the Basel Committee's *Core Principles for Effective Banking Supervision*, which found FME lacking teeth and independence. Although the partial adoption, subsequently, of the latest EU directives and regulations on bank regulation is positive, many of the lacunae identified in 2014 remain pertinent today. In particular, FME's lack of explicit and broad powers to issue binding rules hinders its ability to effectively implement risk based supervision. Yet the recommended review of the *Act on Official Supervision of Financial Activities,* which provides the legal basis for FME operations, continues to be delayed. Staff urged that completion of this review be placed high on the legislative agenda.

Figure 22. Supervisory Ratings



Source: IMF staff calculations.

31. Decisive progress requires an overhaul of the architecture. Staff urged that bold steps be taken to give bank regulation and supervision the requisite legal powers and independence. As before, it noted that the options are essentially two. One is to revamp the institutional arrangements governing the relationship between FME and the Ministry of Finance to ensure financial and operational independence. The other is to take safety and soundness oversight of banks out of FME and unify it with bank liquidity oversight at the CBI—a "twin peaks" reorganization. While either option could achieve the desired outcome, the second would also limit the potential for conflicts, gaps, or coordination issues and would amount to a significant streamlining well suited to a country as small as Iceland. Staff continues to view as unhelpful the division of responsibility between the CBI and FME on liquidity oversight given the inextricable links between bank liquidity and solvency.

32. Staff also emphasized macroprudential readiness. With pension funds originating about half of new mortgages by value, it is good that powers under the new *Act on Mortgage Lending*—to cap loan to value, debt to income, and debt service to income ratios—apply to banks and nonbanks alike. Staff supported fast tracking the bill proposing to grant the CBI powers to limit foreign currency lending to unhedged borrowers, and asked about options to limit inflation indexation of mortgages. It welcomed changes to the *Pension Fund Act* affecting investment allocations and risk management, yet urged a broader review of the regulatory framework for pension funds, including consideration of activity restrictions to proscribe lending. Such steps, by discouraging excessive risk taking at home, could have the added benefit of encouraging more investment abroad.

33. Other priorities include a stronger bank safety net. The government withdrew its crisis era blanket guarantee in September 2016, leaving deposits insured to €20,887 per head under a nongovernment scheme, while the planned transposition of the EU *Bank Recovery and Resolution Directive* has slipped. Reform elements should include adopting the EU guarantee limit of €100,000—which would create an insured deposit base worth some 40 percent of GDP—clarifying emergency backstops, and ensuring the deposit insurance fund is available to help finance bank resolutions. The resolution statute needs to include early intervention powers, authority to replace bank management and abrogate contracts, and the full range of resolution tools.

34. The authorities agreed with staff on the importance of improving financial sector oversight. They stressed the current system is far better than that before the crisis, with strong foreign currency liquidity requirements, a Financial Stability Council, and a Systemic Risk Committee. They noted, however, that the new arrangements have not yet been tested, may be overly reliant on personalities, and may embed an inaction bias. They observed that some members of parliament supported reforming the system, including to unify banking oversight at the CBI, while others felt the central bank is already powerful enough. Importantly, the government has decided to conduct a review of all recommendations on financial sector regulation and supervision, including those that have emerged from several independent reviews over the years.

35. In addition, they underscored recent progress in both legislative and process reforms. FME emphasized 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 the supervisory review and evaluation process, authority to impose a leverage ratio, and definitions of related parties and regulatory capital. It hopes the *Bank Recovery and Resolution Directive* can be transposed before end 2017. While welcoming staff's advice to review options for reorganizing the institutional architecture, FME expressed reservations about separating oversight of banks from that of funds, markets, and insurance. Keeping oversight of all financial intermediaries under one roof, it argued, offered synergies that would not be available under a twin peaks structure.

C. Monetary and Exchange Rate Policy

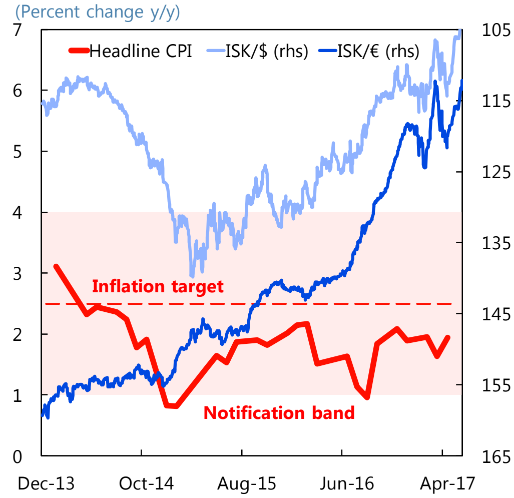
36. Staff advised that monetary policy settings should remain squarely focused on inflation prospects. Credibility gains are best locked in by keeping inflation expectations tightly anchored. With inflation projected to climb a little as the effects of wage growth and domestic demand feed through, staff's baseline embeds a continued tight monetary policy stance. Yet some policy makers have argued lower interest rates at home could helpfully incentivize residents to invest more abroad. Others have hypothesized about a falling natural rate notwithstanding the tourism boom. Staff advocated maintaining a tight posture while standing ready to ease as inflation developments permit, especially if fiscal policy settings are also tightened as recommended. Should large capital outflows occur, causing depreciation and tending to raise inflation, rate hikes may be needed. Conversely, should capital inflows dominate, driving the króna up and inflation down, additional interest rate cuts could be warranted.

37. Staff favored less exchange market intervention and development of an intervention policy consistent with the inflation targeting framework. Capital flows are the big uncertainty, and can buffet the exchange rate. The CBI intervened heavily in 2016 to contain what it saw as a serious risk of an upward overshoot of the króna ahead of capital account liberalization, soaking up some 50–70 percent of gross market turnover. Given improved reserve coverage, staff recommended intervention be more sparing going forward, allowing appreciation to play out, including as a dampener of inflation. As it gains experience with the open capital account, the CBI should develop and communicate an intervention policy consistent with the inflation targeting framework. This should emphasize that there is no exchange rate objective, nor any preconceived maximum tolerance for short-term volatility. It should also clarify that in the event of depreciation pressure reserve drawdowns will be limited to countering disorderly market conditions.

Figure 23. Rates

Inflation and Exchange Rates

(Percent change y/y)

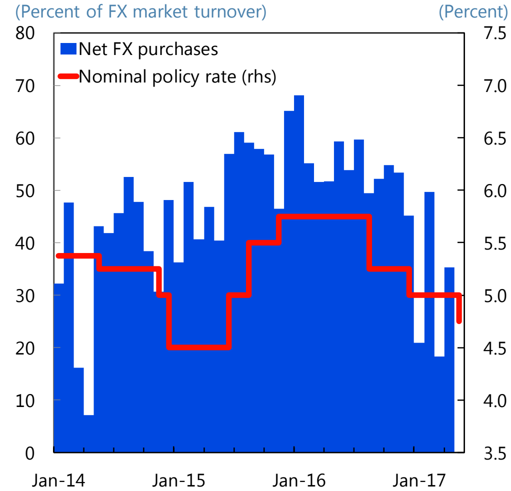


Sources: Central Bank of Iceland; and Statistics Iceland.

Figure 24. Instruments

FX Intervention and Policy Rate

(Percent of FX market turnover) (Percent)



Source: Central Bank of Iceland.

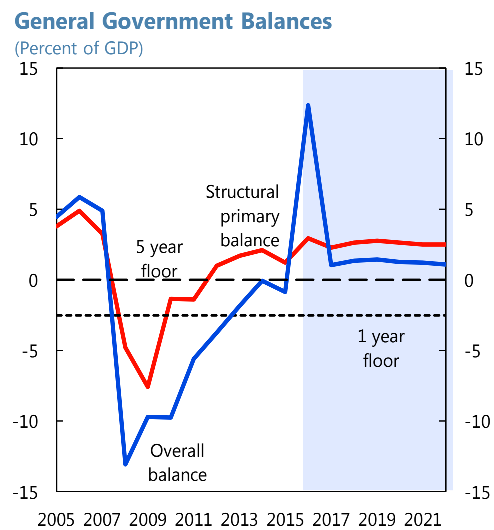
38. Staff felt monetary operations would benefit from the introduction of a fine tuning instrument. At present, the CBI relies on tap facilities to manage domestic liquidity, setting the rates on its term deposit windows without directly controlling quantities and systemic liquidity. Enhancements to the toolkit could include swapping some part of the CBI's foreign currency reserves with the Ministry of Finance for treasury bills, which the CBI could then use outright or in repurchase operations. This would strengthen the CBI's capacity to sterilize its foreign exchange interventions and smooth base money. Having a portfolio of treasury bills would also improve the CBI's income position. Last but not least, effective liquidity management would benefit from enhanced information sharing on government cash flows.

39. The authorities agreed with staff's advice on monetary policy. They concurred that policy settings should focus on meeting the inflation target over the medium term and desist from seeking to influence the exchange rate. Movements of the króna, however, are an important consideration in rate setting decisions, given the strong pass through to domestic prices. Should appreciation continue, further dampening inflation prospects, there may indeed be grounds for more rate cuts, continuing the process of narrowing Iceland's interest rate differential with the rest of the world. Regarding monetary operations, they accepted the need for a fine tuning instrument to improve domestic liquidity management, where they agreed to reflect on staff's proposal to swap some reserves for treasury bills—this would also help offset the cost of carry on reserves. They agreed króna appreciation thus far has been benign, linked to tourism. Nonetheless, they worried the exchange rate could overshoot, causing permanent damage to important export sectors.

D. Fiscal Policy

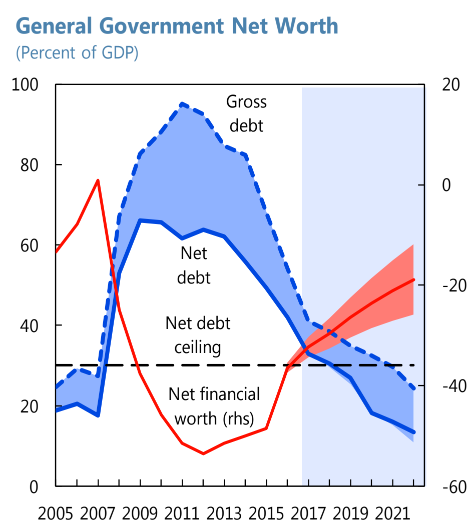
40. Staff took the view that fiscal policy is generally best left to follow the new rules. It is no small victory that the Organic Budget Law has shaped the contours of the fiscal debate through a general election. Staff supports prioritizing expenditure on infrastructure (including tourism infrastructure), health, and education, provided spending increases are responsibly financed. Tax reforms could be considered if needed, ideally to raise indirect taxes such as value added tax (VAT) and taxes on property and natural resources. Staff's position is that Iceland's fiscal policy should target a significantly sized structural primary surplus and otherwise is best not disrupted by fine tuning it to demand developments. Nonetheless, fiscal policy should be used if a recession is threatening or, conversely, to address serious overheating risks, as part of a broader suite of policies.

Figure 25. Net Borrowing



Sources: Statistics Iceland; and IMF staff calculations.

Figure 26. Public Debt



Sources: Statistics Iceland; and IMF staff calculations.

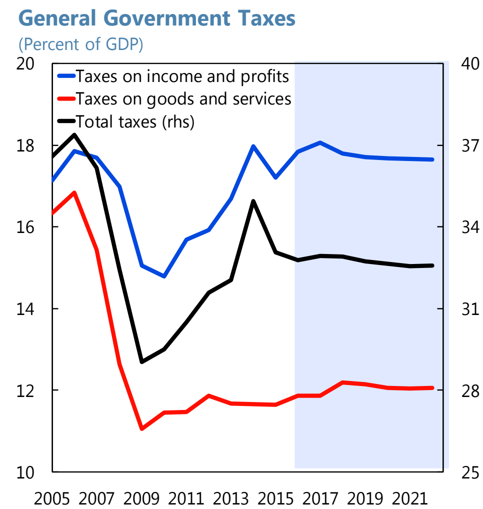
41. Staff welcomed the 2016 public sector pension reform. The authorities secured parliamentary approval for this just before Christmas, while coalition talks were still ongoing. By doing so, they seized a one time opportunity afforded by the roughly 16 percent of GDP of budget receipts from the bank estates to put the public sector pension system on a firmer footing while still respecting the new fiscal rules (Annex IV).

42. Noting that the expansionary budget for 2017 is ill timed given the strong cyclical position of the economy, staff urged strict execution. Passed by the new Althing in December in advance of government formation, the budget targets a central government surplus of about 1 percent of GDP. Staff's baseline projections assume modest slippages on certain categories of central government spending, including procurement. The general government structural primary surplus is thus projected to be slightly smaller than in 2016, implying a modestly expansionary impulse in 2017, with real primary spending growing at an excessively rapid 6½ percent. Noting that this is ill timed, staff urged strict containment of expenditures during the year, ideally to result in significant underspending relative to budget.

43. Looking to the medium term, staff saw the public debt trajectory as appropriately ambitious, and cautiously welcomed tax reform plans. In January this year, the new government presented its Statement of Fiscal Policy to the Althing, following up with its Fiscal Strategy Plan at end March. The Plan calls for a general government overall surplus of 1.3–1.6 percent of GDP over the period 2018–22. Total expenditure is not to exceed 41½ percent of GDP in any year, and all irregular revenues are to go toward retiring gross debt. The Plan also calls for more indirect taxation of the tourism sector, to kick in in mid 2018 (Annex V). Staff cautiously welcomed the tax proposals, which generally follow technical assistance advice from 2014, while advising that the effects on tourism activity be tracked closely. Factoring in the authorities' estimated revenue impacts from the tax measures, staff projects net public debt falling below 30 percent of GDP by 2019.

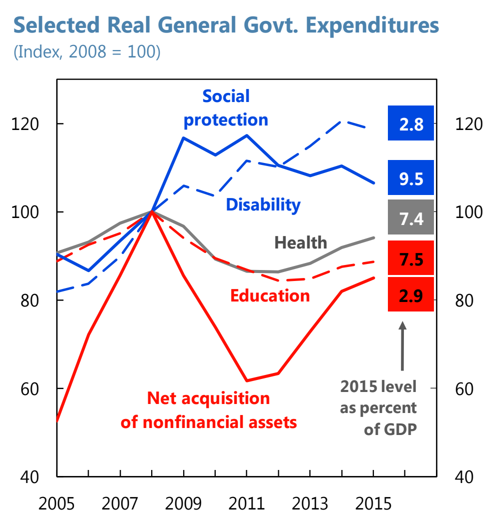
44. Staff mooted that available fiscal space in the outer years could be used to promote additional growth enhancing spending. Informed by a comprehensive review of expenditures, reforms could include further decompressing education, healthcare, and capital outlays while rationalizing spending on social protection. In making this proposal, staff effectively questioned whether fiscal consolidation and debt reduction needed to continue after the net debt ceiling is met, or whether space available under the rules would be best used to support well chosen expenditure priorities.

