



ICELAND

SIXTH POST-PROGRAM MONITORING DISCUSSIONS—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ICELAND

June 2015

In the context of the Sixth Post-Program Monitoring, the following documents have been released and are included in this package:

- A **Press Release** including a statement by the Chair of the Executive Board, and summarizing the views of the Executive Board as expressed during its June 24, 2015 consideration of the staff report on issues related to the Sixth Post-Program Monitoring and the IMF arrangement.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 24, 2015, following discussions that ended on May 21, 2015, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 8, 2015.
- A **Staff Statement** updating information on recent developments.
- A **Statement by the Executive Director** for Iceland.

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IMF Executive Board Concludes the Sixth Post-Program Monitoring Discussion with Iceland

On June 24, 2015 the Executive Board of the International Monetary Fund (IMF) concluded the Sixth Post-Program Monitoring (PPM) Discussion with Iceland.¹

Iceland's economy is facing two major challenges. The first is implementation of its new capital account liberalization strategy, aiming for full reintegration with global financial markets. The second challenge is navigating significant wage increases that look likely to disrupt Iceland's otherwise strong and stable economic position.

Iceland recently updated its capital account liberalization strategy. The strategy takes a staged approach, starting with steps to address the balance of payments (BOP) overhang of the old bank estates—prioritizing a cooperative approach with incentives—in a manner consistent with maintaining stability. The next two stages will address remaining offshore liquid króna (OLK) holders, using an auction format, and then residents. If successfully implemented, the updated strategy will help speed up the pace of liberalization.

Growth is accelerating this year and is expected to reach 4.1 percent, backed by significant investment, wage- and debt relief-fueled consumption, and booming tourism. Inflation is currently low at 1.6 percent—contained by imported deflation—but inflation expectations have picked up. Large wage hikes are projected to push inflation well above the Central Bank of Iceland's (CBI) 2.5 percent inflation target. The CBI's Monetary Policy Committee (MPC) hiked its policy rate by 50 bps at its June meeting and signaled further possible hikes in response to significant wage increases. Growth will likely slow significantly in 2016-17 as efforts to dampen excess domestic demand and inflation pressures take hold. The CBI has stepped up its FX purchases this year.

¹ The central objective of PPM is to provide for closer monitoring of the policies of members that have substantial Fund credit outstanding following the expiration of their arrangements. Under PPM, members undertake more frequent formal consultation with the Fund than is the case under surveillance, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

Risks to growth are tilted to the downside, given uncertainty around the impact of wage increases on the economy. Nonetheless, Iceland appears ready to advance capital account liberalization. The external current account balance--currently supported by favorable terms of trade--is projected to weaken but remain positive over the medium-term.

The general government is projected to record a surplus of 0.8 percent of GDP this year, helped by large one-offs. Small deficits are expected over 2016–20 due to the effects of one-offs, re-starting funding of public pension fund shortfalls, spending on a new hospital, and other factors. The government's recently published medium term (2016-19) fiscal framework affirms key fiscal objectives of achieving balanced budgets and debt reduction. Approval of the draft Organic Budget (fiscal framework) Law is expected soon.

Several important financial sector reforms are underway, including draft legislation to further strengthen financial safety nets and the macroprudential policy framework. Efforts to strengthen financial supervision capacity are continuing. Final agreement on the fate of the loss-making government-owned Housing Financing Fund is pending.

Executive Board Assessment²

Executive Directors commended the Icelandic authorities for their continued progress in strengthening policy frameworks and addressing crisis legacies. They noted, however, that major challenges lie ahead, particularly implementation of the updated capital account liberalization strategy and policy response to pressures for large wage increases. Directors emphasized the need to carefully calibrate the pace of the liberalization process, taking into account the external position and financial stability considerations. They also stressed that appropriately tight macroeconomic policies are essential to limit demand pressures and support external competitiveness.

Directors welcomed the authorities' recent announcement of their updated capital account liberalization strategy. They supported focusing initially on reducing balance-of-payments pressures tied to the estates of the failed banks. Directors underscored the importance of maintaining adequate reserve buffers and sound macroeconomic and financial sector policies to safeguard stability, critical to the success of the liberalization strategy.

Directors viewed the tightening of monetary policy to be an appropriate response to inflationary pressures from large wage increases, and welcomed the authorities' commitment to take further action as necessary to bring inflation in line with the target over the medium term. They stressed that the independence and accountability of the central bank is crucial for maintaining policy credibility and anchoring inflation expectations. Directors supported

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>

ongoing efforts to smooth exchange rate volatility and build up foreign exchange reserves as conditions allow, ahead of further liberalization of the capital account.

Directors agreed that fiscal policy should remain focused on the medium-term objectives of a balanced budget and further debt reduction, while the path could be adjusted if warranted by developments in domestic demand. They noted that the adoption of the organic budget law will provide an important anchor in this regard. Directors also encouraged the authorities to specify more concrete measures to achieve their fiscal objectives, and to formulate contingency plans to address risks related to the Housing Financing Fund (HFF) and financial sector taxation.

Directors welcomed steps to continue to strengthen the financial sector and financial stability framework ahead of full capital account liberalization. They encouraged efforts to further improve the macroprudential framework, and financial supervision and safety nets. Directors called for a swift resolution of the HFF in a manner that minimizes fiscal costs and financial stability risks, and looked forward to further clarity on a well-targeted successor program.

Iceland: Selected Economic Indicators, 2011–16

	2011	2012	2013	2014	2015	2016
					Proj	Proj
	(Percentage change, unless otherwise indicated)					
National Accounts (constant prices)						
Gross domestic product	2.4	1.3	3.6	1.9	4.1	2.8
Total domestic demand	3.3	1.4	1.0	4.1	6.1	3.5
Private consumption	2.6	2.0	0.5	3.7	4.3	2.6
Public consumption	1.2	-1.7	0.7	1.8	3.2	3.1
Gross fixed investment	11.6	5.6	-1.0	13.7	18.2	7.5
Exports of goods and services	3.4	3.7	6.9	3.1	5.2	4.9
Imports of goods and services	6.9	4.7	0.3	9.9	12.0	7.2
Output gap 1/	-1.2	-0.8	-0.3	-0.3	0.6	0.2
Selected Indicators						
Nominal GDP (ISK bn)	1,703	1,780	1,881	1,993	2,160	2,329
Private consumption (percent of GDP)	51.6	53.2	52.3	52.6	51.8	51.8
Public consumption (percent of GDP)	24.6	24.4	24.3	24.3	24.3	24.4
Gross fixed investment (percent of GDP)	15.5	16.1	15.4	16.6	18.5	19.2
Unemployment rate (period average) 2/	7.1	6.0	5.4	5.0	3.7	4.1
Employment	0.0	1.1	3.3	1.6	2.4	1.1
Labor productivity	0.9	0.8	-0.2	0.3	1.6	1.8
Real wages	3.0	2.2	-1.0	3.7	5.9	3.3
Nominal wages	7.0	7.4	2.9	5.7	8.3	8.3
Real GDP per capita (ISK mln)	3.6	3.7	3.8	3.8	3.9	4.0
Consumer price index (period average)	4.0	5.2	3.9	2.0	2.3	5.0
Consumer price index (end of period)	5.3	4.2	4.2	0.8	3.6	5.8
Nominal effective exchange rate 3/	-0.3	-2.4	1.5	5.8	...	...
Real effective exchange rate 3/	0.9	0.6	3.8	6.7	...	...
ISK/EUR	161	161	162	155	...	...
ISK/USD	116	125	122	117	...	...
Terms of trade	-3.0	-3.1	-1.8	3.4	4.1	0.7
Money and Credit						
Base Money	-20.7	32.0	0.3	-17.6	8.4	7.8
Deposit money bank credit	6.9	0.7	1.4	4.1	2.4	4.8
Broad money	8.7	-2.7	4.2	3.9	2.3	4.7
CBI policy rate	4.75	6.00	6.00	5.25	...	...
	(Percent of GDP, unless otherwise indicated)					
Public Finance (General Government 4/)						
Revenue	40.1	41.7	42.4	45.3	44.8	43.7
Expenditure	45.6	45.3	44.1	45.4	44.0	44.0
Balance	-5.6	-3.7	-1.7	-0.2	0.8	-0.4
Primary balance	-2.7	-0.2	1.9	3.4	3.6	1.5
Balance of Payments						
Current account balance 5/	-5.3	-4.2	5.8	3.6	3.3	2.9
Trade balance	8.2	6.2	8.2	6.4	5.4	4.7
Financial and capital account	4.8	-5.2	6.8	3.6	3.2	2.7
Net errors and omissions	1.5	-0.1	0.2	0.0	0.0	0.0
Central bank reserves (USD bn)	8.7	4.3	4.1	4.2	4.8	4.5
Excluding old banks' deposits (USD bn)	5.9	4.2	4.0	4.1	4.7	4.4

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

1/ In percent of potential output.

2/ In percent of labor force.

3/ A positive (negative) sign indicates an appreciation (depreciation).

4/ National accounts basis.

5/ Actual data include the income receipts and expenditures of DMBs in winding up proceedings, and accrued interest payments on intra-company debt held by a large multinational, but estimated and projected data do not.



ICELAND

SIXTH POST-PROGRAM MONITORING DISCUSSIONS

June 8, 2015

KEY ISSUES

Iceland's otherwise strong and stable economic position looks likely to be disrupted by significant wage hikes. Collective wage bargaining looks headed for economy-wide cumulative 3½-year nominal wage growth of 20–25 percent, along with fiscal measures costing ½ percent of GDP annually to help break an impasse between social partners. With a closed output gap and modest productivity gains, this would propel inflation well above the Central Bank of Iceland's (CBI) 2.5 percent target, generate budget pressures, erode competitiveness, and slow capital account liberalization.

A decisive policy response will be needed. Excess demand pressures will likely boost economic growth this year. *Monetary policy* tightening will be needed to bring inflation back down to target. *Fiscal policy* should be adjusted to reduce demand pressures, while staying on track to achieve debt reduction objectives. Fiscal adjustment plans will need to become more specific. The tighter policies are expected to pull inflation gradually toward the target and slow real GDP growth in 2016 and beyond.

Iceland looks ready to finalize its updated capital account liberalization strategy. Considerable effort has been made to better understand the challenges, risks, and range of options for addressing Iceland's still-significant balance of payments (BOP) overhang, estimated at 65–70 percent of GDP. The authorities look ready to proceed with an updated comprehensive, conditions-based liberalization strategy, while maintaining stability and giving emphasis to a cooperative approach with incentives. However, the pace of implementation, particularly for the real sector, may be slowed by macroeconomic volatility and erosion in competitiveness from large wage hikes.

Efforts to strengthen core policy frameworks are broadly on track. Approval of an ambitious budget framework law (Organic Budget Law, or "OBL") is expected soon. Important draft laws to bring financial sector safety nets in line with European Economic Area (EEA) standards and to strengthen the macroprudential policy framework are expected to be passed later this year. Critical efforts to strengthen financial supervision are continuing. Work to refine the monetary policy framework and the role of macroprudential policies is underway. A review of central bank legislation will continue later this year and should aim for an outcome consistent with maintaining independence and accountability. Final agreement on run-off of the loss-making Housing Financing Fund (HFF) and a successor strategy remains elusive.

Approved By
**Jörg Decressin and
 Luis Cubeddu**

Mr. Dohlman (Head), Mr. Antoshin, and Mr. Arena (all EUR), Mr. McHugh (FAD), and Ms. Fayad (SPR) visited Reykjavik during May 7–21. The mission met with senior government and central bank officials, members of parliament, representatives from the trade unions and business community, and academics. Ms. Boranova and Ms. Ilagan (EUR) assisted the mission. Mr. Groenn and Ms. Jonsdottir (both OED) participated in some of the policy discussions.

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RECENT DEVELOPMENTS AND OUTLOOK

A. Context

1. Iceland's economy is navigating two major challenges. There is a strong push to advance capital account liberalization, aiming to reintegrate the economy more fully into international financial markets to harness benefits for savers, investors, and the economy as a whole. However, emerging wage settlements, amid tense discussions among social partners over the distribution and pace of income growth, look likely to disrupt hard won growth and stability gains.

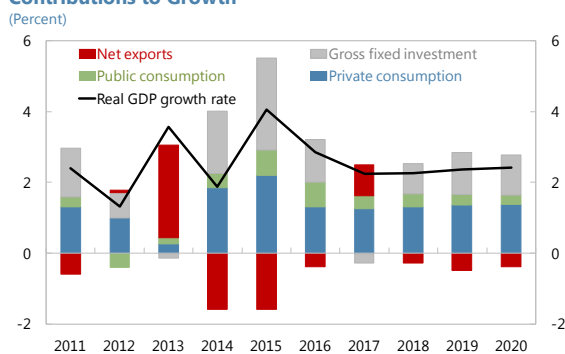
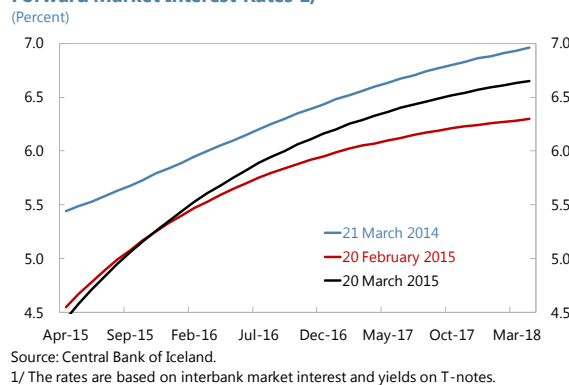
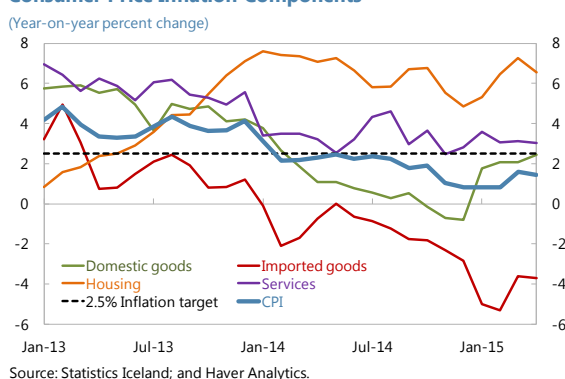
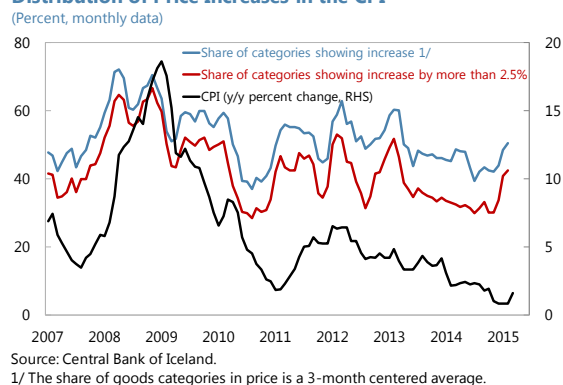
2. Tense collective bargaining appears headed for large wage increases (Annex I). Agreements covering wage increases through 2018 for just over one-third of the workforce were initialed at end-May, averting calls for a general strike. To facilitate the agreement, government committed—premised on private and public sector wage settlements that do not lead to economic instability—to personal income tax (PIT) reform and social and housing programs costing about 0.5 percent of GDP annually. The agreements are still being evaluated, and settlements for remaining private and public sector workers still are uncertain, but look likely to drive large economy-wide wage hikes that push inflation well-above target and erode competitiveness.

3. Expectations of rapid progress in capital account liberalization are building in Iceland. Announcement of an updated strategy is expected soon that would aim to advance the liberalization process and could result in significant one-off fiscal revenues, including from a “stability tax” on the legacy BOP overhang. Efforts to update the strategy reflect a strong desire to reintegrate Iceland with global financial markets and comes against a backdrop of growing public frustration with (and perceived costs of) capital controls. At the same time, the space for overhang release is limited under baseline BOP projections, and could be slowed by adverse effects of large wage increases on competitiveness and the trade surplus.

B. Recent Developments

4. The pace of economic growth has been accelerating, after relatively lackluster 1.9 percent growth in 2014 (Tables 1 and 3; Figure 1). Short-term indicators and import data indicate strong consumption in early 2015, fueled by real wage growth (4.7 percent y-o-y in January–April) and household debt relief. Investment growth is solid and broad-based across silicon plants, fisheries, and construction companies. Tourism continues to boom—with hotel occupancy rates reaching new highs—and now generates one third of exports. Unemployment is close to the estimated NAIRU of 4.0 percent.

5. Inflation expectations and inflation have begun to rise (Figure 2). Inflation expectations appear to have responded to news of wage pressures, with long-term market-derived expectation measures up 1.5 percentage points since January to about 4 percent. Inflation remains below the CBI 2.5 percent target, but rose from 0.8 percent in February to 1.6 percent y-o-y in May, driven by higher housing inflation and easing imported deflation. Core inflation and the share of CPI categories showing increases have also risen, and the yield curve has steepened.

Contributions to Growth**Forward Market Interest Rates 1/****Consumer Price Inflation Components****Distribution of Price Increases in the CPI****6. BOP conditions have been favorable, allowing further accumulation of FX reserves.**

(Table 4; Figure 3). The trade balance continues to benefit from favorable terms of trade—in part due to lower oil prices and higher fish prices—and booming tourism. The CBI is taking advantage of current account-driven appreciation pressures to continue net purchases of FX this year (about \$0.3 billion, or 2 percent of GDP through mid-May) via regular preannounced and ad hoc interventions. Gross reserves reached \$4.5 billion (27 percent of GDP) at end-April. External debt remains on a downward sustainable trajectory (Annex II, External DSA).

7. The financial sector continues to paint a mixed picture (Tables 2 and 6; Figures 4–6).

Iceland's three largest commercial banks are well capitalized with strong liquidity buffers, reflecting a tightening of regulations. The system-wide nonperforming loan ratio (cross-default basis) is down to 7.9 percent. But bank lending has been weak outside a few sectors and profitability driven largely by irregular items. Banks face rising CPI indexation imbalances, though legal risks to CPI loan indexation have receded following a recent court ruling confirming the legality of CPI-indexed mortgages. A final decision on HFF will be made when the authorities settle on a successor housing program.

C. Outlook and Risks: Near-term Disruptions from Wage Hikes**8. Large wage hikes look likely to push inflation well above the CBI's 2.5 percent inflation target.**

The recently initiated wage settlements are still being assessed, but initial estimates suggest cumulative increases of 20–26 percent through 2018, depending on the extent to which sector- and firm-level deviations follow past patterns. Staff baseline projections assume economy-wide cumulative increases of around 26 percent over the same period. In the context of a closed output

gap and projected average productivity growth well under two percent, inflation will be pushed significantly above target by the boost to consumption and higher output prices in low profitability sectors such as construction and services. Such hikes, along with fiscal measures to facilitate wage agreements, are also likely to generate budget pressures, dampen confidence, and erode competitiveness. Inflation is projected to peak near 6.0 percent during 2016 and then fall gradually to target, assuming significant monetary policy tightening over the next several years.

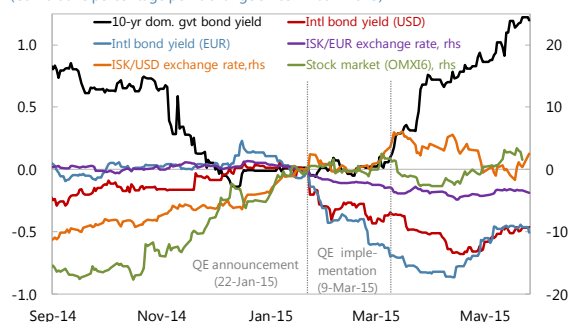
9. Growth is projected to surge this year, and then slow sharply in response to tighter policies. Growth is expected to reach 4.1 percent this year, backed by planned investment, wage- and debt relief-fueled consumption, and booming tourism. Growth will then slow significantly in 2016–17 as debt relief tapers off and the expected tighter monetary policy dampens domestic demand, notably investment. The fallout from wage hikes in the headline growth and current account numbers will be obscured by major investment plans and exports of energy-intensive industries and fisheries as well as a structural expansion in tourism. Higher wage costs will push the unemployment rate up. Growth is expected to reach about 2.4 percent in the medium-term.

- *The authorities have broadly similar views on the position of the economy and the impact of wage hikes.* At the time of the mission, they had a lower, 16 percent cumulative three-year baseline wage hike, but noted that this might be optimistic. They also produced an adverse scenario with higher wages hikes, a more protracted period of high inflation, and deeper disruptions in growth that are consistent with staff estimates. They emphasized the inflation path will also depend on how well inflation expectations are anchored. There was agreement that medium-term growth will be mainly driven by robust domestic demand and tourism, and could be dampened if higher interest rates trigger lower investment.

10. The external sector outlook looks somewhat weaker, but still positive. A more appreciated real exchange rate will dampen external prospects, but the underlying current account surplus is projected to remain positive amid favorable terms of trade and trading partner growth prospects. Over the medium-term, higher goods exports are expected to be outpaced by rising import demand tied to export-oriented investment and consumption while the balance on services, mainly linked to the tourism sector, is projected to remain strong. Borrowing costs are expected to be lower as a result of ECB QE, with external debt on a downward sustainable trajectory (Annex II External DSA). Staff's baseline projections suggest that just under 20 percent of GDP of the BOP overhang could be released over the medium term while maintaining reserve buffers at adequate levels, set conservatively at the upper (150 percent) bound of the reserve adequacy metric.

The Effect of QE on Iceland's Financial Market

(Cumulative percentage point change since 22-Jan-2015)



Sources: Bloomberg; CBI; OMX Nordic Exchange; and IMF staff calculations.

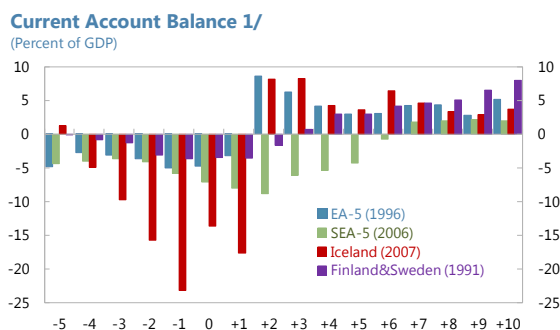
1/ The rhs scale is in cumulative percent changes since 22-Jan-2015.

- *The authorities broadly agreed.* Their baseline trade balance path was more optimistic over the medium-term, but their adverse scenario moves closer to staff views. The authorities assume no

release of BOP overhang and some build-up of reserves over the medium-term, pending an updated strategy. The authorities agreed on the importance of maintaining conservative reserve buffers, but noted that as uncertainty falls, the buffer could be reduced.

Iceland's underlying current account balance is expected to remain positive but decline gradually over the medium term. Iceland's saving-investment balance has so far followed

similar patterns as other countries recovering from a financial crisis. The experiences of Sweden and Finland after 1991 and the East Asian countries after 1998 suggest that savings rise above and investment decline below pre-crisis averages. If this pattern continues, then Iceland's medium-term saving rate should be higher and its investment rate lower not only compared to their pre-crisis levels but also their historical levels.



Sources: IMF WEO; and IMF staff calculations and projections.
1/ Time t=0 is the pre-crisis year. EA-5 includes Indonesia, Malaysia, Korea, Philippines, Thailand. SEA-5 includes Greece, Ireland, Italy, Portugal, Spain. For Iceland, the underlying current account balance is used.

11. Risks are tilted to the downside (Annex III). There are significant uncertainties about the economy-wide path of wage growth, with both better and worse outcomes possible—the latter could unanchor inflation expectations, with deeper and more prolonged adverse effects. Wage growth could also translate into a more pronounced slowdown in tourism. Broader strikes are still possible that would disrupt economic activity and could cause reputational damage to the important tourism sector. Liberalization of the capital account could pick up pace, boosting confidence and private investment, attracting inflows, and raising long-term growth—but missteps could lead to a disorderly unwinding or even prolonged controls. Fiscal risks from legal challenges to financial sector taxation and from contingent liabilities, including the HFF, could increase government debt and interest payments. An economic slowdown in the euro area, financial market uncertainty relating to Greece, or volatility associated with the projected tightening in U.S. monetary conditions could dampen exports and foreign direct investment and raise external borrowing costs. Upside risks to oil prices—including from global political fragmentation—could weaken terms of trade and the trade balance.

- *The authorities broadly agreed with the characterization of risks.* They shared deep concerns about wage developments, emphasizing particularly damaging outcomes if inflation expectations become unanchored. Regarding capital account liberalization, the authorities stressed that they are carefully assessing risks in the context of their planned updated strategy and noted upsides from possible one-off fiscal revenues. There were differences of view among the authorities on financial risks from uncertainty around Greece, with most seeing limited direct impact and some noting a possible increase in global and euro area peripheral risk premia.

