April 3, 2020
Approval: 4/10/20

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/92-2

11:15 a.m., November 9, 2018

2. Iceland—2018 Article IV Consultation

Documents: SM/18/248 and Correction 1; and Supplement 1; and Supplement 2; and Supplement 3; and Supplement 3, Correction 1; SM/18/253; and Correction 1

Staff: Bhatia, EUR; Kostial, SPR

Length: 56 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	B. Jappah (AE), Temporary
M. Raghani (AF)	
	J. Di Tata (AG)
	G. Kim (AP), Temporary
	P. Fachada (BR)
Z. Jin (CC)	
	J. Montero (CE), Temporary
	N. Feerick (CO), Temporary
	S. Benk (EC)
	A. Castets (FF)
S. Meyer (GR)	
	H. Joshi (IN), Temporary
	L. Cerami (IT), Temporary
	Y. Saito (JA)
	G. Nadali (MD), Temporary
	M. Merhi (MI), Temporary
	N. Jost (NE), Temporary
	G. Gunnarsdottir (NO), Temporary
	A. Tolstikov (RU), Temporary
M. Mouminah (SA)	
J. Agung (ST)	
P. Inderbinen (SZ)	
	M. Chen (UK), Temporary
	P. Pollard (US), Temporary

G. Tsibouris, Acting Secretary
K. Hviding, Summing Up Officer
M. Gislen, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
Communications Department: K. Manasseh. European Department: A. Bhatia, M. Maneely Ramos, C. Mikami Baba, A. Paret Onorato, N. Romanova. Legal Department: H. Pham. Monetary and Capital Markets Department: L. Cortavarria Checkley. Strategy, Policy, and Review Department: K. Kostial, P. Morra. Statistics Department: A. Chailloux.

Executive Director: T. Ostros (NO). Alternate Executive Director: R. Alkhareif (SA), H. Razafindramanana (AF). Senior Advisors to Executive Directors: R. Morales (AG), T. Ozaki (JA). Advisors to Executive Directors: E. Boukpessi (AF), S. Buetzer (GR), X. Cai (CC), T. Gade (NO), I. Skrivere (NO), M. Svenstrup (US).

2. ICELAND—2018 ARTICLE IV CONSULTATION

Mr. Ostros and Ms. Gunnarsdottir submitted the following statement:

On behalf of our Icelandic authorities, we thank staff for a productive mission in September and a thorough and well-balanced Article IV Report and pertinent Selected Issues Papers. Our authorities broadly agree with staff's analysis and note that staff considers the overall policy mix appropriate. In the last decade, important strides have been made with the aim of enhancing the resilience of the Icelandic economy. The reform agenda continues with the recent launch of important reforms.

In November 2008, ten years ago, the Executive Board discussed Iceland under very different circumstances, when it approved Iceland's request for a Stand-By Arrangement (SBA) with exceptional access, under conditions that the staff report described as the "Perfect Storm". At that time, inflation was soaring, there was a gaping current account deficit, the banking system had collapsed, and gross external debt equaled 550 percent of GDP. The program included some unorthodox features, and at the time, staff noted that the proposed arrangement for Iceland presented significant financial risks to the Fund.

The ensuing ten years have not gone to waste. Despite invidious challenges in the first months of the program, Iceland graduated from the SBA on target in 2011 and repaid, ahead of schedule, all program-related funding in 2015. The authorities greatly appreciated the partnership with the Fund during this period. With the completion of the program and the economy back on an even keel, the authorities focused primarily on solving the balance of payments crisis and lifting capital controls, improving economic resilience, putting prudential policies in place, and building buffers into all facets of the economy to avoid a recurrence of events resembling those of 2008, which a small and globally integrated economy may always be subject to.

Increased Economic Resilience

After the initial shock of the crisis, growth took off after a couple of years, and the GDP level is currently more than 20 percent above the debt-fueled 2008 peak. The current account has shown a healthy surplus for a decade, and the NIIP turned positive in 2017 and now measures around 10 percent of GDP, which is a first for Iceland. Inflation has remained close to target for the past five years, and domestically financed foreign exchange reserves have been built to over 25 percent of GDP. The banking system has been cut down to size and currently maintains strong capital ratios at above 20 percent, with NPLs below 3 percent of the loan portfolio. Meanwhile, the authorities have introduced extensive micro- and macroprudential measures to enhance the stability and soundness of the financial system. Both public and private sector balance sheets have been repaired and strengthened through targeted measures. Households and businesses are less vulnerable to shocks, with private sector debt shrinking from around 350 percent of GDP to just over 150 percent in ten years. Public debt has been brought down from over 90 percent of GDP in the aftermath of the crisis to slightly over 30 percent currently. At the same time, fiscal planning has undergone an overhaul to strengthen the budget process through a new organic budget law, which provides for long-term fiscal planning and a clear and easily communicable set of fiscal rules. As is noted in the staff report, a sovereign wealth fund is in the works. Meanwhile, the pension fund system remains strong, with diminishing official defined benefit obligations and assets amounting to 1.6 times GDP.

Financial Sector Oversight and Monetary Policy under Review

In October, the Government commenced a review of the statutory framework for monetary policy, macroprudential policy, and financial market supervision. Earlier this year, expert committees submitted reports on the conduct of monetary policy and the framework for macroprudential policy and financial market supervision, on which this review is built. Its scope is wide-ranging, including the Central Bank remit, execution of monetary policy, Central Bank governance, legislation on macroprudential policy, and financial market supervision, with the aim of increasing trust, transparency, and efficiency in economic management. Guiding the review is a decision to merge the Central Bank and the Financial Supervisory Authority (FME) in a manner that aims to improve the implementation of macroprudential policy and financial market supervision. A project management team has been appointed and is tasked with submitting a draft bill of legislation before the end of February 2019, with the aim of presenting the bill to Parliament in the spring session. The authorities are cognizant that the above-mentioned change to the supervisory architecture should not lead to operational risks in the interim.

Fiscal Policy

Parliament is currently heading into the second reading of the 2019 budget. The budget proposal is in line with the five-year fiscal strategy plan presented in the spring and the fiscal policy statement (FPS) presented in late 2017. This new structure for fiscal policy prescribed in the organic budget law has changed the political debate on the budget, with an overriding focus on sustainability and predictability.

The FPS proposes a minimum general government surplus of 1.2 percent of GDP in 2019 and a surplus of 1.0-1.1 percent of GDP from 2020-2022. Our authorities agree with staff's assessment that this would lead to largely neutral fiscal policy. This will allow for a continued reduction in government debt levels. The authorities expect gross debt to fall below 30 percent of GDP by 2021 and net debt to fall below the 30 percent ceiling prescribed in the organic budget law by 2019. It is important to note that the gross debt level peaked at over 100 percent of GDP following the crisis, if we include external debt taken on by the Central Bank, and that the net debt level reached 65 percent of GDP in 2009. The authorities see this debt reduction as essential for a small open economy in an increasingly integrated world.

Our authorities agree with staff that tax reforms must be considered with care. Extensive work is being carried out on the income tax and benefits systems, with consideration given to earlier technical assistance reports. The conclusion of this work may become an important factor in the upcoming wage negotiations, as collective wage contracts in both the private and public sector are up for renegotiation in 2019.

The authorities have used the fiscal space created by the reduction in interest payments on debt to strengthen the social safety net and increase government investment. The focus for the coming years will be on investment in the transport system, healthcare, and education. Our authorities agree with staff's focus on careful prioritization of the new spending. To this effect, systematic use of spending reviews is being prepared.

Monetary Policy

Our authorities share staff's assessment of monetary policy and the good results it has brought in recent years in keeping inflation close to the target. In announcing its intention to merge the Central Bank and the FME, the Government reiterated that the inflation target is to be retained as the main monetary policy objective, and the independence of the Central Bank and its Monetary Policy Committee (MPC) will be preserved.

As is noted in the staff paper, the authorities agree that monetary policy should remain data-driven, but they also emphasize that the real stance of monetary policy must be consistent with keeping inflation at target over the medium term. The authorities will act promptly if warranted by developments that seriously threaten the inflation target; for example, if the upcoming wage negotiations produce excessive wage increases. They agree with the suggestions concerning improvements in communication to the public. On exchange rate policy, the authorities agree that foreign exchange interventions shall be limited to maintaining reserve adequacy and countering disorderly market conditions. This conforms with the MPC's policy statement of May 2017, to the effect that the Central Bank will intervene in the market in order to mitigate volatility when it considers such intervention warranted. This principle has guided the approach of the Central Bank since that time; indeed, it has intervened on only two occasions to calm disorderly developments.

The Capital Flow Management Measure (CFM)

In the last few years, conditions have been ripe for capital inflows that could undermine the warranted stance of monetary policy, risk overvaluation of the currency, and create a significant risk of reversal. These include extraordinary growth rates (reaching more than 7 percent in 2016), the liberalization of capital controls, improved sovereign credit ratings, and a sizable interest rate differential with abroad. Under these circumstances, the special reserve requirement (SRR) on inflows into the bond market and high-yielding deposits has proven to be an effective and targeted tool to limit these risks. It has hindered an overvaluation of the currency and improved the transmission of monetary policy through the interest rate channel. This has made it possible for Iceland to maintain significantly higher interest rates than among major trading partners, as warranted by the relative cyclical position. The SRR has therefore not been a substitute for warranted macroeconomic policies – on the contrary, it has made them possible. As is noted in the staff report, the economic policy mix is considered appropriate, the external position is in line with fundamentals and desired policy settings, and foreign reserves are ample. Our authorities welcomed the Executive Board's support of the application of the CFM in last year's consultation and note the views of the G20 eminent persons group on the practicability of such instruments.

Our authorities have declared that they see the current application of the SRR as temporary and that conditions to reduce it would improve as the interest rate differential narrows. A lower exchange rate would also be conducive to a reduction of the SRR. Our authorities therefore agree with staff that with the slowdown in growth, the weakening of the currency, and the narrowing interest rate differential with abroad, conditions have now developed that permit scaling back the SRR. The Central Bank therefore announced a reduction in the SRR from 40 percent to 20 percent a week ago.

Financial Sector

The three large banks remain profitable, and capital and liquidity ratios are ample in any international comparison. Given the substantial buffers required by the FME, these ratios remain robust despite recent dividend payments, although they are now near the FME's threshold and the banks' self-imposed management buffers. The Government divested its stake in Arion Bank in early 2018, but it remains the controlling shareholder in the other two banks. Arion Bank was successfully listed in the international markets following an IPO in June. The authorities agree with staff that high-quality ownership should be prioritized in future sales of stakes.

Iceland has taken decisive steps to improve both the legal and architectural framework for the financial sector and its oversight in the past decade. This includes enhanced resources and powers for the FME and the establishment of a high-level Financial Stability Council, supported by a Systemic Risk Committee, ensuring continuous communication among the Ministry of Finance and Economic Affairs, the Central Bank, and the FME. Furthermore, implementation of the European framework in this field continues, in line with Iceland's commitment under the European Economic Area Agreement.

Fisheries Sector

Our authorities appreciate the Selected Issues Paper on the fisheries sector. The report provides insight into the complex nature of this sector, traditionally the largest in the economy but later replaced by energy and tourism. The quota system framework, which has been in effect since 1984, is itself an important tool for economic and ecological sustainability. As is noted in the report, the system has been undergoing constant reforms since its inception. The fisheries management system led to considerably enhanced efficiency in the industry and has provided fertile ground for the emergence of a complementary technology and engineering sector, providing measurable input into the economy. Most importantly, it has led to very careful husbandry of this important renewable resource.

An important milestone was reached in the mid-1970s, when Iceland gained full control of its waters, as was later confirmed by the UN Convention on the Law of the Sea adopting the 200-nautical-mile limit. While catch volumes have fluctuated due to both natural and man-made causes, the fisheries system has provided robust long-term harvesting principles for local species. However, the husbanding of migratory species has proven more challenging, as it relies on international cooperation agreements. The authorities agree with staff and have called for coordinated and equitable solutions among coastal states to protect species from overfishing. However, the fate of migratory stocks is not an Iceland-specific issue and will put multilateralism and international institutions to the test, as will many other issues of current importance.

