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March 2015

2014 ARTICLE IV CONSULTATION AND FIFTH POST-PROGRAM MONITORING DISCUSSIONS—STAFF REPORT; PRESS RELEASE; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ICELAND

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2014 Article IV Consultation and Fifth Post-Program Monitoring, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 9, 2015, following discussions that ended on December 18, 2014, 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 February 20, 2015
- An **Informational Annex** prepared by the IMF.
- A **Press Release** including a statement by the Chair of the Executive Board, and summarizing the views of the Executive Board as expressed during its March 9, 2015 consideration of the staff report on issues related to the Article IV Consultation and the IMF arrangement.

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

Selected Issues Paper

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

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ICELAND

February 20, 2015

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND FIFTH POST-PROGRAM MONITORING DISCUSSIONS

KEY ISSUES

Iceland has reached a relatively strong macroeconomic position with good growth prospects. But crisis legacies are still being unwound, including high debt and a large balance of payments (BOP) overhang contained by capital controls. Amidst public pressure for a return to normalcy, policies remain geared towards addressing vulnerabilities, rebuilding buffers, and further strengthening key institutions.

The monetary policy stance has struck an appropriate balance, but is at a difficult juncture. The Central Bank of Iceland (CBI) will need to carefully balance deflationary pressures evident in goods prices against a closing output gap and potentially large wage increases in the upcoming bargaining round. The CBI should continue FX accumulation as conditions permit to smooth eventual BOP outflows. The CBI legislative framework review needs to support independence, accountability, and policy credibility.

With Iceland on-track to achieve core public finance objectives, fiscal policy is well positioned for a transition from consolidation to supporting higher potential growth. The budget is in surplus and public debt is on a downward sustainable path. The government is appropriately aiming to institutionalize its objectives with a proposed budget framework law. With crisis-legacy issues gradually subsiding, the medium-term fiscal policy mix should aim for higher growth, while considering distributional and external sector impacts.

Banking sector buffers have been rebuilt but gaps remain in bank supervision and financial safety nets. Faster progress is needed to strengthen deposit insurance, bank resolution, and emergency liquidity assistance frameworks. A permanent solution is needed for the loss-making government-owned Housing Financing Fund (HFF).

Progress in these areas will provide supportive conditions for successful capital account liberalization and external financial reintegration. The authorities expect significant progress in the coming months in finalizing and implementing an updated liberalization strategy. The updated strategy should aim to preserve stability and be backed by supportive macroeconomic and financial sector policies.

Approved By
Jörg Decressin and Vikram Haksar

Mr. Dohlman (Head), Mr. Antoshin, and Ms. Bordon (all EUR), Mr. McHugh (FAD), Ms. Fayad (SPR), Ms. Croitoru Nedelescu (MCM), and Ms. Stetsenko (LEG) visited Reykjavik during December 8–18. The mission met with senior government and central bank officials, members of parliament, representatives from trade unions and the business community, and academics. Ms. Boranova and Ms. Ilagan (EUR) assisted the mission. Mr. Groenn and Ms. Jonsdottir (OED) participated in selected discussions.

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BACKGROUND

A. Context

1. Overall macroeconomic conditions in Iceland are at their best since 2008, but remaining crisis legacies weigh on prospects. Iceland has used the breathing room under six years of capital controls to make significant inroads in reducing macroeconomic and financial sector vulnerabilities. Fiscal and external balances are now in surplus and economic activity will surpass its pre-crisis peak in 2015. But a number of core macroeconomic indicators remain weak relative to Iceland's own past, to peer countries, and to common vulnerability metrics (Box 1).

2. Amidst improving conditions, there is growing public pressure for a return to normalcy. The public is increasingly vocal about the costs of capital controls, citing burdensome regulations, transparency concerns, elevated risk premia, and inability to tap competitive benefits from outward FDI. Amid low unemployment, wage pressures are building. But communication among social partners has been difficult heading into the H1 2015 collective wage bargaining round over recent cuts to some social benefits and a growing sense of inequity following significant wage hikes to settle several public (health, education) and private (aviation) sector strikes.

3. In response, the authorities are pursuing a broad policy agenda. The fiscal policy focus is shifting from consolidation to medium-term (budget-neutral) adjustments in the policy mix to facilitate potential growth and address distributional issues. Financial sector policies are focused on maintaining buffers ahead of capital account liberalization while addressing gaps in financial supervision and the safety net. Institutional and structural reforms are underway, including modifications to core fiscal and central bank legislation and efforts to enhance productivity. But some reforms remain bogged down, such as the government's expensive housing financing policy. Against this backdrop, the government is overhauling its capital account liberalization strategy, and expects significant progress in the coming months.

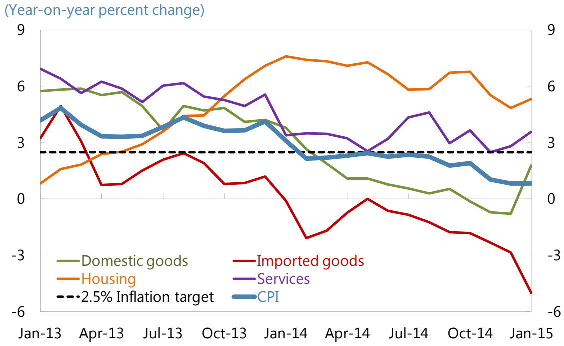
B. Recent Developments

4. Growth slowed in 2014 as a spike in imports weighed against robust domestic demand (Figure 1). Real GDP growth slowed in the first three quarters, due to temporary net trade factors, but is estimated at 1.8 percent for the full year (down from 3½ percent in 2013). Domestic demand growth was supported by strong private consumption and investment, while the boom in tourism propelled services exports and helped revive construction. Weighing against this was a largely temporary spike in imports (airplanes and ships, and services), which subtracted 1.5 percentage points from headline growth. The unemployment rate has fallen to 4.1 percent and real wages accelerated to 5.8 percent by the end of last year.

5. Inflation has fallen rapidly, pulled down by imported deflation and a stronger exchange rate (Figure 2). CPI inflation dropped from 4.2 percent in 2013 to 0.8 percent y-o-y in January 2015, remaining below the CBI's 2.5 percent target for a year. Longer term inflation expectations have adjusted more slowly. Key driving factors have been disinflation in key trading partners, particularly the euro area, a slump in oil prices, and an appreciating currency in the context of high exchange rate pass-through. Domestic goods inflation has also fallen, despite higher wages and a closing output gap. Housing prices and services have been holding up inflation. Despite rapid growth in house prices, staff analysis indicates no clear signs of asset bubbles (see Selected Issues Paper on asset bubbles).

Consumer Price Inflation Components

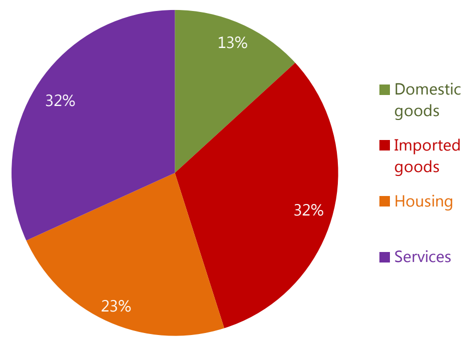
(Year-on-year percent change)



Source: Statistics Iceland; and Haver Analytics.

CPI Weights by Category

(Percent of total)

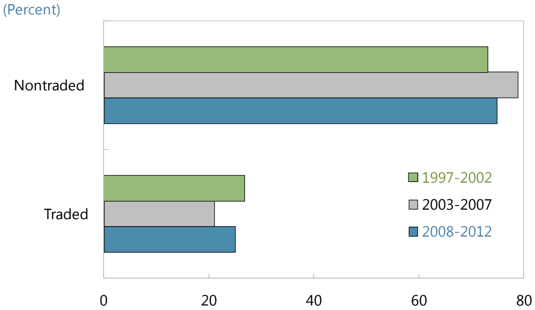


Sources: Statistics Iceland; and Haver Analytics.

6. Favorable BOP conditions have supported reserve accumulation (Figure 5). The 2014 current account surplus reached an estimated 4.7 percent of GDP, underpinned by evidence of rebalancing (including growing tourism) and improving terms of trade, but dampened somewhat by one-off imports.[1] During 2014, the CBI made net purchases of about $0.9 billion (about 5½ percent of GDP) in the context of regular preannounced and ad hoc purchases of FX, pushing gross reserves to $4.2 billion (25 percent of GDP). Despite these purchases, the real exchange rate appreciated by 6.7 percent. The CBI prepaid $0.4 billion of IMF obligations due through early October 2015, as part of its debt management strategy, leaving IMF credit at just over 200 percent of quota. External debt remains on a downward sustainable trajectory (Annex III, External DSA). In January, Fitch changed its outlook on Iceland's sovereign credit rating to positive, citing progress in capital account liberalization and public finances.

Sector Share of Gross Value Added 1/

(Percent)

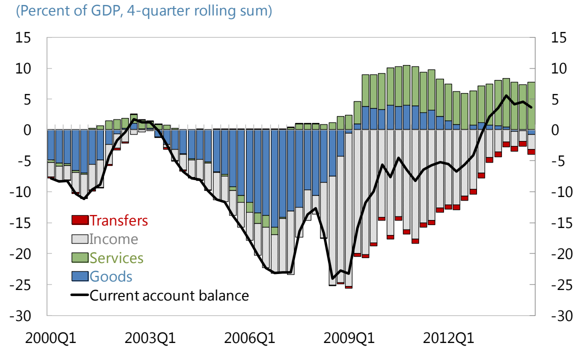


Source: Statistics Iceland.

1/ Preliminary data for 2012. Traded sector consists of agriculture, forestry and fishing; manufacturing and mining; and other professional and scientific activities.

Current Account Balance

(Percent of GDP, 4-quarter rolling sum)

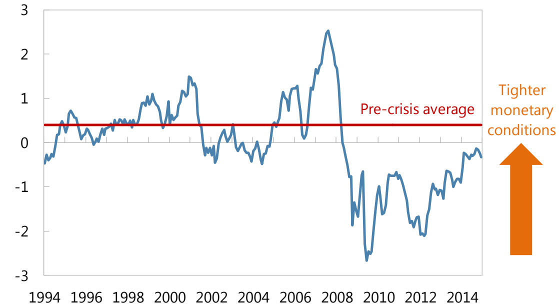


Sources: Central Bank of Iceland; and Haver Analytics.

[1] Throughout the report the headline current account is used for historical data and the underlying current account for estimates and projections. The underlying current account 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, but is not used in the historical period due to data limitations.

7. The CBI eased monetary policy at end-2014 (Figure 3). After two years on hold, the CBI cut its seven-day collateralized lending rate at two successive MPC meetings in November–December 2014 by a combined 75 basis points to 5.25 percent. The nominal easing came in response to a rapid real tightening of monetary conditions driven by falling inflation and exchange rate appreciation. Deeper cuts were ruled out over increasing concerns about wage pressures. Despite this, the real rate has risen slightly since end-October.

Monetary Conditions Index (Standardized) 1/

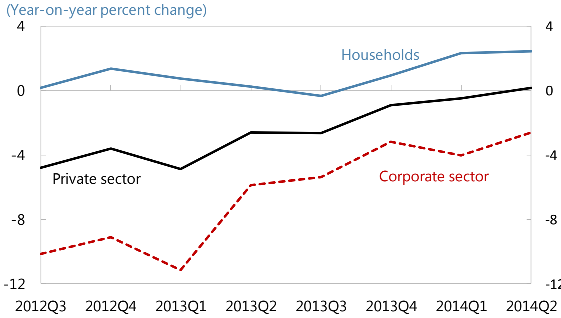


Sources: Central Bank of Iceland; Haver Analytics; and IMF staff calculations.
1/ The MCI is the weighted sum of the standardized real short-term interest rate and real effective exchange rate, with the respective weights of 0.75 and 0.25.

8. The general government recorded its first budget surplus in seven years, helped by one-off revenues (Figure 4). The preliminary 2014 fiscal outturn shows a 1.8 percent of GDP surplus, versus a 1.7 percent of GDP deficit in 2013. The fiscal stance, measured by the change in the structural primary balance, tightened only 0.2 percent of potential GDP, reflecting the importance of one-off dividend revenues. Household debt relief became operational, and more frontloaded to 2014, though the overall fiscal costs are broadly in line with earlier projections. General government gross debt remains high at 82 percent of GDP, but on a downward, sustainable trajectory (Annex III, Public DSA).

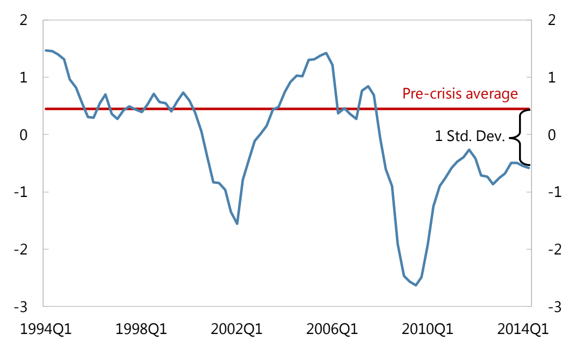
9. The financial sector paints a mixed picture (Figures 6–8). Iceland's three largest commercial banks are well capitalized (Tier 1 ratio of 25 percent) and have strong liquidity buffers, reflecting a tightening of macro-prudential rules, including stricter liquidity coverage ratios (LCRs). Nonperforming loans (NPLs) as a percent of total loans are down to 10 percent, using a more prudent cross-default definition. But bank lending has been weak outside a few sectors and profitability driven largely by irregular items. A financial conditions index (FCI) for Iceland reflects this mixed recovery (see Selected Issues Paper on FCI). Banks' CPI indexation imbalances are rising and legal challenges to CPI loan indexation are still unresolved. Following a Basel Core Principles assessment in March 2014, the financial supervisor (FME) is strengthening supervision. Cross-agency cooperation on financial stability has improved and important regulations are in the pipeline. However, reform of the troubled government mortgage institution HFF remains stalled.

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 2014Q2.

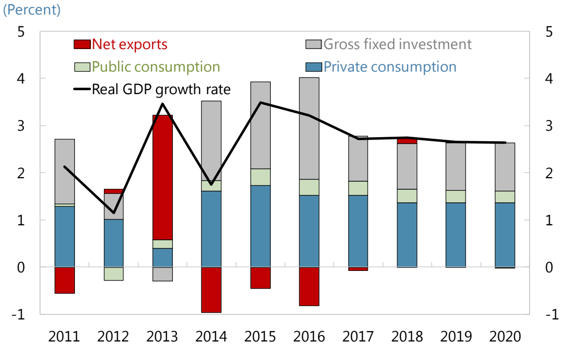
C. Outlook and Risks

10. The outlook for growth is positive. The economy will grow at around 3 percent during 2015–17 under baseline assumptions of large energy-intensive investment projects, robust growth in private consumption boosted by household debt relief, and further expansion of the tourism sector. Terms of trade, consumption, and growth in 2015 will benefit from a sharp decline in oil prices. Investment will be funded by FDI, retained earnings, and, increasingly over time, borrowing. Inflation is expected to stay below 1 percent this year and rise gradually to target by the end of 2016, as the effects from imported deflation and currency appreciation dissipate and pressures from wages and a closing output gap mount.

- *The authorities have broadly similar views on the medium-term growth outlook, though project higher growth of over 4 percent this year, showing higher domestic demand.* There is agreement that medium-term growth will be mainly driven by robust domestic demand and tourism.

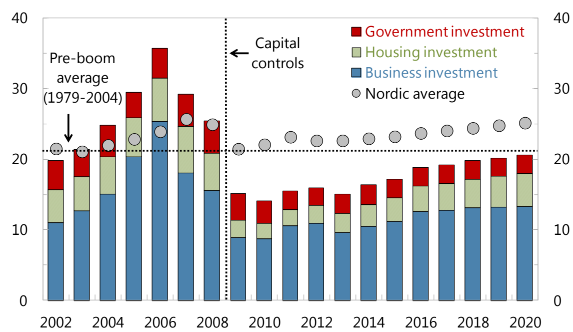
- *The CBI expects inflation to be below 1 percent this year and to move closer to the target in 2016 as well, citing external developments (disinflation in Europe, lower oil prices, and the exchange rate), but highlighted wage discussions as a key risk to stability*. The authorities have adjusted down their estimate of potential output and now believe that slack in the economy has largely disappeared. They emphasized, however, difficulties in assessing the gap given fluid cross-border labor movements and other factors. They also noted uncertainty about how firmly long-term inflation expectations are anchored.

Contributions to Growth
(Percent)



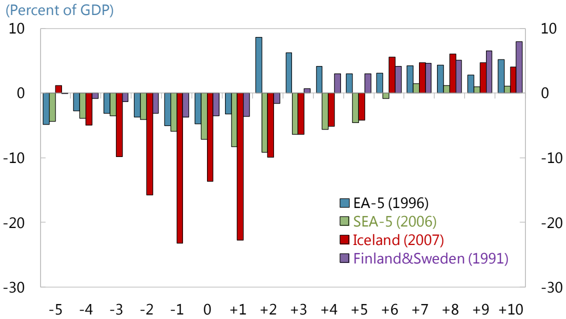
Sources: Statistics Iceland; and IMF staff projections.

Investment
(Percent of GDP)



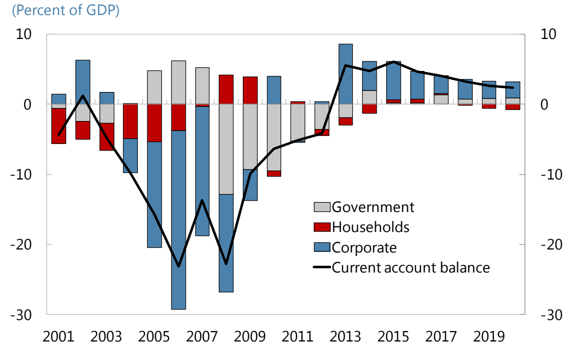
Sources: Statistics Iceland; and IMF staff projections.

Current Account Balance 1/
(Percent of GDP)



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.

Sectoral Saving-Investment Balance
(Percent of GDP)



Sources: Statistics Iceland; UN National Accounts; and IMF staff calculations.

11. The external sector outlook is generally positive. The current account surplus is projected to rise in 2015 boosted by higher terms of trade, including lower oil prices, and then—consistent with the experience of other post-crisis cases—fall gradually over the medium-term (see Selected Issues Paper on Savings, Investment and Rebalancing). For Iceland, further medium-term increases in terms of trade and higher exports—including tourism—will be outpaced by rising import demand tied to export-oriented investment. The net income deficit is expected to deteriorate somewhat given a negative net international investment position (NIIP) and rising global interest rates. Staff baseline BOP projections provide space for release of some of the BOP overhang (16 percent of GDP over 2015–20) while maintaining minimum adequate reserves, set at the upper band (150 percent) of the reserve adequacy metric. However, the specific elements and pace of liberalization and accompanying overhang release will need to be reset in the context of an updated liberalization strategy now under development, and taking factors discussed below into consideration.

- *The authorities' current account projections are more pessimistic, with larger net income deficits* (due to methodological differences in accounting for the old bank estates) but slightly higher trade surpluses. They view 2014 reserve levels as adequate.

12. Risks are tilted to the downside (Annex I). Liberalization of the capital account under a revised strategy could pick up pace, boosting confidence and private investment and raising long-term growth—but missteps could lead to a disorderly unwinding or even prolonged controls. Wage demands in the upcoming round of collective bargaining could lead to further strikes, and resulting wage hikes could increase inflation and weaken competitiveness. Government contingent liabilities, notably relating to HFF, could be partially realized, leading to higher debt and interest costs. Other domestic risks include legal challenges of financial sector taxation and CPI indexation. On the external side, risks of lower growth in trading partners, especially Europe, could dampen exports and—together with falling commodity prices—foreign direct investment. A sharp increase in global risk premia could worsen Iceland's access to external financing and raise the costs of large external repayments in 2016.

- *The authorities broadly agreed*. However, while recognizing downside risks associated with capital account liberalization, they also noted risks from being too cautious and missing a window of relative stability in the economy. They expressed deep concerns about the upcoming collective wage bargaining round and implications for stability. The authorities agreed that legal risks to financial sector taxation are non-negligible, though noted that recent court rulings have reduced legal risks to CPI indexation. They noted external risk factors—slowing global demand and falling commodity prices—to investment, in particular the construction of silicon plants. The authorities also cited upside risks from possible new investment projects such as the proposed power interconnector with Scotland.

POLICY DISCUSSIONS: RETURNING TO NORMALCY

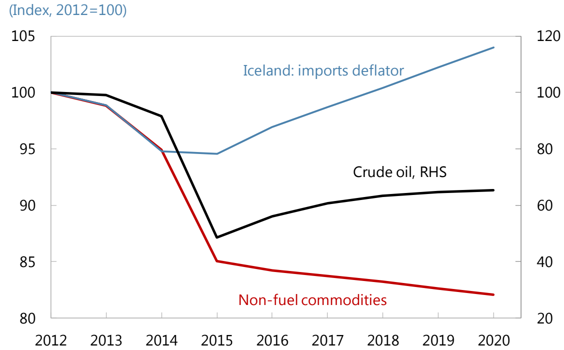
13. Discussions centered on sound macroeconomic and financial sector policies to reduce vulnerabilities and strengthen growth and external prospects and linkages. Monetary policy should remain focused on price stability and building FX reserve buffers. Fiscal policy should pursue balanced budget and debt reduction objectives (and seek their codification in a new budget framework law) while revisiting the mix of policies to support higher potential growth, external prospects, and distributional objectives. Financial sector policies should encourage maintaining bank buffers while addressing gaps in financial supervision and the safety net. Institutional and structural reforms, including to core fiscal and central bank legislation and to enhance productivity are also important. Such policies will help create supportive conditions for successful capital account liberalization.

