EXECUTIVE BOARD MEETING

SM/18/248

October 26, 2018

To: Members of the Executive Board

From: The Secretary

Subject: **Iceland—Staff Report for the 2018 Article IV Consultation**

Board Action:	Executive Directors' **consideration** (Formal)
Tentative Board Date:	**Friday, November 9, 2018**
Publication:	Yes*
Questions:	Mr. Bhatia, EUR (ext. 37626)
Document Transmittal in the Absence of an Objection and in accordance with Board policy:	Monday, November 5, 2018—WTO After Board Consideration—Organisation for Economic Cooperation and Development

***Unless an objection from the authorities is received prior to the conclusion of the Board's consideration, the document will be published.**

INTERNATIONAL MONETARY FUND

ICELAND

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

October 25, 2018

KEY ISSUES

Iceland is experiencing an economic slowdown that has reduced overheating concerns. Tourism growth has decelerated and the króna has stopped appreciating. Demand management has become easier, allowing the authorities to focus on medium-term priorities, including infrastructure, healthcare, education, and the environment.

Risks, however, have become more evident. High fuel prices and other factors are challenging the airline business; world trade tensions are escalating; and the United Kingdom—a vital trading partner—is not yet assured of a smooth EU exit. Icelandic policies thus need to focus on further increasing resilience to shocks.

Iceland's decision to reform financial sector oversight is a fitting way to mark the tenth anniversary of its banking crisis. Careful planning will be essential to ensure a smooth transition as the supervisory body is merged into the central bank. Efforts should focus on independence, accountability, powers, capacity, and resources.

The new government's fiscal plans remain consistent with further debt reduction. A broadly neutral fiscal stance is appropriate in the near term, with countercyclical action reserved for significant deviations from the baseline. Careful prioritization will be needed, however, to ensure that the overall budget surplus targets are met.

Monetary policy should remain centered on price stability. The inflation target should capture the consumer basket as broadly as possible and be well understood by all. Exchange market intervention should be limited to countering disorderly market conditions, with a strong emphasis on maintaining reserve adequacy.

Policies to lift growth potential and enhance sustainability are also important. Steps should include reforms to wage bargaining and education to better support competitiveness, actions to address bottlenecks in tourism, and further efforts to secure equitable and environmentally sustainable regional agreements in fishing.

Approved By
Thanos Arvanitis (EUR) and Kevin Fletcher (SPR)

Discussions took place in Reykjavík September 13–25. The team comprised Ashok Bhatia (head), Chikako Baba, Jorge Canales-Kriljenko, Sílvia Domit, and Anne-Charlotte Paret (all EUR), Luis Cortavarria and Asad Qureshi (both MCM), and Shakill Hassan (SPR). Poul Thomsen (EUR) joined to speak at an event marking the tenth anniversary of the failure of Lehman Brothers. Gudrún Gunnarsdóttir (OED) observed. Niall O'Hanlon (STA) provided inputs. Morgan Maneely and Natalia Romanova (both EUR) assisted.

CONTENTS

AT A GLANCE 4

THE SETTING 4
A. Recent Indicators 5
B. Baseline Outlook 7
C. Risks Around the Baseline 9

MACROECONOMIC POLICIES 10
A. Fiscal Policy 10
B. Monetary and Exchange Rate Policy 12
C. Financial Stability Policy 14

FINANCIAL SECTOR OVERSIGHT 16
A. Banking Oversight and Resolution 16
B. Pension Fund Oversight and Conduct Regulation 18

STRUCTURAL REFORMS 20
A. Wage Bargaining, Education, and Competitiveness 20
B. Sustainability and the Environment 21

STAFF APPRAISAL 22

BOXES
1. External Sector Assessment 8
2. The Fiscal Strategy Plan vs. IMF Staff Projections 11
3. Iceland's Financial System Ten Years After the Crisis 17

FIGURES
1. Tourism and the Króna 4
2. Growth 4
3. Labor 5
4. Rates 5
5. Housing and Credit 5

6. External Balances 6
7. Public Debt and Ratings 6
8. Bank Financials 6
9. IMF Staff Baseline Projections 7
10. Airfares and Fuel Costs 9
11. Exports 9
12. U.K. Links 9
13. Fiscal Impulse 10
14. Public Debt 10
15. Government Spending 10
16. Inflation 13
17. Monetary Policy 13
18. Ratings and Rates 13
19. Household Sector 14
20. Corporate Sector 14
21. Banking Sector 14
22. Flows and Yield Curves 15
23. Financial Account 15
24. Policy Rates 15
25. Bank Funding 18
26. Bank Capital Adequacy 18
27. System Structure 18
28. Asset Allocation 19
29. Pension Fund Lending 19
30. Competitiveness 20
31. Education 20
32. Tourism 21
33. Fishing and Overfishing 22

TABLES

1. Selected Economic Indicators, 2014–23 24
2. Money and Banking, 2014–23 25
3. Financial Soundness Indicators, 2015–18 26
4. General Government Operations, 2014–23 27
5. General Government Financial Balance Sheet, 2014–23 28
6. Balance of Payments, 2014–23 29
7. International Investment Position, 2008–17 30

ANNEXES

I. External Debt Sustainability Analysis 31
II. Public Sector Debt Sustainability Analysis 34
III. Risk Assessment Matrix 41
IV. Responses to Past Policy Recommendations 42

AT A GLANCE

1. **Iceland's economy is set to continue to grow but a significant cooling has made demand management easier**. Growth has fallen from almost 7½ percent in 2016 to closer to 4 percent this year. Tourism growth has slowed and the króna has stopped appreciating. Despite the slowdown, the economy remains at full employment, with firm consumption and investment and rising incomes and wealth.

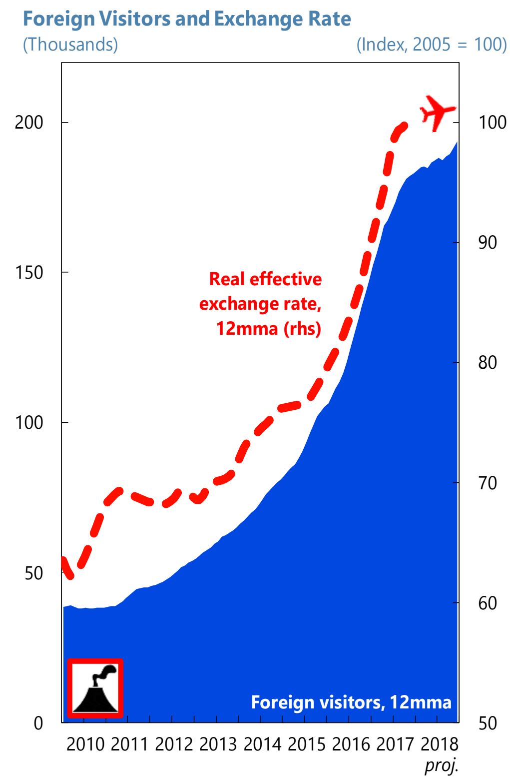
2. **Iceland's new government spans the political spectrum**. In October 2017 the second early election in a span of 12 months ushered a record eight parties into the Althing; a new three-party coalition took office a month later. A prime minister from the Left-Green Movement, a finance minister from the fiscally conservative Independence Party, and an education minister from the Progressive Party together form an influential new committee on economic affairs.

3. **Ten years after its crisis, Iceland has decided to undertake deep institutional reforms**. Reflecting growing awareness that financial risk taking can only increase now that the capital account is open, the debate about how best to upgrade financial sector oversight reached a conclusion. With an increasing number of independent experts supporting uniting banking supervision at the Central Bank of Iceland (CBI), as advised by the IMF in its 2016 and 2017 staff reports, the ministerial committee on economic affairs decided to effect such a change—and has tasked an interagency team with preparing the legislation.

THE SETTING

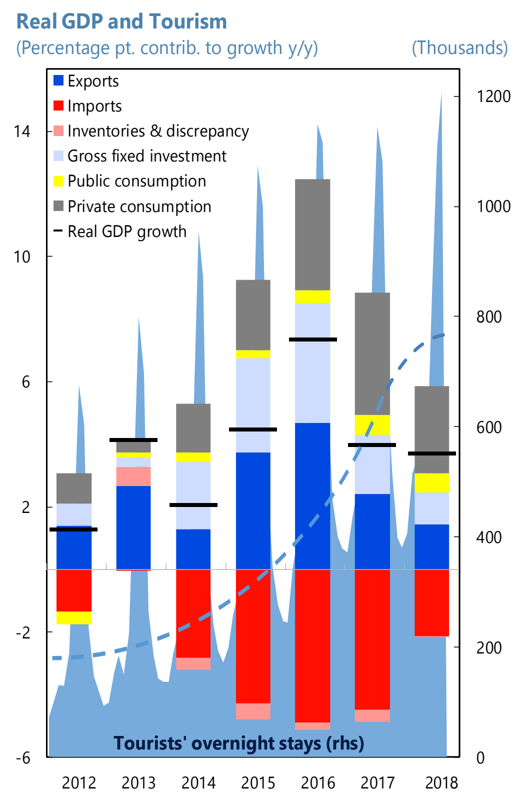
4. **Slower growth has allayed overheating concerns**. Dampened as expected by the strong exchange rate appreciation of 2014–16, the rate of growth of tourist arrivals has decelerated. This has reduced demand pressures and helped cool the housing market, but has also reduced the current account surplus. Staff's central forecast is still for moderate growth, with falling public and external debt

Figure 1. Tourism and the Króna



Sources: CBI; Isavia; and Statistics Iceland.

Figure 2. Growth



Source: Statistics Iceland.

ratios. Overheating risks remain, however, and external threats to Iceland's growth path have ratcheted up.

A. Recent Indicators

5. **Unemployment, at 2½ percent, remains well below its long-run average**. With free movement of labor within the European Economic Area, foreign workers help keep wage pressures at bay in construction and tourism. In other sectors, a major wage bargaining round looms.

6. **The króna has stopped appreciating and inflation is on target**. Appreciation gave way to a short-lived spike in volatility around time of the big capital account opening in March 2017, after which the currency settled—allowing foreign exchange interventions to cease. Import price deflation faded, housing inflation slowed, and overall inflation converged to target. The CBI has kept its main policy rate stable at 4¼ percent since October 2017.

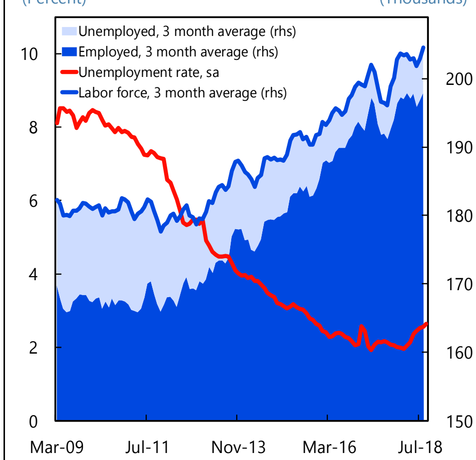
7. **The real estate markets have cooled**. The rate of growth of housing prices fell from a peak of 24 percent y/y in July 2017 to 6 percent 12 months later, while that for commercial real estate slowed from 19 percent y/y to 15 percent. A robust supply response was key, although slowing tourism growth also helped—including by limiting private rental demand via Airbnb (see for instance [Eliasson and Ragnarsson, 2018]). Residential investment and commercial construction continue to expand briskly.

8. **Credit is recovering, but with no obvious impact on asset prices**. After a deep contraction, credit growth has been consistently positive only since late 2015, reaching 14½ percent y/y in May 2018, with the pension funds taking mortgage market share. Recent correlations of credit and property price growth have been negative, however, and the stock index has been flat for two years.

9. **The goods trade deficit has increased but the current account remains in surplus**. Goods imports are outpacing goods exports given still-strong domestic demand while the large service surplus has remained relatively stable, narrowing the current account surplus. That surplus, combined with valuation gains on foreign equities, continues to improve the net international

Figure 3. Labor

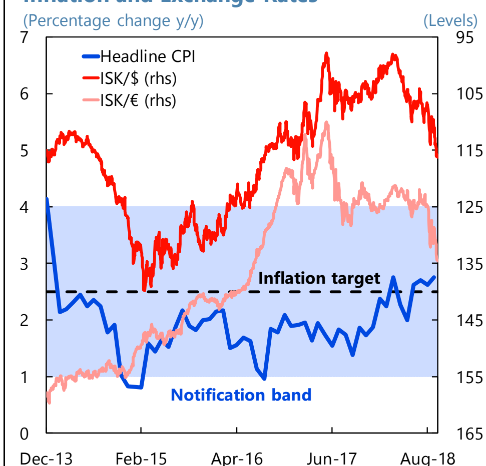
Labor Force and Unemployment



Source: Statistics Iceland.

Figure 4. Rates

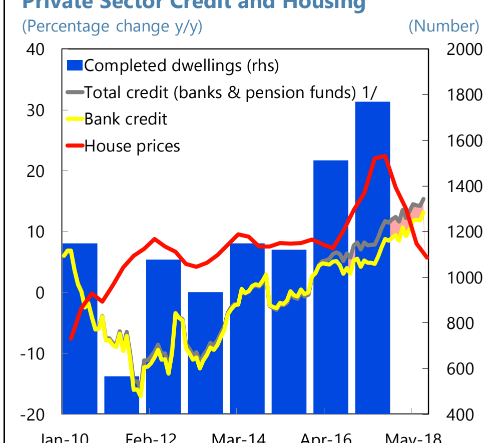
Inflation and Exchange Rates



Sources: CBI; and Statistics Iceland.

Figure 5. Housing and Credit

Private Sector Credit and Housing



Sources: CBI; and Statistics Iceland.
1/ Excludes Housing Financing Fund.

investment position (NIIP), estimated at +9 percent of GDP as of mid 2018. Official reserves have been stable at about $6½ billion—about 150 percent of the Fund's reserve adequacy metric (RAM)—since the offshore króna release and debt payments of 2017 (see 2017 staff report).

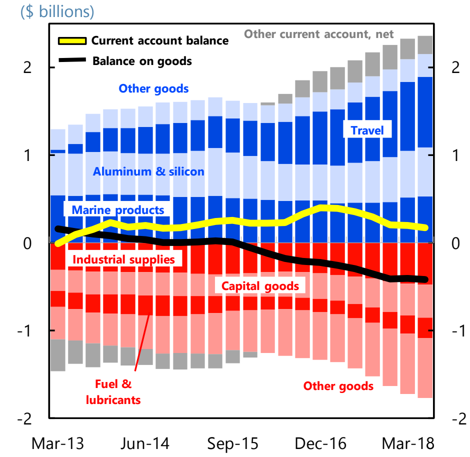
10. Fiscal policy stoked strong demand conditions in 2017. The general government balance for the year is estimated at a surplus of 1½ percent of GDP. Netting out one-off items—including the massive windfall gains from the bank estates and the pension reform outlays of 2016 (see 2016 and 2017 staff reports)—the structural primary surplus is estimated to have fallen by 0.3 percent of GDP, implying some stimulus. Below the line, the government received a first batch of bond repayment proceeds related to a private offering by Arion Bank (see 2017 staff report), helping reduce net debt to about 34 percent of GDP. Sovereign ratings continued to rise.

11. The three main banks continue to report strong results. The government divested its 13 percent stake in Arion Bank in early 2018, but remains controlling shareholder of Íslandsbanki and Landsbankinn. Despite large dividends, the three banks' capital to total asset ratios were still ample at 15½–18½ percent as of mid 2018. Liquidity ratios strengthened, and profitability remained strong, with returns on assets at 0.8–1.6 percent in the first half. Debt issuance abroad has increased. Nonperforming loan (NPL) ratios stood at 4.4–5.9 percent as of June 2018.

Figure 6. External Balances

Balance on Goods

($ billions)

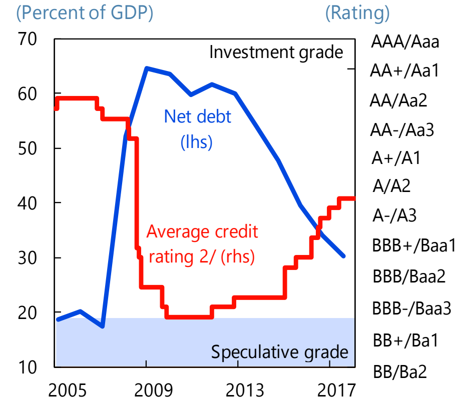


Source: Statistics Iceland.

Figure 7. Public Debt and Ratings

Public Debt and Ratings [1/]

(Percent of GDP) (Rating)

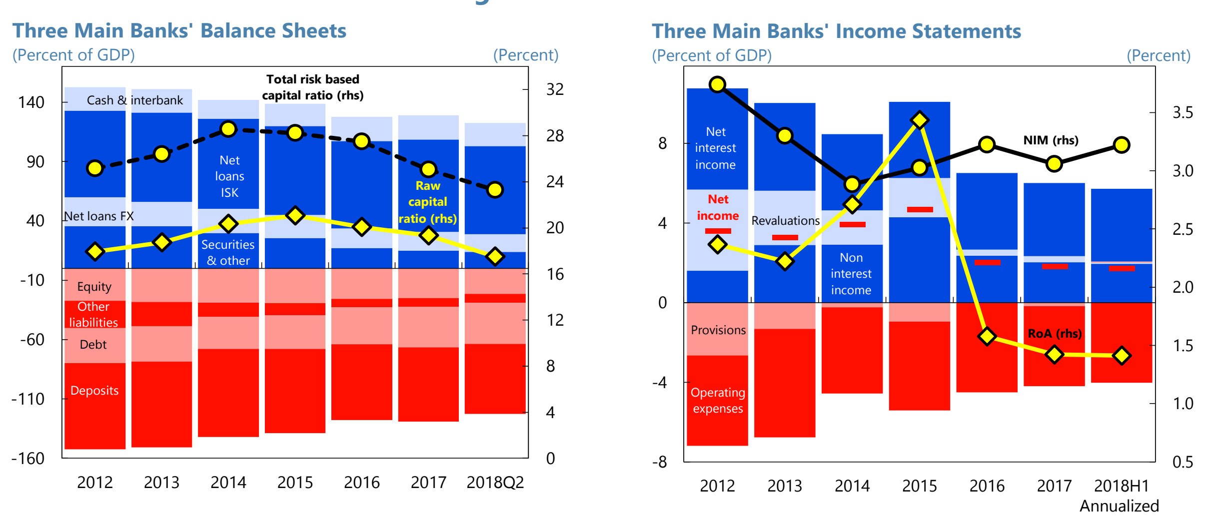


Sources: Fitch; Ministry of Finance; Moody's; and S&P.

1/ General government debt and LT foreign currency sovereign rating.

2/ Average of Fitch, Moody's, and S&P ratings.