Conclusion

The staff report identifies the key challenges confronting the Icelandic economy, and our authorities generally agree with the concerns expressed in the report. While the slowdown in economic growth to a sustainable path is welcome, the economy faces new risks, both internal and external. These include challenges in the tourism sector, international trade tensions, unforeseen consequences of Brexit, and concerns surrounding upcoming wage negotiations. Some of these challenges are exogenous, while others require long-term policy considerations, including sector-specific economic and environmental reforms to strengthen long-term growth and resilience. Iceland is not alone in voicing concerns about trade and protectionism. Any interruption in international trade will pose challenges for a country as globally integrated as Iceland. However, Iceland has retained the flexibility to seek bilateral and multilateral agreements and has successfully done so in recent years. This lever could provide the authorities with scope to address the potential impact of escalating trade tensions, as well as allowing Iceland to manage the risks and opportunities arising from Brexit. Other challenges will require nimble policy-making in the near term, where much will depend on a constructive outcome of the upcoming wage negotiations. Our authorities are confident that the necessary levers are in place and that the economy is sufficiently resilient to take on both short- and long-term challenges, address potential global shocks, and steer the economy towards long-term sustainable growth and stability.

Mr. Kim and Mr. Kim submitted the following statement:

We thank staff for their comprehensive report and Mr. Ostros and Ms. Gunnarsdottir for their clear buff statement. As overheating concerns have receded, the Icelandic economy seems to proceed on a more sustainable growth path. We acknowledge, however, that the economy faces new risks including challenges in the tourism sector, international trade tensions, and unforeseen consequences of Brexit. We agree with the thrust of the staff appraisal and would like to add the following comments for emphasis.

Although the recent slowdown has made growth more sustainable, staff assesses that risks have become more evident. We note that high oil prices and fierce air transport competition could negatively affect Iceland's tourism sector. Also, the sharp tightening of global financial conditions and the possibility of hard Brexit could be a burden to Iceland industries. Does staff have any scenario analysis on Iceland's growth projection when those risks materialize?

Staff and authorities agree that the Icelandic fiscal policy is largely neutral, which creates buffers and enhances public investment. We agree with authorities that debt reduction is essential to Iceland as a small open economy in an increasingly integrated world. In this vein, we welcome that the 2019 budget proposal is in line with the medium-term Fiscal Strategy Plan and fiscal policy statement under the organic budget law. At the same time, we acknowledge that reduction of interest payments has freed up funds to undertake infrastructure investments including the transport system, healthcare, and education.

The current monetary policy stance is appropriate given the subdued inflation outlook and should remain data-driven. We welcome authorities' emphasis that the inflation target is to be retained as the main monetary policy objective and the independence of the Central Bank will be preserved after the merger of the Central Bank and the FME. We do not generally advocate one regulatory structure against the other. However, we expect Iceland's new supervisory structure to provide a clear case of both well-resourced banking regulation and independent Central Bank. We also welcome that the authorities have limited their foreign exchange interventions only to few episodes of disorderly market conditions. We appreciate that the Central Bank has announced a reduction in the special reserve requirement (SRR) by half.

We support staff's call for further structural reforms, with a focus on strengthening growth potential, environment sustainability, and economic resilience. We note that the upcoming wage negotiation leaves some uncertainties in Iceland's economy. We concur with staff that a sound framework needs to be in place to reconcile public and private sector wage increases and to let them go in tandem with productivity growth. In the fisheries sector, we agree with staff that further coordinated and equitable efforts among coastal states should be made to protect species from overfishing.

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for the informative reports and Mr. Ostros and Ms. Gunnarsdottir for their insightful buff statement.

Signaling easing of demand, the secular slowdown in Iceland's growth the recent years has served to protect the economy from overheating. Growth is expected to decelerate to 3.7 percent in 2018 from 4.0 percent in the previous year and to recede further to below 3.0 percent in the coming years. While this slowdown is viewed in a positive light, downside risks, inter alia, from rising oil prices and likely disruption in exports from Brexit continues to cloud Iceland's economic outlook. While inflation is likely to remain contained, the employment rate is expected to decline slowly over the medium term. Both internal and external balances remain positive and serve to stabilize the path of public and external debt over the medium term.

Fiscal policy under the authorities' Fiscal Strategy Plan is well anchored, and its neutrality as attested by staff is a key driver for further debt reduction. We welcome the fiscal policy statement that prescribes minimum fiscal surpluses over 2019-2022 which would facilitate continue reduction in public debt. However, additional expenditure and revenue reforms, which aim at conserving resources for creating fiscal space for productive investments, would sustain long-term growth going forward. In this context, as advised by staff we support the strategy of prioritization of spending and rationalization of taxes which will be key to supporting fiscal stability. The spending reviews being planned by the authorities is a step in the right direction.

Iceland's inflation targeting framework has worked well to keep consumer inflation at its targeted level, although greater clarity on the constitution of the index's consumer basket is pertinent, especially suitable inclusion of housing prices. Moreover, a transparent data driven monetary policy would further enhance the credibility of monetary policy. We note that staff has welcomed the decision to merge Central Bank of Iceland (CBI) and the financial regulator Fjármálaeftirlitid (FME), citing gains in synergy between oversight and key central bank functions namely its role as the lender of last resort and resolution authority. However, it will be imperative to ensure a fair degree of independence and accountability of the merged entity. In this context, we welcome the authorities' plan to preserve the independence of the CBI while keeping the inflation target as monetary policy objective.

We note that the Iceland's financial system is resilient and endowed with adequate capital and liquidity buffers. A number of decisive steps have been taken to improve the legal and architectural framework of oversight while the high-level Financial Stability Council facilitates effective communication among policy making and regulatory bodies. However, we observe that pension funds which have outgrown the size of the banking industry and their indulgence in retail lending pose risks and should be brought under comprehensive oversight that is on par with banks.

Iceland's external position is broadly in sync with fundamentals, and we support staff advising selective interventions to stem unwarranted volatility and maintaining adequate reserves. We believe that the authorities intention to renew the legality of special reserve requirements on glacier bonds debt inflows could be useful for Iceland if such flows are driven by reasons such as carry trade rather than interest rate differentials but nevertheless support its gradual scaling down in keeping with market developments. Could staff comment on the elasticity of these debt inflows vis-à-vis changing interest rate differentials?

Structural reforms should focus on enhancing productivity and competitiveness by improving education and vocational skills besides improving the wage bargaining system to align it with productivity gains. The trend of large increases in wages in the past few years should be modified suitably to give support sustainable momentum of demand and growth consistent with price stability. In this context, we welcome the authorities' commitment to adjust policies to counter any excessive increase in wages. Besides, productive activities namely tourism and fisheries require nurturing from the standpoint of securing sustained economic and environmental benefits. Could staff inform of the process of wage bargaining in Iceland and particularly the powers of the authorities to influence this process?

We wish the authorities every success in their future endeavors.

Mr. Fachada and Mr. Fuentes submitted the following statement:

We thank staff for the reports, and Mr. Ostros and Ms. Gunnarsdottir for their candid statement. Iceland's economy continues to perform well, combining robust economic activity with low inflation, strong public finances and a sustainable external position. Monetary and macroprudential policies have helped contain inflation, excessive capital inflows and exchange rate appreciation pressures. The fiscal stance has enabled a significant reduction in the debt-to-GDP ratio and remains appropriate. Nevertheless, Iceland faces important structural challenges to increase productivity, enhance its resilience to shocks, and further strengthen the role and performance of the financial system.

We appreciate the comments of Mr. Ostros and Ms. Gunnarsdottir on the impressive progress made by Iceland in the 10 years since the country requested a Fund program. Iceland indeed experienced a perfect storm after the collapse of its three banks in 2008. Program design included unconventional measures and was sometimes controversial and opaque. However, program implementation was exemplary. Economic activity and financial stability recovered much faster than most observers could anticipate at the time, and the impact of the banking crisis on public debt was quickly reversed. The credit for the successful program and post-program performance goes entirely to the Icelandic authorities and people.

The introduction in 2016 of the special reserve requirement on selected debt inflows has benefited macro-financial stability. Implementing a capital flow management tool has allowed the authorities to deal with potential big surges in capital inflows, complementing Iceland's strong policy framework and enhancing its macroeconomic management. Even with the narrowing interest rate differential with the US, the UK and the euro area, the authorities should keep the option to use this tool considering the appetite for Icelandic bonds and the impact of changes in capital flows on the country's small bond and FX markets.

Tourism remains both a source of growth and a growing concern. The sector's unprecedented boom has supported economic activity, outperforming traditional sectors in terms of foreign exchange income. However, a much larger tourism sector has affected housing affordability, real estate prices, as well as placed increase pressure on infrastructure. Since the last Article IV, higher oil prices and tougher competition in the North-Atlantic air routes have intensified concerns about the risks connected to the sector. Therefore, we agree with the authorities that a broader policy strategy to integrate the tourist sector with the rest of the Icelandic economy is warranted, and the tourism task force seems an appropriate forum to develop such strategy.

The ongoing cyclical moderation provides an opportunity to boost reform momentum. After performing above potential in recent years, the economy is set to converge gradually to its long-term growth potential, driven by more moderate private consumption and investment. We commend the authorities for their commitment to reform and encourage them to accelerate measures to improve educational outcomes and revamp the wage bargaining system. Attention to policies geared towards supporting productivity-enhancing innovation is welcome, as productivity growth is projected to decline over the medium term.

A decade after the crisis, changes to the financial system should be consolidated. Strong reform ownership in the aftermath of the crisis was necessary to restructure and recapitalize the Icelandic banking sector. At present, the financial system is solid, and the regulatory and supervisory architectures are strong. Nonetheless, we welcome the decision to merge the central bank and the financial supervisory authority to improve the coordination of macroprudential policy and financial market supervision. We take note of, and endorse, staff's advice to the authorities to energize its efforts to combat financial crime and strengthen the AML/CFT framework.

Mr. De Lannoy and Mr. Jost submitted the following statement:

We thank staff for the comprehensive set of papers and Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement. We commend the authorities for their sustained efforts in implementing a broad set of reforms since the onset of the financial crisis. Continuing to increase the economy's resilience during these more favorable times is expedient. We therefore welcome the authorities' commitment to prudent policies and governance reforms, including in the financial sector.

Building up fiscal buffers remains appropriate. While debt levels have been reduced impressively, roughly by half of the 2011 levels, we see merit in continuing on this prudent path, especially given Iceland's open economy. Non-negligible risks, which are mostly external and outside the authorities' sphere of influence, continue to exist. In this sense, we also concur with staff on the merits of setting up a sovereign wealth fund in line with international best practices. Carrying out a spending review can help discern wasteful spending and, more importantly, contribute to further strengthening of fiscal governance.

We welcome the fact that despite the encouraging economic indicators, including an economy at full employment, the authorities continue to actively adapt their strategies to manage growth, as their efforts in the tourism sector illustrate. At the same time, we would like to encourage the authorities to continue diversifying the economy and make it less dependent on a few key sectors, thereby increasing the country's resilience to shocks. Here, investments in productive infrastructure and human capital are sensible. We encourage the authorities to stay vigilant regarding the effectiveness of public spending.

We appreciate staff's articulate review of financial sector developments in the past decade, and their overview of responses to past policy recommendations. They give a good account of the thorough reforms and restructurings carried out in Iceland as well as their positive results, such as the reduction of NPLs from 23 percent in 2011 to roughly 5 percent today. We welcome the strong results reported by the main banks. We agree with staff that CFMs can be useful in certain circumstances and that challenges in the Icelandic financial sector remain. We support staff's view that combatting financial crime should remain a priority.

Mr. Geadah and Ms. Merhi submitted the following statement:

We thank Mr. Ostros and Ms. Gunnarsdottir for their informative buff and staff for an interesting report. Policy discussions have rightly focused on how to further increase resilience to shocks, and on medium-term priorities given that overheating pressures have receded.

Iceland has come a long way since 2008. The authorities have made impressive progress since then in reducing fiscal and external imbalances, addressing financial sector weaknesses, and strengthening institutions. Both public and private sector balance sheets have been repaired and strengthened through targeted measures. The financial system has undergone radical changes and its activities have shrunk significantly, with assets declining from 900 percent in 2008 to 130 percent of GDP in 2018. Nonetheless, the authorities appropriately remain vigilant to external risks including those stemming from Brexit as well as rising global trade tensions, which could particularly impact the aluminum industry.

We concur with staff that a neutral fiscal stance is appropriate given the narrowing output gap. The Fiscal Strategy Plan for 2019-2023 includes a reduction of the tax burden as well as increases in spending on infrastructure, healthcare, and education. Careful prioritization and execution will be needed, and we appreciate the authorities' readiness to adjust measures in each annual budget bill to ensure that medium-term targets are met. We see merit in staff's call for a comprehensive review of expenditures to identify areas for saving and to rank outlays by their effects on growth and productivity. We also welcome the authorities' plan to establish a sovereign wealth fund that will serve as a "disaster relief reserve" when the treasury suffers from severe and unforeseen shocks to the economy.

