EXECUTIVE BOARD MEETING

SM/18/248
Correction 1

November 7, 2018

To: Members of the Executive Board

From: The Acting Secretary

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

Board Action:	The attached corrections to SM/18/248 (10/26/18) have been provided by the staff:
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 1, 4 (para. 2), 5, 11, 13 (para. 28), 14, 15, 18, 22 (para. 59), 23**
Typographical Errors	**Pages 4 (para. 3), 6, 13 (para. 30), 16, 17, 19, 22 (paras. 58 and 61)**
Questions:	Mr. Bhatia, EUR (ext. 37626) Ms. Baba, EUR (ext. 38507

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 joint efforts to secure equitable and environmentally sustainable regional agreements in fishing.

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.

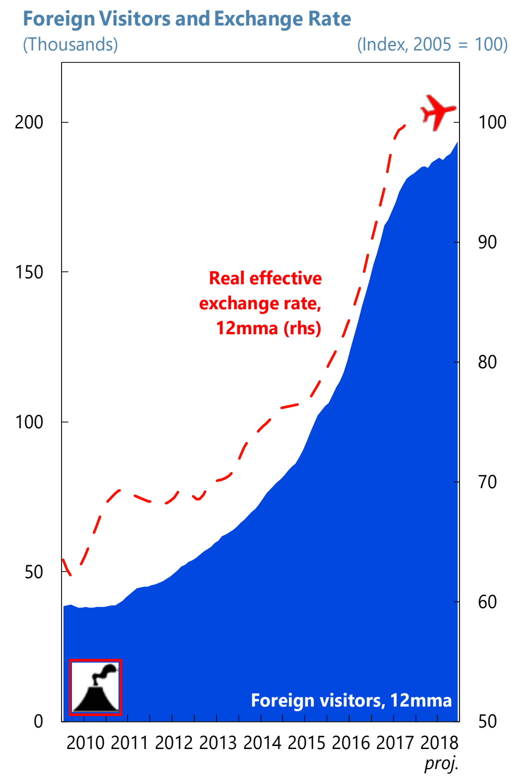
2. Iceland's new government spans the political spectrum. In October 2017 the second early election in a span of 12 months ushered a record eight parties into the Althing; a new three-party coalition took office a month later. A prime minister from the Left-Green Movement, a finance minister from the 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 has 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 has decided to effect such a change—and has tasked an interagency team with preparing the legislation.

THE SETTING

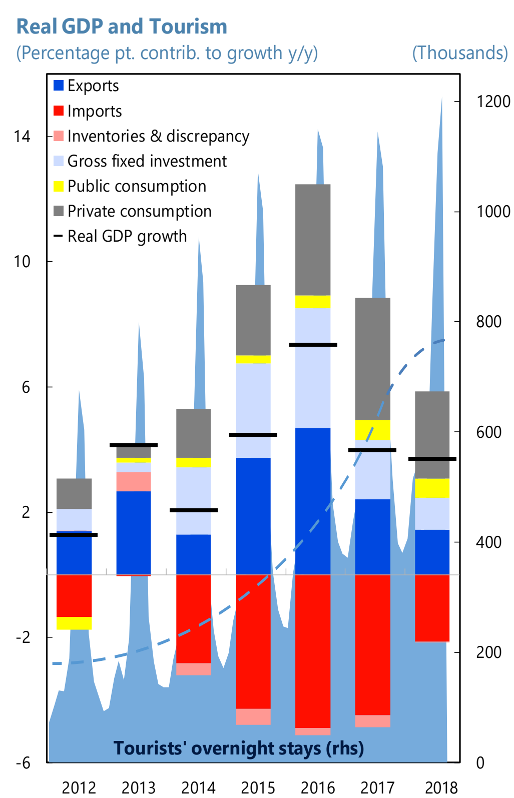
4. Slower growth has allayed overheating concerns. Dampened as expected by the strong exchange rate appreciation of 2014–16, the rate of growth of tourist arrivals has decelerated. This has reduced demand pressures and helped cool the housing market, but has also reduced the current account surplus. 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~~ most 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.