Figure 8. Bank Financials



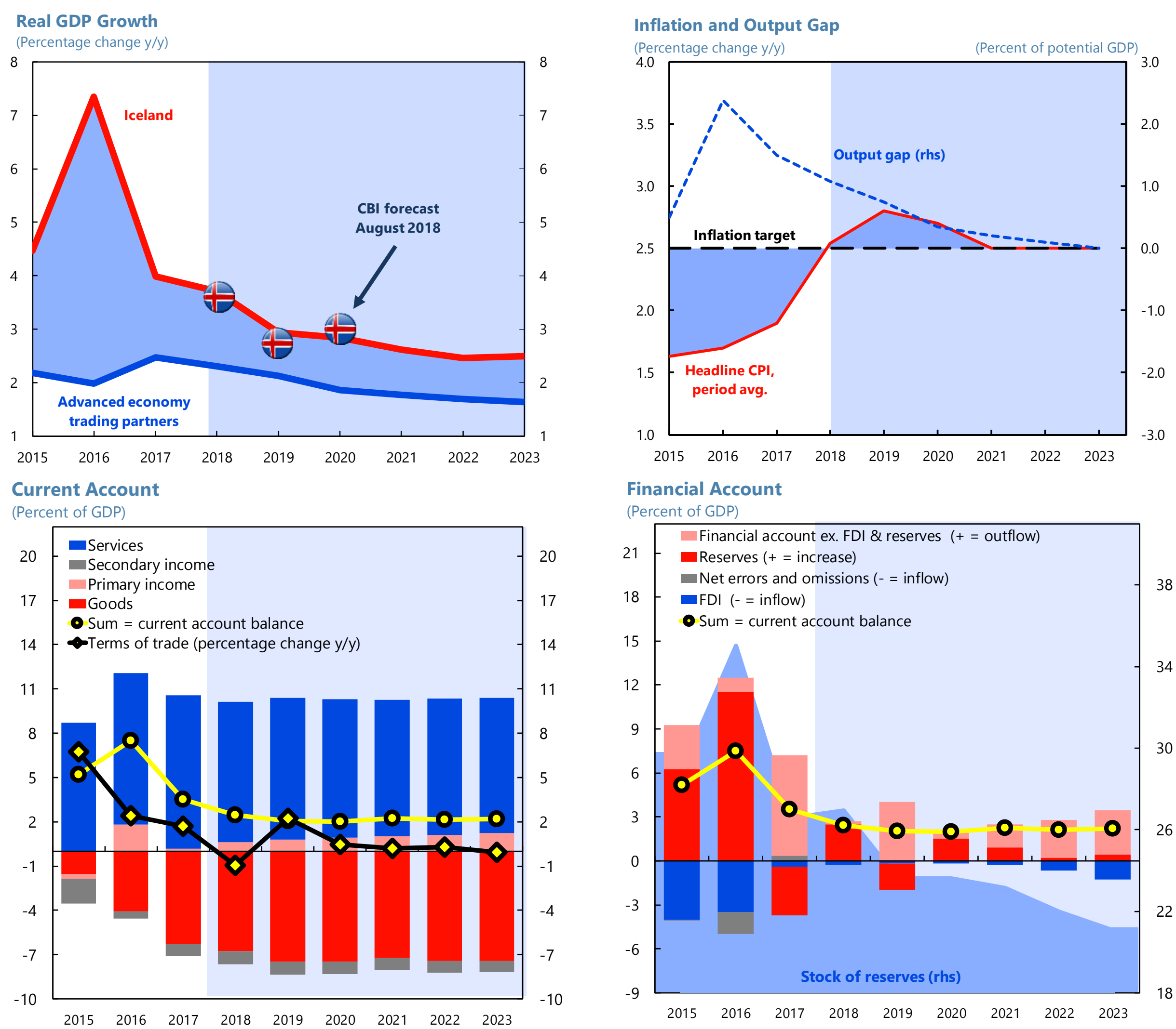
Sources: CBI; Statistics Iceland; and IMF staff calculations.

B. Baseline Outlook

12. Staff's baseline has the economy descending gently to more sustainable growth rates. Growth is seen at around 3 percent in the near term, settling to 2½ percent eventually. Tourism flattens out and private consumption throttles back but remains the main engine. Private investment decelerates while public investment accelerates. Inflation slightly exceeds target in 2019–20, conditional on outcomes from the upcoming wage negotiations. This baseline incorporates the authorities' plans and frameworks, which imply a broadly neutral fiscal stance over 2018–23.

13. Iceland's external position is broadly in line with fundamentals and desired policy settings (Box 1). Staff puts the current account "gap"—the cyclically adjusted current account surplus minus estimated "norm"—at 1 percent of GDP in 2017, implying tolerance for some further króna appreciation should market forces so dictate. Uncertainty around the external assessment is large, however, given Iceland's size, openness, and reliance on a few export sectors.

Figure 9. IMF Staff Baseline Projections



Sources: CBI; Statistics Iceland; and IMF staff calculations.

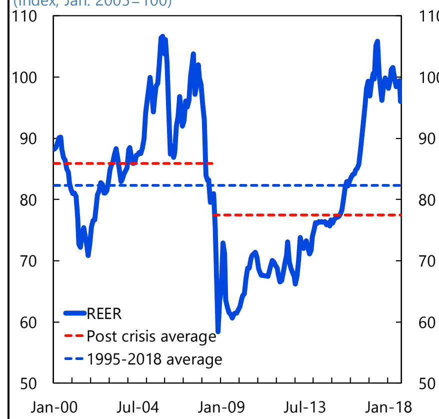
Box 1. External Sector Assessment

Based on a combination of model-based findings, statistical observations, and judgement, staff assesses Iceland's external position to remain broadly in line with fundamentals and desired policy settings.

Iceland's external balance sheet is strong:

- **The NIIP climbed from +3 percent to +5¼ percent of GDP in 2017**. The improvement reflected both the current account surplus and valuation gains on foreign equities. Gross assets stood at close to 118 percent of GDP at end 2017, with some 30 percent of the total in portfolio equities and 22 percent in outward FDI. Gross liabilities were about 113 percent of GDP, with inward FDI comprising about 41 percent of the total.
- **External debt dropped in 2017, from 124 percent to 90 percent of GDP**. Changes in internal financing arrangements by one cross border group were a major driver, albeit with no significant effect on the NIIP.

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



Source: CBI.

The cyclically adjusted current account balance remained above but close to the estimated norm in 2017. The headline current account surplus halved to 3½ percent of GDP, reflecting a deteriorating goods trade deficit, a stable services surplus, and a drop in the primary income surplus on the back of a one-time reduction in net investment income. Staff puts the cyclically adjusted current account balance at 3.8 percent of GDP. The norm is estimated at 2.8 percent. The remaining gap is 1 percent of GDP.

Staff's final real effective exchange rate (REER) assessment is based on its current account gap model. Whereas the REER model suggested króna overvaluation in 2017, by some 15 percent, that result was almost entirely due to the residual. The current account gap model (with an estimated elasticity of -0.33) indicates undervaluation of 3 percent—broadly in line with fundamentals and desired policy settings.

Cross border flows have responded to capital flow management measures (CFMs). The special reserve requirement on selected debt inflows, introduced in June 2016, has all but eliminated nonresidents' net purchases of króna-denominated bonds, with inflows rotating to listed and privately placed equity. The broad absence of controls on outflows, since the big liberalization in March 2017, has seen residents, especially pension funds, increasing their holdings of foreign securities, again mostly equities.

Conditions in the exchange market stabilized in 2017 and intervention ceased. Net foreign currency purchases by the CBI totaled about $0.6 billion in 2017, less than one-fifth of the total in 2016. These were heavily concentrated in the first half of the year, with the CBI discontinuing its preannounced purchases of €6 million per week in May. Gross reserves stood at $6½ billion at end 2017, down from $7.2 billion a year earlier. This level was equivalent to 27 percent of GDP, 152 percent of RAM, and about 6 months of prospective goods and services imports—and amply covered short-term net drains.

14. The current account surplus is expected to shrink further, with reserves remaining sizable. Barring disruptions, tourism will likely stabilize (see 2017 selected issues). Net investment income should stay positive given the improved NIIP. The current account surplus is seen settling near 2 percent of GDP. In the financial account, staff assumes no major divestment proceeds, and the release in 2019 of the remaining blocked offshore krónur, worth some 3 percent of GDP (see 2016 and 2017 staff reports). Reserves remain relatively stable in dollar terms after 2019, but decline gently as a ratio to GDP and RAM, to about 20 percent and 160 percent, respectively, by 2023.

C. Risks Around the Baseline

15. Risks are predominantly negative. High jet fuel prices and fierce air transport competition are challenging the airline business, risking disruptions to tourism. Rising global trade tensions could hurt Iceland's aluminum industry, among other sectors. Brexit could dampen demand from one of Iceland's most important export markets, with a new index developed by IMF staff ranking Iceland among the nine European countries most closely integrated with the United Kingdom in terms of supply chains, finance, and migration (see [IMF, 2018]); Brexit also brings a U.K. departure from the London Fisheries Convention and, most likely, from the EU's Common Fisheries Policy, further complicating the pursuit of cooperative and sustainable outcomes in fishing (see selected issues). These risks come on top of Iceland's permanent exposure to elemental hazards ranging from changing fish migration patterns to volcanic eruptions. And, while domestic overheating concerns have receded, they could resurface if wage increases are excessive.

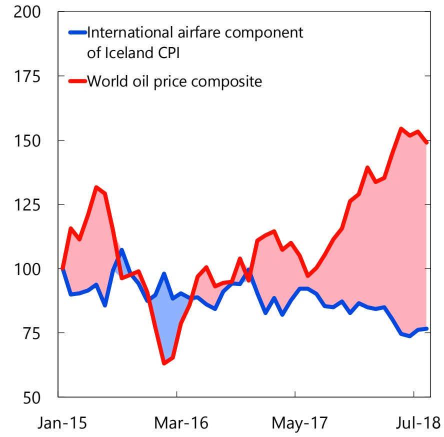
Authorities' Views

16. The authorities shared staff's views on the baseline outlook. They agreed that the cooling down is welcome and noted that it is partly the result of an appropriately tight monetary stance expressly intended to head off overheating risks. They see the economy settling to lower, more sustainable growth rates, with inflation remaining close to target and the current account surplus shrinking to find its medium-term equilibrium level.

17. They agreed, moreover, that risks have become more evident. In particular, the specter of emerging difficulties in tourism has risen with higher oil prices and tough air transport competition. They also agreed with staff's concerns about escalating world trade tensions and the mounting uncertainty around Brexit. At home, they share IMF staff's worry that continued growth in unit labor costs would hurt competitiveness and affect inflation prospects. But they also noted that some of the risks are interrelated—for example, wage demands would likely be lower if some of the other shocks were to materialize.

Figure 10. Airfares and Fuel Costs

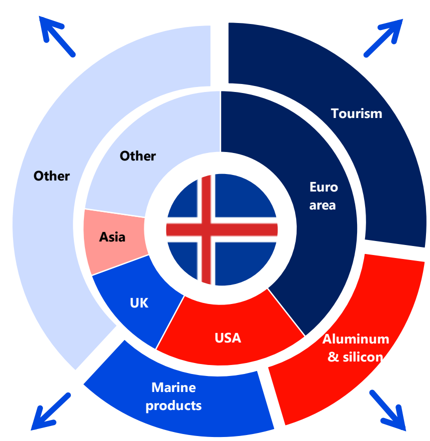
Airfares and Oil Prices
(Dollar index, Jan. 2015 = 100)



Sources: Statistics Iceland; and IMF staff calculations.

Figure 11. Exports

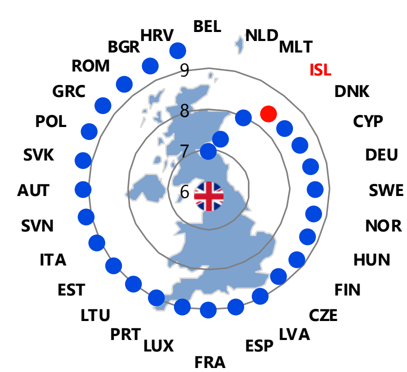
Goods and Services Exports, 2017



Source: Statistics Iceland.

Figure 12. U.K. Links

Synthetic Index of Integration with the U.K. 1/
(0 = tightest; 10 = loosest)



Source: IMF staff calculations.
1/ Ireland, with a value of close to 0, is off the scale.

MACROECONOMIC POLICIES

18. The easing of near-term demand management pressures allows the authorities to focus on medium-term priorities. Given the closing output gap, a broadly neutral fiscal stance is reasonable in the near term, with countercyclical action reserved for significant deviations from baseline. Monetary policy should be data dependent, nimble, and well communicated.

A. Fiscal Policy

19. In the near term, the slowdown in the economy has tempered the need for a countercyclical fiscal stance. After the ill-timed stimulus of 2017, staff estimates that the stance will be essentially neutral in 2018, which is broadly appropriate to the cyclical conditions. Looking to 2019, staff projects a continued neutral stance, with the structural primary balance decreasing by 0.1 percent of potential GDP, to 2.3 percent—significantly above the debt stabilizing level. This seems reasonable.

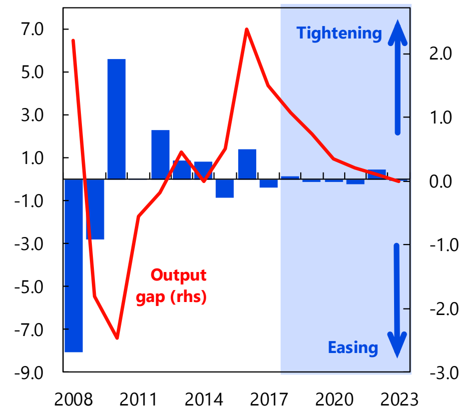
20. Over the coming years, Iceland's fiscal policy should remain geared toward increasing fiscal space. The new government's Fiscal Strategy Plan targets an overall general government surplus of about 1.1 percent of GDP each year; staff projects smaller surpluses, settling at around 0.5 percent of GDP in 2020–23 (Box 2). Staff's projections are compatible with a broadly neutral fiscal stance over the projection period, one that will allow net debt to fall below the statutory ceiling by end 2019 and remain on a downward trend thereafter. The Plan is thus appropriate. In the event of a recessionary shock or if serious overheating risks arise, however, countercyclical fiscal policy action can and should be taken, utilizing available space, as part of a broader suite of policies.

21. Staff urges careful prioritization of ambitious new spending goals. The new government places strong emphasis on infrastructure, healthcare, education, and environmental spending. Staff supports these priorities, but advises the authorities to fully identify and articulate the measures to achieve expenditure savings in other

Figure 13. Fiscal Impulse

Change in Structural Primary Balance

(Percent of potential GDP)

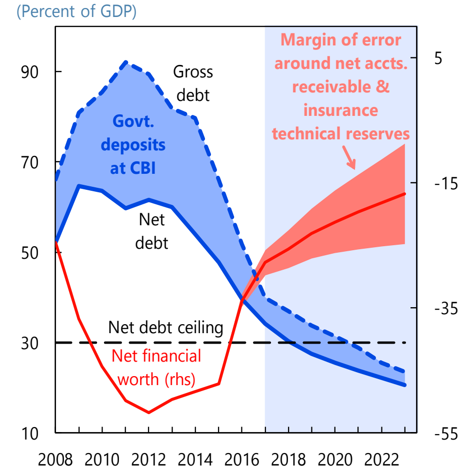


Sources: Ministry of Finance; and IMF staff estimates.

Figure 14. Public Debt

General Government Net Financial Worth

(Percent of GDP)

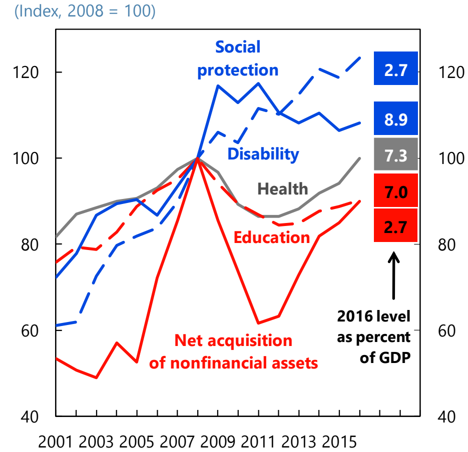


Sources: Statistics Iceland; and IMF staff calculations.

Figure 15. Government Spending

Selected Real General Govt. Expenditures

(Index, 2008 = 100)



Sources: Statistics Iceland; and IMF staff calculations.

areas—advice echoed by the Fiscal Council. Staff repeats its call for a comprehensive review of expenditures. Such a review should seek to identify areas offering scope for savings, and to develop a guiding framework to rank outlays by their medium-term effects on growth and productivity (see Structural Reforms). Such precautions would help ensure the overall surplus targets are met.

Box 2. The Fiscal Strategy Plan vs. IMF Staff Projections

Staff's fiscal projections fully integrate the authorities' revenue numbers; incorporate most, but not all, of their expenditure measures; and build in more conservative assumptions on public consumption.

In April 2018, Iceland's new government presented its Fiscal Strategy Plan for 2019–23 to the Althing as required by the organic budget law. The Plan integrates preliminary fiscal outturns for 2017 published by Statistics Iceland in March 2018 and therefore includes updated fiscal projections for 2018 relative to those in the budget. Its uses the macro projections published by Statistics Iceland in February 2018.

The Plan includes a reduction of the tax burden. Revenues are projected to decrease by 1.8 percent of GDP over the five years. The lower rate of personal income tax is cut by 1 percentage point and the social security contribution rate by ½ percentage point, books are exempted from the value added tax, and both the capital income tax and the bank levy fall. This is accompanied by a 20 percent increase in the carbon tax, changes in the taxation of cars and fuels, the introduction of a new departure tax on tourists, and expected gains from better tax compliance. In sum, the Plan sees taxes and social contributions falling by 0.9 percent of GDP, and other revenues by 0.9 percent of GDP. These figures are fully integrated into staff's projections.

The Plan projects lower interest payments reducing the total expenditure ratio despite new capital spending. Total expenditure decreases by 1.6 percent of GDP. Strong emphasis is placed on investment in infrastructure, as well as healthcare, the environment, education, and culture. Focusing mostly on transport, infrastructure spending increases by 0.6 percent of GDP, financed by "excess" dividend receipts from the state-owned banks.[1/] Public consumption is projected to remain constant as a ratio to GDP. Most, but not all, of the expenditure measures are integrated into staff's projections, coupled with more conservative assumptions on public consumption than those of the authorities.

All in, the Plan foresees a shrinking general government surplus. The overall surplus decreases from 1.4 percent of GDP in 2018 to around 1.1 percent of GDP in 2020–23.[2/] Most of the deterioration is ascribed to the central government, with the combined surplus of the municipalities projected to remain constant at 0.2 percent of GDP. The decline in the overall surplus is explained as the result of a combination of slower growth and purposeful reduction of the tax burden. Staff's projections show more deterioration, with the overall surplus settling at about 0.5 percent of GDP in 2020–23. Both staff's and the authorities' projections show net debt falling below the statutory ceiling of 30 percent of GDP by end 2019.

[1/] The part of bank dividends regarded as "regular" is based on a return on equity of 8.5 percent and a profit distribution ratio of 40 percent; receipts above this are referred to as "excess" dividends. In staff's projections, these excess dividends are considered to be one-off revenues and are therefore purged from the structural balance.

[2/] Base figures for 2017 differ as staff's projections integrate the historical GDP revisions published by Statistics Iceland in September 2018 whereas the Fiscal Strategy Plan uses the previous vintage.

22. **Steps should also be taken to reduce the reliance on irregular revenues, which would facilitate budget planning**. Dividend receipts—previously allocated to debt reduction and financing a new wealth fund—are now also to be used to finance infrastructure. Yet the government projects dividends to peak in 2019–21, lifted by "excess" dividends from the banks, and to fall thereafter. This variability underscores the need for more dependable sources of project financing.