POLICY DISCUSSIONS: MITIGATING WAGE SHOCKS

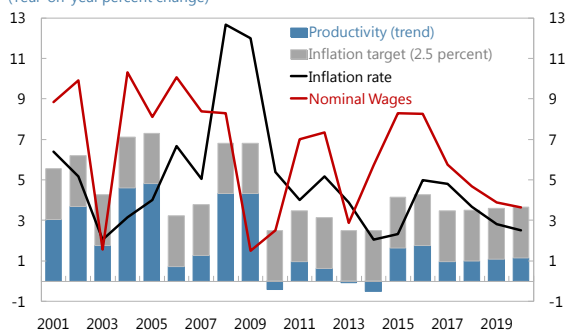
12. Discussions focused on policies to mitigate risks from large wage shocks, further efforts towards capital account liberalization, and supportive policies. To restore stability, monetary policy should be tightened immediately and fiscal policy tightened to help dampen demand pressures, while maintaining a fiscal trajectory consistent with medium-term debt-reduction objectives. The updated capital account liberalization strategy should maintain a conditions-based approach consistent with supporting stability, with emphasis on a cooperative approach with incentives, and be supported by sound policies and strengthened frameworks.

A. Monetary Policy: Containing Wage-Fueled Inflation

13. The CBI’s Monetary Policy Committee (MPC) has signaled it will tighten if large wage hikes are realized. The MPC has kept the policy rate unchanged since end-2014, balancing mounting wage pressures against persistent imported deflation (Figure 7), but strongly signaled a policy rate increase should significant wage hikes occur. The MPC is also monitoring external factors, which have become more uncertain given (i) ECB QE, which could contribute to higher euro area inflation but a stronger króna against the euro; (ii) uncertainty about Fed lift off and the strength of the dollar; and (iii) uncertainty about oil prices. Markets have priced in a sizable policy rate hike.

Wages and Labor Productivity

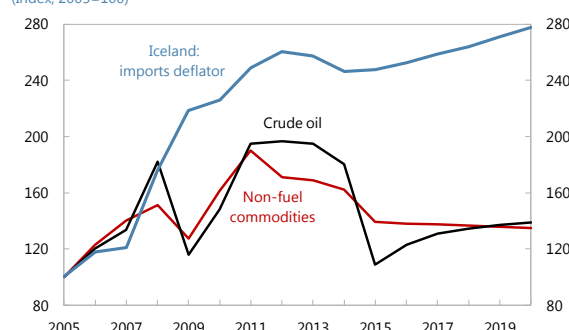
(Year-on-year percent change)



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

Imports Deflator and Global Prices

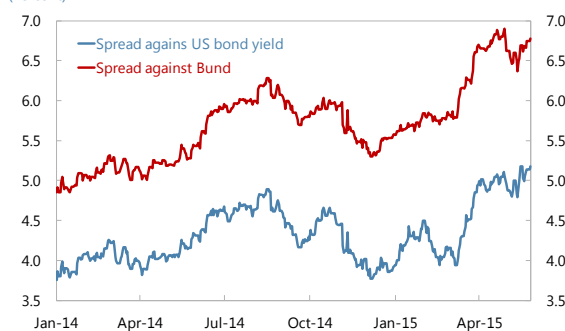
(Index, 2005=100)



Sources: Statistics Iceland; IMF staff calculations and projections.

Iceland: 10-year Domestic Government Bond Spreads

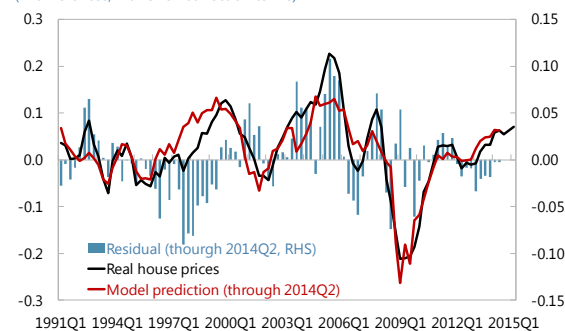
(Percent)



Source: Bloomberg.

House Price Misalignment

(In differences, with error-correction terms)



Sources: CBI; Statistics Iceland; Haver Analytics; and IMF staff estimates.

14. The government has pushed planned amendments to central bank legislation to the fall session of parliament. An experts committee commissioned by the government has proposed that much of the current CBI governance structure remain intact, including the MPC. But to address the government's stated desire for better checks and balances, the experts recommended formation of an executive board, consistent with practices in some other Nordic countries and the Bank of England, which would be responsible for key decisions outside monetary policy.

Policy Discussion

15. Staff supported a monetary policy tightening in response to large wage hikes, to bring inflation back to target. Staff also supported CBI plans to continue its FX programs to smooth volatility and build-up non-borrowed FX reserves ahead of capital account liberalization. The mission stressed the importance of measures to increase productivity, as discussed during the 2014 Article IV consultations. Furthermore, staff recommended efforts to strengthen the collective wage bargaining mechanism, aiming for outcomes more conducive to stability and growth, ahead of the next round.

16. The mission stressed the importance of maintaining CBI independence and accountability in the context of the review of central bank legislation. This is especially important as the central bank responds to wage hikes and supports implementation of an updated capital account liberalization strategy. Staff agreed that formation of an executive board could meet government objectives, and urged stability in current leadership and clarification that the new governance structure will consist of one governor and two deputies to avoid perceptions of a return to the more politicized pre-2009 three governors structure. The mission also recommended tighter oversight by and stricter appointment qualifications and procedures for the Supervisory Board, clarification of the CBI's hierarchy of objectives, and strengthened internal audit mechanisms.

- *The authorities welcomed staff support.* They noted that exchange rate adjustment will be market-driven and that the calibration of FX purchases will be subsumed under the CBI's principle objective of price stability. They concurred that policies to facilitate productivity gains would be important. They also broadly agreed with staff views on central bank legislation and the wage bargaining mechanism, but have postponed final decisions on central bank legislation.

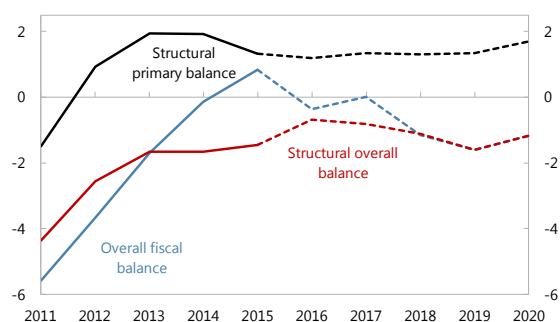
B. Fiscal Policy: A Challenging Agenda

17. The authorities' new medium term (2016–19) fiscal framework aims to enhance the productive capacity of the economy and further reduce debt. To help achieve this, the authorities aim to limit real current expenditure growth to just over one percent per annum, and undertake simplification of the PIT—moving from a 3- to 2-band rate regime costing about 0.4 percent of GDP annually. They intend to gradually prefund shortfalls in the public pension system of about 24 percent of GDP, and are considering a broader review of Iceland's mostly private pension system.

18. Staff projects a general government budget surplus of 0.8 percent of GDP this year, boosted by large one-off revenues, followed by small deficits over the medium-term (Table 5; Figure 8; Annex II Public DSA). 2015 structural revenues are so far broadly on track. On the

expenditure side, staff has incorporated new higher baseline wage projections. Under current projections, the 2015 structural primary fiscal stance is mildly expansionary, loosening by 0.6 percent of potential GDP, but the fiscal impulse is likely much larger taking into account lagged demand effects of end-2014 household debt relief.¹ Staff projects small headline deficits over 2016–20—a significant worsening relative to the 2014 Article IV Consultations—reflecting an unwinding of one-off revenues from the financial sector as well as labor settlement-related wage growth and fiscal measures, resumption of contributions to address public pension fund shortfalls, capital expenditures for a new hospital, and higher interest costs, but also ambitious though largely unspecified measures to limit the growth of real current spending. Expenditure restraint would overtake other developments towards the end of the medium-term, leading to a gradual structural tightening.

Fiscal and Structural Balances
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff projections.

Iceland: Key Fiscal Policy Assumptions
(Percent of GDP)

	2015	2016	2017	2018	2019	2020
Revenues						
PIT reform			-0.2	-0.4	-0.4	-0.4
Expenditures						
Pension contribution 1/			0.3	0.3	0.3	0.2
Additional housing assistance		0.1	0.1	0.1	0.1	0.1
National hospital construction				0.5	1.0	1.0
HFF recapitalization	0.2	0.2	0.2	0.2	0.2	0.2
Unspecified expenditure measures			-0.2	-0.2	-0.3	-0.3
Additional interest costs	0.0	0.0	0.0	0.1	0.2	0.3
Impact on gross debt	0.2	0.6	0.9	2.0	3.5	5.2

Source: IMF staff projections.

1/ Included in the authorities' medium term plan.

19. Preparations to implement the proposed new fiscal framework (OBL) are underway.

Approval of the draft OBL is expected soon, and preparations for its implementation are well underway, supported by FAD. The reform will involve a fundamental restructuring of budget practices, including formal adoption of gender budgeting (Box 1) and a new fiscal rule framework setting a 45 percent of GDP net debt ceiling and targeting budget balances. Implementation of the OBL is expected to provide an important tool for meeting expenditure restraint objectives.

Policy Discussions

20. Staff recommended fiscal tightening to ease wage-driven domestic demand pressure and address medium term fiscal challenges. The 2016 stance already looks to be tighter, despite a projected loosening of the structural balance, given the lagged demand effects of household debt relief in 2015. However, depending on the size of wage hikes and the pace of PIT reform, which may be shifted to 2016, more effort may be needed in 2016–17 to help ease domestic demand and take some of the burden from monetary policy. To help achieve this, staff recommended some combination of further harmonization of VAT rates accompanied by well-targeted offsets for lower

¹ Household debt relief-related revenues and expenditures are treated as one-offs and therefore excluded from the structural balance. This provides a more accurate picture of the permanent fiscal stance, but does not capture the demand effects from debt relief. Moreover, these effects are more pronounced in 2015 than suggested by annual accounts, due to lagged demand effects of large, front-loaded household debt relief launched at end-2014.

income groups, higher property taxes, and deferral or shift to revenue neutrality of planned tax reforms. Better understanding of the causes of social benefit increases in recent years, and possibly civil service reform, could also be helpful in defining better targeted measures, with possible expenditure savings.

- *The authorities highlighted the difficulties of using fiscal policy in the short term as a demand management tool, but are considering medium-term options.* They were anxious to decouple wage negotiations from fiscal management, but recognized that further public sector wage hikes along with measures to facilitate a wage agreement may not allow this. They noted that potentially growth enhancing tax reforms could be delayed or shifted to a revenue neutral approach depending on the extent and implications of eventual labor market disruptions and prevailing demand conditions. They noted, however, that steps such as another round of VAT reform would face political difficulties given deep public concern about the distributional aspects of fiscal policy. The authorities are keen on further developing their capacity to assess distributional consequences of reforms, and pointed to the success of the recent workshop on this topic co-sponsored with FAD.

21. The mission stressed the importance of continuing progress towards fiscal sustainability. It expressed broad support for medium-term fiscal objectives, but highlighted the importance of greater specificity to achieve them. Staff estimated that additional measures of around 1 percent of GDP will be needed to achieve a structural fiscal balance of zero. In addition, further fiscal space will be needed to increase public investment which remains at historically low levels even with planned hospital spending. Greater specificity will also be needed to underpin planned current expenditure restraint. Staff reiterated the importance of contingency plans to address fiscal risks, including the HFF, and legal challenges to financial sector taxation and possibly to measures related to capital account liberalization. Staff strongly supported the authorities' efforts to approve and begin implementation of the OBL.

- *The authorities felt current policies would be sufficient to achieve objectives.* They noted that public investment is unlikely to rise in the near term due to the overriding objective to maintain a downward trajectory for public debt, but noted broad consensus that legacy pension issues should be addressed. The authorities were well aware of fiscal risks, but felt current buffers, including budget contingency funds and government deposits, were sufficient. They noted that the stock of guarantees had fallen in recent years and was projected to fall sharply over the next four years. The authorities were more optimistic regarding potential for reduction in operating costs in the HFF, once shifted to run-off mode. Finally, they indicated that possible future one-off revenues related to privatization and to capital account liberalization could significantly accelerate debt reduction, lower the interest bill, and free up fiscal space.

C. Capital Account Liberalization: Moving Forward

22. Iceland is finalizing an updated capital account liberalization strategy to alleviate BOP overhang pressures and help reintegrate Iceland with international capital markets. In a context of growing expectations and increasing concern about the costs of controls, the authorities have

undertaken considerable effort to better understand the size, complexity, risks, and range of options for accelerating liberalization. Staff estimates the BOP overhang remains around 65–70 percent of GDP, though the resident overhang component in particular remains subject to significant uncertainty. As before, new nonresident investment is unrestricted.

23. The authorities are aiming for a staged approach. The first stage looks to bring more clarity to the failed old bank estates, aiming for cooperative outcomes that maintain stability but also putting in place incentives to help encourage such outcomes. The latter could include a “stability tax” that targets a potentially large portion of the BOP overhang of the estates. The updated strategy will likely rely on an auction format to address remaining liquid offshore króna (carry trade) holders caught by controls. The bulk of resident flows would be released later, conditioned on BOP developments, though small annual outflows may be permitted for pension fund rebalancing, export-oriented FDI, and households. If successfully implemented, portions of the strategy could significantly reduce the BOP overhang in a manner that also generates significant one-off fiscal revenues, though full liberalization remains distant.

Policy Discussion

24. Staff supported finalization of an updated strategy consistent with key recommendations. Staff repeated earlier recommendations that the strategy should (i) be conditions-based, aiming to maintain macroeconomic and financial stability; (ii) be comprehensive, transparent, and well-communicated; (iii) rely on a cooperative approach with incentives; (iv) utilize non-discriminatory measures when possible; (v) be consistent with Iceland’s international obligations; and (vi) be based on credible analysis, especially the BOP. The pace of implementation should be carefully calibrated with external buffers and projected BOP flows, which could be boosted by some additional sovereign borrowing. The mission noted the pace of liberalization for the real economy would likely be slowed due to wage-driven erosion of competitiveness. Implementation should be supported by sound macroeconomic and financial sector policies, including upgrading the fiscal, financial, and macroprudential policy frameworks and core policies that aim for lower debt, stability, and sustainable, robust growth. Contingency plans in the event of missteps are also important.

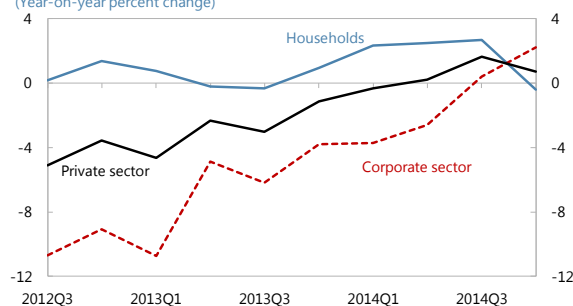
- *The authorities were in broad agreement, putting strong emphasis on building confidence and maintaining stability, while also emphasizing the importance of bringing closure to treatment of various elements of the BOP overhang.* They emphasized the important role of incentives, including the use of statutory powers as needed, to help encourage a cooperative resolution.
- *The authorities shared concerns about the adverse effects of large wage hikes on competitiveness and the pace of liberalization for the real economy.* They agreed on the importance of enhancing Iceland’s BOP prospects and building up adequate reserve buffers. Over the coming months, they intend to further analyze and quantify pressures for resident portfolio rebalancing.

D. Financial Sector

25. The authorities continue to strengthen Iceland’s financial sector and macroprudential policy frameworks (Box 2). Cross-agency cooperation on financial stability has been boosted by

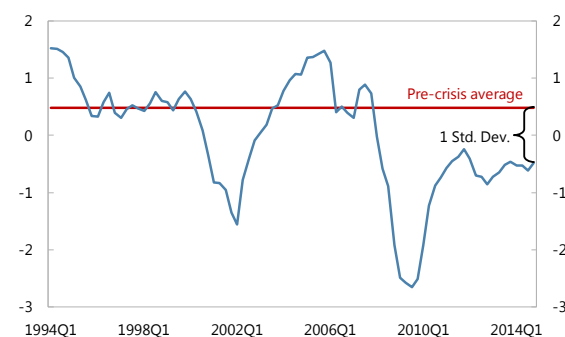
creation of the Financial Stability Council (FSC), which formulates policies on financial stability which is then implemented by the Financial Supervisory Authority (FME) and the CBI. Most recently, the FSC supported strengthened FME oversight of the HFF. Iceland is well-advanced in implementing Basel III liquidity ratios and has also implemented a net stable funding ratio for FX. Approval of additional macroprudential authority—including LTV, countercyclical and systemic risk buffers, limits on unhedged borrowing, and possibly debt-service-to-income (DSTI)—is expected later this year. The authorities are also addressing gaps in financial supervision and safety nets, including risk-based supervision, supported by MCM TA. They expect parliamentary approval of legislation to strengthen the deposit guarantee and resolution frameworks in line with EEA rules in the next parliamentary session and will overhaul the CBI emergency liquidity assistance framework by end-2015.

Real Credit Growth 1/
(Year-on-year percent change)



Sources: Central Bank of Iceland; Statistics Iceland; and IMF staff calculations.
1/ Loans from financial institutions. Credit to households and corporates is deflated by CPI and investment deflator, respectively.

Financial Conditions Index (Standardized) 1/



Source: IMF staff calculations.
1/ Calculated using principal component analysis. Latest data point 2014Q4.

26. The authorities are assessing the potential financial sector implications of capital account liberalization. The CBI and the FME are performing stress-tests, including potential capital outflows and tolerance for currency depreciation. Old bank estates' deposits in commercial banks account for 14 percent of total deposits, with additional deposits held by trapped nonresidents.

Policy Discussions

27. Staff and the authorities were in broad agreement on the importance of efforts to reinforce financial sector and macroprudential policy frameworks. A robust macroprudential policy framework and toolkit is crucial to counter the buildup of systemic financial risks. Sound financial supervision and safety net frameworks are especially important ahead of capital account liberalization of the real economy. Staff encouraged further analysis of the implications of specific capital account liberalization proposals—including through collaborative stress-testing by the CBI and the FME—and close monitoring of developments in financial markets, particularly the housing market. Staff and *the authorities* agreed that bank capital and liquidity buffers should be maintained ahead of capital account liberalization.

28. Staff urged definitive action on the HFF. The mission emphasized the need for a clear run-off plan for HFF. Any successor housing program should have a well-targeted social lending objective and clearly delineated state involvement to minimize fiscal costs and risks. *The authorities* noted that decisions were pending in this area, but that HFF was likely to be put into run-off mode.

POST-PROGRAM MONITORING

29. Iceland's reserve buffers are projected to be at adequate levels, but risks remain. Staff projections show FX reserves remaining at the upper range of adequate levels. Outstanding Fund credit is now at 201 percent of quota, just above the standard PPM threshold, but will fall below the threshold in mid-October and be fully paid down by end-August 2016 (Table 7). Risks are mainly from the external environment, the uncertainty surrounding capital account liberalization, and the impact of wage developments on competitiveness. Given the likelihood of significant movement in these areas in the coming weeks and their importance for Iceland's external sector prospects, staff proposes further assessment before recommending whether developments suggest a need to continue PPM.

STAFF APPRAISAL

30. Labor market wage settlements look likely to disrupt Iceland's strong economic position and stability. Large wage hikes will likely propel inflation, generate budget pressures, reduce competitiveness, and slow the pace of capital account liberalization for the real sector. Social partners and government should work to strengthen the collective wage bargaining mechanism, ahead of the next round, to generate outcomes more conducive to stability and growth.

31. Monetary policy should be tightened to bring inflation to target. Policy credibility will hinge on central bank independence and accountability which should be preserved in the new central bank legislation. The CBI's FX programs should be used to smooth the necessary exchange rate adjustment and build-up reserves, as conditions—including price stability—permit. Work to refine Iceland's monetary policy framework and macroprudential policies should continue.

32. Fiscal policy should be tightened, while aiming to meet medium-term objectives. The authorities should adjust the fiscal path as needed to help ease demand pressures. However, the comparative inflexibility of the budget cycle means that a significant policy response can likely only begin with the 2016 budget. The proposed PIT reform could be beneficial, but should be mindful of the distributional and budget implications. Debt remains on a sustainable downward trajectory, but additional measures, greater specificity, and contingency plans are needed. Approval and implementation of the draft OBL will help meet expenditure restraint objectives.

33. Iceland should finalize its updated capital account liberalization strategy. The revised strategy should aim to strengthen growth-enhancing international financial linkages, with emphasis on a cooperative approach with incentives. The pace of implementation should remain conditions-based and supported by sound macroeconomic and financial sector policies and frameworks.

34. The authorities' financial sector reform efforts deserve strong support. These include legislative initiatives to strengthen financial supervision, financial safety nets, and the macroprudential toolkit. Existing capital and liquid buffers at banks should be maintained. The HFF should be put in a run-off mode. Any successor program should have a well-targeted social lending objective with clearly delineated state involvement that minimizes related fiscal costs and risks.

Box 1. The Organic Budget Law and Gender Budgeting

Over the last decade Iceland has taken significant steps to incorporate gender budgeting— a framework for including gender equality issues in budget development and implementation. The objective of gender budgeting is to incorporate a gender equality perspective at all levels of the budgetary process and restructure revenue and expenditure policies in order to promote gender equality.

The first efforts to explicitly adopt an equality perspective in budget practices began in 2005, when Iceland launched a pilot project on gender budgeting. This was followed up in 2009, when a gender budgeting steering committee was established. This inter-ministerial committee organized a more extensive program of pilot gender budgeting projects with the participation of all ministries. In total, 17 pilot projects were completed, covering a wide range of issues including the provision of government services, tax policy, and social policy. In 2011, the government approved a three year plan to improve the impact of the budget on gender equality. This initiative required each ministry to identify a key policy area that would provide the focus of efforts to improve equality. Ministries were also obliged to prepare intermediate reports that were presented as part of the 2013 and 2014 budget proposals and final results were presented in the 2015 budget proposal. Ministries were also required to provide gender disaggregated statistics for measuring progress towards gender equality in their key policy areas.

These early experiences with gender budgeting have met with mixed results:

- The programs benefited from strong political will, and the widespread participation of ministries. These efforts did score some important achievements which has improved gender equality. Pilot projects and main policy area projects identified a number of surprising gender biases in Icelandic fiscal policy. For example, gender biases have been identified in the provision of agricultural subsidies, waiting periods for cardiac imaging, and the availability of nursing home places for the elderly. These projects have provided input into subsequent budget proposals.
- At the same time, progress on gender budgeting has been hampered by a lack of gender disaggregated data, limited resources, lack of prioritization, and a general lack of expertise and training. Furthermore, the financial crisis severely disrupted fiscal policy and its consequences often exacerbated gender inequality.
- These actions have been taken in the context of one of the most gender equal societies in the world. In 2014, Iceland once again topped the [World Economic Forum's gender equality ranking](#), though still fell well short of parity.

In 2015, gender budgeting took further steps forward. It was explicitly included in the draft OBL which will comprehensively restructure Icelandic budget practices. Specifically, the OBL requires the Ministry of Finance, in consultation with the Minister for Equality, to prepare a gender budget program that should be taken into account in the drafting of the budget bill. The budget bill submitted to parliament should also outline the impact of changes in revenue and expenditure policies on gender equality targets. In parallel, the Finance Ministry is now finalizing a new gender budgeting implementation framework.

Box 2. Financial Stability and Macroprudential Policy Frameworks

Institutional framework. Iceland's financial stability legislative framework was approved in May 2014, establishing the Financial Stability Council (FSC) and the Systemic Risk Committee (SRC) as the official fora for collaboration on financial stability.

The Financial Stability Council

- *Members and frequency.* The 3 member Council (Minister of Finance (chair), CBI Governor, and Director General (DG) of the FME) has 3 scheduled meetings per year and may meet more often if necessary, including as a formal consultation body when a financial crisis is seen to be imminent or has struck, or when there is a risk of events with major contagion effects.
- *Principal tasks:* (1) formulate public policy on financial stability; (2) assess economic imbalances, financial system risks, undesirable incentives and other circumstances liable to jeopardize financial stability; (3) define actions, other than implementing the CBI's monetary policy management tools, which are considered necessary to influence the financial system with the objective of reinforcing and safeguarding financial stability; and (4) confirm definitions of systemically important regulated entities, infrastructure and markets of such nature that their activities can impact financial stability.
- *Functions.* The FSC draws from recommendations and assessments from the SRC and other available data—and submits recommendations to the relevant authorities.

The Systemic Risk Committee

- *Members and frequency.* The five voting member Committee (CBI Governor (chair); DG of the FME (Deputy Chair); CBI Deputy Governor; Deputy DG of the FME; and an outside expert in financial markets appointed by the Finance Minister; Permanent Secretary of the Finance Ministry, non-voting capacity) meets at least 4 times a year and evaluates the current situation and outlook for the financial system, systemic risk, and financial stability.
- *Functions.* The SRC takes account of the FSC's official policy and intermediate objectives on financial stability. Its assessments are based on analysis carried out by the CBI and the FME's joint risk assessment groups. Assessments and recommendations are submitted to the FSC.

Recently adopted measures

- *New liquidity rules* took effect in December 2013 based on the liquidity coverage ratio (LCR) issued by the Basel Committee, and set minimum liquidity under stress scenarios. Banks must fulfill requirements for both foreign-denominated and overall liquidity.
- *A net stable funding ratio (NSFR) on foreign currency funding* came into effect in December 2014 based on the Basel Committee's rules on NSFRs. The funding ratio is intended to ensure a minimum level of stable one-year funding in foreign currencies and therefore restrict the degree to which the commercial banks can rely on unstable short-term funding to finance long-term foreign-denominated lending. The rules on funding ratios reduce maturity mismatches and limit the extent to which the banks can depend on unstable short-term funding to finance long-term assets that could prove difficult to sell.