A. Monetary and Exchange Rate Policy: A Difficult Juncture

Background

14. Monetary policy is facing opposing challenges from external and domestic developments. On one hand, the CBI has signaled it is considering further policy rate cuts given inflation well below the 2.5 percent target, falling inflation expectations, and the possibility of prolonged imported deflation. On the other hand, faced with already rapid wage growth and disappearing economic slack, the CBI has also signaled that if the upcoming collective wage bargaining round results in real wage growth in excess of labor productivity gains, this could prompt a rate hike.

Imports Deflator and Global Prices
(Index, 2012=100)



Sources: Statistics Iceland; IMF staff calculations and projections.

15. Uncertainties about CBI independence have eased. Recent changes to CBI capitalization preserve financial independence. An independent panel of experts reviewing CBI legislation will deliver recommendations to the authorities in 1H 2015. The government intends to preserve key 2009 reforms, including the MPC and selection procedures for top officials, and will consider outstanding items from the 2009 Safeguards Assessment. It is also reviewing coordination between the CBI and the financial supervisor.

16. Staff's exchange rate assessment is giving mixed results, amid uncertainty about the equilibrium exchange rate (Text box). However, these exercises do not fully capture the impact of the BOP overhang on uncertainty (and savings and investment), vulnerabilities from a large negative NIIP, and factors such as the tourism boom. Furthermore, the sizeable real depreciation following the 2008 crisis appears to have shifted the equilibrium real exchange rate to a new (lower) normal, as fundamentals also shifted to post-crisis norms (Figure 5). Taking into account these findings and uncertainties, staff views the exchange rate as slightly overvalued.

Iceland: Exchange Rate Assessment

Regression-based models for exchange rate assessment give mixed results as to whether the current real exchange rate is consistent with macroeconomic fundamentals. While the macroeconomic balance (MB) methodology suggests an undervaluation of 23 percent, the real effective exchange rate (REER) methodology suggests a slight overvaluation of about 5 percent. However, the former methodology seems to provide a relatively poor fit for Iceland given large unexplained residual.

Exchange Rate Assessment Results

	2013 CAB (in % of GDP)	CAB Gap	Unexplained residual	REER gap ('+' = overvaluation)
MB approach	5.5%	8.3%	8.7%	-23.2%
REER approach	5.5%	-	-0.4%	4.6%

Source: IMF staff calculations.

While Iceland's external sector has shown signs of improvement post-2008 crisis, staff is of the view that the exchange rate is slightly overvalued. The large post-crisis depreciation and reduced cost of production have increased Iceland's export competitiveness. However, with the króna appreciating (albeit still remaining below pre-crisis levels), productivity levels and export shares on a declining trend, and the need to improve the NIIP, staff is of the view that the exchange rate is slightly overvalued (see Selected Issues Paper on External Sector Assessment).

Policy Discussions

17. Staff supported the CBI's monetary policy stance and efforts to continue FX purchases to build reserve buffers, as conditions allow, ahead of capital account liberalization.

- Staff agreed the monetary policy stance is in line with the central bank's inflation objective. The recent interest rate reductions were appropriate given a real tightening amidst falling inflation and inflation expectations, and somewhat weaker growth. Staff noted that WEO forecasts for commodity prices have been revised down and that inflation is projected to stay very low for some time in the euro area, which could push inflation in Iceland even lower this year. Staff supported the CBI view that future rate actions should carefully weigh deflationary pressures from the external environment along with still-uncertain wage prospects and a closing output gap.

- Staff supported the CBI's FX purchase program to build up reserve buffers, as conditions permit, ahead of capital account liberalization. Staff agreed that the CBI's FX intervention strategy had also contributed to a significant reduction in exchange rate volatility.

- *The authorities'* exchange rate assessment was consistent with staff's REER approach, pointing towards a slight overvaluation. They view the equilibrium exchange rate as likely shifting to a post-liberalization new normal.

- The mission welcomed the authorities' efforts to review CBI legislation. Staff stressed the importance of stability in the CBI, including protecting the existing terms of current top management. Such stability would underscore commitment to independence, while any shortcomings identified in the review regarding accountability should be addressed. Done properly, this would reinforce policy credibility, which in turn would promote economic stability and growth and ease the path for capital account liberalization. The authorities broadly agreed, but affirmed they are considering changes to the senior management structure of the CBI.

B. Fiscal Policy: Supporting Higher Potential Growth

Background

18. For Iceland, 2014–15 marks an important watershed for fiscal policy (Box 2). For the first time since the crisis, Iceland has recorded a general government budget surplus. The debt ratio, while high, is on a downward sustainable trajectory. The draft budget framework bill (Organic Budget Law, "OBL") now before Parliament would establish strong institutional underpinnings for Iceland's fiscal objectives, including a balanced budget and debt ceiling, and greater accountability and transparency. The authorities have initiated preparations for implementation of the new framework.

19. The 2015 budget is consistent with fiscal objectives, but with some weaknesses. The budget targets a general government surplus of 0.1 percent of GDP and has a broadly neutral fiscal stance (removing the effect of one-off revenues in 2014). The budget also initiates important reform of the VAT system. However, the budget maintains public investment below both pre-crisis historical and cross country average levels and relies on restraint in wages and other current spending that could come under pressure in the upcoming collective wage bargaining round. To support debt reduction, the authorities intend to sell a 30 percent stake in Landsbankinn.

20. The authorities are weighing compositional changes in the budget over the medium-term to support higher potential growth and address inequality. They are considering budget neutral tax simplification (PIT, CIT, labor taxes) and higher investment, combined with as-yet unidentified offsetting measures, while also addressing public concerns about the impact on income distribution and public services. The Finance Ministry is organizing a workshop with FAD in Iceland on this topic this spring. There is strong commitment to preserving the Nordic welfare model while exploring a gradual reduction in the size of government, and to seek a better understanding of the drivers of recent increases in social benefits.

Policy Discussions

21. Staff expressed broad support for the government's medium-term fiscal objectives, while urging greater specificity.

- Staff recommended identifying additional fiscal contingency measures to address risks in implementation of the 2015 budget, including legal challenges to financial sector taxation, HFF fiscal contingencies, and reliance on wage compression. *The authorities* noted that the 2015 budget includes a contingency cushion of around ISK6 billion, but agreed that these funds may prove insufficient if downside risks are realized. Depending on circumstances, measures could include debt issuance or, as discussed during Fourth PPM consultations, modifying the extent of household debt relief.

- The mission urged approval of the OBL and welcomed steps underway to facilitate the challenging task of implementing it. Implementation of this new framework will reinforce stability and confidence among international investors as Iceland undertakes important changes in its capital account liberalization strategy. *The authorities* indicated that the OBL has broad support and that preparations underway will help mitigate implementation risks.

- Staff encouraged the authorities to specify policies to underpin their intention to slow the growth in wages and goods and services expenditures over the medium-term, and to use future one-off revenues for debt reduction until debt objectives are met. *The authorities* agreed, noting that this will be part of the new budget framework process. There was agreement that continued fiscal discipline over the medium-term, coupled with strong growth, will help rebuild buffers, boost confidence, and lower interest rates.

- Staff supported medium-term plans to adjust budget composition in support of higher potential growth and external balances, while carefully assessing distributional consequences (and guarding against unintended fiscal slippages through maintaining adequate contingency funds). The mission presented analytical work assessing compositional changes in fiscal policy (see Selected Issues Paper on fiscal policy and Box 2), highlighting benefits from more investment and improving the efficiency of the tax system, including a shift from direct to indirect taxation, and encouraging saving. Staff noted that such polices could also lend support to Iceland's external position. *The authorities* were in broad agreement. Regarding investment, they identified roads and the public health system as two priority areas. The authorities recently approved (drawing on a cost-benefit study produced by consultants) construction of a new national hospital (4 percent of GDP over 5 years), and noted the pick-up in expenditure on this project in 2016 as a pressing fiscal challenge. They noted that the VAT reforms were an important though difficult step forward, and any further changes to the VAT regime in this election cycle would be limited to efficiency gains.

C. Financial Sector: Reinforcing Resilience

Background

22. Good progress has been made in improving the financial stability framework. The CBI has extended macro prudential measures to include foreign currency liquidity regulations and adopted an FX Net Stable Funding Ratio based on Basel III. Improvements in the FME's risk assessment system are underway and funding of supervisory activities is for now secured. Legislative amendments have been enacted to enhance supervision of related parties and Basel III capital buffers will be introduced in 2015. The Old Landsbanki (LBI) bond agreement (Annex III, ¶2) has improved Landsbankinn's funding profile, thereby enhancing conditions for the removal of capital controls. The authorities are also assessing the financial sector implications of capital account liberalization options under consideration. Nonetheless, there are significant potential liquidity implications posed by the capital account liberalization process. For example, old bank estates' deposits in commercial banks account for 14 percent of total deposits, with additional deposits held by trapped nonresidents.

Policy Discussions

23. Staff called for further steps to reinforce the resilience of the financial sector in advance of capital account liberalization:

- Staff and *the authorities* agreed that the banks' high capital and liquidity buffers should be consistent with managing risks surrounding the unwinding of capital controls and legal risks—including challenges to CPI indexation. Staff emphasized that liquidity needs and available buffers should be carefully reassessed in parallel with efforts to update the liberalization strategy. There was agreement that dividend distribution should be prudent and more long-term funding should be sought.

- Staff recommended further steps to enhance the financial stability framework. The mission recommended establishing a framework to deal with time-varying systemic risks (i.e. differentiated ceilings on loan-to-value and/or debt-service-to-income ratios). To inform the design and the calibration of such instruments, enriched data collection (i.e. per types of loans, properties, borrowers, etc.) is warranted. Staff also recommended further improvements in macro-financial and supervisory stress tests. *The authorities* were receptive to these recommendations and underlined that work is pending in both areas.

- Staff supported the authorities' plans to bring financial safety nets, including the deposit insurance and bank resolution frameworks, in line with international standards. The authorities should ensure that the deposit insurance system is operationally prepared to carry out its function. Staff called for an explicit limited deposit guarantee, noting that key market players did not have a clear understanding of deposit insurance limits—specifically whether the statutory limit of around EUR 21,000 applies or whether the government blanket guarantee stated during the peak of the crisis still applied. Good public communication and enhanced depositor analyses should accompany and inform the reforms. Another priority reform is to ensure that the resolution framework is comprehensive, and that there are clear policies and operational guidance for inter-agency crisis preparedness and management. Finally, a clear and transparent emergency liquidity assistance framework needs to be established with criteria for eligibility, collateral, and conditionality. Staff emphasized the importance of implementing key reforms in these areas ahead of full liberalization of the capital account. The authorities shared staff views on the importance of these reforms and underscored that they plan to submit draft legislation to the Parliament. Staff supported the authorities' intention to raise the statutory limit for banking sector deposit insurance to EUR 100,000, which would put Iceland on equal footing with peers in Europe.

- Staff and the authorities agreed on the need to firmly pursue supervisory reforms. The mission supported FME efforts to further build the operational infrastructure and knowledge and to achieve a truly risk-based and intrusive approach. Staff emphasized the importance of implementing key reforms in these areas ahead of full liberalization of the capital account. Fund technical support is being provided in these areas.

- Staff stressed that HFF should be put into an orderly runoff without delay to minimize fiscal costs and financial stability risks. To minimize fiscal risks, HFF's mandate during runoff should be confined to conducting an orderly dismantling. Staff supported government efforts to refine and better target the social mortgage lending objective and to carefully delineate state involvement in line with this objective. *The authorities* broadly agreed on the need to wind down HFF, though *The Ministry of Welfare* stressed that more work is necessary (and is currently underway in the Ministry) on mechanisms for a successor state program targeting lower income and remote area groups before a final decision on HFF resolution.

D. Structural Reforms

Background

24. Labor productivity remains low in Iceland's non-traditional sectors. Iceland's sectoral productivity compares favorably vis-à-vis its Nordic peers in the "traditional" marine products and energy-intensive exporting sectors, thanks to economies of scale afforded by external markets and through competition, but lags behind in "non-traditional" industries, including tourism. Increasing labor productivity in non-traditional sectors is important for growth and BOP prospects. A public-private "growth forum" has been assessing various structural reforms, drawing from an influential 2012 McKinsey Consulting report. Proposals include: (i) increasing foreign participation (retail and finance); (ii) simplifying the customs environment and trade barriers (food and consumer goods); (iii) attracting higher value tourists and addressing seasonality; and (iv) infrastructure investment (tourism).

Policy Discussions

- Staff encouraged the authorities to follow through on previously identified structural reforms aimed at increasing labor productivity and competitiveness. This could help attract investment, support growth and external balances, and facilitate the capital account liberalization process.

- *The authorities* agreed on the importance of such reforms and noted an active agenda. In early 2015, they will begin inter-ministerial work on a tourism sector strategy that would assess stress points in quality assurance and product delivery, aiming to improve the overall tourism experience and addressing any infrastructure needs. They see room for breaking down barriers to competition and streamlining regulations, particularly in the services sector, to enhance productivity, but noted some natural limitations given the small size of Iceland's economy. The government is also aiming to simplify the non-food customs regime.

E. Capital Account Liberalization: A Renewed Push

Background

25. In parallel with the macroeconomic and financial sector policies discussed above, efforts towards further capital account liberalization have picked up pace. The government-appointed task force on updating Iceland's liberalization strategy presented its assessment and recommendations to Government in December. The same month, an agreement was reached to release 20 percent of GDP in LBI bank estate asset payments to priority creditors (Annex III, ¶2) and Iceland's international advisors met with all three old bank estate winding up boards (WuBs). The authorities indicated they will have an updated strategy in place in the coming months that aims to accelerate the liberalization process. Staff estimates of the BOP overhang have been revised down to about 70 percent of GDP, though this figure remains subject to significant uncertainty (Annex III, ¶3). Staff BOP projections suggest room for some release of the BOP overhang over the medium-term.

Policy Discussions

26. Staff welcomed recent efforts while calling attention to risks and recommending strategies to increase the likelihood of a long-term positive impact on the economy.

- Staff highlighted risks from missteps in the liberalization process that could lead to reserve losses and rapid depreciation of the króna, with knock-on effects on public and private sector debt (via currency mismatches and CPI indexation) and financial stability (e.g., depositor confidence). Realization (or even elevation) of such risks could undermine international market access and worsen borrowing prospects. Staff presented analysis of the potential impact of a liberalization-induced depreciation, including balance sheet effects (see Selected Issues Paper on capital account liberalization).

- The mission recommended that the updated liberalization strategy should: (i) remain conditions-based to help preserve macroeconomic and financial stability; (ii) be based on credible analysis (e.g., BOP overhang, liquidity implications, balance sheet implications, and BOP projections); (iii) give preference to nondiscriminatory measures when possible; (iv) give emphasis to a cooperative approach, combined with incentives to participate, to help mitigate risks; and (v) be comprehensive, transparent, well communicated (with a communication strategy), measurable, and enforceable. More broadly, staff encouraged supportive macroeconomic, financial, and structural policies to address vulnerabilities. Staff supported the authorities' efforts to carefully analyze BOP conditions, public and private balance sheet and liquidity impacts of liberalization measures, and potential for resident outflows. The mission urged due consideration of Iceland's international and domestic obligations.

- To support the pace of liberalization, staff urged a greater policy focus on enhancing Iceland's BOP. Iceland's current account received a boost following the sizable depreciation at the onset of the crisis and subsequent rebalancing towards exports, and also the boom in tourism. These competitiveness gains, and inward portfolio investment, should be nurtured through supporting policies to facilitate higher export-oriented investment and savings—including infrastructure improvements and tax policy measures—and efforts to defuse pressures for wage hikes significantly in excess of productivity gains.

- The authorities were in broad agreement, while emphasizing the importance of bringing closure to treatment of various elements of the BOP overhang. They are putting strong emphasis on maintaining stability. They expect tangible progress on an updated liberalization strategy in the coming months, and noted that a cooperative approach, or process, has been gaining traction. They agreed that nurturing BOP flows is important, but that it should not come at the expense of lower purchasing power or higher government FX or net debt exposure. The authorities requested further dialogue with staff during H1 2015 as they finalize and launch their updated strategy.

- The authorities requested extension of the Fund's approval of three measures that give rise to exchange restrictions subject to Fund jurisdiction under Article VIII, Section 2(a) (see Informational Annex).[2] Staff recommends that the Executive Board approve the retention of the exchange restrictions for a period of twelve months. The exchange restrictions have been imposed for balance of payments purposes, are non-discriminatory, and temporary. The authorities remain committed to lifting the restrictions as soon as macroeconomic and financial conditions permit and based on a conditions-based capital account liberalization strategy which is currently being revised to accelerate the process.

POST-PROGRAM MONITORING

27. Iceland's balance of payments prospects and reserve buffers are projected to be at adequate levels though risks remain. Staff welcomed the early repayment by the authorities, for debt management reasons, of 2015 Fund repurchases falling due through early October. Staff projections show FX reserves remaining at adequate levels (after dipping to 120 percent of the reserve adequacy metric at end-2014). Outstanding Fund credit is now at 201 percent of quota, just above the standard PPM threshold. The authorities noted this would facilitate ongoing dialogue with staff as updated plans for capital account liberalization are finalized. Risks are mainly from the external environment and the uncertainty surrounding capital account liberalization.

STAFF APPRAISAL

28. Iceland is in a relatively strong macroeconomic position with good growth prospects, but has lingering vulnerabilities and faces downside risks. The authorities should maintain policies geared towards preserving stability, addressing vulnerabilities, rebuilding buffers, strengthening key institutions, and facilitating growth. With sound policies, Iceland can expect sustained growth, price stability, healthy fiscal and external balances, a robust financial sector, downward sustainable paths for debt, and external financial reintegration.

[2] The retention of the three exchange restrictions was first approved by the Executive Board on April 6, 2012 (Decision No. 15133-(12/35)) and subsequently extended in March 2013 (Decision No. 15335-(13/25) and further in March 2014 until March 6, 2015 (Decision No. 15552-(14/22).

29. Monetary policy has been appropriate. The CBI should stand ready to cut rates further if imported deflationary pressures persist. However, given that the outcome of wage negotiations is highly uncertain, the current pause is appropriate. Further large wage increases—amidst a closing output gap—would call for a rate hike. The central bank should continue FX reserve accumulation to smooth eventual BOP outflows under liberalization and to reduce appreciation pressures. Maintaining a de facto and de jure independent central bank is important for policy credibility, especially ahead of capital account liberalization.

30. With Iceland on-track to achieve core objectives, fiscal policy is well positioned for a transition from consolidation to supporting higher potential growth. With the budget near balance, the authorities are appropriately turning their attention to budget composition and supporting reforms. More needs to be done in tax policy, including the VAT and the complex personal income tax. On the expenditure side, the authorities need to boost public investment and to assess the distributional consequences of reforms.

31. The core financial sector remains stable with adequate buffers, but gaps in supervision and financial safety nets must be addressed. Uncertainties surrounding the unwinding of crisis legacies call for capital and liquidity buffers to be maintained and supervision to be reinforced. The authorities should strengthen the deposit insurance, bank resolution, and emergency liquidity assistance frameworks. A permanent solution is needed for the loss-making HFF.

32. The authorities should follow-through on structural reform plans to support productivity and competitiveness. Planned steps in the tourism and services sectors are logical starting points. Steps to facilitate investment would help support growth and external balances.

33. Sound macroeconomic and financial sector policies will help create conditions for successful capital account liberalization and external financial reintegration. The updated liberalization strategy now under development should be conditions-based and aim to maintain stability, and embed other key characteristics discussed. Greater policy focus on enhancing Iceland's BOP prospects would help support the pace of liberalization. Staff supports the authorities' request for approval of exchange restrictions.

34. It is recommended that the next Article IV consultation with Iceland be held on the standard 12-month cycle.

Box 1. Iceland's Recovery: A Report Card

Iceland has used breathing room under six years of capital controls to reduce flow and stock vulnerabilities, strengthen institutions, and prepare for full capital account liberalization. Growth is strong, double-digit fiscal and current account deficits have shifted into surplus, financial sector buffers are high, and institutions have been strengthened. *But stock vulnerabilities remain significant relative to Iceland's past, to peer countries, and to common vulnerability metrics.*

Box 2. Iceland: The Medium-Term Fiscal Strategy

Iceland has achieved a number of important fiscal milestones, but there remain important structural fiscal challenges to be addressed over the medium term. With the fiscal position stronger than at any time since the crisis, there is an opportunity to reconsider the medium term fiscal strategy. The broad objectives should be to improve growth prospects, maintain momentum in dealing with crisis legacy issues, and ensure adequate protection for vulnerable social groups. Some important issues (discussed in further detail in the Selected Issues Paper on fiscal policy) include the following:

- **The draft budget framework law (OBL) now before parliament would strengthen the institutional underpinnings of fiscal policy.** It would improve fiscal reporting, transparency and accountability, establish a fiscal council, and set requirements for medium-term fiscal policy statements. The bill would also establish new fiscal rules that mandate a balanced general government budget over the medium term—with provisions for counter-cyclical deficit spending and an escape clause for extraordinary events—and a net debt ceiling of 45 percent of GDP. If approved, implementation will be challenging—both the rules but also technical implementation—including shifting consolidated financial accounts to IPSAS standards, preparing annual statements of fiscal policies, and adjusting roles of ministries.