23. Tax reforms need to be considered with care. Staff cautions that cuts in personal income taxes and social contributions need to take into account the implications for work incentives as well as progressivity (see IMF technical assistance report, 2015). The announced reduction of personal income tax for the lower bracket will enhance progressivity as well as work incentives, but social contribution rate cuts should be designed to address specific objectives. Staff also favors steps to broaden the indirect tax base (see IMF technical assistance report, 2014). The tourist departure tax under consideration, among other options, would have the benefit of preserving progressivity.

24. Staff sees merit in creating a wealth fund. The fund could facilitate future increases in fiscal space without needing to cut gross debt to suboptimally low levels given its benchmarking role in financial markets. Legislation proposing the fund seeks to adhere to the Santiago Principles on institutional arrangements, structure, risk management, and disclosure. The fund would serve as a disaster relief reserve for events such as natural catastrophes, and not be available for general countercyclical purposes. The authorities, noting the strong financial position of Landsvirkjun, the main power utility, propose to channel dividends worth some ⅓ percent of GDP from it to the fund annually, targeting a steady state fund size of 9½–11½ percent of (2018) GDP after about 20 years.

Authorities' Views

25. Staff's fiscal policy assessment resonated with the authorities. They acknowledged that the fiscal plans are tight and emphasized their readiness to adjust measures in each annual budget bill to ensure that medium-term targets are met. They underlined the importance of debt reduction for a few more years, to better position Iceland for potential shocks. Scenario analyses will be included in the next Fiscal Strategy Plan, as recommended by the Fiscal Council.

26. The authorities saw merit in a spending review and further reflection on revenues. Although the focus is on welfare and investment spending at this time, they agreed that more work should be done to comprehensively review expenditures, where the main challenges would be to find a path agreeable to all three parties in the government. The focus is also on managing broader expectations in terms of wage and purchasing power increases. On the revenue side, they stressed the importance of analyzing the effects of tax reforms on progressivity and inequality, noting that they are collecting and processing the micro data. They also mentioned the need to rethink environmental taxation in light of the new reality of hybrid and electric vehicles.

B. Monetary and Exchange Rate Policy

27. Monetary policy should continue to focus on the inflation target. Notwithstanding the challenges of fine-tuning monetary policy in a small open economy, the inflation targeting regime has served Iceland well—a view recently shared by an independent task force on monetary policy that had been created by the previous government with the explicit mandate of considering alternative arrangements including pegs and currency boards.

28. Monetary policy settings should remain data driven. Staff supported keeping rate policy on hold for now and continuing to desist from exchange intervention. Rate hikes would be warranted if inflationary pressures resurfaced (e.g., with large wage increases or unanchored expectations), or in a scenario of large capital outflows. Conversely, rate cuts could resume if inflation prospects softened. Over the medium term, Iceland's strengthened fiscal and external balance sheets—mirrored in its sovereign credit ratings—seem consistent with a gradual path to lower real interest rates, a progression that would also reduce its attractiveness as a carry trade target.

29. The inflation target should capture as well as possible households' spending patterns. A lively debate has re-emerged on excluding some or all housing costs (see selected issues). Staff takes the view that the inflation target, as an accountability device, should capture the consumer basket as well as possible, and be understood by all. While various trimmed measures can help inform policy making, these are best taken as complements to, not substitutes for, the full index. Staff supported further investigation of alternative approaches to computing and targeting a modified index, with a focus on costs associated with owner-occupied housing.

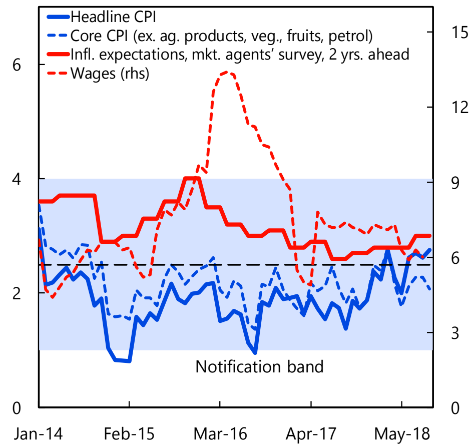
30. The CBI should strive to improve its communication to the public, especially on exchange rate policy. One facet of this would be to adopt an intervention policy consistent with the inflation targeting framework. This should plainly state that there is no exchange rate objective, and that foreign exchange intervention shall be limited to maintaining reserve adequacy and countering disorderly market conditions. Staff agreed that the recent exchange rate flexibility has been appropriate.

Authorities' Views

31. The authorities shared staff's views on the adequacy of the inflation targeting framework. Agreeing that monetary policy must remain data driven, they added that elevated risks at the current juncture

Figure 16. Inflation

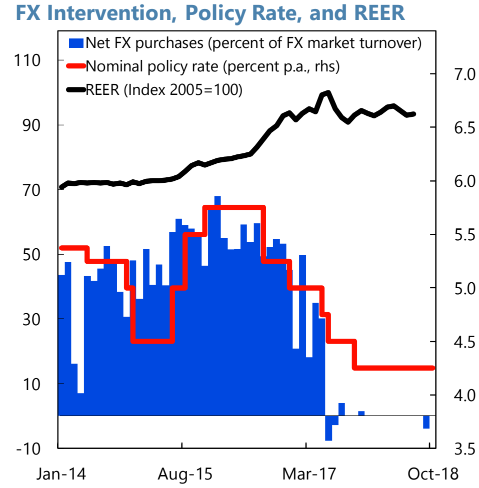
Inflation and Inflation Expectations
(Percentage change y/y)



Source: Statistics Iceland.

Figure 17. Monetary Policy

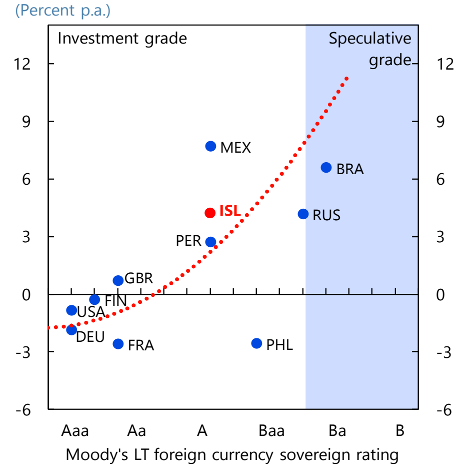
FX Intervention, Policy Rate, and REER



Source: CBI.

Figure 18. Ratings and Rates

Real Policy Rates, September 2018
(Percent p.a.)



Sources: Bloomberg Finance L.P.; and Moody's.

underscore the need for caution in rate setting as developments could push the economy in either direction.

32. Staff's counsel on exchange market intervention was well taken. The authorities view their policy toward participation in the foreign exchange market as consistent with staff advice. They agreed that interventions should not seek to defend any exchange rate level, and viewed their most recent interventions, once in September 2018 and once in October, as appropriate responses to mitigate excessively volatile market conditions on those days; in this vein, they do not preclude future intervention if they assess market participants to be overreacting to news, given the thinness of the market. A review of the substance of intervention policy, to take place over the next 12 months, will also address the attendant communication strategy.

C. Financial Stability Policy

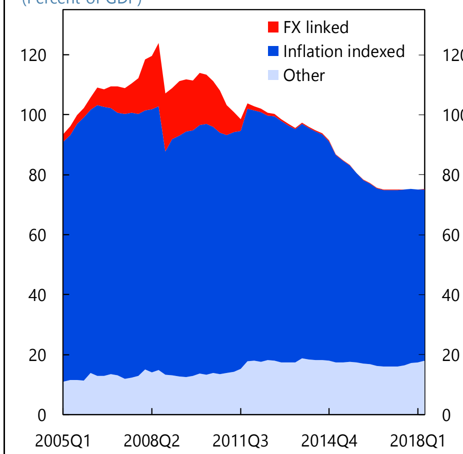
33. Macroprudential policy should focus on ensuring system-wide stability. Concerns are limited at this time, yet it is good that Iceland's toolkit is well developed. Capital buffers imposed by Fjármálaeftirlitid (FME, the financial regulator)—8¾ percent in total for the three main banks—will become increasingly binding as dividend taking reduces excess capitalization. CBI rules on liquidity coverage, net stable funding, and net open foreign currency positions help ensure banking sector resilience; they should be complemented by pre-emptive use of new powers to limit foreign currency lending to unhedged borrowers. Importantly, FME's new loan-to-value ceilings on mortgages—set at 85–90 percent—help limit household borrowers' leverage by acting on lending standards directly, for all types of lenders.

34. Staff again advised the CFM on inflows be lifted. The special reserve ratio, introduced in mid 2016, seeks to prevent a new inflow surge. To ensure that a carry trade cannot get underway abroad through the revival of a "glacier bond" market, in early 2017 the CBI buttressed the CFM by proscribing derivative transactions to hedge exchange rate risk on króna bonds issued offshore. Staff, however, detects no evidence of an inflow surge at this

Figure 19. Household Sector

Household Debt

(Percent of GDP)

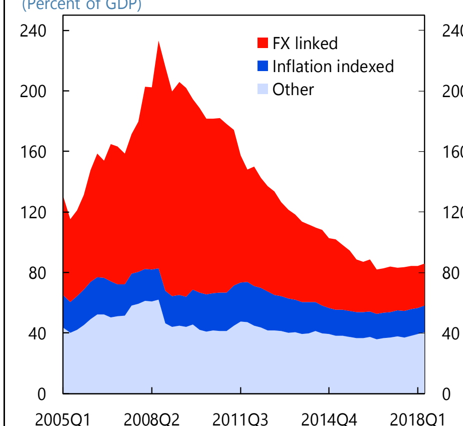


Sources: CBI; and Statistics Iceland.

Figure 20. Corporate Sector

Nonfinancial Corporate Debt 1/

(Percent of GDP)



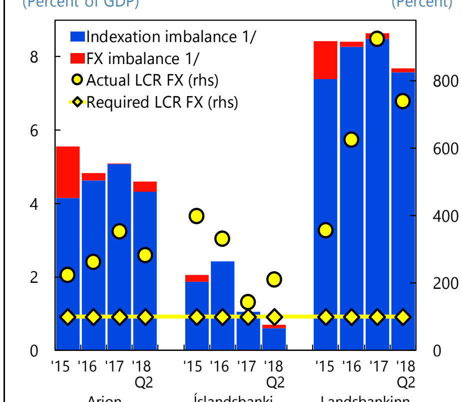
Sources: CBI; and Statistics Iceland.

1/ Excludes holding companies.

Figure 21. Banking Sector

Banking Sector Imbalances

(Percent of GDP) (Percent)



Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.

1/ Imbalances are assets less liabilities.

time—even the flows seen in 2015 were small in historical comparison—and therefore sees no case for the reserve ratio currently. Staff reminded the authorities that they had identified a smaller gap between rates at home and abroad as a condition for dialing back the CFM, and that rate differentials continue to narrow.

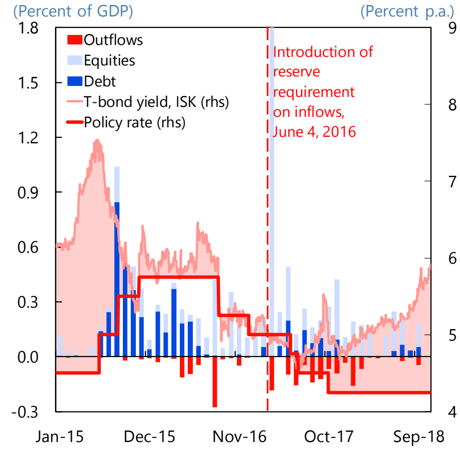
35. **CFMs can be useful in certain circumstances provided they do not substitute for warranted macroeconomic adjustment**. Were an inflow surge to occur, Iceland would have some scope for additional króna appreciation, given the still-positive current account gap; possible further rate cuts, given the high exchange rate pass through; and more reserve accumulation, given the economy's exposure to shocks. Microprudential oversight would act to limit risk taking by individual banks, and macroprudential policies would add a systemic overlay.

36. **The authorities plan to recast the legal basis for future CFMs**. Steps are afoot to streamline the Foreign Exchange Act and restore the presumption of capital mobility. As such steps are taken, the authorities intend to put some version of the special reserve ratio on a permanent statutory footing—allowing the possibility of reimposing it as part of a comprehensive policy response in the event of a future inflow surge. Guided by the IMF's *Institutional View*, staff emphasized that CFMs, if used, should be transparent, targeted, temporary, preferably nondiscriminatory, and should not substitute for warranted macroeconomic adjustment.

37. **The remaining offshore króna accounts should be regularized**. In 2016, the authorities passed a law governing these "accounts subject to special restrictions" to ensure that general capital flow liberalization could be decoupled from the specific treatment of holders of the residue of the pre-crisis carry trade. But with such accounts now locking up offshore krónur worth only about 3 percent of GDP, and with reserves at close to 27 percent of GDP, reserve adequacy no longer hinges on the restrictions—which in staff's view can be liberalized.

Figure 22. Flows and Yield Curves

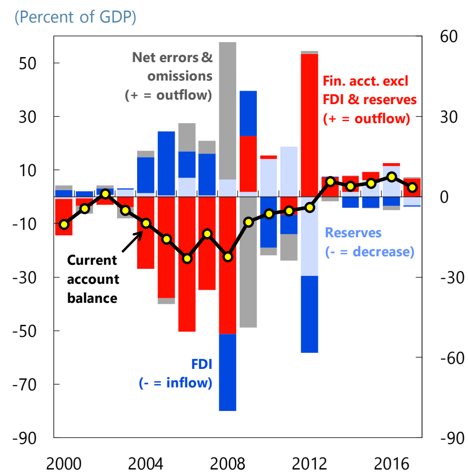
"Yellow Ticket" Flows and Interest Rates



Source: CBI.

Figure 23. Financial Account

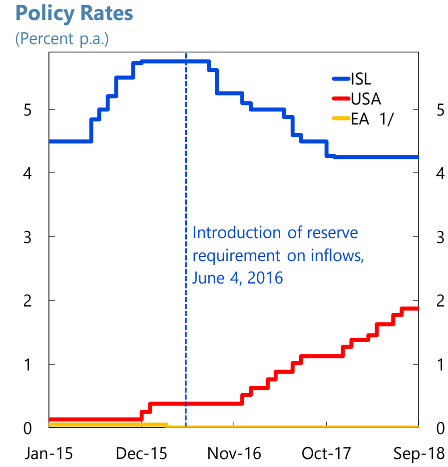
Financial Account



Sources: CBI; and IMF staff calculations.

Figure 24. Policy Rates

Policy Rates



1/ Main refinancing operations.

Sources: CBI; ECB; and U.S. Federal Reserve.

Authorities' Views

38. **The authorities consider Iceland's macroprudential regime to be one of the most active in Europe**. They view the toolkit as generally adequate, but do not rule out new tools. They see the rigorous capital buffer requirements already beginning to influence banks' behavior. Noting that the buffers are high compared to average requirements across Europe, they reminded that the countercyclical capital buffer is set to increase further, from 1¼ percent to 1¾ percent, in May 2019.

39. **There was agreement that conditions for dialing down the special reserve ratio have improved**. The reduction in the interest rate differential vis à vis the dollar goes in this direction. Flagging a still-substantial gap vis à vis the euro, however, the authorities noted that they would not set the ratio to zero at this stage, emphasizing that prudence required gradualism. They also concurred that conditions for releasing the remaining offshore króna accounts had improved, but stressed their intention to pay close attention to sequencing and timing.

FINANCIAL SECTOR OVERSIGHT

40. **On the tenth anniversary of its banking crisis, Iceland stands poised to take decisive steps to upgrade financial sector oversight**. Much restructuring of the financial system has been achieved since the crisis and the three main banks appear sound at this time (Box 3). But with capital account openness comes more risk, increasing the need for strong prudential oversight of banks and pension funds. Oversight of other nonbanks and markets, too, must be rigorous, as must consumer and investor protection. The core issues are regulatory independence, powers, capacity, and resources, but reforms should also seek to remove the potential for conflicts, gaps, or coordination issues, and take local conditions into account, notably the size of the country.

A. Banking Oversight and Resolution

41. **Discussions focused on revamping the regulatory architecture**. It was agreed that risk taking will increase as Iceland reintegrates into global financial markets, and both prolonged government ownership and privatization could add to the challenge. Reminding that Iceland's 2014 Basel Core Principles assessment found FME to be weak, staff emphasized the need for further improvements. Regarding the architecture, it pointed to two options: revamping institutional arrangements to increase FME's distance from the finance ministry, or unifying oversight at the CBI.

42. **Staff saw merit in unifying prudential oversight and resolution of banks at the CBI**. This would capitalize on the established independence of the CBI; recognize basic synergies between the oversight, lender-of-last-resort, and resolution functions; allow an integrated approach to micro- and macroprudential policy; and create a less complex system well suited to a country as small as Iceland. It would also eliminate unnecessary overlaps between the CBI and FME in bank liquidity oversight. Many reviews since the crisis have taken a similar position (see for instance Jännäri, 2009, Forbes, 2018, and Honohan and Orphanides, 2018). Various changes would be required at the CBI, including most likely an additional deputy governor position for financial stability.

Box 3. Iceland's Financial System Ten Years After the Crisis

IMF staff took the opportunity to review a decade of progress in financial sector restructuring and reform and—although it identified some pending tasks—came away with a mostly favorable picture.

Upon the completion of the IMF program in 2011, the authorities and IMF staff agreed that some key vulnerabilities in the financial system were yet to be addressed. These referred mainly to (i) high NPL ratios (about 23 percent), high foreign exchange and interest rate risk exposures, and high liquidity risk, which together necessitated maintaining a ban on bank dividend payments; (ii) weaknesses in financial sector oversight; and (iii) the fragile finances of the state-owned Housing Financing Fund (HFF).

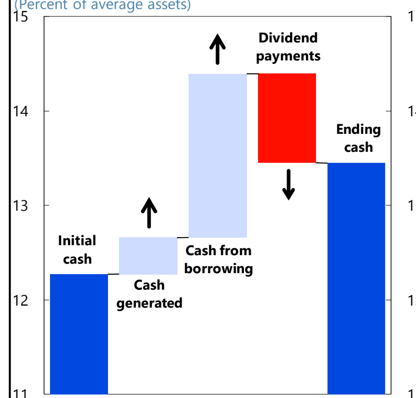
Over the last seven years, the restructuring of the sector has been largely successfully completed—although a few issues remain:

- **NPLs are now low, but there is room to further develop FME's credit risk register as a supervisory tool to assess loan quality**. In particular, the credit register may become a valuable tool for onsite inspection planning.
- **Liquidity risk has fallen, but banks' reporting of liquidity coverage ratios well in excess of the regulatory floor warrants further analysis**. There may be value in studying whether the liquidity coverage ratios fully reflect banks' own perceptions of liquidity risk, and the impact on banks' profitability and funding decisions of holding cash above the prudential floors.
- **Strong capitalization supports the removal of the ban on bank dividends, but future dividend payments should be made subject to cash flow analysis, taking into account banks' borrowing plans**. Although money is fungible, recent dividend payments appear to have been funded in part by borrowing.
- **Banking oversight has continued to strengthen, but issues remain** (see Prudential Oversight and Resolution).
- **The HFF has been recapitalized and its NPLs are low, but risks remain**. The HFF is facing a high rate of loan prepayments, which expose it to losses and interest rate risks given its fixed rate, inflation indexed funding structure.