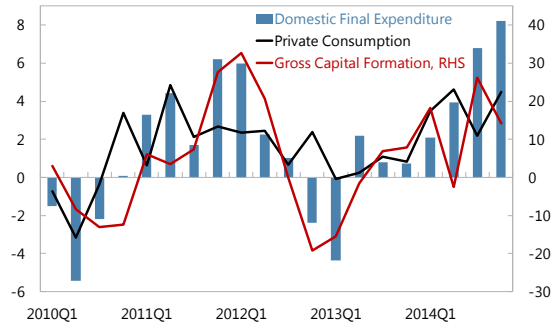
Measures under consideration

- *Capital buffers.* Draft legislation currently before Parliament would, among other things, incorporate provisions into the law on capital buffers consistent with the Basel III standards. Specifically, it would provide authority to the FME (on recommendation of the FSC) to implement four capital buffers: a systemic risk buffer, a buffer for other systemically important institutions (O-SII), a countercyclical buffer, and a capital conservation buffer—to be implemented in stages over 2016–17.
- *Macro prudential rules.* Draft legislation under consideration would: (i) authorize imposition of macroprudential rules including loan-to-value (LTV) and possibly debt-service-to-income (DSTI) ceilings; (ii) authorize the CBI, on recommendation of the FSC, to limit lending in foreign currency to unhedged parties.

Figure 1. Iceland: Recent Developments in Demand and Labor

Domestic demand strengthened last year...

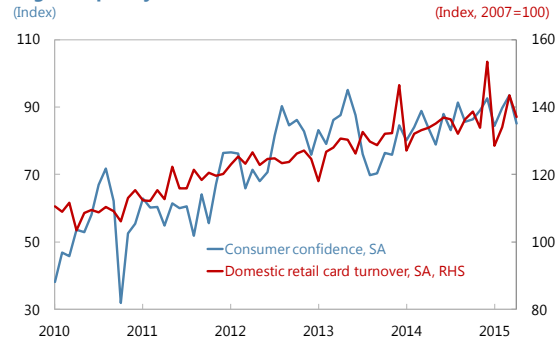
Domestic Demand Growth
(Year-on-year percent change)



Sources: Statistics Iceland; and Haver Analytics.

...on the back of robust consumer spending.

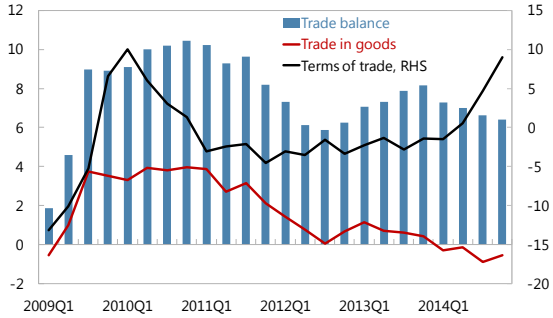
High Frequency Indicators
(Index)



Source: Statistics Iceland.

Higher goods imports have lowered the trade balance, despite improvements in the terms of trade...

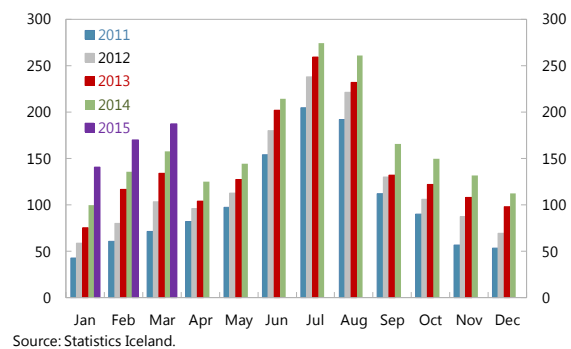
Trade Balance and Terms of Trade
(Percent of GDP, 4quarter rolling sum) (Y/y percent change)



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

...and continued growth in tourism.

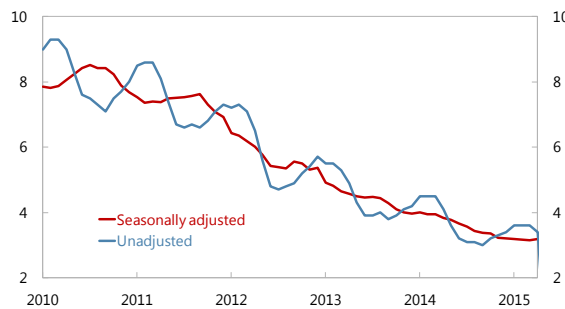
Overnight Stays of Foreigners in Hotels
(Thousands)



Source: Statistics Iceland.

The unemployment rate is trending down...

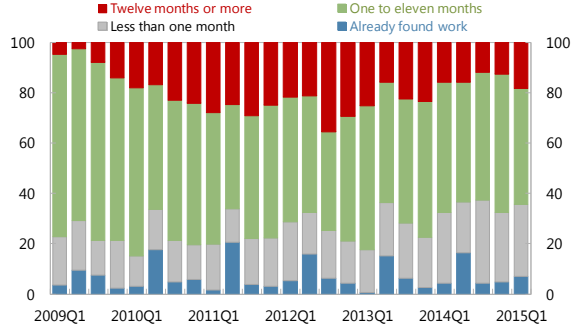
Unemployment Rate 1/
(Percent)



Sources: Department of Labor; and Haver Analytics.
1/ Based on registered unemployment.

...while long-term unemployment is slowly reverting to pre-crisis levels.

Unemployment Duration
(Percent)

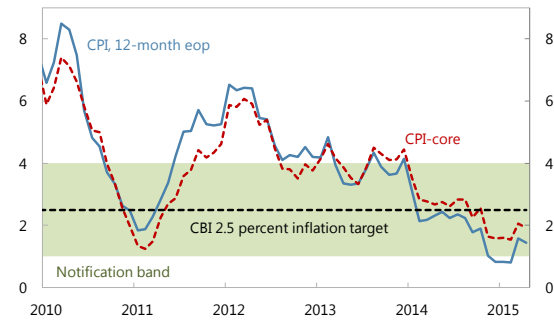


Source: Statistics Iceland Labor Market Survey.

Figure 2. Iceland: Price and Exchange Rate Developments

Headline inflation eased below the CBI's target...

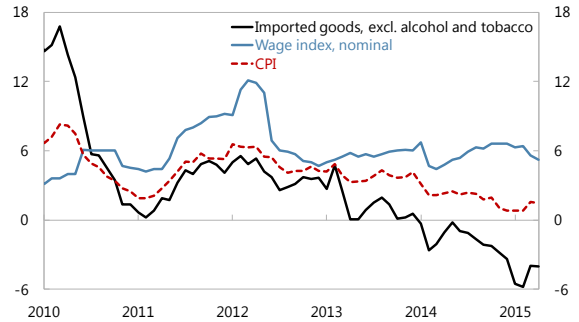
Inflation Rates
(Percent)



Sources: Central Bank of Iceland; and Statistics Iceland.

...driven largely by lower import prices.

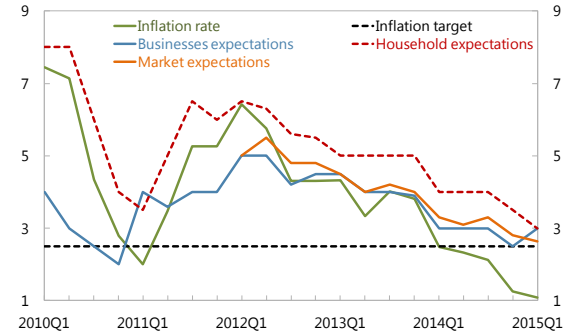
CPI, Wages and Import Prices
(Percent, 12-month growth)



Source: Statistics Iceland.

Near-term inflation expectations have edged up...

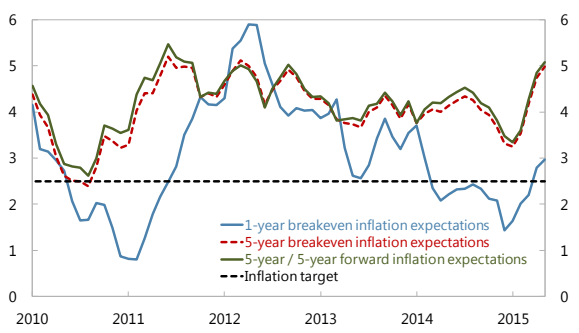
Inflation Expectations, 12-Months Horizon (Survey) 1/
(Percent)



Source: Central Bank of Iceland.

...as have longer-term expectations.

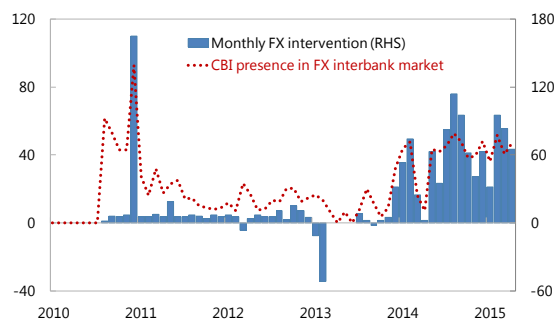
Inflation Expectations (Market-based)
(Percent)



Source: Central Bank of Iceland.

The CBI continues to purchase FX...

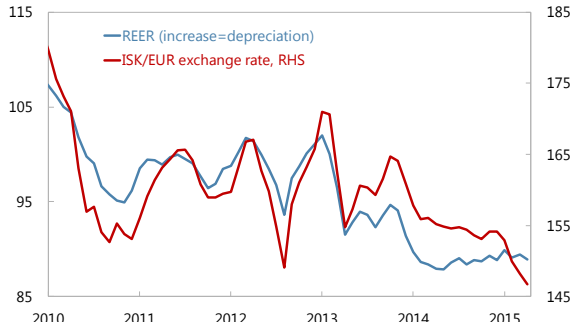
CBI Monthly Foreign Exchange Interventions
(Percent of total turnover) (Millions of euro)



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

...while the króna has appreciated.

Exchange Rates
(Index, 2010=100)



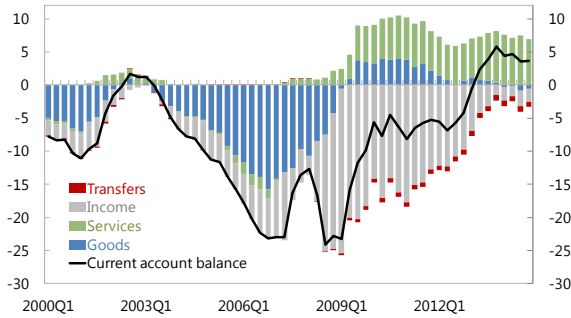
Sources: Central Bank of Iceland; IMF INS database; and Haver Analytics.

Figure 3. Iceland: External Sector Developments and Outlook

Improving trade and income balances have pushed the headline current account into surplus...

Current Account Balance

(Percent of GDP, 4-quarter rolling sum)

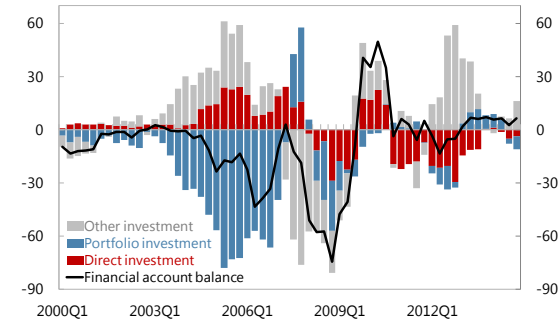


Sources: Central Bank of Iceland; and Haver Analytics.

... while the financial account recorded net outflows, driven by deleveraging.

Financial Account Balance (Net Flows)

(Percent of GDP, 4-quarter rolling sum, "+*" = outflows)

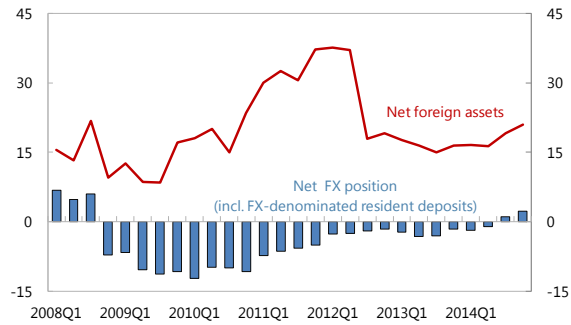


Sources: Central Bank of Iceland; and Haver Analytics.

The central bank's net FX position has turned positive.

Central Bank Net Foreign Assets and Net FX position

(Percent of GDP, quarterly)

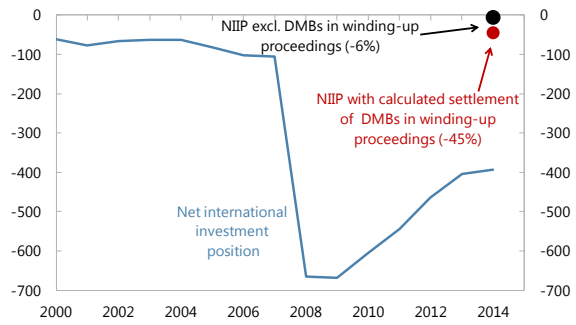


Sources: Central Bank of Iceland; and IMF staff calculations.

The NIIP has improved but net liabilities to old bank nonresident creditors remain large...

Net International Investment Position

(Percent of GDP)

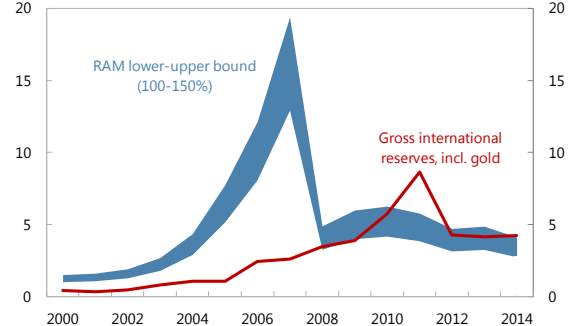


Sources: Central Bank of Iceland; and Haver Analytics.

...while reserve buffers are adequate in the context of existing capital account controls.

Reserve Adequacy Level

(Billions of USD)

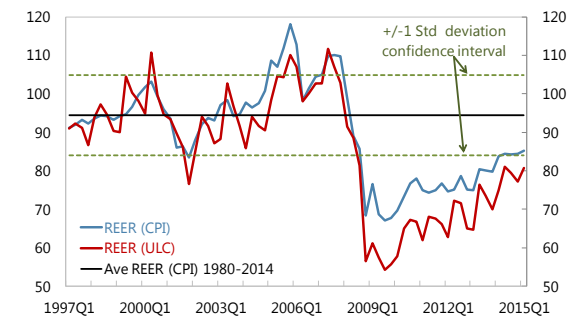


Sources: WEO; IFS; and IMF staff calculations.

The real effective exchange rate continues to appreciate, but remains below the historical average.

Real Effective Exchange Rate

(Index 2000 = 100, quarterly)

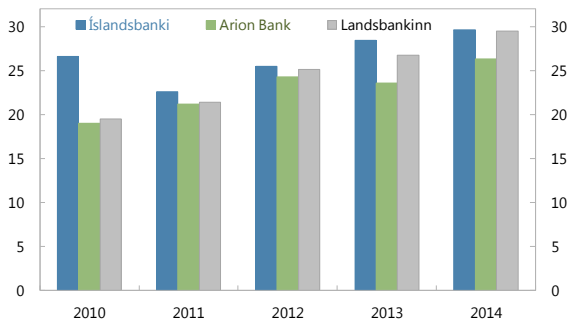


Source: Central Bank of Iceland.

Figure 4. Iceland: Banking Sector Developments

Capital buffers remain high...

Capital Adequacy Ratios of Commercial Banks
(Percent)



Source: Central Bank of Iceland.

...and asset quality is improving.

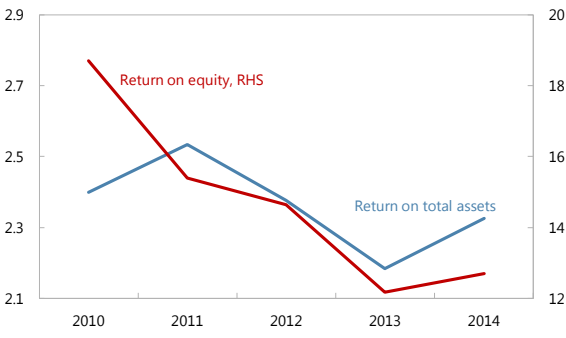
Default Ratio of the Three Largest Commercial Banks 1/
(Percent)



Sources: Financial Supervisory Authority; and Central Bank of Iceland.
1/ Parent companies; book value.

Banks are profitable...

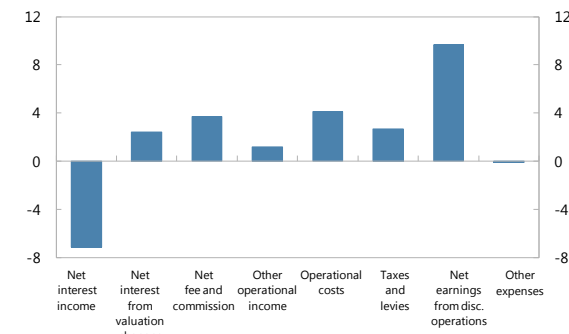
Profitability
(Percent)



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

...but revenues are largely driven by one-offs.

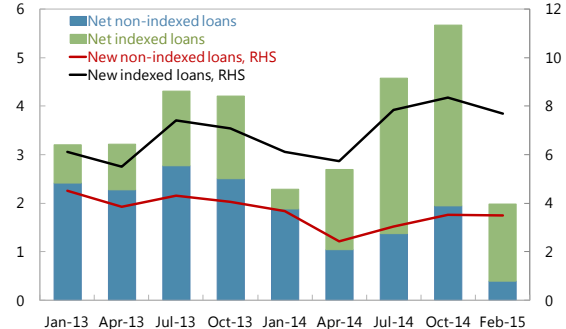
Income Statement Items
(2013/2014 change, billions of ISK)



Source: Central Bank of Iceland.

New indexed mortgage lending continues to increase...

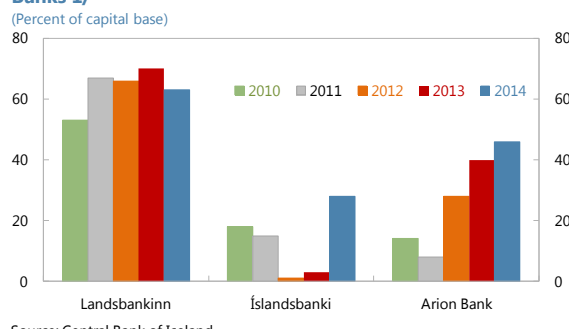
New Mortgage Lending by the Large Commercial Banks
(Billions of ISK)



Source: Central Bank of Iceland.

...and CPI imbalances are growing.

Indexation Imbalances of the Three Largest Commercial Banks 1/
(Percent of capital base)

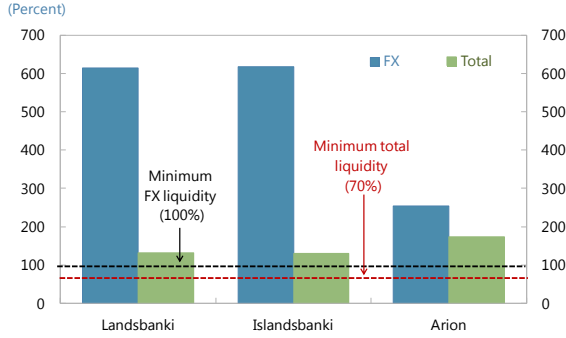


Source: Central Bank of Iceland.
1/ Imbalances reflects the difference between CPI-indexed assets and liabilities.

Figure 5. Iceland: Financial Sector Developments

Bank liquidity is good...

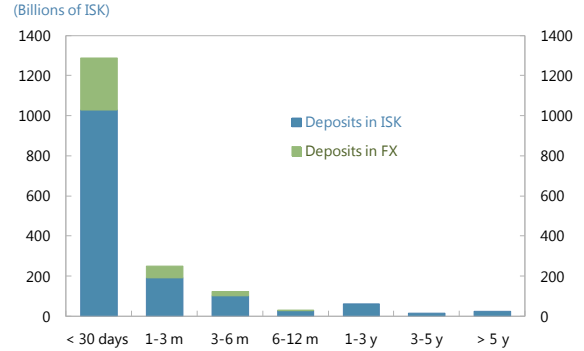
Liquidity Coverage Ratios, December 2014



Source: Central Bank of Iceland (FSR 2015/1).

...but a majority of deposits is short-term.

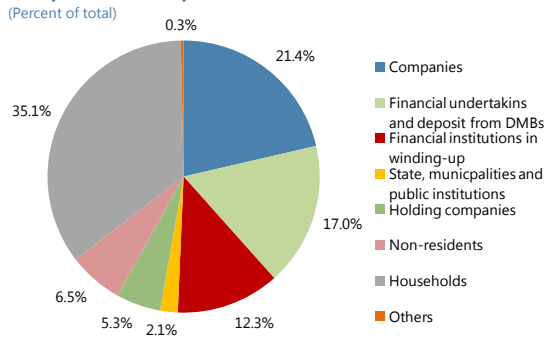
Deposits Breakdown, February 2015



Source: Central Bank of Iceland.

Reliance on old banks' deposits remains high...

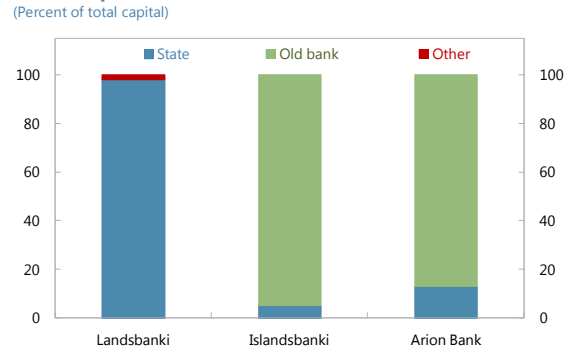
Composition of Deposit Holders, December 2014



Source: Central Bank of Iceland.

...and crisis legacy ownership structure remains in place.

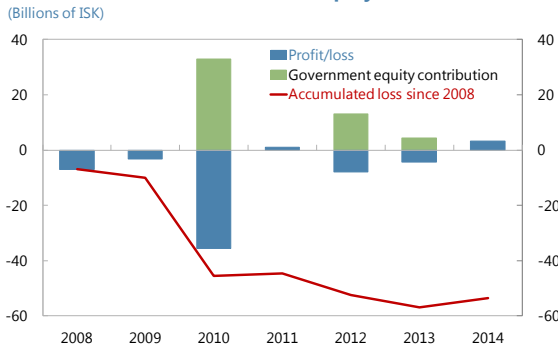
Ownership Structure of Icelandic Banks



Source: Central Bank of Iceland.

The Housing Financing Fund's distress continues...

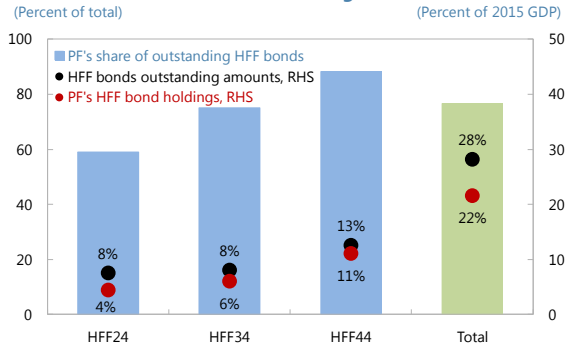
HFF Profit/Loss and Government Equity Contribution



Source: Central Bank of Iceland.

...and its interconnectedness with pension funds is high.

Pension Funds' Share of Outstanding HFF Bonds, Mar-2015

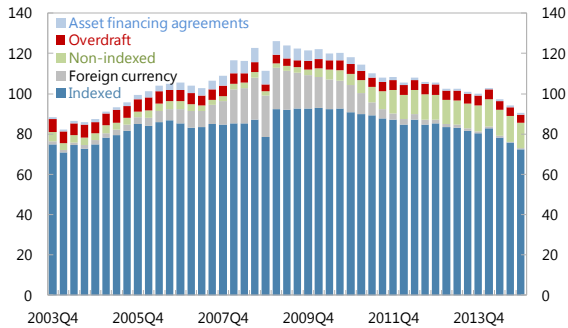


Source: HFF Monthly Report; and IMF staff calculations.

Figure 6. Iceland: Private Sector Deleveraging

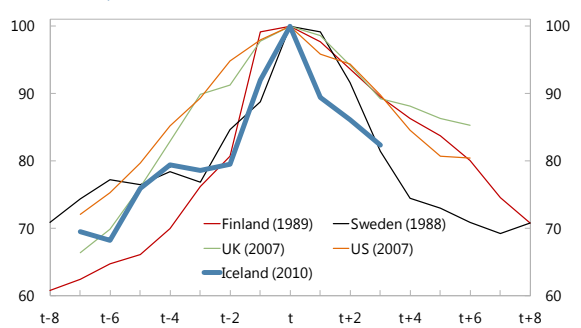
Household debt is declining towards pre-crisis levels...

