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EXECUTIVE BOARD MEETING

SM/17/130
Correction 1

June 9, 2017

To: Members of the Executive Board

From: The Secretary

Subject: **Iceland—Staff Report for the 2017 Article IV Consultation**

Board Action:	The attached corrections to SM/17/130 (5/30/17) have been provided by the staff:
Mischaracterizations of the Views of the Authorities	**Page 18**
Evident Ambiguity	**Pages 4 (para. 2, lines 4 and 5), 5 (para. 9), 9, 15 (Figure 22), 38 (third para.)**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 1, 4 (para. 2, line 3), 5 (para. 5), 6 (Figure 9, data changed), 12, 17, 23, 25, 30, 31, 38 (first and sixth para.), 45 (second column, third row)**
Typographical Errors	**Pages 19 and 45 (first column, third row)**
Questions:	Mr. Bhatia, EUR (ext. 37626) Mr. Arena, EUR (ext. 36735) Mr. Bower, EUR (ext. 36099)

INTERNATIONAL MONETARY FUND

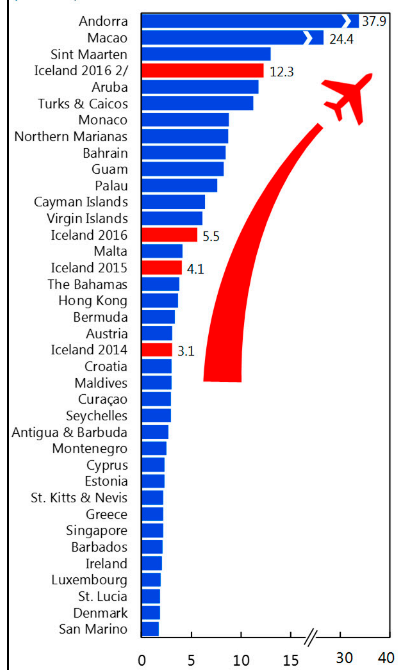
ICELAND

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

May 30, 2017

KEY ISSUES

Tourists per Inhabitant 1/
(Number)



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

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

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

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

DEVELOPMENTS

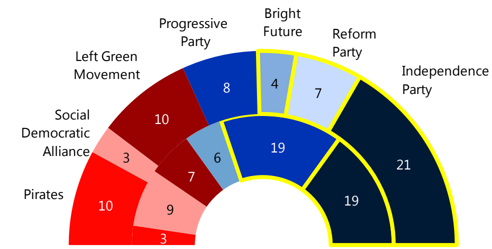
1. Iceland's new government offers some continuity. It centers on the Independence Party, which also sat at the heart of the previous government. The coalition is the outcome of two months of multi party talks that exhaustively explored other options. Yet it has a majority of only one seat, giving every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

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

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

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

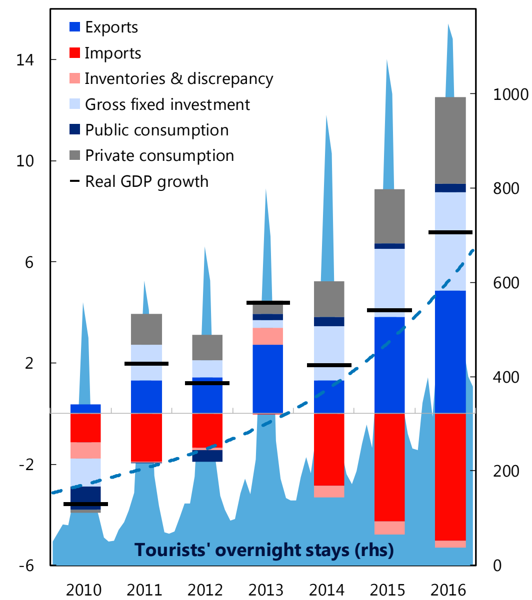
Figure 1. The Althing
2016 (outer) and 2013 (inner)
(Number of seats)



Source: Iceland Monitor.

Figure 2. Growth

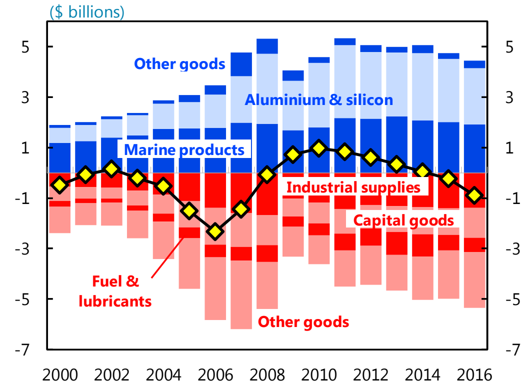
Real GDP and Tourism
(Percentage pt. contrib. to growth y/y) (Thousands)



Source: Statistics Iceland.