Figure 27. Tax Revenue



Sources: Statistics Iceland; and IMF staff calculations.

Figure 28. Spending



Sources: Statistics Iceland; and IMF staff calculations.

45. Staff also sought to better understand the authorities' thinking on a sovereign wealth fund. Reflecting the current government's strong emphasis on fiscal rectitude, in February 2017 an expert group was formed and tasked with drafting a bill for the establishment of a stability fund. The intention, in the first instance, is to channel into such a fund upcoming dividends from Landsvirkjun, the national power company. These dividends are expected to commence at some ½ percent of

GDP next year, rising steadily to 1 percent of GDP by 2022. Staff noted that it was critical to be clear about the objective, design, and investment strategy of the fund.

46. The authorities broadly agreed with staff on fiscal policy. They regretted what they viewed as excessive expenditure growth in the 2017 budget, and agreed forceful budget execution was critical. Looking beyond this year, they reiterated their resolve to meet the net debt ceiling and maintain firm control over expenditures over the medium term. Regarding staff's proposal to consider significant additional expenditures in the outer years, they felt the main political challenge was to manage expectations. On the stability fund, the early thinking is to have a *force majeure* fund given Iceland's history of natural cataclysms. More broadly, the authorities emphasized that all structural changes must be shaped by a good sense for the pulse of parliament, and must enjoy bipartisan support, to be able to weather changes of government.

E. Wage Bargaining and Tourism

47. Staff supported ongoing efforts to revamp the wage bargaining framework. Social partners have outlined an "Icelandic model" featuring specific wage bargaining rules anchored on competitiveness and designed to promote economic stability. Resolve from both the social partners and the authorities is needed to kick start implementation during the 2018 wage round. If successful, this will be a landmark for Iceland's collective wage agreement process.

48. Staff also recommended developing a holistic tourism strategy. The rapid increase in tourist arrivals has placed a burden on infrastructure, public services, and the environment. There is a need, therefore, for ownership and coordination at the political level, channeling into an overarching strategy for the sector. The objective should be to ensure adequate resources and coordination across all agencies to ensure Iceland is able to sustainably reap the benefits of tourism.

49. The authorities welcomed staff's inputs on structural issues. They agreed with staff that revamping the wage bargaining framework is critical. They expect that the new wage bargaining rules, anchored on competitiveness and outlined by social partners in the so called SALEK agreement, will now be put to the test in the 2018 wage round. The authorities also recognized the need for a more comprehensive government strategy for the tourism sector.

STAFF APPRAISAL

50. Iceland is doing well. Growth is firm, inflation low, credit expansion moderate, and the current account in surplus. Reserves are comfortable, and the recent agreement with large holders of offshore krónur reduces risks. Conditional on strong financial sector oversight, capital account openness should over time result in a healthy two-way cross border flow of funds.

51. Capital account opening heralds a new era of greater risk taking. Capital flows will bring risks as well as opportunities. Volatility will increase. Banking, in particular, will be transformed, with sleepy market conditions giving way to fierce competition. This, in turn, could test financial stability. The recent acquisition of Arion Bank is an example of the forces that will drive competition.

52. The top priority must be to strengthen financial sector oversight. Bold steps are needed to give bank regulation and supervision strong powers and independence. On balance, the best solution is to unify all safety and soundness oversight of banks at the central bank, leaving conduct of business oversight and regulation of nonbanks at another body—the so called "twin peaks" approach. Currently, FME is not sufficiently insulated from the political process, and the sharing of aspects of banking oversight between FME and the CBI creates a potential for conflicts, gaps, and coordination issues. Fixing these problems will require amending the *Act on Official Supervision of Financial Activities*. This should be high on the legislative agenda.

53. Policies to ensure high quality bank ownership are very important. Privatization of the two state owned banks should be pursued patiently, with a focus on finding strategic buyers with track records of conservatism and a long-term commitment to Iceland. In all cases, the quality of new bank owners should take priority over transaction speed or price. The recent purchase of Arion Bank poses a test for FME, which must ensure that the mandatory fit and proper assessments are—and are seen to be—thorough, uncompromising, and evenhanded.

54. The real economy, meanwhile, is being reshaped by tourism. Fundamentally, this is a positive development. Job opportunities in services and construction have multiplied, pulling in foreign workers. This, together with króna appreciation, strong terms of trade, and prudent monetary policy, has kept inflation below target despite the large wage awards of 2015. Evidence from elsewhere suggests the tourists are not about to swim away abruptly.

55. The external position is judged to be broadly in line with underlying fundamentals and policies. If the tourism shock is permanent, then the equilibrium real exchange rate needs to find a higher level. This explains the apparent paradox of 20 percent króna appreciation and a current account surplus of 8 percent of GDP last year. Appreciation is a dampening mechanism, helping to guide the economy to a more sustainable growth path. There will be challenges for some export sectors, including the innovation sector. Fishing may see some industry consolidation, with continued success resting on embracing the best technologies. The lagged impact of króna appreciation, together with slipping terms of trade, will gradually erode the external surplus.

56. Housing pressures could tip the economy into overheating. Mortgage lending, while still moderate, is picking up, calling for vigilance. Macroprudential tools should address this if needed, and should include new powers to limit foreign currency lending to unhedged borrowers and, potentially, to prohibit lending by pension funds. Construction could keep lagging demand, pushing housing prices higher. If rising living costs kept foreign workers away, labor market conditions would heat up. Another round of large wage increases would compound domestic demand pressures.

57. Further interest rate cuts are not necessarily inconsistent with keeping inflation close to target. The CBI has maintained a tight monetary policy stance and should on balance continue to do so given demand pressures and procyclical fiscal policy this year. At the same time, indications are that upward pressure on the króna could persist. To the extent króna appreciation drives inflation prospects lower, and especially if fiscal policy can be restrained this year, there may be room for additional rate cuts. A capital outflow scenario is also possible, especially if policy missteps or misstatements trigger a loss of confidence. In such a scenario, the policy rate could need to rise.

58. The inflation targeting framework is delivering positive results. Inflation has been low for three years and inflation expectations have converged to target. Credibility of the framework could be further enhanced by developing and communicating an intervention policy eschewing any exchange rate objective and focused on managing disorderly market conditions. Monetary operations would benefit from the introduction of a fine tuning instrument to better sterilize foreign exchange interventions. Placing a portfolio of treasury bills at the central bank for use in outright sales or as collateral seems a promising option. Effective liquidity management also requires enhanced information sharing on government cash flows.

59. Strict expenditure control is needed to deliver a tighter than budgeted fiscal stance this year. The new government's Fiscal Statement embodies prudence, with net public debt set to fall below 30 percent of GDP even without privatization. In contrast, the budget for 2017 approves too much spending in a year when the cyclical position of the economy is again expected to again be very strong. Outlays must be financed responsibly, and fiscal policy should stand ready to tighten if serious overheating risks materialize. The proposal to increase VAT on tourism embraces past Fund advice. Later in the planning horizon, there may be room for significantly more spending on infrastructure, health, and education, guided by a comprehensive review of expenditures.

60. Capital flow surges may be difficult to manage. Microprudential oversight must prevent excessive risk taking by banks, at home or abroad. Macroprudential policies should be deployed as needed to minimize systemic risks. CFMs can be useful in certain circumstances, but should not substitute for warranted macroeconomic adjustment—which can include tighter expenditure control, some further currency appreciation, possible additional interest rate cuts, and more reserve accumulation. This leeway, and the absence of any obvious link between capital flows and systemic risks currently, suggests the special reserve requirement on debt inflows is not needed at this time.

61. Structural reforms should seek to protect competitiveness and nurture sustainable tourism. Work to revamp wage bargaining must continue. Social partners, having outlined a new model anchored on competitiveness, should focus on implementation in the 2018 wage round. Equally, a holistic tourism strategy should be developed. The growth of tourism has stretched infrastructure and public services. It may be beneficial to establish a high level body tasked with coordinating licensing rules, infrastructure development, and environmental protection.

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

Table 1. Iceland: Selected Economic Indicators, 2013–22

	2013	2014	2015	2016	2017 Proj	2018 Proj	2019 Proj	2020 Proj	2021 Proj	2022 Proj
					(Percentage change unless otherwise indicated)					
National Accounts (constant prices)										
Gross domestic product	4.4	1.9	4.1	7.2	5.8	3.6	3.2	3.1	2.6	2.6
Total domestic demand	0.7	5.2	5.9	8.7	6.4	3.3	3.8	3.1	2.7	3.1
Private consumption	1.0	2.9	4.3	6.9	6.4	4.6	3.8	3.2	3.1	3.0
Public consumption	1.0	1.7	1.0	1.5	1.3	1.3	1.4	1.5	1.5	1.5
Gross fixed investment	2.2	16.0	17.8	22.7	9.9	2.5	6.4	4.7	3.0	5.0
Net exports (contribution to growth)	2.7	-1.6	-0.4	-0.2	0.0	0.6	-0.3	0.2	0.1	-0.2
Exports of goods and services	6.7	3.2	9.2	11.1	6.9	4.4	3.2	2.4	1.6	1.8
Imports of goods and services	0.1	9.8	13.5	14.7	8.6	3.8	4.7	2.4	1.7	2.8
Output gap (percent of potential output)	-0.4	0.0	0.5	1.9	2.2	1.3	0.7	0.3	0.0	0.0
Selected Indicators										
Gross domestic product (ISK bn.)	1,891	2,006	2,214	2,422	2,632	2,820	3,001	3,188	3,366	3,555
Gross domestic product ($ bn.)	15.5	17.2	16.8	20.0	23.0	25.8	27.6	28.8	29.7	30.7
GDP per capita ($ thousands)	47.5	52.2	50.5	59.6	67.6	75.1	79.5	81.9	83.6	85.3
Private consumption (percent of GDP)	52.3	52.2	49.8	49.0	49.1	49.2	49.3	49.2	49.2	49.2
Public consumption (percent of GDP)	24.3	24.2	23.6	23.1	23.1	23.2	23.0	22.9	22.9	22.8
Gross fixed investment (percent of GDP)	15.7	17.2	18.9	21.2	21.9	21.5	22.2	22.5	22.5	22.9
Gross national saving (percent of GDP)	21.5	21.3	24.6	29.3	28.5	28.1	28.1	28.4	28.3	28.3
Unemployment rate (percent of labor force)	5.4	5.0	4.0	3.0	3.0	3.3	3.6	3.9	4.0	4.0
Employment	3.3	1.6	3.4	3.7	3.3	2.4	2.0	1.4	1.1	1.0
Labor productivity	0.6	0.0	0.8	3.5	2.5	1.2	1.1	1.7	1.5	1.6
Real wages	0.9	1.9	6.2	8.1	3.7	2.6	2.1	1.8	1.8	1.6
Nominal wages	4.8	4.0	7.9	10.1	5.9	5.3	4.8	4.5	4.3	4.2
Consumer price index (average)	3.9	2.0	1.6	1.7	2.2	2.7	2.8	2.7	2.5	2.5
Consumer price index (end period)	4.2	0.8	2.0	1.9	2.4	2.9	2.7	2.6	2.5	2.5
ISK/€ (average)	162	155	146	134	...	...	...	...	...	...
ISK/$ (average)	122	117	132	121	...	...	...	...	...	...
Terms of trade (average)	-1.9	3.3	6.7	2.4	1.2	0.3	0.2	0.1	0.1	0.0
Money and Credit (end period)										
Base money (M0)	0.3	-17.6	27.8	3.0	8.7	7.3	12.8	4.2	4.6	5.7
Broad money (M3)	4.5	7.1	5.6	-4.6	7.8	7.5	7.2	6.3	5.5	5.6
Bank credit to nonfinancial private sector	-3.2	-2.4	3.5	4.3	4.8	6.1	6.4	6.2	5.6	5.6
Central bank 7 day term deposit rate 1/	5.75	4.50	5.75	5.00	4.75	...	...	...	...	...
					(Percent of GDP unless otherwise indicated)					
General Government Finances 2/										
Revenue	42.1	45.2	42.0	58.4	41.6	41.8	41.7	41.5	41.2	41.1
Expenditure	43.9	45.3	42.9	46.1	40.6	40.4	40.2	40.2	40.0	40.0
Overall balance	-1.8	-0.1	-0.8	12.4	1.0	1.4	1.4	1.3	1.2	1.1
Structural primary balance	1.7	2.1	1.2	2.9	2.3	2.7	2.8	2.6	2.5	2.5
Gross debt	84.7	82.4	68.1	54.0	41.1	38.5	34.9	32.5	29.6	24.3
Net debt	62.2	55.8	49.3	41.9	32.9	30.4	26.9	18.2	16.0	13.5
Balance of Payments										
Current account balance 3/	6.0	4.0	5.5	8.0	6.6	6.5	5.9	5.9	5.8	5.4
of which: services balance	7.5	6.8	9.1	10.7	11.1	11.1	10.9	10.7	10.4	10.1
Capital and financial account (+ = outflow)	7.0	3.5	5.5	10.1	6.5	6.4	5.8	5.7	5.6	5.2
of which: direct investment, net (+ = outflow)	0.3	-4.3	-4.2	-3.6	-2.3	-1.8	-1.7	-7.4	-1.4	-1.5
Gross external debt 4/	248.7	205.5	180.0	125.1	114.9	102.0	96.1	92.6	91.0	83.9
Central bank reserves ($ bn.)	4.1	4.2	5.0	7.2	6.2	5.3	5.6	7.3	7.5	7.5

Sources: Central Bank of Iceland; Ministry of Finance; Statistics Iceland; and IMF staff projections.
1/ For 2017, rate as of May 25.
2/ Data for 2016 are preliminary.
3/ Actual data include accrued interest payments on intracompany debt held by a large multinational; projected data do not.
4/ Data for 2013–14 use fund staff's calculated measure for the external debt of the bank estates; data from 2015 onward reflect the impact of the estates' compositions.