- **The Icelandic indirect tax system (VAT) is comparatively inefficient.** The 2015 budget raises the reduced VAT rate from 7 to 11 percent, lowers the main rate by 1.5 percentage points to 24 percent, and eliminates exemptions for some tourist activities. But the main VAT rate remains well above the OECD average, the gap between the main and reduced rates remains large, and widespread exemptions remain. More will be needed to reverse the decline in recent years of the share of VAT in total revenues and as a percent of GDP.

- **The burden of taxation has shifted decisively towards more distortionary direct taxes, weakening growth prospects**. This, in part, reflects design flaws in the personal income tax. By international standards, the entry tax rate is very high while the highest rate is comparatively low. Furthermore, the higher tax brackets do not generate significant revenues. In addition, the tax wedge on labor income has increased over time, which has tended to put a brake on growth.

- **Benefit expenditures rose sharply during the crisis**. This higher expenditure reflected a strong commitment and consensus that the costs of the crisis should, to the extent possible, be shared. With the consequences of the crisis now diminishing, there is a need to return social expenditures to their pre-crisis levels, in terms of GDP.

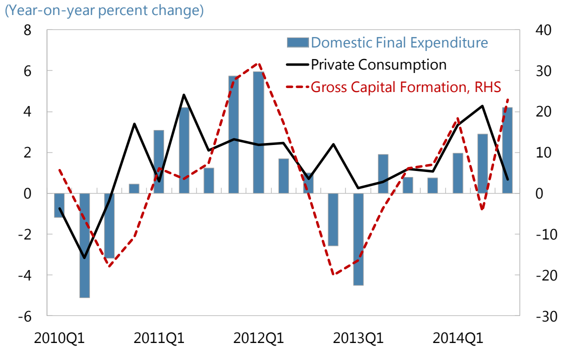
- **Public investment bore the brunt of the post-crisis fiscal adjustment**. Investment levels are low both by international and historical standards. There is a growing list of urgent public investment projects, particularly in the health and transportation sectors.

Figure 1. Iceland: Recent Developments in Demand and Labor

Domestic demand strengthened last year…

Domestic Demand Growth

(Year-on-year percent change)

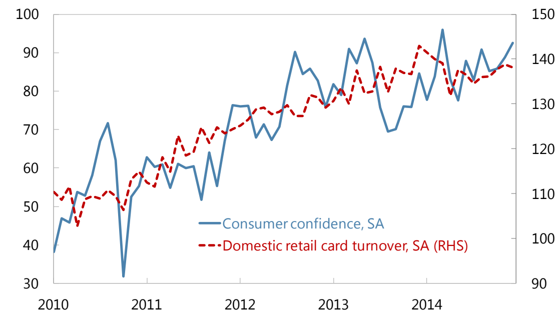


Sources: Statistics Iceland; and Haver Analytics.

…on the back of robust consumer spending.

High Frequency Indicators

(Index) (Index, 2007=100)

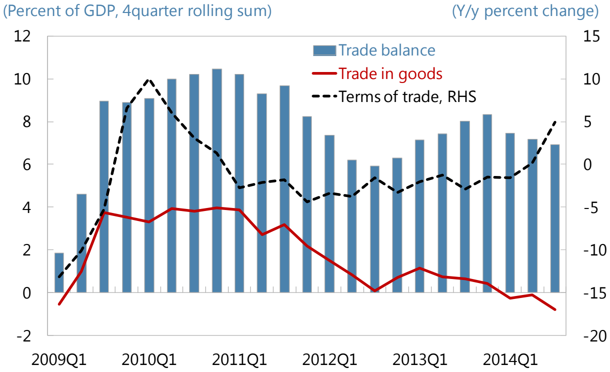


Source: Statistics Iceland.

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)

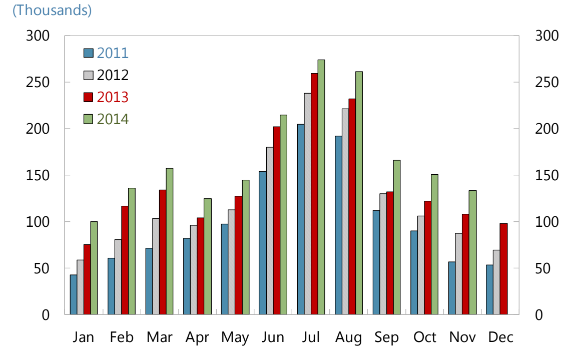


Sources: Central Bank of Iceland; Haver Analytics; and Statistics Iceland.

…and continued growth in tourism.

Overnight Stays of Foreigners in Hotels

(Thousands)

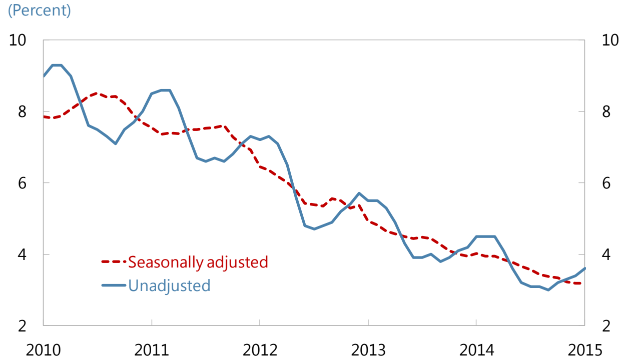


Source: Statistics Iceland.

The unemployment rate is trending down…

Unemployment Rate 1/

(Percent)



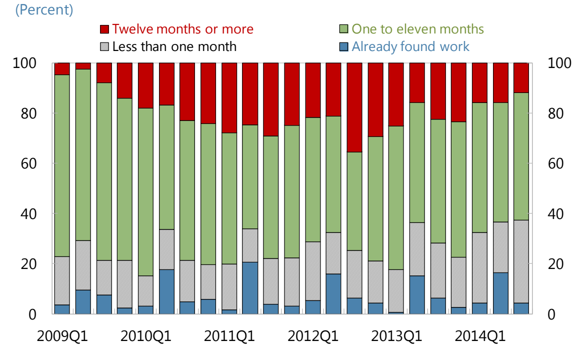
Sources: Department of Labor; and Haver Analytics.

1/ Based on registered unemployment.

…while long-term unemployment slowly reverts to pre-crisis levels.

Unemployment Duration

(Percent)

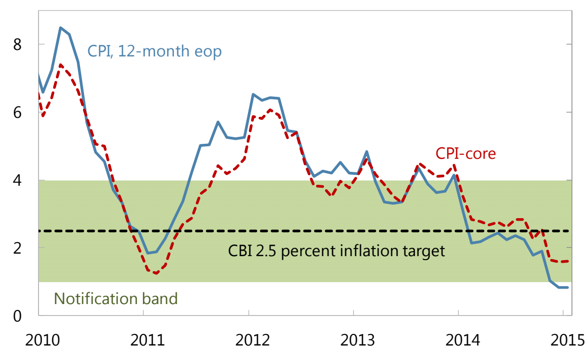


Source: Statistics Iceland Labor Market Survey.

Figure 2. Iceland: Price and Exchange Rate Developments

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

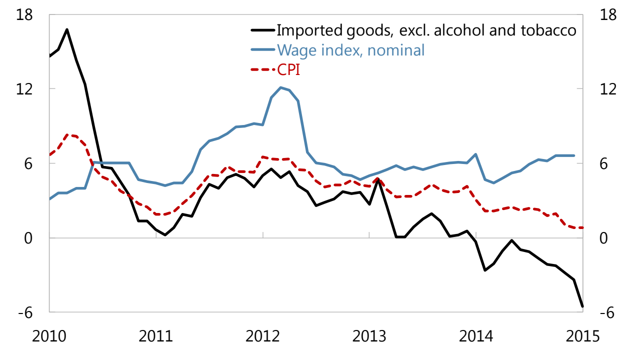
Inflation Rates
(Percent)



Sources: Central Bank of Iceland; and Statistics Iceland.

...driven largely by lower import prices.

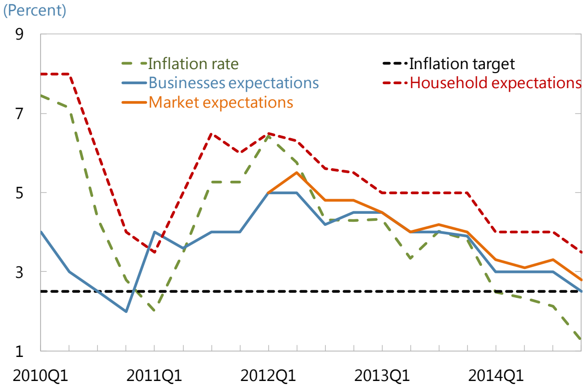
CPI, Wages and Import Prices
(Percent, 12-month growth)



Source: Statistics Iceland.

Near-term inflation expectations are trending down...

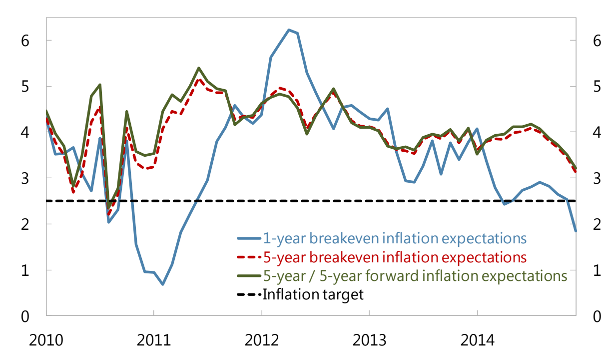
Inflation Expectations, 12-Months Horizon (Survey) 1/
(Percent)



Source: Central Bank of Iceland.

...though longer-term expectations have been slower to adjust.

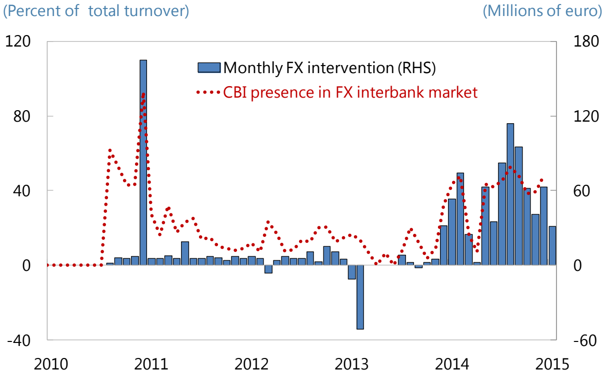
Inflation Expectations (Market-based)
(Percent)



Source: Central Bank of Iceland.

The CBI has stepped up FX purchases...

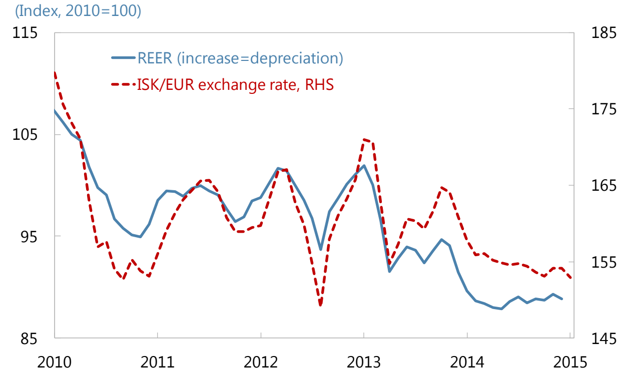
CBI Monthly Foreign Exchange Interventions
(Percent of total turnover) (Millions of euro)



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

...as the króna has appreciated.

Exchange Rates
(Index, 2010=100)

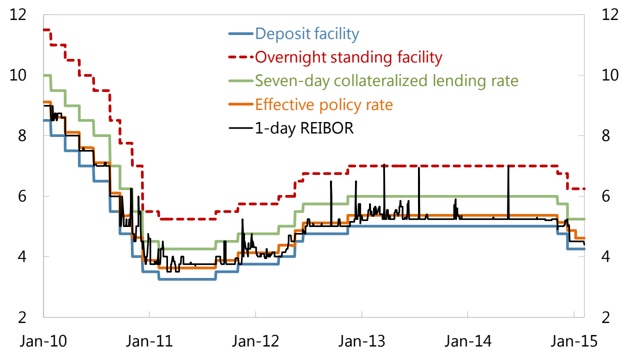


Sources: Central Bank of Iceland; IMF INS database; and Haver Analytics.

Figure 3. Iceland: Monetary Policy Developments

The central bank recently lowered its policy rate...

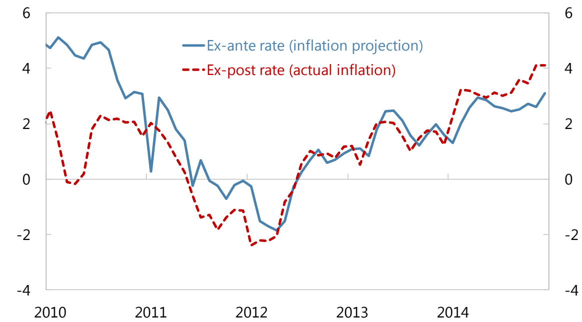
Policy and Interbank Rates
(Percent)



Source: Central Bank of Iceland.

...though real policy rates are still high...

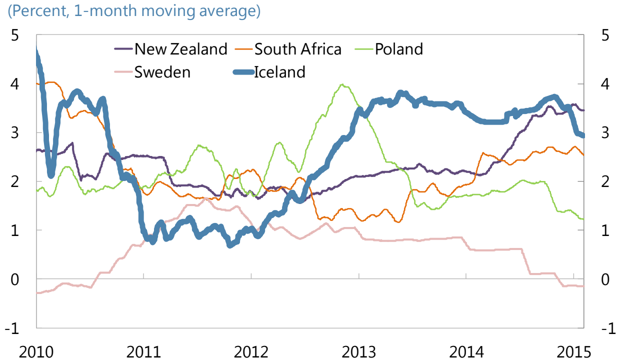
Real Effective Policy Rates
(Percent)



Sources: Central Bank of Iceland; IMF staff calculations.

...and the risk-adjusted policy rate is elevated.

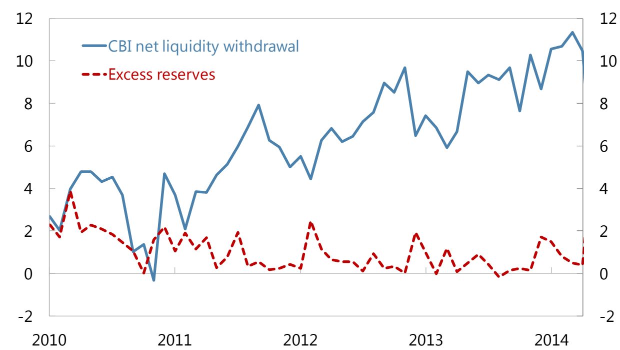
Risk-adjusted Policy Rates 1/
(Percent, 1-month moving average)



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...

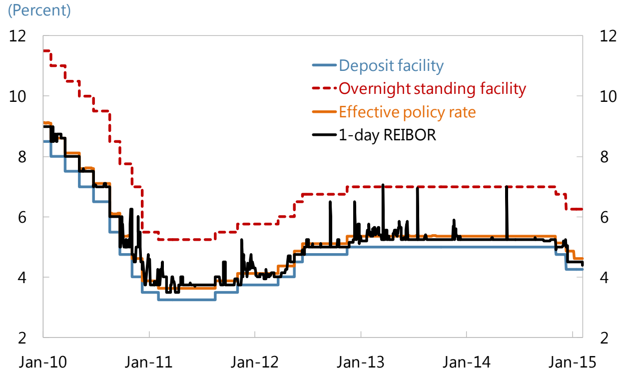
CBI Liquidity Management and Excess Reserves
(In percent of domestic deposits)



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

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

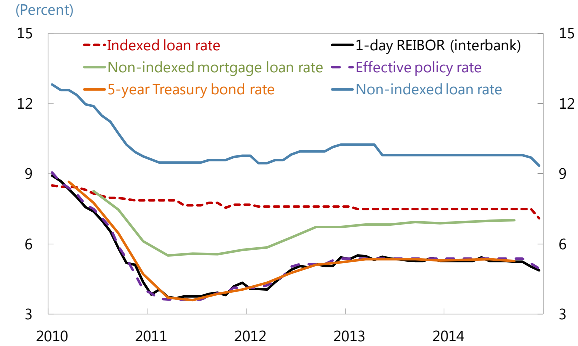
The Interest Rate Corridor
(Percent)



Source: Central Bank of Iceland.

Market rates have closely tracked the effective policy rate.

Market and Lending Rates
(Percent)

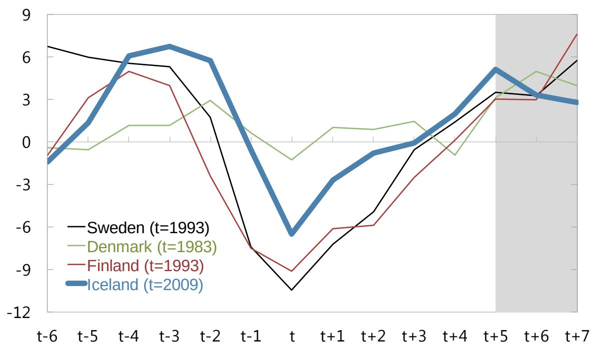


Sources: Central Bank of Iceland; Statistics Office of Iceland; and Haver Analytics.

Figure 4. Iceland: Fiscal Policy Developments and Outlook

Post-crisis fiscal adjustment is in line with peers…

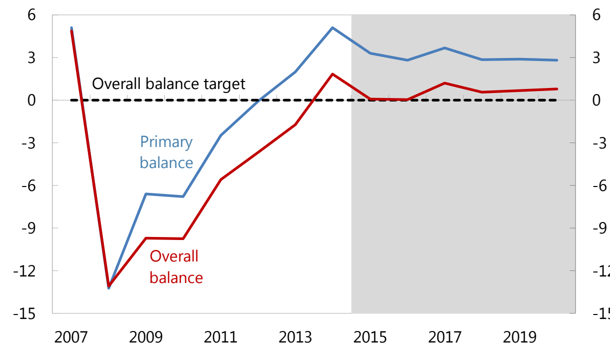
Primary Balances
(Percent of GDP, t=primary balances trough)



Source: IMF WEO; and IMF staff projections.

…leading to balanced budgets…

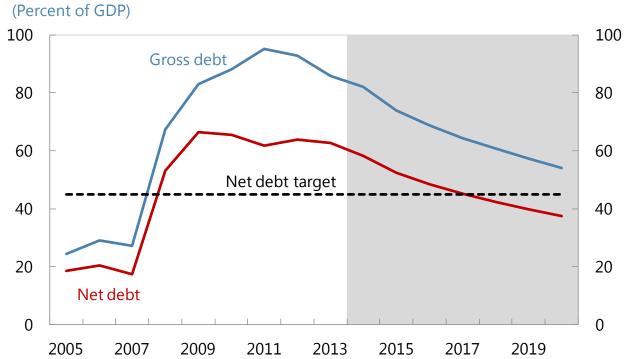
General Government Balances and Target
(Percent of GDP)



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

…and putting general government debt on a declining path.

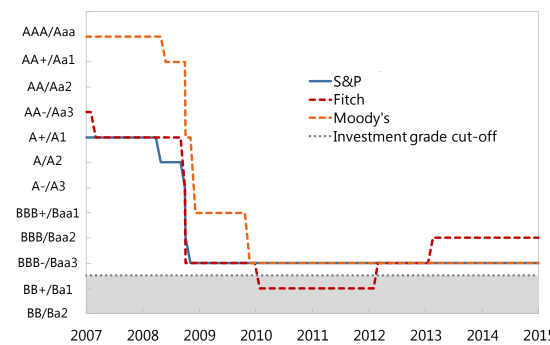
Gross and Net Debt 1/
(Percent of GDP)



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…

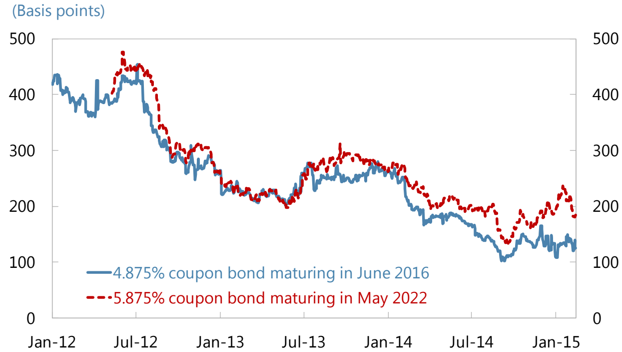
Long-Term Sovereign Credit Ratings



Source: Bloomberg.

Sovereign spreads have inched up recently…

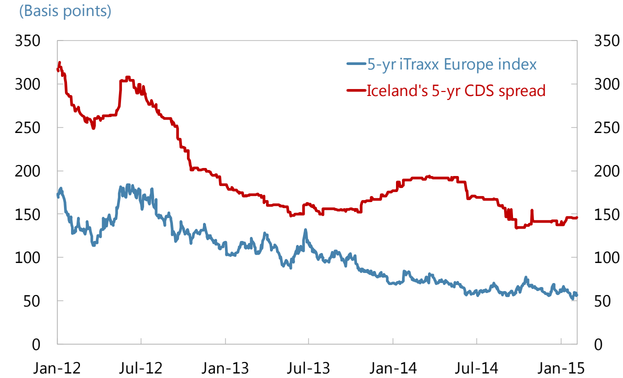
Spreads on Icelandic Bonds against US Treasuries 1/
(Basis points)



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.

…while CDS spreads have flattened.