Figure 3. Balance on Goods

Balance on Goods
($ billions)



Sources: Statistics Iceland; and IMF staff calculations.

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

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

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

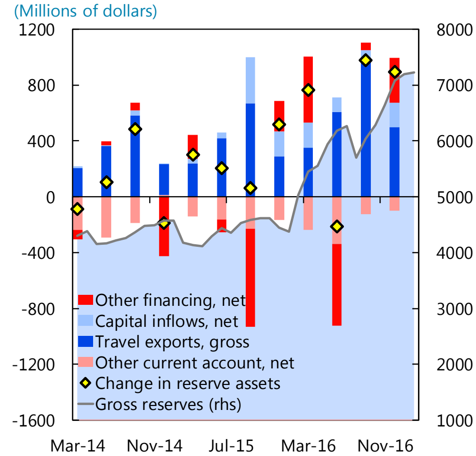
8. Króna appreciation in 2016 dwarfed that in 2015. The real effective exchange rate (REER) climbed almost 20 percent in 2016, fell back slightly in early 2017 as a fishing strike played out, and then resumed its ascent. Upward pressure has reflected the combination of the large current account surplus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

9. Iceland's ~~new~~ capital flow management measure (CFM) has shaped the composition and perhaps the size of inflows. After the introduction in June 2016 of a 40 percent reserve requirement on selected debt inflows (with a 12 month holding period at an interest rate of nil), capital inflows saw a shift from debt

Figure 4. Tourism and Reserves

Balance of Payments and Reserves

(Millions of dollars)

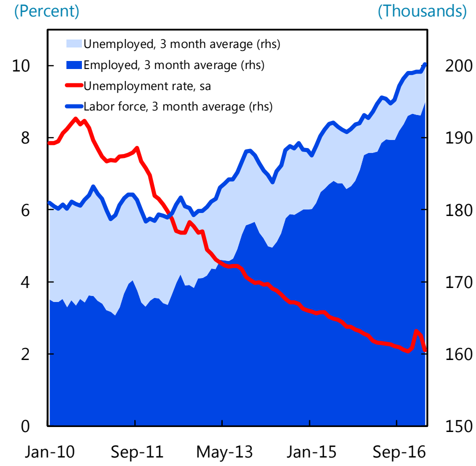


Sources: Central Bank of Iceland; Statistics Iceland; and IMF.

Figure 5. Labor

Labor Force and Unemployment

(Percent) (Thousands)

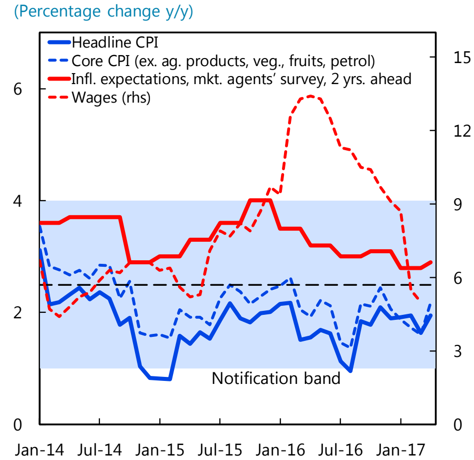


Source: Statistics Iceland.

Figure 6. Inflation

Inflation and Inflation Expectations

(Percentage change y/y)



Source: Statistics Iceland.

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

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

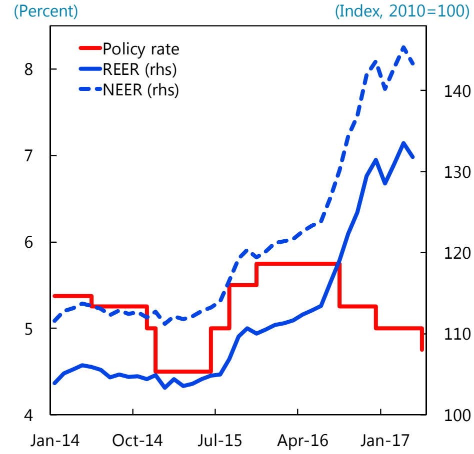
11. The banks remain profitable. The three main banks' "raw" total capital to total (unweighted) assets ratios were 17–23 percent at end 2016, with returns on assets at 1.4–2.0 percent. Funding is still dominated by domestic deposits, and net interest margins are improving on the back of recovering credit growth. Revaluation gains have run their course. Asset quality at one bank took a hit in Q4 with troubles at a large silicon company. In Q1 2017, three foreign funds and a U.S. investment bank acquired 29.1 percent of Arion Bank from the successor to the Kaupthing estate (in which they have a combined stake of about two thirds), with an option to take their stake in the bank to 51 percent ahead of an IPO this summer. The first leg of sales proceeds, amounting to just under 2 percent of GDP, flowed to the state as prepayment on a secured bond issued as part of Kaupthing's wind up. Net public debt fell accordingly, and reserves rose.