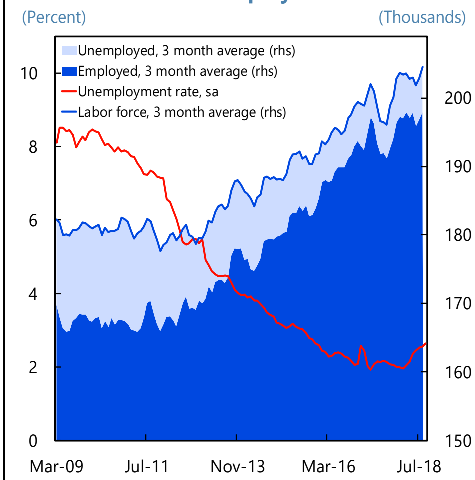
7. The real estate markets have cooled. The rate of growth of housing prices fell from a peak of 24 percent y/y in July 2017 to 6 percent 12 months later, while that for commercial real estate slowed from 19 percent y/y to 15 percent. A robust supply response was key, although slowing tourism growth 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

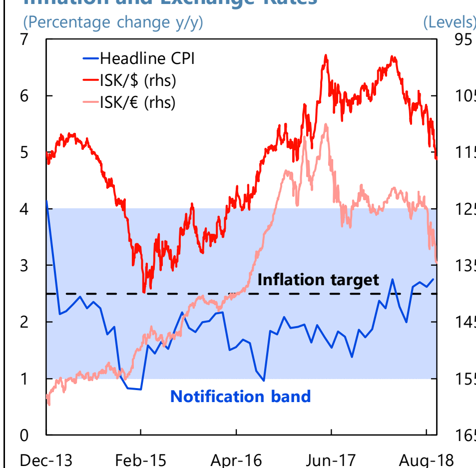
Labor Force and Unemployment



Source: Statistics Iceland.

Figure 4. Rates

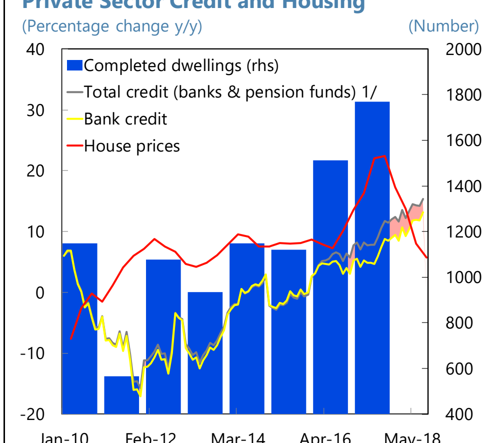
Inflation and Exchange Rates



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.

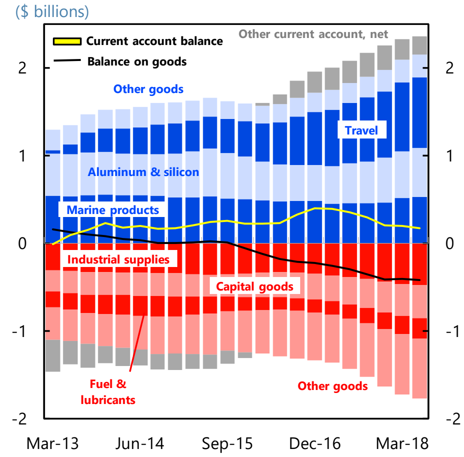
investment position (NIIP), estimated at +9 percent of GDP as of mid 2018. Official reserves have been stable at about \$6½ billion—about 150 percent of the Fund's reserve adequacy metric (RAM)—since the offshore króna release and debt payments of 2017 (see 2017 staff report).

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

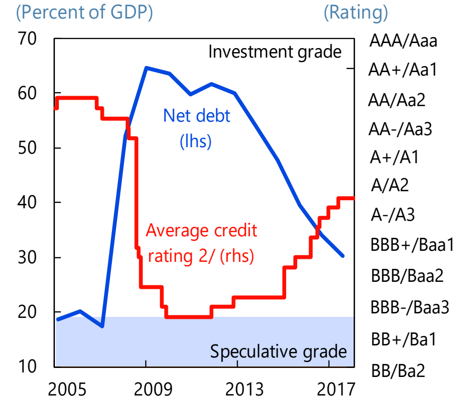
Balance on Goods
($ billions)



Source: Statistics Iceland.