In addition, crisis resolution has left two deep structural legacies:

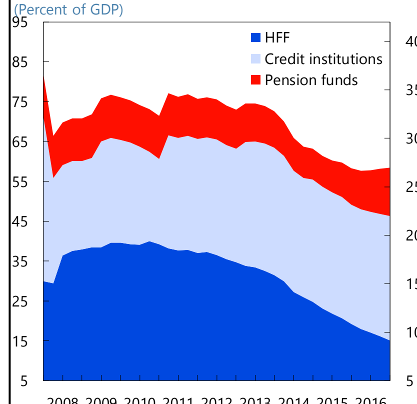
- **The state owns some two-thirds of banking sector assets**. To facilitate divestment, consideration could be given to appointing an independent team—supported by reputed international advisors—to identify potential buyers with banking expertise and long-term perspective, as well as public policies and bank business strategies that may act as impediments to privatization.
- **The pension fund industry's exposure to domestic risks has grown**. To a considerable extent, this reflects its role in bank clean-up operations after the crisis, as well as the effects of capital controls. Pension funds supported bank funding through a difficult period by keeping their domestic deposits stable, acquired some restructured large corporations, and expanded their own loan and investment books at home. Here too there is now a need more for more stringent oversight and, perhaps, better coordination with the CBI on plans to invest abroad (see Pension Fund Oversight and Conduct Regulation).

Three Main Banks' Cash Flow, 2017
(Percent of average assets)



Source: Banks' audited financial statements.

Residential Mortgage Debt by Lender
(Percent of GDP)



Source: CBI.

43. Staff warned, however, that unifying banking oversight at the CBI would not be a panacea: to succeed, the new oversight function would need powers and resources. And restructuring would entail risks—central bank independence could be challenged as new, politically sensitive roles were taken on, and incentives for regulatory forbearance could arise when lender-of-last-resort exposures are large. Conversely, though, if the supervisory agency was left beholden to the executive branch, the legislature, or both for its resources and authority, then regulatory and supervisory independence would be fundamentally hobbled. Ultimately, in any structure, political will, operational independence with accountability, rulemaking and enforcement powers, technical capacity, and resource adequacy would remain central and indispensable.

44. Staff also reiterated that divestment efforts should prioritize high quality ownership. Privatization of the two state owned banks should be pursued patiently, with a focus on finding strategic buyers with track records of conservatism and banking expertise, and robust fit-and-proper testing is vital. In the interim, the ministry of finance must resist taking too much excess capital out of the banks as dividends—excess capitalization has already come down significantly. A white paper on the future of financial services in Iceland, currently being prepared by a government-appointed committee, is expected to lay out a vision for state ownership in the financial sector.

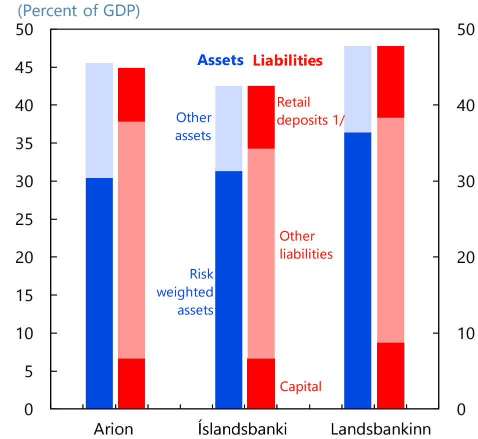
B. Pension Fund Oversight and Conduct Regulation

45. There was agreement that oversight of the pension funds also needed to be enhanced. Iceland's three-pillar pension system manages assets worth almost 160 percent of GDP, making it larger than the banking system. The funds have become increasingly important retail lenders, originating a larger volume of mortgages than the banks in 2017. In part, such lending reflects a search for króna-denominated long-term assets to match benefits, especially now that the HFF is in run-off mode.

Figure 25. Bank Funding

Assets and Liabilities, 2018Q2

(Percent of GDP)

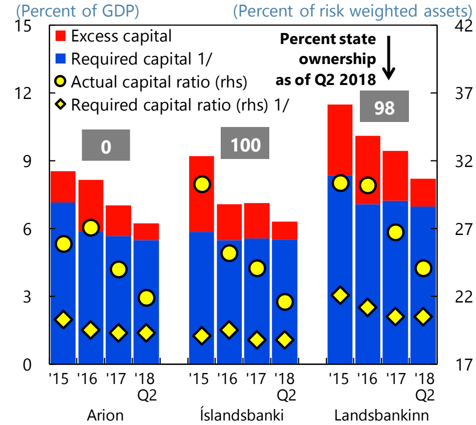


Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.
1/ Deposit balances of €100,000 or less.

Figure 26. Bank Capital Adequacy

Total Regulatory Capital

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

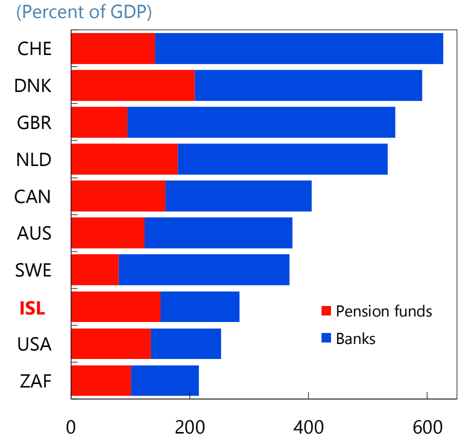


Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.
1/ Includes pillar 1 buffer and pillar 2 requirements.

Figure 27. System Structure

Total Assets, 2016

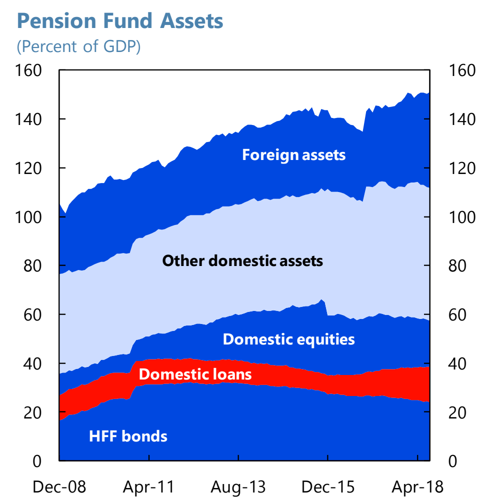
(Percent of GDP)



Sources: OECD Global Pension Statistics; and national central banks and statistics offices.

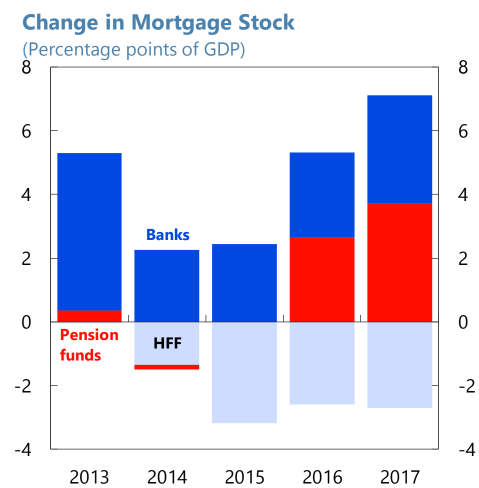
But it also taps into a tax advantage, and raises level-playing-field issues vis à vis the banks. Given limited support within Iceland for banning pension fund retail lending—the optimal solution—staff advised strong steps be taken to strengthen pension fund oversight, and supported positioning such oversight alongside that of banks at the CBI, with all necessary rulemaking powers. Such a solution would also further streamline macroprudential policy arrangements.

Figure 28. Asset Allocation



Source: CBI.

Figure 29. Pension Fund Lending



Sources: CBI; and Iceland Chamber of Commerce.

46. Staff thus gravitated to a solution where all financial sector oversight would move to the CBI. This solution, to unite FME with the CBI as one, would appropriately reflect the structure of the system and the small size of the country. It marked an evolution from staff's previous preference for a "twin peaks" solution under which—for clarity of mandates, and to avoid overburdening the CBI—most nonbank regulation, all consumer and investor protection, and market oversight would remain at FME, which would evolve into a conduct-policing agency focused on rules for truth, transparency, and disclosure, and their enforcement. Staff's modified position recognized that, as a matter of pragmatism, a twin peaks approach risked leaving behind a conduct agency that could be too small and too weak.

47. Staff also urged that Iceland energize its efforts to combat financial crime. The Financial Action Task Force's 2018 mutual evaluation report has identified priority areas and made a series of recommendations, indicating that insufficient progress could push Iceland to its "gray list." With events elsewhere showing how anti money laundering deficiencies can create stability risks, it is important that such reclassification be pre-empted by implementing the needed correctives.

Authorities' Views

48. The government subsequently decided to move forward with a merger of the CBI and FME. This decision, made by the ministerial committee on economic affairs in mid-October 2018, shortly after the Article IV mission, calls for a merger of the two bodies in a manner that builds greater trust and ensures efficiency in the implementation of macroprudential policy and financial market supervision. An interagency team comprising representatives of the prime minister's office and the finance ministry, plus liaisons from the CBI and FME, is tasked with preparing the draft legal amendments by end February 2019, for consideration by the Althing in its spring session.

49. The authorities assured that they are taking their anti-money laundering efforts very seriously. They have tripled the number of personnel working on this issue, with funding increasing accordingly, and have sought external support to help improve their practices and regulations.

STRUCTURAL REFORMS

50. Strengthening growth potential, environmental sustainability, and economic resilience are important medium-term priorities. Discussions centered on wage bargaining and educational reforms, but there was also a sectoral element, focusing on tourism and fisheries. In tourism, well-designed policies to address bottlenecks can open up growth potential. In fisheries, policies must continue to concentrate on sustainability, with a strong international dimension.

A. Wage Bargaining, Education, and Competitiveness

51. As before, staff supported the authorities efforts to institute a new wage bargaining mechanism anchored on external competitiveness. Unit labor costs are rising despite productivity gains—and those gains are diminishing. After the new government agreed in early 2018 to review the tax and benefit system with a view to making it more progressive, social partners acquiesced to reopening the collective wage agreements closer to their expiry dates. Intense talks loom for the winter of 2018–19. Staff, noting that the growth of purchasing power has been remarkable in recent years, reiterated its advice that wage increases should not exceed productivity growth.

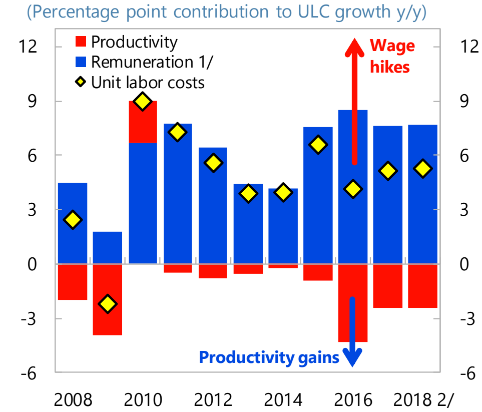
52. Staff also noted that a sound framework needs to be in place to reconcile public and private sector wage increases. Shortcomings in this area were exposed by the furor around the generous awards in 2017 by the Compensation Court, the body responsible for high-level public sector wage setting. Recent steps to reform the Compensation Court move in the right direction, enhancing transparency and trust.

53. Faster productivity growth requires a push to improve educational outcomes and reduce skills mismatches. Recent Program for International Student Assessment (PISA) scores suggest Iceland's educational outcomes have declined with crisis-induced cuts to education spending. Iceland lags the OECD average in science and reading—and the Nordic average in

Figure 30. Competitiveness

Contributions to Unit Labor Costs

(Percentage point contribution to ULC growth y/y)

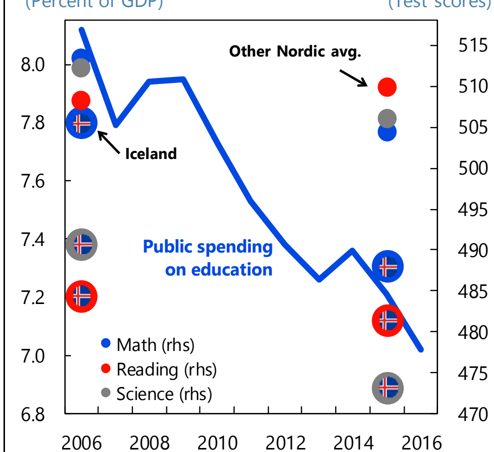


Source: CBI.
1/ Wage and non-wage compensation.
2/ CBI forecast.

Figure 31. Education

Education Spending and PISA Scores

(Percent of GDP) (Test scores)



Sources: OECD; and Statistics Iceland.

mathematics also—and the drop-out rate of adults not completing upper secondary education is one of the highest in the OECD. The case seems strong, therefore, for a decompression of public investment in education, embedded in a comprehensive strategy. Enhancing vocational training schemes could curb mismatches and strengthen the middle-layer educational segment. This, in turn, would help bridge the opportunity gap confronting university graduates.

Authorities' Views

54. The authorities viewed the coming wage round as a key source of uncertainty, and were resolute on pressing forward with educational reforms. Recent changes in union leadership cast doubt on whether wage awards based on competitiveness are within reach. In the event that wage increases are once again excessive, the authorities stand ready to adjust policies as needed to maintain macroeconomic stability. On education, they view Iceland's PISA scores with concern, but note that these do not capture aspects such as equity in access to education, where Iceland does well. Political commitment to greater educational spending is strong, within the overall envelopes and targets laid out in the Fiscal Strategy Plan.

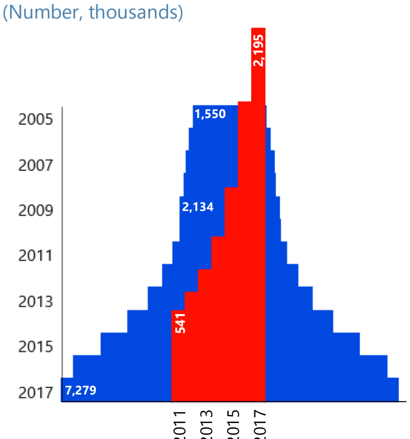
B. Sustainability and the Environment

55. The leveling out of tourism adds urgency to the need to develop a comprehensive strategy for the sector. Concerns include deteriorating price competitiveness, overcrowding of the main nature sites near Reykjavík, and stretched infrastructure. Tourist satisfaction declined in 2017. Staff welcomed the work of the tourism task force, which now brings together the key ministries, local authorities, and industry bodies. The task force is developing a measurement framework for tourism and its economic, environmental, and social impacts. Beyond data issues, it is important to lay out a high-level strategy addressing capacity constraints and detailing contingency measures in the event of temporary disruptions—for instance, should there be a serious volcanic eruption. Staff also urged careful analysis of the critical role of airlines for Iceland's tourism performance.

56. In the fisheries sector, redoubled efforts are needed to secure durable agreements with other north Atlantic fishing nations for several migratory species. Icelandic fishing enjoys a strong reputation for sustainability as regards demersal species—notably cod in Icelandic waters. However, the lack of international cooperation agreements for several migratory species results in overfishing and risks depletion of some pelagic stocks—mackerel, a new arrival, and blue whiting, among others. Staff urged that Iceland's efforts to eliminate such areas of overfishing be energetic and relentless.

Figure 32. Tourism

Tourists' Overnight Stays (Blue) and Airport Arrivals (Red)
(Number, thousands)



Source: Statistics Iceland.

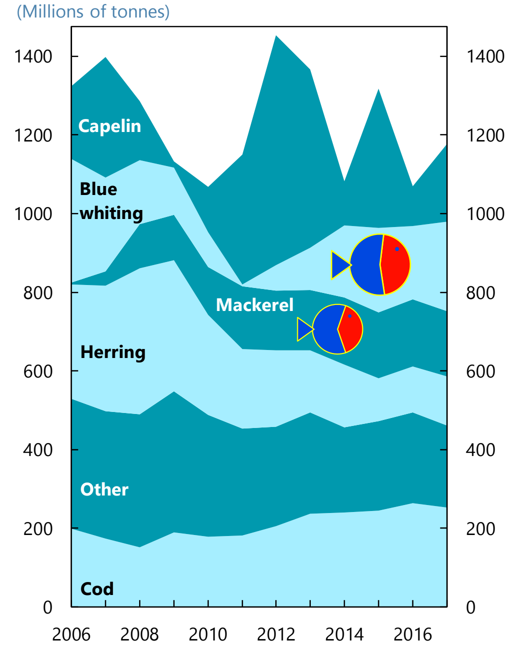
Authorities' Views

57. There was agreement on the need for a comprehensive policy approach for the tourism industry. The tourism task force is seen as the natural forum to develop such policies, where consideration should also be given to potential steps to influence the number of tourist arrivals, almost all of which occur through one gateway: Keflavík airport.

58. The authorities welcomed staff's focus on the fisheries sector and stressed their total commitment to sustainability. They pride themselves for Iceland's adherence to scientific advice in determining fishing quotas and for their tough enforcement. They agree there is a pressing need for international cooperation agreements to ensure sustainable harvesting of transboundary stocks in the north Atlantic, which is a shared responsibility of all the coastal states. They highlighted their ongoing efforts to secure equitable agreements—and noted that, in the interim, Iceland has taken unilateral steps to set its own quotas for several of the migratory species.

Figure 33. Fishing and Overfishing

Icelandic Fish Catch and International Overfishing 1/
(Millions of tonnes)



Source: International Council for the Exploration of the Sea (ICES); and Statistics Iceland.
1/ "Ocean waves" show Icelandic catches; "swimming fish" show, in red, overfishing of all countries fishing in the Northeast Atlantic relative to ICES advice, 2014–16 average.

STAFF APPRAISAL

59. Overheating concerns have receded, for now. Past króna appreciation has, with a lag, guided tourism to a plateau and dampened aggregate demand. At the same time, a rising supply of new homes and office space has cooled the real estate markets.

60. Risks, however, have become more evident. Strong oil prices and fierce air transport competition are challenging the airline business, risking disruptions to tourism. Escalating trade tensions could hurt Iceland's aluminum industry, among other sectors. Brexit could dampen demand in a vital export market, while also further complicating the pursuit of cooperative and sustainable outcomes in fishing. And overheating concerns could resurface if upcoming wage awards are excessive. These risks come on top of Iceland's permanent exposure to elemental hazards.

61. Staff supports the new government's emphasis on infrastructure, health, and education spending, but calls for greater clarity in its fiscal plans. A broadly neutral fiscal stance and further debt reduction are appropriate going into 2019–20. Spending should be prioritized carefully, however, based on their medium-term effects on growth and productivity. Saving measures should be spelled out, reliance on unpredictable dividend flows reduced, and tax reforms considered carefully, to ensure observance of the overall surplus targets.

62. Monetary policy should remain focused on price stability. Five years of on-target inflation is a remarkable achievement given Iceland's history of price instability. The inflation target, as an accountability device, should capture the consumer basket as well as possible, and be understood by all. Foreign exchange intervention should be limited to countering disorderly market conditions, with a strong emphasis on maintaining adequate reserves. Staff judges Iceland's external position to be broadly in line with fundamentals and desired policy settings.