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

Figure 7. Rates

Interest Rates and Exchange Rates

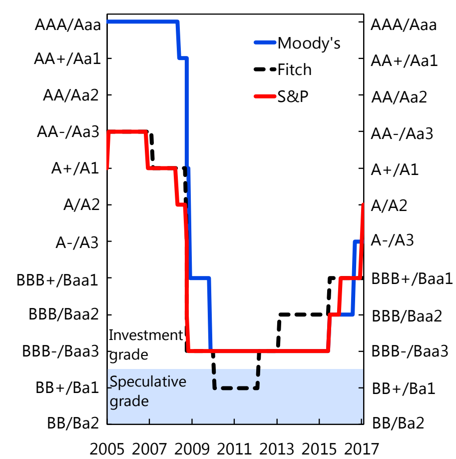
(Percent) (Index, 2010=100)



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

Figure 8. Sovereign Ratings

LT Foreign Currency Sovereign Rating

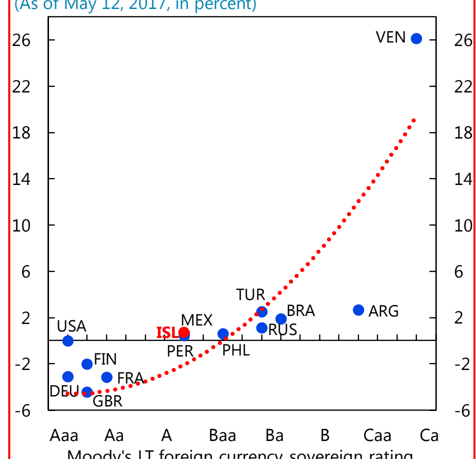


Source: Bloomberg.

Figure 9. Ratings and Spreads

Five Year Sovereign Dollar Spreads

(As of May 12, 2017, in percent)



Source: Bloomberg.

Box 1. External Sector Assessment

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

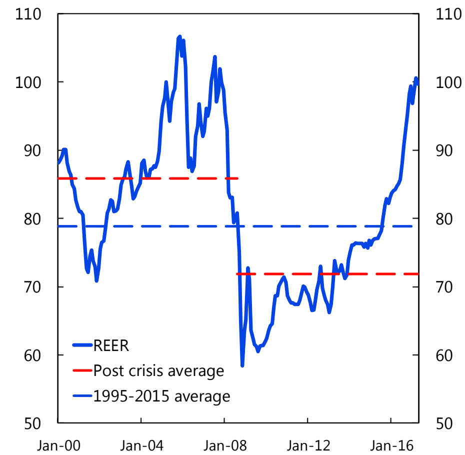
Arguably, Iceland's exchange rate is adjusting to a permanent shock. If the tourism shock is permanent, then it follows that the exchange rate needs to find a higher equilibrium level. Such adjustment will help guide tourism to a plateau, and output to its sustainable long-run growth path.

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

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

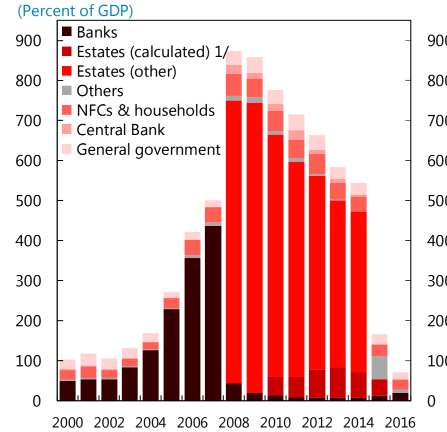
On balance, reflecting a judgement that the tourism shock is permanent, staff's overall assessment is that Iceland's external position remains broadly consistent with evolving fundamentals. If the tourism shock is permanent, then much of the recent króna appreciation must reflect a reassessment of its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

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



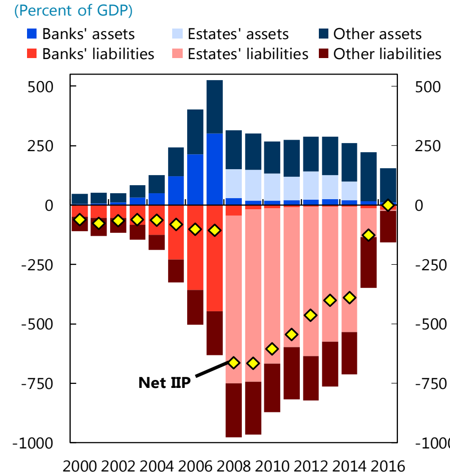
Sources: Central Bank of Iceland; and IMF staff calculations.