Table 2. Iceland: Money and Banking, 2013–22
(Billions of krónur, unless otherwise indicated)

	2013	2014	2015	2016	2017 Proj	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.
Central Bank										
Net foreign assets	-30	47	295	586	546	436	458	452	475	566
Assets	488	530	653	816	713	616	650	857	885	902
Liabilities	517	483	358	230	167	180	192	405	410	336
of which: central government foreign currency deposits	315	368	301	185	122	134	147	360	365	290
of which: bank estates' foreign currrency deposits	23	24	18	0	0	0	0	0	0	0
Net domestic assets	128	34	-191	-478	-429	-311	-317	-305	-321	-404
Central government, net	89	7	7	-28	-43	-43	-43	-43	-43	-43
Assets	180	153	98	41	12	12	12	12	12	12
of which: recapitalization bond	172	146	91	29	0	0	0	0	0	0
Liabilities (current account)	90	146	91	69	55	55	55	55	55	55
Credit institutions (incl. nonbanks), net	-95	-82	-216	-407	-340	-215	-227	-221	-244	-335
Assets	56	59	58	2	30	45	55	55	55	55
Liabilities	151	142	274	410	370	260	282	276	299	390
of which: term deposits and CDs	133	106	242	339	299	190	211	205	228	319
Others items, net	134	109	17	-42	-47	-53	-47	-41	-34	-26
ESI (asset management company)	276	210	127	31	16	0	0	0	0	0
Capital	90	75	79	40	28	20	14	7	0	-9
Base Money	99	81	104	107	116	125	141	147	154	162
Currency issued	47	50	56	62	68	79	98	105	110	116
Deposit money banks' deposits at the central bank	52	31	48	45	48	46	43	41	44	46
Deposit Money Banks										
Net foreign assets	294	244	66	-257	-233	-231	-229	-224	-221	-215
Assets	438	395	349	251	275	278	279	285	287	293
Liabilities	144	151	283	508	508	508	508	508	508	508
of which: bonds	18	37	175	406	406	406	406	406	406	406
Net domestic assets	1,189	1,344	1,608	1,846	1,944	2,063	2,179	2,296	2,409	2,526
Central bank, net	131	82	238	385	321	194	202	195	220	314
Assets	184	139	295	385	348	237	255	248	273	367
Liabilities	54	57	56	0	28	43	53	53	53	53
General government, gross	227	237	231	184	138	151	146	140	139	120
of which: bonds	213	217	210	164	118	131	126	120	119	101
Private sector, gross	2,275	2,192	2,217	2,285	2,389	2,530	2,688	2,850	3,006	3,170
Nonfinancial	2,022	1,973	2,043	2,131	2,233	2,370	2,522	2,679	2,830	2,990
Corporations	1,157	1,079	1,128	1,172	1,224	1,295	1,378	1,467	1,547	1,632
Households	865	894	915	959	1,009	1,074	1,144	1,213	1,283	1,357
Financial	253	219	174	154	156	161	165	170	176	181
Other items, net	-1,444	-1,168	-1,078	-1,008	-904	-813	-857	-890	-956	-1,079
Domestic deposits	1,483	1,588	1,674	1,589	1,711	1,833	1,950	2,072	2,188	2,310
Krona deposits	1,180	1,295	1,393	1,449	1,560	1,672	1,779	1,890	1,995	2,107
Foreign currency deposits	303	293	281	140	150	161	171	182	192	203
Consolidated Banking System										
Net foreign assets	264	291	361	329	312	206	229	228	253	351
Net domestic assets	1,260	1,341	1,362	1,316	1,459	1,699	1,812	1,942	2,037	2,069
General government, net	317	245	238	156	95	108	103	97	96	77
Private sector, gross	2,275	2,192	2,217	2,285	2,389	2,530	2,688	2,850	3,006	3,170
Other items, net	-1,331	-1,096	-1,093	-1,125	-1,025	-940	-979	-1,005	-1,065	-1,179
Broad money	1,524	1,632	1,723	1,644	1,772	1,904	2,041	2,170	2,290	2,419
of which: currency in circulation	42	44	49	55	61	72	91	98	103	109
Memorandum item:										
Bank estates' deposits at deposit money banks 1/	0	230	205	6	6	6	6	6	6	6

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, 2014–16 1/

(Percent)

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Regulatory capital to risk-weighted assets 2/	25.6	27.0	27.1	28.4	26.3	26.5	27.3	28.2	29.3	28.5	27.7	27.5
Regulatory tier 1 capital to risk-weighted assets 2/	23.3	24.9	25.0	26.1	24.6	25.3	26.1	27.4	28.5	27.6	27.5	27.0
Net interest margin 2/	3.0	3.1	3.0	2.6	2.8	3.4	3.3	2.9	3.0	3.5	3.2	3.3
Return on assets 2/	2.1	4.3	1.9	2.7	3.5	2.3	3.1	4.9	1.2	3.1	1.9	0.1
Return on equity 2/	11.4	23.1	10.0	14.2	18.5	11.9	16.2	24.9	6.1	15.3	9.4	0.5
Net interest income to total income 2/ 3/	55.0	40.3	57.0	38.5	37.3	56.7	46.4	32.2	65.0	48.6	56.8	73.0
Noninterest expense to total income 2/ 3/	105.4	124.4	123.5	128.6	120.7	57.4	78.1	117.4	86.9	109.5	92.5	70.3
Liquid assets to total assets 2/ 4/	27.9	27.9	28.3	24.7	27.0	26.4	26.3	25.0	24.2	23.6	24.7	24.0
High-quality liquid assets to total assets	19.1	18.7	19.7	16.5	16.8	18.1	19.2	19.0	18.6	18.0	19.3	17.3
Net open foreign exchange position to capital 2/	11.2	11.4	10.4	11.0	10.6	8.0	8.0	9.0	5.4	1.7	0.6	1.2
Total nonperforming loans (NPLs), facility level 5/	4.3	3.2	3.2	2.5	2.1	2.1	2.0	1.7	1.6	1.6	2.2	2.0
Household NPLs, cross default basis 6/	12.6	12.0	11.1	10.1	8.8	8.7	8.1	7.2	5.9	5.4	4.9	4.2
Corporate NPLs, cross default basis 6/	11.6	10.8	10.1	7.2	6.1	6.7	6.8	9.0	8.7	7.4	5.9	5.8
Household and corporate NPLs, cross default basis 6/	11.6	10.8	10.0	7.9	6.7	7.0	6.7	7.9	7.6	6.6	5.5	5.2
Allowances to household loans in default	50.2	49.3	49.7	48.9	52.1	51.4	52.7	50.4	49.6	50.1	50.0	39.4
Allowances to corporate loans in default	62.6	47.3	44.6	42.7	45.3	44.8	41.3	36.5	35.8	39.1	41.8	38.9
Allowances to total loans in default	58.5	48.1	46.8	45.7	48.6	47.8	46.3	41.8	40.9	43.2	45.1	39.2

Sources: Central Bank of Iceland, Fjármálaeftirlitid, IMF staff calculations.

1/ Three largest deposit money banks unless otherwise indicated.

2/ Data for 2014Q1 through 2016Q4 are IMF staff estimates.

3/ Total income is total comprehensive income.

4/ Liquid assets comprise cash and balances with the central bank, claims on credit institutions, and bonds and debt instruments.

5/ Over 90 days in default.

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

Table 4. Iceland: General Government Operations, 2013–22
(Percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Prel.	Proj	Proj	Proj	Proj	Proj	Proj
Total revenue	**42.1**	**45.2**	**42.0**	**58.4**	**41.6**	**41.8**	**41.7**	**41.5**	**41.2**	**41.1**
Taxes	**32.1**	**34.9**	**33.1**	**32.8**	**32.9**	**32.9**	**32.7**	**32.6**	**32.6**	**32.6**
Taxes on income and profits	16.7	18.0	17.2	17.8	18.1	17.8	17.7	17.7	17.7	17.6
Personal income tax	13.7	13.5	13.5	14.2	14.1	14.1	14.0	14.0	14.0	14.0
Corporate income tax	2.1	3.3	2.4	2.5	2.6	2.5	2.4	2.4	2.4	2.4
Capital gains tax and rental income	0.9	1.2	1.4	1.1	1.3	1.3	1.3	1.3	1.3	1.3
Taxes on payroll and workforce	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Taxes on property	2.5	2.5	2.0	1.9	1.9	1.8	1.7	1.8	1.7	1.8
Taxes on goods and services	11.7	11.7	11.6	11.9	11.9	12.2	12.2	12.1	12.0	12.1
Value added tax	7.9	8.0	8.3	8.5	8.5	8.7	8.7	8.5	8.5	8.4
Other taxes on goods and services	3.8	3.6	3.3	3.3	3.4	3.5	3.5	3.5	3.6	3.6
Taxes on international trade	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other taxes	0.6	2.2	1.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social contributions	**3.7**	**3.7**	**3.6**	**3.6**	**3.5**	**3.5**	**3.5**	**3.5**	**3.4**	**3.3**
Grants	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Other revenues	**6.2**	**6.5**	**5.3**	**21.9**	**5.1**	**5.2**	**5.3**	**5.2**	**5.1**	**5.0**
of which: interest income	1.1	1.1	0.8	0.8	0.9	0.8	0.6	0.6	0.7	0.6
Total expenditure	**43.9**	**45.3**	**42.9**	**46.1**	**40.6**	**40.4**	**40.2**	**40.2**	**40.0**	**40.0**
Current expenses	**43.0**	**44.2**	**41.8**	**45.0**	**39.5**	**39.5**	**39.1**	**38.9**	**38.7**	**38.7**
Compensation of employees	13.5	13.7	13.9	13.8	13.9	13.9	13.8	13.7	13.6	13.6
Use of goods and services	11.8	11.5	10.9	10.5	10.4	10.4	10.4	10.4	10.4	10.4
Consumption of fixed capital	2.0	2.0	1.8	1.7	1.7	1.9	1.9	1.9	1.9	1.9
Interest	4.6	4.7	4.6	4.2	3.2	2.8	2.4	2.3	2.2	2.1
Subsidies	1.6	1.5	1.3	1.3	1.5	1.5	1.5	1.5	1.5	1.5
Grants	0.2	0.3	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Social benefits	7.1	7.0	6.4	6.2	6.4	6.8	6.9	6.9	6.9	6.9
Other expense 1/	2.2	3.6	2.6	7.1	2.2	2.1	2.1	2.1	2.1	2.2
Nonfinancial assets	**0.9**	**1.1**	**1.1**	**1.0**	**1.1**	**1.0**	**1.1**	**1.3**	**1.3**	**1.3**
Nonfinancial assets, acquisition	2.9	3.1	2.9	2.8	2.8	2.9	3.0	3.2	3.2	3.2
Consumption of fixed capital (-)	-2.0	-2.0	-1.8	-1.7	-1.7	-1.9	-1.9	-1.9	-1.9	-1.9
Net lending/borrowing	**-1.8**	**-0.1**	**-0.8**	**12.4**	**1.0**	**1.4**	**1.4**	**1.3**	**1.2**	**1.1**
Financial assets, transactions 2/	**-2.0**	**2.6**	**-8.0**	**6.5**	**-7.2**	**0.7**	**1.0**	**1.5**	**0.7**	**-2.0**
Currency and deposits	-2.8	4.4	-5.2	-5.1	-2.9	0.4	0.4	6.7	0.2	-2.1
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.3	0.0	-2.0	-2.3	0.1	0.3	0.3	0.3	0.3	0.3
Shares and other equities	2.1	-0.1	0.0	7.6	0.0	0.0	0.0	-5.8	0.0	0.0
Other accounts receivable	-1.6	-1.8	-0.8	6.2	-4.3	0.0	0.3	0.3	0.3	-0.2
Liabilities, transactions 2/	**-0.2**	**2.7**	**-7.1**	**-5.9**	**-8.2**	**-0.7**	**-0.4**	**0.2**	**-0.5**	**-3.1**
Securities other than shares	-0.2	1.7	0.4	-1.4	-4.6	-0.6	-1.2	-0.3	-1.0	-3.3
Loans	-1.0	-1.4	-7.0	-5.1	-3.8	-0.1	-0.1	-0.1	-0.1	-0.5
Krona denominated	-0.2	-1.2	-2.2	-2.6	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Foreign currency denominated	-0.8	-0.1	-4.9	-2.5	-3.8	0.0	0.0	0.0	0.0	-0.4
Insurance technical reserves	0.2	0.2	0.2	0.1	-0.2	0.3	0.3	0.3	0.3	0.3
Other accounts payable	0.7	2.2	-0.7	0.4	0.4	-0.3	0.6	0.3	0.3	0.4
Gross debt	**84.7**	**82.4**	**68.1**	**54.0**	**41.1**	**38.5**	**34.9**	**32.5**	**29.6**	**24.3**
Krona denominated	64.1	61.8	54.3	45.7	37.3	34.9	31.5	29.3	26.6	21.8
Foreign currency denominated	20.6	20.7	13.8	8.3	3.8	3.6	3.4	3.2	3.0	2.4
Net debt 3/	**62.2**	**55.8**	**49.3**	**41.9**	**32.9**	**30.4**	**26.9**	**18.2**	**16.0**	**13.5**
Memorandum items:										
Primary revenue	41.0	44.2	41.2	57.6	40.7	41.0	41.0	40.8	40.5	40.4
Primary expenditure	39.3	40.6	38.3	41.9	37.3	37.6	37.8	37.9	37.8	37.9
Primary balance	1.6	3.6	2.9	15.7	3.4	3.4	3.2	2.9	2.7	2.5
Structural balance	-1.8	-1.5	-2.6	-0.4	-0.1	0.6	1.0	1.0	1.1	1.1
Structural primary balance	1.7	2.1	1.2	2.9	2.3	2.7	2.8	2.6	2.5	2.5
Gross domestic product (ISK bn)	1,891	2,006	2,214	2,422	2,632	2,820	3,001	3,188	3,366	3.555

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

1/ Figure for 2016 includes a one off contribution by the central government to the state pension fund of ISK 117.2 billion.

2/ Figures for 2016 are based on staff assumptions and calculations.

3/ Gross debt less currency and deposits.

Table 5. Iceland: General Government Financial Balance Sheet, 2013–22
(Percent of GDP)

	2013	2014	2015	2016 Prel.	2017 Proj	2018 Proj	2019 Proj	2020 Proj	2021 Proj	2022 Proj
Financial assets	**63.2**	**64.3**	**51.4**	**51.3**	**40.0**	**38.1**	**36.8**	**36.1**	**34.9**	**31.1**
Currency and deposits	22.5	26.6	18.8	12.1	8.2	8.1	8.0	14.2	13.6	10.8
Other assets	40.7	37.7	32.6	39.2	31.8	30.0	28.8	21.9	21.3	20.3
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	10.4	9.8	6.9	3.3	3.1	3.2	3.3	3.4	3.5	3.6
Shares and other equities	21.2	19.2	17.4	23.5	21.6	20.2	19.0	12.1	11.4	10.8
Other accounts receivable	9.1	8.6	8.4	12.5	7.1	6.6	6.5	6.4	6.3	5.8
Liabilities	**114.7**	**114.2**	**100.0**	**87.8**	**72.4**	**67.7**	**63.2**	**59.7**	**56.0**	**50.0**
Gross debt	84.7	82.4	68.1	54.0	41.1	38.5	34.9	32.5	29.6	24.3
Securities other than shares	44.6	43.8	40.2	35.4	28.9	26.4	23.6	21.9	19.7	15.3
Loans	40.2	38.6	27.9	18.6	12.2	12.1	11.3	10.6	10.0	8.9
Krona denominated	18.9	17.8	13.9	10.1	8.2	8.4	7.8	7.3	6.8	6.4
Foreign currency denominated	21.3	20.9	14.0	8.5	4.0	3.7	3.5	3.3	3.1	2.6
Other liabilities	29.9	31.8	31.9	33.7	31.3	29.2	28.3	27.2	26.4	25.7
Insurance technical reserves	24.2	24.4	26.2	27.5	25.1	23.7	22.6	21.5	20.7	19.9
Other accounts payable	5.8	7.4	5.7	6.3	6.2	5.5	5.7	5.7	5.7	5.8
Net financial worth	**-51.4**	**-50.0**	**-48.6**	**-36.4**	**-32.3**	**-29.6**	**-26.4**	**-23.6**	**-21.1**	**-18.9**
Memorandum item:										
Net debt 1/	62.2	55.8	49.3	41.9	32.9	30.4	26.9	18.2	16.0	13.5

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

1/ Gross debt less currency and deposits.