63. The authorities' decision to merge the CBI and FME is a decisive step toward better, more integrated oversight. The new structure will capitalize on the independence of the CBI; recognize important synergies between the bank oversight, lender-of-last-resort, and resolution functions; eliminate unnecessary overlaps; and create a less complex system better suited to a country as small as Iceland. Nonetheless, the restructuring is not a panacea, and efforts must remain focused on the basic building blocks: independence, accountability, rulemaking and enforcement powers, technical capacity, and resources. And it is important that the authorities plan carefully to avoid unduly taxing financial oversight and monetary policy during the transition.

64. CFMs can be useful in certain circumstances provided they do not substitute for warranted macroeconomic adjustment. In this regard, staff notes the authorities' plans to renew the legal basis for the special reserve requirement on selected debt inflows. But staff also notes that narrowing interest rate differentials provide further grounds for rolling back the ratio at this time.

65. Iceland's efforts to improve its wage bargaining system should seek to anchor it on productivity growth and competitiveness. With purchasing power having increased by some 25 percent over the last four years—and even more if viewed in foreign currency terms—wage agreements should seek to be in line with productivity gains to protect competitiveness.

66. Strengthening economic and environmental sustainability must also be a high priority. In tourism, the growth slowdown adds urgency to adopting a comprehensive strategy and taking concrete actions, including to improve tourism services at popular sights and the accessibility of destinations farther afield from Reykjavík. In fisheries, careful management of marine resources remains central to success—and this should include further efforts to secure durable fishing agreements with other north Atlantic fishing nations for several migratory species.

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

Table 1. Iceland: Selected Economic Indicators, 2014–23

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Percentage change unless otherwise indicated)									
National Accounts (constant prices)										
Gross domestic product	2.1	4.5	7.4	4.0	3.7	2.9	2.8	2.6	2.5	2.5
Total domestic demand	5.3	6.4	8.8	7.0	4.6	4.5	3.2	2.5	2.8	2.6
Private consumption	3.2	4.5	7.2	7.9	5.4	4.0	3.2	2.8	3.1	3.1
Public consumption	1.3	1.1	1.9	3.1	3.1	2.1	2.1	1.7	1.9	1.2
Gross fixed investment	15.9	19.7	21.7	9.5	4.8	7.9	4.3	2.6	3.0	2.5
Net exports (contribution to growth)	-1.5	-0.5	-0.2	-2.1	-0.7	-1.3	-0.2	0.2	-0.3	0.0
Exports of goods and services	3.2	9.1	10.9	5.5	3.2	3.1	2.5	2.4	2.4	2.4
Imports of goods and services	9.8	13.8	14.5	12.5	5.5	6.8	3.3	2.1	3.2	2.6
Output gap (percent of potential output)	0.0	0.5	2.4	1.5	1.1	0.7	0.3	0.2	0.1	0.0
Selected Indicators										
Gross domestic product (ISK bn.)	2,074	2,288	2,503	2,615	2,797	2,993	3,178	3,359	3,543	3,732
Gross domestic product ($ bn.)	17.8	17.3	20.7	24.5	26.6	28.2	30.2	32.1	34.1	36.3
GDP per capita ($ thousands)	54.0	52.2	61.2	70.2	75.5	79.1	83.7	87.9	92.6	97.5
Private consumption (percent of GDP)	52.7	50.1	49.4	50.3	50.4	50.3	50.2	50.0	50.1	50.3
Public consumption (percent of GDP)	23.9	23.4	22.8	23.3	23.8	23.9	23.9	23.9	24.0	24.0
Gross fixed investment (percent of GDP)	17.2	19.2	21.5	22.3	22.8	23.7	24.0	24.0	24.0	24.0
Gross national saving (percent of GDP)	21.2	24.5	29.1	25.8	25.5	25.8	26.0	26.2	26.1	26.2
Unemployment rate (percent of labor force)	5.0	4.0	3.0	2.8	3.2	3.3	3.6	3.8	3.8	3.8
Employment	1.6	3.4	3.7	1.8	2.3	2.6	2.1	1.6	1.5	1.0
Labor productivity	0.2	0.9	3.6	2.2	1.4	0.3	0.8	1.0	1.0	1.5
Real wages	2.1	6.0	7.0	5.6	2.8	2.2	1.9	1.8	1.0	1.5
Nominal wages	4.1	7.6	8.7	7.4	5.3	4.8	4.5	4.3	4.2	4.2
Consumer price index (average)	2.0	1.6	1.7	1.8	2.5	2.6	2.6	2.5	2.5	2.5
Consumer price index (end period)	0.8	2.0	1.9	1.9	2.6	2.6	2.6	2.5	2.5	2.5
ISK/€ (average)	155	146	134	121	124	124	125	125	125	124
ISK/$ (average)	117	132	121	107	105	106	105	105	104	103
Terms of trade (average)	3.3	6.7	2.4	1.7	-1.0	2.2	0.4	0.2	0.3	-0.1
Money and Credit (end period)										
Base money (M0)	-17.6	27.8	3.0	37.9	7.7	14.5	8.6	9.5	10.1	9.4
Broad money (M3)	7.1	5.6	-4.6	5.0	9.5	7.2	6.5	6.2	5.9	6.0
Bank credit to nonfinancial private sector	-2.4	3.5	4.4	9.2	7.5	6.4	6.2	5.6	5.6	5.6
Central bank 7 day term deposit rate 1/	4.50	5.75	5.00	4.25	4.25	…	…	…	…	…
	(Percent of GDP unless otherwise indicated)									
General Government Finances 2/										
Revenue	43.7	40.7	56.7	42.4	41.6	41.5	41.4	41.1	40.8	40.7
Expenditure	43.8	41.5	44.3	41.0	40.7	40.8	40.9	40.7	40.3	40.2
Overall balance	-0.1	-0.8	12.3	1.5	0.9	0.7	0.5	0.4	0.5	0.5
Structural primary balance	2.0	1.2	2.6	2.3	2.4	2.3	2.1	1.9	2.3	2.3
Gross debt	79.7	66.0	51.7	40.0	37.0	33.8	31.4	28.9	25.6	23.6
Net debt	54.0	47.8	39.6	34.2	30.3	27.6	25.5	23.8	22.2	20.6
Balance of Payments										
Current account balance 3/	3.9	5.2	7.5	3.5	2.4	2.0	2.0	2.2	2.1	2.2
of which: services balance	6.5	8.7	10.3	10.4	9.5	9.6	9.4	9.3	9.3	9.2
Capital and financial account (+ = outflow)	3.4	5.1	8.9	3.0	2.3	1.9	1.9	2.1	2.0	2.1
of which: direct investment, net (+ = outflow)	-4.1	-4.0	-3.5	-0.4	-0.3	-0.2	-0.2	-0.2	-0.7	-1.3
Gross external debt 4/	198.8	176.0	124.4	90.0	76.0	72.3	67.6	64.6	61.4	58.2
Central bank reserves ($ bn.)	4.2	5.0	7.2	6.5	7.2	6.7	7.1	7.4	7.5	7.7

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

1/ For 2018, rate as of June 20.

2/ Data for 2017 are preliminary.

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

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

Table 2. Iceland: Money and Banking, 2014–23
(Billions of krónur, unless otherwise indicated)

	2014	2015	2016	2017	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.
Central Bank										
Net foreign assets	47	295	587	565	593	655	721	802	852	827
Assets	530	653	817	687	696	756	999	1,056	1,073	1,070
Liabilities	483	358	230	122	103	101	279	254	220	243
of which: central government foreign currency deposits	368	301	185	81	62	60	238	213	179	203
of which: bank estates' foreign currrency deposits 1/	24	18	0	0	0	0	0	0	0	0
Net domestic assets	34	-191	-479	-417	-434	-472	-523	-585	-613	-566
Central government, net	7	7	-30	-23	-23	-23	-23	-23	-23	-23
Assets	153	98	41	56	56	56	56	56	56	56
of which: recapitalization bond	146	91	29	0	0	0	0	0	0	0
Liabilities (current account)	146	91	71	79	79	79	79	79	79	79
Credit institutions (incl. nonbanks), net	-82	-216	-407	-378	-367	-418	-484	-565	-616	-590
Assets	59	58	2	6	45	55	55	55	55	55
Liabilities	142	274	410	384	412	473	539	620	671	645
of which: term deposits and CDs	106	242	339	303	331	392	458	539	590	564
Other items, net	109	17	-42	-16	-44	-31	-15	4	26	48
ESI (asset management company)	210	127	36	9	0	0	0	0	0	0
Capital	75	79	44	22	11	-2	-18	-37	-59	-81
Base Money	81	104	107	148	159	182	198	217	239	261
Currency issued	50	56	62	68	115	141	158	174	194	214
Deposit money banks' deposits at the central bank	31	48	45	80	45	42	40	42	45	47
Deposit Money Banks										
Net foreign assets	244	66	-257	-267	-264	-266	-266	-265	-267	-267
Assets	395	349	251	324	328	325	326	326	325	324
Liabilities	151	283	508	591	591	591	591	591	591	591
of which: bonds	37	175	406	494	494	494	494	494	494	494
Net domestic assets	1,344	1,608	1,845	1,932	2,046	2,158	2,272	2,389	2,506	2,631
Central bank, net	82	238	385	379	332	381	445	529	582	559
Assets	139	295	385	379	371	430	494	578	631	608
Liabilities	57	56	0	0	39	49	49	49	49	49
General government, gross	237	231	184	91	98	95	91	89	82	79
of which: bonds	217	210	164	70	77	74	70	69	61	58
Private sector, gross	2,192	2,217	2,285	2,483	2,662	2,828	2,999	3,163	3,337	3,520
Nonfinancial	1,973	2,043	2,133	2,328	2,503	2,665	2,830	2,990	3,158	3,336
Corporations	1,079	1,128	1,174	1,302	1,410	1,500	1,596	1,683	1,776	1,874
Households	894	915	959	1,027	1,094	1,165	1,235	1,306	1,382	1,462
Financial	219	174	152	154	159	164	169	174	179	184
Other items, net	-1,168	-1,078	-1,009	-1,020	-1,047	-1,146	-1,263	-1,393	-1,495	-1,527
Domestic deposits	1,588	1,674	1,588	1,665	1,782	1,892	2,006	2,124	2,239	2,364
Krona deposits	1,295	1,393	1,448	1,502	1,607	1,706	1,809	1,915	2,019	2,131
Foreign currency deposits	293	281	140	164	175	186	197	209	220	232
Consolidated Banking System										
Net foreign assets	291	361	330	298	329	388	455	536	586	560
Net domestic assets	1,341	1,362	1,314	1,428	1,560	1,637	1,701	1,754	1,840	2,010
General government, net	245	238	154	68	74	72	67	66	59	56
Private sector, gross	2,192	2,217	2,285	2,483	2,662	2,828	2,999	3,163	3,337	3,520
Other items, net	-1,096	-1,093	-1,125	-1,123	-1,177	-1,263	-1,365	-1,476	-1,555	-1,565
Broad money	1,632	1,723	1,643	1,726	1,889	2,025	2,156	2,290	2,426	2,570
of which: currency in circulation	44	49	55	60	107	133	150	167	186	206

Sources: CBI; and IMF staff projections.

1/ Deposits of successor holding companies to the bank estates from 2016.

Table 3. Iceland: Financial Soundness Indicators, 2015–18 1/

(Percent)

	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2
Regulatory capital to risk-weighted assets 2/	26.3	26.6	27.4	28.2	29.4	28.5	27.7	27.5	26.3	26.6	25.6	25.1	23.3	22.6
Regulatory tier 1 capital to risk-weighted assets 2/	24.6	25.3	26.2	27.4	28.6	27.6	27.5	27.0	25.8	26.1	25.1	24.2	22.8	22.1
Net interest margin 2/	2.8	3.4	3.3	2.9	3.0	3.5	3.2	3.3	3.0	3.4	3.0	3.0	3.0	3.3
Return on assets 2/	3.5	2.3	3.1	4.9	1.2	3.1	1.9	0.1	1.8	2.2	0.7	1.2	1.4	1.4
Return on equity 2/	18.5	11.9	16.2	24.9	6.1	15.3	9.4	0.5	8.7	11.1	3.5	6.2	7.6	7.6
Net interest income to total income 2/ 3/	37.3	56.7	46.4	32.2	65.0	48.6	56.8	73.0	55.9	62.9	77.5	58.9	62.6	65.3
Noninterest expense to total income 2/ 3/	70.3	108.2	71.5	56.7	212.8	89.2	120.1	2833.8	145.2	106.7	352.0	231.0	181.8	187.3
Liquid assets to total assets 2/ 4/	27.0	26.4	26.3	25.0	24.2	23.6	24.7	24.0	25.4	24.5	23.9	21.9	21.8	21.6
High-quality liquid assets to total assets	16.8	18.1	19.2	19.0	18.6	18.0	19.3	17.3	17.6	16.1	14.6	13.2	12.8	11.9
Net open foreign exchange position to capital 2/	10.6	8.0	8.0	9.0	5.4	1.7	0.6	1.2	0.2	0.3	1.2	0.5	0.3	2.2
Total nonperforming loans (NPLs), facility level 5/	2.1	2.1	2.0	1.7	1.6	1.6	2.2	2.0	1.6	1.7	2.2	1.9	1.9	1.6
Household NPLs, cross default basis 6/ 7/	8.8	8.7	8.1	7.2	5.9	5.4	4.9	4.8	4.3	3.3	3.0	2.6	2.2	2.0
Corporate NPLs, cross default basis 6/	6.1	6.7	6.8	9.0	8.7	7.4	5.9	5.8	6.0	6.6	7.3	6.6	7.1	7.0
Household and corporate NPLs, cross default basis 6/	6.6	7.0	6.4	7.7	7.4	6.5	5.4	5.2	5.1	5.2	5.5	4.9	5.1	5.0
Allowances to household loans in default	52.1	51.4	52.7	50.4	49.6	50.1	50.0	39.4	40.5	39.4	37.8	36.0	36.6	34.6
Allowances to corporate loans in default	45.3	44.8	41.3	36.5	35.8	39.1	41.8	38.9	35.5	27.3	25.0	25.1	23.9	22.5
Allowances to total loans in default	48.6	47.8	46.3	41.8	40.9	43.2	45.1	39.2	36.9	30.9	28.3	27.8	26.5	24.8

Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.

1/ Three largest deposit money banks unless otherwise indicated.

2/ Data for 2015Q1 through 2016Q4 are IMF staff estimates.

3/ Total income is total comprehensive income.

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

5/ Over 90 days in default.

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

7/ Includes loans from the Housing Financing Fund.

Table 4. Iceland: General Government Operations, 2014–23
(Percent of GDP)

	2014	2015	2016	2017	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.
Total revenue	**43.7**	**40.7**	**56.7**	**42.4**	**41.6**	**41.5**	**41.4**	**41.1**	**40.8**	**40.7**
Taxes	**33.8**	**32.0**	**47.2**	**33.4**	**33.3**	**33.4**	**33.4**	**33.3**	**33.4**	**33.5**
Taxes on income and profits	17.4	16.7	17.2	18.2	18.2	18.2	18.2	18.1	18.1	18.1
Personal income tax	13.0	13.0	13.5	14.2	14.2	14.1	14.2	14.1	14.1	14.1
Corporate income tax	3.2	2.3	2.5	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Capital gains tax and rental income	1.1	1.3	1.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Taxes on payroll and workforce	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Taxes on property	2.4	1.9	17.3	2.0	2.0	2.0	2.0	1.9	2.0	2.0
Taxes on goods and services	11.3	11.3	11.6	12.1	12.2	12.2	12.2	12.2	12.2	12.3
Value added tax	7.8	8.0	8.2	8.6	8.6	8.6	8.6	8.6	8.6	8.7
Other taxes on goods and services	3.5	3.2	3.4	3.5	3.6	3.6	3.6	3.6	3.6	3.6
Taxes on international trade	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Other taxes	2.1	1.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social contributions	**3.5**	**3.5**	**3.4**	**3.4**	**3.4**	**3.3**	**3.2**	**3.1**	**3.1**	**3.0**
Grants	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Other revenues	**6.3**	**5.1**	**6.0**	**5.5**	**4.7**	**4.7**	**4.6**	**4.5**	**4.2**	**4.1**
Property income	3.0	1.8	2.9	2.5	2.0	1.9	1.9	1.8	1.4	1.4
of which: interest income	1.0	0.8	0.9	0.7	0.6	0.5	0.4	0.4	0.3	0.2
Total expenditure	**43.8**	**41.5**	**44.3**	**41.0**	**40.7**	**40.8**	**40.9**	**40.7**	**40.3**	**40.2**
Current expenses	**42.7**	**40.5**	**43.3**	**39.5**	**39.1**	**39.0**	**38.9**	**38.6**	**38.5**	**38.4**
Compensation of employees	13.3	13.4	13.3	13.9	14.0	14.0	14.1	14.1	14.2	14.2
Use of goods and services	11.1	10.6	10.1	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Consumption of fixed capital	1.9	1.8	1.7	1.6	1.7	1.7	1.7	1.7	1.7	1.7
Interest	4.6	4.4	3.9	3.9	3.0	2.8	2.5	2.2	2.1	2.0
Subsidies	1.4	1.3	1.4	1.4	1.5	1.4	1.4	1.4	1.4	1.4
Grants	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Social benefits	6.7	6.2	5.9	6.6	6.9	6.9	6.9	6.9	6.9	6.9
Other expense 1/	3.5	2.5	6.8	1.8	2.0	2.0	2.0	2.0	2.0	2.0
Nonfinancial assets	**1.1**	**1.0**	**1.0**	**1.5**	**1.7**	**1.8**	**2.0**	**2.1**	**1.8**	**1.8**
Nonfinancial assets, acquisition	3.0	2.8	2.7	3.1	3.3	3.5	3.7	3.8	3.5	3.5
Consumption of fixed capital (-)	-1.9	-1.8	-1.7	-1.6	-1.6	-1.7	-1.7	-1.7	-1.7	-1.7
Net lending/borrowing	**-0.1**	**-0.8**	**12.3**	**1.5**	**0.9**	**0.7**	**0.5**	**0.4**	**0.5**	**0.5**
Financial assets, transactions	**2.4**	**-7.8**	**6.5**	**-4.7**	**-0.5**	**0.3**	**0.4**	**-0.1**	**-1.0**	**0.1**
Currency and deposits	4.3	-5.0	-3.1	-5.7	1.3	0.0	0.0	-0.5	-1.4	-0.2
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	-1.9	1.5	0.1	0.3	0.3	0.3	0.3	0.3	0.3
Shares and other equities	-0.1	0.0	7.0	0.0	-0.8	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	-1.8	-0.9	1.2	1.0	-1.3	0.1	0.1	0.1	0.1	0.1
Liabilities, transactions	**2.5**	**-7.0**	**-5.8**	**-6.1**	**-1.4**	**-0.4**	**-0.1**	**-0.5**	**-1.5**	**-0.4**
Securities other than shares	1.6	0.4	-1.9	-2.5	-0.6	-0.6	-0.4	-0.6	-1.6	-0.5
Loans	-1.3	-6.9	-5.5	-3.9	-0.2	-0.1	-0.1	-0.2	-0.2	-0.2
Krona denominated	-1.6	-2.1	-2.8	0.0	-0.2	-0.1	-0.1	-0.2	-0.2	-0.2
Foreign currency denominated	0.2	-4.7	-2.7	-3.9	0.0	0.0	0.0	0.0	0.1	0.0
Insurance technical reserves	0.1	0.1	0.0	-0.2	0.3	0.3	0.3	0.3	0.3	0.3
Other accounts payable	2.1	-0.7	1.6	0.4	-0.9	0.0	0.0	0.0	0.0	0.0
Gross debt	**79.7**	**66.0**	**51.7**	**40.0**	**37.0**	**33.8**	**31.4**	**28.9**	**25.6**	**23.6**
Krona denominated	59.7	52.7	43.6	36.1	33.4	30.5	28.3	25.9	22.7	20.9
Foreign currency denominated	20.0	13.3	8.1	3.9	3.6	3.4	3.2	3.0	2.9	2.8
Net debt 2/	**54.0**	**47.8**	**39.6**	**34.2**	**30.3**	**27.6**	**25.5**	**23.8**	**22.2**	**20.6**
Memorandum items:										
Primary revenue	42.7	39.9	55.8	41.7	41.0	41.1	41.0	40.7	40.4	40.5
Primary expenditure	39.3	37.0	40.4	37.0	37.7	38.1	38.3	38.5	38.2	38.2
Primary balance	3.5	2.9	15.3	4.6	3.3	3.0	2.6	2.2	2.3	2.3
Structural balance	-1.5	-2.5	-0.4	-1.0	-0.1	-0.1	0.0	0.0	0.5	0.6
Structural primary balance	2.0	1.2	2.6	2.3	2.4	2.3	2.1	1.9	2.3	2.3
Gross domestic product (ISK bn)	2,074	2,288	2,503	2,615	2,797	2,993	3,178	3,359	3.543	3.732

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

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

2/ Gross debt less currency and deposits.