Gross External Debt
(Percent of GDP)



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

International Investment Position
(Percent of GDP)



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

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

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

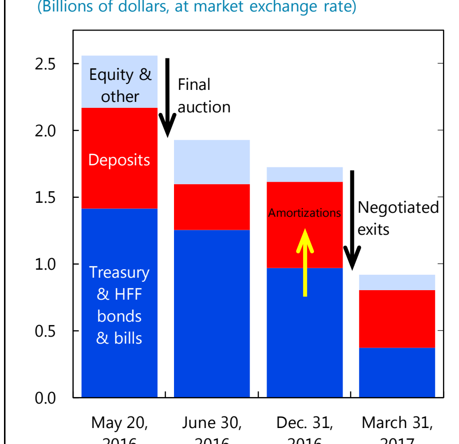
POLICIES

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

A. Capital Controls

Figure 15. Offshore Krónur

Offshore Króna Assets
(Billions of dollars, at market exchange rate)



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

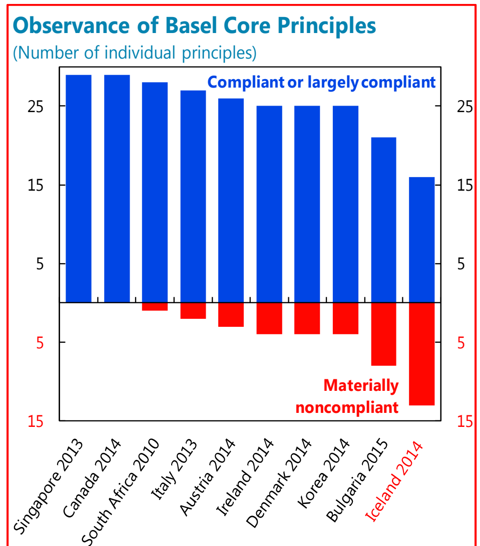
23. The recent lifting of capital controls seized an opportune moment. First, the economic omens were propitious, with output growing robustly, the tourism shock looking to be permanent, inflation low, and the current account in surplus. Second, the reserve dynamics were supportive, taking reserves to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

24. Staff saw the latest agreement with offshore króna holders as positive. One result has been the foreign currency exposures, including exposures abroad. Currency and credit risks will mount, with the latter potentially amplified by slipping underwriting standards.

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

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

Figure 22. Supervisory Ratings



Source: IMF staff calculations.

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

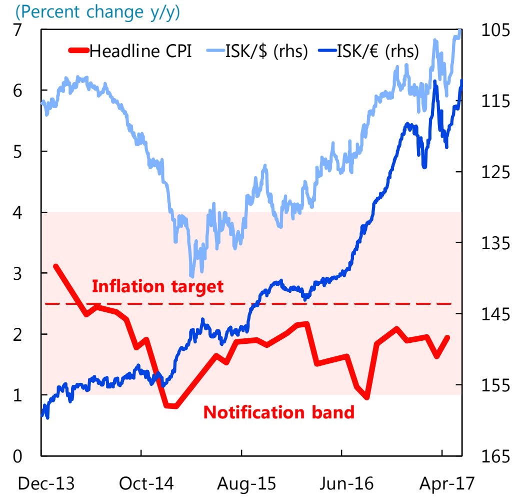
32. Staff also emphasized macroprudential readiness. With pension funds originating about half of new mortgages by value, it is good that powers under the new *Act on Mortgage Lending*—to cap loan to value, debt to income, and debt service to income ratios—apply to banks and nonbanks alike. Staff supported fast tracking the bill proposing to grant the CBI powers to limit foreign tourism boom. Staff advocated maintaining a tight posture while standing ready to ease as inflation developments permit, especially if fiscal policy settings are also tightened as recommended. Should large capital outflows occur, causing depreciation and tending to raise inflation, rate hikes may be needed. Conversely, should capital inflows dominate, driving the króna up and inflation down, additional interest rate cuts could be warranted.