Table 6. Iceland: Balance of Payments, 2013–22

	2013	2014	2015	2016	2017 Proj	2018 Proj	2019 Proj	2020 Proj	2021 Proj	2022 Proj
				(Billions of dollars)						
Current account 1/	**0.9**	**0.7**	**0.9**	**1.6**	**1.5**	**1.7**	**1.6**	**1.7**	**1.7**	**1.6**
Trade balance	1.2	1.1	1.3	1.3	1.4	1.6	1.5	1.6	1.6	1.5
Balance on goods	0.1	-0.1	-0.3	-0.8	-1.2	-1.3	-1.5	-1.5	-1.5	-1.6
Merchandise exports f.o.b.	4.6	4.9	4.7	4.5	4.6	4.8	5.0	5.2	5.2	5.4
Merchandise imports f.o.b.	4.5	5.0	4.9	5.3	5.8	6.1	6.5	6.7	6.8	7.0
Balance on services	1.2	1.2	1.5	2.2	2.6	2.9	3.0	3.1	3.1	3.1
Exports of services, total	4.0	4.3	4.4	5.4	6.0	6.7	7.0	7.2	7.3	7.5
Imports of services, total	2.8	3.1	2.8	3.2	3.5	3.8	4.0	4.1	4.2	4.4
Primary income balance 1/	-0.2	-0.3	-0.1	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Receipts	1.1	0.9	0.9	1.0	1.0	1.0	1.1	1.1	1.2	1.2
of which: interest receipts	0.6	0.5	0.4	0.5	0.5	0.5	0.5	0.6	0.6	0.6
Expenditures	1.3	1.2	1.0	0.6	0.7	0.8	0.8	0.8	0.9	0.9
of which: interest payments	1.5	1.8	1.5	1.2	1.0	1.0	1.1	1.1	0.9	0.7
Secondary income balance	-0.1	-0.1	-0.3	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2
Capital and financial account (+ = outflow)	**1.1**	**0.6**	**0.9**	**2.0**	**1.5**	**1.6**	**1.6**	**1.7**	**1.7**	**1.6**
Capital account balance (+ = inflow)	0.0	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	0.9	2.0	1.5	1.7	1.6	1.7	1.7	1.6
Direct investment (+ = outflow)	0.0	-0.7	-0.7	-0.7	-0.5	-0.5	-0.5	-2.1	-0.4	-0.5
Portfolio investment ("+" = outflow)	1.1	-1.2	3.8	1.8	1.8	1.3	0.5	0.7	0.8	0.9
Assets (+ = outflow)	1.2	-0.1	-3.0	0.9	0.4	0.4	0.7	0.9	1.0	1.1
Liabilities (+ = inflow)	0.1	1.1	-6.8	-0.9	-1.4	-0.8	0.1	0.1	0.2	0.2
of which: net borrowing (+ = inflow)	...	...	-6.7	-1.0	-1.6	-0.8	0.1	0.1	0.2	0.2
Other investment (+ = outflow)	-0.1	2.2	-3.3	-1.5	1.3	1.8	1.2	1.3	1.1	1.1
Assets (+ = outflow)	-0.9	-3.2	-0.4	-5.4	0.9	1.1	1.0	1.1	1.0	0.9
Liabilities (+ = inflow)	-0.9	-5.4	2.9	-3.9	-0.3	-0.6	-0.2	-0.1	-0.1	-0.2
of which: net outflows related to bank estates' compositions	...	...	0.2	0.2	0.0	-0.4	0.0	0.0	0.0	0.1
Change in reserve assets (+ = increase/outflow)	0.0	0.3	1.1	2.4	-1.0	-1.0	0.3	1.7	0.2	0.0
Net errors and omissions (+ = inflow)	**0.2**	**-0.1**	**0.0**	**0.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
				(Percent of GDP)						
Current account 1/	**6.0**	**4.0**	**5.5**	**8.0**	**6.6**	**6.5**	**5.9**	**5.9**	**5.8**	**5.4**
Trade balance	8.0	6.3	7.5	6.6	6.0	6.1	5.5	5.4	5.3	4.9
Balance on goods	0.4	-0.5	-1.6	-4.2	-5.1	-5.0	-5.4	-5.3	-5.1	-5.2
Merchandise exports f.o.b.	29.7	28.3	27.7	22.3	19.9	18.6	18.3	17.9	17.6	17.6
Merchandise imports f.o.b.	29.3	28.8	29.4	26.5	25.1	23.7	23.7	23.3	22.7	22.8
Balance on services	7.5	6.8	9.1	10.7	11.1	11.1	10.9	10.7	10.4	10.1
Exports of services, total	25.7	24.9	25.9	26.8	26.2	25.9	25.5	25.1	24.7	24.3
Imports of services, total	18.2	18.2	16.8	16.0	15.1	14.8	14.6	14.3	14.2	14.2
Primary income balance 1/	-1.2	-1.6	-0.5	2.1	1.3	1.0	1.0	1.0	1.0	1.0
Receipts	6.9	5.4	5.2	4.9	4.4	4.1	3.9	3.9	3.9	3.9
of which: interest receipts	3.6	3.1	2.5	2.4	2.1	2.0	1.9	2.0	1.9	1.9
Expenditures	8.1	7.0	5.7	2.8	3.1	3.0	2.9	2.9	2.9	2.9
of which: interest payments	10.0	10.2	8.7	5.9	4.4	4.0	3.8	3.7	3.1	2.4
Secondary income balance	-0.7	-0.6	-1.6	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6	-0.6
Capital and financial account (+ = outflow)	**7.0**	**3.5**	**5.5**	**10.1**	**6.5**	**6.4**	**5.8**	**5.7**	**5.6**	**5.2**
Capital account balance (+ = inflow)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Financial account (+ = outflow)	7.1	3.5	5.6	10.2	6.6	6.5	5.9	5.8	5.7	5.3
Direct investment (+ = outflow)	0.3	-4.3	-4.2	-3.6	-2.3	-1.8	-1.7	-7.4	-1.4	-1.5
Portfolio investment ("+" = outflow)	7.1	-6.9	22.8	9.2	7.7	4.9	2.0	2.6	2.7	2.9
Assets (+ = outflow)	7.9	-0.4	-17.7	4.7	1.7	1.7	2.4	3.0	3.3	3.4
Liabilities (+ = inflow)	0.8	6.5	-40.4	-4.5	-6.0	-3.2	0.4	0.4	0.6	0.5
of which: net borrowing (+ = inflow)	...	...	-39.8	-5.1	-7.2	-3.2	0.4	0.4	0.6	0.5
Other investment (+ = outflow)	-0.4	13.0	-19.6	-7.5	5.5	6.9	4.5	4.4	3.6	3.6
Assets (+ = outflow)	-6.0	-18.5	-2.5	-26.9	4.0	4.4	3.7	3.9	3.4	3.0
Liabilities (+ = inflow)	-5.6	-31.5	17.2	-19.4	-1.5	-2.5	-0.8	-0.5	-0.2	-0.6
of which: net outflows related to bank estates' compositions	...	...	1.4	0.8	0.2	-1.4	0.1	0.1	0.0	0.3
Change in reserve assets (+ = increase/outflow)	0.1	1.8	6.5	11.9	-4.3	-3.7	1.0	6.1	0.6	0.0
Net errors and omissions (+ = inflow)	**1.1**	**-0.4**	**0.2**	**2.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Central bank reserves ($ bn)	**4.1**	**4.2**	**5.0**	**7.2**	**6.2**	**5.3**	**5.6**	**7.3**	**7.5**	**7.5**
(Percent of GDP)	26.8	24.7	29.9	36.1	27.2	20.5	20.1	25.4	25.2	24.4
(Percent of reserve adequacy metric)	110.1	117.2	145.9	260.0	223.7	209.3	194.3	271.3	268.6	222.7
Memorandum item:										
Gross domestic product ($ bn)	15.5	17.2	16.8	20.0	23.0	25.8	27.6	28.8	29.7	30.7

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, 2007–16

(Percent of GDP)

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Assets	**524.8**	**314.0**	**299.9**	**267.5**	**273.9**	**287.5**	**287.4**	**259.8**	**222.2**	**155.6**
Central bank	12.0	27.7	30.4	41.0	61.6	30.4	25.8	26.4	29.5	33.8
Deposit taking corporations	300.3	29.7	17.2	17.6	21.2	21.3	25.6	19.6	15.7	10.4
General government	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	120.9	131.0	114.0	98.1	120.7	101.2	79.0	0.0	0.0
Other financial corporations 1/	38.3	32.5	35.1	31.0	30.4	33.8	34.3	37.2	70.8	37.9
Nonfinancial corporations, households, etc.	40.0	22.8	19.3	13.0	11.3	11.7	11.0	14.6	10.6	8.4
Unallocated: direct investment excl. estates	133.9	79.9	66.4	50.4	50.8	69.1	88.9	82.5	95.2	65.0
Unallocated: other investment, other equity	0.3	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.2
Liabilities	**631.2**	**977.5**	**965.5**	**872.6**	**818.8**	**751.5**	**688.7**	**648.5**	**227.4**	**150.8**
Central bank	0.1	22.5	12.8	17.3	23.4	10.9	9.1	4.4	1.7	1.9
of which: SDRs	0.1	0.2	1.4	1.2	1.2	1.2	1.1	1.0	0.9	0.7
Deposit taking corporations	446.2	44.5	19.0	12.8	9.1	6.9	7.7	7.5	12.7	19.7
General government	17.8	34.3	40.4	34.7	38.9	35.7	29.4	28.9	24.6	16.2
Deposit money banks undergoing winding up proceedings 2/	0.0	705.9	725.1	653.5	589.1	557.0	492.5	462.6	89.0	0.0
Other financial corporations 1/	11.2	14.0	16.2	12.3	13.1	9.0	7.6	7.1	63.9	7.1
Nonfinancial corporations, households, etc.	34.9	52.5	45.5	47.3	43.1	45.8	38.0	34.1	23.9	19.5
Unallocated: direct investment, excl. estates	94.4	102.9	102.9	91.9	99.3	83.3	101.0	100.2	96.4	82.5
Unallocated: portfolio investment, equity	...	...	3.6	2.9	2.9	3.0	3.2	3.6	4.1	3.9
Unallocated: portfolio investment, equity and investment fund shares	26.5	0.8	...	...	...	...	...	...	...	...
Net international investment position	**-106.4**	**-663.5**	**-665.6**	**-605.2**	**-544.9**	**-464.1**	**-401.3**	**-388.7**	**-5.1**	**4.7**

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 past debt sustainability analyses, 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).

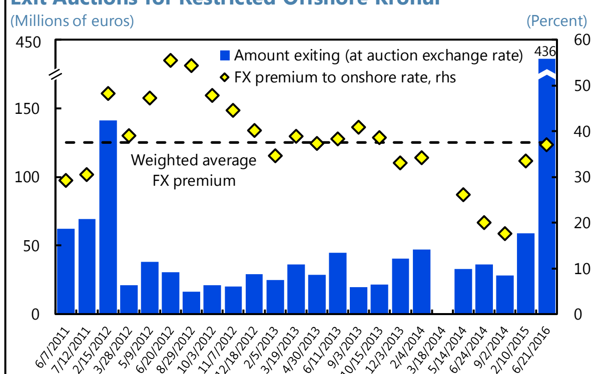
Annex I. Removing Capital Controls

Iceland has all but completed its capital account opening. On October 21, 2016, the CBI removed restrictions on outward FDI; allowed individual parties to buy one real property abroad each year irrespective of type or price; and allowed parties to take own funds out of the country for debt amortization or portfolio investment, the latter using domestic custodians, subject to a per party ceiling of ISK 30 million ($275,000). On January 1, 2017, it removed the custodianship requirement, added cross border deposit transfers to the list of permissible flows, and raised the per party ceiling to ISK 100 million ($915,000). Then, on March 12, 2017, it announced a comprehensive lifting of most remaining controls, excluding those on offshore króna holders.

Virtually all capital controls are gone. Households and businesses are no longer subject to restrictions on foreign exchange transactions, foreign investment, hedging, or cross border lending, or to foreign exchange repatriation requirements. With the stated purpose of preventing a carry trade, however, restrictions still apply to (i) derivatives trading for purposes other than hedging, (ii) cross border foreign exchange transactions not intermediated by a financial undertaking, and (iii) certain foreign currency lending by residents to nonresidents. The changes have been effected through CBI exemptions from the *Foreign Exchange Act*, leaving the streamlining or repeal of the Act itself as a pending item for the Althing.

These steps follow the wind up of the bank estates and sustained efforts to clear the stock of offshore krónur. The compositions of the estates around end 2015 and the CBI's foreign exchange auctions for offshore króna holders in 2011–16 both were guided by an overarching need to protect reserves. The estates assigned assets worth 16 percent of GDP to the state. The auction and post auction tender in June 2016 saw offshore krónur worth over 3 percent of 2017 GDP exit at a foreign exchange premium of 37 percent to the market rate; 1,688 smaller investors left while four foreign funds with large holdings chose to stay.

Exit Auctions for Restricted Offshore Krónur



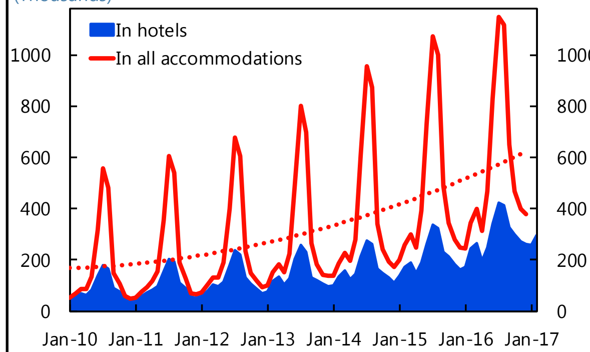
Sources: Central Bank of Iceland; and IMF staff calculations.

Currently, the CBI is in the process of buying what could amount to almost 4½ percent of GDP of additional restricted offshore krónur at a discount of about 20 percent. Agreement on the bulk of this amount was announced on March 12, 2017, precipitating the sweeping capital control liberalization. As before, the wedge against the market exchange rate softens the impact on reserves. Final settlement, likely to take place around mid year, is expected to see reserves reduced by almost $850 million and the remaining offshore króna stock to about 3 percent of GDP. The latter will remain subject to controls pending an eventual review of the *Act on the Treatment of Króna Denominated Assets Subject to Special Restrictions*.