The tight monetary stance has been successful in containing overheating risks. We agree with the authorities that given elevated risks at the current juncture, there is a need to be cautious in setting the policy rate. We also agree that the inflation target should capture the consumer basket as comprehensively as possible, as elaborated in the useful SIP. With the results of the wage settlements still unclear, we welcome that the authorities are ready to act should this threaten the inflation target.

The financial sector remains liquid and profitable, and non-performing loans are at a low level. Nevertheless, banks should remain cautious against excessive credit and foreign currency exposures. We commend the reform of financial sector oversight, including the merger of the CBI and the FME. However, we agree with staff that careful planning will be needed to ensure a smooth transition as the supervisory body is merged into the central bank.

The authorities agree with staff that with the slowdown in growth, the weakening of the currency, and the narrowing interest rate differential with abroad, conditions are in place to scale back the special reserve requirement (SRR). We therefore welcome the central bank's announcement of a reduction in the SRR from 40 percent to 20 percent a week ago, as elaborated in the buff. Staff mentions that they did not detect an inflow surge in 2017 to justify the 40 percent reserve ratio. Could staff comment whether this could be attributed to the introduction of the CFM?

With these remarks, we wish the Icelandic authorities the best in their stabilization efforts.

Mr. Agung and Mr. Shaari submitted the following statement:

We thank staff for the comprehensive set of reports and Mr. Ostros and Ms. Gunnarsdottir for the informative buff statement. We commend the Icelandic authorities for their sound macroeconomic management which has been instrumental in sustaining Iceland's robust economic performance in the recent period. We also welcome the staff's assessment that Iceland's medium-term outlook remains favorable. Given this background, the main policy challenge for the authorities is to ensure long-term economic sustainability, with policy focus geared towards enhancing economic and financial resilience, as well as addressing supply constraints. We broadly agree with staff's appraisal and limit our comments to the following points for emphasis.

Timely calibration and well-coordinated policy actions are essential to ensure continued macroeconomic sustainability. We note positively the authorities' prudent and vigilant macroeconomic management approach. This has translated into agile, appropriate and complementary fiscal and monetary policy actions. In this regard, we laud the adoption of the Fiscal Strategy Plan for 2019–23 that aims to anchor fiscal policy direction in the medium-term and build sustainable fiscal space. Complementary to this, we see merit in staff's recommendation to consider establishing a dedicated wealth fund as a sovereign reserve for contingency events. On the monetary policy front, we welcome the latest assessment from staff and an independent taskforce set-up by the authorities that the inflation targeting regime has served Iceland well. To enhance its effectiveness, authorities may consider conducting further analysis on staff's findings about broadening the measurement of CPI in Iceland. Given the more evident risks to the baseline outlook, we also support maintaining the data-driven stance for interest rate setting at the current juncture, and for the CBI to limit its foreign exchange intervention to mitigating excessive volatility.

Concrete improvements in financial sector oversight will strengthen the financial system. The authorities' recent progress to streamline the regulatory architecture is commendable, with the decisive step to merge the CBI and FME into a unified financial regulatory agency. Once operationalized, this unified agency will improve the effectiveness and coordination between macroprudential policy and financial market supervision in Iceland. To this end, we note that supervisory independence and accountability are key prerequisites for the credibility of the unified agency. Effective supervision, with a forward-looking capacity to monitor, assess and address emerging risks within the financial system, requires strong internal governance that encompasses an unambiguous mandate and clear operational independence. These must be complemented with adequate resources and technical capabilities to proactively discharge supervisory responsibilities. Finally, we also join staff in encouraging the authorities to follow through with the recommendations to enhance financial crime prevention, as contained in the 2018 Financial Action Task Force mutual evaluation report.

Advancing structural reforms are important policy priorities to boost resilience, competitiveness and economic potential. The Icelandic economy has experienced structural challenges related to stagnant labor productivity and declining trade competitiveness. To address these challenges, we support staff's recommendation for the authorities to accelerate reform implementation in the labor market and education system. At the sectoral level, the formation of the tourism taskforce to develop a comprehensive strategy in addressing bottlenecks in the tourism industry is appropriate to uplift the full potential of the tourism sector as the growth engine. We also welcome the authorities’ reiterated commitment to secure equitable agreements with other North Atlantic fishing nations to ensure sustainability of the Icelandic fishing industry.

We support the authorities’ cautious and gradual approach in lifting the CFM measures. We appreciate staff’s balanced approach in highlighting the benefits and risks of lifting the special reserve ratio in Iceland. While CFMs should not be used as a substitute for macro-adjustment policies, we agree with the authorities’ approach of gradualism and vigilance to fully lifting them when the interest rate conditions are firmly on a favorable path, particularly when the risks for the baseline outlook are judged to have become more evident. The success of the special reserve ratio to curb the surge of rapid inflows from destabilizing the Iceland economy, is a good case in point of how the adoption of well-designed CFM measures, under appropriate circumstances, can play an important complementary role to other macro policies and contribute significantly to macroeconomic and financial stability. Staff highlighted about Icelandic authorities’ plan to renew the legal basis for future CFMs, as part of authorities’ comprehensive policy response in the event of a future inflow surge. We view the plan favorably, as it will widen the authorities’ policy options and instruments to complement other macroeconomic policies. Can staff provide further details about this plan?

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its reports and Mr. Ostros and Ms. Gunnarsdottir for their insightful buff. We share staff’s appraisal and would like to add some comments on specific areas.

Ten years after the crisis, Iceland’s economy finds itself in an enviable situation thanks to the skillful management of the economy by the Icelandic authorities, sometimes utilizing welcome unorthodox solutions. The recent economic slowdown has reduced overheating risks, which will allow the authorities to focus on medium-term challenges, such as infrastructure, healthcare, education and the environment. Risks, notwithstanding, have intensified over the recent period, so Icelandic policies may need some recalibration to ensure an adequate degree of resilience.

The current fiscal stance seems roughly appropriate. Like staff, we believe that—in view of the ambitious new spending goals—it would be an adequate moment for a comprehensive expenditure review. This review should seek to improve efficiency and identify areas with scope for savings to ensure medium-term fiscal targets. In this regard, medium-term fiscal plans seem consistent with the goals of further debt reduction and fiscal sustainability. Indeed, gross public debt is projected to fall about 14 pp to 23.6 percent of GDP by 2023. In view of this development, we wonder whether it would be desirable to aim for a higher debt ratio given the need of pension funds for króna-denominated long-term assets to match their liabilities.

We concur with staff that monetary policy should remain focused on price stability and that the inflation target should capture as well as possible households' spending patterns, while exchange rate interventions should be limited to maintaining reserve adequacy and countering disorderly market conditions. CFMs should be used in compliance with the Fund's Institutional View and as part of a comprehensive policy strategy. We welcome the recent announcement to reduce the special reserve requirement (SRR) from 40 percent to 20 percent. We would like to know whether staff considers that in the current context of rising external (financial) risks the appropriate level for the SRR would be 0 percent.

We commend the authorities for their intention to undertake deep institutional reforms to upgrade financial system oversight to keep pace with the opening of the capital account. Like staff, we strongly support the decision to merge the central bank and the financial regulator and call on the authorities to provide the necessary degree of autonomy, accountability and of legal and resource powers. Besides, we concur with staff that, given the role and size of pension funds in credit intermediation, it would be desirable to position pension fund oversight at the central bank. This would have the additional benefit of rationalizing macroprudential policy.

Finally, on a more structural footing, we welcome the authorities' focus on strengthening growth potential, environmental sustainability, and economic resilience. We encourage the authorities to improve its wage bargaining system by anchoring it on productivity growth and competitiveness to ensure an adequate degree of flexibility for a very small open economy such as Iceland. We also praise the authorities for their comprehensive policy approach to tourism, as well as for their commitment to sustainable fishing.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We thank staff for the insightful set of papers and Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement. We agree with the thrust of the staff appraisal and appreciate the convergence of views between staff and the authorities.

Iceland has made remarkable progress over the last ten years, achieving a strong recovery from a deep crisis, successfully rebalancing its fiscal and external positions, and restoring financial stability. The recent economic slowdown in the face of a still positive outlook is welcome, as it will reduce the need for countercyclical policies and allow the authorities to shift their focus on structural reforms in order to increase economic and financial resilience. As clearly acknowledged in the buff statement, there is no room for complacency in a small and globally integrated economy and we welcome the authorities' commitment to continue to build buffers.

In this vein, we particularly welcome the decision to reform the financial sector oversight framework, including the merger of the Financial Supervisory Authority (FME) into the Central Bank with the view to exploit the synergies between the oversight, lender of last resort and resolution functions, strengthen the independence of the combined authority, and improve the coordination between micro and macroprudential policies. At the same time, we agree with staff, that even an optimal design of the institutional reform is no substitute for a rigorous focus on operational independence, technical capacity, and adequate enforcement powers and resources. Furthermore, so long as pension funds maintain a prominent role as retail lenders, it will be of utmost importance to ensure that they are subject to bank-like regulation and oversight. Finally, we share staff's concerns about the strength of the AML-CFT framework and call on the authorities to address the shortcomings underscored by the recent FATF's evaluation.

The real estate market is a cause for concern from a financial stability perspective, given the high volatility of house prices, which has also reignited the debate about the most suitable reference index for Iceland's inflation target. In this respect, we agree with the Selected Issues Paper conclusions that a refinement of the CPI definition to better account for housing costs may strengthen Iceland's inflation targeting framework and that any revisions should be carefully considered for their monetary policy implication. Beyond monetary policy, we would also appreciate further details and staff's assessment of house price developments for their financial stability implications. We note that house prices increased strongly in 2017 and have lately decelerated. What measures have been taken or might be considered to dampen house prices dynamics? What macroprudential measures, in addition to the new loan-to-value ceilings on mortgages, have been implemented to guard against financial stability risks arising from the real estate sector?

We support the focus on infrastructure to sustain the growing touring industry while protecting the environment, including through careful management of marine resources. We commend the authorities for the design and successful implementation of a quota and fees system that has contributed to boost productivity in the fisheries sector and spur the development of ancillary sectors. We appreciate the detailed Selected Issue Paper and join staff in encouraging the authorities to continue refining the current system to ensure it remains efficient and consistent with scientific evidence. With respect to the ongoing debate on possible changes to the current profit-based fee system, we note that the option of auctioning fish rights been discarded. Could staff elaborate on the relative merits of the two options, namely collecting fees versus selling fishing rights?

Mr. Saito, Mr. Ozaki and Mr. Minoura submitted the following statement:

We thank staff for the informative papers and Mr. Ostros and Ms. Gunnarsdottir for their helpful buff statement. Same as the previous board, we commend well-designed and beautiful figures in the staff paper to facilitate reader's visual and intuitive understanding. We positively take note that Iceland's economy continues to grow but overheating concerns have receded. At the same time, we commend the progress in financial sector restructuring and reform over a decade after its banking crisis. However, risks have become more evident including high oil prices and fierce air transport competition, escalating trade tensions and Brexit. Against this background, we encourage the authorities' further efforts to increase resilience to shocks and enhance sustainability. As we broadly agree with the thrust of the staff's appraisal, we will limit our comments to the following points:

Capital Flow Management Measure (CFM)

As the interest rate differential narrows, the currency weakens and the overheating concerns recede, we welcome the central bank's announcement of a reduction in the special reserve ratio from 40 percent to 20 percent. We would appreciate it if staff could share market reactions after the Central Bank's announcement. Going forward, we encourage staff's further discussion with the authorities on condition, sequencing and timing for lifting the CFMs, taking account both global and country specific factors. We also take note of the authorities' plans to renew the legal basis for the special reserve requirement on selected debt inflows. We would appreciate it if staff could share the view on the renewal of the legislation.

We reiterate our full support to the Fund's Institutional View (IV). At the same time, we continue to underscore the importance of the Fund's work to facilitate a practical guidance for CFMs. In this regard, we urge staff to make more granular guidance to evaluate the effectiveness and adequacy of individual CFMs, making use of the experience of Iceland.