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

Figure 23. Rates

Inflation and Exchange Rates

(Percent change y/y)

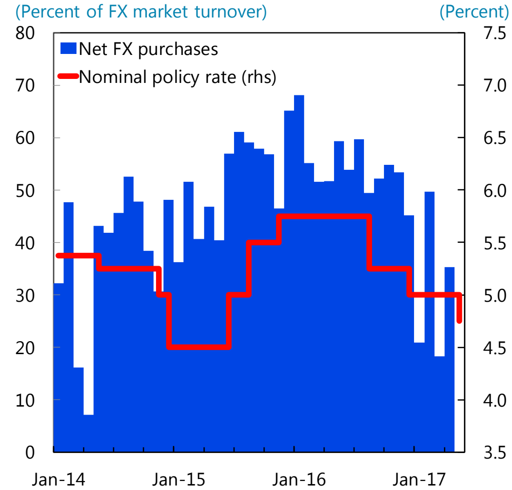


Sources: Central Bank of Iceland; and Statistics Iceland.

Figure 24. Instruments

FX Intervention and Policy Rate

(Percent of FX market turnover) (Percent)



Source: Central Bank of Iceland.

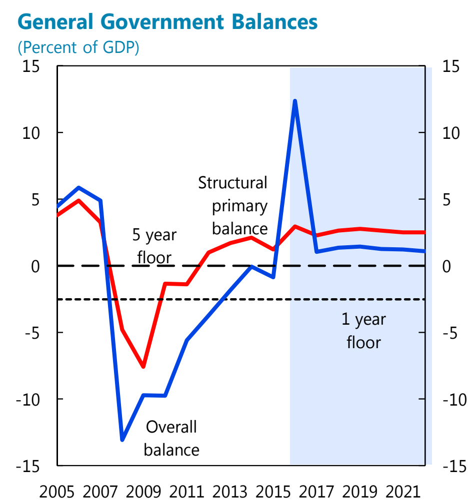
38. Staff felt monetary operations would benefit from the introduction of a fine tuning instrument. At present, the CBI relies on tap facilities to manage domestic liquidity, setting the rates on its term deposit windows without directly controlling quantities and systemic liquidity. Enhancements to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

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

D. Fiscal Policy

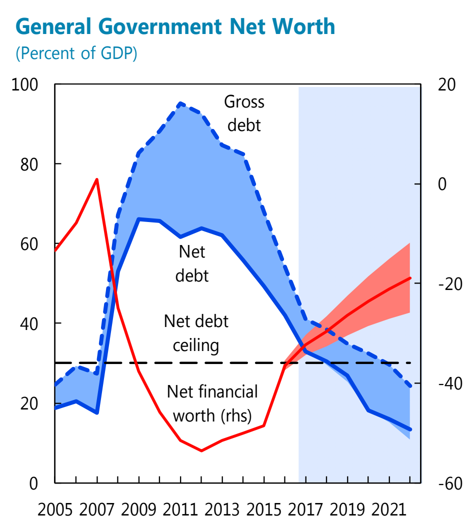
40. **Staff took the view that fiscal policy is generally best left to follow the new rules**. It is no small victory that the Organic Budget Law has shaped the contours of the fiscal debate through a general election. Staff supports prioritizing expenditure on infrastructure (including tourism infrastructure),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

Figure 25. Net Borrowing



Sources: Statistics Iceland; and IMF staff calculations.

Figure 26. Public Debt



Sources: Statistics Iceland; and IMF staff calculations.

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

42. **Noting that the expansionary budget for 2017 is ill timed given the strong cyclical position of the economy, staff urged strict execution**. Passed by the new Althing in December in advance of government formation, the budget targets a central government

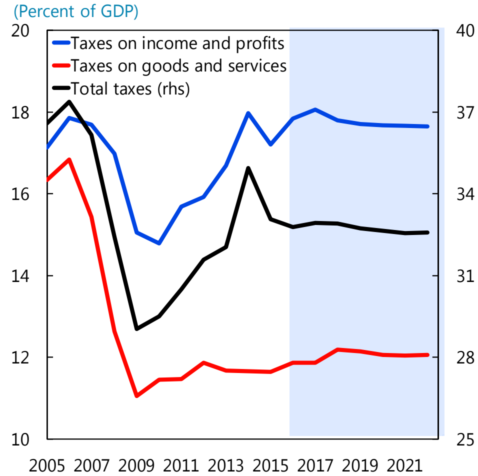
surplus of about 1 percent of GDP. Staff's baseline projections assume modest slippages on certain categories of central government spending, including procurement. The general government structural primary surplus is thus projected to be slightly smaller than in 2016, implying a modestly expansionary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