Table 5. Iceland: General Government Financial Balance Sheet, 2014–23

(Percent of GDP)

	2014	2015	2016	2017 Est.	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.
Financial assets	**62.2**	**49.7**	**51.2**	**44.4**	**40.9**	**38.6**	**36.7**	**34.6**	**31.8**	**30.3**
Currency and deposits	25.7	18.2	12.1	5.8	6.7	6.2	5.9	5.1	3.4	3.0
Other assets	36.4	31.5	39.2	38.6	34.3	32.4	30.9	29.6	28.4	27.3
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	9.5	6.6	7.5	7.3	7.1	6.9	6.8	6.8	6.7	6.7
Shares and other equities	18.6	16.8	21.4	20.6	18.4	17.2	16.2	15.3	14.5	13.8
Other accounts receivable	8.4	8.1	10.2	10.7	8.8	8.3	7.8	7.5	7.1	6.8
Liabilities	**110.5**	**96.8**	**85.1**	**72.1**	**66.5**	**61.7**	**58.0**	**54.3**	**50.0**	**47.1**
Gross debt	79.7	66.0	51.7	40.0	37.0	33.8	31.4	28.9	25.6	23.6
Securities other than shares	42.3	39.0	33.9	28.0	26.1	23.8	22.1	20.3	17.6	16.2
Loans	37.4	27.0	17.8	12.0	10.9	10.0	9.3	8.6	8.0	7.4
Krona denominated	17.2	13.5	9.6	7.9	7.1	6.5	6.0	5.5	5.0	4.5
Foreign currency denominated	20.2	13.5	8.2	4.0	3.8	3.5	3.3	3.1	3.0	2.9
Other liabilities	30.8	30.8	33.4	32.2	29.5	27.9	26.6	25.4	24.4	23.5
Insurance technical reserves	23.6	25.4	27.7	26.3	24.9	23.6	22.5	21.6	20.8	20.0
Other accounts payable	7.1	5.5	5.7	5.8	4.6	4.3	4.0	3.8	3.6	3.4
Net financial worth	**-48.4**	**-47.1**	**-33.8**	**-27.8**	**-25.6**	**-23.1**	**-21.2**	**-19.7**	**-18.2**	**-16.7**
Memorandum item:										
Net debt 1/	54.0	47.8	39.6	34.2	30.3	27.6	25.5	23.8	22.2	20.6

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

1/ Gross debt less currency and deposits.

Table 6. Iceland: Balance of Payments, 2014–23

	2014	2015	2016	2017	2018 Proj.	2019 Proj.	2020 Proj.	2021 Proj.	2022 Proj.	2023 Proj.
				(Billions of dollars)						
Current account 1/	**0.7**	**0.9**	**1.6**	**0.9**	**0.6**	**0.6**	**0.6**	**0.7**	**0.7**	**0.8**
Trade balance	1.1	1.2	1.3	1.0	0.7	0.6	0.6	0.7	0.6	0.6
Balance on goods	-0.1	-0.3	-0.8	-1.5	-1.8	-2.1	-2.3	-2.3	-2.5	-2.7
Merchandise exports f.o.b.	4.9	4.7	4.5	5.0	5.4	5.6	5.8	6.0	6.3	6.6
Merchandise imports f.o.b.	5.0	4.9	5.3	6.5	7.2	7.7	8.1	8.3	8.8	9.3
Balance on services	1.2	1.5	2.1	2.5	2.5	2.7	2.8	3.0	3.2	3.3
Exports of services, total	4.3	4.4	5.4	6.3	6.8	7.0	7.4	7.8	8.2	8.7
Imports of services, total	3.1	2.8	3.2	3.8	4.3	4.3	4.5	4.8	5.1	5.4
Primary income balance 1/	-0.3	-0.1	0.4	0.0	0.2	0.2	0.3	0.3	0.4	0.4
Receipts	0.9	0.9	1.0	1.5	1.2	1.3	1.4	1.4	1.4	1.4
of which: dividends and reinvested earnings	0.2	0.3	0.4	0.3	0.5	0.5	0.6	0.6	0.6	0.6
of which: interest receipts	0.5	0.4	0.5	0.6	0.5	0.5	0.5	0.5	0.5	0.5
Expenditures	1.2	0.9	0.7	1.4	1.1	1.1	1.1	1.1	1.1	1.0
of which: dividends and reinvested earnings	-0.6	-0.5	-0.5	0.2	0.1	0.1	0.1	0.1	0.1	0.1
of which: interest payments	1.7	1.4	1.2	1.2	0.9	0.9	0.9	0.9	0.8	0.7
Secondary income balance	-0.1	-0.3	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3
Capital and financial account (+ = outflow)	**0.6**	**0.9**	**1.8**	**0.7**	**0.6**	**0.5**	**0.6**	**0.7**	**0.7**	**0.7**
Capital account balance (+ = inflow)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account (+ = outflow)	0.6	0.9	1.9	0.8	0.6	0.6	0.6	0.7	0.7	0.8
Direct investment (+ = outflow)	-0.7	-0.7	-0.7	-0.1	-0.1	0.0	-0.1	-0.1	-0.2	-0.5
Portfolio investment ("+" = outflow)	-1.2	3.8	1.9	2.6	0.5	1.7	0.9	1.2	0.5	0.7
Assets (+ = outflow)	-0.1	-3.0	1.0	1.3	1.1	1.0	1.1	1.4	0.6	0.7
Liabilities (+ = inflow)	1.1	-6.8	-0.9	-1.3	0.6	-0.7	0.2	0.2	0.1	0.0
of which: net borrowing (+ = inflow)	...	-6.7	-1.0	-1.7	0.1	-0.7	0.1	0.2	0.1	0.0
Other investment (+ = outflow)	2.2	-3.3	-1.7	-1.0	-0.6	-0.7	-0.8	-0.8	0.3	0.4
Assets (+ = outflow)	-3.2	-0.5	-5.5	-0.8	-0.8	-0.9	-1.0	-0.9	0.0	0.0
Liabilities (+ = inflow)	-5.4	2.9	-3.8	0.2	-0.3	-0.3	-0.2	-0.1	-0.3	-0.4
of which: net outflows related to bank estates' compositions	...	0.2	0.2	0.0	-0.4	0.0	0.0	0.0	0.1	0.0
Change in reserve assets (+ = increase/outflow)	0.3	1.1	2.4	-0.8	0.7	-0.5	0.5	0.3	0.1	0.2
Net errors and omissions (+ = inflow)	**-0.1**	**0.0**	**0.3**	**-0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
				(Percent of GDP)						
Current account 1/	**3.9**	**5.2**	**7.5**	**3.5**	**2.4**	**2.0**	**2.0**	**2.2**	**2.1**	**2.2**
Trade balance	6.0	7.2	6.2	4.1	2.7	2.1	1.9	2.1	1.8	1.7
Balance on goods	-0.5	-1.6	-4.1	-6.3	-6.8	-7.5	-7.5	-7.2	-7.4	-7.4
Merchandise exports f.o.b.	27.4	26.9	21.6	20.3	20.3	19.9	19.2	18.8	18.4	18.2
Merchandise imports f.o.b.	27.9	28.4	25.6	26.6	27.1	27.4	26.7	25.9	25.9	25.6
Balance on services	6.5	8.7	10.3	10.4	9.5	9.6	9.4	9.3	9.3	9.2
Exports of services, total	24.1	25.1	25.8	25.8	25.5	24.7	24.4	24.2	24.1	24.0
Imports of services, total	17.6	16.4	15.5	15.5	16.0	15.1	15.0	15.0	14.8	14.8
Primary income balance 1/	-1.4	-0.3	1.8	0.2	0.6	0.8	0.9	1.0	1.1	1.2
Receipts	5.2	5.1	5.0	6.1	4.7	4.6	4.5	4.3	4.2	3.9
of which: interest receipts	3.0	2.4	2.3	2.3	1.8	1.7	1.6	1.5	1.4	1.3
Expenditures	6.6	5.4	3.2	5.9	4.1	3.8	3.6	3.3	3.1	2.7
of which: interest payments	9.8	8.3	5.6	4.8	3.4	3.1	2.9	2.7	2.4	2.0
Secondary income balance	-0.7	-1.7	-0.5	-0.8	-0.9	-0.9	-0.9	-0.8	-0.8	-0.8
Capital and financial account (+ = outflow)	**3.4**	**5.1**	**8.9**	**3.0**	**2.3**	**1.9**	**1.9**	**2.1**	**2.0**	**2.1**
Capital account balance (+ = inflow)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Financial account (+ = outflow)	3.5	5.2	9.0	3.1	2.4	2.0	1.9	2.2	2.1	2.1
Direct investment (+ = outflow)	-4.1	-4.0	-3.5	-0.4	-0.3	-0.2	-0.2	-0.2	-0.7	-1.3
Portfolio investment ("+" = outflow)	-6.5	22.1	9.1	10.7	2.0	6.1	3.1	3.8	1.6	1.8
Assets (+ = outflow)	-0.4	-17.0	4.6	5.4	4.3	3.7	3.6	4.5	1.8	1.8
Liabilities (+ = inflow)	6.1	-39.1	-4.5	-5.2	2.2	-2.4	0.5	0.7	0.2	0.0
of which: net borrowing (+ = inflow)	...	-38.5	-4.8	-7.0	0.4	-2.5	0.4	0.6	0.2	0.0
Other investment (+ = outflow)	12.5	-19.3	-8.3	-4.1	-2.1	-2.4	-2.7	-2.5	0.8	1.0
Assets (+ = outflow)	-18.0	-2.7	-26.7	-3.5	-3.2	-3.2	-3.3	-2.8	0.0	0.0
Liabilities (+ = inflow)	-30.5	16.6	-18.4	0.7	-1.1	-0.9	-0.6	-0.4	-0.8	-1.0
Change in reserve assets (+ = increase/outflow)	1.7	6.3	11.5	-3.3	2.5	-1.8	1.6	0.9	0.2	0.4
Net errors and omissions (+ = inflow)	**-0.4**	**0.1**	**1.5**	**-0.3**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Central bank reserves ($ bn)	**4.2**	**5.0**	**7.2**	**6.5**	**7.2**	**6.7**	**7.1**	**7.4**	**7.5**	**7.7**
(Percent of GDP)	23.9	28.9	35.0	26.6	26.9	23.6	23.6	23.2	22.0	21.1
(Percent of reserve adequacy metric)	117.2	161.9	164.4	152.8	163.6	148.2	161.8	165.4	160.1	158.1
Memorandum item:										
Gross domestic product ($ bn)	17.8	17.3	20.7	24.5	26.6	28.2	30.2	32.1	34.1	36.3

Sources: CBI; and IMF staff projections.

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

Table 7. Iceland: International Investment Position, 2008–17

(Percent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Assets	**309.4**	**293.6**	**259.1**	**265.2**	**277.6**	**277.4**	**251.8**	**215.1**	**157.7**	**117.8**
Direct investment	102.9	112.7	88.2	89.1	95.6	110.0	100.0	92.1	63.9	26.5
Portfolio investment	65.1	54.4	47.0	52.3	58.1	62.3	63.9	40.6	37.5	45.0
Equity and investment fund shares	51.4	45.2	33.1	32.5	34.2	34.6	36.9	35.7	35.0	41.4
Debt securities	13.7	9.2	13.9	19.8	23.9	27.7	27.0	4.9	2.5	3.6
Financial derivatives	0.1	0.1	0.0	0.0	0.1	0.2	0.6	0.5	0.3	0.5
Other investment	114.0	96.7	84.2	64.2	94.5	79.9	61.7	53.4	23.4	19.6
Reserve assets	27.3	29.8	39.7	59.6	29.3	24.9	25.6	28.5	32.6	26.3
Liabilities	**963.0**	**945.1**	**845.3**	**792.6**	**725.7**	**664.9**	**627.2**	**219.7**	**154.7**	**112.6**
Direct investment	101.4	100.7	90.4	97.0	82.0	97.6	97.0	93.3	81.0	45.1
Portfolio investment	390.2	407.4	350.8	327.3	324.8	287.6	290.9	42.2	49.2	43.4
Equity and investment fund shares	0.8	3.8	3.2	3.2	3.2	3.5	3.7	4.0	3.6	4.9
Debt securities	389.4	403.6	347.6	324.1	321.5	284.1	287.3	38.2	45.5	38.5
Financial derivatives	0.8	0.0	0.1	0.2	0.1	0.3	0.9	0.6	0.4	0.4
Other investment	470.7	437.0	404.1	368.1	318.8	279.5	238.4	83.6	24.1	23.8
Net international investment position	**-653.6**	**-651.5**	**-586.2**	**-527.5**	**-448.2**	**-387.5**	**-375.4**	**-4.6**	**3.0**	**5.2**

Sources: CBI; and IMF staff calculations.

Note: The large reductions in external assets and liabilities in 2017 were primarily due to changes in direct investment, driven mainly by adjustments within consolidated entities in the pharmaceuticals sector (Central Bank of Iceland, *Financial Stability Report*, Vol.22, April 2018).

Annex I. External Debt Sustainability Analysis

Iceland's external debt position has continued to improve. It appears robust to most stresses, and its sensitivity to króna depreciation has lessened. Total external debt is projected to reach 57 percent of GDP by 2023 (from 126 percent in 2016), reflecting much improved solvency.

1. Iceland's external debt has been slashed. It fell, on average, by about one-third per year, between 2013 and 2017, from 240 percent of GDP in 2013 to 90 percent in 2017. This was mainly due to reductions in public and, above all, banking sector debt—the bank estates' gargantuan external debts were cleared in the winter of 2015–16 (IMF, 2016). Robust growth played a supporting role, as did the introduction of the special reserve requirement on selected debt inflows in June 2016, which slowed nonresidents' investment in króna-denominated debt to a trickle.

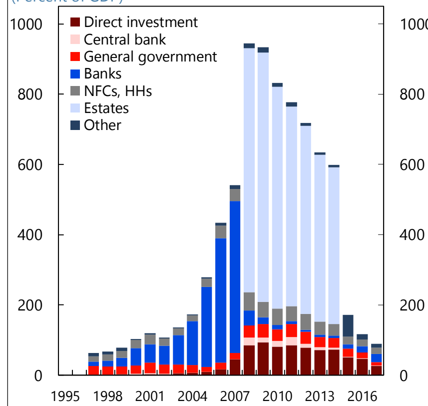
2. It is projected to fall further. Gross debt is projected to drop by a further 14 percent of GDP in 2018 and to continue on a more gradual decline thereafter, stabilizing below 60 percent of GDP by 2023.

3. The maturity structure is comfortably long. Short-term debt accounts for less than 20 percent of the total.

4. The gross external financing requirement has fallen yet remains significant. Iceland's external financing need was 28 percent of GDP in 2017—a significant improvement from 55 percent of GDP in 2015, but barely changed from 2016. It is projected to drop to a healthier 8 percent of GDP by 2023—marking a sharp reduction in liquidity risk. The mix of much lower external debt, a current account surplus, and steady reserve levels will continue to improve the ratio of reserves to the gross external financing requirement.

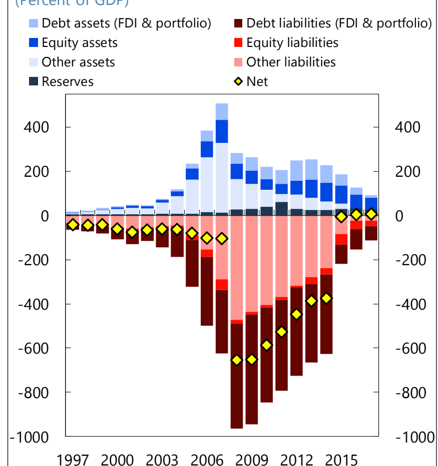
5. The projected downward path for total external debt is robust to most shocks. Standard growth and current account shocks do not materially alter the baseline trajectory. The sensitivity of the baseline path to exchange rate shocks remains more significant.

Gross External Debt
(Percent of GDP)



Sources: CBI; and IMF staff calculations.
1/ As used in past debt sustainability analyses; liquid assets apportioned to nonresidents claimants.

IIP Assets and Liabilities
(Percent of GDP)



Source: CBI.