Annex II. Iceland's Tourism Boom

The tourism boom amounts to a major positive real external demand shock. In hindsight, the Eyjafjallajökull ash eruptions of 2010 were the ultimate advertising for Iceland's natural wonders. From an average of 3 percent of GDP in 2000–05, travel receipts have surged, reaching an estimated 15 percent of GDP by 2016. The number of foreign travelers has risen from 460,000 in 2010 to 1.8 million in 2016, growing by 40 percent in 2016 alone; 2.2 million are expected in 2017. The ratio of tourists to inhabitants has increased almost exponentially, with accommodation seekers now outnumbering residents by more than 12:1, even as the average length of stay has remained fairly stable. Tourism has thus established itself at the heart of the economy, bringing in larger export receipts than marine products, aluminum, and silicon combined.

Foreign Tourists' Overnight Stays
(Thousands)



Source: Statistics Iceland.

The shock does not appear transitory. Demand side determinants such as economic growth in visitors' countries of origin explain some, but not all, of the surge. Supply side factors also play a big part. For island destinations, Culiuc (2014) argues that an increasing number of flight connections can provide a strong boost. In 2009, only seven airlines offered scheduled flights to Iceland; by 2016, 26 airlines did, with an expansion of Keflavík airport's baggage handling capacity playing an important supporting role. Reviewing evidence from relevant other countries, IMF (2014) finds that surges in tourism tend to be durable. Nearly all countries whose travel exports increased by at least 4 percent of GDP over a span of ten years—very much the case for Iceland in 2003–13—saw the ratio remain above its pre surge levels ten years later. Where declines did occur, they tended to be associated with political turmoil, crumbling infrastructure, overcrowding in tourist sites, environmental degradation, or a loss in price competitiveness. So far, Iceland's tourism boom has been robust to króna appreciation—even visitor numbers from the United Kingdom have held up (in the top slot) despite the almost 30 percent fall of sterling vis à vis the króna since the Brexit vote. There are some signs, however, that tourists may be starting to cut back on the number of days they stay.

Spillovers to the rest of the economy are considerable. Most are positive. While fisheries and aluminum and silicon are heavily capital intensive, tourism is a major generator of jobs. The fishing industry benefits from the increased number of direct flight connections, dispatching high value unfrozen product in the bellies of passenger aircraft, reaching more markets faster. There are also pressure points. Tourism related foreign exchange inflows drive króna appreciation, hurting the other export sectors. Hotel construction has crowded out homebuilding, and rentals to tourists have crowded out rentals to residents, including foreign workers. Some public infrastructure is coming under strain as investment lags demand.

Annex III. Risk Assessment Matrix[1]

Risks	Relative Likelihood	Impact if Realized	Policy Response
DOMESTIC RISKS			
1. Vicious interaction between overheating and a carry trade	**Medium** • Flexible labor supply hits limits and wage pressures resurface • Strong growth, high interest rate differentials, and expectations of further króna appreciation suck in capital flows	**High** • Inflation climbs well above target, hurting central bank credibility • Króna appreciation overshoots fundamentals • Credit fueled asset boom turbocharges domestic demand, hurts bank soundness, and creates systemic risk	• Keep interest rate policy squarely focused on inflation prospects • Limit exchange market intervention and allow appreciation to play out • Consider additional fiscal tightening to help manage domestic demand pressures • Take decisive steps to strengthen microprudential bank supervision • Deploy well targeted macroprudential measures to head off systemic risks
2. Policy mistakes result in unexpectedly large capital outflows	**Low** • Missteps or misstatements trigger capital flight	**High** • Capital flight feeds on itself and drains reserves, resulting in rating downgrades and second round damage	• Raise interest rates to counter inflationary pressures from currency depreciation • Limit reserve drawdowns to countering disorderly market conditions • Allow automatic fiscal stabilizers to operate • Take decisive steps to strengthen microprudential bank supervision
3. Break in tourism	**Low** • Global shock, too much króna strength, or a natural *force majeure*	**High** • Sharp dip in growth • Sharp deterioration in current account balance • Drain on reserves	• Keep interest rate policy squarely focused on inflation prospects • Limit reserve drawdowns to countering disorderly market conditions • Allow automatic fiscal stabilizers to operate
GLOBAL RISKS			
4. Significant further strengthening of the dollar and/or higher global rates	**High** • Term premiums decompress as investors reassess policy fundamentals • More rapid Fed normalization	**Low** • Borrowing terms abroad worsen as Iceland risk premium rises • Some capital outflows	• Keep interest rate policy squarely focused on inflation prospects • Limit reserve drawdowns to countering disorderly market conditions • Allow automatic fiscal stabilizers to operate
5. Weaker than expected global growth	**High/Medium** • Structurally weak growth in European trading partners	**Medium** • Weaker export demand, including for tourism, and persistently low import prices	• Accelerate structural reforms to increase competitiveness, including a revamp of wage bargaining

[1] Shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the IMF staff). The relative likelihood of risks listed is the 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 the staff's views on the source 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 IV. The 2016 Pension Reform

Iceland has a three pillar pension system. Pillar I is social security, provided by the state and funded by social security contributions and other taxes. Pillar II involves mandatory employer based pensions, funded jointly by employees and employers. Pillar III comprises voluntary employer based pensions, offering the option of additional, tax exempt contributions. Pillar II and Pillar III assets are managed by the pension funds.

The Pillar II schemes differ across the private and public sectors. Private sector pensions are on a defined contributions basis where returns and payouts to workers are not guaranteed. Public sector pensions have been on a defined benefits basis and fall into two categories: (i) the active state pension funds that receive larger employers' contributions (from the government) relative to private sector pension funds, and where the government guarantee is implicit; and (ii) the grandfathered state pension funds that ceased accepting new participants after the 1997 pension reform, where the government guarantee is explicit.

At end 2016, the Althing passed a major reform of the active public sector pension system. The focus was on the public sector's active Pillar II scheme, where affected funds were moved from defined benefits to defined contributions. The main new development was the recognition by the government of the funds' underfunding. Absent an explicit guarantee, these funds' negative actuarial position (which had been computed for years) had not been included in the government balance sheet. The reform was twofold: to close this gap with budgetary resources and, as a *quid pro quo*, to move to defined contributions.

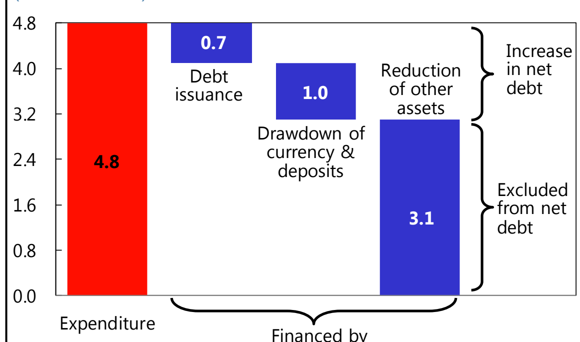
The broader goal of the reform was to help harmonize the labor market. More comparable and transparent pension packages across the public and private sectors, it was felt, would improve labor mobility and reduce the preference, especially pronounced among older workers, for public sector jobs. The authorities further argued that this would help to streamline the wage bargaining process.

The reform cost 4.8 percent of 2016 GDP. It was financed by a mix of noncash asset transfers, deposit drawdowns, and bond issuance. Net debt increased by 1.7 percent of GDP. Additional net interest expenses will amount to 0.2 percent of GDP per year starting in 2017. The upfront expenditure is recorded above the line in 2016, seizing the opportunity afforded by the one time stability contributions from the bank estates to push the reform through without breaching any rule under the Organic Budget Law.

Separately, the old state pension funds continue to suffer an actuarial gap. Their NPV of assets minus NPV of liabilities amounted to -24 percent of GDP in 2016, recognized explicitly in general government liabilities as insurance technical reserves. As noted in the 2016 Article IV report, the medium-term fiscal plan includes an allocation of some 0.3 percent of GDP per year to plug this gap, starting in 2017.

Active State Pension Fund Reform

(Percent of GDP)



Source: Ministry of Finance.

Annex V. Revenue Measures in the Fiscal Strategy Plan

Iceland's last VAT reform saw a reduction of the top rate and an increase in the lower rate. The top rate was cut from 25½ percent to 24 percent effective January 1, 2015; the lower rate was raised from 7 percent to 11 percent. Also, the taxable base was broadened to include more of the tourism industry—private passenger transport, spas, and travel agency services—taking effect one year later.

Now, with tourism burgeoning, the plan is to move several tourism related services to the higher rate band while lowering the top VAT rate. The proposal is to tax hotel accommodations, guided tours, travel agency services, tour operators and travel partners, and private passenger transportation at the top VAT rate starting in mid 2018. It is also proposed that the top rate be cut to 22½ percent effective January 1, 2019.

The authorities estimate that the reconstitution of rate bands will increase costs for the typical tourist by about 4 percent and the consumer price index by 0.06 percent. The proposed subsequent reduction of the top VAT rate is then estimated to reduce the consumer price index by 0.47 percent. Recent analysis suggests a very small impact on the number of tourists visiting Iceland. Net VAT revenues, in contrast, are expected to increase by almost 0.4 percent of 2016 GDP in 2018, and by a further 0.2 percent of 2016 GDP in 2019 after deducting the effects of a lower standard rate.

In addition, the authorities have proposed to double the carbon tax rate starting in January 2018. This measure is expected to raise additional revenues worth 0.2 percent of 2016 GDP in the first year.

Annex VI. External Debt Sustainability Analysis

Iceland's external debt position has improved dramatically. On the Fund staff measure (as explained in the 2016 Article IV report), gross debt fell from 257 percent of GDP in 2012 to 132 percent in 2016. It is projected to continue to fall at a rapid pace through 2018, and thereafter more gradually, to about 86 percent of GDP by 2022. Average annual real GDP growth over the projection period is 3½ percent, similar to that at the time of the 2016 Article IV consultation.

The noninterest current account surplus needed to stabilize Iceland's external debt ratio has been slashed. The debt stabilizing surplus is now put at 0.4 percent of GDP, down from 1.6 percent of GDP last year. This is a small fraction of the expected current account surplus excluding interest for 2017, estimated at around 11 percent of GDP, and the surplus in each year of the projection period.

The gross external financing requirement has fallen rapidly yet remains significant. The mix of sharply lower external debt, the large current account surplus, and reserve accumulation has resulted in a rapid drop in the ratio of the gross external financing need to reserves. The financing need is defined as the sum of the noninterest current account balance, short-term external debt one year previously, and debt service falling due. Short-term debt includes debt of the banks (4 percent of GDP at end 2015), trade credit (3 percent of GDP), and debt of the holding companies that succeeded the bank estates (37 percent of GDP), with the latter expected to decline sharply over the next three years. The financing need fell by 21 percentage points in 2016, to 35 percent of GDP, and is projected to fall to 11 percent of GDP by 2022.

The projected downward path for total external debt is robust to most shocks. Standard growth and current account shocks do not materially alter the baseline trajectory. The sensitivity of the baseline path to exchange rate shocks is more significant, reflecting a substantial weight of foreign currency liabilities in the stock of nonfinancial corporate sector external debt.

Table 1. Iceland: External Debt Sustainability Framework, 2012–22

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						Debt-stabilizing
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	non-interest CA 7/
Baseline: External debt (including old banks) 1/	257.4	248.7	205.5	161.0	131.6			**125.5**	**110.1**	**103.7**	**98.4**	**96.6**	**86.3**	**0.4**
Change in external debt	2.9	-8.7	-43.3	-44.4	-29.5			-6.0	-15.4	-6.4	-5.3	-1.8	-10.3	
Identified external debt-creating flows (4+8+9)	-20.2	-25.2	-31.8	-3.9	-29.6			-15.3	-11.1	-9.7	-15.2	-8.3	-8.1	
Current account deficit, excluding interest payments	-5.7	-11.9	-9.3	-10.4	-12.4			-11.0	-10.5	-9.7	-9.6	-8.9	-7.8	
Deficit in balance of goods and services	-6.0	-8.0	-6.3	-7.5	-6.6			-6.0	-6.1	-5.5	-5.4	-5.3	-4.9	
Exports	57.0	55.4	53.3	53.7	49.1			46.2	44.6	43.7	43.0	42.3	41.9	
Imports	51.0	47.5	47.0	46.2	42.5			40.2	38.5	38.3	37.6	37.0	37.0	
Net non-debt creating capital inflows (negative)	-29.6	1.1	-3.4	-0.7	2.8			-2.1	-0.5	-0.5	-6.2	-0.1	-0.2	
Automatic debt dynamics 2/	15.1	-14.4	-19.2	7.1	-20.0			-2.3	0.0	0.5	0.7	0.7	0.0	
Contribution from nominal interest rate	9.6	5.9	4.4	4.9	4.4			4.4	4.0	3.8	3.7	3.1	2.4	
Contribution from real GDP growth	-3.2	-10.4	-4.3	-8.6	-9.7			-6.6	-4.0	-3.3	-3.1	-2.5	-2.5	
Contribution from price and exchange rate changes 3/	8.7	-9.8	-19.3	10.8	-14.7			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	23.1	16.5	-11.4	-40.5	0.1			9.3	-4.4	3.3	9.9	6.6	-2.3	
External debt-to-exports ratio (in percent)	451.8	448.9	385.8	300.0	267.9			271.9	247.0	237.1	228.9	228.4	206.1	
Gross external financing need (in billions of US dollars) 5/	17.9	6.9	9.7	9.4	7.0			3.7	5.9	3.3	6.5	3.9	3.4	
in percent of GDP	125.6	44.4	56.4	55.8	34.7	10-Year	10-Year	16.0	22.7	12.0	22.7	13.2	11.2	
Scenario with key variables at their historical averages 6/								**125.5**	**124.0**	**124.8**	**130.2**	**131.2**	**121.6**	
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
								2017	**2018**	**2019**	**2020**	**2021**	**2022**	
Real GDP growth (in percent)	1.2	4.4	1.9	4.1	7.2	2.1	4.7	5.8	3.6	3.2	3.1	2.6	2.6	
GDP deflator in US dollars (change in percent)	-4.3	4.3	8.9	-6.1	11.4	0.4	12.5	8.4	8.5	3.7	1.1	0.7	0.5	
Nominal external interest rate (in percent) 8/	3.7	2.5	2.0	2.3	3.3	3.2	0.8	3.8	3.6	3.7	3.8	3.3	2.6	8/
Underlying external interest rate (in percent)	4.5	3.4	3.0	3.3	4.4	3.5		4.3	3.9	4.0	4.1	3.5	2.7	
Growth of exports (US dollar terms, in percent)	-2.4	5.9	6.7	-1.5	9.2	7.0	12.4	7.8	8.5	5.0	2.5	1.6	2.0	
Growth of imports (US dollar terms, in percent)	1.7	1.3	9.9	-4.0	10.1	1.6	15.6	8.3	7.6	6.4	2.4	1.6	3.0	
Current account balance, excluding interest payments	5.7	11.9	9.3	10.4	12.4	4.1	7.5	11.0	10.5	9.7	9.6	8.9	7.8	
Net non-debt creating capital inflows	29.6	-1.1	3.4	0.7	-2.8	4.2	20.9	2.1	0.5	0.5	6.2	0.1	0.2	

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.