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

Figure 27. Tax Revenue

General Government Taxes

(Percent of GDP)

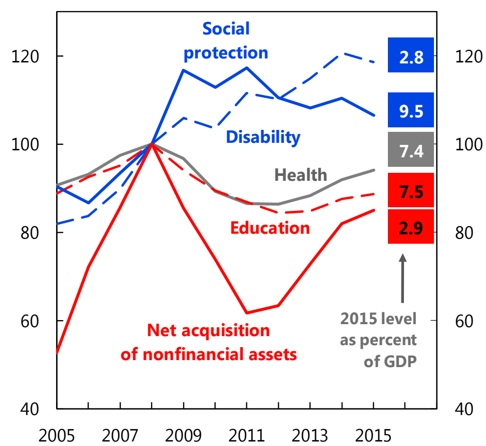


Sources: Statistics Iceland; and IMF staff calculations.

Figure 28. Spending

Selected Real General Govt. Expenditures

(Index, 2008 = 100)



Sources: Statistics Iceland; and IMF staff calculations.

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

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

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

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
					Proj	Proj	Proj	Proj	Proj	Proj
	(Percentage change unless otherwise indicated)									
National Accounts (constant prices)										
Gross domestic product	4.4	1.9	4.1	7.2	5.8	3.6	3.2	3.1	2.6	2.6
Total domestic demand	0.7	5.2	5.9	8.7	6.4	3.3	3.8	3.1	2.7	3.1
Private consumption	1.0	2.9	4.3	6.9	6.4	4.6	3.8	3.2	3.1	3.0
Public consumption	1.0	1.7	1.0	1.5	1.3	1.3	1.4	1.5	1.5	1.5
Gross fixed investment	2.2	16.0	17.8	22.7	9.9	2.5	6.4	4.7	3.0	5.0
Net exports (contribution to growth)	2.7	-1.6	-0.4	-0.2	0.0	0.6	-0.3	0.2	0.1	-0.2
Exports of goods and services	6.7	3.2	9.2	11.1	6.9	4.4	3.2	2.4	1.6	1.8
Imports of goods and services	0.1	9.8	13.5	14.7	8.6	3.8	4.7	2.4	1.7	2.8
Output gap (percent of potential output)	-0.4	0.0	0.5	1.9	2.2	1.3	0.7	0.3	0.0	0.0
Selected Indicators										
Gross domestic product (ISK bn.)	1,891	2,006	2,214	2,422	2,632	2,820	3,001	3,188	3,366	3,555
Gross domestic product ($ bn.)	15.5	17.2	16.8	20.0	23.0	25.8	27.6	28.8	29.7	30.7
GDP per capita ($ thousands)	47.5	52.2	50.5	59.6	67.6	75.1	79.5	81.9	83.6	85.3
Private consumption (percent of GDP)	52.3	52.2	49.8	49.0	49.1	49.2	49.3	49.2	49.2	49.2
Public consumption (percent of GDP)	24.3	24.2	23.6	23.1	23.1	23.2	23.0	22.9	22.9	22.8
Gross fixed investment (percent of GDP)	15.7	17.2	18.9	21.2	21.9	21.5	22.2	22.5	22.5	22.9
Gross national saving (percent of GDP)	21.5	21.3	24.6	29.3	28.5	28.1	28.1	28.4	28.3	28.3
Unemployment rate (percent of labor force)	5.4	5.0	4.0	3.0	3.0	3.3	3.6	3.9	4.0	4.0
Employment	3.3	1.6	3.4	3.7	3.3	2.4	2.0	1.4	1.1	1.0
Labor productivity	0.6	0.0	0.8	3.5	2.5	1.2	1.1	1.7	1.5	1.6
Real wages	0.9	1.9	6.2	8.1	3.7	2.6	2.1	1.8	1.8	1.6
Nominal wages	4.8	4.0	7.9	10.1	5.9	5.3	4.8	4.5	4.3	4.2
Consumer price index (average)	3.9	2.0	1.6	1.7	2.2	2.7	2.8	2.7	2.5	2.5
Consumer price index (end period)	4.2	0.8	2.0	1.9	2.4	2.9	2.7	2.6	2.5	2.5
ISK/€ (average)	162	155	146	134	122	116	115	117	120	122
ISK/$ (average)	122	117	132	121	115	109	109	111	113	116
Terms of trade (average)	-1.9	3.3	6.7	2.4	1.2	0.3	0.2	0.1	0.1	0.0
Money and Credit (end period)										
Base money (M0)	0.3	-17.6	27.8	3.0	8.7	7.3	12.8	4.2	4.6	5.7
Broad money (M3)	4.5	7.1	5.6	-4.6	7.8	7.5	7.2	6.3	5.5	5.6
Bank credit to nonfinancial private sector	-3.2	-2.4	3.5	4.3	4.8	6.1	6.4	6.2	5.6	5.6
Central bank 7 day term deposit rate 1/	5.75	4.50	5.75	5.00	4.75	…	…	…	…	…
	(Percent of GDP unless otherwise indicated)									
General Government Finances 2/										
Revenue	42.1	45.2	42.0	58.4	41.6	41.8	41.7	41.5	41.2	41.1
Expenditure	43.9	45.3	42.9	46.1	40.6	40.4	40.2	40.2	40.0	40.0
Overall balance	-1.8	-0.1	-0.8	12.4	1.0	1.4	1.4	1.3	1.2	1.1
Structural primary balance	1.7	2.1	1.2	2.9	2.3	2.7	2.8	2.6	2.5	2.5
Gross debt	84.7	82.4	68.1	54.0	41.1	38.5	34.9	32.5	29.6	24.3
Net debt	62.2	55.8	49.3	41.9	32.9	30.4	26.9	18.2	16.0	13.5
Balance of Payments										
Current account balance 3/	6.0	4.0	5.5	8.0	6.6	6.5	5.9	5.9	5.8	5.4
of which: services balance	7.5	6.8	9.1	10.7	11.1	11.1	10.9	10.7	10.4	10.1
Capital and financial account (+ = outflow)	7.0	3.5	5.5	10.1	6.5	6.4	5.8	5.7	5.6	5.2
of which: direct investment, net (+ = outflow)	0.3	-4.3	-4.2	-3.6	-2.3	-1.8	-1.7	-7.4	-1.4	-1.5
Gross external debt 4/	248.7	205.5	180.0	125.1	114.9	102.0	96.1	92.6	91.0	83.9
Central bank reserves ($ bn.)	4.1	4.2	5.0	7.2	6.2	5.3	5.6	7.3	7.5	7.5