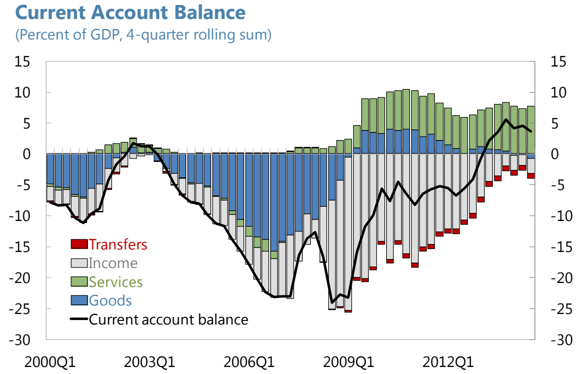
Iceland's CDS spread and the ITRAXX Europe Index
(Basis points)



Source: Thompson Reuters.

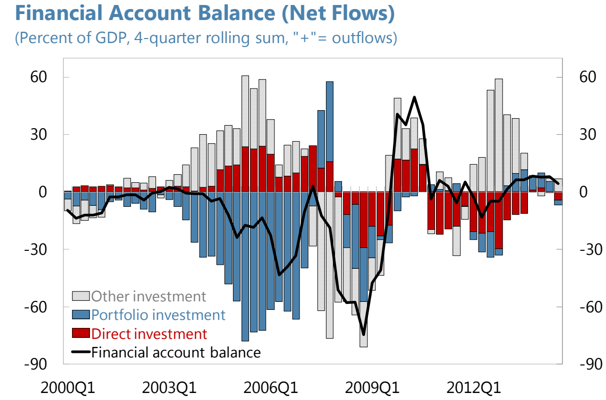
Figure 5. Iceland: External Sector Developments and Outlook

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



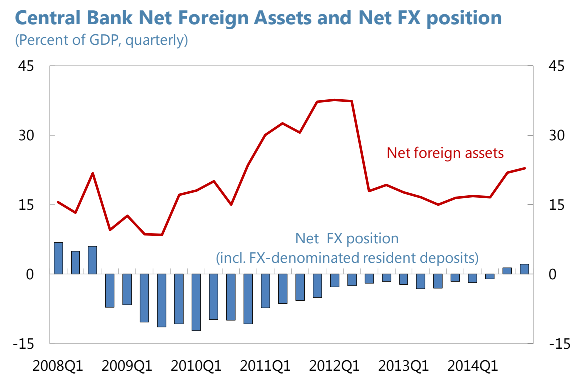
Sources: Central Bank of Iceland; and Haver Analytics.

…though the financial account has weakened, driven by deleveraging.



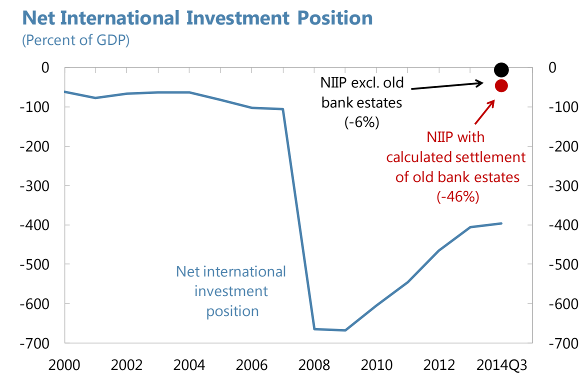
Sources: Central Bank of Iceland; and Haver Analytics.

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



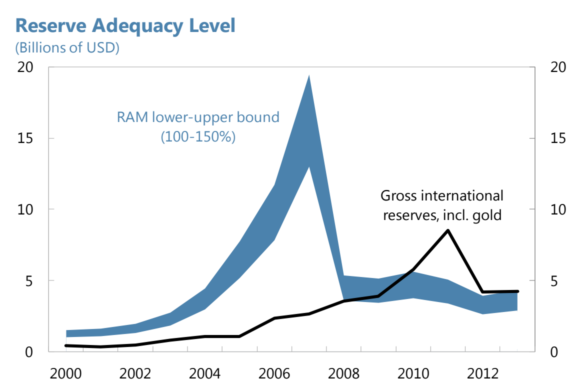
Sources: Central Bank of Iceland; and IMF staff calculations.

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



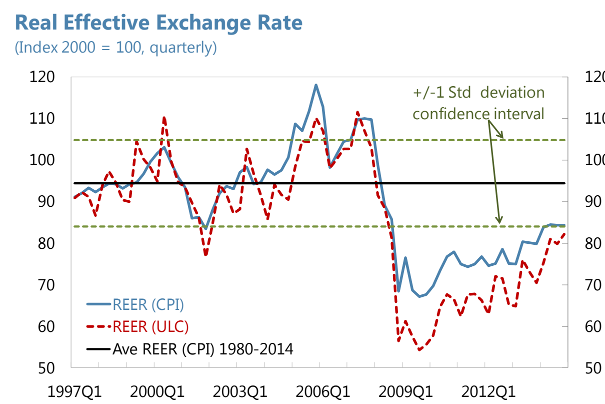
Sources: Central Bank of Iceland; and Haver Analytics.

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



Sources: WEO; IFS; and IMF staff calculations.

The real effective exchange rate remains below the historical average.

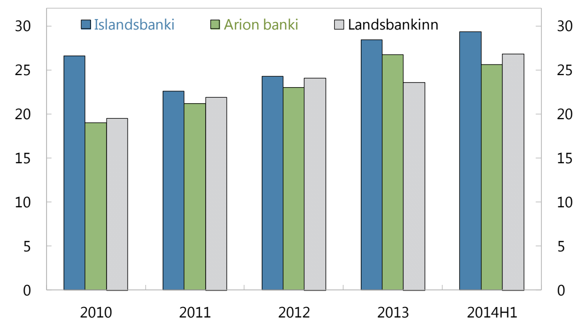


Source: Central Bank of Iceland.

Figure 6. Iceland: Banking Sector Developments

Capital buffers remain high…

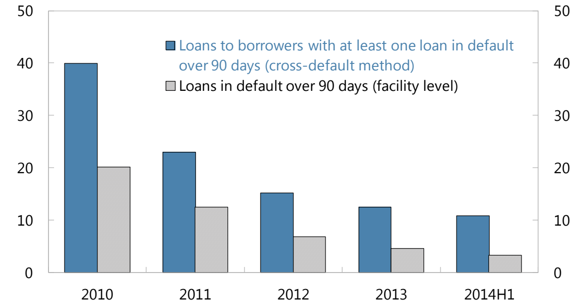
Capital Adequacy Ratios of Commercial Banks
(Percent)



Source: Central Bank of Iceland.

…and asset quality is improving.

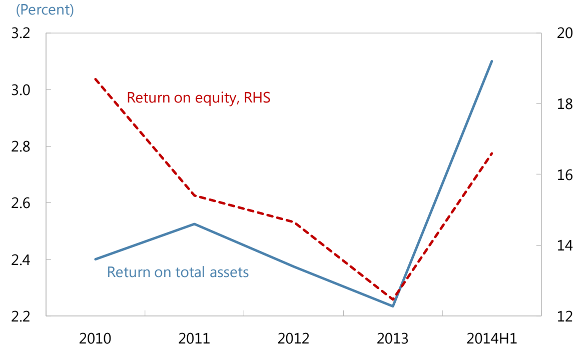
Default Ratio of the Three Largest Commercial Banks 1/
(Percent)



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

Banks are profitable…

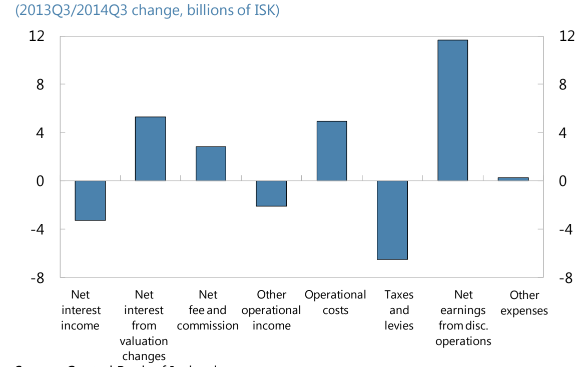
Profitability
(Percent)



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

…but revenues are largely driven by one-offs.

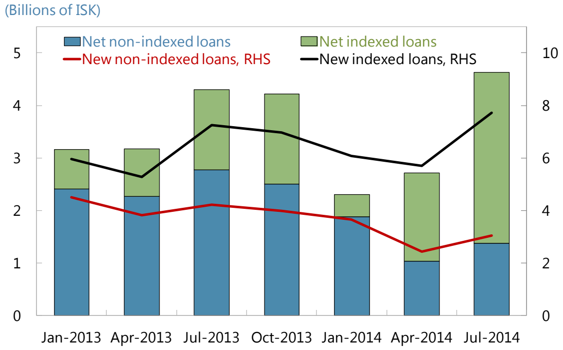
Income Statement Items
(2013Q3/2014Q3 change, billions of ISK)



Source: Central Bank of Iceland.

New indexed mortgage lending continues to increase…

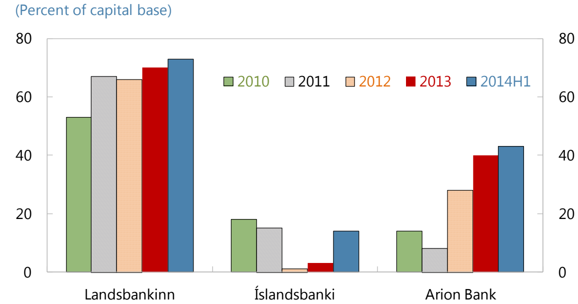
New Mortgage Lending by the Large Commercial Banks
(Billions of ISK)



Source: Central Bank of Iceland.

…and CPI imbalances are growing.

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

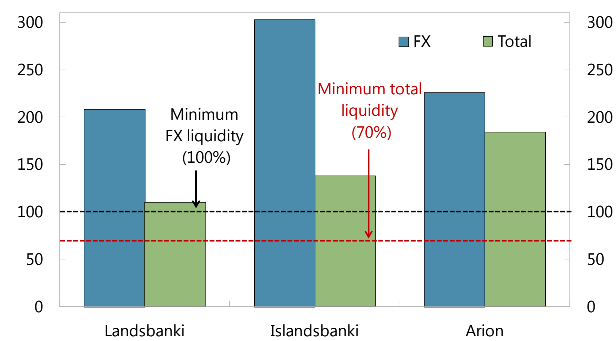


Source: Central Bank of Iceland.
1/ Imbalances reflects the difference between CPI-indexed assets and liabilities.

Figure 7. Iceland: Financial Sector Developments

Bank liquidity is good...

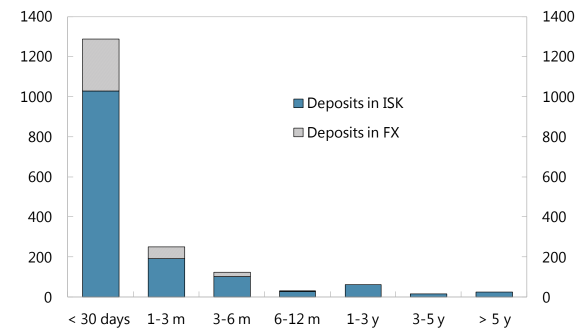
Liquidity Coverage Ratios, June 2014
(Percent)



Sources: Commercial banks' reports.

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

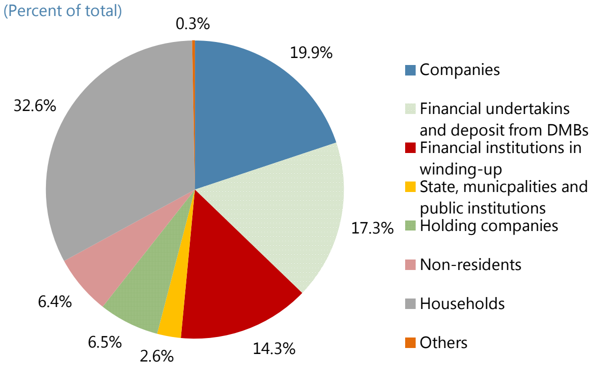
Deposits Breakdown by Currency and Maturity, Sep-2014
(Billions of ISK)



Source: Central Bank of Iceland.

Reliance on old banks' deposits remains high...

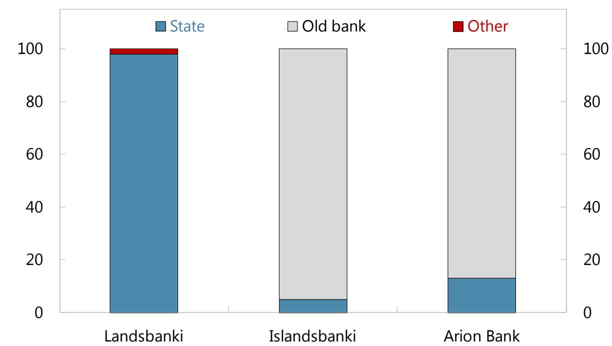
Composition of Deposit Holders
(Percent of total)



Source: Central Bank of Iceland.

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

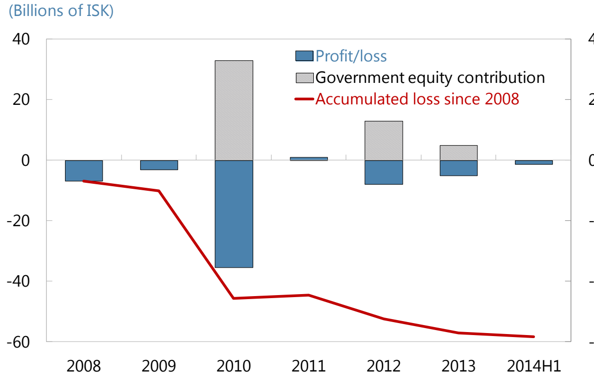
Ownership Structure of Icelandic Banks, September 2014
(Percent of total capital)



Source: Central Bank of Iceland.

The Housing Financing Fund's distress continues...

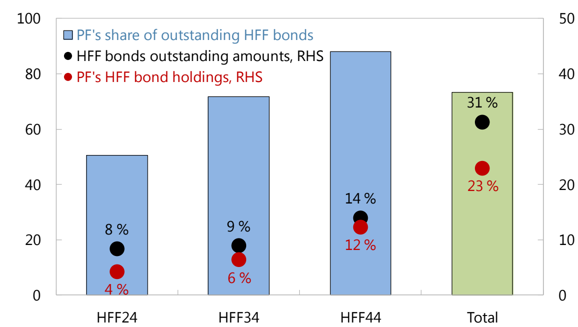
HFF Profit/Loss and Government Equity Contribution
(Billions of ISK)



Source: Central Bank of Iceland.

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

Pension Funds' Share of Outstanding HFF Bonds, Sep-2014
(Percent of total) (Percent of 2014 GDP)

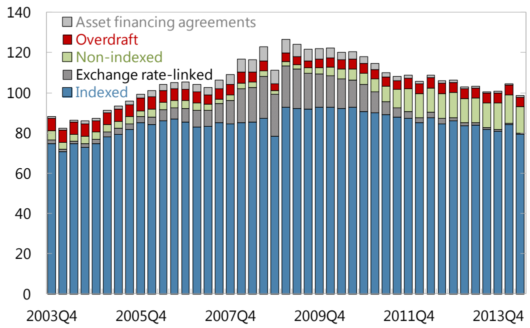


Source: HFF Monthly Report; and IMF staff calculations.

Figure 8. Iceland: Private Sector Deleveraging

Household debt is declining...

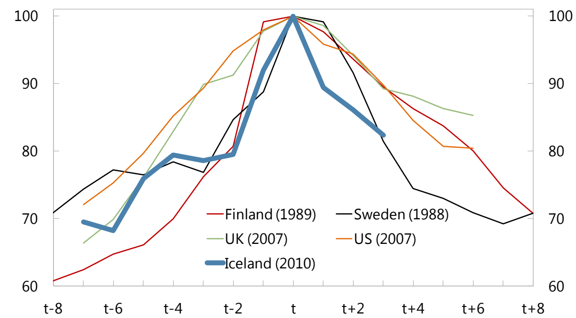
Household Debt
(Percent of GDP)



Sources: Central Bank of Iceland; Statistics Iceland.

...but deleveraging is still ongoing...

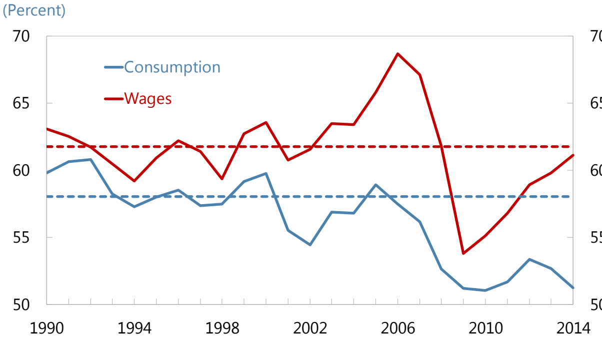
Normalized Household Debt
(Percent of disposable income)



Sources: IMF WEO; and Haver Analytics.

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

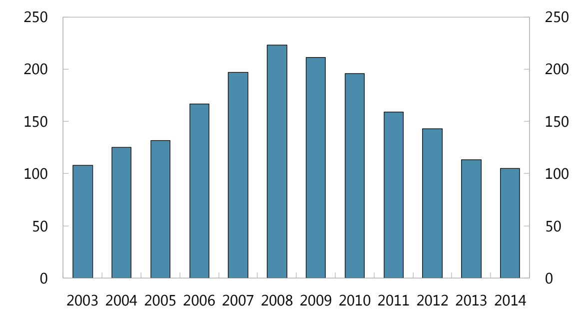
Consumption and Wage Shares 1/
(Percent)



Sources: Statistics Iceland; and IMF staff calculations.
1/ Consumption and wages in percent of GDP and gross factor income, respectively. Dash lines represent respective pre-boom long-term averages.

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

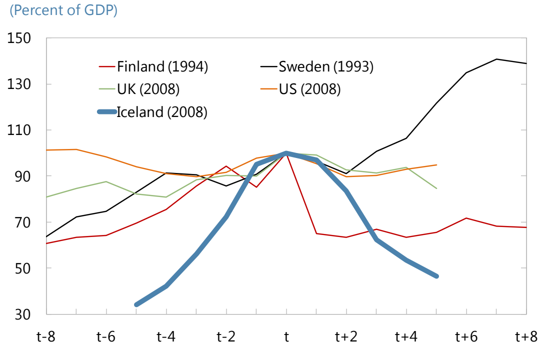
Corporate Debt 1/
(Percent of GDP)



Source: Central Bank of Iceland, Monetary Bulletin 2014/4.
1/ Excludes holding companies.

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

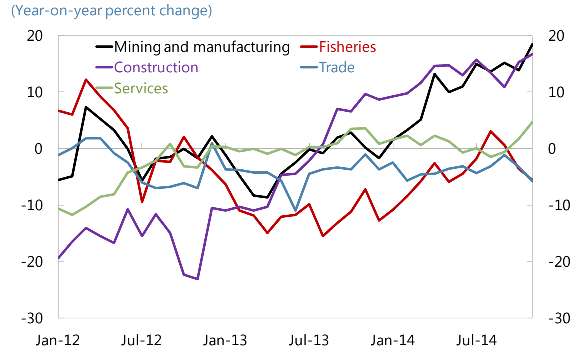
Normalized Corporate Debt
(Percent of GDP)



Sources: IMF WEO; and Haver Analytics.

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

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



Source: Central Bank of Iceland.

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

	2011	2012	2013	2014 Est	2015 Proj	2016 Proj
	(Percentage change, unless otherwise indicated)					
National Accounts (constant prices)						
Gross domestic product	2.1	1.1	3.5	1.8	3.5	3.2
Total domestic demand	3.0	1.2	0.9	3.1	4.4	4.5
Private consumption	2.5	2.0	0.8	3.2	3.4	3.0
Public consumption	0.2	-1.2	0.8	1.0	1.6	1.6
Gross fixed investment	11.6	4.3	-2.2	13.4	13.2	14.1
Exports of goods and services	3.4	3.9	6.9	4.3	4.6	3.4
Imports of goods and services	6.8	4.9	0.4	9.4	7.7	7.0
Output gap 1/	-1.3	-1.0	-0.6	-1.2	-0.4	0.0
Selected Indicators						
Nominal GDP (ISK bn)	1,701	1,774	1,873	1,961	2,121	2,237
Private consumption (percent of GDP)	51.7	53.4	52.7	52.9	51.0	50.8
Public consumption (percent of GDP)	24.4	24.4	24.3	24.2	23.8	24.0
Gross fixed investment (percent of GDP)	15.5	16.0	15.1	16.4	17.2	18.8
Unemployment rate (period average) 2/	7.1	6.0	5.4	5.0	4.0	4.0
Employment	0.0	0.5	3.7	1.9	2.9	2.2
Real GDP per capita (ISK mln)	3.6	3.6	3.7	3.8	3.9	4.0
Consumer price index (period average)	4.0	5.2	3.9	2.0	0.9	2.1
Consumer price index (end of period)	5.3	4.2	4.2	0.8	0.8	2.3
Nominal wage index	7.0	7.9	3.5	5.5	6.7	5.1
Real wage	2.3	2.6	-0.3	3.5	5.8	3.0
Nominal effective exchange rate 3/	0.3	-3.3	2.3	5.9	...	...
Real effective exchange rate 3/	0.9	0.6	3.8	6.7	...	...
Terms of trade	-2.8	-3.1	-1.9	2.4	5.1	-0.2
Money and Credit						
Base Money	-20.7	32.0	0.3	-25.4	8.8	0.0
Deposit money bank credit	6.9	0.7	1.4	4.7	4.3	5.3
Broad money	8.7	-2.7	4.2	9.4	1.5	1.5
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	41.8	42.5	47.9	43.9	42.9
Expenditure	45.7	45.5	44.2	46.0	43.8	42.8
Balance	-5.6	-3.7	-1.7	1.8	0.1	0.1
Primary balance	-2.5	-0.1	2.0	5.1	3.3	2.8
Balance of Payments						
Current account balance 5/	-5.2	-4.2	5.5	4.7	6.1	4.7
Trade balance	8.2	6.3	8.3	7.1	8.1	6.4
Financial and capital account	5.1	-4.9	8.2	10.1	5.9	4.5
Net errors and omissions	1.5	-0.1	0.4	0.9	0.0	0.0
Central bank reserves (USD bn)	8.7	4.3	4.1	4.2	4.5	4.2
Excluding old banks' deposits (USD bn)	5.9	4.2	4.0	4.0	...	...