Financial Stability

While it is encouraging that much restructuring of the financial system has been achieved since the crisis and the three main banks appear sound, we agree with the staff's appraisal of strengthening financial sector oversight, as capital account openness comes more risk. In this regard, we welcome the authorities' decision to merge the central bank (CBI) and FME, which is a decisive step toward better and more integrated oversight. Nevertheless, as staff rightly pointed out, efforts remain focused on the basic building blocks: independence, accountability, rulemaking and enforcement powers, technical capacity, and resources, in order to make the reform effective and successful. In this light, we would appreciate it if staff could share the best practice on how to ensure central bank independence and address regulatory forbearance, derived from past experiences in other countries that unified banking oversight functions to central banks.

Structural Reforms

We commend the authorities' efforts to institute a new wage bargaining mechanism anchored on external competitiveness and the commitment to greater educational spending. We take note that the authorities stand ready to adjust policies in case that wage increases are once again excessive. Could staff share their views on possible policy responses if it materializes.

As staff pointed out, strengthening economic and environmental sustainability also need to be given a high priority. In this light, we welcome the work of the tourism task force and the authorities' strong commitment to sustainability in the fisheries sector.

Mr. Jin and Ms. Cai submitted the following statement:

We thank staff for the informative reports and Mr. Ostros and Ms. Gunnarsdottir for the helpful buff statement. While economic growth slows, overheating concerns have been mitigated, with low inflation, fiscal and current account surpluses, and contained public debt. We commend these achievements and encourage the authorities to put more effort in addressing the remaining vulnerabilities in the economy. We broadly agree with staff's appraisals and offer the following points for emphasis.

Neutral fiscal stance is appropriate given the closing output gap. The new government's emphasis on infrastructure, healthcare, education, and environmental spending is welcome, and is conducive to release growth potential. We encourage the authorities to better prioritize fiscal spending and increase the efficiency in this regard. According to the Fiscal Strategy Plan for 2019-2023, total expenditure will decrease by 1.6 percent of GDP, while infrastructure spending will increase by 0.6 percent, which will be financed by excess dividend. Could staff elaborate more on how much the spending on healthcare, education, and environment will be increased and how it will be financed? Regarding the reliance on irregular revenues, we share with staff's concern and encourage the authorities to explore more dependable sources of project financing. We agree with staff that establishing a wealth fund would facilitate future increases in fiscal space, and the authorities also propose to channel dividends from Landsvirkjun to the fund. Do the authorities have a timeframe as to when the fund will be created?

Considering that the inflation targeting regime served the economy well, monetary policy should continue to focus on inflation target and remain data-dependent. Communication to the public should be further improved to avoid undue market volatilities. We take positive note that the Central Bank of Iceland announced a reduction in the Special Reserve Requirement from 40 percent to 20 percent and encourage the authorities to further lift the CFM when conditions permit. We are glad to see that credit is recovering. At the same time, recent correlations of credit and property price growth have been negative. Could staff shed light on to which sectors the credit flows into?

We are encouraged to see the progress made in financial sector restructuring and reform after the crisis, and commend the authorities' decisive steps to strengthen financial sector oversight, including unifying prudential oversight and resolution of banks at the CBI. In the buff, it is mentioned that the NPLs is below 3 percent of the loan portfolio, while staff pointed out that NPL ratios of the three main banks stood at 4.4-5.9 percent. Could staff elaborate more on the reasons of the difference? Does it mean that small banks have better asset quality? Are the three main banks' NPLs the legacy of the crisis or recently formed? We also take note that Icelandic bank's outstanding loans to fisheries sector accounted for 11 percent of total loans to customers and NPL ratio on these exposures was 7 percent, higher than the average level. We encourage the authorities to closely monitor its developments and introduce macroprudential measures when necessary.

More work needs to be done to enhance the oversight of the pension funds, given the funds have become important retail lenders and even originate more mortgages than the banks in 2017. Have the authorities had any specific plans to strengthen pension fund oversight given the limited support for banning pension fund from retail lending?

Strengthening growth potential, environmental sustainability, and economic resilience should be prioritized in the medium term. Wage growth should be better aligned with the growth of productivity. We encourage the authorities to steadfastly implement structural reforms to protect competitiveness and foster sustainable tourism, including promoting innovation and improving labor skills.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Di Tata and Mr. Morales submitted the following statement:

We would like to thank staff for a clear and concise report and Mr. Ostros and Ms. Gunnarsdottir for their helpful buff statement.

Iceland is experiencing a slowdown in economic activity, but the economy remains at full employment with rising income levels. Overheating concerns have subsided as the rate of growth of tourist arrivals has declined. The krona appreciation has stopped, housing inflation has slowed, and overall inflation has converged to target. Staff and authorities agree that the cooling down is welcome and the economy is expected to settle to more sustainable growth rates, with inflation remaining close to target. At the same time, several risks have become more evident, including those related to higher jet fuel prices, intense air transport competition, and global trade tensions. In addition, Brexit may have a significant impact on the demand for Iceland’s exports of goods and services, given the country’s close integration with the United Kingdom. The baseline outlook presented in the staff report envisages declining growth rates, with economic activity supported mainly by private consumption. Private investment is expected to decelerate, notwithstanding the continuous expansion of residential investment and commercial construction. Could staff elaborate on the factors behind the expected deceleration of private investment?

The authorities' new Fiscal Strategy Plan, which allows for a lower tax burden and higher capital spending, is consistent with a gradual reduction of the general government surplus. The staff's fiscal scenario shows a further decline in the surplus because it does not incorporate all the expenditure measures envisaged by the authorities. In any case, the staff's fiscal projections appear to be in line with a substantial reduction of external and public debt discussed in Annexes I and II. We agree with staff on the need to review and prioritize public expenditures carefully and to be cautious on tax reform, striking the right balance between progressivity and incentives to work. Could staff comment on the status of the legislation to establish a wealth fund that could serve as a disaster relief reserve?

We welcome the authorities' planned upgrade of Iceland's financial sector oversight, in line with staff's recommendations. Progress in this area in the context of the unification of prudential oversight and resolution of banks at the Central Bank of Iceland (CBI) has become more relevant given the recent acceleration of credit growth. We note that non-performing loans (NPLs) have declined from crisis levels. However, financial soundness indicators show still high corporate NPLs. Given the important share of the Housing Financing Fund and pension funds in residential mortgage loans, it would be useful if staff could provide disaggregated information on credit growth and NPLs for banks and non-banks.

We certainly agree that the unification of prudential oversight and banking resolution at the CBI should be mindful of the complementarity between micro and macro-prudential policies and recognize basic synergies between oversight, lender-of-last-resort, and resolution functions. In this regard, we note that Iceland's macroprudential toolkit, comprising rules on capital buffers, liquidity coverage, net stable funding, and net open foreign currency positions, is well suited to buttress banking sector resilience.

We wonder if the staff proposal to lift the Capital Flow Management Measure (CFM) on inflows altogether at this juncture would be a prudent decision, given lingering concerns about financial sector oversight. Pending reforms to financial regulation and supervision would eventually support a healthy two-way cross border flow of funds. We note that the interest rate differential vis-a-vis the dollar has continued to narrow and that identifiable flows that may be affected by the lifting of the CFM appear small. However, more robust regulation and supervision would contribute to a smoother transition to a more open capital account in the face of external uncertainties. In this regard, we note from the buff statement the authorities' decision to proceed gradually. Staff's comments on this issue would be welcome. We also encourage the authorities to move ahead with the recommendations made by the Financial Action Task Force to address anti-money laundering deficiencies.

We concur with the staff's emphasis on the need to strengthen economic and environmental sustainability. A comprehensive strategy to improve tourism services and accessibility to alternative destinations seems warranted, as well as careful management of marine resources. This will help raise Iceland's growth potential and better prepare the economy in case external risks were to materialize. Regarding domestic risks, the existing wage bargaining framework has resulted in excessive wage increases which, if continued, could adversely affect competitiveness and inflation. In this regard, we would welcome staff's description of the wage setting mechanisms for public and private sector wages and the prospects for future wage increases to be in line with productivity.

With these comments, we wish the authorities well in their endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Rouai submitted the following statement:

We welcome this opportunity to discuss recent developments in Iceland. We thank staff for a comprehensive set of papers and Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement. We broadly share staff conclusions and policy recommendations and would like to focus our comments on the following issues.

The progress achieved by Iceland, ten years after the global financial crisis, is impressive, as detailed in the buff. Macroeconomic indicators have improved, the stability and soundness of the financial sector have been enhanced, and the institutional framework has been strengthened. More importantly, Iceland is among the few countries where GDP level regained rapidly, and later surpassed, the pre-crisis level and we would appreciate staff elaborations on any lessons from the Icelandic experience?

We welcome Box 3 detailing the decade of progress in financial sector restructuring and reform. We encourage the authorities to address the two remaining crisis legacies, namely the high level of state ownership in the banking sector (two-thirds of banking sector assets) and the pension fund industry's exposure to domestic risks.

We are concerned by the treatment of dividend receipts from state-owned banks. The authorities relied on these dividends to reduce debt and will also use these receipts to finance the investment programs under the Fiscal Strategy Plan. However, we note that staff considers that some of these dividends are “excess” dividends as they go beyond the regular dividends consistent with traditional return on equity and profit distribution rules. More concerning is the indication in Box 3 that “recent dividend payments appear to have been funded in part by borrowing”. In this regard, is there a risk that these “excess” dividends could also be considered as quasi-bank financing of the government? Staff elaborations would be welcome. In any case, we join staff in encouraging the authorities to ensure greater clarity in its fiscal plans and to reduce reliance on unpredictable dividends flows. While still on the financial sector, we welcome staff pragmatism in accepting the authorities’ preference to move all financial sector oversight and resolution to the central bank, instead of staff’s previous preference for a “twin peaks” solution.

On the issue of capital flow management measures (CFM), we continue to sympathize with the authorities’ view on the need for a gradual and conditions-based rollback. We commend the authorities for the progress in orderly removal of capital controls imposed in the aftermath of the crisis. We take note of staff views regarding the need to roll back to zero the special reserve requirement (SRR) on selected debt inflows. We consider that the authorities are on the right track towards this goal following the recent reduction in the SRR from 40 percent to 20 percent. As risks associated with capital inflows remain, we encourage, however, the authorities to strengthen microprudential oversight and rely more on macroprudential policies to ensure financial stability.

With these remarks, we wish the authorities all the success.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written set of papers and Messrs. Ostros and Gunnarsdottir for their helpful buff statement.

Skillful economic management over the past decade has helped Iceland experience significant progress and a remarkable turnaround from the financial crisis. In 2018, growth has continued at a slower pace that has allayed overheating concerns; inflation has converged to target with a narrowing output gap; and unemployment is well below its long-run average. The fiscal and external current accounts remain in surplus, public debt is on a firm downward path, and reserves are ample. The financial sector also presents a mostly positive picture after a decade of restructuring and reform, with the three main banks continuing to report strong results. We commend the authorities for sound policies that have bolstered market confidence, as reflected in favorable and improving sovereign credit ratings. These achievements notwithstanding, risks to the outlook place a premium on continued efforts to safeguard fiscal sustainability, upgrade financial sector oversight, and advance growth-enhancing structural reforms. We concur with the thrust of staff appraisal.

A broadly neutral fiscal stance remains appropriate, given the easing of near-term demand pressures and the slowdown in the economy. The Fiscal Strategy Plan for 2019-23 strikes the right balance between supporting growth and further debt reduction, and we welcome the authorities' readiness to adjust measures in annual budget bills to ensure that medium-term targets are met. The strong emphasis on infrastructure, healthcare, education, and environmental spending is praiseworthy and should be accompanied by a comprehensive expenditure review to identify savings in other areas. Broadening the tax base and strengthening the tax administration will help lower the dependence on irregular dividend receipts and facilitate budget planning. We agree that tax reforms should be carefully designed, including by analyzing their impact on work incentives, social objectives, progressivity, and inequality. We also see merit in creating a wealth fund to help increase fiscal space and serve as a disaster relief reserve, given the country's permanent exposure to elemental hazards. While the authorities plan to further reduce debt to better prepare for potential shocks, staff cautions against cutting gross debt to sub-optimally low levels, given its benchmarking role in financial markets. We appreciate staff further elaboration, including by indicating what it regards as the lowest optimal debt-to-GDP ratio in Iceland's case.

Monetary policy, under the inflation-targeting framework, has served the country well by delivering low and stable inflation. It should remain centered on price stability and be data driven. Notwithstanding the recent divergence between housing costs and other prices, we agree that inflation target should capture the consumer basket as broadly as possible and be well understood by all. We welcome the authorities' commitment to a flexible exchange rate regime and to limiting foreign exchange interventions to maintaining reserve adequacy and mitigating excessive rate volatility and look forward to the upcoming review of the intervention policy that will also address the attendant communication strategy.