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

1/ For 2017, rate as of May 25.

2/ Data for 2016 ~~is~~ are preliminary.

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

4/ ~~Includes the effects of the compositions in 2015; projected data for the remaining debt of the bank estates calculated from their foreign claims on the domesntic deposit money banks.~~ Data for 2013–14 use fund staff's calculated measure for the external debt of the bank estates; data from 2015

Table 3. Iceland: Financial Soundness Indicators, 2014–16 1/
(Percent)

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Regulatory capital to risk-weighted assets 2/	25.6	27.0	27.1	28.4	26.3	26.5	27.3	28.2	29.3	28.5	27.7	27.5
Regulatory tier 1 capital to risk-weighted assets 2/	23.3	24.9	25.0	26.1	24.6	25.3	26.1	27.4	28.5	27.6	27.5	27.0
Net interest margin 2/	3.0	3.1	3.0	2.6	2.8	3.4	3.3	2.9	3.0	3.5	3.2	3.3
Return on assets 2/	2.3	4.7	5.2	2.9	7.4	2.5	3.4	5.3	1.3	3.3	2.1	0.1
Return on equity 2/	11.4	23.1	25.7	14.2	35.7	11.9	16.2	24.9	6.1	15.3	9.4	0.5
Net interest income to total income 2/ 3/	55.0	40.3	57.0	38.5	37.3	56.7	46.4	32.2	65.0	48.6	56.8	73.0
Noninterest expense to total income 2/ 3/	105.4	124.4	123.5	128.6	120.7	57.4	78.1	117.4	86.9	109.5	92.5	70.3
Liquid assets to total assets 2/ 4/	27.4	27.5	27.9	24.2	26.5	25.9	25.7	24.6	23.6	23.0	24.1	23.6
High-quality liquid assets to total assets 5/	18.7	18.2	19.3	16.0	16.3	17.3	18.5	18.3	17.9	17.2	18.1	15.8
Net open foreign exchange position to capital 2/ 5/	11.2	11.4	10.4	11.0	10.6	8.0	8.0	9.0	5.4	1.7	0.6	1.2
Total nonperforming loans (NPLs), facility level 6/	4.3	3.2	3.2	2.5	2.1	2.1	2.0	1.7	1.6	1.6	2.2	2.0
Household NPLs, cross default basis 7/ 8/	12.6	12.0	11.1	10.1	8.8	8.7	8.1	7.2	5.9	5.4	4.9	4.8
Corporate NPLs, cross default basis 8/	11.6	10.8	10.1	7.2	6.1	6.7	6.8	9.0	8.7	7.4	5.9	10.9
Household and corporate NPLs, cross default basis 8/	11.6	10.8	10.0	7.9	6.7	7.0	6.7	7.9	7.6	6.6	5.5	7.8
Allowances to household loans in default	50.2	49.3	49.7	48.9	52.1	51.4	52.7	50.4	49.6	50.1	50.0	44.9
Allowances to corporate loans in default	62.6	47.3	44.6	42.7	45.3	44.8	41.3	36.5	35.8	39.1	41.8	33.2
Allowances to total loans in default	58.5	48.1	46.8	45.7	48.6	47.8	46.3	41.8	40.9	43.2	45.1	36.9