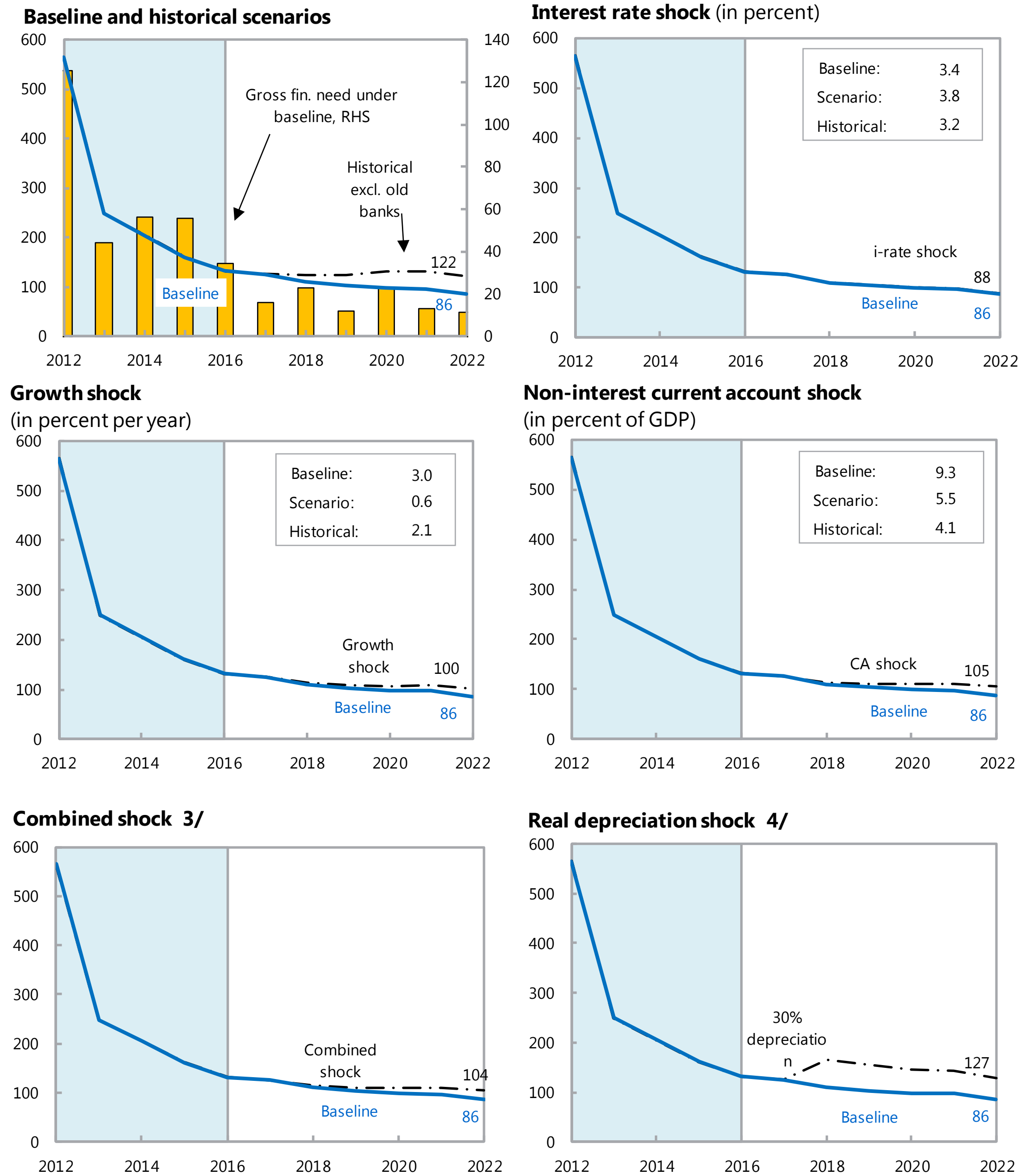
5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

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. Iceland: 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 VII. Public Sector Debt Sustainability Analysis

Iceland's public sector debt sustainability indicators have improved markedly and are projected to continue to improve over the medium term. The authorities received about 16 percent of GDP of budgetary resources from the bank estates in 2016, which will be used to reduce public debt over time. Iceland's net public debt ratio is projected to fall below 30 percent of GDP by 2019.

Even excluding the one off receipts from the bank estates, Iceland has made impressive progress unwinding liabilities taken on during the crisis. Since its peak in 2011, the gross public debt ratio has fallen by some 40 percent of GDP. The gross general government debt was estimated at about 54 percent of GDP at end 2016—still above the pre crisis ratio of about 29 percent.

The government has continued to use its deposits and irregular income to finance early repayment of crisis related bonds. It accelerated the repayment of a large nonmarketable instrument issued during the crisis to recapitalize the CBI, reducing the balance on this bond to ISK 28½ billion (1.2 percent of GDP) by end 2016, from ISK 90 billion (4 percent of GDP) a year earlier.

The structure of the public debt helps reduce fiscal risks. As of March 2017, around 86 percent of the stock of treasury bills and bonds was held by domestic investors, mostly banks, pension funds, and mutual funds. Around 2 percent of the total is short term. Just above 80 percent of central government debt is denominated in krónur, with most of the rest in dollars or euros. Also, above 80 percent of the stock carries fixed rates. The weighted average time to maturity on central government debt is 6.2 years.

There is still a large volume of government guarantees issued to state owned enterprises. As of February 2017, guarantees outstanding were equivalent to about 42 percent of GDP, down from a peak of 81 percent of GDP in 2009. About 98 percent of these guarantees are to two entities, the Housing Financing Fund and Landsvirkjun. The latter has, however, been able to borrow without government guarantees.

This analysis is based on staff's macroeconomic framework:

- **Fiscal outlook**. In line with the Fiscal Strategy Plan, the authorities aim to maintain a general government overall surplus over 2018–22 that implies primary surpluses averaging 2.8 percent of GDP. Coupled with asset sales, drawdowns of government deposits, use of irregular income, and a negative interest rate–growth differential in most years, this puts the gross debt to GDP ratio on a firmly downward trajectory.
- **Debt management**. Substantial asset sales proceeds in 2017–20 are assumed to reduce liabilities, with domestic bonds not refinanced as they fall due.

The realism of staff's baseline growth projections has improved, yet challenges remain. The median forecast error over 2007–15 was -1.2 percent. Staff tended to be overly pessimistic about growth before the crisis and overly optimistic in its wake. Inflation forecasts have been subject to larger errors, particularly before and during the crisis. Here too, forecast accuracy has improved recently. The median forecast error for the primary balance shows a similar pattern of pessimism turning to optimism with forecast accuracy improving.

The heat map indicates Iceland's current debt levels do not pose high levels of risk. The public sector external debt ratio fell from 8.4 percent of GDP at end 2016 to 4.3 percent of GDP as of April 2017 as a result of the buyback of a foreign bond maturing in 2022.

Stress tests give cause for comfort. Debt sustainability indicators recover relatively quickly in all shock scenarios. This is contingent, however, on the authorities' commitment to reduce liabilities using both government deposits and receipts from the estates. The assessment also assumes the commitment to fiscal adjustment is durable and the macroeconomic and external environment remains relatively benign.

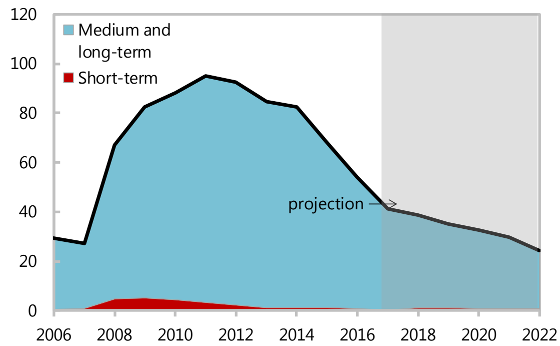
Based on an asymmetric restriction of the shocks, the public debt ratio peaks at around 70 percent of GDP with a 95 percent confidence interval. Five scenarios are considered:

- **Growth shock**. Real GDP growth is subjected to a one standard deviation negative shock. Inflation declines 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 decline in the primary balance. The debt ratio rises to about 41 percent of GDP by 2019 but falls thereafter.
- **Primary balance shock**. A 2 percent of GDP decline in revenues is applied over two years, coupled with a rise in interest rates over the same period. The debt to revenue ratio deteriorates relative to the baseline before recovering.
- **Interest rate shock**. A 200 basis point increase in spreads is applied throughout the projection period. The decline in the debt ratio decelerates modestly relative to the baseline in 2018 but returns to its downwards trajectory thereafter.
- **Real exchange rate shock**. A 25 percent devaluation of the real exchange rate is applied in the first year, couple with a 25 basis point increase in interest rates for each 1 percent of GDP deterioration in the primary balance. The debt ratio increases slightly in 2019 but returns to its downward trajectory thereafter.
- **Contingent liabilities shock**. The assumption is that 7 percent of the state guarantees on the Housing Financing Fund are called in 2017, with interest rates increasing by 25 basis points for every 0.75 percent of GDP worsening in the primary balance. The primary balance deteriorates to a deficit of about 3 percent of GDP in 2018 and interest rates increase by 150 basis points, taking the debt ratio to just above 50 percent of GDP before it resumes its downward path.

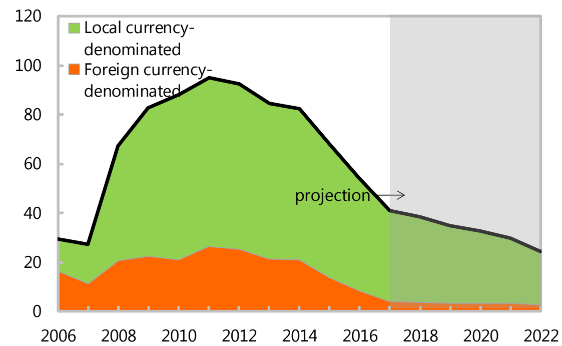
Figure 1. Iceland: Public DSA - Composition of Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



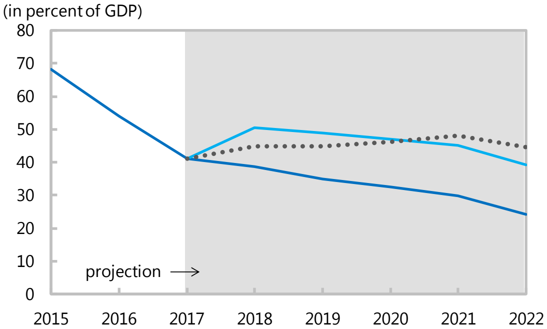
By Currency
(in percent of GDP)



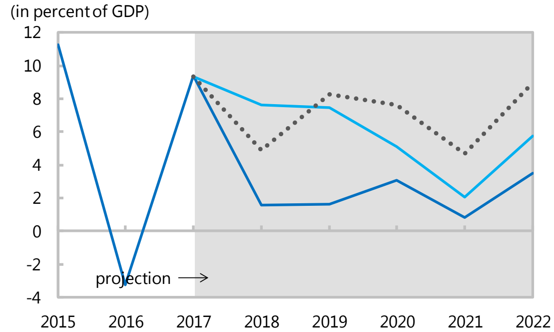
Alternative Scenarios

Baseline
Contingent Liability Shock
Historical

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



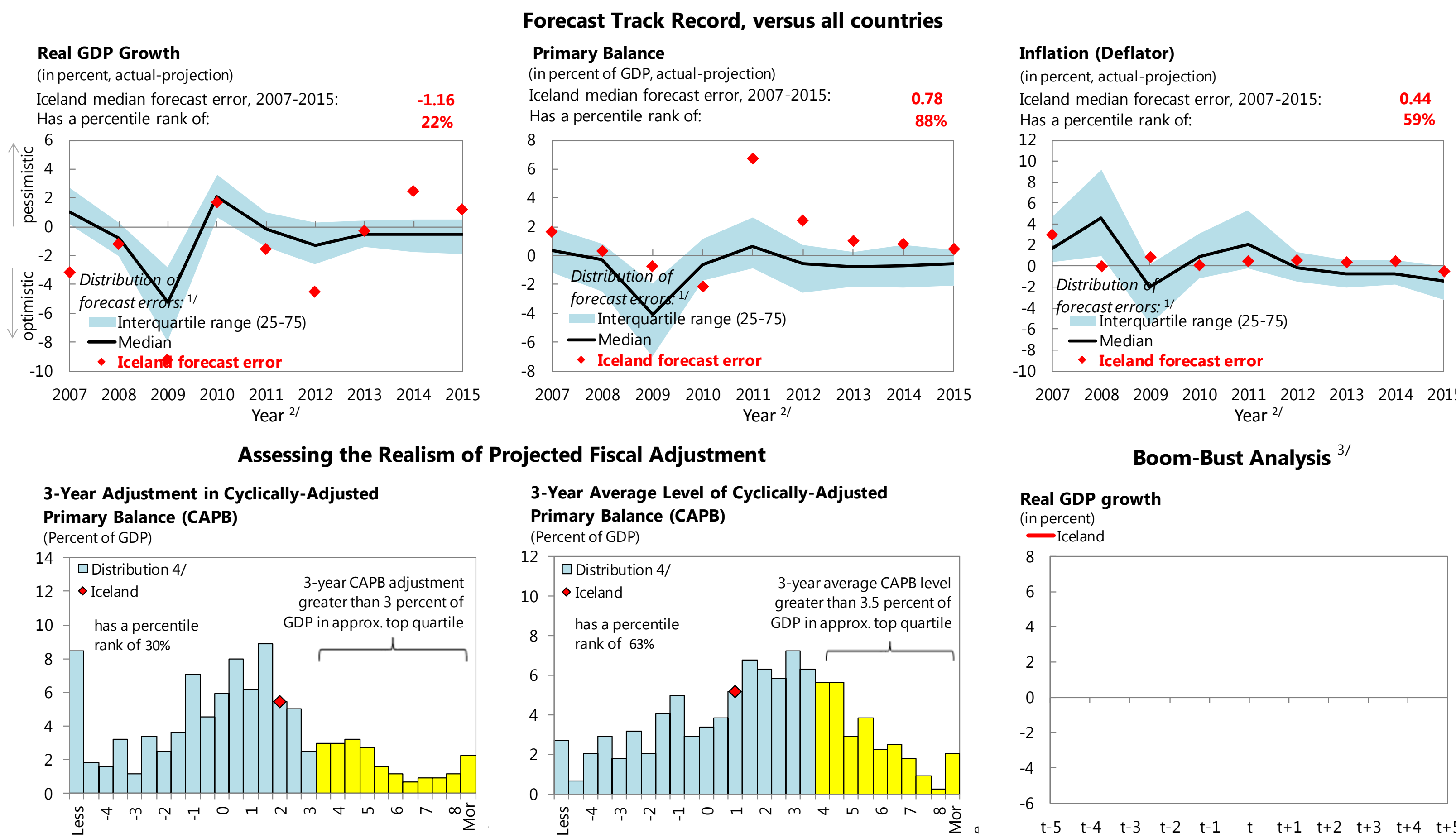
Underlying Assumptions
(in percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	5.8	3.6	3.2	3.1	2.6	2.6
Inflation	2.7	3.4	3.1	3.0	2.9	2.9
Primary Balance	3.4	3.4	3.2	2.9	2.7	2.5
Effective interest rate	4.9	5.9	5.2	4.8	4.4	4.8
Constant Primary Balance Scenario						
Real GDP growth	5.8	3.6	3.2	3.1	2.6	2.6
Inflation	2.7	3.4	3.1	3.0	2.9	2.9
Primary Balance	3.4	3.4	3.4	3.4	3.4	3.4
Effective interest rate	4.9	5.9	5.2	5.0	4.4	4.7

Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	5.8	2.1	2.1	2.1	2.1	2.1
Inflation	2.7	3.4	3.1	3.0	2.9	2.9
Primary Balance	3.4	-0.1	-0.1	-0.1	-0.1	-0.1
Effective interest rate	4.9	5.9	5.2	5.4	5.1	5.4
Contingent Liability Shock						
Real GDP growth	5.8	0.0	-0.4	3.1	2.6	2.6
Inflation	2.7	2.5	2.2	3.0	2.9	2.9
Primary Balance	3.4	-2.5	3.2	2.9	2.7	2.5
Effective interest rate	4.9	6.3	5.6	5.8	5.4	5.6

Source: IMF staff.