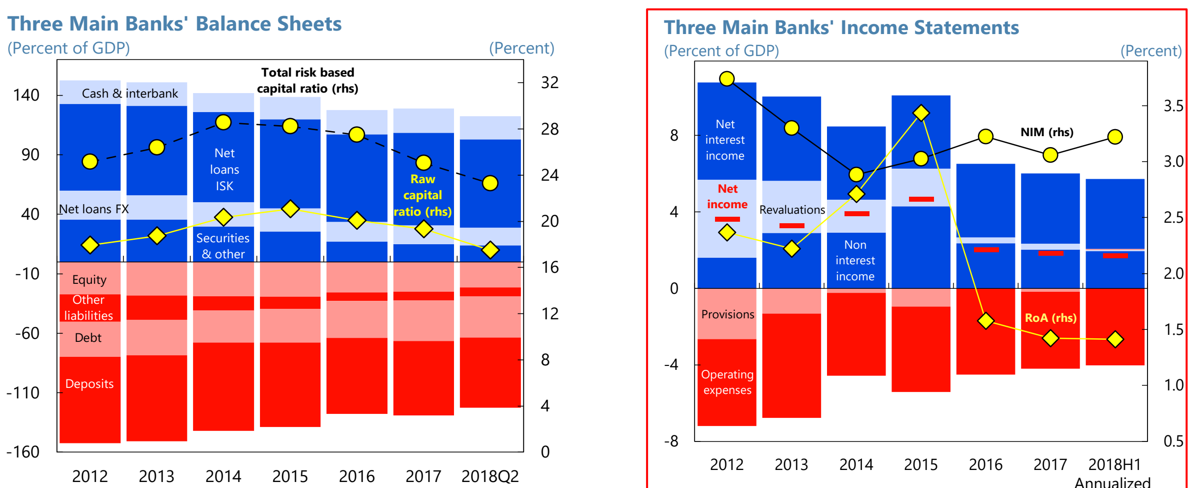
Figure 7. Public Debt and Ratings

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.

areas—advice echoed by the Fiscal Council. Staff repeats its call for a comprehensive review of expenditures~~. Such a review~~ that 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.

28. Monetary policy settings should remain data driven. Staff supported keeping rate policy on hold for now ~~and continuing to desist from~~with limited 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 communications 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.

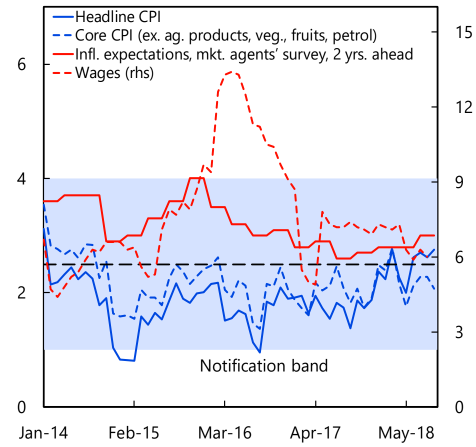
Authorities' Views

31. The authorities shared staff's views on the adequacy of the inflation targeting framework.

Figure 16. Inflation

Inflation and Inflation Expectations

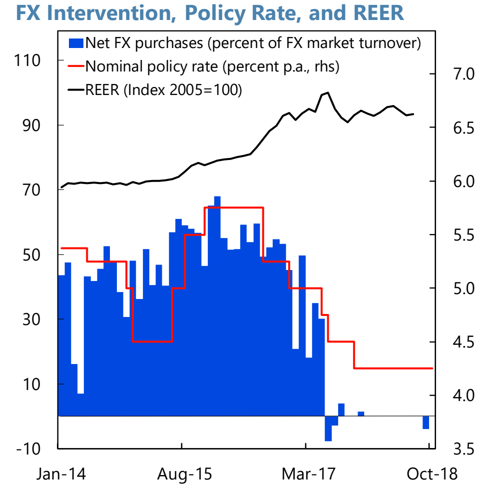
(Percentage change y/y)



Source: Statistics Iceland.

Figure 17. Monetary Policy

FX Intervention, Policy Rate, and REER

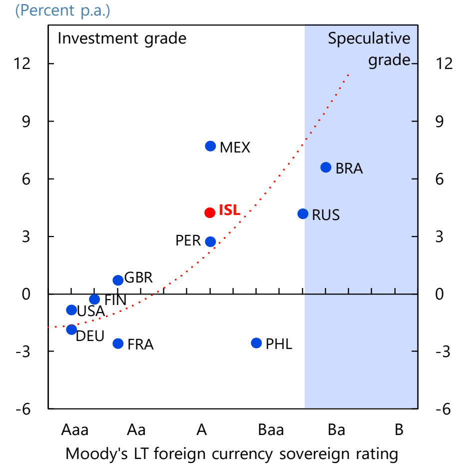


Source: CBI.