The financial sector appears well-capitalized, liquid, and profitable, with low NPLs. The largely successful completion of the sector's restructuring since the crisis has made the sector more resilient. However, capital account openness presents risks, as do banks' foreign currency lending to unhedged borrowers, and growing pension funds' exposure to domestic market. While there is currently no evidence of an inflow surge, the large interest rate differential vis-à-vis the euro justifies the authorities' gradual approach to lifting the CFM on inflows. In this context, we take positive note of the recent reduction in the special reserve requirement on inflows, as indicated by Messrs. Ostros and Gunnarsdottir. Given the increasing need for strong prudential oversight of banks and pension funds, we welcome the decision to merge the CBI and FME, and encourage further efforts to ensure sufficient supervisory independence, powers, capacity, and resources. The state still owns two-thirds of banking sector assets, and we see merit in measures outlined by staff to facilitate high quality divestment and privatization.

Structural reforms to revamp the wage bargaining framework, improve educational outcomes and reduce skills mismatches, develop a holistic tourism strategy, and carefully manage marine resources remain crucial to boost competitiveness, increase economic resilience, enhance environmental sustainability, and lift growth potential. Wage increases should be in line with productivity growth and we welcome the authorities' readiness to adjust policies in case upcoming wage awards are excessive. Public investment in education should be decompressed and vocational training schemes enhanced. Given the leveling out of tourism and the decline in tourist satisfaction, including because of capacity constraints and stretched infrastructure, we take positive note of the task force established to develop a comprehensive strategy for the tourism industry. The authorities' unilateral steps to enforce fishing quotas bode well for the sustainability of the fisheries sector and should be complemented by securing coordinated, equitable, and durable fishing agreements amongst North Atlantic coastal states.

We wish the authorities continued success in their endeavors.

Mr. Benk and Mr. Hagara submitted the following statement:

We thank staff for their report and well-focused Selected Issues Papers, and Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement. Owing to continued broad-based reform efforts, the authorities have put Iceland's economy on a stronger footing by increasing its resilience and rebuilding buffers. Since the risks of macroeconomic overheating, housing pressures, and the tourism boom seem to have abated, this year's Article IV Consultations rightly focused on medium-term priorities. We broadly concur with the staff appraisal and would like to add the following comments for emphasis.

The strong fiscal position should be sustained to boost buffers against increased risks. Public debt has fallen significantly from 90 percent of GDP in 2011 to below 40 percent. Nevertheless, against the positive output gap and higher external risks, planned headline fiscal surpluses in the medium horizon, leading to a further reduction of public debt and paving the way to the creation of a wealth fund, seem about right. The enhanced focus on infrastructure investment, healthcare, and education spending is also appropriate and we welcome that the authorities will support their fiscal plans through expenditure reviews to ensure the proper prioritization and effectiveness of their spending. In addition, we concur with staff that the reliance on dividend receipts should be reduced going forward.

Monetary policy decisions should remain guided by inflation developments. With inflation close to target, the monetary policy stance seems to be adequate for now. While various inflation measures are useful to better understand underlying price developments, the full inflation index, capturing the broad consumer basket, seems appropriate for monetary policy targeting. At the same time, a clear communication that foreign exchange interventions will be limited to disorderly market volatility would further support the authorities' inflation-targeting. We welcome the authorities' announcement to reduce the special reserve requirement from 40 percent to 20 percent.

We welcome the authorities' efforts to boost financial sector resilience. The three main banks seem to be in sound condition, well-capitalized, and profitable. Financial sector oversight should be further improved by the recent decision to merge the Central Bank of Iceland with the Financial Supervisory Authority (FME), including to strengthen oversight of the pension funds' retail lending activities. Furthermore, the authorities' divestment efforts should continue, while seeking high-quality ownership. We also encourage the authorities to address the weaknesses identified in the 2018 Financial Action Task Force's mutual evaluation.

Mr. Mozhin and Mr. Tolstikov submitted the following statement:

We thank staff for the well-written papers and Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement. Improvements in Iceland's economy since the 2008 financial crisis are commendable. In ten years Iceland has restored macroeconomic stability, secured financial system soundness, and achieved impressive results in reducing excessive debt burden.

Private sector debt dropped from 350 percent of GDP to about 150 percent, while public debt was reduced from more than 90 percent of GDP to slightly over 30 percent. Higher growth rates were achieved on a more sustainable basis.

The restored resilience of Iceland's economy should be maintained and strengthened. While financial vulnerabilities have been reduced significantly, Iceland's small and open economy continues to face numerous risks, including potential disruption of the tourism sector, the negative impact of Brexit on exports and fisheries, the side effects of U.S. sanctions on Iceland's aluminum industry – all on top of the permanent exposure to natural disaster risks. Therefore, the authorities rightly prioritize stability and sustainability. We broadly support the policy recommendations and the authorities' efforts in implementing the structural reforms to lift growth potential and enhance sustainability.

The focus of the fiscal policy on increasing fiscal space while prioritizing investment in infrastructure and human capital remains appropriate. Iceland's success in reducing debt burden and interest payments provides some space for increased spending in priority areas. We agree with staff that planned tax reforms, which may reduce revenues, should be considered with care and should be supplemented by a comprehensive spending review. We also agree that reliance on dividend payments as a regular source of revenue in budget planning should be reduced. Establishment of the wealth fund could create additional buffer against shocks.

Monetary policy based on inflation targeting regime has served Iceland well. Relatively tight monetary stance helped keep inflation on target. Taking into account the elevated uncertainty, monetary policy should remain data driven, to react to developments in both directions. Exchange market interventions should be limited to preventing disorderly exchange rate movements, while maintaining the goals of reserve adequacy.

The macroprudential management in Iceland has been one of the most active in Europe and the authorities have accumulated substantial experience in this area. The CFM measures were instrumental in reducing risk of excessive capital inflows and overvaluation of the currency. However, with the ongoing narrowing of the interest rate differentials the CFM could be eased. The recent decision of the Central Bank of Iceland (CBI) to reduce special reserve requirements from 40 to 20 percent looks appropriate.

We commend the authorities for the progress in strengthening the financial regulatory framework. Strong regulation allowed to complete successfully the restructuring of the financial system and restore its soundness. The incorporation of the supervisory agency (FME) into the CBI should further strengthen financial sector supervision, increase its independence, and reduce duplication.

We welcome the SIP on fisheries, which remain a major systemically important industry in Iceland. Being heavily dependent on fishing, Iceland is strongly interested in sustainable use of naval resources in the North Atlantic. The rational usage of migratory fish species requires international cooperation and coordination. As one of the most interested parties, Iceland should continue its efforts in convincing other North Atlantic fishing nations to achieve durable solutions.

Mr. de Villeroché, Mr. Castets and Ms. Gilliot submitted the following statement:

Prudent macroeconomic policies have enabled a successful soft landing of this small, open and relatively little diversified economy. After having experienced a combination of strong growth, below-target inflation, full employment and current account surplus, the economy still shows encouraging signals. The outlook is rather positive as the authorities are engaged in structural reforms to bolster growth potential and remove the fragilities generated by a low diversification of its output and trade. On another ground, Iceland has become a textbook case for monetary policy makers on how to conciliate the conduct of an independent monetary policy in a small, open and financially integrated economy while preserving the stability of the financial system. The country has bear the brunt of being an attractive investment destination that turned out to be a ripe incentive for carry trade activities and surging financial disruptions, which cannot be addressed by monetary policy alone.

We recognize the efforts made by the authorities to deliver on their commitment to stabilize the macroeconomic framework building on prudent macroeconomic policies, strong business environment and a decline in gross public debt and more specifically on foreign currency denominated debt. The slowdown of GDP growth since 2016 has been indeed desirable and is getting closer to its long-term trend. We also see growth fueled by private consumption and investment as a positive signal to increase furthermore investments in the tourist sector as well as in new potential sources of growth like financial innovation. Regarding investment, we are surprised that the risks for the local energy industry linked to crypto mining were not covered in the report. Our understanding is that this new activity has caused the electricity consumption to skyrocket over the recent years[1]. Given the current appetite for cryptocurrencies, we would all but overlook in the next consultations the upturn of this activity that some say to be in the process of exceeding the consumption of all Iceland's homes. We would be pleased to listen for staff's feedback on this issue.

We share staff's concerns that the economy remains vulnerable to economic overheating. In that sense the high level of credit growth should be carefully monitored to remain in line with households' balance sheets growth and avoid falling back into the same pre-crisis situation. Likewise, we support staff's recommendation that wage increases should not exceed productivity growth to preserve the country's competitiveness and we note that Iceland membership of the EEA contributes to mitigate this risk. Among other vulnerabilities, we acknowledge that the deceleration of net exports growth and the continuous deterioration of terms of trade for several years have contributed to the narrowing of the current account surplus. This trend should not be interpreted too narrowly as it also reflects the dynamism of domestic demand.

We share staff's fiscal policy assessment. We note that staff and the authorities agree on maintaining a neutral fiscal stance at the current juncture but to remain ready to react if a recessionary shock should materialize. Given the low level of public debt, we would probably have put less emphasis than staff on the need to further increase fiscal space. On the expenditure side, we agree that priority should be given to the most strategic sectors including infrastructure, healthcare and education spending.

Along with capital flows measures, the authorities have also used foreign exchange intervention to reduce short-term exchange rate fluctuations and strong appreciation pressures try to preserve the independence of their monetary policy, which we believe, in this case, to have been the better option to deal with free capital movements. The special non-remunerated reserve requirement [of 40 percent with a holding period of a year] on capital inflows invested into the bond market and high-yielding deposits have served the financial system well. And if it helps restore the monetary transmission and avoid the build-up of carry trade positions – which is still not the case vis a vis the euro according to the report – we support the authorities in their wish to

[1] 840 gigawatt hours of electricity per year to support the server farms and cooling equipment of the crypto mining industry according to Icelandic energy firm HS Orka. According to a recent report by KPMG, about 90 per cent of the power consumption of Iceland's data centres last year was dedicated to the mining of cryptocurrencies.

remain cautious and reduce the ratio on a gradual path. Our position does echo the dilemma monetary and macro financial policies struggle with to mitigate on the one hand the risk of overheating of the economy while avoiding on the other hand the pre-crisis situation of unsustainable volatile inflows attracted by appealing interest rates. As any guidance, IMF's Institutional View on capital flows management faces theoretical limitations when it comes to dealing with domestic constraints, excess exchange rate volatility, spread effects and monetary independence and, as known, no single policy is a silver bullet.

We acknowledge that much has been done since the last financial crisis to regulate more closely the banking sector. In that, we fully support the authorities in their going-on efforts to upgrade the financial system regulation and prudential supervision. We would like to put an emphasis on the necessity of achieving the implementation of an exhaustive supervision framework including banks, non-banks, markets and pension funds under the CBI as a single supervisory body. Moreover, we echo staff's recommendation on the importance of swiftly implementing the FATF recommendations to prevent the inscription of Iceland on the "grey list".

Mr. Inderbinen and Mr. Tola submitted the following statement:

We thank staff for their valuable report and Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement. Thanks to carefully calibrated policy measures, the authorities have steered growth toward a lower but more sustainable path, while maintaining unemployment levels well below their long-run average, keeping inflation on target, and improving the country's net international position. Furthermore, the authorities have continued to increase the resilience to financial risk by undertaking a series of deep institutional reforms. The economy is more diversified, and the banks are better supervised. At the same time, overheating concerns are still present, mainly in the labor market.

We welcome the efforts to maintain a general government surplus and reduce public debt. At the same time, we share staff's call for a careful prioritization of new spending, to ensure that the overall target is met. Moreover, tax cuts and higher spending may result in the reemergence of overheating risks as the economy runs close to capacity and inflation is on the rise. We also share staff's recommendation to reduce the reliance on irregular revenue and identify dependable sources of project financing.

We agree with staff's view that the monetary policy stance should remain data driven. The dissipating effects of past krona appreciation, expected fiscal loosening and growing labor costs, should also be followed closely. We take good note of the commitment of the authorities to maintain the inflation target as the principle policy objective and to preserve the independence of the Monetary Policy Committee following the envisaged merger of the CBI and FME.