Table 1. Iceland: External Debt Sustainability Framework, 2013–23

(Percent of GDP, unless otherwise indicated)

	Actual							Projections						Debt-stabilizing
	2013	2014	2015	2016	2017			2018	2019	2020	2021	2022	2023	non-interest CA 7/
Baseline: External debt (including old banks) 1/	240.1	198.8	176.0	124.4	90.0			**76.0**	**72.3**	**67.6**	**64.6**	**61.4**	**58.2**	**1.7**
Change in external debt	-8.4	-41.4	-22.7	-51.7	-34.4			-14.0	-3.7	-4.7	-3.0	-3.2	-3.2	
Identified external debt-creating flows (4+8+9)	-24.5	-29.6	-4.8	-31.7	-18.0			-3.3	-0.7	-0.6	0.3	-0.1	-1.5	
Current account deficit, excluding interest payments	-11.4	-9.0	-9.9	-11.6	-7.1			-5.8	-5.1	-4.9	-4.9	-4.4	-4.2	
Deficit in balance of goods and services	-7.7	-6.0	-7.2	-6.2	-4.1			-88.9	-87.1	-85.2	-83.9	-83.2	-82.7	
Exports	53.5	51.5	51.9	47.4	46.1			45.8	44.6	43.6	43.0	42.5	42.2	
Imports	45.8	45.5	44.8	41.2	42.0			-43.1	-42.5	-41.6	-40.9	-40.7	-40.5	
Net non-debt creating capital inflows (negative)	0.9	-3.3	-1.1	2.7	2.5			2.1	3.4	3.3	4.2	3.6	2.2	
Automatic debt dynamics 2/	-14.0	-17.2	6.1	-22.8	-13.4			0.4	1.0	1.0	1.0	0.8	0.6	
Contribution from nominal interest rate	5.7	5.1	3.9	4.1	3.6			3.4	3.1	2.9	2.7	2.3	2.0	
Contribution from real GDP growth	-9.4	-4.5	-9.1	-10.8	-4.2			-3.0	-2.1	-1.9	-1.7	-1.5	-1.4	
Contribution from price and exchange rate changes 3/	-10.2	-17.8	11.3	-16.1	-12.8			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	16.1	-11.8	-17.9	-20.0	-16.3			-10.7	-3.0	-4.2	-3.3	-3.2	-1.7	
External debt-to-exports ratio (in percent)	448.9	385.8	338.9	262.3	195.2			165.9	162.1	155.0	150.2	144.2	137.9	
Gross external financing need (in billions of US dollars) 5/	6.9	9.7	9.5	6.0	6.9			4.5	3.2	6.0	3.8	3.2	2.9	
in percent of GDP	43.0	54.5	54.8	28.8	28.2	10-Year	10-Year	17.0	11.4	19.8	11.9	9.4	8.1	
Scenario with key variables at their historical averages 6/								**76.0**	**63.0**	**49.3**	**35.8**	**22.3**	**10.2**	
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
								2018	**2019**	**2020**	**2021**	**2022**	**2023**	
Real GDP growth (in percent)	4.1	2.1	4.5	7.4	4.0	1.7	4.1	3.7	2.9	2.8	2.6	2.5	2.5	
GDP deflator in US dollars (change in percent)	4.6	8.5	-6.5	11.3	13.6	0.4	12.4	4.9	2.9	4.2	3.5	3.8	3.9	
Nominal external interest rate (in percent) 8/	2.5	2.4	1.9	2.8	3.4	3.1	0.8	4.1	4.3	4.3	4.2	3.8	3.5	8/
Underlying external interest rate (in percent)	3.4	3.4	2.9	2.8	3.4	3.1		4.1	4.3	4.3	4.2	3.8	3.5	
Growth of exports (US dollar terms, in percent)	5.9	6.7	-1.5	9.0	15.0	5.1	8.7	8.1	3.1	4.6	4.8	5.3	5.6	
Growth of imports (US dollar terms, in percent)	1.3	9.9	-3.8	9.9	20.6	2.6	16.6	11.5	4.4	5.0	4.3	5.8	5.8	
Current account balance, excluding interest payments	11.4	9.0	9.9	11.6	7.1	5.4	6.0	5.8	5.1	4.9	4.9	4.4	4.2	
Net non-debt creating capital inflows	-0.9	3.3	1.1	-2.7	-2.5	7.4	15.3	-2.1	-3.4	-3.3	-4.2	-3.6	-2.2	

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

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

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

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

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

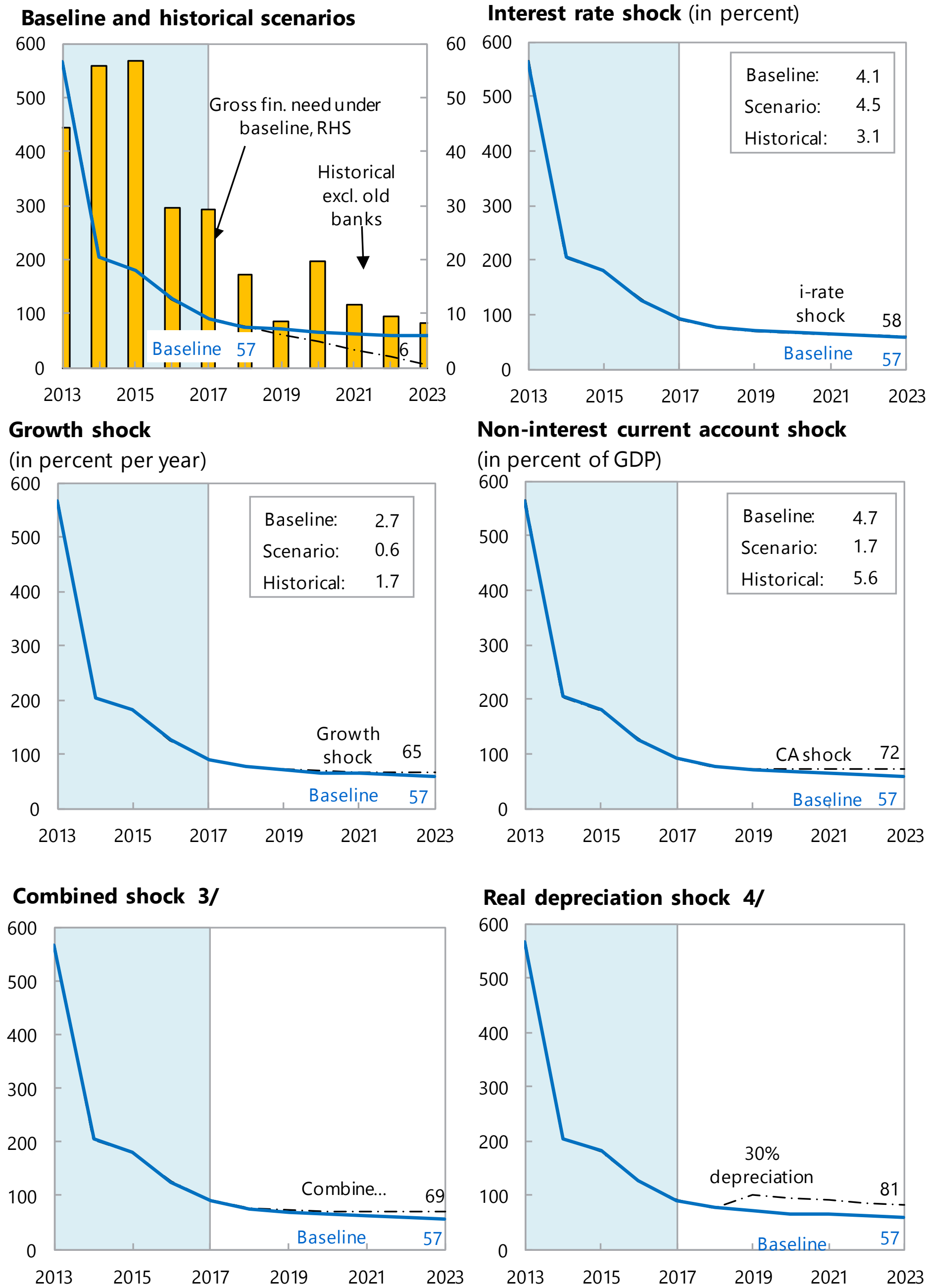
6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

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

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

Figure 1. Iceland: External Debt Sustainability Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund; country desk data, and IMF staff projections.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2018.

Annex II. Public Sector Debt Sustainability Analysis

Iceland's public debt sustainability has continued to improve, with public debt ratio on a firm downward path. Staff's baseline projections rely on relatively ambitious primary surplus objectives over the medium term, however, and significant dividend receipts. A large macro-financial shock could jolt this trend.

Gross public debt has declined considerably since the financial crisis. Gross general government debt was estimated at around 40 percent of GDP in 2017, down from 92 percent of GDP in 2011. This important debt reduction is the result of sound public finances—reflected in sustained primary surpluses—as well as a positive growth–interest differential over recent years, accompanied by large irregular income receipts.

Going forward, the Fiscal Strategy Plan envisages more active liquidity management, with greater use of government deposits at the CBI to meet financing needs. Although dividend receipts will continue to support debt reduction, they will also help finance planned investment projects.

The composition of public debt exhibits little vulnerability to exchange rate movements and short-term spikes in interest rates. As of May 2018, 84 percent of the stock of treasury bills and bonds was held by domestic investors, and 87 percent of central government debt was denominated in krónur. The average time to maturity of central government debt was around 6½ years, with only 2 percent of the total being short term.

State contingent liabilities are still significant and concentrated, but should continue to diminish. As of May 2018, liabilities guaranteed by the state amounted to about 37 percent of GDP, down from a peak of about 80 percent of GDP in 2009. By beneficiary, 91 percent of the guarantees were to the HFF and Landsvirkjun, the former being in run-off mode and the latter having issued no state guaranteed debt since 2011. Illustratively, if 15 percent of these guarantees were to crystallize upon the state, gross public debt would increase by a total of 7 percent of GDP relative to the baseline, after factoring in the additional interest costs.

This debt analysis is based on staff's macroeconomic projections:

- **Fiscal outlook.** In line with the Fiscal Strategy Plan for 2019–23, the authorities aim for a general government surplus of around 1 percent of GDP at the end of the period. Staff shows slightly lower surpluses—by around 0.5 percent of GDP—in its projections. This implies a primary surplus averaging 2.5 percent of GDP over the projection period. Together with the drawdown in government deposits at the CBI, the use of irregular income flows, and asset sales, it will contribute to a declining trajectory, despite a less favorable interest–growth differential going forward.
- **Revenues.** In line with the Fiscal Strategy Plan, staff assumes cuts in the tax burden (personal income tax and social contributions). They also integrate irregular dividends, based on the authorities' projections.
- **Expenditures.** Important investment measures, concentrated over 2019–21, are integrated into staff's baseline, in line with the government's plans to undertake infrastructure projects, mostly in transport.
- **Debt management.** Asset sales proceeds are assumed in 2017 and 2018, reducing liabilities and allowing bonds to mature without refinancing.

Forecast errors do not show any persistent bias. The median forecast error for growth over 2009–17 was 0.5 percent, implying slightly above average excess pessimism in staff's baseline projections—staff tended to be too optimistic during the crisis years and too pessimistic thereafter. Inflation errors have been important in some years, but relatively low on average, with the projections tilted slightly toward optimism. Primary balance forecasts have been subject to small errors, except in 2009 and 2016 (due to the resources from the compositions of the bank estates in the latter case).

The projected primary balance leans slightly to the ambitious side. While the 3 year adjustment in the cyclically adjusted primary balance (CAPB) over the projection period seems feasible with regards to peers' experiences, the 3 year average CAPB ranks in the top one-third by level of ambition (excluding 2018, where the 3 year average is very high due to the exceptionally high primary balance in 2016).

The heat map suggests current debt levels present low levels of risks. Gross debt and gross financing needs are expected to remain well below 85 percent and 20 percent of GDP, respectively, under all considered macro-fiscal stress tests. External financing requirements remain slightly above the lower-risk assessment benchmark of 17 percent of GDP, but have decreased significantly since 2016.

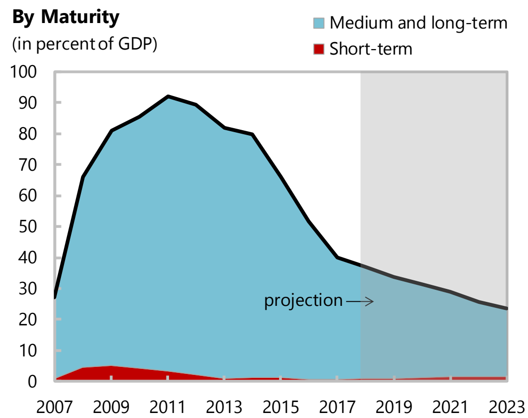
Unlikely extreme shocks could, however, seriously affect the debt trajectory. Staff also looked at a spectrum of possible debt outcomes based on the stochastic properties of Icelandic data. Based on an asymmetric distribution of shocks, the debt ratio could peak above 70 percent of GDP in 2023 in 5 percent of cases (where restrictions on the good shocks are applied).

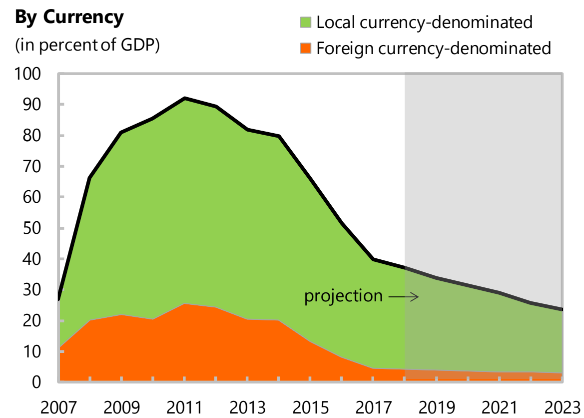
While the debt ratio is relatively resilient to the standard shock scenarios, it would be more challenged by a combined shock. In all individual shock scenarios, the debt ratio recovers relatively quickly. This is contingent, however, on the authorities' commitment to reduce liabilities using both government deposits and receipts from assets received from the bank estates. The assessment also assumes the commitment to fiscal adjustment is durable and that the macroeconomic and external environments remain relatively benign:

- **Growth shock**. Real GDP growth is subjected to a one standard deviation negative shock. Inflation declines in line with lower growth, dropping ¼ percentage point for every 1 percentage point reduction in growth. Reflecting higher risk premiums, nominal interest rates rise by 25 basis points for every 1 percent of GDP decline in the primary balance. The debt ratio rises to about 37 percent of GDP by 2020 and falls thereafter.
- **Primary balance shock**. A 4 percent of GDP decline in revenues is applied over 2 years, coupled with a rise in interest rates. The debt to revenue ratio deteriorates relative to the baseline before recovering.
- **Interest rate shock**. A 200 basis point increase in spreads is applied throughout the projection period, with a negative feedback effect on growth. The rate of decline of the debt ratio slows slightly relative to the baseline in 2019 but returns to its downward trajectory thereafter.
- **Real exchange rate shock**. A 25 percent devaluation of the real exchange rate is applied in the first year, with pass through effects to inflation. The rate of decline in the debt ratio accelerates slightly relative to the baseline in 2019 but tracks the baseline path thereafter.
- **Combined macro-fiscal shock**. This test combines shocks to growth, the interest rate, the exchange rate, and the primary balance. The debt ratio climbs to 47 percent of GDP before resuming its downtrend in 2020.

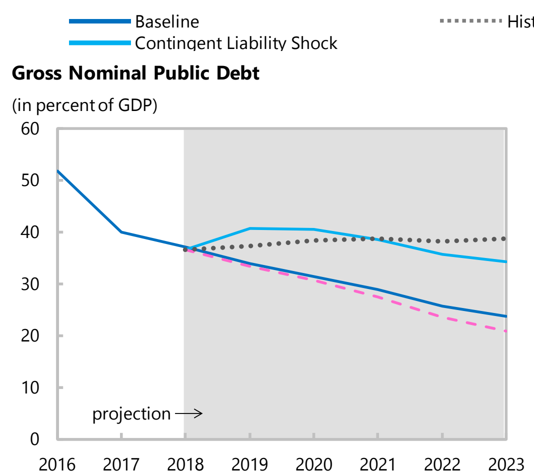
Figure 1. Iceland: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt





Alternative Scenarios



Underlying Assumptions

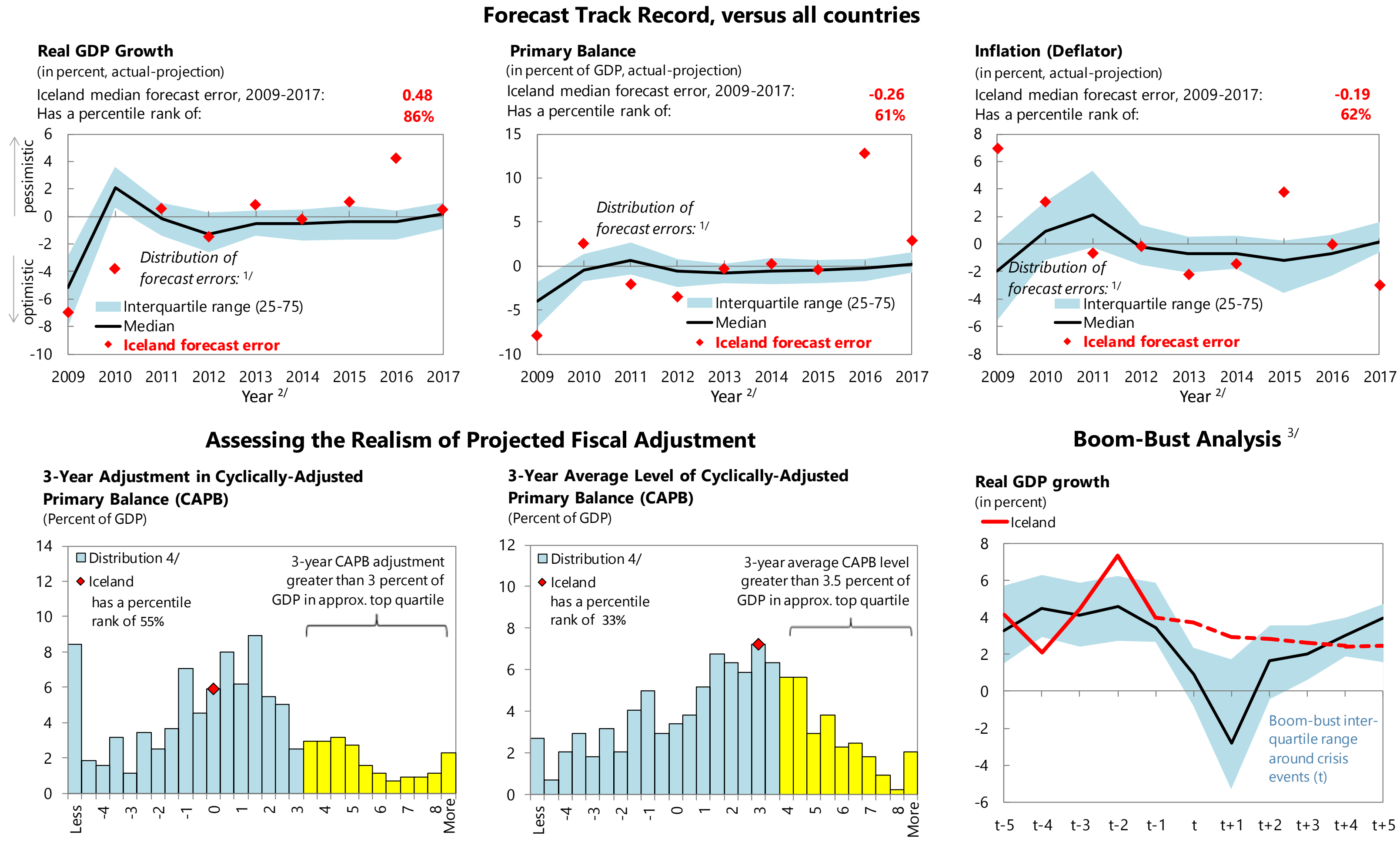
(in percent)

Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.7	2.9	2.8	2.6	2.5	2.5
Inflation	3.1	4.0	3.2	3.0	2.9	2.8
Primary Balance	3.3	3.0	2.6	2.2	2.3	2.3
Effective interest rate	8.0	7.9	8.0	7.5	7.8	8.5
Constant Primary Balance Scenario						
Real GDP growth	3.7	2.9	2.8	2.6	2.5	2.5
Inflation	3.1	4.0	3.2	3.0	2.9	2.8
Primary Balance	3.3	3.3	3.3	3.3	3.3	3.3
Effective interest rate	8.0	8.0	8.1	7.7	8.1	9.1

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	3.7	1.7	1.7	1.7	1.7	1.7
Inflation	3.1	4.0	3.2	3.0	2.9	2.8
Primary Balance	3.3	-0.2	-0.2	-0.2	-0.2	-0.2
Effective interest rate	8.0	8.0	7.4	6.4	6.3	6.3
Contingent Liability Shock						
Real GDP growth	3.7	-0.1	-0.2	2.6	2.5	2.5
Inflation	3.1	3.2	2.5	3.0	2.9	2.8
Primary Balance	3.3	-2.5	2.6	2.2	2.3	2.3
Effective interest rate	8.0	8.6	8.1	7.7	7.9	8.5

Source: IMF staff.