Figure 2. Iceland: Public DSA - Realism of Baseline Assumptions



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. Iceland: Public DSA - Baseline Scenario

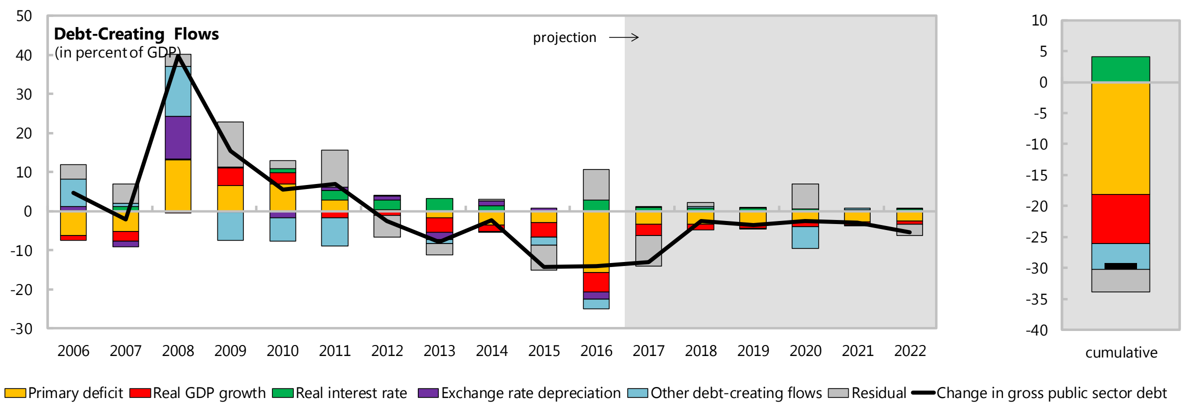
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2006-2014 [2/]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	72.2	68.1	54.0	41.1	38.6	35.0	32.5	29.7	24.3
Public gross financing needs	15.2	11.3	-3.3	9.4	1.6	1.6	3.0	0.8	3.5
Real GDP growth (in percent)	1.7	4.1	7.2	5.8	3.6	3.2	3.1	2.6	2.6
Inflation (GDP deflator, in percent)	5.8	6.0	2.0	2.7	3.4	3.1	3.0	2.9	2.9
Nominal GDP growth (in percent)	7.5	10.4	9.4	8.7	7.1	6.4	6.2	5.6	5.6
Effective interest rate (in percent) [4/]	7.6	6.2	6.7	4.9	5.9	5.2	4.8	4.4	4.8

As of May 12, 2017		
Sovereign Spreads		
Spread (bp) 3/		81
CDS (bp)		84
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	A	A
Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

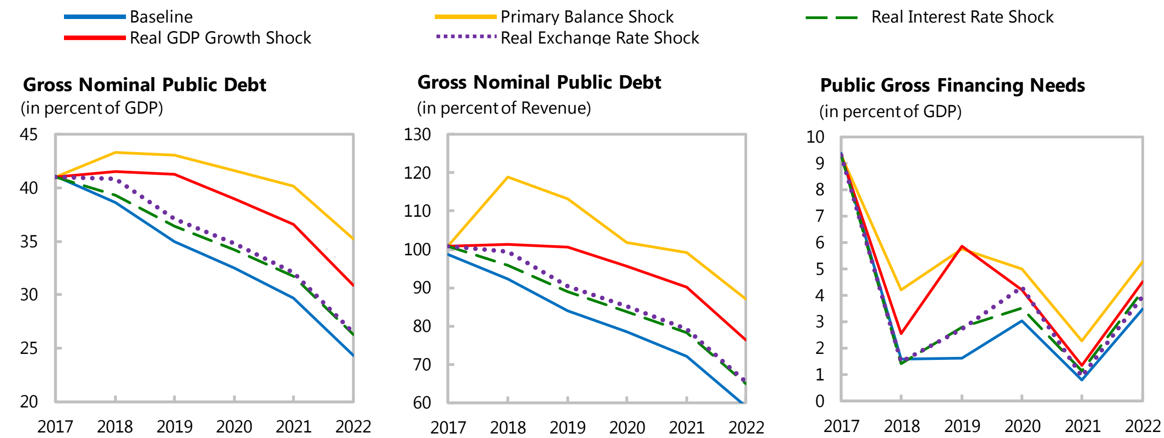
	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	6.4	-14.3	-14.1	-13.0	-2.5	-3.6	-2.5	-2.8	-5.4	-29.7	0.2
Identified debt-creating flows	3.4	-7.8	-22.1	-5.2	-3.7	-3.3	-8.8	-2.7	-2.4	-26.1	
Primary deficit	1.5	-2.9	-15.7	-3.4	-3.4	-3.2	-2.9	-2.7	-2.5	-18.1	
Primary (noninterest) revenue and grants	40.6	41.2	57.6	40.7	41.0	41.0	40.8	40.5	40.4	244.5	
Primary (noninterest) expenditure	42.1	38.3	41.9	37.3	37.6	37.8	37.9	37.8	37.9	226.4	
Automatic debt dynamics [5/]	2.0	-2.8	-4.0	-1.9	-0.6	-0.4	-0.4	-0.3	-0.1	-3.8	
Interest rate/growth differential [6/]	0.8	-3.6	-2.2	-1.9	-0.5	-0.4	-0.5	-0.4	-0.2	-3.8	
Of which: real interest rate	1.3	-0.1	2.8	1.0	0.9	0.7	0.6	0.4	0.5	4.1	
Of which: real GDP growth	-0.5	-3.6	-5.0	-2.9	-1.4	-1.2	-1.0	-0.8	-0.7	-8.0	
Exchange rate depreciation [7/]	1.2	0.8	-1.8	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	-2.0	-2.4	0.1	0.3	0.3	-5.5	0.3	0.3	-4.2	
General government net privatization proceeds (negative)	-0.5	0.0	-0.1	0.0	0.0	0.0	-5.8	0.0	0.0	-5.8	
Net lending for policy purposes	0.0	-2.0	-2.3	0.1	0.3	0.3	0.3	0.3	0.3	1.6	
Residual, including asset changes [8/ 10/]	3.0	-6.5	8.0	-7.8	1.2	-0.3	6.3	-0.1	-3.0	-3.7	



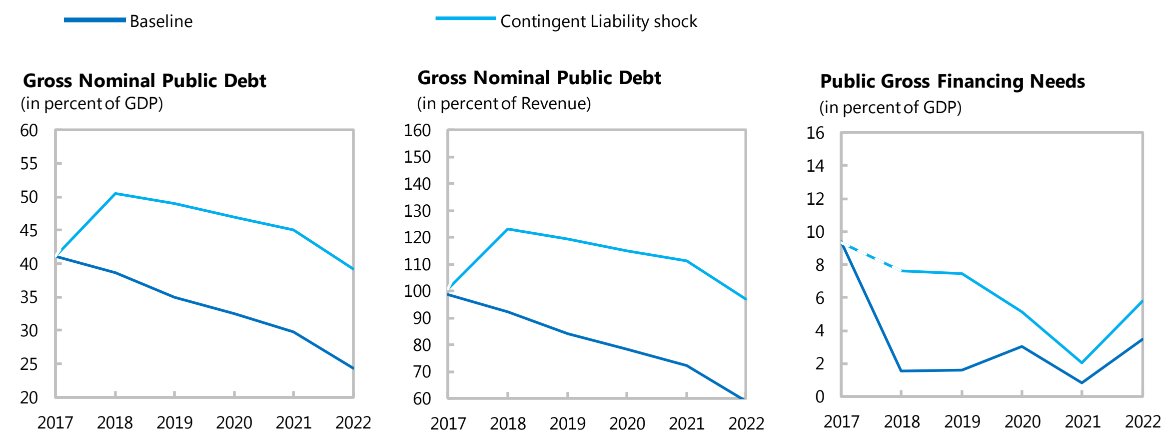
Source: IMF staff.
1/ Public sector is defined as general government.
2/ Based on available data.
3/ Bond Spread over U.S. Bonds.
4/ Defined as interest payments divided by debt stock at the end of previous year.
5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, 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 2016-22 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. Iceland: Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	5.8	2.6	3.2	3.1	2.6	2.6
Inflation	2.7	3.4	3.1	3.0	2.9	2.9
Primary balance	3.4	0.8	0.2	2.9	2.7	2.5
Effective interest rate	4.9	5.9	6.5	7.3	6.7	7.0
Real Interest Rate Shock						
Real GDP growth	5.8	1.6	1.2	3.1	2.6	2.6
Inflation	2.7	3.4	3.1	3.0	2.9	2.9
Primary balance	3.4	3.4	3.2	2.9	2.7	2.5
Effective interest rate	4.9	5.9	5.4	5.3	5.1	5.5
Contingent Liability shock						
Real GDP growth	5.8	0.0	-0.4	3.1	2.6	2.6
Inflation	2.7	2.5	2.2	3.0	2.9	2.9
Primary balance	3.4	-2.5	3.2	2.9	2.7	2.5
Effective interest rate	4.9	6.3	5.6	5.8	5.4	5.6

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	5.8	1.2	0.8	3.1	2.6	2.6
Inflation	2.7	2.8	2.5	3.0	2.9	2.9
Primary balance	3.4	2.3	1.0	2.9	2.7	2.5
Effective interest rate	4.9	5.9	5.2	5.3	4.9	5.2
Real Exchange Rate Shock						
Real GDP growth	5.8	-6.4	3.2	3.1	2.6	2.6
Inflation	2.7	11.8	3.1	3.0	2.9	2.9
Primary balance	3.4	3.4	3.2	2.9	2.7	2.5
Effective interest rate	4.9	6.0	5.1	5.0	4.4	4.7

Source: IMF staff.

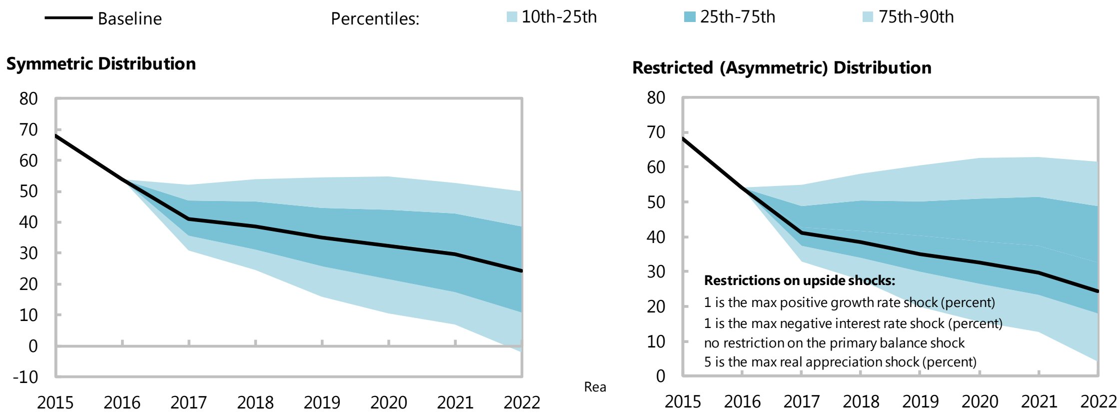
Figure 5. Iceland Public DSA - Risk Assessment

Heat Map

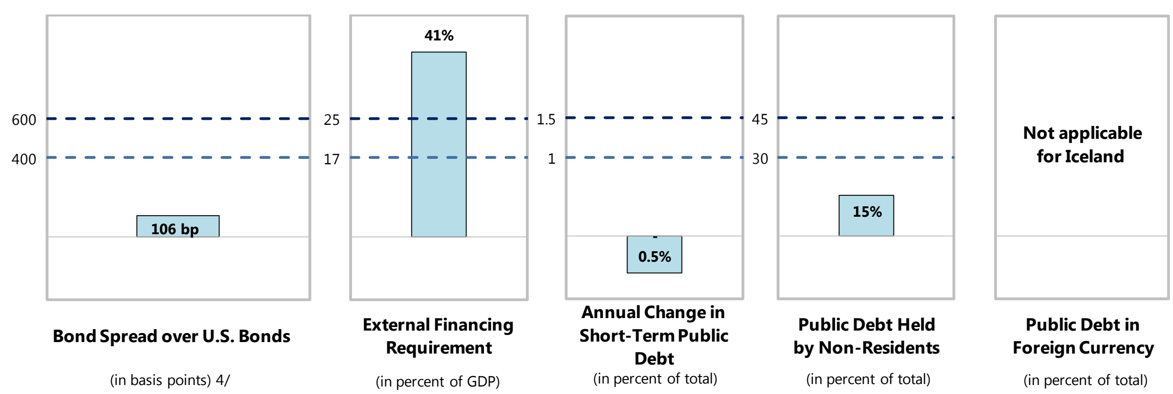
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	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, 12-Jan-17 through 12-Apr-17.