We welcome the strengthening of financial sector oversight. The integration of supervision at the CBI should strengthen prudential oversight and contribute to further financial sector resilience. Integrated supervision also seems merited given the mortgage lending by pension funds. Could staff comment on the adequacy of pension funds' risk management practices; to what extent are the risks associated with mortgage lending transferred to pensioners? As mentioned in the staff report, the tourism, aluminum and fisheries sectors are vulnerable to external factors. Could staff comment on the exposure of financial institutions to external risk via lending to these sectors? Finally, as staff note, the government has retained controlling equity stakes in Íslandsbanki and Landsbankinn. Can staff inform of any intention of the authorities to divest from these institutions, following the successful divestment from Arion Bank?

We welcome the recent reduction in the special reserve ratio. This underlines the temporary nature of the measure. At the same time, krona interest rates remain relatively high. We also note the authorities' assessment that the SSR was effective in providing macroeconomic policy space. We support the authorities gradual approach to scaling back the SSR.

Ms. Levonian and Mr. Feerick submitted the following statement:

We thank staff for their excellent report and their well-focused selected issues papers. We also thank Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement, which provides useful context and sets the backdrop for the present conjuncture. We broadly agree with the staff assessment and offer the following comments for emphasis.

Fiscal policy remains prudent but Iceland is entering a new fiscal paradigm. Given the depth of the crisis, a focus on consolidation was warranted at a point in time. However, looking to the future, the need to buttress potential growth while not stoking pro-cyclical pressures, underscores the need to develop fiscal space. Comprehensive and systematic review of expenditure, and indeed revenue measures, are key pillars in any effective fiscal framework. We welcome the authorities' willingness to implement some such elements into the future. We note some reservations from staff around the use of dividends to fund infrastructure rather than reduce debt but would argue that this is not necessarily a bad thing, given the declining debt-to-GDP level (forecast at 33 percent next year) and assuming the proceeds are invested in growth enhancing projects, and receive value for money. The more important policy recommendation is that one-off revenue windfalls are not used to fund recurrent expenditure.

We note that capital adequacy of the banking sector is assessed as solid, while profitability and liquidity continue to improve. Notwithstanding the success in these metrics, it remains the case that two thirds of the banking sector remains under state control. Given the overarching objective to divest the state of these assets, a slow, phased and deliberate divestment of the banking sector remains appropriate and will underpin financial stability. As outlined in Box 3, there has been significant reform of the financial sector that has taken place over the last decade. We welcome the traction that Fund advice is receiving from the authorities, as exemplified by the amalgamation of the supervisory function with the Central Bank. Staff's views on the important modalities and structures of the new arrangement, contained in paragraph 43, seem well placed.

On monetary policy, staff advice on the continued focus on inflation targeting is appropriate. We would specifically highlight the excellent Selected Issues Paper on 'Inflation Targeting in Iceland – The Issue of Housing Costs' as providing valuable food for thought to the Icelandic authorities. As regards capital flow measures, a legacy of the crisis, we welcome the update from the buff Statement that the authorities have reduced the special reserve requirement from 40 to 20 percent and have stated that when conditions are right, they will go further.

Turning to structural reforms, there is a clear need to enhance potential growth, through an improvement in the quality of capital stock and the productivity channels. Staff consider that the legacy impacts of the crisis are being keenly felt in the education sector and Figure 31 shows a clear correlation between the contraction in expenditure and the fall in PISA scores. Additionally, Iceland has the highest drop-out rates from secondary education in the OECD. As such, we agree that a comprehensive review of the educational sector, coupled with increased resources is worth of consideration. As regards competitiveness, as a small open economy, it is imperative that the competitiveness gains over the last decade are not lost and staff advice around limiting wage increases to productivity are well grounded. From a sectoral perspective, tourism has grown appreciably in importance over the last decade (now 42 percent of exports). However, the lack of a coordinating body for this sector has hampered efficiencies and the authorities' intention to create one is welcome. Perhaps the most important sector to the Icelandic economy is the oldest – fishing. Given the potential for this natural resource to be exhausted, careful management of marine resources will be crucial. It is fair to say however, that as a significant portion of total fish take relates to migratory species, there is a clear need for international agreement to ensure longer term sustainability of fish stocks.

Finally, on presentation, we find that the staff report and the selected issues and its graphics are refreshing, novel and informative.

Mr. Meyer and Mr. Buetzer submitted the following statement:

We thank staff for an interesting report and Mr. Ostros and Ms. Gunnarsdottir for their insightful buff statement. While we broadly share staff's appraisal we would like to add a few remarks, including on fiscal policy, the financial sector, and the assessment of the CFM.

We welcome Iceland's continued strong macroeconomic development and highly robust institutional frameworks. As also pointed out by Mr. Ostros and Ms. Gunnarsdottir in their buff, the post-crisis recovery has been nothing less than impressive, supported by the steadfast implementation of prudent policies and comprehensive reforms.

At the same time, we share staff's assessment that the authorities need to remain mindful of emerging vulnerabilities, in particular pertaining to tourism, fisheries, and competitiveness. Appropriate measures should be taken to mitigate associate risks in these sectors. In this vein, we would be grateful if staff could comment on the big Icelandic airlines' strategies in dealing with increased oil prices, including an assessment of their current and projected profitability. Against the backdrop of rapidly rising unit labor costs we underscore the need to have wage increases firmly rooted in productivity growth to preserve external competitiveness.

Fiscal Policy

We appreciate the ongoing rebuilding of fiscal buffers which enhances overall resilience and is warranted by the cyclical position of the economy. In view of rapidly declining public debt, we also see merit in the authorities' plans to establish a sovereign wealth fund in order to preserve the benchmarking role of government debt in financial markets.

As regards the composition of public expenditures, we agree with staff on the desirability of a thorough review and prioritization of the different spending categories. For instance, the fall in education spending over the past ten years, during which Iceland's PISA scores deteriorated, should be halted. Could staff comment on the drivers behind the substantial and continuous increase in disability spending, which appears to have doubled as a share of GDP between 2001 and 2016 (Fig. 15), and to what extent this is attributable to demographic change alone?

While the tax reform appears to contain some desirable elements, we share staff's view that care should be taken in the design of such reforms to safeguard revenues and to preserve progressivity. In this vein, we would like to emphasize that the projection of lower interest rate payments does not substitute for structural fiscal measures to offset potential losses. Could staff provide information on how Iceland compares to peer countries in terms of its labor tax wedge and overall tax-to-GDP ratio? Also, since the tax cuts are motivated in part by improving the incentive to work (para. 23), we were wondering how that squares with an unemployment rate of 2.8 percent.

Financial Sector, Monetary Policy, and CFMs

The large systemic role of Iceland's financial sector requires a strong regulatory architecture and powerful supervisory structures. We acknowledge that staff has modified its position on the adequate structure, moving from a "twin peaks" to a unified solution under the roof of the central bank. While this may indeed be appropriate for a relatively small-scale economy, it is essential that central bank independence will not be impinged upon and that monetary policy preserves its square focus on price stability.

We also urge the authorities to further strengthen their anti-money laundering activities further given the grave risks and implications as also outlined by staff.

We take positive note of the more balanced and conciliatory tone in the passages regarding the country's CFM in comparison with last year's document. Nevertheless, we continue to have sympathy for the authorities' view, that – given the particular circumstances and economic realities at hand – the special reserve requirement appears justified for the time being. The economy is still running above potential, the interest rate differential with the

US and the euro area remains substantial, and the external position is assessed to be broadly in line with fundamentals.

We therefore find it hard to follow staff's reasoning that the Icelandic economy would be better served through interest rate cuts or further exchange rate appreciation – which in any case would have to be substantial to deter investors and reduce carry trade opportunities. Interest rate cuts at this juncture would also stand in stark contrast to the CBI's assessment of current economic developments and prospects, as the CBI actually raised its key interest rate this week in pursuit of its price stability mandate. Against this backdrop, rather than the CFM somehow substituting for warranted macroeconomic adjustment, it allows for it, as pointed out by Mr. Ostros and Ms. Gunnarsdottir. Moreover, it has played a key role in preventing the resurgence of the "glacier bond" market, an inflated financial sector, and all the associated financial stability risks that come with it – and which have led to the crisis in the first place.

That being said, we do, of course, share the view that CFMs, if used, should be transparent, targeted, temporary, preferably non-discriminatory, and should not substitute for warranted macroeconomic adjustment. Accordingly, we welcome the announced reduction of the special reserve requirement from 40 to 20 percent and encourage the authorities to lift it fully as soon as conditions allow.

Ms. Pollard and Ms. Svenstrup submitted the following statement:

We thank staff for a very well written report and Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement.

The Icelandic authorities have made commendable progress over the last decade in stabilizing the economy, strengthening resilience and prudential oversight, and removing capital controls. The recent economic slowdown, driven in part by a deceleration in tourism, reduces the risk of overheating and puts growth on a more sustainable path. As Iceland navigates through this new phase of stability and openness, we agree with the focus on further building buffers and policy frameworks. We concur with the thrust of staff's policy recommendations and offer a few comments for emphasis.

The Icelandic financial sector is stable with strong capital ratios and low NPLs – a particularly notable achievement ten years after the country's banking crisis. The authorities deserve significant credit for their efforts to enhance financial sector oversight, including the development of a robust framework for macroprudential policies. The recent decision to unify prudential oversight and bank resolution at the central bank is sensible given the size of the economy and the integrated nature of micro- and macroprudential policies. We appreciate that the authorities recognize that this restructuring may present operational risks, as noted by Mr. Ostros and Ms. Gunnarsdottir. We also fully agree with staff that it will be important to maintain the central bank's operational independence during and after this transition.

We commend staff's clear analysis of the CFM on inflows in the context of the Fund's Institutional View. Like staff, we see no case for the special reserve requirement at this time, and we welcome the authorities' recent decision to reduce the requirement by half as a first step. In the absence of an inflow surge and in the context of ample macroeconomic policy space, we urge the authorities to fully phase out this CFM.

The 2017 current account surplus fell by about half, year-over-year, and was over 3 percentage points of GDP less than what staff projected in the previous Article IV. This is a dramatic change. Could staff provide more detail on the underlying drivers of the deterioration in the trade balance and whether this is expected to be permanent? On the external sector assessment, staff determine that Iceland's external position is still in line with fundamentals and desired policies. Could staff provide the underlying components of the calculated norm and how they changed between the 2017 and 2018 assessments? Last year, staff adjusted the norm upward by 1½ percent of GDP to account for the permanent tourism shock. Did staff make any adjustments to the norm this year?

We welcome the authorities' Fiscal Strategy Plan to increase spending on infrastructure, healthcare, and education, while remaining faithful to the overall goal of further reducing debt. We look forward to seeing further clarity on the authorities' fiscal plans and urge them to prioritize spending on areas most likely to enhance growth and productivity over the medium term. Despite external and domestic risks (e.g., upcoming wage negotiations), we agree with staff that the authorities should stand ready to tighten fiscal policy if overheating risks re-materialize.

We agree with staff's assessment that the current inflation targeting regime has served Iceland well and that future policy settings should remain data dependent. We appreciated staff's interesting analysis on excluding some or all of housing costs from the inflation target. We think that it is important for any inflation target to be transparent, clearly understood by all, and easy to communicate. Did staff discuss these potential revisions to the CPI basket with the central bank? We urge the authorities to continue to refrain from exchange rate intervention and note that the current exchange rate policy will facilitate smooth adjustment as the external environment changes.

Mr. Raghani made the following statement:

We thank the staff for the informative reports and Mr. Ostros and Ms. Gunnarsdottir for their insightful buff statement.

Our office did not issue a gray statement. We broadly share staff's conclusions and policy recommendations and would like to offer the following comments.

First, we would like to commend the authorities for the remarkable progress made over the last 10 years since the country requested a Fund Stand-By Arrangement (SBA). The authorities' sound policy management, aiming at reducing fiscal and external imbalances, addressing vulnerabilities in the financial sector, and strengthening the institutional framework, were instrumental in the recovery of the country's economy. Like other Directors, we welcome the staff's assessment that the current slowdown in economic growth has allayed overheating concerns, with appropriate inflation level, fiscal and current account surpluses, and reduced public debt. At the same time, the country still faces some risks, including: high oil prices; the potential adverse impact of Brexit to exports, including fisheries; and risks related to global trade tensions. Going forward, with a somewhat positive medium-term outlook, priority should be put on maintaining prudent national policies to increase the resilience of the economy to shocks and to improve sustainability, as rightly underscored by the new government.