Household Debt
(Percent of GDP)



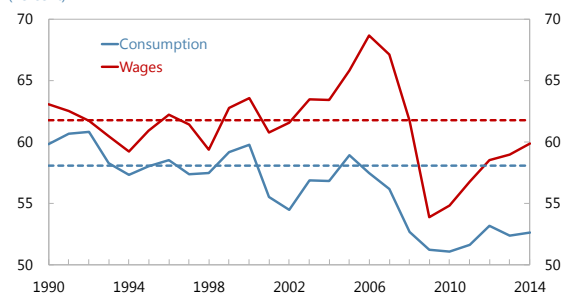
...in line with peer experiences.

Normalized Household Debt
(Percent of disposable income)



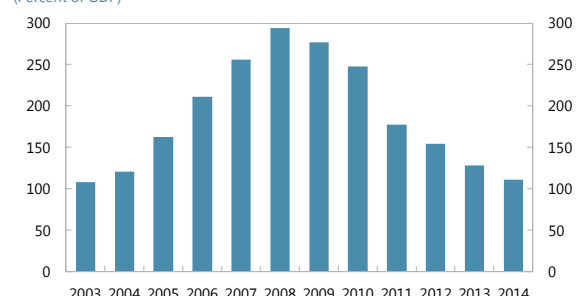
Private consumption is lagging relative to its long-term averages and wage developments.

Consumption and Wage Shares 1/
(Percent)



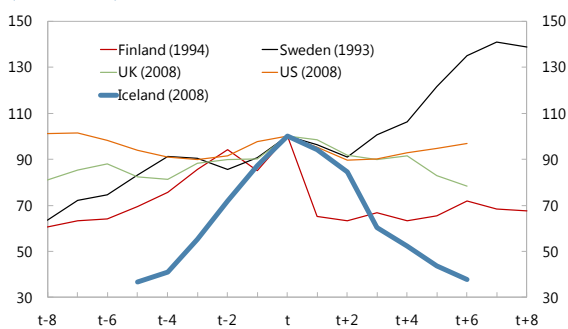
Corporate deleveraging has lowered debt to pre-boom levels...

Corporate Debt 1/
(Percent of GDP)



...and progressed further compared to peers...

Normalized Corporate Debt
(Percent of GDP)



...enhancing firms' capacity to borrow and invest in some sectors.

Bank Credit to the Corporate Sector
(Year-on-year percent change)

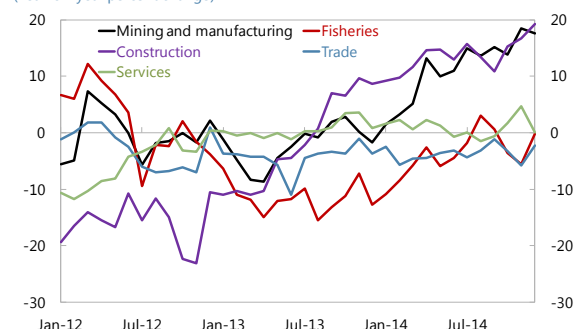
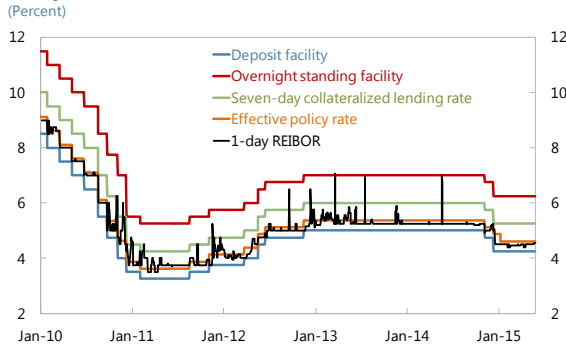


Figure 7. Iceland: Monetary Policy

The central bank recently lowered its policy rate...

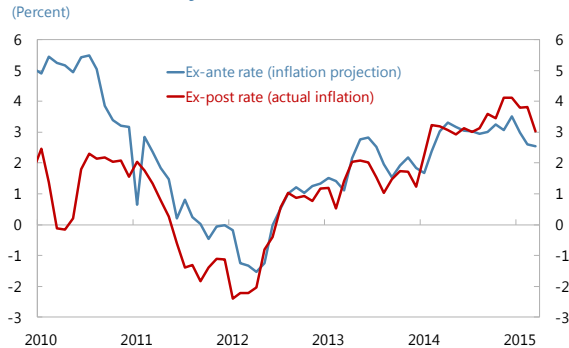
Policy and Interbank Rates



Source: Central Bank of Iceland.

...and real policy rates have begun to fall...

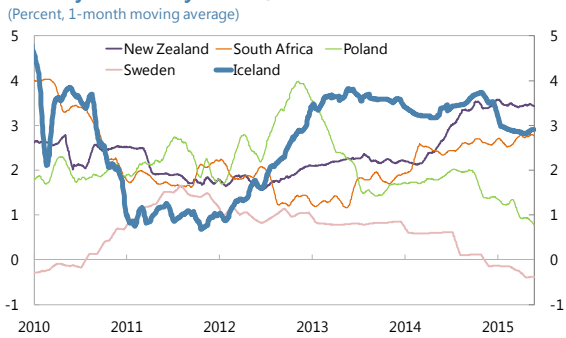
Real Effective Policy Rates



Sources: Central Bank of Iceland; IMF staff calculations.

...and the risk-adjusted policy rate has edged down.

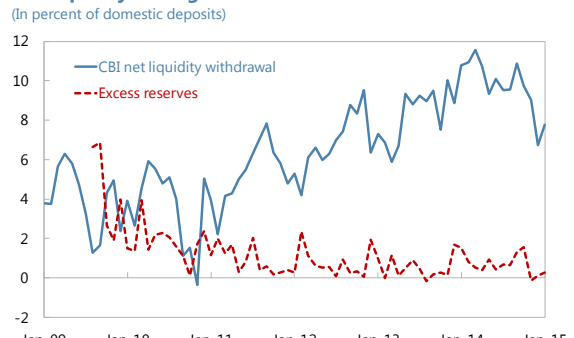
Risk-adjusted Policy Rates 1/



Sources: National Authorities; Thomson Reuters; and IMF staff calculations.
1/ Calculated as a difference between policy rate and 5-year CDS rate.

The CBI has absorbed excess liquidity...

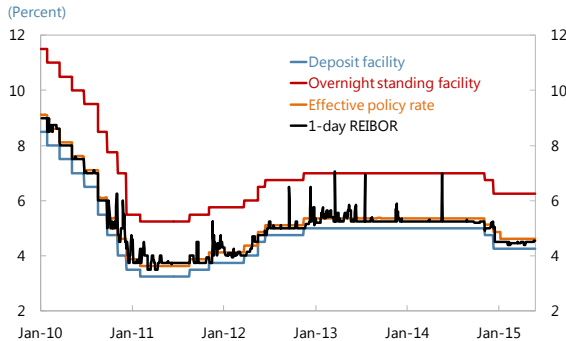
CBI Liquidity Management and Excess Reserves



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

...keeping the overnight rate near the CBI's effective policy rate.

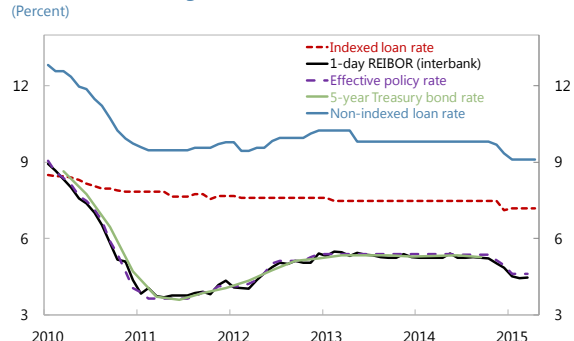
The Interest Rate Corridor



Source: Central Bank of Iceland.

Market rates have closely tracked the effective policy rate.

Market and Lending Rates



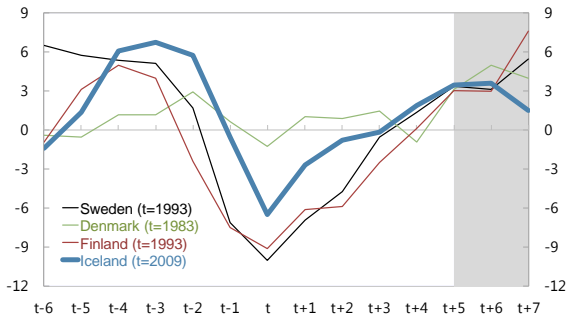
Sources: Central Bank of Iceland; Statistics Office of Iceland; and Haver Analytics.

Figure 8. Iceland: Fiscal Policy Developments and Outlook

Post-crisis fiscal adjustment is in line with peers...

Primary Balances

(Percent of GDP, t=primary balances trough)

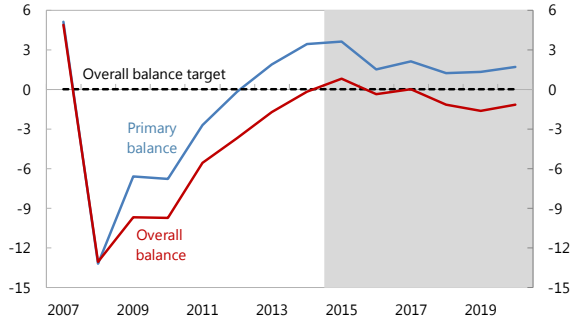


Source: IMF WEO; and IMF staff projections.

...leading to near-balanced budgets...

General Government Balances and Target

(Percent of GDP)

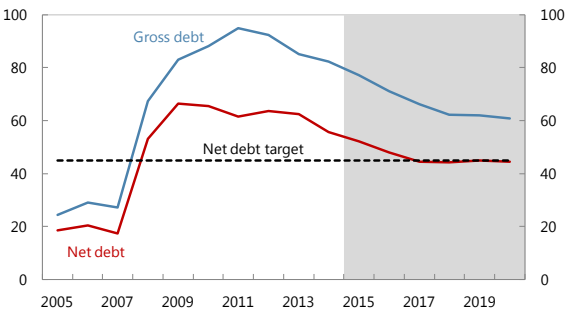


Sources: Ministry of Finance; and IMF staff projections (shaded area).

...and putting general government debt on a declining path.

Gross and Net Debt 1/

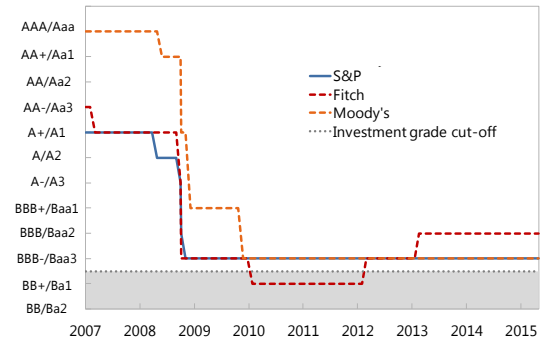
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff projections (shaded area).
1/ Net debt includes government deposits.

Iceland's last ratings upgrade was in 2013, but two of three agencies have shifted to positive outlooks.

Long-Term Sovereign Credit Ratings

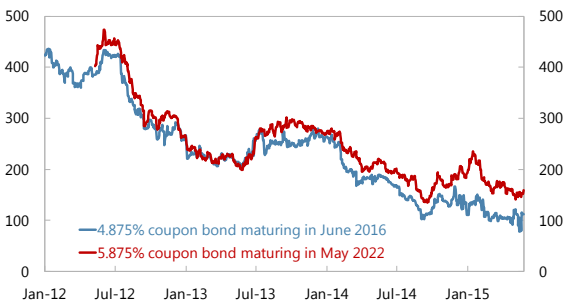


Source: Bloomberg.

Sovereign spreads have flattened...

Spreads on Icelandic Bonds against US Treasuries 1/

(Basis points)

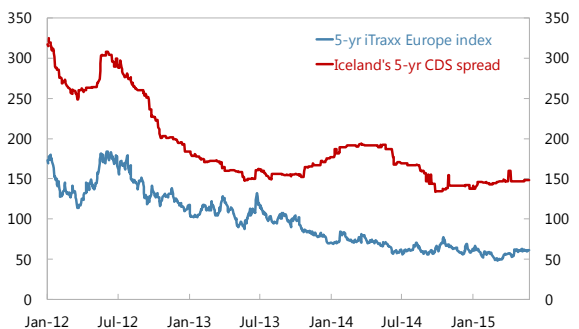


Sources: Bloomberg; and IMF staff calculations.
1/ 3.25% coupon bond maturing on 5/31/2016 and 1.75% coupons bond maturing on 5/15/2020 were used as respective benchmarks.

...as have CDS spreads.

Iceland's CDS spread and the ITRAXX Europe Index

(Basis points)



Source: Thompson Reuters.

Table 1. Iceland: Selected Economic Indicators, 2011–16

	2011	2012	2013	2014	2015 Proj	2016 Proj
	(Percentage change, unless otherwise indicated)					
National Accounts (constant prices)						
Gross domestic product	2.4	1.3	3.6	1.9	4.1	2.8
Total domestic demand	3.3	1.4	1.0	4.1	6.1	3.5
Private consumption	2.6	2.0	0.5	3.7	4.3	2.6
Public consumption	1.2	-1.7	0.7	1.8	3.2	3.1
Gross fixed investment	11.6	5.6	-1.0	13.7	18.2	7.5
Exports of goods and services	3.4	3.7	6.9	3.1	5.2	4.9
Imports of goods and services	6.9	4.7	0.3	9.9	12.0	7.2
Output gap 1/	-1.2	-0.8	-0.3	-0.3	0.6	0.2
Selected Indicators						
Nominal GDP (ISK bn)	1,703	1,780	1,881	1,993	2,160	2,329
Private consumption (percent of GDP)	51.6	53.2	52.3	52.6	51.8	51.8
Public consumption (percent of GDP)	24.6	24.4	24.3	24.3	24.3	24.4
Gross fixed investment (percent of GDP)	15.5	16.1	15.4	16.6	18.5	19.2
Unemployment rate (period average) 2/	7.1	6.0	5.4	5.0	3.7	4.1
Employment	0.0	1.1	3.3	1.6	2.4	1.1
Labor productivity	0.9	0.8	-0.2	0.3	1.6	1.8
Real wages	3.0	2.2	-1.0	3.7	5.9	3.3
Nominal wages	7.0	7.4	2.9	5.7	8.3	8.3
Real GDP per capita (ISK mln)	3.6	3.7	3.8	3.8	3.9	4.0
Consumer price index (period average)	4.0	5.2	3.9	2.0	2.3	5.0
Consumer price index (end of period)	5.3	4.2	4.2	0.8	3.6	5.8
Nominal effective exchange rate 3/	-0.3	-2.4	1.5	5.8	...	...
Real effective exchange rate 3/	0.9	0.6	3.8	6.7	...	...
ISK/EUR	161	161	162	155	...	...
ISK/USD	116	125	122	117	...	...
Terms of trade	-3.0	-3.1	-1.8	3.4	4.1	0.7
Money and Credit						
Base Money	-20.7	32.0	0.3	-17.6	8.4	7.8
Deposit money bank credit	6.9	0.7	1.4	4.1	2.4	4.8
Broad money	8.7	-2.7	4.2	3.9	2.3	4.7
CBI policy rate	4.75	6.00	6.00	5.25	...	...
	(Percent of GDP, unless otherwise indicated)					
Public Finance (General Government 4/)						
Revenue	40.1	41.7	42.4	45.3	44.8	43.7
Expenditure	45.6	45.3	44.1	45.4	44.0	44.0
Balance	-5.6	-3.7	-1.7	-0.2	0.8	-0.4
Primary balance	-2.7	-0.2	1.9	3.4	3.6	1.5
Balance of Payments						
Current account balance 5/	-5.3	-4.2	5.8	3.6	3.3	2.9
Trade balance	8.2	6.2	8.2	6.4	5.4	4.7
Financial and capital account	4.8	-5.2	6.8	3.6	3.2	2.7
Net errors and omissions	1.5	-0.1	0.2	0.0	0.0	0.0
Central bank reserves (USD bn)	8.7	4.3	4.1	4.2	4.8	4.5
Excluding old banks' deposits (USD bn)	5.9	4.2	4.0	4.1	4.7	4.4
Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and IMF staff projections.						
1/ In percent of potential output.						
2/ In percent of labor force.						
3/ A positive (negative) sign indicates an appreciation (depreciation).						
4/ National accounts basis.						
5/ Actual data include the income receipts and expenditures of DMBs in winding up proceedings, and accrued interest payments on intra-company debt held by a large multinational, but estimated and projected data do not.						

Table 2. Iceland: Money and Banking, 2011–16

(Billion of ISK, unless otherwise indicated)

	2011	2012	2013	2014	2015 Proj	2016 Proj
Central Bank (CBI)						
Net foreign assets 1/	-89	-28	-30	47	126	148
Assets	1,047	540	488	530	614	577
Liabilities	1,136	568	518	483	488	429
Net domestic assets	163	126	129	34	-38	-53
Net claims on the public sector	47	43	89	33	-17	-22
Net claims excluding recap bond	-145	-142	-90	-146	-157	-157
Recapitalization bond	192	185	180	145	140	135
Net claims on banks 2/ 3/	-66	-83	-73	-44	-39	-35
Others Items, net	182	166	113	44	18	4
Base Money 3/ 4/	74	98	99	81	88	95
Currency issued	39	41	42	44	44	44
DMB deposits at the central bank	35	57	57	37	44	51
Banking System						
Net foreign assets	205	255	306	244	227	200
Net domestic assets 3/	1,331	1,236	1,248	1,370	1,425	1,532
Net claims on the central bank	121	147	184	139	135	131
Credit to private sector	1,934	1,948	1,976	2,058	2,107	2,209
Credit to government	240	233	227	239	249	258
Other items, net	-965	-1,092	-1,139	-1,065	-1,065	-1,065
Domestic deposits	1,536	1,491	1,554	1,614	1,653	1,733
Local currency	1,462	1,391	1,428	1,496	1,532	1,606
Foreign currency	74	100	126	118	121	127
Consolidated Financial System						
Net foreign assets	116	227	277	291	354	348
Net domestic assets 3/	1,459	1,305	1,319	1,367	1,343	1,428
Net claims on the public sector	287	276	316	272	232	236
Net credit to private sector	1,934	1,948	1,976	2,058	2,107	2,209
Other, net	-762	-919	-973	-963	-996	-1,017
Broad Money (M3) 3/	1,575	1,532	1,596	1,658	1,697	1,777
Memorandum items:						
Net foreign assets	116	227	277	291	354	348
Broad money (y-o-y percentage change)	8.7	-2.7	4.2	3.9	2.3	4.7
Credit to private sector (y-o-y percentage change)	6.9	0.7	1.4	4.1	2.4	4.8
Money velocity (GDP/base money)	22.9	18.1	19.1	24.5	24.5	24.5
Broad money velocity (GDP/M3)	1.1	1.2	1.2	1.2	1.3	1.3
Multiplier (M3/base money)	21.1	15.6	16.2	20.4	19.3	18.7

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

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

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

3/ Does not reflect BOP overhang release.

4/ Base money includes currency in circulation (ex cash in vault) and DMBs deposits at the CBI in krona.

Table 3. Iceland: Medium-Term Projections, 2013–20

	2014	2015	2016	2017	2018	2019	2020
		Proj	Proj	Proj	Proj	Proj	Proj
(Percentage change, unless otherwise indicated)							
Real economy							
Real GDP	1.9	4.1	2.8	2.2	2.3	2.4	2.4
Real domestic demand	4.1	6.1	3.5	1.5	2.8	3.1	3.0
Private consumption	3.7	4.3	2.6	2.5	2.6	2.7	2.7
Public consumption	1.8	3.2	3.1	1.6	1.6	1.3	1.2
Gross fixed investment	13.7	18.2	7.5	-1.6	5.2	7.1	6.5
Net exports 1/	-1.6	-1.6	-0.4	0.9	-0.3	-0.5	-0.4
Exports of goods and services	3.1	5.2	4.9	4.5	3.8	4.4	4.7
Imports of goods and services	9.9	12.0	7.2	3.0	5.4	6.6	6.7
Output gap 2/	-0.3	0.6	0.2	-0.2	-0.1	0.0	0.0
Unemployment rate (period average) 3/	5.0	3.7	4.1	4.4	4.3	4.2	4.2
Employment	1.6	2.4	1.1	1.3	1.3	1.3	1.3
Labor productivity	0.3	1.6	1.8	1.0	1.0	1.1	1.1
Real wages	3.7	5.9	3.3	1.0	1.0	1.1	1.1
Nominal wages	5.7	8.3	8.3	5.8	4.7	3.9	3.6
CPI inflation (period average)	2.0	2.3	5.0	4.8	3.7	2.8	2.5
CPI inflation (end of period)	0.8	3.6	5.8	4.2	3.4	2.5	2.5
Terms of trade	3.4	4.1	0.7	0.2	0.0	0.0	0.0
Nominal GDP (ISK bn)	1,993	2,160	2,329	2,488	2,624	2,748	2,877
(Percent of GDP, unless otherwise indicated)							
Balance of Payments							
Current account 4/	3.6	3.3	2.9	3.7	2.8	1.8	0.9
Trade balance	6.4	5.4	4.7	5.5	4.7	3.7	2.8
Primary income balance 4/ 5/	-2.0	-1.3	-1.0	-0.9	-1.1	-1.0	-1.1
Secondary income balance	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Capital and financial account	3.6	3.2	2.7	3.6	2.7	1.7	0.8
Direct investment, net	-4.1	-1.6	-1.9	-2.3	-2.5	-2.6	-3.0
Portfolio investment, net	-7.3	0.7	5.5	1.8	2.4	1.3	1.3
Other investment, net	15.8	0.5	1.3	3.0	3.5	1.0	4.2
Reserve assets	-0.6	3.6	-2.0	1.1	-0.6	2.2	-1.7
Gross external debt 6/	208	194	196	189	184	182	180
Underlying gross external debt 7/	147	129	116	112	112	111	111
Short-term external debt 6/ 8/	83	92	93	89	77	79	69
Central bank reserves (USD bn)	4.2	4.8	4.5	4.7	4.6	5.0	4.7
General government accounts							
Revenue	45.3	44.8	43.7	42.9	41.8	41.6	41.6
Expenditure	45.4	44.0	44.0	42.9	42.9	43.2	42.8
Overall balance	-0.2	0.8	-0.4	0.0	-1.2	-1.6	-1.2
Primary balance	3.4	3.6	1.5	2.2	1.3	1.3	1.7
Gross debt	82.4	77.3	71.2	66.3	62.3	62.0	60.9
Net debt	55.7	52.2	47.9	44.5	44.4	44.9	44.6
Sources: Central Bank of Iceland; and IMF staff projections.							
1/ Contributions to growth.							
2/ In percent of potential output.							
3/ In percent of labor force.							
4/ Actual data include the income receipts and expenditures of DMBs in winding up proceedings, and interest payments on intra-company debt held by a large multinational, but estimated and projected data							
5/ Includes interest payments due from the financial sector and income receipts to the financial sector.							
6/ Excludes old banks' total liabilities, but includes TIF's deposit liabilities, and accumulated recovered assets from both external and domestic sources before being paid out to foreign creditors. Once recovered, these assets are recorded as short-term debt. Does not reflect impact on external debt from outflows related to liberalization (impact will be included once a revised liberalization strategy is in place).							
7/ Excludes old bank-related debt.							
8/ Includes the recovered domestic and foreign assets of the old banks.							