Annex VIII. Responses to Past Policy Recommendations

2016 Article IV Recommendations	Authorities' Responses
Fiscal Policy Respect the fiscal rules in the Organic Budget Law and embrace growth enhancing expenditure reforms. Execute the 2016 budget firmly, and have a moderately tighter budget for 2017.	**Partly Consistent** While the approved 2017 budget delivers a positive overall balance in line with the fiscal rules, potential unplanned additional expenditures would reduce it in a year when the output gap will continue to increase.
Monetary Policy Stand ready for further rate hikes, to be executed in measured, data driven steps. Keep inflation near target while finding a smooth glide path for the economy. Articulate an exchange market intervention policy consistent with the inflation targeting framework.	**Consistent** The CBI has maintained a tight monetary policy stance, where rate cuts have sought to keep real rates level as inflation has fallen. Inflation has been below target for three years and inflation expectations have converged to target. The CBI has announced its intention to design an intervention policy for the post capital controls period.
Capital Controls Keep steps to unlock restricted offshore krónur simple. Develop a comprehensive plan to guide capital account liberalization for residents, embedding concrete commitments to further improve microprudential oversight.	**Consistent** The CBI's final auction and post auction tender in mid 2016 cleared some 3½ percent of GDP of restricted offshore krónur, leaving holdouts in segregated accounts. Subsequently, in October 2016 and January 2017, the authorities effected two large steps to ease outflow controls. In March 2017, most remaining outflow controls were lifted, accompanied by an agreement with offshore króna holders.
Financial Sector Consider a fundamental reform of the regulatory architecture, where one solution could be to unify safety and soundness oversight of banks at the CBI. Build a stronger bank safety net. Complete the macroprudential toolkit.	**Partly Consistent** The authorities have stepped up efforts to improve supervisory processes, and have amended the *Pension Fund Act*, but no steps have been taken to reform the architecture or build a stronger bank safety net. The new *Act on Mortgage Lending* grants the regulator powers to cap loan to value, debt to income, and debt service to income ratios on lending originated by banks and nonbanks alike.
Structural Revamp the wage bargaining framework.	**Consistent** The Confederation of Labor and Association of Employers signed the so called SALEK agreement which lays down basic principles and it is expected that it will be used in the 2018 wage negotiations round. In addition, in December 2016 parliament passed a major reform which moves the active public sector pension system from defined benefits to defined contributions in order to harmonize the labor market. Participants of the wage negotiations scheduled for this year have to be mindful that the outcome of their negotiations will have an impact on the wage bargaining process in 2018.

INTERNATIONAL MONETARY FUND

ICELAND

May 30, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

The European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of April 30, 2017)

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	111.78	99.64

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):

	2017	**2018**	**2019**	**2020**	**2021**
Principal					
Charges/Interest	0.00	0.01	0.01	0.01	0.01
Total	**0.00**	**0.01**	**0.01**	**0.01**	**0.01**

Implementation of HIPC Initiative: Not applicable.

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

Implementation of Catastrophe Containment and Relief (CCR): Not applicable.

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

Exchange Rate Arrangement and Exchange Restrictions:

The *de jure* exchange rate arrangement is free floating. In 2016, the Central Bank of Iceland (CBI) continued to follow a strategy of significant foreign exchange intervention as set forth by the Monetary Policy Committee in May 2013. The objective of the intervention strategy is to mitigate short-term exchange rate volatility and to grow the CBI's reserves as conditions permit. Exchange rate volatility diminished significantly after the strategy was announced. The CBI publishes monthly data on its interventions in the foreign exchange market. CBI transactions accounted for around 55 percent of total exchange market turnover in 2016, significantly higher than in 2015. The *de facto* exchange rate arrangement is classified as a floating arrangement.

Iceland has accepted the obligations under Article VIII, Sections 2(a), 3, and 4 and maintains no exchange restrictions subject to Fund jurisdiction under Article VIII, Section 2(a). The previously identified exchange restrictions arising from limitations on the conversion and transfer of (i) interest on bonds which the foreign exchange rules apportioned depending on the period of the holding, (ii) amortized principal on bonds, and (ii) the indexed portion of the principal on bonds were removed by force of legislative amendments passed in October 2016 and May 2017. Iceland continues to maintain certain measures that constitute exchange restrictions imposed for security reasons based on UN Security Council Resolutions.

Safeguards Assessment:

Iceland repaid all credit outstanding ahead of schedule in October 2015. The CBI is no longer subject to safeguards monitoring.

Last Article IV Consultation:

Discussions for the 2016 Article IV Consultation were held in Reykjavik during March 30–April 12, 2016. The Staff Report (Country Report No. 16/179) was considered by the Executive Board on June 20, 2016. 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. The composition agreements reached by the bank estates around 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 2010* and the data starting in 1997 were revised. 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.

Price statistics. Data provision is adequate for surveillance.	
Government finance statistics. The authorities publish a monthly Treasury cash flow statement, 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* 2014 framework in the *Government Financial Statistics Yearbook*, and is an up to date contributor to the *International Financial Statistics*.	
Monetary and financial statistics. The concepts and definitions conform to the guidelines of the *Monetary and Financial Statistics Manual*. The CBI reports detailed monetary (CBI and deposit money bank) balance sheet data promptly at 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*. Data were back-cast to 1995 for both the balance of payments and the IIP. BoP data do not provide a breakdown of services before 2013.	
B. Data Standards and Quality	
Subscriber to the *Special Data Dissemination Standard (SDDS)* since June 1996. Uses SDDS flexibility options on the periodicity and timeliness of the industrial production index.	A *Report on the Observation of Standards and Codes* data module was published in November 2005.

Iceland: Table of Common Indicators Required for Surveillance

(As of May 15, 2017)

	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]	Memorandum Items:[8] Data Quality – Accuracy and Reliability[10]
Exchange Rates	May 15, 2017	May 15, 2017	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	March 2017	April 2017	M	M	M		
Reserve/Base Money	March 2017	April 2017	M	M	M	LO, O, LO, LO	LO, O, O, O, O
Broad Money	March 2017	April 2017	M	M	M		
Central Bank Balance Sheet	April 2017	May 2017	M	M	M		
Consolidated Balance Sheet of the Banking System	March 2017	April 2017	M	M	M		
Interest Rates[2]	May 15, 2017	May 15, 2017	D	D	D		
Consumer Price Index	March 2017	April 2017	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4, 2016	March 2017	Q	Q	Q	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Q4, 2016	March 2017	M and Q	M and Q	M and Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q3, 2016	Dec. 2016	M	M	M		
External Current Account Balance	Q4, 2016	March 2017	Q	Q	Q	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	Q4, 2016	March 2017	Q	Q	Q		
GDP/GNP	Q4, 2016	March 2017	Q	Q	Q	O, LO, O, LO	LO, O, LO, LO, O
Gross External Debt	Q4, 2016	March 2017	Q	Q	Q		
International Investment Position[6]	Q4, 2016	March 2017	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.

Statement by Thomas Ostros, Executive Director for Iceland and Gudrun Soley Gunnarsdottir, Advisor to Executive Director
June 12, 2017

On behalf of my authorities, I would like to thank staff for an interesting report based on candid and constructive discussions in Reykjavík. My authorities very much appreciate the dialogue with IMF staff. The report presents a good picture of the current economic conditions, prospects and challenges and accurately reflects my authorities' views.

Iceland is doing well, as stated by staff. The economy is growing strongly, inflation has been close to, or below, the inflation target for more than three years, the fiscal budget remains in surplus with low and falling public net debt, capital controls introduced at the height of the 2008 crisis have been more or less fully removed, unemployment has reached its pre-crisis low, and the labor market remains very flexible and open to foreign labor. The net international investment position turned positive for the first time in 2016, the financial system is strong; capital and leverage ratios are high by any comparison, liquidity is sound, and the private sector's balance sheets have strengthened significantly since 2008. These good conditions were driven by positive external shocks, but were also achieved through prudent fiscal and monetary policies, a successful resolution of the estates of the old banks which failed in 2008, careful lifting of capital controls, and a timely use of a capital flow management measure introduced a year ago.

My authorities agree with staff that there are risks to the outlook, but mechanisms are in place to mitigate the potential risks and they remain fully committed to taking further steps if needed. Monetary policy is tight and bent on maintaining price stability over the medium term, the foreign exchange reserves are at a historically high level, fiscal policy is stability oriented within a medium-term framework anchored in both numerical and procedural rules, the financial regulatory framework is strong, including prudential rules to limit the banks' foreign currency risk, and the pension fund system is largely funded with pension fund assets equaling about 160 percent of GDP. In addition, in 2014, my authorities introduced high level monitoring of stability and risks through the establishment of a Financial Stability Council supported by a Systemic Risk Committee, engaging the Ministry of Finance and Economic Affairs, the Central Bank and the Financial Supervisory Authority (FSA).

Capital controls and CFM

The capital controls have more or less been removed through a phased and orderly process with the last big step taken in March 2017 without any disruption to financial markets or the exchange rate of the Icelandic króna. The remaining stock of offshore krónur referred to in the Staff Report is of a modest size, so its eventual resolution will not materially impact foreign exchange reserves.

On the CFM, my authorities note staff's views that the special reserve requirement which it entails should be rolled back to zero. The staff report correctly reflects my authorities' disagreement with an immediate rollback and the reasons why. They believe that the measure should only be scaled back under a gradual and conditions-based process. Capital controls have recently been lifted, Iceland is experiencing extraordinary rates of growth and there is currently a significant interest rate differential with other advanced economies. In this context, it should be noted that despite sizeable interventions to bolster reserves and reduce exchange rate volatility, the Icelandic króna has strengthened by more than 25 percent in trade-weighted terms since the introduction of the CFM a year ago and a further appreciation of the currency runs the risk of turning into an overvaluation. Under current domestic and global conditions, the risk of excessive and volatile carry trade-related capital inflows is significant, with resulting volatility in thin domestic financial markets. In addition to threatening economic and financial stability, such inflows would significantly complicate the conduct of monetary policy and shift its transmission towards the exchange rate channel and away from the interest rate channel which would not be desirable under current circumstances. It is therefore of paramount importance to proceed with caution in scaling back the use of the CFM so as not to undermine what it has achieved in restoring the transmission mechanism of monetary policy, stabilizing the economy, and re-anchoring inflation and inflation expectations. As stated in the staff report, this is an area of strong national consensus born of recent bitter experience. Furthermore, the economic benefits of capital inflows into the bond market are at the current juncture highly questionable, to say the least, given the high interest rate differential, low government borrowing requirement and the need to treat such inflows as potentially volatile when assessing FX reserve adequacy.

Prudential policies

My authorities note staff's concerns about financial sector oversight and the need to strengthen it. The report cites the Government's intention to conduct a review of all recommendations on financial sector regulation and supervision from several independent reviews. This does not detract from the fact that the financial regulatory framework and oversight have been greatly strengthened since the crisis. Since the 2014 Fund review of compliance with the Basel Committee's Core Principles for Effective Banking Supervision (BCP), good progress has been made in strengthening the legal framework and supervisory practices, and thereby in observing BCPs. Nevertheless, more is to be done, and my authorities are determined to further improve financial oversight and address as a matter of priority the areas of less than complete compliance with the BCP. That includes reviewing the Act on Official Supervision of Financial Activities.

My authorities also welcome a discussion of how the architecture can be further improved. However, they emphasize that the Ministry of Finance and Economic Affairs fully and unreservedly respects the operational independence of the FSA, and the financial arrangements are shaped by legal/technical considerations rather than political ones.

Monetary policy

My authorities agree with staff that demand pressures and an increasing positive output gap call for a tight monetary stance to safeguard medium-term price stability. But the Monetary Policy Committee (MPC) has also been taking counterbalancing forces into account, such as the appreciation of the króna and growing indications that the credibility of the inflation target has been significantly strengthened as witnessed by stronger anchoring of inflation expectations at the target. These developments have made it possible to achieve the target over the medium term with lower interest rates than before. Consistent with this, the MPC decided last month to lower its key rate by 25 basis points to 4.75 percent. As suggested by staff, the Central Bank has recently scaled down its FX intervention and has stopped weekly pre-announced FX purchases. Nevertheless, the Bank will continue to intervene in the FX market to mitigate volatility.

Fiscal policy

On the basis of the newly introduced Organic Budget Law, Parliament enacted this spring both a five-year Fiscal Policy Statement and a Fiscal Strategy Plan. These initiatives prescribe an overall surplus on the public finances of 1.6 percent of GDP in 2018 and 2019, instead of an earlier projected 1 percent, which is underpinned by a 4.4 percent surplus on the primary balance. The plan envisages a slight fiscal easing in the last three years, while maintaining an overall balance of 1.3 percent of GDP in 2022. As the negative interest balance continues to weigh on public finances, the fiscal plan remains firmly committed to continued debt reduction, aiming for net public debt to falling to 30 percent of GDP by 2019, in line with a fiscal rule in the new law. My authorities concur with staff that the new Organic Budget Law has gained a firm foothold and that it was a major achievement that it permeated the entire debate on the public finances through a general election last year and the formulation of fiscal policy on behalf of the new government earlier this year.

Although the overall fiscal stance is prudent, my authorities agree with staff that a surplus above 1 percent of GDP in the enacted budget for 2017 would have aligned better with the current economic circumstances. It would have been more judicious if at least a portion of the expenditure expansion could have been delayed until the outer years of the plan. This, in turn, calls for a stringent implementation of the current budget. In this respect, however, it needs to be borne in mind that a considerable pent-up demand for renovating vital infrastructures had built up during the years of restraint after the 2008 crisis. My authorities agree with staff's assessment that to stay on course, fiscal policy needs to adhere to the fiscal rules and procedural framework of the new law while allowing the automatic fiscal stabilizers to work, unless economic developments, such as overheating, warrant specific measures.

My authorities have introduced further steps to underpin the long-term sustainability of the public finances. One such measure was an agreement with the unions of public employees on a reform of their main pension fund so that it will be fully funded, without any government guarantee, for the foreseeable future by providing it with an injection of the equivalent of 5 percent of GDP in 2016. Another step involves preparations for establishing a sovereign wealth fund based on dividend revenues from the national electrical power company, which are set to rise significantly in coming years.

Wage bargaining

My authorities welcome staff´s recommendation on the outlined wage bargaining rules anchored on competitiveness and economic stability in the Salek agreement. The Icelandic wage bargaining model with social partners and the government has often worked effectively, especially during times of crisis. However, it has been less successful in good times when labor unions have shown a fragmented front. Successful implementation of the Salek agreement is very important in the period ahead.

In conclusion

Iceland's rapid growth has primarily been driven by what staff refers to as the tourism eruption. The changes in the tourism sector have been extraordinarily large and rapid, which in and of itself creates challenges for macroeconomic management. Small economies tend to be vulnerable to large external shocks and experience teaches us that positive shocks can often be rapidly reversed. As staff suggests, this may not be the case with the tourism industry as it is expected to level off, but not decrease in volume. While my authorities agree that this is probably the case, they feel that it is still appropriate to tread carefully through this cycle, especially regarding other sectors of the economy.

The biggest challenge will be to prudently manage the good fortunes which Iceland enjoys, again in an environment of financial openness. Current risks are partly external which Iceland can do little about. But there are also domestic risks, mainly relating to potential overheating of the economy. My authorities are determined to minimize these and pave the way for the smooth transition to balanced growth in line with the long-term trend in an environment of economic and financial stability.