Second, as regards capital flow management measures (CFMs), we are pleased by the central bank's decision to dial down the special reserve requirement (SRR), from 40 percent to 20 percent, and would appreciate the staff's preliminary analysis of the effects of this announcement. We share the view, that merging the Central Bank of Iceland (CBI) and the financial supervisory authority (FME) is key to ensure operational independence, to improve the implementation of macroprudential policies and sector oversight. As stated by other chairs, we look forward to a smooth transition.

Third, the recent slowdown in tourism called for an adequate response by the authorities. As a small open economy, we agree with the staff, and would continue to encourage the authorities to develop a tourism strategy with appropriate policies, as this sector is well positioned to be a sustainable driver of economic growth. Therefore, we welcome the ongoing work by the tourism task force that comprises the key ministries, local authorities, and industry bodies, and look forward to the task force's conclusions and the recommendations. The staff's comments on the progress made so far would be appreciated.

With these remarks, we wish the Icelandic authorities continued success in their endeavors.

Mr. Agung made the following statement:

We thank the staff for the comprehensive report and Mr. Ostros and Ms. Gunnarsdottir for their insightful buff statement.

Iceland's impressive economic performance in the recent period comes from the dividends of the authorities' sound macroeconomic management, which is pegged by its agility in calibrating the policy stimulus and pragmatism on deploying the appropriate policy instruments.

At the current phase of the economic cycle, the main policy challenge is to retain the momentum of policy discipline and avoid the dangers of policy complacency. In this regard, we join other Directors in encouraging the Icelandic authorities to continue with their ongoing efforts in implementing structural reforms to further strengthen their growth potential, environmental sustainability, and economic resilience.

Managing the economy, which is operating at a full employment level, could be as challenging as managing the economic slowdown. Thus, for fiscal and monetary policy, we support the call of staff and other Directors for the Icelandic authorities to be vigilant and agile in fine-tuning the policy inputs. This will avoid excessive economic imbalances to ensure the economy will continue to grow at a sustainable pace. Toward this end, we see the need to complement the existing policy toolkits with other complementary instruments. In certain circumstances, the use of traditional and blended monetary policy instruments, like interest rates, has limited effectiveness to tackle specific challenges.

In the case of Iceland, the challenge to manage policy trilemma and the risk of destabilizing capital inflows cannot be adequately managed by using traditional monetary policy instruments alone. In this regard, like many Directors—Mr. Meyer, Mr. Gokarn, Mr. Saito, and others—we support the prudent approach taken by the Icelandic authorities to use CFMs as part of its policy toolkit.

As we noted in our gray statement, Iceland is a good case in point of how the adoption of well-designed CFMs can play an important complementary role to other macroeconomic policies and contribute significantly to macroeconomic and financial stability.

While we reiterate our stance that CFMs should not be used as a substitute for macroeconomic policy adjustment, we also see the importance of giving the authorities the option to use CFM measures to complement their policy actions in certain circumstances.

Mr. Saito made the following statement:

We thank the staff for the informative papers and Mr. Ostros and Ms. Gunnarsdottir for their insightful statement. In particular, we commend the well-designed and beautiful figures in the staff report to facilitate the reader's intuitive understanding.

As we have issued a comprehensive gray statement, we would like to offer two comments regarding CFMs.

The first is on the SRR. As the interest rate differential narrows, the currency weakens, and the overheating concerns recede, we welcome the central bank's recent announcement of the reduction in the SRR from 40 percent to 20 percent. Going forward, we encourage the staff to further their discussions with the authorities on the conditions, sequencing, and the timing for lifting the CFMs, taking account of global and country-specific factors.

Second, on the importance of making granular guidance for CFMs, we fully support the Fund's Institutional View. Having said that, in light of the differences of view between the authorities and the staff in some countries and the recent capital flow volatilities, partly driven by the normalization in the United States, we are of the view that the Fund's efforts to create practical guidance for CFMs gained more importance in order to ensure an evenhanded application of the Institutional View. In this regard, Iceland's case offers an insightful example, where the judgment of the availability of the macro policy space is difficult. It is a gray zone case because the exchange rate has appreciated substantially in recent years, reserves are judged to be adequate, and the economy faced overheating concerns. Mr. Meyer detailed this point in his gray statement.

We believe that Iceland's experience gives valuable lessons to consider the appropriateness, sequences, and conditions for installing or eliminating CFMs for other countries. Like Mr. Agung, we urge the staff to provide more granular guidance to evaluate the effectiveness and the adequacy of individual CFMs, making use of their experience with Iceland.

Ms. Pollard made the following statement:

We thank the staff for the well-written report and commend the authorities for their efforts to put in place strong policy frameworks over the last 10 years. We issued a gray statement, and I want to emphasize one point and ask a few questions.

With regard to the CFMs, as we stressed in our gray statement, we commend the staff's clear analysis of the CFMs on inflows in the context of the Fund's Institutional View, and we fully agree with their conclusions. Like Mr. Moreno and Mr. Montero, we believe CFMs should be used in compliance with the Institutional View. In this case, we note that the Institutional View does not support the preemptive use of CFMs to manage systemic risks that may arise from capital flows. We agree with this view and, like the staff, see no case for the SRR at this time. Although we welcome the steps the authorities have taken to reduce the SRR, we urge them to fully phase out this CFM.

In the staff's response to our questions on the external assessment, there are still a few things that we find confusing. In our question No. 8, where we asked for details on the underlying drivers of the deterioration in the trade balance, the staff first notes that goods imports as a share of GDP have fallen by about 3 percentage points over 2011-17; but then they say that strong domestic demand has buoyed goods imports. I am trying to figure out exactly what has happened to goods imports.

On the External Balance Assessment (EBA)-lite assessment, I welcome the additional detail that the staff has provided. But we would specifically like to see the components of the norms for the 2017 and the 2018 assessments and also to get a sense of whether the staff made any adjustments to the norm this year, given that they did so in the 2017 assessment.

Mr. Inderbinen made the following statement:

We thank the staff for their good documentation and also Mr. Ostros and Ms. Gunnarsdottir for the helpful and informative buff statement.

In our gray statement, we welcomed the well-calibrated policy measures that the authorities have taken to steer growth toward a lower but more sustainable path, maintaining low unemployment levels, and keeping inflation on target. We particularly welcomed the ongoing reform of financial sector oversight, for which we commend the authorities, which we believe should, over time, set the stage for the authorities to further divest from the financial sector, following the example of the divestment in the Arion Bank, and also should lift the restrictions on capital mobility going forward. We take note of the staff's recommendation to lift the restrictions on the remaining offshore króna accounts. We believe that the authorities should take this under advisement.

We also welcome the ongoing work to amend the Foreign Exchange Act and to switch the presumption of cross-border capital mobility. These are good trends.

Also, as we stated in the gray statement, we welcome the recent reduction in the SRR. This underlines how the authorities perceive this measure as a temporary one.

We also note the continuing differences between the authorities and the staff on this and the staff's take that the reserve requirement could be set to zero as of today, vis-à-vis the more cautious approach by the authorities.

While we retain an unqualified support for the Institutional View, we do note that the guidance note is not quite so clear on how to treat this aspect of preemptive measures to avoid disorderly inflows. We were wondering whether the staff could comment on one or two aspects there.

In our understanding, for a CFM under the policy, one issue is the labeling of a measure as a CFM, and the other is the distinction of whether that measure is approvable or not. In our understanding, the approvability would be linked to possible alternatives that will be out there to meet the authorities' objectives. In this case, one of the objectives is to avoid hot money inflows and not be placed in a situation where recourse would have to be taken to macroeconomic measures that would not be necessary otherwise—the ones described in paragraph 35 of the staff report.

We were wondering whether the staff could comment on the judgment it makes against the objectives of the authorities. Would that be an alternative for this measure or not? Normally, the objective is related to macroeconomic and financial stability, but here, it is the avoidance of being in a situation where the authorities would have to take extraordinary macroeconomic measures.

The Acting Chair (Mr. Zhang) noted that the Board would soon have the opportunity to discuss the Institutional View in more detail in a forthcoming Board discussion.

Mr. Meyer made the following statement:

I thank the staff for the well-written report and their helpful answers to our questions. I also thank Mr. Ostros and Ms. Gunnarsdottir for their insightful buff statement.

Since we issued a gray, let me restrict myself to the following remarks.

We welcome the impressive economic recovery that has taken place in Iceland over the past 10 years, aided by prudent policies, the steadfast implementation of structural reforms, and, not least, by a successful Fund program. The country surely provides an example of how to recover from even deep contractions.

It is now essential that these gains are safeguarded and that the authorities remain vigilant to emerging risks. Once again, we would like to highlight the role that the CFM—such as the SRR—can play in order to contain financial stability risks and to allow for the prudent conduct of fiscal and monetary policy.

Given the obvious attractiveness of Icelandic debt markets for foreign investors and a clear opportunity for carry trades, it seems plausible that, in the absence of an SRR, a capital inflow surge would have occurred. Therefore, and as most Directors have expressed in their gray statements, the CFM appears warranted for the time being; and the approach of the authorities, to gradually reduce it as conditions allow, appears economically sensible.

Many Directors have commented and my additional comment would go in the same direction as Mr. Inderbinen's because, looking at the text that we have—not only the Staff Guidance Note but also the 2012 document on the Institutional View and the 2018 document, the Institutional View on

Capital Flows in Practice—in our reading, our Institutional View does not include the point that a CFM could never be imposed before there is a surge of inflows. It clearly makes the case that once there was a surge, there is a clear case to do so under certain conditions. But in our reading, there might be situations—it is not excluded—where before the surge, it could be sensible—if all the macroeconomic adjustment has been done—to also have a CFM. That is the crucial part to look at.

Having said that, we are fully supportive of the Institutional View. We are not of the view that we should open up the Institutional View for discussion. From our perspective, the underlying point is that we have another look at the staff guidance, and how our documents were then translated in this regard.

Mr. Moreno made the following statement:

I thank the staff for its set of well-written reports and Mr. Ostros and Ms. Gunnarsdottir for their insightful buff statement. I want to make two points.

First, I want to join others in commending the authorities for their skillful management of the economy over the last 10 years, which has allowed them to reach an enviable situation. They have achieved macro indicators and social indicators which are very good after a huge crisis 10 years ago.

My second comment relates to the possibility of setting floors to the level of public debt. I thank the staff for their detailed responses in the technical questions. This is a topic that we will need to look more deeply into, only in those countries where public debt ratios are reaching very low levels because, at the end of the day, we need a yield curve; we need safe assets for pensions, pension funds. There are quite a few countries in this situation that may be reaching these very low levels.

Mr. Jost made the following statement:

I thank the staff for the thorough reports and Mr. Ostros and Ms. Gunnarsdottir for their buff statement.

I would like to join others in commending the authorities for their thorough reform efforts over the course of the last decade in many areas, including the financial sector. I thank the staff for Box 3 and Annex IV, which give a good overview on what has been done, and which show the strong track record and determination of the authorities to remedy the situation they were in.

It is good to see that the authorities continue to increase fiscal resilience. Despite the encouraging trajectories, in particular, on debt levels, we believe that this is a prudent approach and expedient, given the open nature of the economy and the external risks which open economies are facing. These external risks cannot be influenced by the authorities; so increasing fiscal resilience is a necessary approach. In that sense, I would also like to thank the staff for recognizing this and supporting these prudent fiscal policies.

With that, I wish the authorities the best of luck for the continuation of this ambitious agenda.

Mr. Kim made the following statement:

We have already issued a gray statement; therefore, I would like to make brief comments for emphasis and ask a question.

First, we welcome that the risk of overheating has abated and growth has slowed to more sustainable levels. However, the staff assess that risks have become more pronounced. For example, disruptions in airline services could result in sizable macroeconomic costs, according to the staff's written responses. We acknowledge that the recent announcement of a merger between two major airlines would mitigate the risk of potential disruptions in the tourism sector. Nonetheless, it is noteworthy that there are still downside risks. In this regard, while we agree with the staff that fiscal policy should remain geared toward increasing fiscal space and a comprehensive review of expenditures is warranted, countercyclical actions should be reserved. We would like to ask how the new government's fiscal strategy plan accommodates actions against such downside risks.

Second, the financial supervisory system is an outcome of the economic history of each economy. In this vein, we support Iceland's financial supervisory restructuring. We hope there will be a smooth transition as the supervisory body is merged into the central bank.

Finally, we welcome that the authorities have limited their foreign exchange interventions to only a few episodes of disorderly market conditions. We also appreciate that the central bank has recently announced a reduction in the SRR by half.