Table 4a. Iceland: Balance of Payments, 2011–20

(Billions of USD, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Proj	Proj	Proj	Proj	Proj	Proj
Current Account 1/	-0.8	-0.6	0.9	0.6	0.5	0.5	0.7	0.5	0.4	0.2
Trade Balance	1.2	0.9	1.3	1.1	0.9	0.8	1.0	0.9	0.7	0.6
Balance on Goods	0.3	0.1	0.1	-0.1	0.3	0.2	0.2	0.1	0.0	-0.1
Merchandise exports f.o.b.	4.9	4.6	4.6	4.9	4.9	5.2	5.4	5.5	5.6	5.8
Merchandise imports f.o.b.	4.5	4.5	4.5	4.9	5.0	5.5	5.5	5.7	6.0	6.4
Balance on Services	0.9	0.8	1.2	1.2	1.0	1.1	1.1	1.1	1.1	1.2
Exports of services, total	3.4	3.4	4.0	4.3	4.2	4.5	4.7	4.9	5.2	5.5
Imports of services, total	2.5	2.6	2.8	3.1	3.1	3.4	3.6	3.8	4.0	4.3
Primary Income balance 1/	-1.9	-1.4	-0.2	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Receipts	1.4	0.8	1.0	0.9	0.8	0.8	0.8	0.8	0.9	0.9
of which dividends and reinvested earnings	0.7	0.3	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
of which interest receipts	0.6	0.4	0.6	0.5	0.5	0.5	0.5	0.5	0.6	0.6
Expenditures	3.2	2.2	1.3	1.2	1.0	1.0	1.0	1.0	1.0	1.1
of which dividends and reinvested earnings	0.2	0.0	-0.3	-0.6	0.1	0.1	0.1	0.1	0.1	0.1
of which interest payments	3.0	2.2	1.6	1.8	0.9	0.8	0.8	0.9	0.9	0.9
Secondary income balance	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2
Capital and Financial Acct	0.7	-0.7	1.1	0.6	0.5	0.5	0.7	0.5	0.3	0.1
Capital account balance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	0.7	-0.7	1.1	0.6	0.5	0.5	0.7	0.5	0.3	0.2
Direct investment	-1.1	-4.2	0.0	-0.7	-0.3	-0.3	-0.4	-0.5	-0.5	-0.6
Portfolio investment 2/	-0.1	-0.5	1.1	-1.3	0.1	1.0	0.3	0.4	0.2	0.3
Assets	0.9	0.6	1.2	-0.1	0.3	0.3	0.3	0.3	0.3	0.3
Liabilities	1.0	1.1	0.1	1.2	0.2	-0.7	0.0	-0.1	0.1	0.1
Net borrowing	...	...	...	...	0.2	-0.7	0.0	-0.1	0.1	0.1
Other investment 2/	-1.0	8.3	-0.1	2.7	0.1	0.2	0.6	0.7	0.2	0.8
Assets	-4.2	2.0	-0.9	-2.6	-0.3	-0.3	-0.3	-0.3	-0.3	-0.4
Liabilities 3/	-3.2	-6.3	-0.9	-5.3	-0.4	-0.5	-0.9	-1.0	-0.5	-1.2
of which outflows related to liberalization 2/	...	...	...	...	0.0	-0.3	-0.7	-1.0	-0.3	-1.0
Change in reserve assets ("+" = increase)	2.9	-4.3	0.0	-0.1	0.6	-0.3	0.2	-0.1	0.4	-0.3
Net errors and omissions	1.5	-0.1	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memo										
Level of gross reserves (eop)	8.7	4.3	4.1	4.2	4.8	4.5	4.7	4.6	5.0	4.7
Reserve floor (150% of reserve adequacy metric)	5.7	4.7	4.8	4.1	5.0	4.5	4.7	4.6	5.0	4.7
Reserves/S-T debt (residual basis, percent) 4/	79	83	78	117	100	133	120	139	111	151
Reserves/S-T debt (residual basis, percent) 5/	149	210	170	355	191	416	292	458	225	478
Reserves (percent of GDP)	59.0	30.0	26.9	24.8	29.2	25.1	25.3	24.2	25.9	23.9
Underlying current account balance 6/	0.6	0.5	1.0	0.8	0.5	0.5	0.7	0.5	0.4	0.2
GDP	14.7	14.2	15.4	17.1	16.6	17.9	18.6	19.0	19.3	19.5

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

1/ Actual data include the income receipts and expenditures of DMBs in winding up proceedings, and accrued interest payments on intra-company debt held by a large multinational, but estimated and projected data do not.

2/ Projections assume a gradual release of overhang while maintaining minimum reserve adequacy.

3/ Reflects debt service payments on Fund repurchases and Nordic loans repay.

4/ Reserves and short-term debt exclude old bank-related stocks.

5/ Reserves and short-term debt exclude both old bank-related stocks and offshore liquid krona holdings.

6/ Excludes the income receipts and expenditures of DMBs in winding up proceedings, and accrued interest payments on intra-company debt held by a large multinational. It is therefore identical to headline current account in estimated and projected years.

Table 4b. Iceland: Balance of Payments, 2011–20
(Percent of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Proj	Proj	Proj	Proj	Proj	Proj
Current Account 1/	-5.3	-4.2	5.8	3.6	3.3	2.9	3.7	2.8	1.8	0.9
Trade Balance	8.2	6.2	8.2	6.4	5.4	4.7	5.5	4.7	3.7	2.8
Balance on Goods	2.2	0.7	0.4	-0.4	1.6	1.1	0.9	0.5	0.0	-0.5
Merchandise exports f.o.b.	33.0	32.4	29.8	28.4	29.3	29.2	29.3	28.8	29.1	29.4
Merchandise imports f.o.b.	30.9	31.7	29.4	29.0	30.2	30.6	29.7	30.1	31.3	32.6
Balance on Services	6.1	5.6	7.8	7.0	6.3	6.1	5.9	6.0	5.9	6.0
Exports of services, total	23.0	24.1	25.8	25.0	25.0	25.0	25.2	25.8	26.8	27.9
Imports of services, total	16.9	18.6	18.0	18.1	18.7	18.9	19.3	19.9	20.9	21.9
Primary Income balance 1/	-12.7	-9.7	-1.5	-2.0	-1.3	-1.0	-0.9	-1.1	-1.0	-1.1
Receipts	9.2	5.9	6.7	5.3	4.7	4.4	4.4	4.4	4.4	4.5
of which dividends and reinvested earnings	4.6	2.4	2.1	0.9	0.6	0.6	0.6	0.6	0.6	0.6
of which interest receipts	3.8	2.5	3.6	3.2	3.1	2.9	2.9	2.9	2.9	2.9
Expenditures	22.0	15.7	8.3	7.3	6.0	5.4	5.3	5.5	5.4	5.5
of which dividends and reinvested earnings	1.1	-0.2	-2.1	-3.6	0.5	0.4	0.4	0.4	0.4	0.4
of which interest payments	20.6	15.6	10.1	10.5	5.1	4.6	4.6	4.7	4.7	4.8
Secondary income balance	-0.7	-0.7	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Capital and Financial Acct	4.8	-5.2	6.8	3.6	3.2	2.7	3.6	2.7	1.7	0.8
Capital account balance	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Financial Account	4.9	-5.1	6.9	3.7	3.2	2.8	3.6	2.7	1.8	0.8
Direct investment	-7.4	-29.7	0.3	-4.1	-1.6	-1.9	-2.3	-2.5	-2.6	-3.0
Portfolio investment 2/	-0.4	-3.3	7.0	-7.3	0.7	5.5	1.8	2.4	1.3	1.3
Assets	6.1	4.4	7.9	-0.6	1.8	1.7	1.7	1.7	1.7	1.7
Liabilities	6.5	7.8	0.8	6.8	1.1	-3.8	-0.1	-0.7	0.4	0.4
Net borrowing	...	...	...	...	1.2	-3.7	0.0	-0.6	0.5	0.5
Other investment 2/	-6.7	58.4	-0.5	15.8	0.5	1.3	3.0	3.5	1.0	4.2
Assets	-28.5	14.2	-6.1	-15.5	-1.9	-1.8	-1.8	-1.8	-1.8	-1.8
Liabilities 3/	-21.8	-44.3	-5.7	-31.3	-2.4	-3.1	-4.8	-5.3	-2.8	-6.0
of which outflows related to liberalization 2/	...	...	...	...	0.0	-1.8	-3.7	-5.3	-1.3	-5.0
Change in reserve assets ("+" = increase)	19.4	-30.5	0.1	-0.6	3.6	-2.0	1.1	-0.6	2.2	-1.7
Net errors and omissions	10.2	-0.8	1.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Memo										
Level of gross reserves (eop)	59.0	30.0	26.9	24.8	29.2	25.1	25.3	24.2	25.9	23.9
Reserve floor (150% of reserve adequacy metric)	39.1	32.9	31.4	23.9	29.9	25.1	25.3	24.2	25.9	23.9
Underlying current account balance 4/	4.3	3.6	6.4	4.6	3.3	2.9	3.7	2.8	1.8	0.9

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

1/ Actual data include the income receipts and expenditures of DMBs in winding up proceedings, and accrued interest payments on intra-company debt held by a large multinational, but estimated and projected data do not.

2/ Baseline projections no longer incorporate the 2011 capital account liberalization strategy. Instead, projections assume a gradual release of overhang while maintaining minimum reserve adequacy.

3/ Reflects debt service payments on Fund repurchases and Nordic loans repay.

4/ Excludes the income receipts and expenditures of DMBs in winding up proceedings, and accrued interest payments on intra-company debt held by a large multinational. It is therefore identical to headline current account in estimated and projected years.

Table 5. Iceland: General Government Operations, 2011–20

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

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
					Proj	Proj	Proj	Proj	Proj	Proj
Total revenue	40.1	41.7	42.4	45.3	44.8	43.7	42.9	41.8	41.6	41.6
Taxes	30.5	31.5	32.2	35.0	34.2	33.0	32.6	31.9	32.1	32.1
Taxes on income and profits	15.7	15.9	16.8	18.0	17.8	17.1	16.9	16.8	16.9	16.9
Personal income tax	13.0	13.2	13.8	13.8	13.9	13.9	13.6	13.5	13.6	13.6
Corporate income tax	1.7	1.9	2.2	3.0	2.8	2.1	2.1	2.1	2.1	2.1
Capital gains tax, rental income	1.0	0.8	0.9	1.2	1.1	1.1	1.1	1.1	1.1	1.1
Taxes on payroll and workforce	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4
Taxes on property	2.3	2.5	2.5	2.5	2.1	2.1	2.1	2.1	2.1	2.1
Taxes on goods and services	11.5	11.8	11.7	11.8	11.8	11.8	11.8	12.0	12.1	12.2
VAT	7.7	8.0	8.0	8.1	8.1	8.1	8.0	8.2	8.3	8.3
Other taxes on goods and services	3.8	3.8	3.8	3.7	3.8	3.8	3.8	3.8	3.8	3.9
Taxes on international trade	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2
Other taxes	0.5	0.6	0.6	2.1	1.9	1.4	1.3	0.4	0.4	0.4
Social contributions	3.9	3.6	3.7	3.7	3.7	3.7	3.7	3.7	3.7	3.7
Grants	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue	5.5	6.3	6.3	6.5	6.6	6.8	6.4	6.0	5.6	5.6
Property income	2.0	2.7	2.7	3.1	3.3	3.5	3.1	2.7	2.4	2.4
o/w Interest income	1.4	1.4	1.1	1.1	1.2	2.1	1.8	1.3	1.0	0.9
Total expenditure	45.6	45.3	44.1	45.4	44.0	44.0	42.9	42.9	43.2	42.8
Current expense	45.1	44.9	43.3	44.5	43.2	43.3	42.2	41.7	41.5	41.1
Compensation of employees	13.5	13.6	13.7	13.8	13.8	13.9	13.7	13.6	13.5	13.4
Use of goods and services	12.0	11.9	11.7	11.5	11.5	11.5	11.4	11.2	11.1	10.9
Consumption of fixed capital	2.1	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Interest	4.3	4.9	4.7	4.7	4.0	3.9	3.9	3.8	3.9	3.7
Subsidies	1.7	1.7	1.7	1.6	1.5	1.5	1.5	1.4	1.4	1.4
Grants	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social benefits	8.1	7.6	7.1	6.9	7.0	7.1	7.2	7.2	7.2	7.2
Other expense	3.1	2.8	2.2	3.8	3.2	3.2	2.3	2.3	2.3	2.2
Nonfinancial assets	0.6	0.5	0.8	0.9	0.7	0.7	0.7	1.2	1.7	1.7
Nonfinancial assets, acquisition	2.6	2.6	2.8	2.9	2.7	2.7	2.7	3.2	3.7	3.7
Consumption of fixed capital (-)	-2.1	-2.1	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Net lending/borrowing 2/	-5.6	-3.7	-1.7	-0.2	0.8	-0.4	0.0	-1.2	-1.6	-1.2
Financial assets, transactions	3.6	-4.2	-2.0	-0.4	1.1	-1.2	-1.1	-2.4	0.3	-0.5
Currency and deposits	11.3	-4.3	-2.8	-0.4	0.5	0.0	0.0	-2.7	0.0	-0.8
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	-6.1	0.4	0.3	0.0	0.3	0.3	0.3	0.3	0.3	0.3
Shares and other equities	0.1	0.3	2.1	0.0	0.0	-1.5	-1.4	0.0	0.0	0.0
Other accounts receivable	-1.6	-0.6	-1.6	0.0	0.3	0.0	0.0	0.0	0.0	0.0
Liabilities, transactions	9.2	-0.5	-0.3	-0.2	0.3	-0.8	-1.1	-1.2	1.9	1.5
Securities other than shares	3.6	2.5	-0.2	0.0	1.4	1.3	-1.0	-1.1	2.2	1.9
Loans	5.3	-3.3	-1.0	-0.2	0.1	-2.1	0.2	0.1	0.0	-0.1
Domestic loans	0.7	-0.6	-0.3	0.0	0.1	0.1	0.2	0.1	0.0	-0.1
Foreign loans	4.6	-2.8	-0.7	-0.2	-0.1	-2.3	0.0	0.0	0.0	0.0
Insurance technical reserves	0.3	0.3	0.2	0.0	0.0	0.0	-0.3	-0.3	-0.3	-0.2
Other accounts payable	0.0	0.1	0.6	0.0	-1.2	0.0	0.0	0.0	0.0	0.0
Stock of debt										
General government gross debt	95.0	92.5	85.2	82.4	77.3	71.2	66.3	62.3	62.0	60.9
Domestic	68.0	67.9	64.5	61.5	57.8	55.1	50.7	47.2	47.3	46.7
Foreign currency	27.0	24.6	20.7	20.8	19.4	16.1	15.6	15.2	14.8	14.3
General government net debt 3/	61.6	63.7	62.5	55.7	52.2	47.9	44.5	44.4	44.9	44.6
Structural Balances										
Structural balance	-4.4	-2.6	-1.7	-1.7	-1.5	-0.7	-0.8	-1.1	-1.6	-1.2
Structural primary balance	-1.5	0.9	1.9	1.9	1.3	1.2	1.3	1.3	1.3	1.7
Memo Items										
Nominal GDP (ISK bn)	1,703	1,780	1,881	1,993	2,160	2,329	2,488	2,624	2,748	2,877
Primary revenue	38.6	40.3	41.2	44.2	43.6	41.6	41.1	40.4	40.6	40.7
Primary expenditure	41.3	40.4	39.4	40.7	39.9	40.1	39.0	39.2	39.3	39.0
Primary balance	-2.7	-0.2	1.9	3.4	3.6	1.5	2.2	1.3	1.3	1.7

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

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

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

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

Table 6. Iceland: Financial Soundness Indicators, 2012–14

(Percent)

	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4	2014Q1	2014Q2	2014Q3	2014Q4
Regulatory capital to risk-weighted assets 1/	21.6	23.1	23.4	25.0	25.5	25.9	25.5	26.2	25.3	27.2	27.2	28.5
Regulatory Tier 1 capital to risk-weighted assets 1/	19.2	20.9	21.1	22.6	23.1	23.6	23.3	24.0	23.1	25.0	25.1	26.2
Return on assets 1/	2.5	2.5	2.1	2.4	2.0	2.3	2.2	2.2	2.1	3.2	2.7	1.3
Return on equity 1/	16.5	15.5	12.8	13.8	11.3	13.0	12.3	12.1	11.7	17.5	14.6	7.0
Net interest income to gross income 1/	56.7	50.3	53.3	48.8	51.7	41.7	45.1	45.2	53.5	46.5	49.2	43.1
Non interest expense to gross income 1/	72.9	79.0	80.7	79.9	77.4	77.2	75.5	77.5	77.6	66.4	68.1	58.0
Liquid assets to total assets 1/	18.0	17.6	19.8	20.7	21.0	20.3	20.5	21.4	23.2*	24.7*	25.4*	21.5*
Liquid assets to short-term liabilities 1/	31.4	30.5	34.6	35.9	36.9	35.2	35.3	36.3	...	...	...	...
Net open position in foreign exchange to capital 1/	25.9	18.2	18.4	7.7	3.7	3.6	6.4	6.3	4.9	4.5	5.2	6.1
NPLs, facility level (over 90 days in default) 1/	12.4	10.2	8.5	6.8	6.1	5.5	5.7	4.5	4.3	3.2	3.2	2.4
Household NPLs, cross-default (over 90 days in default or deemed unlikely to be paid) 2/	16.9	15.9	15.3	14.0	13.2	12.4	11.3	10.1	12.6	12.0	11.1	10.1
Corporate NPLs, cross-default (over 90 days in default or deemed unlikely to be paid) 1/	21.7	20.5	19.5	15.3	14.6	12.4	15.3	12.1	11.6	10.8	10.1	7.2
Corporate and household NPLs, cross-default (over 90 days in default or deemed unlikely to be paid) 1/	21.4	19.6	18.4	15.2	14.4	12.5	13.8	12.5	11.6	10.8	10.0	7.9
Coverage ratio of household loans in default	43.6	49.3	49.4	48.1	47.6	49.8	52.0	50.1	50.2	49.3	49.7	48.9
Coverage ratio of corporate loans in default	64.0	65.5	65.4	64.8	63.8	68.2	63.1	64.1	62.6	47.3	44.6	42.7
Coverage ratio of loans in default	59.4	61.6	61.4	60.2	59.2	62.9	60.3	59.8	58.5	48.1	46.8	45.7

Source: Central Bank of Iceland.
1/ The three largest commercial banks.
2/ The three largest commercial banks and the Housing Financing Fund.
* 2014, based on a new definition of liquid assets (LCR liquid assets, MM loans and nostro accounts)

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

(Millions of SDR)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
								Proj	Proj
Existing Fund credit									
Disbursements	560	105	210	525	0	0	0	0	0
Stock	560	665	875	1,400	512	512	237	171	0
Obligations	0	13	18	29	914	10	285	68	172
Principal (repurchases)	0	0	0	0	888	0	275	66	171
Charges and interest	0	13	18	29	26	10	10	2	1
Stock of existing Fund credit									
In percent of quota	476	565	744	1,190	435	435	201	145	0
In percent of GDP	4.9	8.1	10.2	14.6	5.5	5.1	2.0	1.5	0.0
In percent of exports of goods and services	12	16	19	26	10	9	4	3	0
In percent of gross reserves	24	27	23	25	18	19	10	5	0
Obligations to the Fund from existing Fund arrangements									
In percent of quota	0	11	15	25	777	9	242	62	146
In percent of GDP	0.0	0.2	0.2	0.3	9.8	0.1	2.5	0.6	1.4
In percent of exports of goods and services	0.0	0.3	0.4	0.6	17.3	0.2	4.7	1.1	2.5
In percent of gross reserves	0.0	0.5	0.5	0.5	32.8	0.4	12.1	2.3	5.2

Source: IMF staff estimates and projections.

Annex I. Iceland: Labor Market Developments¹

Overview. *In recent months, social partners have been far apart in their views over the pace and distribution of income growth, with sporadic labor actions and threats of a general strike. At end-May, some of the largest unions in Iceland, representing just over one-third of the labor force, reached a 3½ year wage agreement with employers. The cumulative wage growth is still being assessed, but looks likely to be in the 20–26 percent range through 2018, depending on the extent to which sector- and firm-level deviations follow past patterns. Agreement was facilitated by new government fiscal measures costing about 0.5 percent of GDP. Prospects for most other private and public workers remain uncertain. This annex provides background on Iceland’s collective wage bargaining framework and on recent trends in wage growth, equality, poverty, and some other distributional issues.*

Tensions among social partners over the pace and distribution of income growth have been disruptive to the current collective wage bargaining round. However, at end-May, wage agreements were initialed covering about 70,000 workers in the private sector (about 37 percent of the labor force). But agreements have not been concluded for 40,000 workers in the private sector, and for public workers, who are also asking for pay raises.

Difficulties first emerged in 2013 when social partners launched negotiations on a new 3-year wage agreement but opted for a one-year deal for 2014. This agreement targeting a nominal economy-wide increase of 2.8 percent (4.1 percent with wage drift and minimum wage hike), but was quickly followed by breakout strikes by public sector teachers and doctors and private sector pilots that were resolved with double-digit wage increases. These groups represent a small share of employment, but other sectors also seem to have broken ranks as the economy-wide nominal wage increases in 2014 reached 6.6 percent.

- Iceland’s wage setting mechanism is normally highly centralized, coordinated, and synchronized. Negotiations sometimes become fragmented, but remain synchronized in that wage agreements typically cover the same duration and expire at similar times.
- Iceland used a collective bargaining framework in the early 1990s to overcome a long period of frequent strikes and double digit inflation. The framework has evolved over time, most notably several years ago when Iceland adopted a version of the “Nordic model” of collective wage bargaining that placed emphasis on (i) price and exchange rate stability; and (ii) purchasing power. The aim has been for the two groups of social partners—labor and employers—to negotiate long term (3-year) stability pacts aiming for an economy-wide wage path thought to be consistent with expected inflation and productivity gains, while ensuring adequate increases in the minimum wage. In the past, such pacts have been “sealed” by government measures considered important

¹ Prepared by Marco Arena.

by social partners. Each sector then finalized increases, reflecting sector-specific developments. This process generated relatively cohesive results in 2009 and again in 2011, when partner agreed on 3-year cumulative wage hikes of 11.4 percent.

- Iceland has one of the highest rates of unionization, 85 percent, among OECD countries. Individual unions are mostly represented by federations or associations. The largest is the Confederation of Labor (ASI), which covers more than 60 percent of all unionized workers, though many unions are quite small. As of end-April, wage contracts for about 75 percent of the labor force (about 140,000 workers) have expired. Wage contracts expire for most municipal workers by end-August 2015. Without further agreements, a majority of workers in Iceland (unionization is about 85 percent) will be working without contracts by August.
- Employers of over 70 percent of all private sector employees are represented by an umbrella organization, the Confederation of Icelandic Employers.

Wages have rebounded, but are only now reaching pre-crisis peaks (see panel charts).

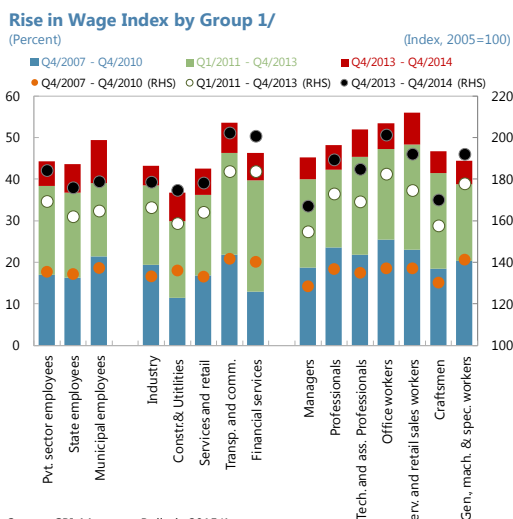
- Real wages are around their pre-crisis level (though nominal wages have risen by over 50 percent since 2008). This reflects the slow recovery of economic activity, which is only now reaching pre-crisis levels. The wage share in gross factor income has steadily increased since the aftermath of the global financial crisis, reaching its 20-year historical average (around 60 percent). At this level, Iceland's wage share is one of the highest among advanced economies but still below Iceland's pre-crisis wage share peak of 70 percent.
- Iceland's ULC-based real exchange rate has appreciated by almost 30 percent since 2009, but remains well below its pre-boom level. ULC increases implied by the wage hikes under discussion would far outstrip projected trading partner ULC growth of around 1.0–1.5 percent annually and would erode Iceland's competitiveness. Wage dispersion has narrowed over time, with the exception of public sector administration where earnings grew steadily.

Rates of poverty and income inequality, already one of the best in the world, have fallen further since the crisis.

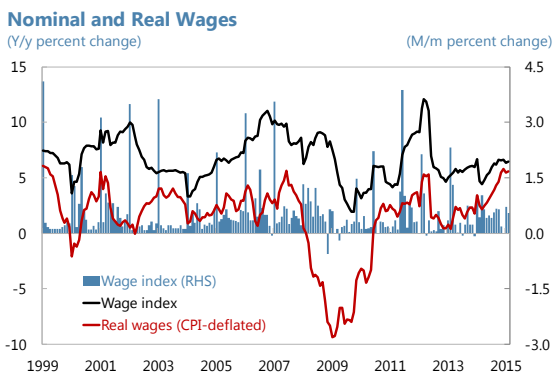
- The poverty rate has declined after the global financial crisis. According to Statice, the percent of population at-risk-of-poverty, after transfers, or social exclusion declined from 13.7 in 2010 to 11.3 percent in 2014. Relative to other Nordic countries and the euro area, Iceland shows a lower poverty rate.
- Income inequality, measured by the Gini coefficient, has declined since the crisis. Compared to other advanced economies, Iceland has a lower degree of income inequality. In Iceland, the Gini coefficient fell from 29.6 in 2009 to 24 in 2012 (similar to 2004 level of 24). Moreover, the ratio of the 80th percentile to the 20th percentile of the disposable income distribution is lower compared to other advanced economies. It is important to note that recent wage developments are not captured due to lags in reporting.

Annex I. Figure 1. Iceland: Wage Negotiations and Developments

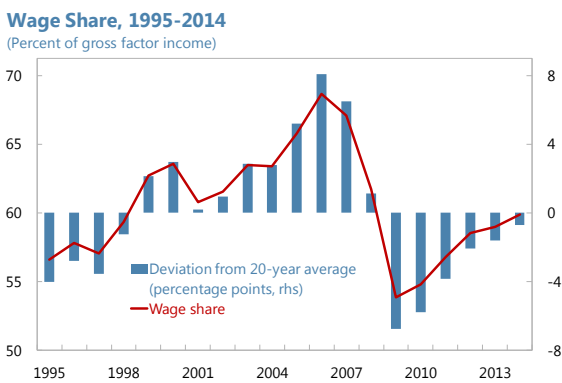
Wage increases were considerably larger in 2014 than contracting parties assumed by end-2013.