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

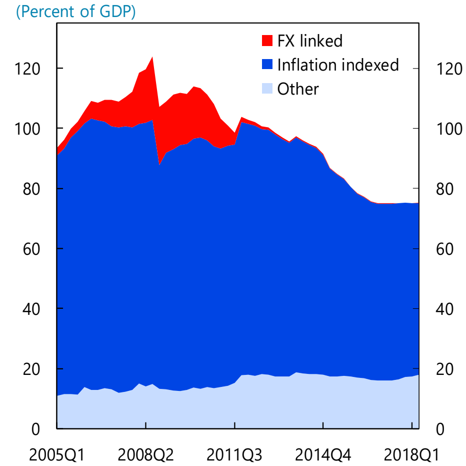
33. Macroprudential policy should focus on ensuring system-wide stability. Concerns are limited at this time, yet it is good that Iceland's toolkit is well developed. Capital buffers imposed by Fjármálaeftirlitid (FME, the financial regulator)—8¾ percent in total for the three main banks—will become 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~~ mid 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)

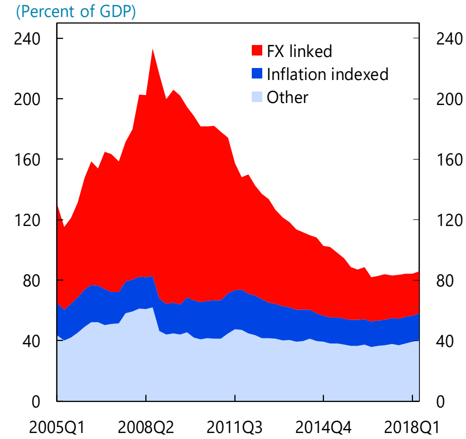


Sources: CBI; and Statistics Iceland.

Figure 20. Corporate Sector

Nonfinancial Corporate Debt 1/

(Percent of GDP)



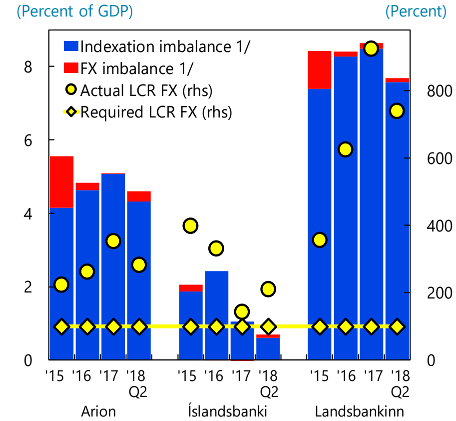
Sources: CBI; and Statistics Iceland.

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.

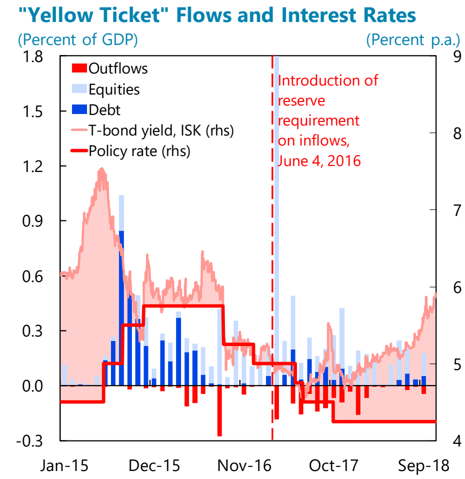
time—even the flows seen in 2015 were small in historical comparison—and therefore sees no case for the reserve ratio currently. Staff reminded the authorities that they had identified a smaller gap between rates at home and abroad as a condition for dialing back the CFM, and that policy rate differentials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

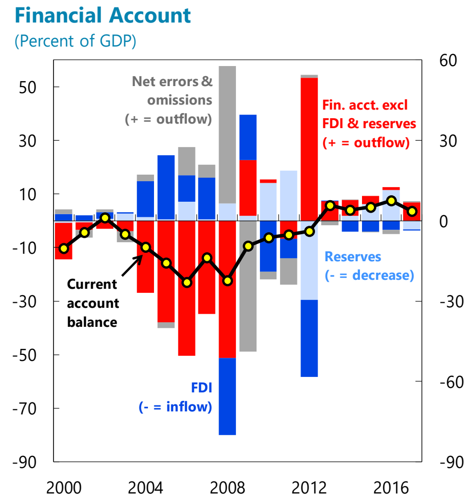
37. The remaining offshore króna accounts should be regularized. In 2016, the authorities passed a law governing these "accounts subject to special restrictions" to ensure that general capital flow liberalization could be decoupled from the specific treatment of holders of the residue of the pre-crisis 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