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 Est	2015 Proj	2016 Proj
Central Bank (CBI)						
Net foreign assets 1/	-89	-28	-30	40	40	40
Assets	1,047	540	488	566	523	562
Liabilities	1,136	568	518	526	484	522
Net domestic assets	163	126	129	34	40	40
Net claims on the public sector	47	43	89	60	35	30
Net claims excluding recap bond	-145	-142	-90	-119	-105	-105
Recapitalization bond	192	185	180	145	140	135
Net claims on banks 2/ 3/	-66	-83	-73	-87	-152	-166
Others Items, net	182	166	113	61	157	176
Base Money 3/ 4/	74	98	99	74	80	80
Currency issued	39	41	42	41	41	41
DMB deposits at the central bank	35	57	57	32	39	39
Banking System						
Net foreign assets	205	255	306	307	333	359
Net domestic assets 3/	1,331	1,236	1,248	1,397	1,397	1,397
Net claims on the central bank	121	147	184	176	190	205
Credit to private sector	1,934	1,948	1,976	2,069	2,159	2,273
Credit to government	240	233	227	235	245	256
Other items, net	-965	-1,092	-1,139	-1,083	-1,197	-1,336
Domestic deposits	1,536	1,491	1,554	1,704	1,731	1,757
Local currency	1,462	1,391	1,428	1,584	1,584	1,584
Foreign currency	74	100	126	120	146	172
Consolidated Financial System						
Net foreign assets	116	227	277	347	373	399
Net domestic assets 3/	1,459	1,305	1,319	1,398	1,398	1,398
Net claims on the public sector	287	276	316	295	280	286
Net credit to private sector	1,934	1,948	1,976	2,069	2,159	2,273
Other, net	-762	-919	-973	-965	-1,040	-1,160
Broad Money (M3) 3/	1,575	1,532	1,596	1,746	1,772	1,798
Memorandum items:						
Net foreign assets	116	227	277	347	373	399
Broad money (y-o-y percentage change)	8.7	-2.7	4.2	9.4	1.5	1.5
Credit to private sector (y-o-y percentage change	6.9	0.7	1.4	4.7	4.3	5.3
Money velocity (GDP/base money)	22.8	18.0	19.0	26.7	26.5	28.0
Broad money velocity (GDP/M3)	1.1	1.2	1.2	1.1	1.2	1.2
Multiplier (M3/base money)	21.1	15.6	16.2	23.7	22.1	22.5

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

	2013	2014 Est	2015 Proj	2016 Proj	2017 Proj	2018 Proj	2019 Proj	2020 Proj
	(Percentage change, unless otherwise indicated)							
Real economy								
Real GDP	3.5	1.8	3.5	3.2	2.7	2.7	2.6	2.6
Real domestic demand	0.9	3.1	4.4	4.5	3.1	2.9	2.9	2.9
Private consumption	0.8	3.2	3.4	3.0	3.0	2.7	2.7	2.7
Public consumption	0.8	1.0	1.6	1.6	1.4	1.4	1.2	1.2
Gross fixed investment	-2.2	13.4	13.2	14.1	5.7	5.5	5.6	5.5
Net exports 1/	2.6	-1.0	-0.4	-0.8	-0.1	0.1	0.0	0.0
Exports of goods and services	6.9	4.3	4.6	3.4	4.2	4.0	4.2	4.2
Imports of goods and services	0.4	9.4	7.7	7.0	5.5	4.7	5.2	5.2
Output gap 2/	-0.6	-1.2	-0.4	0.0	0.0	0.0	0.0	0.0
Unemployment rate (period average) 3/	5.4	5.0	4.0	4.0	4.0	4.0	4.0	4.0
Employment	3.7	1.9	2.9	2.2	1.9	1.8	1.8	1.8
Real wages	-0.3	3.5	5.8	3.0	2.5	2.0	1.8	1.8
CPI inflation (period average)	3.9	2.0	0.9	2.1	2.5	2.5	2.5	2.5
CPI inflation (end of period)	4.2	0.8	0.8	2.3	2.5	2.5	2.5	2.5
Terms of trade	-1.9	2.4	5.1	-0.2	-0.1	0.0	0.1	0.2
Nominal GDP (ISK bn)	1,873	1,961	2,121	2,237	2,354	2,485	2,615	2,754
	(Percent of GDP, unless otherwise indicated)							
Balance of Payments								
Current account 4/	5.5	4.7	6.1	4.7	4.0	3.3	2.6	2.4
Trade balance	8.3	7.1	8.1	6.4	5.8	5.4	5.0	4.7
Primary income balance 4/ 5/	-2.0	-1.5	-1.2	-0.9	-0.9	-1.4	-1.6	-1.5
Secondary income balance	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Capital and financial account	8.2	10.1	5.9	4.5	3.9	3.1	2.5	2.2
Direct investment, net	1.0	-1.5	-1.8	-2.5	-2.0	-1.8	-2.1	-2.5
Portfolio investment, net	7.5	1.7	4.9	7.8	4.2	6.3	4.0	5.3
Other investment, net	-0.2	9.7	0.9	0.9	1.6	-1.4	-1.1	0.7
Reserve assets	0.1	0.2	2.0	-1.7	0.1	0.1	1.7	-1.2
Gross external debt 6/	257	224	226	216	207	209	207	196
Underlying gross external debt 7/	176	141	121	115	111	113	112	108
Short-term external debt 6/ 8/	102	68	112	103	98	99	103	92
Central bank reserves (USD bn)	4.1	4.2	4.5	4.2	4.2	4.3	4.6	4.3
General government accounts								
Revenue	42.5	47.9	43.9	42.9	42.8	41.8	41.8	41.5
Expenditure	44.2	46.0	43.8	42.8	41.6	41.3	41.1	40.7
Overall balance	-1.7	1.8	0.1	0.1	1.2	0.6	0.7	0.8
Primary balance	2.0	5.1	3.3	2.8	3.7	2.8	2.9	2.8
Gross debt	85.7	82.1	73.8	68.7	64.4	60.8	57.4	54.0
Net debt	62.8	58.3	52.5	48.4	45.1	42.4	39.9	37.4

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 accrued interest payments on intra-company debt held by a large multinational, but estimated and projected data do not.

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 4. Iceland: Balance of Payments, 2011–20 1/

(Billions of USD, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Est	Proj	Proj	Proj	Proj	Proj	Proj
Current Account 2/	-0.8	-0.6	0.8	0.8	1.1	0.9	0.8	0.7	0.6	0.5
Trade Balance	1.2	0.9	1.3	1.2	1.4	1.2	1.1	1.1	1.1	1.1
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	4.8	5.4	5.6	5.9	6.2	6.5	6.8
Merchandise imports f.o.b.	4.5	4.5	4.5	4.9	5.1	5.4	5.7	6.1	6.5	6.9
Balance on Services	0.9	0.8	1.2	1.3	1.2	1.0	0.9	1.0	1.1	1.1
Exports of services, total	3.4	3.4	4.0	4.3	4.5	4.6	4.8	5.2	5.6	6.0
Imports of services, total	2.5	2.6	2.7	3.0	3.3	3.6	3.9	4.2	4.5	4.9
Primary Income balance 2/	-1.9	-1.4	-0.3	-0.3	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3
Receipts	1.4	0.8	1.0	0.9	0.9	1.0	1.0	1.0	1.1	1.1
of which dividends and reinvested earnings	0.7	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
of which interest receipts	0.6	0.4	0.5	0.5	0.6	0.6	0.6	0.6	0.6	0.6
Expenditures	3.2	2.2	1.3	1.2	1.2	1.1	1.2	1.3	1.4	1.4
of which dividends and reinvested earnings	0.2	0.0	-0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
of which interest payments	3.0	2.2	1.6	1.0	1.0	0.9	0.9	1.1	1.2	1.2
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	1.3	1.7	1.1	0.8	0.7	0.6	0.5	0.5
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	0.8	-0.7	1.3	1.7	1.1	0.8	0.8	0.6	0.5	0.5
Direct investment	-1.1	-4.2	0.1	-0.2	-0.3	-0.5	-0.4	-0.4	-0.4	-0.6
Portfolio investment 3/	-0.1	-0.5	1.1	0.3	0.9	1.4	0.8	1.3	0.9	1.2
Assets	0.9	0.6	1.3	0.7	0.7	0.7	0.7	0.8	0.8	0.8
Liabilities	1.0	1.1	0.1	0.4	-0.2	-0.7	-0.1	-0.5	-0.1	-0.3
Net borrowing	...	...	...	0.4	-0.2	-0.7	-0.1	-0.5	0.0	-0.3
Other investment 3/	-1.0	8.3	0.0	1.6	0.2	0.2	0.3	-0.3	-0.2	0.2
Assets	-4.2	2.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.1	-1.1	-1.1
Liabilities 4/	-3.2	-6.3	-0.9	-2.6	-1.2	-1.2	-1.3	-0.8	-0.8	-1.3
of which outflows related to liberalization 3/	...	...	...	0.0	-0.2	-0.3	-1.1	-0.5	-0.4	-0.9
Change in reserve assets ("+" = increase)	2.9	-4.3	0.0	0.0	0.4	-0.3	0.0	0.0	0.4	-0.3
Net errors and omissions	1.5	-0.1	0.4	0.9	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	4.5	4.2	4.2	4.3	4.6	4.3
Reserve floor (150% of reserve adequacy metric)	4.9	3.7	4.5	4.2	4.5	4.2	4.2	4.3	4.6	4.3
Reserves (months of imports of goods&services)	14.5	7.1	6.3	6.0	6.0	5.2	5.0	4.7	4.7	4.1
Reserves/S-T debt (residual basis, percent) 5/	99	121	100	121	119	145	148	132	102	121
Reserves/S-T debt (residual basis, percent) 6/	232	899	339	435	377	1,360	1,478	651	239	478
Reserves (percent of GDP)	59.0	30.1	27.1	25.0	25.4	22.9	22.0	21.0	21.6	19.2
GDP	14.7	14.2	15.3	16.7	17.8	18.4	19.3	20.3	21.3	22.5

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

1/ This table is in BPM6 format. The previous report (4th PPM staff report) used BPM5 format.

2/ 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.

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

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

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

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

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

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

	2011	2012	2013	2014 Est	2015 Proj	2016 Proj	2017 Proj	2018 Proj	2019 Proj	2020 Proj
Total revenue	**40.1**	**41.8**	**42.5**	**47.9**	**43.9**	**42.9**	**42.8**	**41.8**	**41.8**	**41.5**
Taxes	**30.5**	**31.7**	**32.4**	**35.7**	**34.0**	**33.2**	**33.3**	**32.3**	**32.3**	**32.0**
Taxes on income and profits	15.7	16.0	16.8	18.5	17.6	17.0	17.2	17.1	17.1	17.1
Personal income tax	13.0	13.2	13.8	14.0	13.6	13.8	13.9	13.9	13.9	13.9
Corporate income tax	1.7	1.9	2.2	3.3	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	0.4	0.4	0.4	0.4	0.4
Taxes on property	2.3	2.5	2.5	2.5	2.0	2.2	2.2	2.3	2.3	2.2
Taxes on goods and services	11.5	11.9	11.8	11.9	11.9	11.9	11.9	11.9	11.9	11.8
VAT	7.7	8.1	8.0	8.2	8.1	8.1	8.1	8.1	8.1	8.1
Other taxes on goods and services	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.8	3.7
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	1.4	0.4	0.4	0.4
Social contributions	**3.9**	**3.7**	**3.7**	**3.8**	**3.7**	**3.9**	**3.9**	**3.9**	**3.9**	**3.9**
Grants	**0.2**	**0.2**	**0.2**	**0.1**	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Other revenue	**5.5**	**6.3**	**6.2**	**8.3**	**5.9**	**5.7**	**5.6**	**5.5**	**5.5**	**5.5**
Property income	2.0	2.7	2.7	4.7	2.7	2.6	2.5	2.5	2.5	2.5
o/w Interest income	1.4	1.4	1.1	1.3	1.2	1.2	1.1	1.1	1.1	1.1
Total expenditure	**45.7**	**45.5**	**44.2**	**46.0**	**43.8**	**42.8**	**41.6**	**41.3**	**41.1**	**40.7**
Current expense	**45.2**	**45.0**	**43.4**	**45.2**	**43.1**	**42.3**	**41.1**	**40.8**	**40.6**	**40.2**
Compensation of employees	13.5	13.7	13.7	13.8	13.6	13.7	13.7	13.7	13.7	13.7
Use of goods and services	11.8	11.8	11.6	11.5	11.1	11.0	10.9	10.9	10.8	10.8
Consumption of fixed capital	2.1	2.1	2.0	2.1	2.0	2.2	2.2	2.2	2.2	2.2
Interest	4.6	5.0	4.8	4.6	4.5	3.9	3.6	3.4	3.3	3.1
Subsidies	1.7	1.7	1.7	1.5	1.4	1.4	1.4	1.4	1.4	1.4
Grants	0.3	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Social benefits	8.1	7.5	7.1	7.3	7.0	6.9	6.9	6.9	6.9	6.9
Other expense	3.1	2.8	2.2	4.3	3.3	3.2	2.3	2.3	2.2	2.1
Nonfinancial assets	**0.6**	**0.5**	**0.8**	**0.8**	**0.7**	**0.5**	**0.5**	**0.5**	**0.5**	**0.5**
Nonfinancial assets, acquisition	2.6	2.6	2.8	2.9	2.7	2.7	2.7	2.7	2.7	2.7
Consumption of fixed capital (-)	-2.1	-2.1	-2.0	-2.1	-2.0	-2.2	-2.2	-2.2	-2.2	-2.2
Net lending/borrowing	**-5.6**	**-3.7**	**-1.7**	**1.8**	**0.1**	**0.1**	**1.2**	**0.6**	**0.7**	**0.8**
Financial assets, transactions	**3.6**	**-4.2**	**-2.6**	**2.1**	**-2.0**	**-1.2**	**0.4**	**0.3**	**0.3**	**-0.6**
Currency and deposits	11.3	-4.4	-2.8	1.9	-0.6	0.0	0.1	0.0	0.0	-0.9
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	-6.2	0.4	-0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Shares and other equities	0.1	0.3	1.9	0.0	-1.6	-1.6	0.0	0.0	0.0	0.0
Other accounts receivable	-1.6	-0.6	-1.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, transactions	**9.2**	**-0.5**	**-0.9**	**0.2**	**-2.1**	**-1.3**	**-0.8**	**-0.3**	**-0.4**	**-0.5**
Securities other than shares	3.6	2.5	-0.2	0.4	-2.1	1.7	-0.9	-0.3	-0.5	-0.3
Loans	5.3	-3.4	-1.0	-0.2	0.0	-3.0	0.1	0.0	0.1	-0.2
Domestic loans	0.7	-0.6	-0.3	0.0	0.0	0.0	0.1	0.0	0.1	-0.1
Foreign loans	4.7	-2.8	-0.7	-0.2	-0.1	-3.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.3	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Stock of debt										
General government gross debt	95.1	92.8	85.7	82.1	73.8	68.7	64.4	60.8	57.4	54.0
Domestic	68.1	68.1	64.9	60.9	55.3	53.8	50.2	47.2	44.5	41.8
Foreign currency	27.0	24.7	20.8	21.2	18.5	14.9	14.3	13.6	12.9	12.2
General government net debt 2/	61.7	64.0	62.8	58.3	52.5	48.4	45.1	42.4	39.9	37.4
Structural Balances										
Structural balance	-4.3	-2.5	-1.5	-0.8	-1.0	-0.2	0.2	0.6	0.7	0.8
Structural primary balance	-1.2	1.1	2.2	2.4	2.2	2.6	2.7	2.9	2.9	2.8
Memo Items										
Nominal GDP (ISK bn)	1,701	1,774	1,873	1,961	2,121	2,237	2,354	2,485	2,615	2,754
Primary revenue	38.7	40.3	41.4	46.5	42.6	41.7	41.7	40.7	40.7	40.4
Primary expenditure	41.2	40.4	39.4	41.4	39.3	38.9	38.0	37.9	37.8	37.6
Primary balance	-2.5	-0.1	2.0	5.1	3.3	2.8	3.7	2.8	2.9	2.8

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

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

2/ 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, 2012–14Q3

(Percent)

	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3	2013 Q4	2014 Q1	2014 Q2	2014 Q3
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
Regulatory Tier 1 capital to risk-weighted ass	19.2	20.9	21.1	22.6	23.1	23.6	23.3	24.0	23.1	25.0	25.1
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
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
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
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
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*
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 ca|	25.9	18.2	18.4	7.7	3.7	3.6	6.4	6.3	4.9	4.5	5.2
NPLs, facility level (over 90 days in default)	12.4	10.2	8.5	6.8	6.1	5.5	5.7	4.5	4.3	3.2	3.2
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	11.2	12.6	12.0	11.1
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
Corporate and household NPLs, cross-default (over 90 days in default or deemed	21.4	19.6	18.4	15.2	14.4	12.5	13.8	12.5	11.6	10.8	10.0
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
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
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

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 Est	2015 Proj	2016 Proj
Existing and prospective 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	73	172
Principal (repurchases)	0	0	0	0	888	0	275	66	171
Charges and interest	0	13	18	29	26	10	10	3	1
Stock of existing and prospective 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	14.7	5.5	5.1	2.1	1.4	0.0
In percent of exports of G&S	12	16	19	26	10	9	4	3	0
In percent of gross reserves	24	27	23	25	18	19	10	6	0
Obligations to the Fund from existing and prospective 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	9.9	0.1	2.6	0.6	1.4
In percent of exports of G&S	0.0	0.3	0.4	0.6	17.4	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	2.4	5.3

Source: IMF staff estimates and projections.

Annex I. Iceland Risk Assessment Matrix (RAM)

Risks	Relative Likelihood	Impact if Realized
1. Capital account liberalization missteps (domestic risk)	**Low-Medium** • Public pressure may lead to liberalization before necessary conditions are in place. • Old bank estates could fall into protracted litigation and uncertainty. • BOP pressures from potential residents' rebalancing and confidence shocks could be higher. • Inaction could lead to prolonged capital controls.	**Medium-High** • Disorderly lifting of controls could lead to: reserve losses and rapid depreciation of the króna, with knock-on effects on public and private sector debt (via currency mismatches and CPI indexation) and problems in the banking system; and higher uncertainty, which could undermine international market access and worsen borrowing prospects. • Litigation involving the old bank estates could bring reputational and legal risks and weaken Iceland's growth-enhancing external linkages. • Excessive delay in lifting controls could weaken growth and external prospects by discouraging FDI and innovation, encouraging rent seeking, inhibiting market access, and inflating asset prices.
Policy Response	• Shift strategy to be consistent with policy discussions, focusing on a conditions-based approach with supporting macroeconomic and financial sector policies. Actively pursue policies to establish the prerequisites for full liberalization of the capital account.	
2. Large wage hikes (domestic risk)	**Medium** • 2015 negotiations could be difficult following strikes and sectoral demands for large wage hikes.	**Medium** • Would put upward pressure on inflation and start eroding cost competitiveness.
Policy Response	• Increase interest rates to contain inflation. • Structural reforms to increase productivity and competition.	
3. Realization of public sector contingent liabilities (domestic risk)	**Medium** • Faster erosion of HFF's balance sheet following debt relief, and possibly legal challenges of CPI-indexation. • Litigation risks arising from one-off revenue measures aimed at the financial sector.	**Medium** • Government contingent liabilities could be partially realized, leading to higher debt and interest costs.
Policy Response	• Identify fiscal measures to further strengthen the budget to achieve balanced budget objective and gradually reduce debt. Use one-off revenues to reduce debt. Provide additional budget contingencies to address litigation risks.	
4. Protracted period of slower growth in advanced economies, particularly in Europe	**High** • Lower-than-anticipated potential growth and persistently low inflation from a failure to fully address crisis legacies, leading to secular stagnation and lower commodity prices.	**Medium** • Stagnation in advanced Europe (which accounts for 80 percent of Iceland's exports) could lead to a slowdown in Iceland's growth and deterioration in its trade balance. FDI from Europe could slow as well. • Imported disinflation would persist, and core inflation (excl. housing) could turn negative.
Policy Response	• Let exchange rate absorb the shock. • Tighten monetary policy to counter inflationary pressures from depreciation or lower rates if imported disinflation accelerates. • Speed up structural reforms to increase competitiveness.	

5. A surge in financial market volatility	**High** • Investors reassess underlying risk and move to safe-haven assets given slow and uneven growth as well as asymmetric monetary exit.	**Medium** • A sharp increase in global risk premia would worsen Iceland's access to external financing and complicate refinancing of large external repayments in 2016. • Higher interest rates and market segmentation would hinder the private-sector's (corporates and banks) newly re-gained access to international markets and hold back the needed shift to long-term financing.
Policy Response	• Further strengthen implementation of existing policy mix to support investor confidence.	