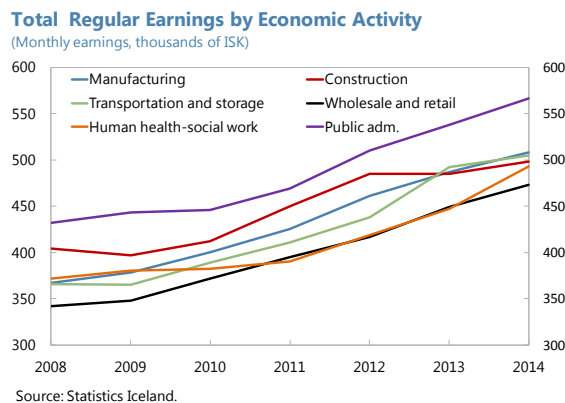
Since end-2007, nominal wages have increased by about 52 percent but with little change in real terms.



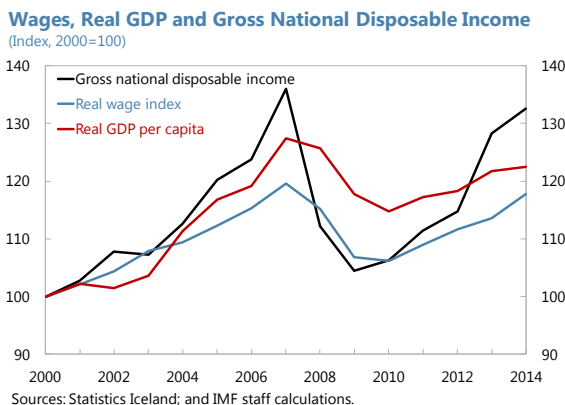
The wage share in gross factor income has steadily increased, reaching its 20-year historical average (60 percent) but remains below its pre-crisis peak.



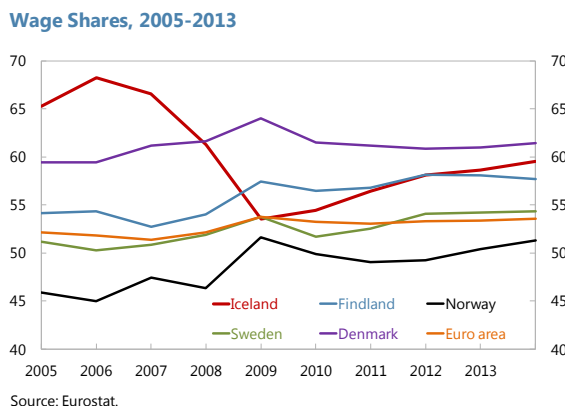
By economic activity, there has been a narrowing of earnings differentials with the exception of public sector administration.



Real wages have increased by about 12 percent since end-2010. The latter is reflected in a still recovering real household consumption per capita.



The average wage share for the period 1997-2013 is one of the highest among advanced economies.

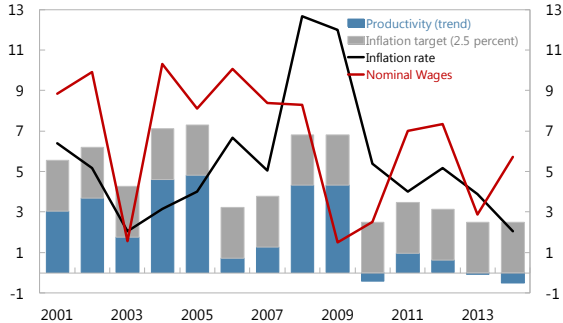


Annex I. Figure 2. Iceland: Wage Negotiations and Developments

In recent years, real wages have been above productivity gains (though the output gap has been negative).

Wages and Labor Productivity

(Year-on-year percent change)



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

Productivity has declined since the global financial crisis and most recently approached negative rates of variation.

Real Wages and Labor Productivity (Trend)

(Year-on-year percent change)

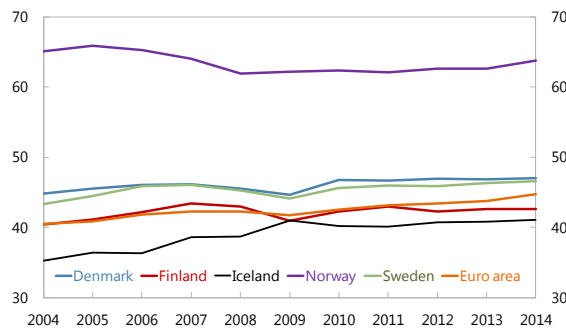


Sources: Central Bank of Iceland; and IMF staff calculations.

Productivity levels have been below the Nordic average.

GDP per Hour Worked

(USD, constant prices, 2005 PPPs)

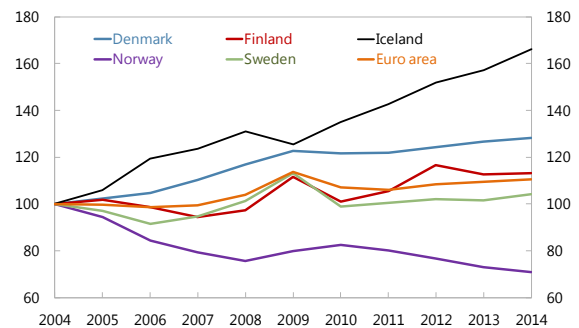


Source: OECD.

Unit labor costs (ULCs) in Iceland have increased more than in trading partners.

Unit Labor Cost in Manufacturing

(Index, 2004=100)

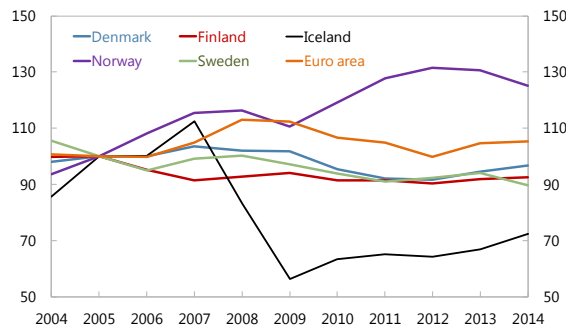


Source: IMF WEO.

REER-ULC based has appreciated by almost 30 percent since 2009, but remains well below its pre-boom level.

Real Effective Exchange Rate, ULC-based

(Index, 2005=100)

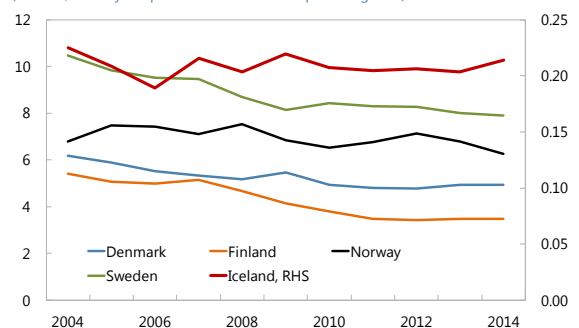


Sources: IMF WEO; and IMF staff calculations.

Iceland's market share (goods exports) with respect to the euro area has been flat in recent years.

Market Share in Euro Area Imports

(Percent, country's exports relative to EA's imports of goods)



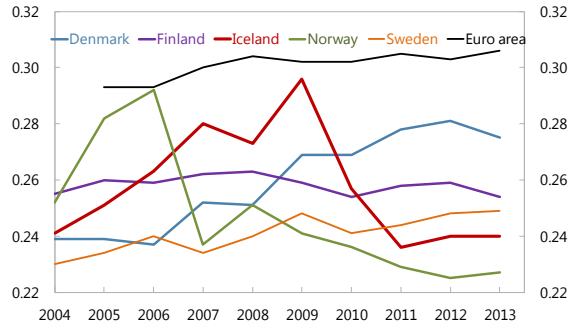
Sources: IMF WEO; and IMF staff calculations.

Annex I. Figure 3. Iceland: Wage Negotiations and Developments

Income inequality has declined since the crisis and is lower degree than in most Nordics and the Euro area average.

GINI Index

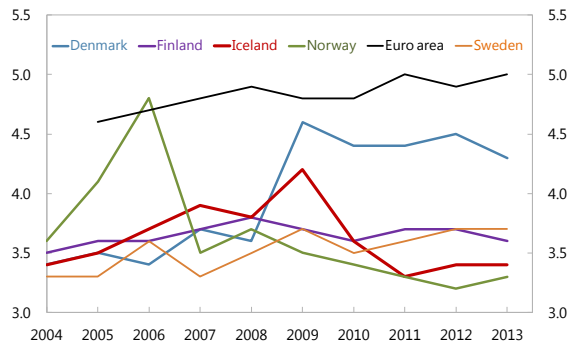
(Of equivalized disposable income)



Source: Eurostat.

The gap between the highest and lowest quintiles in Iceland is lower compared to other advance economies.

Percentile 80/20 Disposable Income Decile Ratio

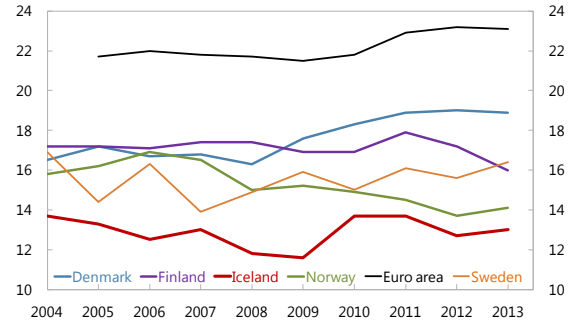


Source: Eurostat; and SILC.

Iceland has a lower poverty rate than other Nordic countries and the euro area,

People at Risk of Poverty or Social Exclusion

(Percent of population below 60 percent of the national median equivalised disp. income)



Source: Eurostat.

Annex II. Iceland: Debt Sustainability Analyses¹

1. External and public debt are on sustainable downward trajectories over the medium term, but risks remain elevated. In addition to projected trajectories of macroeconomic variables and core policies, the large króna balance of payments overhang and its release are major policy challenges that will influence the path of debt.

A. External Debt Sustainability Analysis

2. The following assumptions for the baseline external debt path are changed from the Fifth Post Program Monitoring and Article IV staff report (“previous report”):

- **Macro framework.** Real growth projections have been revised downward by about 0.2 percentage points on average during 2015–20. The medium-term path for the current account is on average about 1 percentage points of GDP lower during 2015–20, mainly reflecting worse trade balances. The ISK/USD exchange rate is projected to be weaker over the forecast horizon in comparison to the previous report, due to the strengthening of the dollar.
- **Debt-stabilizing current account.** As a result, the non-interest current account needed to stabilize the external-debt-to-GDP ratio is a surplus of 5.1 percent of GDP compared to a deficit of 0.5 percent of GDP as suggested in the previous DSA.
- **Old banks estates.** Estimates of the three old banks’ asset recoveries were updated through 2014 (as before, assets of old banks are not recorded as debt until they are recovered into liquid form). We assume that old banks liquidate their shares in the new banks by 2016, which explains the uptick in external debt that year. Like in the previous report, we assume in our baseline scenario that capital controls are not lifted and no payouts to specific foreign creditors are made (apart from payments to priority creditors). However, in our baseline projections we do assume a gradual release of the BOP overhang which maintains reserves at minimum adequate levels (150 percent of reserve adequacy metric). As this is not currently reflected as debt reductions, the external debt path can be viewed as conservative (and will likely be lower). Once a revised liberalization strategy is in place, we will adjust the BOP and external debt figures (and macro framework) accordingly.

3. The three main components of the BOP overhang include the failed estates and locked in carry trade (largely nonresidents) amounting to about 40 percent of GDP, and residents accounting for another roughly 25 percent of GDP (though difficult to estimate).

- **Nonresident creditors of failed estates** (net BOP overhang of 25 percent of GDP). The private nonresident claims on failed estate domestic assets remain blocked from exiting by capital controls. Total assets of the failed estates, nearly all attributable to the three large failed bank

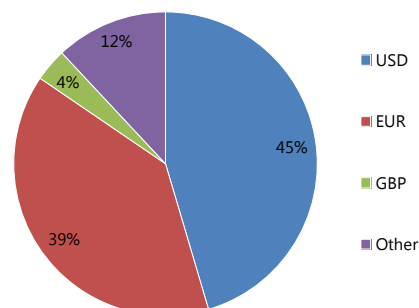
¹ Prepared by Ghada Fayad and Jimmy McHugh.

estates (Kaupthing, Glitner, and LBI), are around ISK 2,200 billion, or 112 percent of GDP. However, the Central Bank of Iceland (CBI) reports that their collective net pressure on the BOP is far less than this because (i) nearly 60 percent of failed estate assets are FX assets held in overseas accounts; (ii) resident creditors hold around 6 percent of combined claims; and (iii) some of the domestic debtor counterparties of the failed estate confirmed asset claims hold offsetting FX assets overseas that they would draw down when paying their obligations to the failed estates. Together, these factors bring the net BOP overhang attributable to the failed estates down to an estimated 25 percent of GDP, according to the CBI. Details are provided below.

- **Liquid offshore króna (OLK) holders** (BOP overhang of 15 percent of GDP): These are mostly nonresident claims originating from carry trade transactions that were caught by imposition of capital controls. They are generally liquid, consisting of deposits and money market accounts, short- and MLT Treasury securities, and HFF bonds.
- **Residents** (BOP overhang of 25 percent of GDP, but uncertain). There are three readily identifiable groups of residents that could seek to rebalance their portfolios once controls are removed: (i) private pension funds; (ii) corporates, particularly those interested in outward FDI, and (iii) households, particularly their DMB deposits. It is difficult to assess the possible outflows from domestic parties upon the removal of capital controls, but staff portfolio rebalancing analysis suggests it could be in the range of 25 percent of GDP, or higher if significant household deposit flight emerges. Household deposits amount to around 90 percent of GDP.

4. The currency composition of external debt suggests a majority USD denominated debt, which has appreciated by about 6 percent against the króna since end-2014. Most of the remainder is in Euros, against which the króna has appreciated by about 4 percent.

Currency Breakdown of Foreign Debt¹
(Percent of Total)



Source: Central Bank of Iceland.

¹/Includes debt related to the Treasury, Central bank, municipalities, municipal-owned firms, government-guaranteed firms, banks, and foreign denominated debt of failed banks (Avens, Landsvirkjun, and Landsbankinn), but excludes other old-bank related debt and offshore liquid krona.

5. External debt is expected to decline over the medium term. External debt is estimated at 208 percent at end-2014, and expected to fall to around 180 percent of GDP by 2020. It is worth noting that a large portion of this debt is old banks related debt: external debt for end-2014 excluding old banks' recovered assets is 158 percent of GDP. In addition, more than half of non-old bank private external debt is FDI related (about 60 percent end-2014).

6. Stress tests suggest that the downward trajectory is relatively robust, but risks remain. Apart from the historical and real depreciation scenarios, standard shocks would not alter the downward trajectory of the external debt ratio. Overall, remaining risks relate to the upcoming unwinding of capital controls, and to the outcomes of ongoing wage negotiations, with worse than expected wage increases further harming competitiveness and growth prospects, and thus negatively affecting debt sustainability.

Annex II. Table 1. Iceland: External Debt Sustainability Framework, 2010–20
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest CA 7/	
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020		
Baseline: External debt (including old banks) 1/	280.3	254.4	258.2	251.5	208.0	193.7	195.7	189.2	183.8	181.8	179.8	5.1	
Change in external debt	24.5	-25.8	3.8	-6.8	-43.5	-14.3	2.0	-6.5	-5.4	-2.0	-2.0		
Identified external debt-creating flows (4+8+9)	-28.5	-27.7	-20.8	-23.6	-30.7	-12.5	-8.8	-9.0	-8.2	-7.5	-6.8		
Current account deficit, excluding interest payments	-1.2	-6.1	-5.0	-11.5	-9.2	-8.4	-7.5	-8.3	-7.5	-6.5	-5.7		
Deficit in balance of goods and services	-10.5	-8.2	-6.2	-8.2	-6.4	-5.4	-4.7	-5.5	-4.7	-3.7	-2.8		
Exports	53.5	56.0	56.5	55.6	53.5	54.3	54.2	54.5	54.7	55.9	57.4		
Imports	43.1	47.9	50.3	47.4	47.1	48.9	49.6	49.0	50.0	52.2	54.5		
Net non-debt creating capital inflows (negative)	-27.1	-7.4	-29.5	1.0	-3.4	-0.6	-0.8	-1.1	-1.2	-1.4	-1.6		
Automatic debt dynamics 2/	-0.3	-14.1	13.7	-13.1	-18.1	-3.5	-0.5	0.4	0.5	0.4	0.5		
Contribution from nominal interest rate	7.6	11.4	8.2	5.7	5.6	5.1	4.6	4.6	4.7	4.7	4.8		
Contribution from real GDP growth	7.6	-6.1	-3.4	-8.5	-4.2	-8.7	-5.1	-4.2	-4.2	-4.3	-4.3		
Contribution from price and exchange rate changes 3/	-15.4	-19.5	8.9	-10.3	-19.4	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 4/	53.0	1.8	24.6	16.8	-12.8	-1.8	10.9	2.5	2.8	5.5	4.8		
External debt-to-exports ratio (in percent)	523.5	454.0	456.9	452.2	389.0	356.4	361.1	347.5	336.1	325.4	313.5		
Gross external financing need (in billions of US dollars) 5/	13.2	15.7	17.4	6.9	9.3	5.3	7.5	6.8	7.9	6.5	8.8		
in percent of GDP	99.9	107.1	122.6	44.7	54.5	32.2	41.7	36.3	41.4	33.6	45.1		
						10-Year	10-Year						
Scenario with key variables at their historical averages 6/						193.7	217.5	225.7	230.7	237.7	243.1	0.3	
Key Macroeconomic Assumptions Underlying Baseline													
						Historical Average	Standard Deviation						
Real GDP growth (in percent)	-3.1	2.4	1.3	3.6	1.9	2.2	4.2	2015	2016	2017	2018	2019	2020
GDP deflator in US dollars (change in percent)	6.7	8.2	-4.4	4.4	8.9	0.9	13.2	4.1	2.8	2.2	2.3	2.4	2.4
Nominal external interest rate (in percent) 8/	3.1	4.5	3.1	2.4	2.5	3.3	0.8	-6.5	5.1	1.4	-0.3	-0.7	-1.0
Underlying external interest rate (in percent)	3.4	5.8	4.0	3.3	3.6	4.2		2.4	2.6	2.4	2.5	2.6	2.7
Growth of exports (US dollar terms, in percent)	11.4	15.9	-2.3	6.4	6.6	8.0	12.5	3.4	3.9	4.1	4.3	4.3	4.4
Growth of imports (US dollar terms, in percent)	9.2	23.0	1.8	2.1	10.0	6.1	18.9	-1.2	7.8	4.1	2.4	3.9	4.0
Current account balance, excluding interest payments	1.2	6.1	5.0	11.5	9.2	-1.6	10.4	1.1	9.4	2.4	4.1	6.2	5.9
Net non-debt creating capital inflows	27.1	7.4	29.5	-1.0	3.4	-0.7	25.8	8.4	7.5	8.3	7.5	6.5	5.7
								0.6	0.8	1.1	1.2	1.4	1.6

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

2/ Derived as $[r - g - r(1+g) + ea(1+r)] / (1+g+r+g)$ 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 $[-r(1+g) + ea(1+r)] / (1+g+r+g)$ 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.

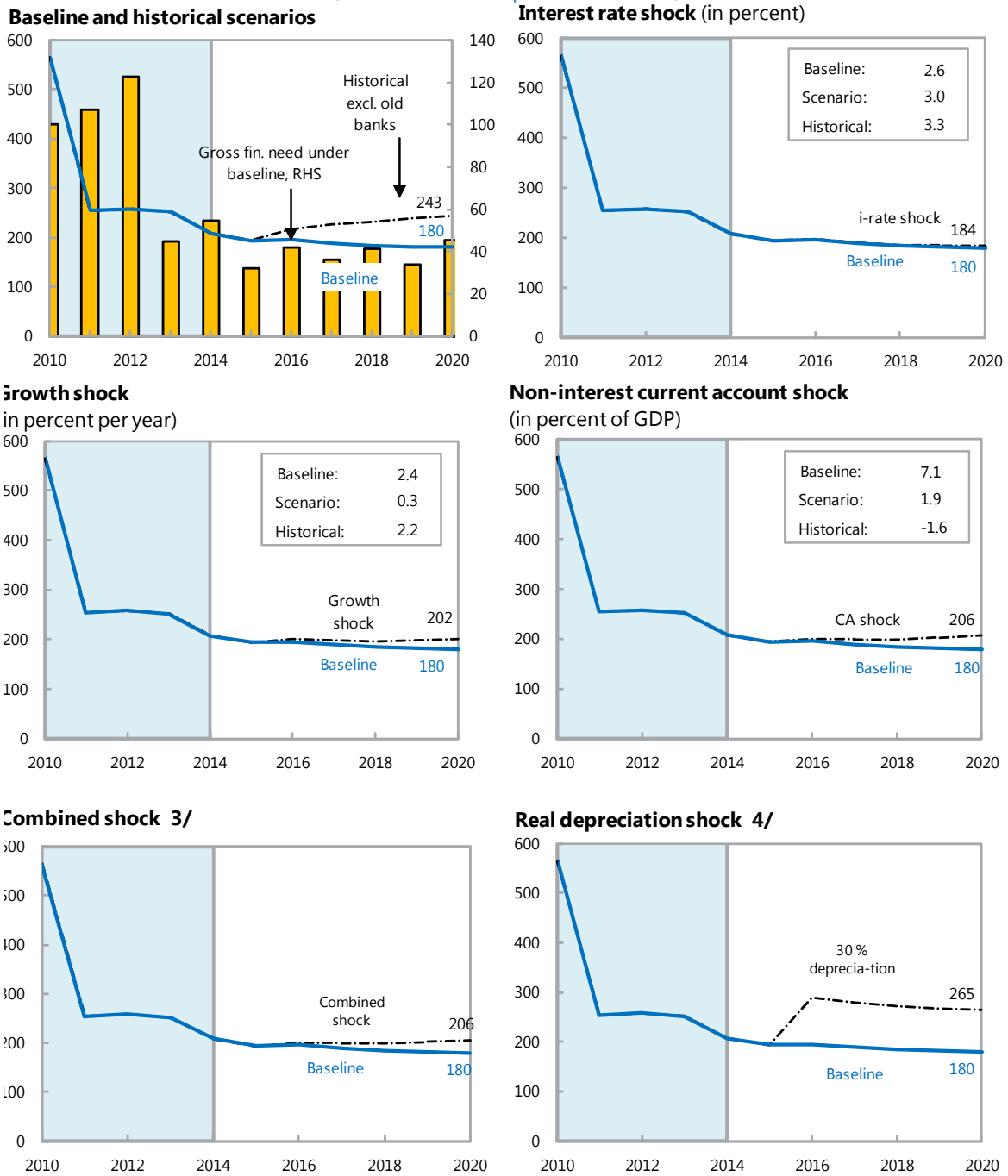
6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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.

Annex II. Figure 1. Iceland: External Debt Sustainability–Bound Tests ^{1/ 2/}
 (External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

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

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

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

B. Public Sector Debt Sustainability Analysis

Although Iceland's headline debt sustainability indicators are high, they are projected to improve over the medium term. Gross financing needs are manageable; maturities are relatively long and the stock of short-term debt is limited.

The Icelandic authorities recently revised their medium term fiscal framework. This plan highlights a number of important medium term fiscal challenges, including personal income tax reform, dealing with the remaining shortfall arising from the 1997 pension reform, and the construction of a new national hospital. This debt sustainability analysis examines the implications of these challenges as well as further recapitalizations of the Housing Finance Fund (HFF) and their implications for the future path of public debt.

The assessment from DSA stress tests is broadly unchanged from the last review. The downward trajectory for public debt is robust against most negative shocks. For all shock scenarios, the downward trajectory for the debt ratio would be re-established over the medium term. Nevertheless, general government debt-to-GDP levels would remain well above the benchmark throughout the medium-term in the event of a large combined macroeconomic or a financial contingent liabilities shock.

7. As a consequence of the financial crisis, Iceland's public debt ratio increased sharply and remains elevated. At the end of 2014, gross general government debt was estimated to be 82 percent of GDP, compared to a pre-crisis debt ratio of only 28.5 percent in 2007. As the crisis abated, Iceland made considerable progress towards restoring debt sustainability. Since the peak year of 2011, the general government gross debt ratio has fallen by around 13 percentage points of GDP.

8. The structure of Iceland's general government debt in large part reflects the policy response to the financial crisis. In 2009, the government issued a bond to cover capital contributions to troubled domestic financial institutions. The remaining obligation on this bond is estimated to be ISK 213 billion (10.8 percent of GDP) at end-2014. There are other debts assumed by the government arising from called guarantees issued by the Treasury. There is also a sizable non-marketable instrument that was issued to recapitalize the CBI that was restructured in December 2014, reducing the gross debt stock by 1.2 percent of GDP. In summer 2014, the external general government debt stock owed to Nordic governments has been repaid from the proceeds of the Eurobond issued in July 2014, and remaining balances on a much smaller loan from Poland was paid down in May 2015. These debts were accumulated during the crisis when Nordic partners offered bilateral financial support for FX reserve purposes.