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



Source : IMF Staff.

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

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

3/ Iceland has had a positive output gap for 3 consecutive years, 2015-2017. For Iceland, t corresponds to 2018; for the distribution, t corresponds to the first year of the crisis.

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.

Figure 3. Iceland: Public DSA—Baseline Scenario

(Percent of GDP, unless otherwise indicated)

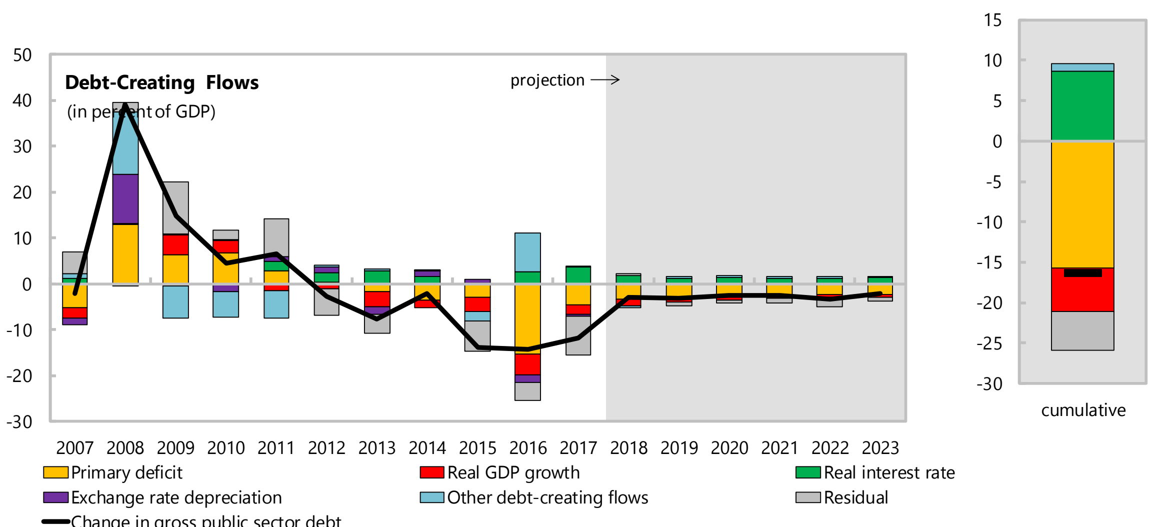
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2007-2015 [2]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	74.3	51.7	40.0	37.0	33.8	31.4	28.9	25.6	23.6
Public gross financing needs	14.5	-2.3	8.4	2.8	2.8	3.8	2.5	5.2	1.4
Real GDP growth (in percent)	1.7	7.4	4.0	3.7	2.9	2.8	2.6	2.5	2.5
Inflation (GDP deflator, in percent)	5.7	1.9	0.5	3.1	4.0	3.2	3.0	2.9	2.8
Nominal GDP growth (in percent)	7.4	9.4	4.5	6.9	7.0	6.2	5.7	5.5	5.3
Effective interest rate (in percent) [4]	7.2	6.5	7.9	8.0	7.9	8.0	7.5	7.8	8.5

As of October 02, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		240
5Y CDS (bp)		70
Ratings	Foreign	Local
Moody's	A3	A3
S&Ps	A	A
Fitch	A	A

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	4.1	-14.3	-11.7	-2.9	-3.2	-2.4	-2.5	-3.3	-2.0	-16.3	
Identified debt-creating flows	2.8	-10.4	-3.4	-3.4	-2.4	-1.8	-1.4	-1.3	-1.2	-11.6	
Primary deficit	1.8	-15.3	-4.6	-3.3	-3.0	-2.6	-2.2	-2.3	-2.3	-15.7	1.1
Primary (noninterest) revenue and gra	39.1	55.8	41.7	41.0	41.1	41.0	40.7	40.4	40.5	244.7	
Primary (noninterest) expenditure	40.9	40.4	37.0	37.7	38.1	38.3	38.5	38.2	38.2	229.0	
Automatic debt dynamics [5]	1.5	-3.5	1.2	0.4	0.3	0.6	0.5	0.6	0.8	3.2	
Interest rate/growth differential [6]	0.4	-1.7	1.7	0.4	0.3	0.6	0.5	0.6	0.8	3.2	
Of which: real interest rate	1.2	2.7	3.7	1.8	1.3	1.5	1.3	1.3	1.4	8.6	
Of which: real GDP growth	-0.8	-4.4	-2.0	-1.4	-1.0	-0.9	-0.8	-0.7	-0.6	-5.4	
Exchange rate depreciation [7]	1.1	-1.7	-0.5	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.6	8.4	0.1	-0.5	0.3	0.3	0.3	0.3	0.3	1.0	
General government net privatizatior	0.0	7.0	0.0	-0.8	0.0	0.0	0.0	0.0	0.0	-0.8	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Net lending	-0.6	1.5	0.1	0.3	0.3	0.3	0.3	0.3	0.3	1.8	
Residual, including asset changes [8]	1.3	-3.9	-8.4	0.5	-0.8	-0.6	-1.1	-2.0	-0.8	-4.8	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

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

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = 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 numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

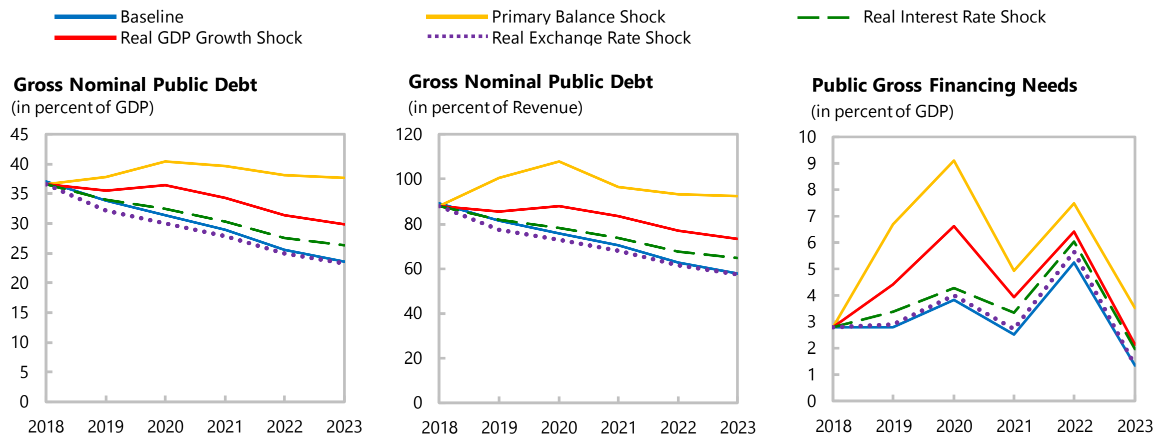
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

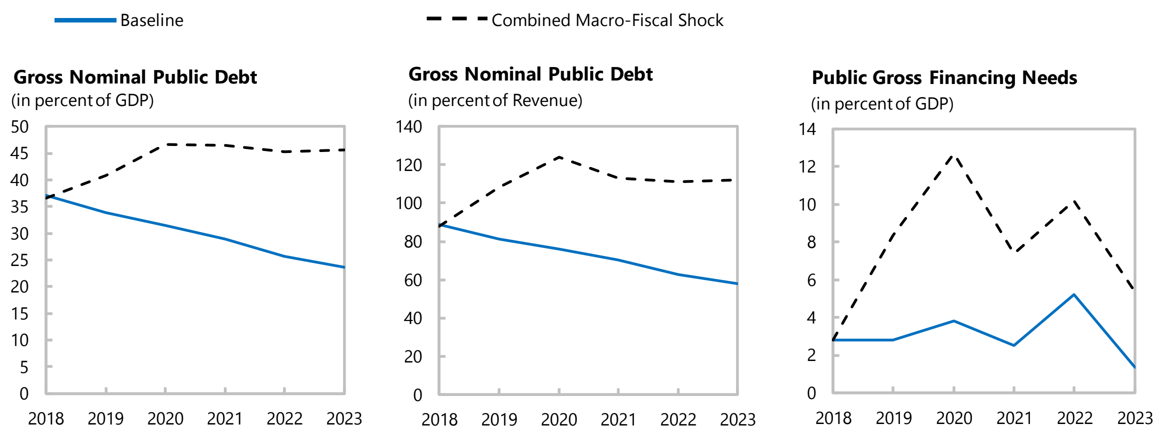
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. Iceland: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

	2018	2019	2020	2021	2022	2023
Primary Balance Shock						
Real GDP growth	3.7	1.9	2.8	2.6	2.5	2.5
Inflation	3.1	4.0	3.2	3.0	2.9	2.8
Primary balance	3.3	-0.9	-1.2	2.2	2.3	2.3
Effective interest rate	8.0	8.0	9.6	10.9	10.6	11.0
Real Interest Rate Shock						
Real GDP growth	3.7	1.9	1.8	2.6	2.5	2.5
Inflation	3.1	4.0	3.2	3.0	2.9	2.8
Primary balance	3.3	3.0	2.6	2.2	2.3	2.3
Effective interest rate	8.0	8.0	8.3	8.1	8.5	9.6
Combined Shock						
Real GDP growth	3.7	0.9	0.8	2.6	2.5	2.5
Inflation	3.1	3.5	2.7	3.0	2.9	2.8
Primary balance	3.3	-1.8	-3.2	2.2	2.3	2.3
Effective interest rate	8.0	8.1	9.8	11.4	11.1	11.8

	2018	2019	2020	2021	2022	2023
Real GDP Growth Shock						
Real GDP growth	3.7	0.9	0.8	2.6	2.5	2.5
Inflation	3.1	3.5	2.7	3.0	2.9	2.8
Primary balance	3.3	2.0	0.7	2.2	2.3	2.3
Effective interest rate	8.0	8.0	8.1	7.6	7.8	8.5
Real Exchange Rate Shock						
Real GDP growth	3.7	2.9	2.8	2.6	2.5	2.5
Inflation	3.1	12.3	3.2	3.0	2.9	2.8
Primary balance	3.3	3.0	2.6	2.2	2.3	2.3
Effective interest rate	8.0	8.1	7.9	7.5	7.8	8.6

Source: IMF staff.

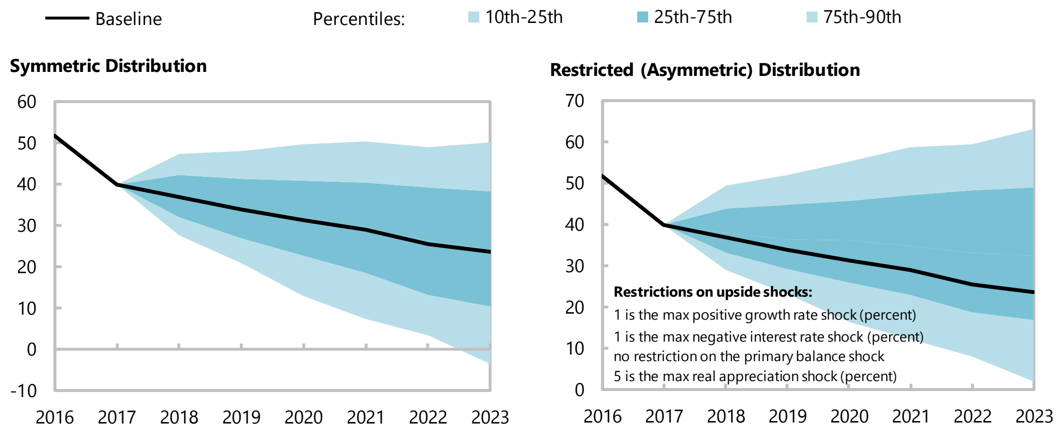
Figure 5. Iceland Public DSA—Risk Assessment

Heat Map

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

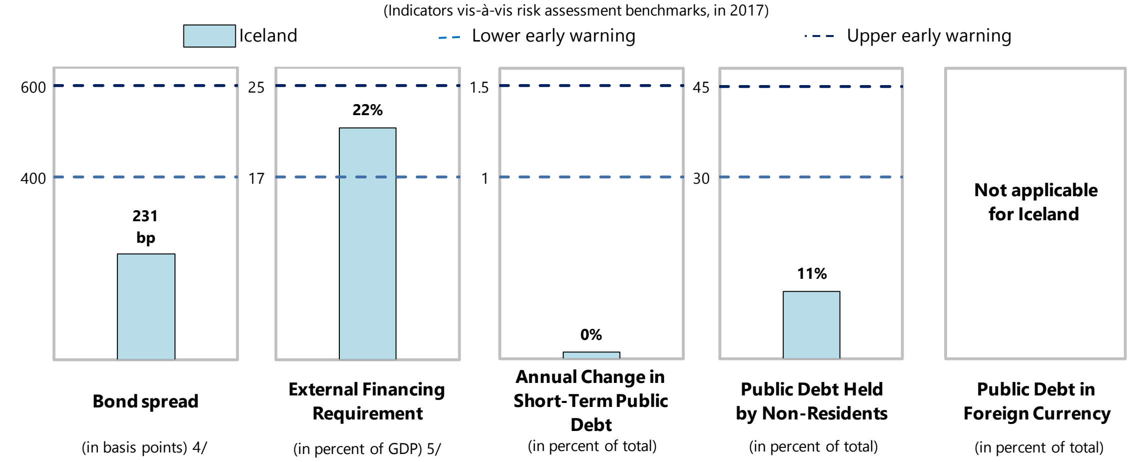
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



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/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 04-Jul-18 through 02-Oct-18.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex III. Risk Assessment Matrix[1]

Risks	Relative Likelihood	Impact if Realized	Policy Response
DOMESTIC RISKS			
1. Break in tourism	**Medium** • Financial difficulty of airline operators • Excessive real appreciation, including through higher airfares • Loss of attractiveness due to overcrowding • Natural *force majeure*	**High** • Sharp dip in growth • Sharp deterioration in current account	• Develop contingency plan • Limit reserve drawdowns to countering disorderly market conditions • Keep interest rate policy squarely focused on inflation prospects • Allow fiscal stabilizers to operate • Advance comprehensive tourism strategy • Boost tourism-related infrastructure
2. Overheating	**Medium** • Excessive wage awards rekindle domestic demand pressures	**High** • Higher growth and inflation • Loss of export competitiveness • Current account deterioration	• Raise interest rates to counter inflationary pressures • Allow exchange rate to appreciate • Tighten macroprudential policy if credit pressures arise • Tighten fiscal policy if necessary • Reintroduce or raise special reserve ratio if capital inflows surge
GLOBAL RISKS			
3. Sharp tightening of global financial conditions	**High** • Term premiums decompress as investors reassess policy fundamentals • More rapid Fed normalization	**Medium** • Borrowing terms abroad worsen as Iceland risk premium rises • Some capital outflows	• Keep interest rate policy squarely focused on inflation prospects • Cut special reserve ratio on inflows to nil • Limit reserve drawdowns to countering disorderly market conditions • Allow fiscal stabilizers to operate
4. Weaker than expected global growth	**Medium** • Structurally weak growth in European trading partners	**Medium** • Weaker export demand, including for tourism	• Accelerate structural reforms to increase competitiveness, including a revamp of wage bargaining
5. Rising protectionism and retreat from multilateralism	**High** • Erosion of trust in the rules-based system • Uncertainty triggers financial market volatility • Threat to labor mobility, regulatory collaboration	**High** • Fall in exports • Deterioration in current account • Drain on reserves • Borrowing terms abroad worsen as Iceland risk premium rises • Some capital outflows	• Step up support for the rules-based global trading system • Keep interest rate policy squarely focused on inflation prospects • Limit reserve drawdowns to countering disorderly market conditions • Allow fiscal stabilizers to operate

[1] Shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability of 10–30 percent, and "high" a probability of over 30 percent). Reflects the staff's views on the source of risks and overall level of concern at the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Annex IV. Responses to Past Policy Recommendations

2017 Article IV Recommendations	Authorities' Responses
Financial Sector Give bank regulation and supervision strong powers and independence, ideally by unifying all safety and soundness oversight of banks at the central bank. Better insulate the FME from the political process by amending the *Act on Official Supervision of Financial Activities*. Ensure high-quality bank ownership and conduct fit and proper tests in a thorough, uncompromising, and evenhanded manner.	**Consistent** The authorities have decided to merge the CBI and FME. A new committee has been tasked with developing a vision for the future of the financial system, with a focus on state ownership.
Monetary Policy Continue to maintain a tight monetary policy stance given demand pressures and procyclical fiscal policy in 2017. Consider further rate cuts to the extent that króna appreciation drives inflation prospects lower, and if fiscal policy can be restrained. In a capital outflow scenario, stand ready for rate hikes. 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 and inflation expectations have converged to target. Foreign exchange interventions have virtually ceased since mid-2017. The CBI has announced its intention to design an intervention policy for the post capital controls period.
Fiscal Policy Exercise strict expenditure control to deliver a tighter than budgeted fiscal stance in 2017. Stand ready to tighten fiscal policy if serious overheating risks materialize. Implement plans to increase taxes on tourism. Consider increased expenditure on infrastructure, health, and education later in the planning horizon, guided by a spending review.	**Partly Consistent** The 2017 fiscal outturn delivered a surplus, but this was mainly achieved by extraordinary revenues, and the fiscal impulse was positive and untimely. Overheating risks have abated. Plans to increase value added tax on tourism were replaced by a proposal for a departure tax. The Fiscal Strategy Plan foresees increased spending on infrastructure, healthcare, and education.
Capital Flow Management Dial down the special reserve requirement while keeping the tool on the books. Use microprudential oversight to prevent excessive risk taking by banks. Deploy macroprudential policies as needed to minimize systemic risks. CFMs should not substitute for warranted macroeconomic adjustment.	**Not Consistent** The special reserve requirement has not been dialed down.
Structural Revamp the wage bargaining framework to protect competitiveness. Develop a holistic tourism strategy and consider establishing a high-level body tasked with coordinating licensing rules, infrastructure development, and environmental protection.	**Partly Consistent** The next major wage round occurs in winter 2018–19, where effort will be made to apply the SALEK agreement, which lays down basic principles. A working group on the reform of the Compensation Court proposed to freeze wages of high-level public officials, but not to reverse agreed increases. A tourism task force, initially established in 2015, has been reinvigorated and charged with addressing measurement issues and developing performance indicators.