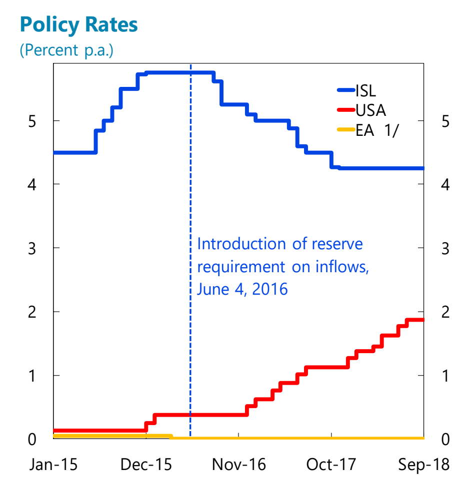
Source: CBI.

Figure 23. Financial Account



Sources: CBI; and IMF staff calculations.

Figure 24. 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 require~~d~~s 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:

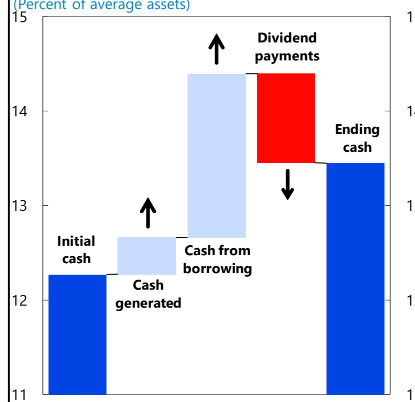
- **NPLs are now low, but there is room to further develop FME's credit risk register as a supervisory tool to assess loan quality**. In particular, the credit register may become a valuable tool for onsite inspection planning.
- **Liquidity risk has fallen, but banks' reporting of liquidity coverage 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 dividends ~~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

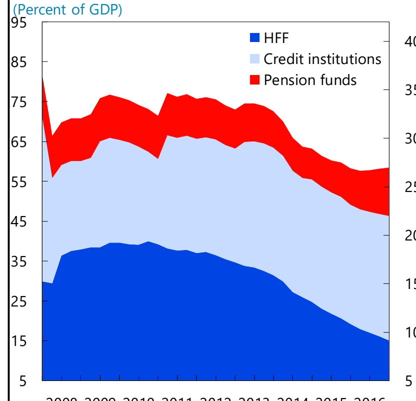
(Percent of average assets)



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, FME should seek to ensure moderate ~~the ministry of finance must resist taking too much excess capital out of the banks as~~ dividend~~s~~ taking—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.

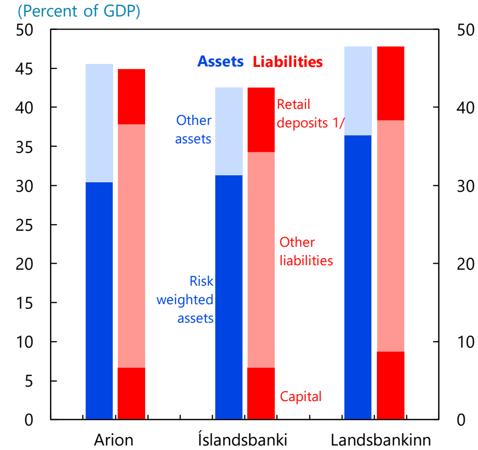
B. Pension Fund Oversight and Conduct Regulation

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

Figure 25. Bank Funding

Assets and Liabilities, 2018Q2

(Percent of GDP)

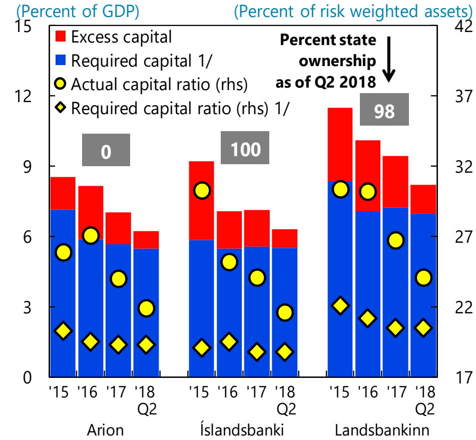


Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.
1/ Deposit balances of €100,000 or less.