9. More recently, a significant proportion of recent general government debt issuance has been used to bolster foreign exchange holdings. The government has deposited the foreign exchange proceeds for use by the CBI and thereby has built up sizable deposits at the

CBI. This is reflected in the large divergence between gross and net debt. At end-2014, net general government debt amounted to 56 percent of GDP.

10. While the level of general government debt is high, the structure of the debt helps minimize fiscal risks:

- **Domestic debt.** Around three quarters of general government debt is domestic. About 10 percent of this debt stock has been issued by local government entities. The bulk of this local government debt is held domestically.
- **Short-term debt.** The outstanding stock of short-term debt (original maturity) is small, comprising of just 2 percent of domestic general government debt. Only a minimal amount of external debt is coming due in the coming year, although a more sizable repayment of \$1 billion (5.6 percent of GDP) will be amortized in June 2016.
- **Denomination.** As of May 2015, 76 percent of central government debt is denominated in local currency; 18.6 percent issued in U.S. dollars and 5.2 percent issued Euros, with negligible amounts in Yen, Zloty and Sterling.
- **Fixed versus floating interest rate.** About 82 percent of the debt stock was issued using fixed interest rates.
- **Duration.** As of May 2015, the weighted average time to maturity on central government debt is 7.5 years. The time to maturity on foreign currency debt is lower at 4.5 years.
- **Ownership.** Holdings of Icelandic debt are concentrated in local banks and pension funds.

11. The Ministry of Finance recently revised its Medium-Term Debt Management strategy for 2015-19. The plan aims to reduce the gross debt to GDP ratio to 60 percent by end-2018 and achieve a long-run objective of a net debt to GDP ratio of 45 percent. The plan also targets a minimum average time-to-maturity of five years and a limit on treasury redemptions to 15 percent of GDP per year. The plan also sets guidelines for the structure of public debt; nominal debt should account for between 70-90 percent of the outstanding stock, while indexed debt should be range between 15-30 percent.

Fiscal Risks and Medium-Term Challenges

12. A significant fiscal risk is posed by the large outstanding stock of government guaranteed debt. At end-2014, the stock of state guaranteed debt was around ISK 1.2 trillion (62 percent of GDP) falling from a peak of 84 percent of GDP in 2009. During the early months of 2015, the stock of guarantees fell in nominal terms. Moreover, the government has stated its intention to reduce the stock guarantees as soon as it is practical. Around three quarters of these guarantees are denominated in domestic currency.

13. Around 84 percent of these guarantees were issued to two enterprises—HFF and the National Power Company (Landsvirkjun)—heightening fiscal vulnerabilities. The government is expected to cover any losses related to HFF through the budget, including any potential losses from the household debt relief program. Therefore, state guarantees on HFF debt is not anticipated to be called, though the potential budgetary losses surrounding HFF could be significant. The remaining state guarantees have been issued to other financial institutions and state-owned enterprises. Based on the current maturity profile, around a quarter of these guarantees will expire over the next four years.

14. The recently published medium term fiscal strategy has highlighted the importance of addressing legacy pension issues. Iceland reformed its pension system in 1997, establishing a fully funded pension system for private sector workers and public sector workers hired after 1997. At that time, public sector workers were given the option of remaining with the old PAYE system or moving to the newly established fully funded system. The authorities have made some provision for meeting this liability; however these funds are likely to be exhausted by 2030. Based on detailed actuarial projections, the Icelandic authorities estimate that there is around 24 percent of GDP in unfunded pension liabilities,⁴ which will need to be met from 2030 onwards.

Baseline and Realism of Projections

15. The Debt Sustainability Analysis (DSA) focuses on general government gross debt and is based on the following policy assumptions.

- **Fiscal outlook.** In line with the government's Spring 2015 Economic Program and the 2015 budget, the authorities will target a general government balance of close to zero over the period 2015–17.
 - However, deficits in the range of 1 percent of GDP will emerge as Iceland confronts the challenges arising from pension liabilities (0.3 percent per year) and public expenditure related to a new national hospital (0.5 to 1 percent per year).
 - The DSA also assumes sizable allocations towards recapitalizing the HFF (around 1 percent over four years).
 - Reform of the personal income tax system is also included in the baseline.⁵ In terms of revenues, this reform is assumed to cost around 0.4 percent of GDP.

⁴ These liabilities are published annually by Stacice and recorded as Insurance and Technical Reserves in the GFSM2001 presentation of general government assets and liabilities. These liabilities are not included in the gross debt figures.

⁵ The authorities have made commitments, both in the 2014 and 2015 fiscal plans, to reform the personal income tax by reducing the number of PIT tax rates from three to two.

- Taken together, these imply primary surpluses in the range of 1.3 to 3.6 percent of GDP over the medium term, coupled with a negative interest rate growth differential, will place the public debt ratio firmly on a downward trajectory.
- **Debt management strategy.** The primary objective of the Icelandic government's debt management strategy is a return to debt sustainability.
 - This is defined as a net debt to GDP ratio of 45 percent; a benchmark that is established in the Ministry of Finance's medium term debt management strategy. This objective is also explicitly set out in the draft Organic Budget Law (OBL) currently under consideration in Parliament.
 - At the same time, the authorities are trying to maintain adequate foreign exchange buffers while capital controls are liberalized. The baseline also assumes that the Treasury will pay down one half of the large external bond amortization due in 2016 (with the remainder rolled over). Thereafter, the DSA assumes that the government will issue sufficient external debt to rollover repayments coming due in 2017 onwards.
 - In line with the authorities' plans, the scenario also assumes that around a third of a large domestic bond coming due in 2018 will be amortized using funds drawn down from government deposits.
 - Finally, the scenario has taken into account the government's planned asset sales in 2016–17 of about 3½ percent of GDP, with the resources eventually used to reduce the debt stock.
- **Macroeconomic assumptions.** Due to higher wage demands, the scenario assumes an increase in inflation beyond the CBI's target. This provokes an interest rate hike, which leads to a slowdown in growth over the medium term.
- **Realism of baseline assumptions.** The median forecast error for real GDP growth during 2004–14 is 0.3 percent. During the earlier years, staff tended to be marginally pessimistic about growth and slightly optimistic during the crisis years. More recently, growth forecasts have been close to outturns. Inflation forecasts have been subject to larger error, particularly before and during the crisis. Since 2011, inflation forecast accuracy has improved. The median forecast error for the general government primary fiscal balance indicates that staff projections were overly pessimistic before the crisis and too optimistic during the crisis, but again forecast accuracy has improved in recent years.

16. The baseline envisages a gradual reduction in the general government gross debt ratio to around 61 percent of GDP by 2020. Likewise, the net debt ratio will continue its downward trajectory. By 2017, the authorities are projected to be very close to meeting their net debt fiscal rule, which will be established under the new OBL, currently under consideration in Parliament.

17. The risk assessment heat map indicates that Iceland has transitioned in 2014 from a high to a moderate debt risk. Under the previous DSA, which used end-2013 data, the general government debt ratio breached the high risk benchmark of 85 percent. In 2014, Iceland's debt ratio fell below that benchmark. Notwithstanding two repayments peaks in 2016 and 2018, gross financing needs are manageable over the medium term. This is due to the small amounts of outstanding short term debt, and comparatively long maturities. The gross external financing requirement (including public and private obligations) is significantly above the upper benchmark of the early warning benchmark.

Shocks and Stress Tests

18. The DSA baseline indicates that Iceland will continue to make further progress towards bringing the debt ratio down over the medium term. By 2017, the authorities are projected to meet their 45 percent of GDP net debt objective—the new fiscal rule outlined in the draft organic budget law. This conclusion assumes that the commitment to fiscal adjustment is sustained and the macroeconomic and external environment is relatively benign.

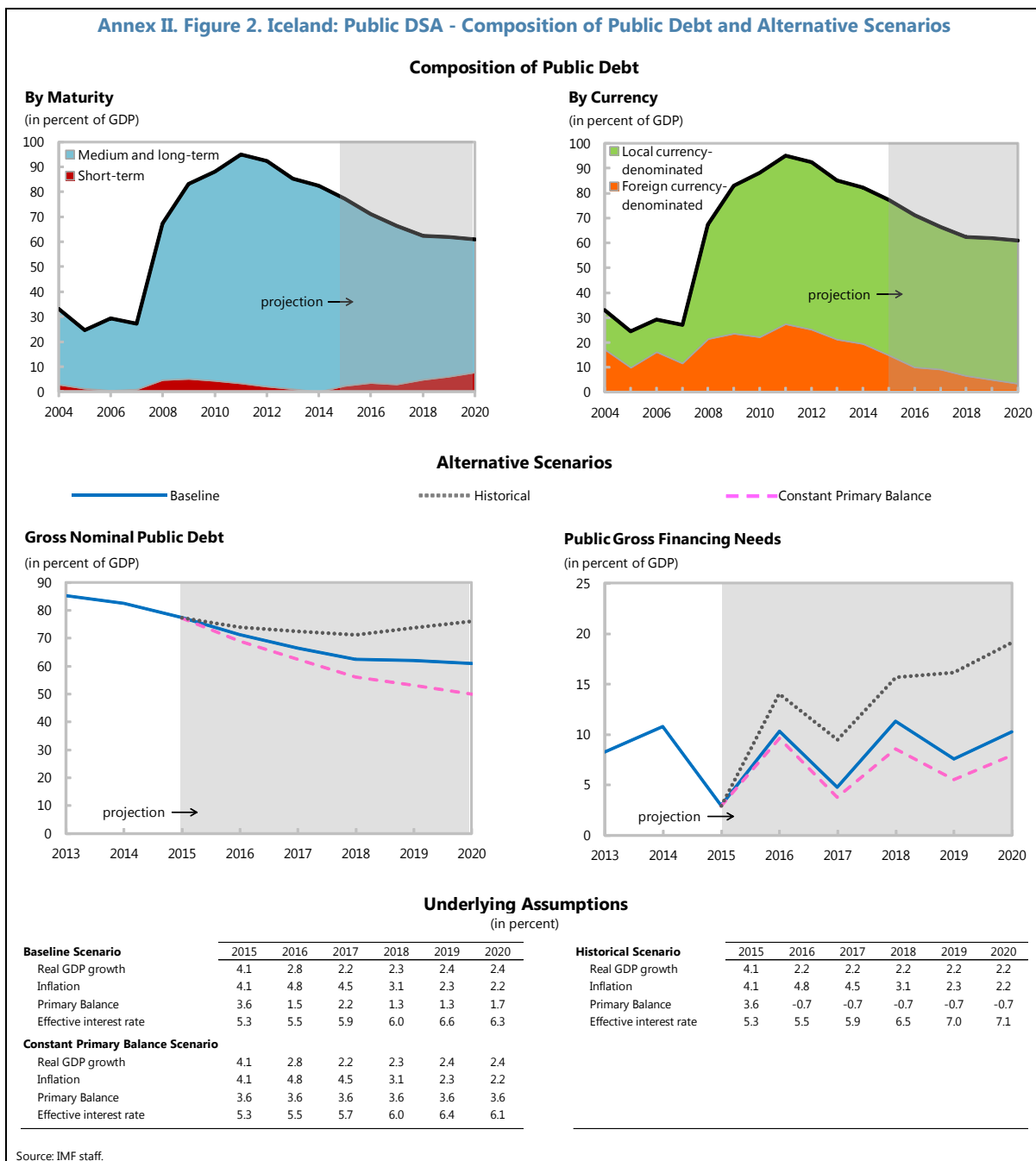
19. Based on an asymmetric restriction of the shocks (Annex 1 Figure 2), the debt ratio peaks at around 110 percent of GDP at a 95 percent confidence interval.

- **Growth shock.** Under this scenario the real growth rate is subjected to a comparatively large 0.5 standard deviation negative shock starting in 2015–16. The scenario assumes a 0.25 percentage point decline in inflation for every one percentage point decrease in GDP. The scenario also assumes higher risk premia, further worsening the primary balance. Under this scenario, the debt-to-GDP ratio continues on its downward trajectory. The debt ratio in 2020 is 7 percentage points higher relative to the baseline.
- **Interest rate shock.** This scenario assumes a 200 basis point increase in spreads throughout the projection period. However, the shock has a modest effect on the debt scenario due to the comparatively high proportion of fixed interest debt and the relatively low future debt rollover requirement. The debt ratio in 2020 is around 4 percentage points higher relative to the baseline.
- **Real exchange rate shock.** This scenario assumes that the real exchange rate will devalue by 25 percent in the current year. The shock results in a slowdown in GDP growth and an increase in the debt ratio by 8.5 percentage points of GDP.
- **Primary balance shock.** This scenario considers a 2 percentage point decline in revenues in 2015 and 2016. These shocks lead to a 9 percentage point increase in the debt ratio relative to the baseline in 2020 and adds almost one percent of GDP to gross financing needs.
- **Combined macro-fiscal shock.** This scenario combines shocks to real growth, the interest rate, the real exchange rate, and the primary balance while eliminating double-counting of the effects of individual shocks. Under this scenario, the debt ratio increases sharply, peaking

at 90 percent of GDP in 2017, and remaining high throughout the projection period. Gross financing needs would be significant, rising to almost 20 percent of GDP in 2016.

Financial contingent liabilities shock. Reflecting the large outstanding stock of state guarantees, this scenario assumes that 10 percent of these guarantees are called upon in 2015. This assumes a significant deterioration in the balance sheet of HFF. The scenario also assumes that interest rates increase by 25 basis points for every 1 percent of GDP worsening in the primary balance. Interest rates increase by over 210 basis points. The debt ratio remains elevated throughout the projection period. In 2020, the debt ratio under this shock scenario is projected to be around 20 percentage points higher than in the baseline.

Annex II. Figure 2. Iceland: Public DSA - Composition of Public Debt and Alternative Scenarios



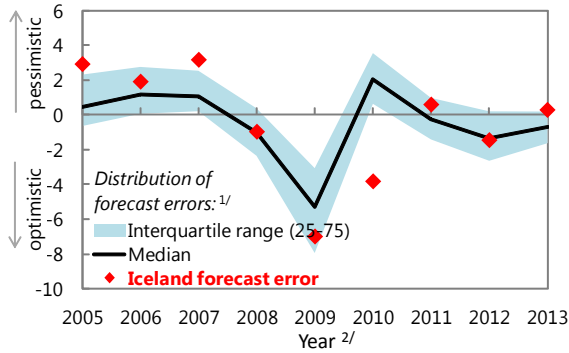
Annex II. Figure 3. Iceland: Public DSA - Realism of Baseline Assumptions

Forecast Track Record, versus all countries

Real GDP Growth

(in percent, actual-projection)

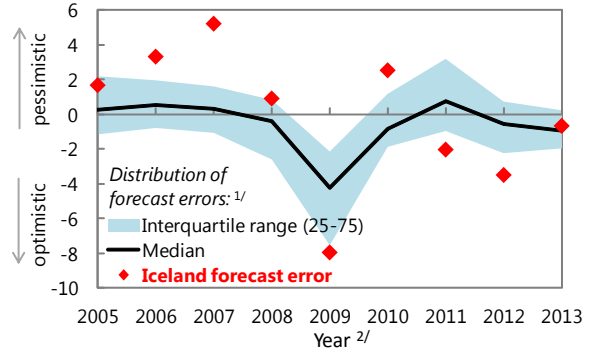
Iceland median forecast error, 2005-2013: **0.28**
 Has a percentile rank of: **68%**



Primary Balance

(in percent of GDP, actual-projection)

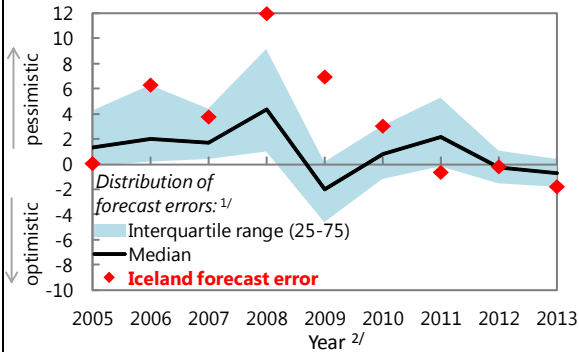
Iceland median forecast error, 2005-2013: **0.92**
 Has a percentile rank of: **84%**



Inflation (Deflator)

(in percent, actual-projection)

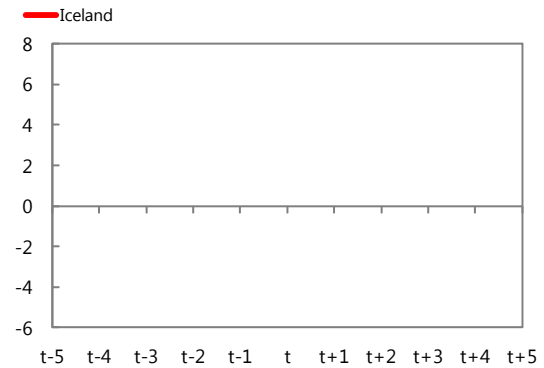
Iceland median forecast error, 2005-2013: **3.04**
 Has a percentile rank of: **74%**



Boom-Bust Analysis^{3/}

Real GDP growth

(in percent)



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

Annex II. Figure 3. Iceland: Public DSA - Realism of Baseline Assumptions (continued)

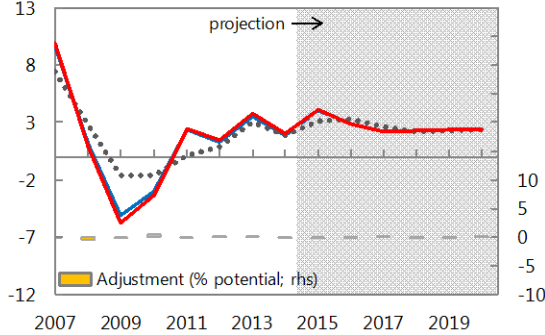
Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 1, persistence of 0.6

Real GDP Growth

(in percent)

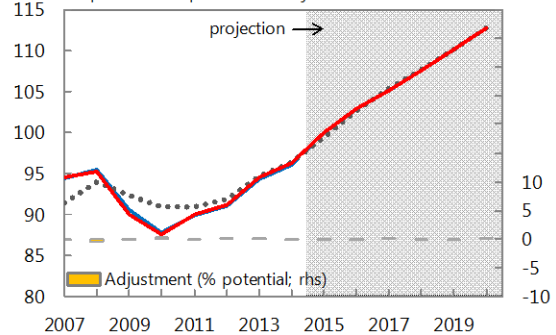
- Baseline real growth
- Baseline real potential growth
- Implicit real growth without adjustment



Real Output Level

(Baseline real output in 2015=100)

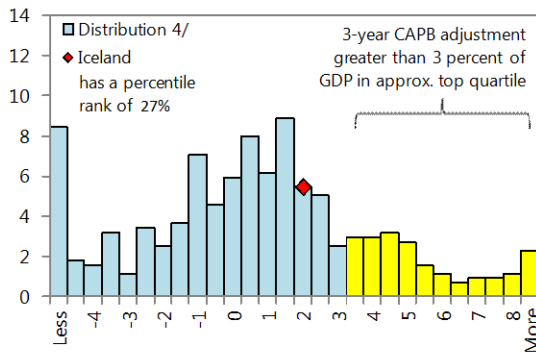
- Baseline real output
- Baseline real potential output
- Implicit real output without adjustment



Assessing the Realism of Projected Fiscal Adjustment

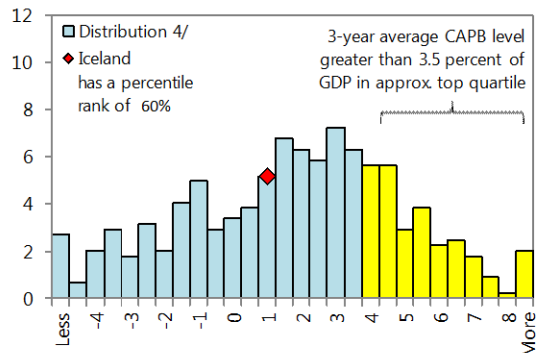
3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)

(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)

(Percent of GDP)



Source : IMF staff.

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

Annex II. Figure 4. Iceland: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

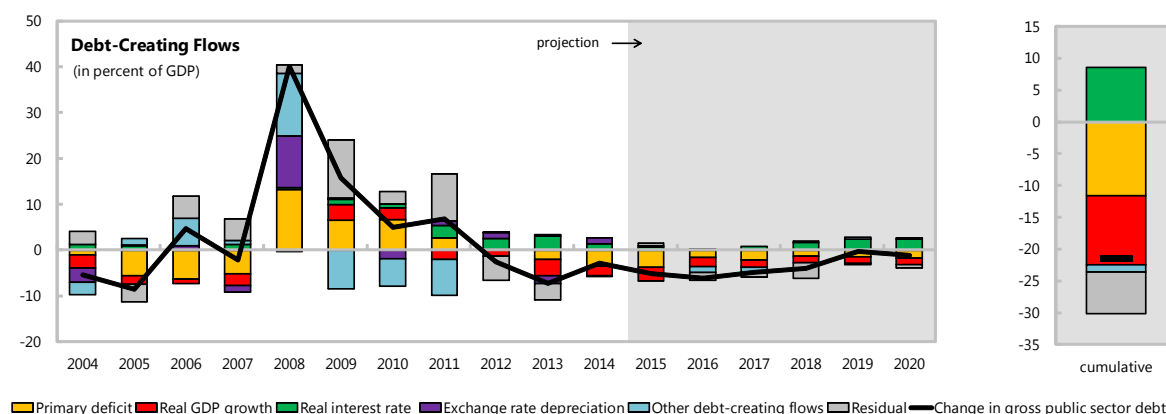
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual		Projections						As of February 06, 2015		
	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	85.2	82.4	77.3	71.2	66.3	62.3	62.0	60.9	Spread (bp) 3/		
Public gross financing needs	8.3	10.8	2.9	10.3	4.8	11.3	7.5	10.3	CDS (bp)		
State guarantees	70	61							Ratings	Foreign	Local
Unfunded pension liabilities	24.3	24.1							Moody's	Baa3	Baa3
Real GDP growth (in percent)	3.6	1.9	4.1	2.8	2.2	2.3	2.4	2.4	S&Ps	BBB-	BBB-
Inflation (GDP deflator, in percent)	2.0	4.0	4.1	4.8	4.5	3.1	2.3	2.2	Fitch	BBB	BBB+
Nominal GDP growth (in percent)	5.7	6.0	8.4	7.8	6.8	5.5	4.7	4.7			
Effective interest rate (in percent) ^{4/}	5.4	5.8	5.3	5.5	5.9	6.0	6.6	6.3			

Contribution to Changes in Public Debt

	Actual		Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2013	2014	2015	2016	2017	2018	2019	2020		
Change in gross public sector debt	-7.3	-2.8	-5.1	-6.1	-4.9	-4.0	-0.3	-1.1	-21.5	
Identified debt-creating flows	-3.8	-2.8	-4.9	-4.2	-3.6	-0.3	0.3	-0.3	-13.0	
Primary deficit	-1.9	-3.4	-3.6	-1.5	-2.2	-1.3	-1.3	-1.7	-11.6	1.4
Primary (noninterest) revenue and grants	41.2	44.2	43.6	41.6	41.1	40.4	40.7	40.8	248.2	
Primary (noninterest) expenditure	39.4	40.7	40.0	40.1	39.0	39.2	39.3	39.1	236.6	
Automatic debt dynamics ^{5/}	-2.2	0.7	-1.6	-1.5	-0.3	0.6	1.3	1.1	-0.3	
Interest rate/growth differential ^{6/}	-0.4	-0.6	-2.3	-1.7	-0.6	0.3	1.1	1.0	-2.2	
Of which: real interest rate	3.2	1.4	0.7	0.4	0.8	1.8	2.5	2.4	8.6	
Of which: real GDP growth	-3.6	-2.0	-3.1	-2.0	-1.5	-1.4	-1.4	-1.4	-10.9	
Exchange rate depreciation ^{7/}	-1.7	1.3	...	...	...	...	...	...	...
Other identified debt-creating flows	0.3	-0.1	0.3	-1.2	-1.1	0.3	0.3	0.3	-1.1	
General government net privatization proceeds (negative)	0.0	-0.1	0.0	-1.5	-1.4	0.0	0.0	0.0	-2.9	
Net lending for policy purposes	0.3	0.0	0.3	0.3	0.3	0.3	0.3	0.3	1.8	
Residual, including asset changes ^{8/10/}	-3.5	0.0	-0.2	-1.9	-1.3	-3.7	-0.6	-0.8	-8.5	



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 $r - \pi(1+g)$ and the real growth contribution as $-g$.