Annex II. Authorities' Responses to 2013 IMF Article IV Consultation Recommendations

IMF 2013 Article IV Recommendations	Authorities' Response
Fiscal Policy Adhere to Iceland's existing fiscal targets and improve the quality of the adjustment. Enact the proposed budget framework law. Any new household debt relief measures should be targeted on distressed households falling through the cracks of existing programs.	**Broadly Consistent** The 2014 surplus exceeded the government's balanced budget target, but relied on one-offs and nondurable measures (dividends, recap bond, bank levy). The 2015 budget enacted an important VAT reform, but further harmonization of rates is needed to reduce revenue mobilization inefficiencies, and greater specificity in planned current spending cuts is needed to achieve durable balanced budgets. The OBL has been submitted to parliament. Household debt relief aiming at across-the-board reductions in household mortgages is operational.
Monetary Policy Little change in the policy interest rate is needed to gradually bring inflation to target.	**Consistent** With inflation below target and real policy rates tightening (reflecting falling inflation and inflation expectations), the central bank lowered the nominal policy rate.
Capital Controls Handle winding up of old banks in a manner consistent with external and financial stability. Strengthen incentives to participate in capital account liberalization mechanisms by publishing a well-defined strategy with clear timeline. Impose speed limits on resident outflows.	**Broadly Consistent** There is broad agreement between staff and the authorities that liberalization should be conditions-, not time-based, aiming to maintain stability. The authorities are now updating their liberalization strategy which they expect to launch in the coming months.
Financial Sector Banks should continue to maintain strong capital and liquidity buffers. Plans to strengthen the financial safety net should be advanced and the proposed inter-agency framework for tackling systemic risks should be implemented. HFF should be reformed.	**Broadly Consistent** Banks are liquid and well-capitalized. The authorities are stepping up efforts to improve banking supervision. The Systemic Risk Committee, which supports the Financial Stability Council, has been established. The intergovernmental working group on housing finance proposed that HFF be put in a runoff mode, but will require a political decision.
Structural Consideration should be given to improving expenditure efficiency in health and education.	**Progress made** The Ministry of Education has published plans to shorten secondary education by 1 year to 3 years and improve student completion ratios and a health care reform plan was recently announced.

Annex III. Iceland: Debt Sustainability Analyses[1]

1. **External and public debt ratios 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-denominated BOP overhang and its release will significantly influence the path of debt.

A. External Debt Sustainability Analysis

2. **The following assumptions for the baseline external debt path are changed from the Fourth Post Program Monitoring staff report ('previous report')**:

- **Current account.** The medium-term path for the current account, excluding interest payments, is on average about 1.5 percentage points of GDP higher, mainly reflecting stronger trade balances and lower primary income deficits. The latter change is due to updates based on a recently completed comprehensive assessment of income generation by IIP assets and liabilities, which the authorities shared with staff.

- **Real GDP growth.** Real growth projections have been revised downwards for 2014, and 2017-2020, by about 0.6 percentage point per year on average. The average medium term GDP deflator growth has also been revised downwards about 2 percentage points. The exchange rate is also projected to be weaker over the forecast horizon in comparison to the previous report.

- **Debt-stabilizing current account.** As a result, the non-interest current account needed to stabilize the external-debt-to-GDP ratio is a smaller deficit of 0.5 percent of GDP compared to a deficit of 2.9 percent of GDP in the previous DSA.

- **Central government external borrowing.** Our rollover assumptions are unchanged from the previous report. However, unlike the previous report, we no longer assume capital controls will be lifted according to the 2011 published strategy, which will be updated in the coming months. In that respect, the government is no longer assumed to issue two long-term Eurobonds in 2014–15 to swap with short-term króna assets held by non-residents. However, this would have not affected total public debt position (only foreign exchange exposure) as it would have been just a debt swap. In addition, following the prepayment of IMF obligations through early October 2015 from reserves, we no longer assume that the Treasury will issue Eurobonds in the exact amount of CBI debt payments coming due.

- **Old banks estates.** Estimates of the three old banks' asset recoveries were updated through 2014 Q3 (as before, assets of old banks are not recorded as debt until they are recovered

[1] Prepared by Serpil Bouza and Jimmy McHugh.

into liquid form), leading to an slight downward adjustment in the external debt stock for end-2014. As for payments to foreign creditors, Landsbankinn and LBI reached an agreement in early December to amend the LBI bond and extend its maturity with final payment extended by 8 years until 2026. The WuB of LBI received exemptions from the government to make payments to its priority foreign creditors (UK Government and other holders of deposit claims), that will allow the British government for instance to recover 85 percent of its total claims from the collapse of Icesave (the other two WuBs have already paid all priority creditors). Landsbankinn is expected to refinance the payments in foreign credit markets. Apart from the LBI agreement, we now assume in our baseline scenario that capital controls are not lifted and no payouts to specific foreign creditors are made, unlike in the previous report, which assumed that in year 2017 capital controls could be gradually lifted where the timing of relaxing the controls and the pace of payouts to foreign creditors each year was dependent on adequate reserve position of the external sector. This new treatment is due to current uncertainty on what the new capital controls strategy will be. In addition, we no longer assume newly recovered foreign assets will be distributed to creditors immediately despite these being BOP neutral. These will rather be reflected as an increase in external debt stock. Hence, unlike the previous report, external debt related to old banks is rising over time reflecting the path of asset recovery and the lack of payment to foreign 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. Staff's estimate of the size of the BOP overhang has been revised down to about 70 percent of GDP, consisting of liquid offshore króna (16 percent), old banks estates (close to 30 percent, down from 44 percent) and resident overhang (25 percent). Resident overhang estimates includes portfolio rebalancing by pension funds and corporates, and could be much larger should household depositors also seek to exit whether for rebalancing reasons or for loss of confidence, or much lower if domestic investment opportunities are attractive and confidence is reinforced. The old banks' overhang is just a fraction of the estimated asset recovery of about 138 percent of GDP (before recent LBI payments). The difference is due to:

- roughly two-thirds of the old bank estate assets are held in overseas FX instruments that would have a broadly neutral BOP effect if paid out;
- about 6 percent (by value of assets) of old bank creditors are residents; and
- some old bank resident debtors, such as commercial banks holding old banks' FX deposits, are understood to be hedged, having offsetting FX assets overseas that the CBI estimates would be used to pay down obligations.

4. External debt is expected to decline substantially over the medium term but much slower than previously estimated. External debt is estimated at 257 percent at end-2013, and is expected to fall to around 207 percent by 2019 and 196 percent of GDP by 2020, about 54 percentage points of GDP higher in 2019 than previous DSA due to the assumption that capital controls will prevent payouts being made by the old banks to foreign creditors over the forecast horizon even though assets will continue to be recovered and become liquid adding to the stock of recovered debt. Another reason that the external debt ratio is higher is because we no longer assume that FX auctions will be held, starting in year 2015, that were being used as a channel to release the offshore liquid króna overhang (about 16 percent of GDP). Hence, the offshore liquid króna overhang is also not on a declining path in our baseline scenario where capital controls are in place. However, as noted above, our baseline treatment of the BOP overhang likely overstates the path of external debt. Once a revised capital account liberalization strategy is in place, we will adjust the BOP and external debt figures (and macro framework) accordingly.

5. 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 (Annex I, Figure 1). The historical scenario would put the external debt ratio on an upward trend because of the large capital outflows that occurred during the crisis and sizeable pre-crisis current account deficits. An orderly lifting of capital controls, however, would prevent such large capital outflows.

Annex III. Table 1. Iceland: External Debt Sustainability Framework, 2009–20

(In percent of GDP, unless otherwise indicated)

	Actual							Projections								
	2009	2010	2011	2012	2013			2014	2015	2016	2017	2018	2019	2020		Debt-stabilizing non-interest current account 7/
Baseline: External debt (including old banks) 1/	255.9	281.6	251.0	253.6	257.2			**223.5**	**226.1**	**216.5**	**207.3**	**209.1**	**207.3**	**195.6**		**-0.5**
Change in external debt	75.5	25.6	-30.5	2.6	3.6			-33.7	2.6	-9.7	-9.2	1.9	-1.9	-11.7	0.0	
Identified external debt-creating flows (4+8+9)	69.0	-28.3	-28.1	-19.1	-21.4			-8.8	-13.9	-12.6	-10.3	-9.1	-8.4	-8.4	0.0	
Current account deficit, excluding interest payments	0.2	-1.2	-6.2	-5.5	-11.4			-10.6	-11.4	-9.6	-8.9	-8.5	-8.0	-7.6	0.5	
Deficit in balance of goods and services	-8.9	-10.5	-8.2	-6.3	-8.3			-7.1	-8.1	-6.4	-5.8	-5.4	-5.0	-4.7		
Exports	49.7	53.5	56.1	56.7	55.7			54.5	55.2	55.4	55.8	55.9	56.4	56.9		
Imports	40.8	43.1	47.9	50.4	47.4			47.4	47.1	49.0	50.0	50.5	51.4	52.2		
Net non-debt creating capital inflows (negative)	15.6	-26.9	-6.9	-29.1	2.4			0.0	-0.5	-0.9	-0.6	-0.4	-0.5	-0.8	0.8	
Automatic debt dynamics 2/	53.1	-0.3	-14.9	15.5	-12.5			1.7	-2.0	-2.1	-0.7	-0.1	0.1	0.0	-1.3	
Contribution from nominal interest rate	9.7	7.6	10.4	9.7	5.8			5.8	5.3	4.9	4.9	5.3	5.4	5.2	9.1	
Contribution from real GDP growth	12.7	7.6	-5.4	-3.0	-8.1			-4.1	-7.3	-7.0	-5.6	-5.4	-5.3	-5.2	-4.9	
Contribution from price and exchange rate changes 3/	30.7	-15.4	-19.8	8.8	-10.2			...	...	...	...	...	...	...	-5.5	
Residual, incl. change in gross foreign assets (2-3) 4/	6.5	53.9	-2.5	21.7	25.0			-24.9	16.5	3.0	1.0	10.9	6.6	-3.3	0.0	
External debt-to-exports ratio (in percent)	515.1	526.0	447.3	447.2	461.6			410.2	409.4	390.6	371.5	374.2	367.5	343.9		
Gross external financing need (in billions of US dollars) 5/	6.5	9.4	14.0	16.4	12.5			17.1	10.9	20.0	18.2	18.6	19.5	21.6		
in percent of GDP	50.6	70.9	95.1	115.3	81.5	10-Year	10-Year	102.5	61.3	108.8	94.3	91.5	91.2	95.6		
Scenario with key variables at their historical averages 6/								**223.5**	**253.0**	**261.6**	**272.6**	**295.0**	**312.2**	**320.3**		**2.0**
						Historical	Standard								For debt	
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation								stabilization	
								2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**		
Real GDP growth (in percent)	-5.1	-3.1	2.1	1.1	3.5	2.8	4.6	1.8	3.5	3.2	2.7	2.7	2.6	2.6	2.6	
GDP deflator in US dollars (change in percent)	-23.2	6.7	8.3	-4.4	4.5	1.2	13.4	7.0	3.1	0.0	2.1	2.6	2.3	2.9	2.9	
Nominal external interest rate (in percent) 8/	3.9	3.1	4.1	3.7	2.5	3.5	0.8	2.5	2.6	2.3	2.4	2.7	2.7	2.6	4.9 8/	
Underlying external interest rate (in percent)	.	3.4	5.3	4.6	3.4	4.2		3.6	4.0	4.2	4.5	5.0	5.0	4.9		
Growth of exports (US dollar terms, in percent)	-12.1	11.4	15.9	-2.3	6.2	9.3	13.0	6.5	8.1	3.5	5.5	5.6	6.0	6.5		
Growth of imports (US dollar terms, in percent)	-31.4	9.2	22.9	1.9	1.6	7.9	20.2	9.0	6.0	7.4	6.9	6.3	6.9	7.4		
Current account balance, excluding interest payments	-0.2	1.2	6.2	5.5	11.4	-3.3	9.8	10.6	11.4	9.6	8.9	8.5	8.0	7.6		
Net non-debt creating capital inflows	-15.6	26.9	6.9	29.1	-2.4	-3.6	26.5	0.0	0.5	0.9	0.6	0.4	0.5	0.8		

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

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

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

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

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

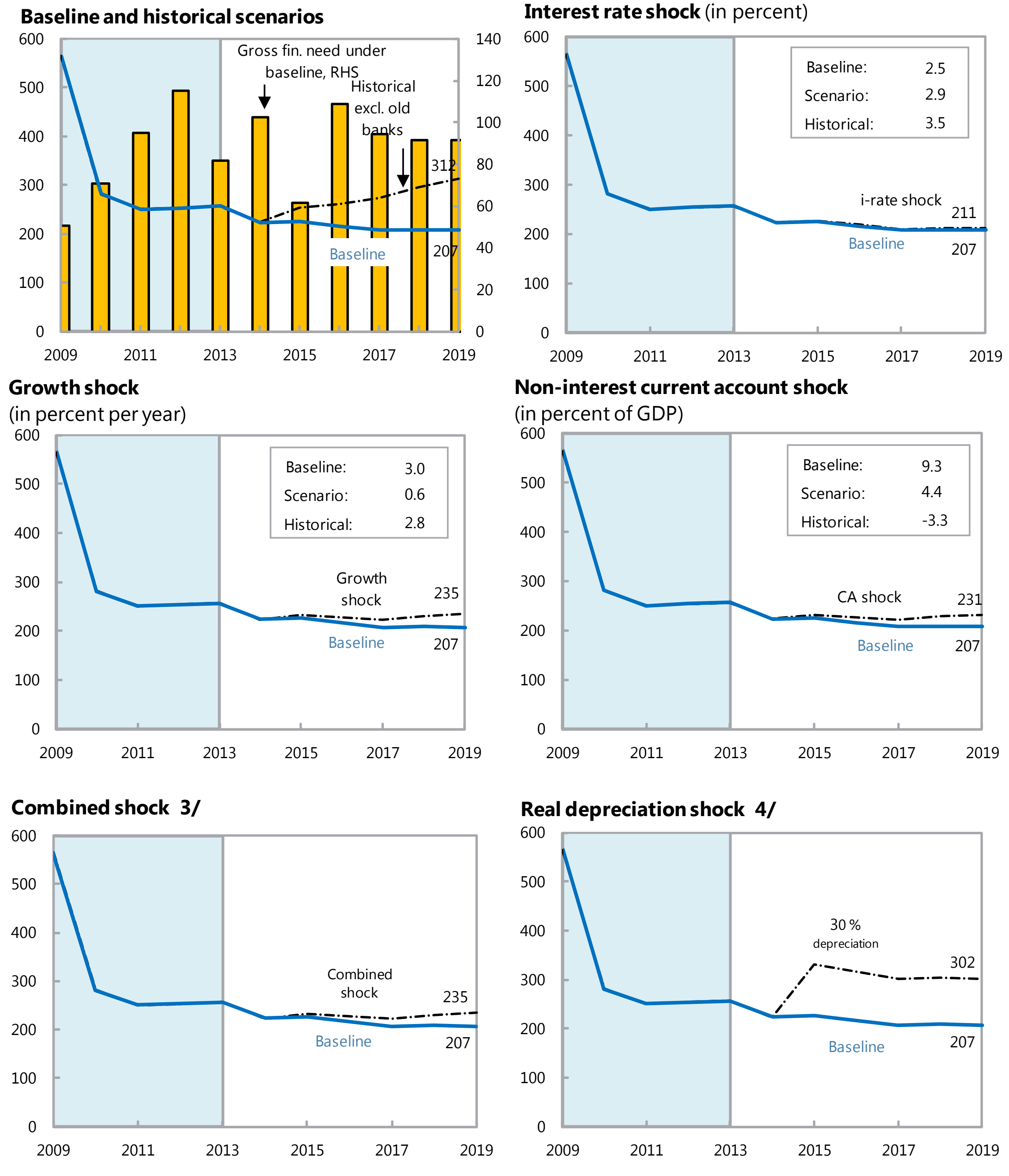
6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

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

Annex III. 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

Since the last review in early July 2014, Iceland's debt sustainability has improved slightly. In July, the authorities issued a €750 million Eurobond with a 2.5 percent coupon. The proceeds of this bond were used to pay off higher cost external debt, thus reducing debt servicing requirements over the medium term. The Ministry of Finance has also reached an agreement with the Central Bank of Iceland (CBI) to restructure a CBI recapitalization bond, which has also helped reduce repayment vulnerabilities. Furthermore, the stock of outstanding government guarantees fell by two percentage points of GDP.

Nevertheless, the general government debt ratio (debt-to-GDP) is high albeit on a downward trajectory over the medium term. Gross financing needs are manageable given the relatively long maturities and the limited stock of short-term debt. Iceland has also accumulated a large stock of assets, which means that the net debt ratio is some 24 percentage points lower than gross debt, helping to ameliorate debt sustainability risks.

The assessment from stress tests is broadly unchanged from the last review. The downward trajectory 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. The outstanding stock of state guarantees is 62 percent of GDP. These guarantees are concentrated in two large state owned enterprises and pose significant fiscal risks.

1. **Iceland's public debt increased sharply as a consequence of the financial crisis 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 just 28.5 percent in 2007. Nevertheless, Iceland has made significant progress towards reducing debt vulnerability. Since the peak year of 2011, the general government gross debt ratio has fallen by around 14 percentage points of GDP.

2. **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 distressed 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. The external general government debt stock owed to Nordic governments has been repaid from the proceeds of the Eurobond issued in July 2014. These debts were accumulated during the crisis when Nordic partners offered bilateral financial support for FX reserve purposes.

3. 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 58.3 percent of GDP.

4. 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.** Around three quarters of general government debt is denominated in local currency with the remainder issued in U.S. dollars and Euros, along with negligible amounts in Sterling.

- **Fixed versus floating interest rate.** About 85 percent of the debt stock was issued using fixed interest rates.

- **Duration.** The weighted average time to maturity on central government debt is 7.3 years. The time to maturity on foreign currency debt is lower at 4.7 years.

- **Ownership.** Ownership of Icelandic debt is concentrated in local banks and pension funds.

5. 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 2014, 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. 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 though 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. Furthermore, the Icelandic authorities estimate that there is around 24 percent of GDP in unfunded pension liabilities, which are recorded separately from the gross public debt stock.[4]

Baseline and Realism of Projections

6. 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 2014 Economic Program and the 2015 budget, the authorities will target a general government balance of close to zero over the medium term. This implies primary surpluses in the range of 2.8 to 3.3 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, which is defined as a net debt[5] to GDP ratio of 45 percent. This objective is 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. Finally, the scenario has taken into account the government's planned asset sales in 2015–16 of about 3½ percent of GDP, with the resources eventually used to reduce the debt stock.

- **Macroeconomic assumptions.** Real GDP growth will be relatively robust within the range of 2.5 to 3.2 percent over the medium term, while inflation (GDP deflator) will be contained below 5 percent.

- **Realism of baseline assumption** 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

[4] These liabilities are recorded as Insurance and Technical Reserves in the GFSM2001 presentation of general government assets and liabilities.

[5] Net debt is defined is defined as Gross General Government Liabilities, excluding insurance technical reserves and other accounts payable, minus currency and deposits held by the general government, as reported in the Government Financial Statistics.

projections were overly pessimistic before the crisis and too optimistic during the crisis, but again forecast accuracy has improved in recent years.

7. **The baseline envisages a gradual reduction in the general government gross debt ratio to around 54 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.

8. **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 (Annex I, Figure 2). 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. A large external bond will come due in 2016. The authorities' current repayment plan is to roll over 50 percent of the amortized amount and repay the remainder from government deposits. A second large bond—denominated in domestic currency—will amortize in 2018. 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

9. **The DSA baseline indicates that Iceland will continue to make further substantial 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. Based on an asymmetric restriction of the shocks (Annex 1 Figure 2), the debt ratio peaks at around 100 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. However, the debt ratio in 2020 is 10 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 a 25 percent real exchange rate devaluation in 2014. The shock results in a small increase in the debt ratio due to the large share of domestically denominated debt.

- **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 then resumes a downward trajectory but with an only limited reduction in the level of debt by the end of the projection period. Gross financing needs would be significant, rising to almost 20 percent of GDP in 2016 and 2018.

- **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 19 percentage points higher than in the baseline.