Figure 26. Bank Capital Adequacy

Total Regulatory Capital

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

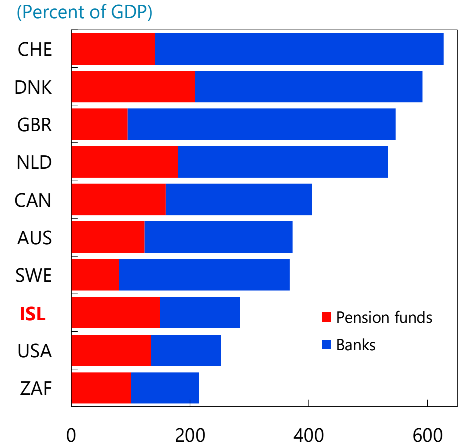


Sources: CBI; Fjármálaeftirlitid; and IMF staff calculations.
1/ Includes pillar 1 buffer and pillar 2 requirements.

Figure 27. System Structure

Total Assets, 2016

(Percent of GDP)



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

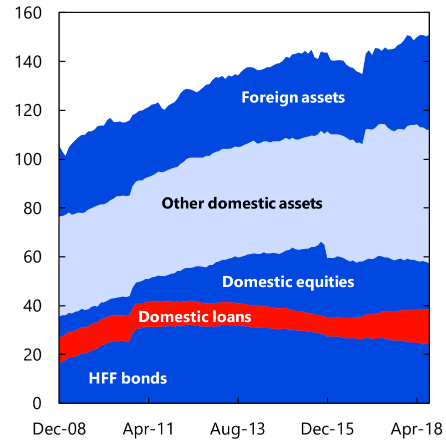
But it also taps into a tax advantage, and raises level-playing-field issues vis à vis the banks. Given limited support within Iceland for banning pension fund retail lending—the optimal solution—staff advised strong steps be taken to strengthen pension fund oversight, and supported positioning such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

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.

Figure 28. Asset Allocation

Pension Fund Assets

(Percent of GDP)

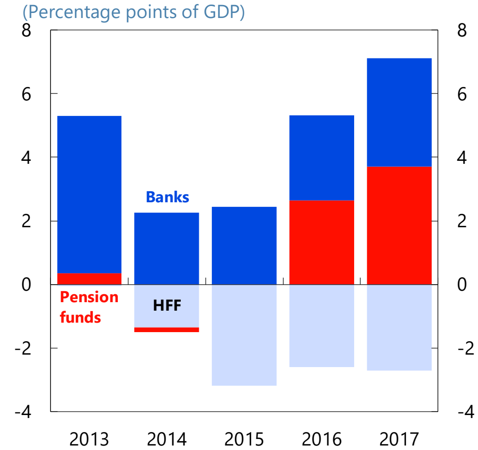


Source: CBI.

Figure 29. Pension Fund Lending

Change in Mortgage Stock

(Percentage points of GDP)



Sources: CBI; and Iceland Chamber of Commerce.

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.

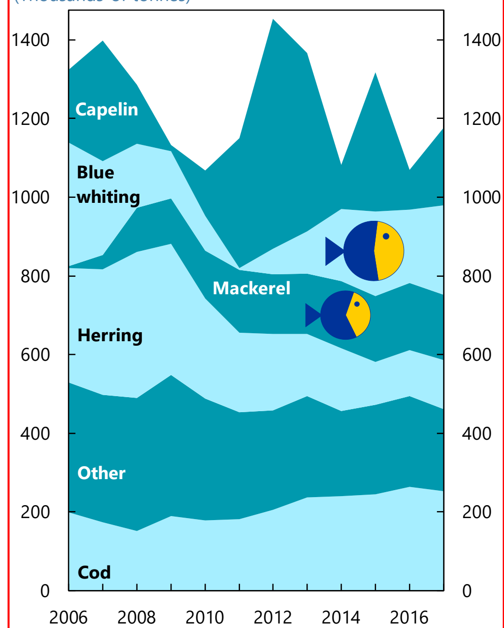
Authorities' Views

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~~ on 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/
(Thousands 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 gold, 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~~ slower growth rate 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, healthcare, 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~~close-to-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.