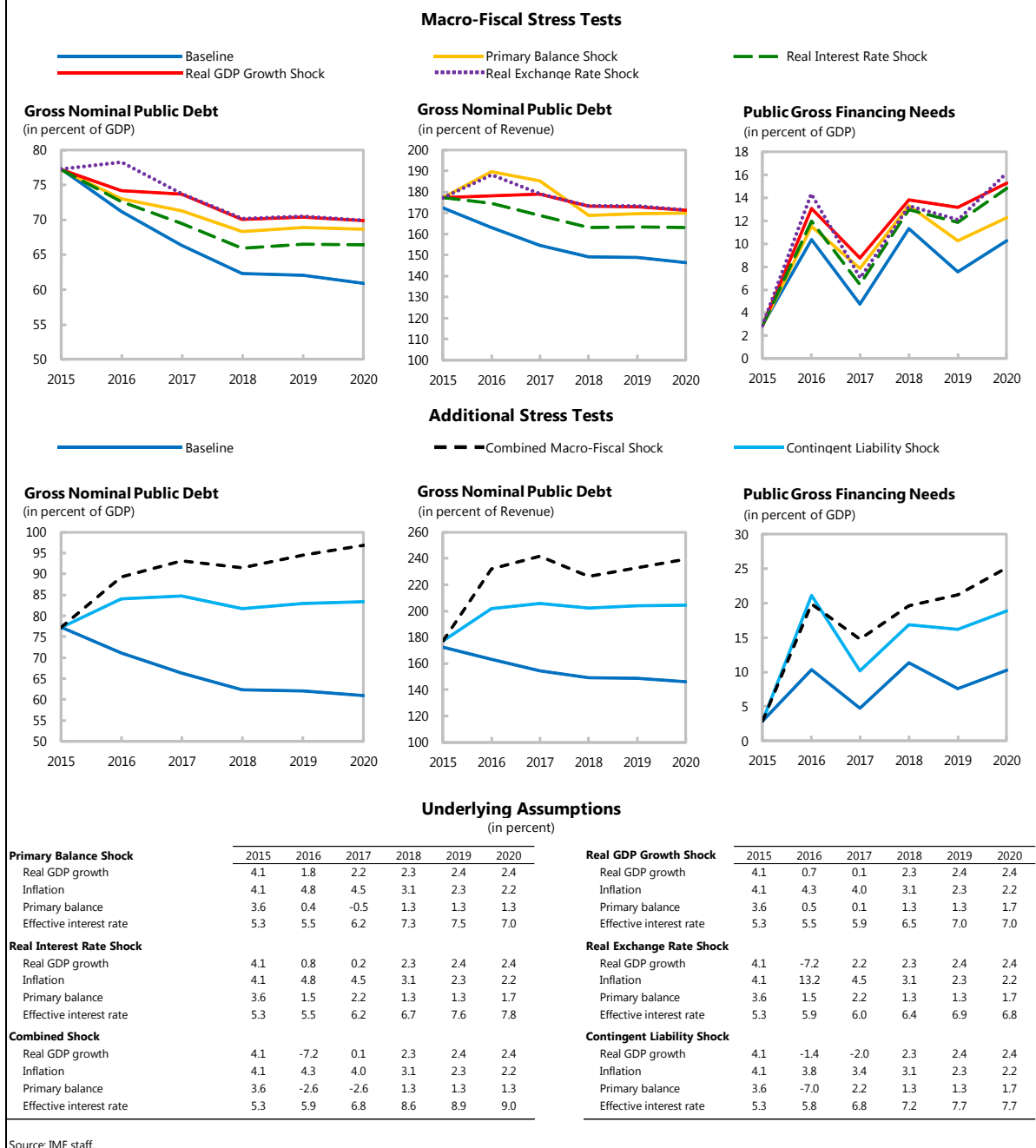
7/ The exchange rate contribution is derived from the numerator in footnote 2/ as $ae(1+r)$.

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 residual in 2014-17 reflects the over-financing of the fiscal balance, an initial build-up of government deposits held at the central bank, and the subsequent drawdown of deposits to finance external debt.

Annex II. Figure 5. Iceland: Public DSA - Stress Tests



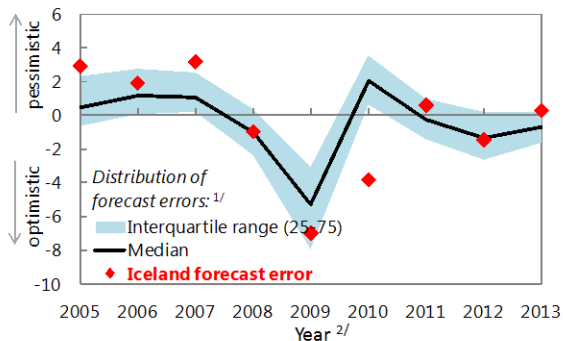
Annex II. Figure 6. Iceland Public DSA - Realism of Baseline Assumptions

Real GDP Growth

(in percent, actual-projection)

Iceland median forecast error, 2005-2013: **0.28**

Has a percentile rank of: **68%**



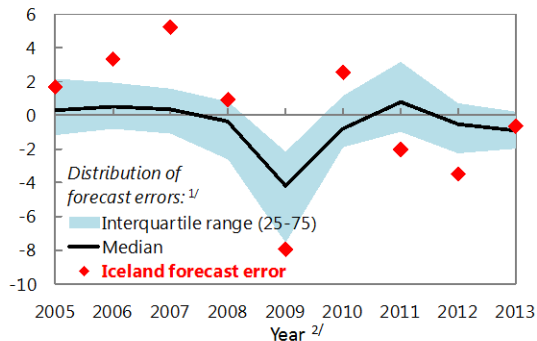
Forecast Track Record, versus all countries

Primary Balance

(in percent of GDP, actual-projection)

Iceland median forecast error, 2005-2013: **0.92**

Has a percentile rank of: **84%**

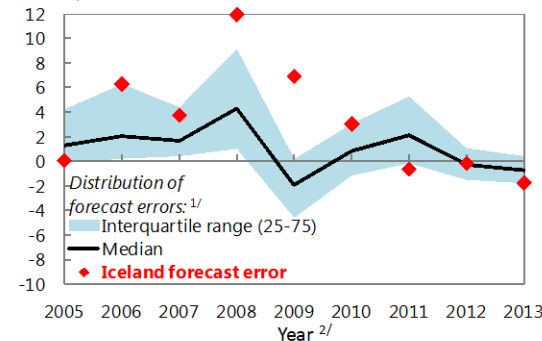


Inflation (Deflator)

(in percent, actual-projection)

Iceland median forecast error, 2005-2013: **3.04**

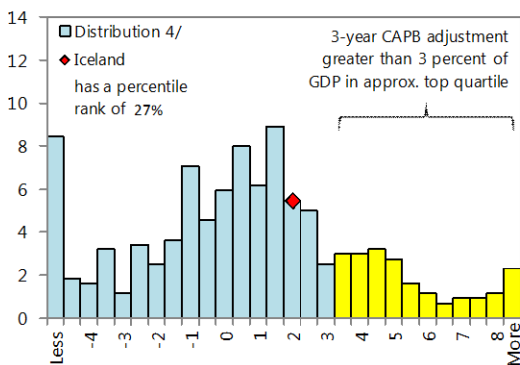
Has a percentile rank of: **74%**



Assessing the Realism of Projected Fiscal Adjustment

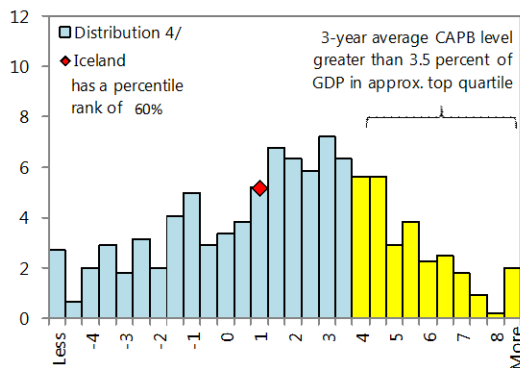
3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)

(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)

(Percent of GDP)

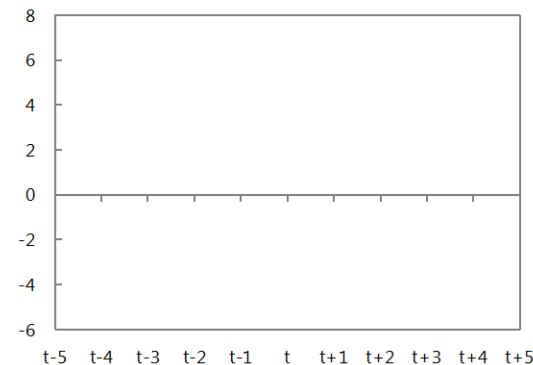


Boom-Bust Analysis^{3/}

Real GDP growth

(in percent)

— Iceland



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.

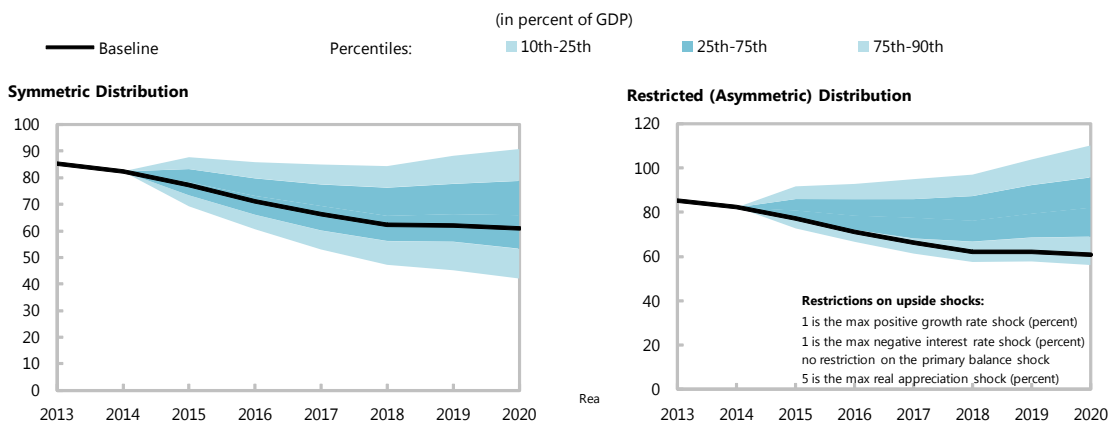
4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex II. Figure 7. Iceland Public DSA Risk Assessment

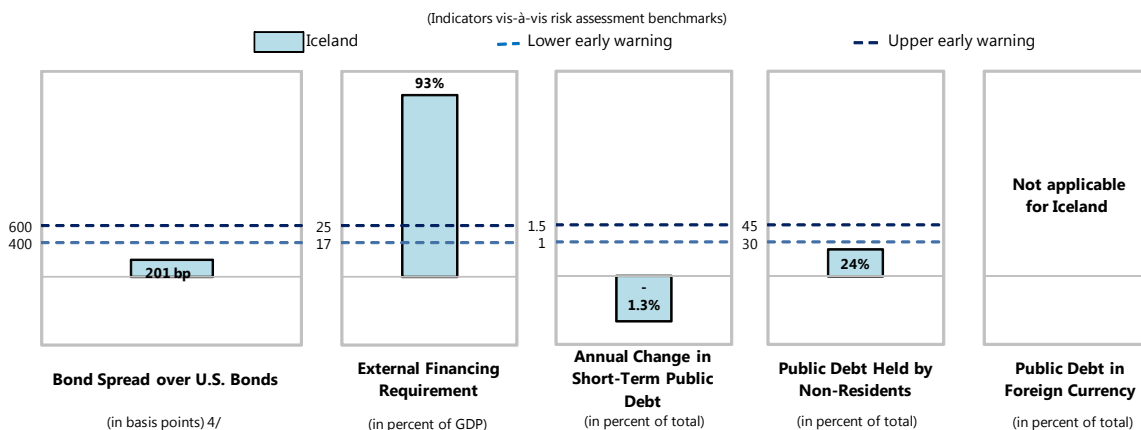
Heat Map

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



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, 08-Nov-14 through 06-Feb-15.

Annex III. Iceland: Risk Assessment Matrix

Risks	Relative Likelihood	Impact if Realized
1. Capital account liberalization: missteps or progress (domestic risk)	<p style="text-align: center;">Low-Medium</p> <ul style="list-style-type: none"> • Full liberalization may take place before necessary conditions are in place, leading to significant BOP outflows. • Mismanagement could lead to prolonged capital controls and/or protracted litigation and uncertainty. • Successful acceleration of liberalization could boost confidence and growth. 	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • BOP outflows could lead to reserve losses and rapid depreciation of the króna, higher external borrowing costs, and banking sector problems. • Litigation involving the old bank estates could bring reputational and legal risks and weaken growth prospects. • Prolonged controls could weaken growth and external prospects by discouraging FDI and innovation.
Policy Response	<ul style="list-style-type: none"> • <i>Liberalization should be conditions-based and include speed limits.</i> • <i>A revised capital controls liberalization strategy should be transparent and comprehensive to address all potential outflows. The approach should be consistent with macroeconomic and financial stability, and conditioned on BOP prospects (including maintaining adequate reserve buffers).</i> • <i>Emphasis should be given to a cooperative approach, with appropriate incentives, that minimizes the legal and reputational risks.</i> 	
2. Large wage hikes (domestic risk)	<p style="text-align: center;">Low-Medium</p> <ul style="list-style-type: none"> • 2015 negotiations could result in wage growth above 25 percent over three years or even general strikes. <p style="text-align: center;">Low</p> <ul style="list-style-type: none"> • On the upside, an outcome could be more consistent with productivity gains. 	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • An adverse outcome would exert further upward pressure on inflation, un-anchor inflation expectations, and bring a period of instability. General strikes would disrupt economic activity and could cause reputational damage. • An outcome more consistent with productivity gains would support growth, stability, and reform impetus.
Policy Response	<ul style="list-style-type: none"> • <i>Significantly hike interest rates to contain inflation; let the exchange rate adjust to compensate for losses in competitiveness. Tighten fiscal policy to ease domestic demand pressures.</i> • <i>Structural reforms to increase productivity and competition.</i> 	
3. Realization of fiscal risks (domestic risk)	<p style="text-align: center;">Medium-High</p> <ul style="list-style-type: none"> • Realization of contingent liabilities (HFF, other); legal challenges to financial sector taxation. 	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Higher government debt and interest costs.
Policy Response	<ul style="list-style-type: none"> • <i>Identify fiscal measures to restore budget balance and gradually reduce debt. Use one-off revenues to reduce debt.</i> 	
4. Protracted period of slower growth in the euro area	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> • Weak demand and persistently low inflation, leading to “new mediocre” rate of growth in advanced economies. 	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Lower growth in the euro area could lead to a slowdown in Iceland’s FDI and growth. Imported disinflation would persist.

Policy Response	<ul style="list-style-type: none"> Loosen monetary policy if imported disinflation accelerates if overall inflationary pressure subsides. 	
5. Sovereign market stress due to protracted period of uncertainty in the euro area, notably Greece	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> Sovereign bond market stress re-emerges due to uncertainty in the euro area, particularly Greece 	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> Higher sovereign risk premium in the euro area periphery and possibly global risk aversion could entail higher external borrowing costs for the government, banks, and large exporters. The rest of the economy is unaffected through the financial channel due to capital controls and limited access to foreign markets.
Policy Response	<ul style="list-style-type: none"> Loosen monetary policy if imported disinflation accelerates. 	
6. Upside risks to oil prices	<p style="text-align: center;">High/Medium</p> <ul style="list-style-type: none"> Increased volatility due to uncertainty about the persistence of the oil supply shock and the underlying drivers of the price decline. Political fragmentation erodes the globalization process and fosters inefficiency. 	<p style="text-align: center;">Low-Medium</p> <ul style="list-style-type: none"> Higher oil prices would put upward pressures on prices and revert the positive effect of the oil price decline on terms of trade, thus, weakening the BOP and reserve accumulation. The effect from movements in the spot price is mitigated by medium-term contracts and high taxes on petroleum.
Policy Response	<ul style="list-style-type: none"> Let the exchange rate adjust to absorb the commodity price shock. CBI should stand ready to hike rates to counter inflationary pressures from commodity prices. Iceland should seek to expand its energy and energy-intensive export capacity to dampen the effects of energy price shocks in the BOP. 	
7. Persistent dollar strength	<p style="text-align: center;">High</p> <ul style="list-style-type: none"> Further strengthening of dollar (combined with more modest appreciation against euro), boosting non-US trade and raising dollar debt costs. 	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> Could reduce trade balance with the euro area through imports and increase payments on largely USD-denominated external debt. However, a strong dollar is net positive for terms of trade. Low euro interest rates shove inflows to Iceland and cheapen external borrowing.
Policy Response	<ul style="list-style-type: none"> Step up FX purchases to dampen appreciation pressures if conditions allow, building up reserves ahead of liberalization. If needed, let exchange rate absorb the shock. Employ macroprudential policies to curb short-term inflows, if needed. 	

**Statement by the Staff Representative on Iceland
June 24, 2015**

This supplement provides information that has become available since the issuance of the staff report. The information does not alter the thrust of the staff appraisal in the Sixth PPM staff report.

Iceland announced its updated capital account liberalization strategy. Details are still emerging, but the updated strategy is broadly in line with staff expectations. The strategy takes a staged approach.

- The first stage targets a reduction in the balance of payments (BOP) overhang—nonresident net claims on domestic assets—of the old bank estates, consistent with maintaining stability. Preliminary proposals have been put forward by key creditors of each old bank estate to release their assets from capital controls in exchange for voluntary ‘stability contributions’ to the government which will be used to retire debt. The next step will be votes by a qualified majority of creditors of each estate on composition agreement—a legal step where creditors agree on the terms of satisfaction of their claims and assets’ distributions, including “stability contributions”. The key elements of the composition agreements are expected to be in line with the tentative understandings reached by creditors’ groups with the authorities and will require formal approval of the central bank to be followed by approval by government. To provide incentives to finalize composition agreements, the authorities are seeking parliamentary approval of a ‘stability tax’ targeting the estates’ BOP overhang that would be assessed as of end-2015 on any old bank estate that has not reached composition by that date. If successfully implemented, the strategy will help accelerate the pace of liberalization.
- The next two stages will address remaining offshore liquid króna (OLK) holders and then residents. An auction open to OLK holders is expected to take place later this year. The format for liberalization of residents will be elaborated at a later stage and will depend on conditions, though small amounts of resident outflows will be allowed for pension funds, outward FDI, and households.

Additional interim measures have been introduced in the context of the liberalization strategy. To prevent potential circumventions undermining progress in capital flow liberalization, the authorities have introduced certain measures including capital flow management measures, through amendments in the Foreign Exchange Act. The measures target principally the old bank estates and in particular they limit (i) cross-border intercompany borrowing-lending by the estates and (ii) FX purchases by the estates and other

residents for the repayment of cross-border intercompany loans. The authorities believe that the measures will not have a significant impact on intercompany lending between residents and nonresidents as foreign exchange purchases for such purposes are trivial given that most resident borrowers use their own FX to repay such loans. Staff is currently assessing the details and implications of these measures and whether such measures may give rise to an exchange restriction subject to the Fund's jurisdiction under Article VIII.

Wage negotiations are still ongoing, with possibilities of further strikes and disputes.

While wage agreements have been reached for just over one-half of the private sector workforce—and are in line with staff baseline projections—negotiations are ongoing for remaining private sector and most public sector workers. Parliament has approved legislation to temporarily ban strikes by university educated public servants, including nurses—partly to alleviate the situation in the healthcare sector—to be followed by binding arbitration if no wage agreement is reached by July 1. Workers in other sectors have announced their intention to go on strike. The government submitted bills to Parliament targeting housing affordability in connection with efforts to facilitate wage agreements.

The Monetary Policy Committee (MPC) raised its policy rate by 50 basis points to 5 percent at its June meeting and signaled further 'sizeable' rate hikes in response to mounting inflation pressures. The MPC noted that recently negotiated wage increases were larger than what the CBI assumed in its May forecast and raised its expectations for the path of inflation. Inflation expectations have continued to rise. The CBI will release its updated macroeconomic forecast on August 19, in conjunction with the next MPC meeting.

GDP grew 2.9 percent y-o-y in Q1, supported by strong domestic demand. Private consumption rose 3.9 percent. Investment surged 23.5 percent—boosted by purchases of airplanes and by regular business investment—but residential construction weakened. Net exports subtracted from growth as tourism-driven and aluminum exports were outpaced by imports of airplanes and other goods.

**Statement by Audun Groenn, Executive Director for Iceland and
Ragnheidur Jonsdottir, Advisor to the Executive Director
June 24, 2015**

The Icelandic authorities wish to thank the staff for constructive dialogue during the Post-Program staff visit in May. The authorities broadly agree with staff views and analysis. As staff points out, the economy is navigating two major challenges related to the liberalization of the capital account and excessive wage demands. Developments in both areas have been rapid in recent weeks; a settlement strategy for the old bank estates and a strategy solving the offshore króna asset problem has been announced, and a wage settlement covering a large part of the private sector has been negotiated. However, nurses and academics in the public sector have been on strike, and several other groups are preparing to strike later this summer. As no agreement was in sight with key public sector workers and the situation in the health sector was deemed critical, the Parliament passed a law on June 13 stipulating an immediate end to the strike and an establishment of a court of arbitration if the associations of nurses and academics have not negotiated a settlement before July 1.

Key policy issues

Following careful preparations, the authorities have designed and presented a final strategy for the failed banks' estates, which will neutralize the negative balance of payments effects that would otherwise stem from the unwinding of the estates. This is due to the fact that the estates hold significant amounts of domestic assets while the claimants are mostly non-residents. The estates are faced with two possibilities: either pay a stability tax amounting to 39 percent of assets early next year and then finalize payments to creditors, or propose a settlement plan based on stability conditions, which are designed to neutralize króna outflow and term out domestic deposits in foreign currency. The legislation laying the foundation for this strategy has been prepared and is expected to be approved by Parliament before summer recess. Legislation paving the way for composition agreements in the financial sector is also before Parliament.

New legislation aimed at closing potential loopholes in existing capital controls and thereby preventing circumvention during the next critical steps regarding the estates of the old banks has already been passed by the Parliament. Important stakeholders in the old bank estates have already presented proposals based on the stability criteria that are considered to be compatible with economic and financial stability. As a next step in the capital account liberalization process, the Central Bank will hold an auction aimed at addressing the non-resident short-term króna overhang. Stakeholders will be offered to exit through the auction or alternatively invest in Government securities for the long-term. Those choosing not to participate will remain in blocked accounts for an extended period. After this strategy is implemented, capital controls on domestic entities will be gradually relaxed. Some restrictions on foreign investments of pension funds may be

extended, which in turn will be allowed to invest moderate amounts in foreign assets before controls are lifted.

The large wage increases resulting from the collective bargaining process call for a tightening of monetary policy to attain the inflation target over the medium term and anchor inflation expectations. Measures to contain a potential deterioration in fiscal balances will also be needed. This should also help to maintain an appropriate current account balance. The Monetary Policy Committee (MPC) raised its key policy rate by 0.5 percent on June 10 and has signaled further rate increases at future meetings. On the fiscal side, measures to ensure that the fiscal balance and primary surplus are maintained will be included in the 2016 budget proposal. Despite the planned response, my authorities are concerned that some disruptive effects of wage increases well in excess of the sum of productivity growth and the inflation target will push inflation up temporarily, cause additional fiscal outlays, and lead to a deterioration in the general competitiveness of the economy, as staff warns.

State of the economy

Economic growth was robust in the first quarter, fueled by domestic demand. The tourism sector continues to grow, and large-scale investments in hotels are underway or in the planning stages. The fishing industry has enjoyed strong demand for its products, and profitability is high in both fishing and fish processing. However, it should be kept in mind that the fishing industry is based on a natural resource that is highly variable, although the demand side has been stabilized by specific products and end-user preference adaptation. The energy-intensive industry output is robust, and a few moderate size projects are reaching implementation stage. Economic policies are geared towards higher productivity, diversification, and sustainability. Legislation on fishing quotas and the resource levy is being adjusted. The aim is to build on the success of the present system in order to conserve and utilize fishing resources.

GDP is projected to grow by around four percent in 2015 and, cautiously estimated, between two and three percent thereafter. A trade balance of around five percent of GDP annually over the next three years will ensure a current account surplus, but stronger household finances and income due to wage increases may be quickly reflected in stronger import growth. Although the effects from the financial crisis still linger, Iceland scores high on various welfare indices such as life expectancy, happiness, income equality, and gender equality.

Staff's analysis of debt sustainability shows that debt is on a definitive downward path. The settlement of the failed banks' estates will generate, as a side-effect, substantial one-off Treasury revenues. The legislation before Parliament stipulates that it can only be utilized in a manner that is consistent with economic stability. In practice, that means retiring central government debt, and thus reducing the government interest payment

burden. However, debt levels will be higher than before the crash in 2008, and the authorities will continue to pay down debt to create fiscal space and obtain improved credit ratings, which in turn will help reduce financing costs for the public and private sector alike.

Going forward

Significant steps have been taken or are being taken to open the capital account and reduce the overhang from the 2008 banking crisis. At the same time, prospects for solid economic growth are favorable. The shorter term inflation outlook is less favorable, due to the effects of recent wage settlements. Over the medium term there are tools available to restore stability, and these tools will be used as needed. Much hinges on positive economic developments in trading partner countries, which could enhance growth in tourism, sustain fish prices, and deliver stable oil prices. Plans to increase aid and support for developing countries were abandoned after the crisis. Now, however, the Icelandic authorities are in a position to strengthen cooperation with developing countries, with particular focus on areas of special competence such as geothermal energy utilization and the commercial fishing industry.

Later this year, after the next payment to the Fund, outstanding debt will fall below the 200 percent threshold requiring Post-Program Monitoring. The authorities wish to emphasize that cooperation with the Fund has been very useful and that the Fund-supported program, which was completed in 2011, was successful.