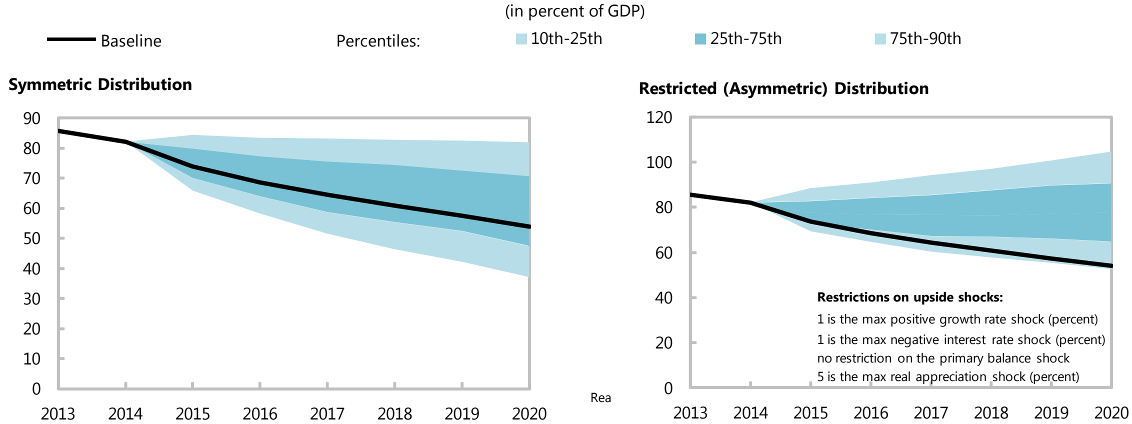
Annex III. Figure 2. Iceland: Public DSA—Risk Assessment

Heat Map

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

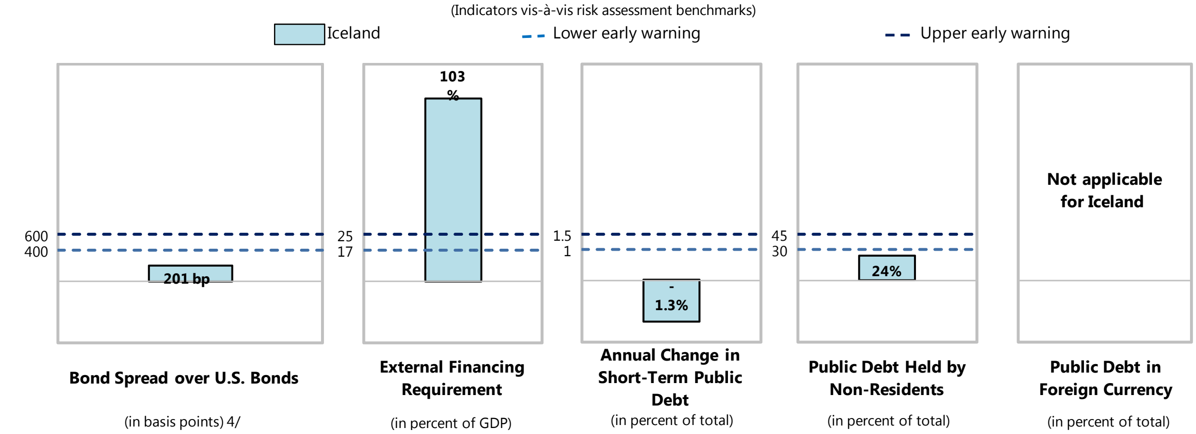
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



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.

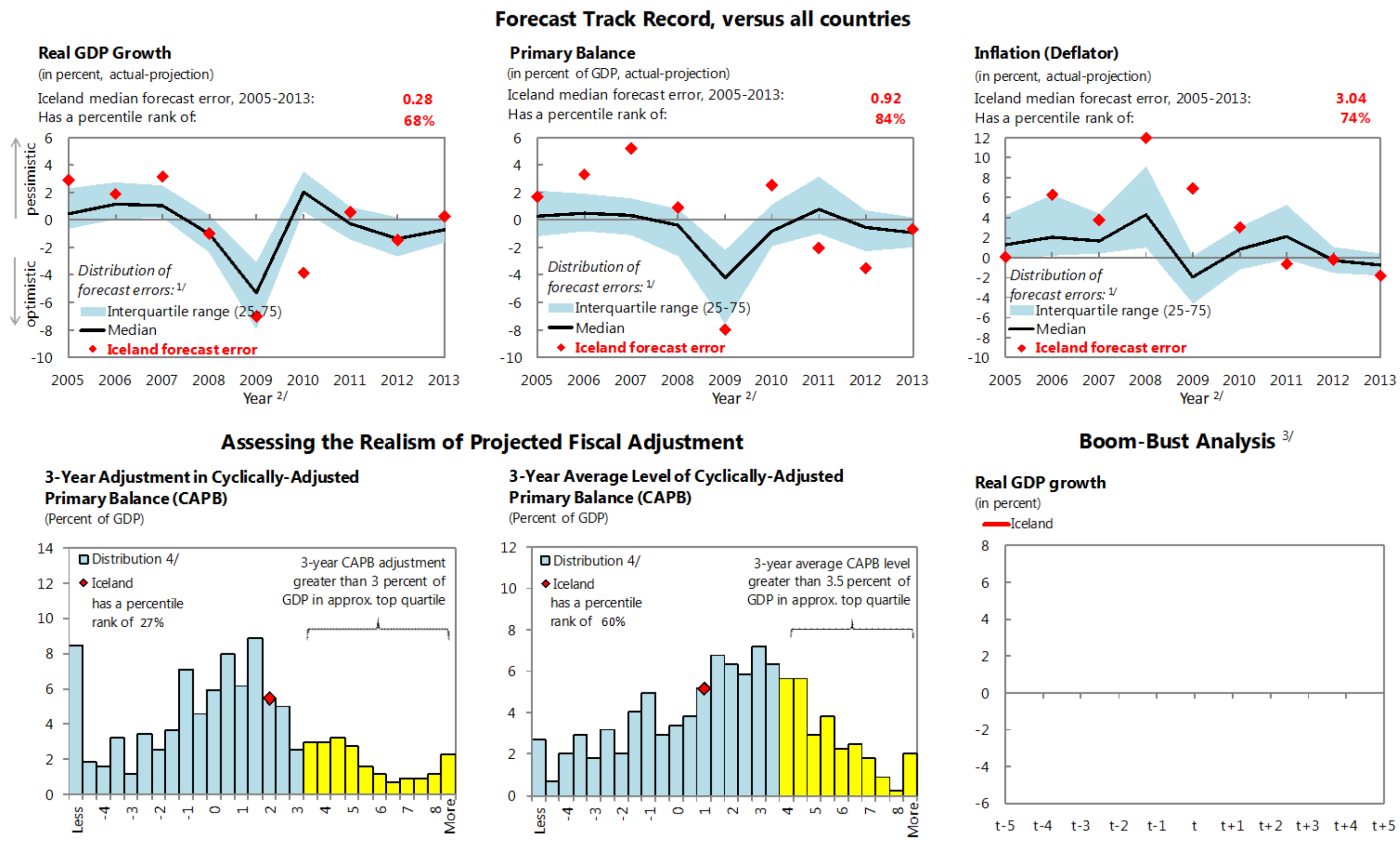
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, 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. Figure 3. Iceland: Public DSA–Realism of Baseline Assumptions



Source : IMF Staff.

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

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

3/ Not applicable for Iceland.

4/ Data cover annual 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 III. Figure 4. Iceland: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

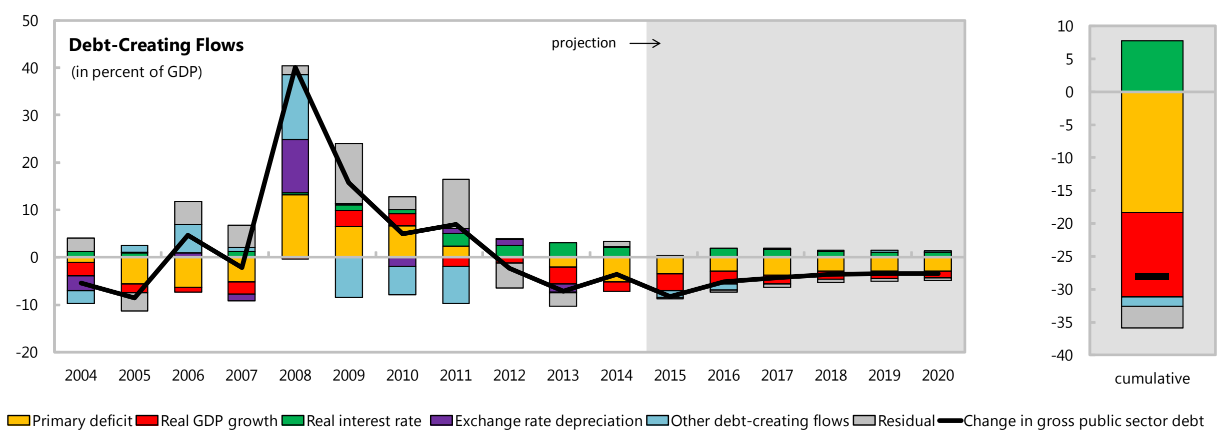
Debt, Economic and Market Indicators [1/]

	Actual		Projections					
	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	85.7	82.1	73.8	68.7	64.4	60.8	57.4	54.0
Public gross financing needs	8.2	8.9	3.2	9.6	0.4	10.1	2.8	8.6
State guarantees	70	62						
Real GDP growth (in percent)	3.5	1.8	3.5	3.2	2.7	2.7	2.6	2.6
Inflation (GDP deflator, in percent)	2.1	2.9	4.5	2.2	2.5	2.7	2.5	2.6
Nominal GDP growth (in percent)	5.6	4.7	8.1	5.4	5.3	5.6	5.2	5.3
Effective interest rate (in percent) [4/]	5.5	5.6	5.2	5.2	5.1	4.9	4.7	4.7

As of February 06, 2015		
Sovereign Spreads		
Spread (bp) 3/		183
CDS (bp)		163
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB-	BBB-
Fitch	BBB	BBB+

Contribution to Changes in Public Debt

	Actual		Projections							
	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-7.1	-3.6	-8.3	-5.1	-4.3	-3.6	-3.4	-3.4	-28.1	
Identified debt-creating flows	-4.2	-4.7	-7.4	-4.5	-3.4	-2.9	-2.9	-2.9	-24.0	
Primary deficit	-2.0	-5.1	-3.3	-2.8	-3.7	-2.8	-2.9	-2.8	-18.3	-0.1
Primary (noninterest) revenue and grants	41.4	46.5	42.7	41.7	41.7	40.7	40.7	40.4	248.0	
Primary (noninterest) expenditure	39.4	41.4	39.3	38.9	38.0	37.9	37.8	37.6	229.6	
Automatic debt dynamics [5/]	-2.1	0.2	-2.8	-0.4	-0.1	-0.4	-0.3	-0.4	-4.3	
Interest rate/growth differential [6/]	-0.4	0.2	-3.2	-0.7	-0.1	-0.4	-0.3	-0.3	-5.0	
Of which: real interest rate	3.2	2.2	0.4	2.1	1.7	1.3	1.2	1.1	7.8	
Of which: real GDP growth	-3.5	-1.9	-3.6	-2.7	-1.8	-1.7	-1.5	-1.4	-12.8	
Exchange rate depreciation [7/]	-1.7	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.1	0.1	-1.3	-1.3	0.3	0.3	0.3	0.3	-1.4	
General government net privatization proceeds (negative)	0.0	-0.1	-1.6	-1.6	0.0	0.0	0.0	0.0	-3.2	
Net lending for policy purposes	-0.1	0.2	0.3	0.3	0.3	0.3	0.3	0.3	1.8	
Residual, including asset changes [8/ 10/]	-2.9	1.1	-0.9	-0.6	-0.9	-0.7	-0.5	-0.5	-4.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

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

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

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

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

8/ For projections, this line includes exchange rate changes during the projection period.

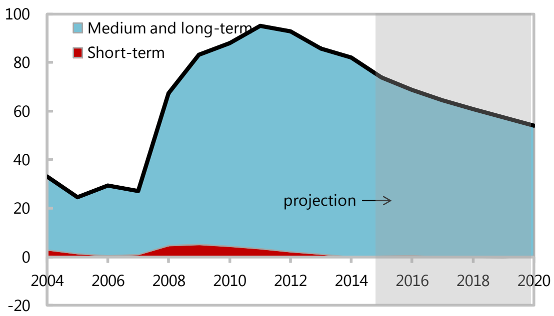
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

10/ The 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.

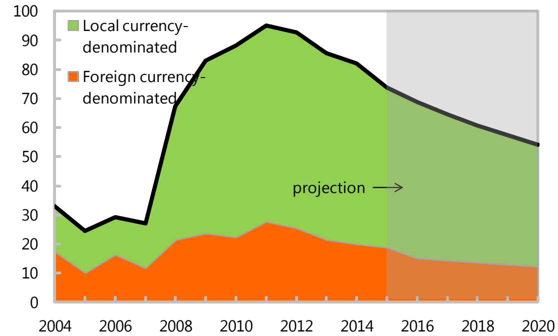
Annex III. Figure 5. Iceland: Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



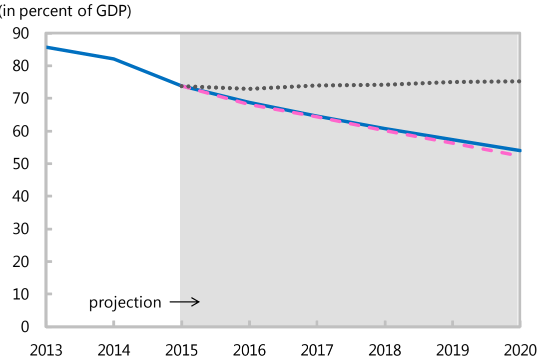
By Currency
(in percent of GDP)



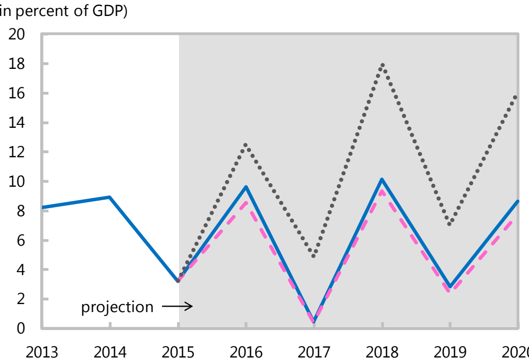
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	3.5	3.2	2.7	2.7	2.6	2.6
Inflation	4.5	2.2	2.5	2.7	2.5	2.6
Primary Balance	3.3	2.8	3.7	2.8	2.9	2.8
Effective interest rate	5.2	5.2	5.1	4.9	4.7	4.7
Constant Primary Balance Scenario						
Real GDP growth	3.5	3.2	2.7	2.7	2.6	2.6
Inflation	4.5	2.2	2.5	2.7	2.5	2.6
Primary Balance	3.3	3.3	3.3	3.3	3.3	3.3
Effective interest rate	5.2	5.2	5.1	4.9	4.7	4.7

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	3.5	2.1	2.1	2.1	2.1	2.1
Inflation	4.5	2.2	2.5	2.7	2.5	2.6
Primary Balance	3.3	-0.5	-0.5	-0.5	-0.5	-0.5
Effective interest rate	5.2	5.2	5.0	4.7	4.2	4.0

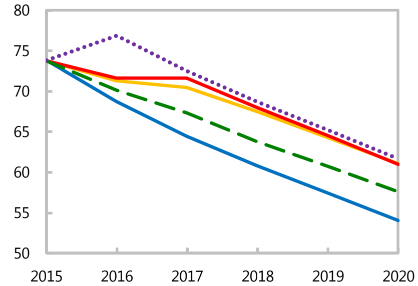
Source: IMF staff.

Annex III. Figure 6. Iceland: Public DSA—Stress Tests

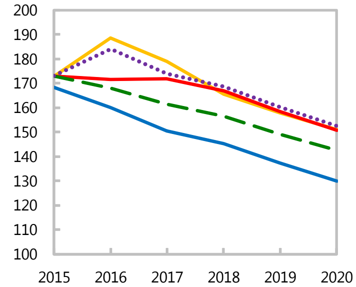
Macro-Fiscal Stress Tests

Baseline
Real GDP Growth Shock
Primary Balance Shock
Real Exchange Rate Shock
Real Interest Rate Shock

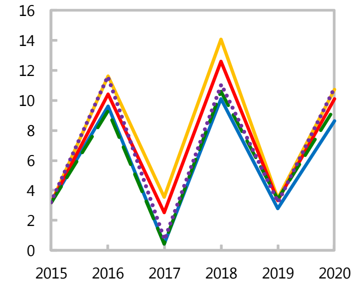
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



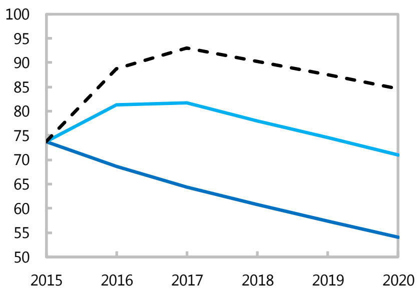
Public Gross Financing Needs
(in percent of GDP)



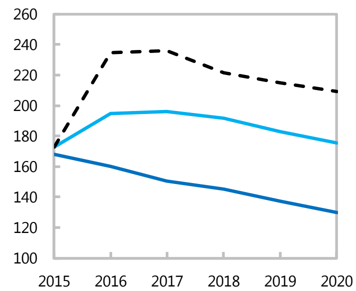
Additional Stress Tests

Baseline
Combined Macro-Fiscal Shock
Contingent Liability Shock

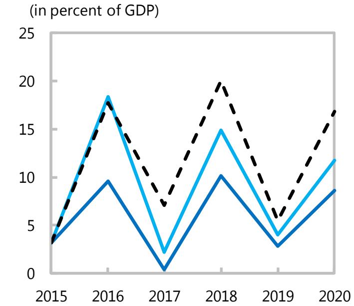
Gross Nominal Public Debt
(in percent of GDP)



Gross Nominal Public Debt
(in percent of Revenue)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

	2015	2016	2017	2018	2019	2020
Primary Balance Shock						
Real GDP growth	3.5	2.2	2.7	2.7	2.6	2.6
Inflation	4.5	2.2	2.5	2.7	2.5	2.6
Primary balance	3.3	0.9	1.4	2.8	2.9	2.8
Effective interest rate	5.2	5.2	5.7	5.6	4.9	4.8
Real Interest Rate Shock						
Real GDP growth	3.5	1.2	0.7	2.7	2.6	2.6
Inflation	4.5	2.2	2.5	2.7	2.5	2.6
Primary balance	3.3	2.8	3.7	2.8	2.9	2.8
Effective interest rate	5.2	5.2	5.3	5.1	5.2	5.2
Combined Shock						
Real GDP growth	3.5	-6.8	0.6	2.7	2.6	2.6
Inflation	4.5	1.6	2.0	2.7	2.5	2.6
Primary balance	3.3	-2.1	-0.7	2.8	2.9	2.8
Effective interest rate	5.2	5.6	5.6	5.7	5.2	5.0

	2015	2016	2017	2018	2019	2020
Real GDP Growth Shock						
Real GDP growth	3.5	1.1	0.6	2.7	2.6	2.6
Inflation	4.5	1.6	2.0	2.7	2.5	2.6
Primary balance	3.3	1.8	1.7	2.8	2.9	2.8
Effective interest rate	5.2	5.2	5.1	4.8	4.5	4.5
Real Exchange Rate Shock						
Real GDP growth	3.5	-6.8	2.7	2.7	2.6	2.6
Inflation	4.5	10.5	2.5	2.7	2.5	2.6
Primary balance	3.3	2.8	3.7	2.8	2.9	2.8
Effective interest rate	5.2	5.6	4.9	4.7	4.5	4.4
Contingent Liability Shock						
Real GDP growth	3.5	-1.0	-1.5	2.7	2.6	2.6
Inflation	4.5	1.1	1.4	2.7	2.5	2.6
Primary balance	3.3	-5.7	3.7	2.8	2.9	2.8
Effective interest rate	5.2	5.4	5.1	4.8	4.5	4.4

Source: IMF staff.

INTERNATIONAL MONETARY FUND

ICELAND

February 20, 2015

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION AND FIFTH POST-PROGRAM MONITORING DISCUSSIONS—INFORMATIONAL ANNEX

Prepared By

The European Department
(in consultation with other departments)

CONTENTS

FUND RELATIONS

(As of January 31, 2015)

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

General Resources Account:

	SDR Million	Percent Quota
Quota	117.60	100.00
Fund holdings of currency		
(Exchange Rate)	335.73	285.48
Reserve Tranche Position	18.75	15.95

SDR Department:

	SDR Millions	Percent Allocation
Net cumulative allocations	112.18	100.00
Holdings	5.52	4.92

Outstanding Purchases and Loans:

	SDR Million	Percent Quota
Stand-by Arrangements	236.88	201.42

Latest Financial Arrangements:

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

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

	Forthcoming				
	2015	2016	2017	2018	2019
Principal	66.25	170.63			
Charges/Interest	3.49	1.04	0.05	0.05	0.05
Total	69.74	171.67	0.05	0.05	0.05

Implementation of HIPC Initiative: Not applicable.

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

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

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

Exchange Rate Arrangements: The Icelandic króna is floating effective October 2008. Iceland accepted the obligations under Article VIII, Sections 2(a), 3, and 4 but maintains exchange restrictions arising from limitations imposed on the conversion and transfer of (i) interest on bonds (whose transfer the FX rules apportion depending on the period of the holding), (ii) the principal payments from holdings of amortizing bonds, and (iii) payments on the indexation of principal from holdings of amortizing bonds. The retention of the three exchange restrictions was first approved by the Executive Board on April 6, 2012 (Decision No. 15133-(12/35)) and subsequently extended in March 2013 (Decision No. 15335-(13/25) and further in March, 2014 until March 6, 2015 (Decision No. 15552-(14/22). In addition, Iceland has in place measures that constitute exchange restrictions imposed for security reasons related to financial transactions based on UN Security Council Resolutions. The de jure exchange rate arrangement is free floating and the de facto exchange rate arrangement is classified as floating. Since the króna followed an appreciating trend within a 2 percent band against the euro in 2014, the de facto exchange rate arrangement is currently under review for possible revision to crawl-like as of January 2014.

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

Last Article IV Consultation: Discussions for the 2013 Article IV Consultation were held in Reykjavik during June 4-14, 2013. The Staff Report (country report No. 13/256) was considered by the Executive Board on August 1, 2013. Article IV consultations with Iceland are currently held on a 12-month cycle.

ROSC: A Basel Core Principles for Effective Banking Supervision (BCP) ROSC was published in August 2014.