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

1/ Three largest deposit money banks unless otherwise indicated.

2/ ~~Total income is total comprehensive income.~~ Data for 2014Q1 through 2016Q4 are IMF staff estimates.

3/ Total income is total comprehensive income.

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

5/ All banks.

6/ Over 90 days in default.

7/ Includes loans from the Housing Financing Fund.

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

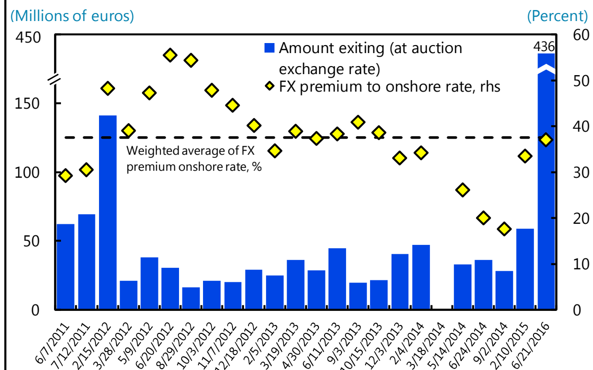
Annex I. Removing Capital Controls

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

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

These steps follow the wind up of the bank estates and sustained efforts to clear the stock of offshore krónur. The compositions of the estates around end 2015 and the CBI's foreign exchange auctions for offshore króna holders in 2011–16 both were guided by an overarching need to protect reserves. The estates assigned assets worth ~~20~~ 16 percent of GDP to the state. The auction and post auction tender in June 2016 saw offshore krónur worth over 3 percent of 2017 GDP exit at a foreign exchange premium of 37 percent to the market rate; 1,688 smaller investors left while four foreign funds with large holdings chose to stay.

Exit Auctions for Restricted Offshore Krónur



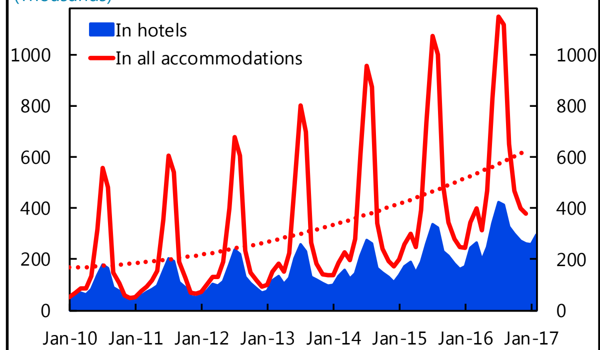
Sources: Central Bank of Iceland; and IMF staff calculations.

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

Annex II. Iceland's Tourism Boom

The tourism boom amounts to a major positive real external demand shock. In hindsight, the Eyjafjallajökull ash eruptions of 2010 were the ultimate advertising for Iceland's natural wonders. From an average of 3 percent of GDP in 2000–05, travel receipts have surged, reaching an estimated 15 percent of GDP by 2016. The number of foreign travelers has risen from 460,000 in 2010 to 1.8 million in 2016, growing by 40 percent in 2016 alone; 2.2 million are expected in 2017. The ratio of tourists to inhabitants has increased almost exponentially, with ~~visitors~~ accommodation seekers now outnumbering residents by more than ~~10~~12:1, even as the average length of stay has remained fairly stable. Tourism has thus established itself at the heart of the economy, bringing in larger export receipts than marine products, aluminum, and silicon combined.

Foreign Tourists' Overnight Stays
(Thousands)



Source: Statistics Iceland.

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

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

Annex VII. Public Sector Debt Sustainability Analysis

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

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

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

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

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

This analysis is based on staff's macroeconomic framework:

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

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

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

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

Annex VIII. Responses to Past Policy Recommendations

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