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Iceland—Concluding Statement of an IMF mission for the Second Post-Program Monitoring Discussions[1]

Reykjavik, September 28, 2012

A post-crisis rebound, underpinned by solid policy implementation is now in its second year. The outlook is upbeat but there are downside risks, including a potential intensification of the euro area crisis and the lifting of capital controls before conditions are right. Policy implementation needs to remain strong in order to promote external viability and sustainable growth. The near-term challenges are to implement orderly capital account liberalization and bring the multiyear fiscal adjustment to conclusion.

1. **Growth has recovered and the outlook is good.** Following a deep and protracted recession, the economy grew by 2.6 percent in 2011—a performance that looks set to be broadly repeated in 2012 and sustained over the medium term. The output gap is closing, unemployment has decreased, and inflation, though still high, is expected to converge toward the Central Bank's target of 2½ percent in the medium term if monetary tightening resumes. Public and external debt ratios are on a downward path and financial sector conditions are improving.

2. **Risks to the outlook are tilted to the downside.** Lifting capital controls before the necessary conditions are in place would destabilize the krona, fueling inflation and increasing private sector debt, with spillovers to the banking sector. An intensification of the euro area crisis could harm exports, growth, and market access. A setback in fiscal consolidation could undermine confidence and impede access to financial markets. Finally, growth could be reduced by delays in investments in the energy-related sector or by an inflation-induced wage-price spiral.

3. **Current conditions call for policies that promote external viability and growth and thereby support lifting capital controls.** Well sequenced and cautiously paced capital account liberalization is needed to remove distortions without disrupting the external position in the near term. Continued fiscal consolidation, in line with the authorities' medium-term plan, would keep public debt on a sustainable path and support continued market access, which is critical to the lifting of the capital controls. Further monetary policy tightening would help bring down inflation and normalize monetary conditions in advance of lifting capital controls. Ensuring that banks maintain adequate liquidity and capital buffers would help safeguard financial stability as capital controls are lifted.

[1] Post-Program Monitoring discussions were held in Reykjavik during September 18-28 by an International Monetary Fund (IMF) staff team led by Daria Zakharova.

Orderly lifting of capital controls

4. **The strategy for lifting capital controls should continue to be conditions-based.** In addition to a significant reduction (or elimination) of the "overhang" of liquid offshore krona, the preconditions for liberalization include sound public finances, a strong balance of payments—including access to international financial markets—and healthy capital and liquidity buffers in the banks. While capital controls are being lifted, the monetary stance will need to be sufficiently tight to support a stable krona. It will also be essential to maintain strong prudential rules and supervision as well as strict enforcement of controls. These conditions, some of which are in place, are needed to allow liberalization to proceed without destabilizing the krona or the balance of payments.

5. **Progress in reducing the stock of liquid offshore krona has been slow.** Modest amounts have been released through the channels opened up by the authorities' liberalization strategy. But the stock remains at 23 percent of GDP and could rise significantly as the estates of the "old banks" are wound up. Liberalization in the presence of such a sizable overhang would disrupt the exchange rate and destabilize the financial system.

6. **To accelerate progress it is necessary to strengthen the incentives for holders of liquid offshore krona to participate in the liberalization strategy.** A key step will be to curtail expectations that capital controls will be lifted soon, including by removing a reference in legislation to a terminal date for the controls. In addition, the strategy should clarify that the conditions under which liquid offshore kronas are allowed to exit will become less favorable over time.

7. **Once incentives are in place, the authorities could open the next channels envisaged in their strategy—bond swaps and an exit tax**. The objective of the bond swaps would be to reduce the stock of offshore krona before introducing an exit tax and ultimately lifting the controls. Swapping short-term krona-denominated assets into long-term euro-denominated bonds would distribute the pressure on the balance of payments over several years. The bond swaps and exit tax should be designed with a view to managing their impact on the exchange rate, sovereign debt management, and bank liquidity. Foreign exchange controls should be strengthened as necessary to prevent use of these new channels for circumvention.

Completing fiscal adjustment

8. **The fiscal consolidation is broadly on track, but implementation risks are high.** The authorities are maintaining their targets of a balanced overall position in 2014 and a primary surplus of 5 percent of GDP in 2016. While the proposed 2012 supplementary budget has an overall deficit about ½ percentage point of GDP higher than under the medium-term plan, the draft 2013 budget offsets part of the past slippages, making the 2014 target within reach. However, expenditure pressures remain high in the run-up to the elections, and key proposed revenue measures face political headwinds.

9. **Additional measures are needed to address risks and reach the medium-term targets.** Reaching the targets will safeguard debt sustainability and support continued

market access—both of which are critical to the successful lifting of the capital controls—while also providing room for automatic stabilizers to operate should external conditions deteriorate. For the 2013 budget, additional measures amounting to about 0.2 percent of GDP would put the overall balance firmly on track for a balanced position in 2014. Any additional revenues should be used to address potential weaknesses in the budget rather than to finance additional expenditures. Adequate contingency plans should also be prepared to mitigate implementation risks.

10. **The government's plans to strengthen the fiscal framework are welcome.** The draft organic budget law will improve budget procedures, broaden the coverage of fiscal reporting, and increase government accountability to parliament. Early passage of the law would ensure that important provisions come into effect with the post-election government.

Tightening monetary policy

11. **Further monetary tightening is needed to bring inflation down to the CBI's target.** The central bank accelerated the pace of its monetary tightening early in 2012 but has since paused. The mission's assessment is that the recent decline in inflation has been driven by seasonal factors and that, with the output gap closing, the policy stance is still accommodative. Continued tightening is needed to reach the central bank's inflation target and normalize monetary conditions in advance of capital account liberalization.

Reducing vulnerabilities in the financial sector

12. **Banks' balance sheets have strengthened but risks still need to be addressed.** The three largest banks are profitable and well-capitalized but nonperforming loan ratios are still high, though well below their post-crisis peak. Although progress has been made, legacy risks remain, including a reliance on deposits locked in by capital controls, asset-liability mismatches, and loan and deposit concentration. There is also still uncertainty in the face of Supreme Court rulings on foreign exchange-indexed loans. To help manage these risks it will be important to maintain large equity buffers determined through periodic supervisory reviews. An early assessment of the Housing Financing Fund's capital adequacy should be undertaken through the ICAAP process. Maintaining a strong, independent, and adequately resourced Financial Supervisory Authority (FME) is essential for effective financial sector oversight.

We are grateful to the authorities and other counterparts for open and constructive discussions.