Technical Assistance:

Department	Purpose	Date
MCM	Capital account liberalization	March 2010
MCM	Reserves building and liquidity management	June 2010
MCM	Public debt management	July 2010
FAD	Fiscal framework issues	August 2010
MCM	Capital Control Liberalization	November 2010
MCM	Liquidity management	March 2011
FAD	Tax policy	March 2011
STA	External Sector Statistics	April 2011
FAD	Organic Budget Law	October 2011
FAD	Follow up on Organic Budget Law	May 2012
FAD	IPSAS in Iceland: Towards Enhanced Fiscal Transparency	December 2013
FAD	VAT reform	March 2014

STATISTICAL ISSUES

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

Data on a wide range of economic and financial variables are provided to the Fund in a timely manner during and between consultations. In addition to periodic press releases, statistical information is disseminated to the public through a range of monthly, quarterly, and annual publications by three main institutions (The Central Bank of Iceland (CBI), the Ministry of Finance, and Statistics Iceland), and is available on their internet sites. Provision of electronic data in English has improved substantially in recent years, especially from Statistics Iceland.

The existing methodological framework for producing national accounts data was replaced in September 2014 with the new European System of Accounts (ESA 2010). Statistics Iceland (SI) published revisions of national accounts calculated backwards to 1997. Alongside the implementation of ESA 2010, additional new statistics standards, improved benchmarks and sources of data have been introduced. The main methodological changes which were introduced are:

- Recognition that expenditure on ***research and development (R&D) has the nature of investment***. Research and development expenditure is recorded as gross fixed capital formation and no longer as current expenditure. This increased the level of yearly GDP by 1.4 percent on average. The impact on gross fixed capital formation is a level raise by 7.5 -17.3 percent per year.

- Thorough revision of the methodology for calculating ***financial intermediation services indirectly measured (FISIM)***. According to Chapter 14 of ESA 2010 FISIM are calculated as the the difference between the loan rates and reference rates, or reference rates and the deposit rates, multiplied by the corresponding stock of loans or deposits. SI defined the reference rates as the weighted average of monthly loans and deposit rates for each type of loan. In volume terms, FISIM are calculated based on the CPI published by SI in regard to the general price index for resident non-indexed and inflation-indexed loans and deposits. The narrow trade index and OECD World CPI are used for currency-linked and foreign currency loans and deposits as is used for foreign private consumption. Due to the different methodology as well as improved sources of data, there is a drastic change in the FISIM data during the boom-bust years (2006-09), especially in relation to private consumption and exports.

- ***A new standard for foreign trade statistics*** which resulted in transfer between trade in goods to trade in services was introduced.

- Measures of ***illegal activities*** were added to the household final consumption statistics increasing the GDP by less than 0.5%.

- Other minor methodological changes affected the investment, public consumption, and private consumption accounts, and also resulted in a marginal increase of about 0.5% to 1% of GDP over the revision period.

In December 2014, the authorities (CBI) raised an issue about the quality and interpretation of Statistics Iceland's Q3 data, particularly on domestic demand and inventories. The mission and CBI discussed the issue with Statistics Iceland, which resulted in the conclusion that the difficulties with dealing with Iceland's national accounts data stem mainly from high seasonality and volatility of the quarterly data. This data pattern particularly affects inventories, but also consumption and deflators in a given quarter. Looking into and adopting best practices from the countries with similar data patterns are advisable to better adjust for volatility in the quarterly data.

The authorities publish a Treasury cash flow statement on a monthly basis, quarterly data on the general government operations, and annual data on the general government operations and financial assets and liabilities.

Iceland reports government finance statistics in accordance with the GFSM 2001 framework in the GFS Yearbook, and is an up-to-date contributor to the International Financial Statistics (IFS). Fiscal data was revised in autumn 2014 to reflect changes in treatment of capital expenditure and research and development. The 2014 preliminary accounts reflect a number of one-off items related to revenues generated by the financial sector. The accounting treatment of these items will be revisited when the final GFS accounts are finalized during 2015.

In September 2014, the CBI concluded the migration of the balance of payments (BOP) and International Investment Position (IIP) to the 6^{th} edition of the Balance of Payments Manual (BPM6), and published for the first time BOP statistics (Q2 2014) using the new standards. The new standards take the place of the 5^{th} edition, implemented in Iceland since 1996. The changes will affect foreign direct investment, external trade in goods and services, and insurance, pension, and standardized guarantee schemes that will be included with financial assets and liabilities. In addition to better reflecting Iceland's external trade and IIP positions, the migration to BPM6 ensured compliance to most recent standards, as well as greater consistency with other statistical reporting standards, such as the System of National Accounts. It also improved overall transparency, presentation, and comparability with other countries.

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

Iceland: Table of Common Indicators Required for Surveillance

(As of February 13, 2015)

	Date of latest observation	Date received	Freq. of Data	Freq. of Reporting	Freq. of publication	Memo Items: Data Quality – Methodological soundness	Data Quality – Accuracy and reliability
Exchange Rates	Feb. 13, 15	Feb. 13, 15	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities	Nov. 31, 14	Dec. 5, 14	M	M	M		
Reserve/Base Money	Nov. 31, 14	Dec. 5, 14	M	M	M	LO, O, LO, LO	LO, O, O, O, O
Broad Money	Nov.31, 14	Dec. 5, 14	M	M	M		
Central Bank Balance Sheet	Nov.31, 14	Dec. 5, 14	M	M	M		
Consolidated Balance Sheet of the Banking System	Nov.31, 14	Dec. 5, 14	M	M	M		
Interest Rates	Feb. 13, 15	Feb. 13, 15	D	D	D		
Consumer Price Index	Jan. 2015	Jan. 29, 15	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing – General Government	Q3, 2014	Jan. 2015	Q	Q	Q	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing– Central Government	Nov. 2014	Jan. 2015	M and Q	M and Q	M and Q		
Stocks of Central Government and Central Government-Guaranteed Debt	Dec. 2014	Jan. 2015	M	M	M		
External Current Account Balance	Q3, 2014	Dec. 2, 14	Q	Q	Q	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	Q3, 2014	Dec. 2, 14	Q	Q	Q		
GDP/GNP	Q3, 2014	Dec. 2, 14	Q	Q	Q	O, LO, O, LO	LO, O, LO, LO, O
Gross External Debt	Q3, 2014	Dec. 2, 14	Q	Q	Q		

Press Release No. 15/114
FOR IMMEDIATE RELEASE
March, 13, 2015

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

IMF Executive Board Concludes 2014 Article IV Consultation and Fifth Post-Program Monitoring Discussion with Iceland

On March 9, 2015 the Executive Board of the International Monetary Fund (IMF) concluded the 2014 Article IV consultation[1] and Fifth Post-Program Monitoring Discussion with Iceland[2].

Iceland has reached a relatively strong macroeconomic position with good growth prospects. Unemployment continues to trend down, now at 4 percent. Growth slowed last year but is expected to pick up to around 3 percent over 2015–17, supported by robust domestic demand and tourism. Consumption will be boosted by household debt relief and—together with net trade—will benefit from favorable commodity prices.

Against this positive economic backdrop, vulnerabilities remain and risks are tilted to the downside. Crisis legacies are still being unwound, including a large balance of payments (BOP) overhang contained by capital controls. The authorities expect significant progress this year in finalizing and implementing an updated capital account liberalization strategy. The current account balance is forecast at around 6 percent of GDP this year—boosted by falling oil prices—and is expected to gradually decline over the medium term to 2 percent of GDP.

Inflation has fallen to 0.8 percent—well below the 2.5 percent target—pulled down by imported deflation and a stronger exchange rate. However, real wages accelerated to almost 6 percent, and the outcome of 2015 wage negotiations is highly uncertain. Inflation is expected to move closer to the target by the end of 2016. The Central Bank of Iceland (CBI) paused in February and continued foreign exchange accumulation. The CBI legislative framework review is currently in progress.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] 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.

The general government recorded a surplus of 1.8 percent of GDP last year—its first surplus in seven years—helped by one-off revenues. The fiscal stance, measured by the change in the structural primary balance, tightened 0.2 percent of potential GDP in 2014 and is projected to tighten further by about 0.5 percent of GDP over the medium term. Household debt relief became operational, and more frontloaded to 2014, though the overall costs are broadly as expected. General government gross debt remains high but on a downward sustainable path. The draft budget framework bill now before Parliament—when approved—will strengthen Iceland's fiscal framework. The government has begun an important reform of the VAT system.

Good progress has been made in improving the financial stability framework, but gaps remain. Banking sector buffers are strong but uncertainties surrounding the unwinding of crisis legacies and legal risks, including challenges to CPI indexation, remain high. The CBI and the Financial Supervisory Authority (FME) are making progress in improving macrofinancial and supervisory stress tests, but gaps remain in bank supervision and financial safety nets. The authorities are working on permanent solutions for the loss-making government-owned Housing Financing Fund (HFF) and are developing mechanisms for a successor lender.

Executive Board Assessment[3]

Executive Directors welcomed the improving economic conditions and progress in addressing crisis legacies. Directors noted that with sound policies, the outlook is for sustained growth, price stability, and declining debt ratios. However, downside risks remain, including from lower global growth, wage pressures, and uncertainty surrounding capital account liberalization. It would therefore be important to maintain macroeconomic and financial stability, while enhancing growth, rebuilding confidence, and preparing for the eventual removal of capital controls.

Directors agreed that the strategy for liberalizing the capital account should remain conditions-based, be well communicated, and benefit from the support of sound macroeconomic and financial sector policies. In this context, they recommended that greater focus be placed on policies to strengthen Iceland's balance of payments and on structural reforms to boost labor productivity and competitiveness.

Directors agreed that the monetary policy stance appropriately focuses on price stability. They encouraged the central bank to remain vigilant and stand ready to respond to opposing pressures from external deflationary developments and potentially large wage increases. Directors supported ongoing efforts to accumulate foreign currency reserves to smooth eventual outflows,

[3] 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

as conditions permit. They stressed the importance of maintaining an independent and accountable central bank, and looked forward to the outcome of the review of legislation in this area.

Directors welcomed progress in consolidating public finances and the early repayment to the Fund. They saw merit in developing contingency measures to achieve the 2015 fiscal targets. Directors supported the medium-term objectives of pursuing a balanced budget and further reducing public indebtedness. They noted that, with Iceland on track to achieve core objectives, fiscal policy is well positioned for a transition toward boosting potential growth, particularly through public investment, while being mindful of the distributional consequences of any reforms. Directors underscored the importance of adopting the organic budget law to provide an institutional anchor for fiscal policy, thus reinforcing market confidence ahead of capital account liberalization. Improving the efficiency of the tax system also remains a priority.

Directors emphasized the need to maintain adequate buffers in the core financial sector in light of risks surrounding the unwinding of capital controls and some legal challenges. They recommended that the authorities continue to improve the financial stability framework, including supervision, deposit insurance, bank resolution, and emergency liquidity assistance. Directors called for a swift resolution of the Housing Financing Fund to minimize fiscal costs and financial stability risks.

Iceland: Selected Economic Indicators, 2011–16

	2011	2012	2013	2014 Est	2015 Proj	2016 Proj
	(Percentage change, unless otherwise indicated)					
National Accounts (constant prices)						
Gross domestic product	2.1	1.1	3.5	1.8	3.5	3.2
Total domestic demand	3.0	1.2	0.9	3.1	4.4	4.5
Private consumption	2.5	2.0	0.8	3.2	3.4	3.0
Public consumption	0.2	-1.2	0.8	1.0	1.6	1.6
Gross fixed investment	11.6	4.3	-2.2	13.4	13.2	14.1
Exports of goods and services	3.4	3.9	6.9	4.3	4.6	3.4
Imports of goods and services	6.8	4.9	0.4	9.4	7.7	7.0
Output gap 1/	-1.3	-1.0	-0.6	-1.2	-0.4	0.0
Selected Indicators						
Nominal GDP (ISK bn)	1,701	1,774	1,873	1,961	2,121	2,237
Private consumption (percent of GDP)	51.7	53.4	52.7	52.9	51.0	50.8
Public consumption (percent of GDP)	24.4	24.4	24.3	24.2	23.8	24.0
Gross fixed investment (percent of GDP)	15.5	16.0	15.1	16.4	17.2	18.8
Unemployment rate (period average) 2/	7.1	6.0	5.4	5.0	4.0	4.0
Employment	0.0	0.5	3.7	1.9	2.9	2.2
Real GDP per capita (ISK mln)	3.6	3.6	3.7	3.8	3.9	4.0
Consumer price index (period average)	4.0	5.2	3.9	2.0	0.9	2.1
Consumer price index (end of period)	5.3	4.2	4.2	0.8	0.8	2.3
Nominal wage index	7.0	7.9	3.5	5.5	6.7	5.1
Real wage	2.3	2.6	-0.3	3.5	5.8	3.0
Nominal effective exchange rate 3/	0.3	-3.3	2.3	5.9	...	...
Real effective exchange rate 3/	0.9	0.6	3.8	6.7	...	...
Terms of trade	-2.8	-3.1	-1.9	2.4	5.1	-0.2
Money and Credit						
Base Money	-20.7	32.0	0.3	-25.4	8.8	0.0
Deposit money bank credit	6.9	0.7	1.4	4.7	4.3	5.3
Broad money	8.7	-2.7	4.2	9.4	1.5	1.5
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	41.8	42.5	47.9	43.9	42.9
Expenditure	45.7	45.5	44.2	46.0	43.8	42.8
Balance	-5.6	-3.7	-1.7	1.8	0.1	0.1
Primary balance	-2.5	-0.1	2.0	5.1	3.3	2.8
Balance of Payments						
Current account balance 5/	-5.2	-4.2	5.5	4.7	6.1	4.7
Trade balance	8.2	6.3	8.3	7.1	8.1	6.4
Financial and capital account	5.1	-4.9	8.2	10.1	5.9	4.5
Net errors and omissions	1.5	-0.1	0.4	0.9	0.0	0.0
Central bank reserves (USD bn)	8.7	4.3	4.1	4.2	4.5	4.2
Excluding old banks' deposits (USD bn)	5.9	4.2	4.0	4.0	...	...

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.

Statement by Audun Groenn, Executive Director for Iceland
And Ragnheidur Jonsdottir, Advisor to the Executive Director
March 9, 2015

The Icelandic authorities appreciate the productive discussions during the Article IV mission in December last year.

My authorities broadly agree with the staff appraisal and recommendations. The Icelandic economy has continued to make progress towards stability and sustainable growth. The slack in the economy is disappearing, public finances and the current account of the balance of payments are in surplus, and inflation expectations are settling on the target, with actual inflation already below it. Economic policy aims at building on this progress and strengthening its foundation.

As staff points out, however, significant downside risks remain. Some are exogenous, such as possible deterioration of demand from slow-growing overseas markets. Other risks require careful maneuvering and a cautious approach by the authorities so as to ensure outcomes that are consistent with stability. This includes orderly liberalization of capital controls and general wage settlements that are on the whole consistent with the inflation target. There is some uncertainty about growth in 2014, and figures based on preliminary estimates for the first three quarters might be revised upwards. This will redistribute growth outcomes between 2014 and 2015 but will not change the overall prospects of annual growth in excess of 3 percent during the forecast period to 2017. This outcome is helped by the recent significant improvement in terms of trade, but it remains more than satisfactory given the present weakness of important trading partners and the fact that the scope to increase growth by eating into the slack is rapidly disappearing.

Fiscal policy

Fiscal policy aims to ensure further stability and continued debt reduction. The general government balance showed a surplus of 1.8 percent of GDP in 2014, after having improved steadily from 2009, when it showed a post-crisis deficit of 8.6 percent of GDP. A continued surplus, albeit a small one, is targeted for 2015 and 2016. The organic budget law, when adopted, will strengthen the institutional foundations for fiscal discipline and credibility. The VAT system has been improved to expand coverage and reduce differences between the lower and higher rates. There is a clear need to increase public investment, including the road system and the healthcare system. Moreover, policies to make the public sector more productive and efficient are an important part of the medium-term fiscal strategy.

The main VAT rate has been lowered from 25.5 percent to 24 percent, while the lower rate was increased from 7 to 11 percent. At the same time, the high and distorting excise tax previously applied to items such as household appliances has been abolished. Finding the optimal balance between direct and indirect taxes is a difficult task that bears directly on welfare policies, including income distribution. The authorities will continue to seek improvements in the tax system so as to make it more efficient.

Staff's DSA indicates that public debt is on a falling trajectory and that the net debt ratio objective of 45 percent of GDP is a realistic goal for 2017. Contingent liabilities related to the Housing Financing Fund (HFF) guarantees are a point of concern; however, work on restructuring the HFF is advancing, and proposals should emerge in the near future. Although scaling down the HFF to support a more limited function for low-income groups and regional housing development is easy in principle, the exact implementation of such a strategy is not a simple task, either technically or politically. Liabilities related to the state pension fund, estimated at 24 percent of GDP, will be met within a framework of a fully funded pension system for future generations.

The household debt relief program is being implemented. The purpose is to provide holders of index-linked mortgages with direct and indirect compensation for the impact of the inflation shock following the banking crisis. The program has been shifted forward so that the bulk of the relief occurs in one year instead of three. The financing is included in the fiscal budget for 2015, and the remainder will be included in the 2016 budget proposal.

Monetary policy

Inflation has fallen below the inflation target. Since December, the year-on-year inflation rate has been 0.8 percent. Excluding housing, the inflation rate is negative. Inflation is projected to remain below 2 percent into 2016. Inflation expectations have also subsided from being well above the inflation target to being by many measures consistent with it.

The Central Bank's key rate – the seven-day term deposit rate – remains at 4.5 percent after being lowered by 75 basis points in late 2014 but has been on hold since, consistent with MPC statements that the Committee looks through the first-round effects of lower oil prices and needs greater clarity on future wage developments.

The Central Bank has been active in the FX market with the aims of smoothing exchange rate fluctuations and building reserves that are not financed by foreign borrowing. In the given environment of a positive current account balance, the Bank has been particularly successful in this regard. In 2014, the Bank's net purchases in the interbank market amounted to the equivalent of 5.6 percent of GDP, and the pace has been similar so far in 2015. The size of the reserves is now close to 30 percent of GDP. Coverage of the foreign exchange reserves is more than adequate, as long as the capital controls remain in place, but cannot cover potential unrestricted outflows. The Central Bank has the long-term aim of keeping reserves close to 1.2 times short-term debt. They are currently well above that level if short-term debt blocked by capital controls is excluded, but otherwise they are below it. Reserve adequacy in the near term has to be seen in light of plans to lift the capital controls as soon as conditions allow.

Capital controls

Foreign currency auctions have been applied successfully to reduce the off-shore overhang of claims on short-term ISK assets held by non-residents. The final auction under the Central Bank's Investment Program was held in February 2015. The foreign currency auctions held since mid-2011 have transferred volatile ISK assets in the amount of 175 billion ISK from non-residents to long-term investors. As a share of GDP, the balance of short-term ISK assets has declined from 25 percent (of year-2011 GDP) at year-end 2011 to 15 percent of estimated year-2014 GDP following the February auction.

The auctions have significantly reduced the risk of instability emanating from the current stock of offshore claims associated with capital account liberalization. But, as is documented in the IMF Staff Papers and several publications from the authorities, there are two other "overhangs" that must be dealt with. The risk from the unwinding of the old banks has been thoroughly measured and must be mitigated before the capital controls can be lifted. The risk of outflows from domestic residents is highly uncertain, however, and will depend partly on the level of confidence at the time.

Work on capital account liberalization is progressing on several fronts. The authorities' work has reached the phase of working out the details of selected policy options, and the implementation of some of those options is drawing closer.

As is underlined in one of the selected issues papers, a sudden abolition of capital controls could potentially lead to rapid outflows of foreign currency, with the associated disruptive consequences. Meanwhile, aspirations to lift the controls and restore the free flow of capital existing before the banking crisis have gained momentum. It should be kept in mind that, although the liberalization strategy is conditions-based and the steps are appropriately phased and based on careful analysis, the effects of liberalizing the capital account cannot be fully anticipated or calculated. Some risk will be involved. The authorities expect to take significant further steps towards freer capital movements over the course of this year.

Financial sector

The Icelandic banks are well capitalized, with a Tier 1 ratio over 25 percent, which is well above minimum requirements, due in part to strong profits in recent years. The banks also have strong liquidity and funding buffers, reflecting early implementation of the Basel recommended liquidity coverage ratios (LCRs) and net stable funding ratio (NSFR) in foreign currency. Nonperforming loans are on a downward trend.

The authorities are in the process of implementing European directives that will bring domestic legislation on deposit insurance and bank resolutions in line with international standards. A bill of legislation incorporating the European Bank Recovery and Resolution Directive into Icelandic law is expected to be presented to Parliament in the fall. The FME is strengthening its skills and knowledge base and steadily improving its risk assessment methodology. The Fund continues to provide valuable technical assistance and support for this work.

The authorities agree with the IMF staff that the banks' high capital ratios and robust liquidity buffers should be maintained at a level that increases the banks' resilience through the process of lifting the capital controls. In light of this, the banks' dividend distribution should be prudent, and more long-term funding, both domestic and foreign, should be sought.

The labor market

The upcoming general wage negotiations are critical for stability in the economy. In past years, excessive wage increases have invariably resulted in currency depreciation, inflation spikes, weakening of the labor market, and sometimes fiscal and external deficits. Recent wage agreements with physicians in the healthcare sector should not serve as a model for others. The differential in wages and working conditions between Iceland and neighboring countries in this field had widened to such an extent that severe brain drain was considered imminent. Moreover, long-term efficiency gains were an integral part of the agreement. Although the authorities do not participate directly in the collective wage bargaining process in the private sector, they will support the process as much as possible, as long the outcome is consistent with economic stability and growth.