Mr. Castets made the following statement:

I thank the staff for the well-written reports. I also thank Mr. Ostros and Ms. Gunnarsdottir for the helpful buff statement.

Like Mr. Raghani and others, we commend the authorities for the progress made in the architecture of the supervisory framework of the financial system. This is a major step forward since it will allow them to better identify and tackle the financial stability risks arising from the interactions between the different segments of the financial markets. We encourage the authorities to continue, and to consider some recommendations to go further in that direction.

Second, since many Directors commented on the CFM issue, I would like to add my voice to those who value a case-by-case approach to CFM issues. In this case, it is justified to lean toward the cautious side, as the authorities do.

The buff statement clearly states the reasons why the authorities remain attached to keeping this CFM limited in its magnitude. They explain the specific risks and tradeoffs that they are facing.

Second, it has been clearly explained by Mr. Meyer, and we fully share his analysis on the preemptive actions to curtail inflows. The reading of our policies may be not as clear-cut as maybe the presentation in the report could lead us to think. I did not go back to the 2012 paper; but for the Institutional View, at least our reading will be a bit more cautious and not as clear-cut as the presentation in the report.

Mr. Mouminah made the following statement:

I thank the staff for the comprehensive set of papers that they have issued and Mr. Ostros and Ms. Gunnarsdottir for their informative buff statement.

I have two comments. First, given the progress that was achieved by Iceland over the last 10 years—everybody has recognized that—it is now a completely different conversation from that time. We believe that Iceland is among the few countries that were able to take the GDP level and regain it rapidly. It later surpassed the pre-crisis level. We would appreciate the staff's elaborations on any lessons learned from this experience. There is a huge experience that could be shared here.

My second comment is to urge the authorities to ramp-up the efforts on tourism and to really understand what is causing this drop in tourism. I urge them to put together a comprehensive strategy for the long-term development of the sector, with a clear implementation plan, because this is good for the diversification of the economy, and it has been promising over the past few years. If there are any comments from staff on this, it would be highly appreciated.

Ms. Mehri commended the authorities for the progress made in their reform efforts. Like other Directors, including Mr. Meyer, she supported the authorities' cautious position on the CFM. She remarked that it was difficult to establish whether the absence of an inflow could be attributed to the introduction of the CFM and that the authorities had undertaken the warranted macroeconomic adjustment.

The staff representative from the European Department (Mr. Bhatia), in response to questions and comments from Executive Directors, made the following statement:[2]

There were a number of questions presented today. I will try to address each of them.

Starting with the trade balance, what has happened—and I agree, it can be a little puzzling at first sight—is that GDP has grown more strongly than imports. This has seen imports shrink modestly as a percent of GDP, despite generally strong domestic demand; while the export ratio has shrunk significantly more, resulting in a deterioration in the trade balance.

On the EBA, we are happy to revert with the components bilaterally. We used the new EBA-lite model this year, and there were some changes to the input parameters, but not to the overarching judgment, which remains as last year.

There were a few questions on the tourism task force. We welcome the fact that this task force is now up and running; but as we gently allude in the staff report, its focus at this time seems to still be on measurement issues, on data gathering, on trying to address some slightly esoteric questions, perhaps, on Iceland's total load-carrying capacity in terms of the number of tourists the country can handle. We are encouraging the task force to move to phase two of that work, which would be concrete plans to see how one can make tourism destinations a little further away from the capital more accessible, and to

[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these were included in an annex to these minutes.

improve some of the facilities at the more crowded destinations. Insofar as we encourage contingency planning, we are encouraged by the announcement of a proposed merger between the two main airlines, which goes some way toward mitigating the risk of disruptions in the tourism sector that we mentioned several times in the staff report.

There was a question on how the authorities' fiscal plan can accommodate countercyclical actions in the event of a materialization of downside risks. Icelandic fiscal policy, since late 2015, is guided by the Organic Budget Law. This includes a ceiling on net debt, at 30 percent of GDP, with quite a narrow definition of net debt. It also has limits on the budget balance or budget deficit in any given year and over a five-year period. This Organic Budget Law was designed with significant input from Fund staff; TA from the Fiscal Affairs Department, in particular. As with many such laws, there is an escape clause, so the staff sees sufficient flexibility to accommodate more significant countercyclical actions, should such be needed.

There was a question on lessons from the crisis. I would refer Directors to a detailed speech that was given in Reykjavik on September 15 this year, on the tenth anniversary of the collapse of Lehman Brothers, by Mr. Thomsen, in which he went into Iceland's crisis experience in a good amount of detail. He discussed some unorthodox elements of the program, some forced by circumstances, others reflecting the extraordinary pressures that were evident at the time. We would be happy to engage further on lessons, but I would recommend that speech as an excellent place to start.

There were a number of comments and questions around the issue of Iceland's use of the CFM on selected debt inflows. I should preface my answer by saying that we do feel strongly, that the broader milieu of this Article IV consultation has been an extremely positive one, both in terms of economic prospects and policies. We tried to answer some questions on the CFM issue in writing yesterday. We have covered this issue since 2016, when the measure was introduced.

As we note, the staff welcomes the dialing back of the CFM last Friday as fit for purpose, given Iceland's specific circumstances. We note that no inflow surge followed the halving of the SRR this week, certainly none that moved the exchange rate, which has actually modestly depreciated. The central bank this past Wednesday followed up with a 25 basis-point increase in the policy rate, to 4.5 percent.

Since its introduction, the staff has not seen a compelling case for the inflow CFM. Fundamentally, this is because the staff has not detected any sign of a surge in capital inflows that brings domestic financial stability concerns in tow. It is true that in the first year or so of the CFM being in effect, the króna appreciated significantly. But it is also true that during the first roughly nine months that the CFM was in effect, Iceland also had in place comprehensive capital controls on outflows. The latter were lifted in mid-March 2017. During that period, even as the exchange rate appreciated, domestic credit growth remained relatively subdued.

Finally, I would just like to note that as we quote language from the Institutional View, the staff does not state or insinuate that Iceland has not undertaken a warranted macroeconomic adjustment. On the contrary, as we note, policies have generally been appropriate to conditions, and decisive efforts have been made to strengthen financial sector oversight. We welcome this.

The Deputy Director of Strategy, Policy, and Review Department (Ms. Kostial), in response to questions and comments from Executive Directors, made the following statement:

I will make a few comments on the Institutional View. It was a relatively hard-won compromise in 2012, and we just also did a review a few years ago.

The staff has been consistently and evenhandedly applying the Institutional View, which does not envisage a preemptive CFM—only under specific circumstances, if there is an inflow surge. Then, the CFMs should not substitute for warranted macro adjustment.

A word of caution is that if we want to review the Institutional View, we would open up the full Institutional View.

At the same time, we are not deaf to Directors' concerns. We do see scope for more elaboration, discussion of the challenges Directors see in the application of the Institutional View. In July, we provided operational guidance and operational practical examples on how we are applying the Institutional View. In September, we provided a stocktake of capital flow measures. Work will be going on. We are also now in a different world than when the Institutional View came into place. The Institutional View in terms of its application has been mostly on inflows. Under current circumstances, we will have to think about the application of the Institutional View also on outflows.

On November 20 we will also discuss the Work Program, and that is also another opportunity to raise the issue of the Institutional View.

Mr. Inderbinen made the following statement:

We thank the staff for those elaborations. We agree that it would be not the best thing to reopen the old discussion on the Institutional View. As I have said earlier, we retain our strong support for the policy. We also acknowledge that staff is doing its very best in terms of evenhanded application of the policy.

The question comes back to the way it is presented in the report. If there is a labeling of a measure as a CFM, then there needs to be some discussion: Is this, nevertheless, approvable under the policy? One element is that it does not discriminate on the basis of currency and residence. This is not given here, since it would defeat the purpose.

But the other issue is, is there an alternative? The alternative, in my view, should be judged against the policy objectives of the authorities. If one looks at the policy objectives of the authorities, can the staff arrive at the conclusion that the CFM is not something that they would approve? Implicitly, they do that because they say it should be set to zero because there was no surge. But the objective is precisely to prevent the surge. Under those criteria, it is not quite clear how the staff arrives at the assessment that the measure is not approvable; albeit, it is clear that it is a CFM.

The Deputy Director of Strategy, Policy, and Review Department (Ms. Kostial) responded that what counted was not the intention of the CFM, but the effect of the CFM.

Ms. Gunnarsdottir made the following concluding statement:

I thank the staff for the reports, the discussion in Reykjavik, and for the well-articulated policy advice, which my authorities broadly agree with. I also thank Directors for their valuable input. I will convey the key messages and concerns to my authorities.

Apart from the traditional order of business, the Fund mission in September reflected on the past 10 years, on the 10-year anniversary of the Fund program. My authorities greatly appreciated the partnership with the

Fund during those times, an effort which was well captured in a speech made by Mr. Thomsen in Reykjavik in September.

On Wednesday, the monetary policy committee announced a 25 basis-point rate increase on the back of stronger growth than previously forecasted and an uptick in inflation. The upcoming wage negotiations raise concerns regarding the inflation and competitiveness outlook in the near term.

While purchasing power has increased substantially in the past few years, some groups have felt left behind, an issue that has been seen in many other countries. The government has been reviewing the tax benefit system in this regard, aimed at supporting the upcoming wage negotiations, while emphasizing the importance of aligning wage growth with productivity.

The CFM on selected inflows was widely covered in gray statements and in the Board, where Iceland continues to receive significant support from the Board. My authorities believe that the use of a CFM has been successful, limiting the risks from large and volatile capital flows. Precisely because of the CFM, there has been no surge of speculative capital inflows in the past few years. Like Mr. Meyer, Mr. de Villeroché, and others acknowledge, this tool has made warranted macroeconomic policies possible, rather than substituting for them.

As conditions for the carry trade have been deteriorating, the authorities have now taken steps toward dialing down the CFM, which was always part of the plan. Risks and uncertainties are ever-present in a small, globally integrated economy like Iceland. My authorities need to remain up to speed with the reform agenda, as many Directors have pointed out. One such step widely discussed in the staff report and the gray statements is the authorities' decision to merge the central bank and Financial Supervisory Authority. In addition, my authorities have redoubled their efforts at addressing Anti-Money Laundering and Combating the Financing of Terrorism issues. A steering committee, supported by external experts, was established last year to address the recommended actions in the Financial Action Task Force mutual evaluation report. On the basis of this effort, the Justice Ministry recently introduced a legislative bill, implementing the fourth and parts of the fifth anti-money laundering directives.

Finally, we welcome the selected issues paper on the fisheries sector. Just to be clear, Iceland's fishing policies focus strictly on protecting the sustainability of the fishing stock in Iceland's waters, both of local and migratory species. The stock of the migratory species, however, relies on a multilateral solution by the North Atlantic Coastal States, and the Icelandic authorities have spoken for a joint solution.

Let me end by, once again, thanking Mr. Bhatia and his team for the candid and constructive dialogue during the Article IV mission in Reykjavik, even including his macro-critical insights, which are highly appreciated by my authorities.

The Acting Chair (Mr. Zhang) noted that Iceland is an Article VIII member and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the favorable economic outlook and the dissipation of overheating concerns, noting that past króna appreciation has helped guide growth to more sustainable rates. Other risks have, however, become more evident—strong oil prices, competitive pressures in the airline sector, escalating trade tensions, potentially excessive wage awards, and Brexit—thus underscoring the need for continued prudent macroeconomic and structural policies.

Directors viewed the broadly neutral fiscal stance as appropriate in the near term and supported the authorities' medium-term fiscal plan aimed at further debt reduction. While supporting the focus on infrastructure, healthcare, and education, Directors noted that careful prioritization will be needed to reach the overall budget targets. They advised the authorities to prioritize expenditures based on their medium-term effects on growth and productivity, with less reliance on ad hoc revenues such as dividend flows and on a careful assessment of tax reforms.

Directors agreed that monetary policy should remain focused on price stability. The inflation target should reflect households' spending patterns and be understood by all. Directors advised that foreign exchange intervention should continue to be limited to countering disorderly market conditions, with a strong emphasis on maintaining reserve adequacy. Directors judged Iceland's external position to be broadly in line with fundamentals and desired policy settings.

Directors supported the creation of an integrated financial supervisor by merging the financial regulator into the central bank, to cover all aspects of the financial sector including pension funds. While the merger should tap into synergies and increase simplicity, efforts should focus on ensuring a smooth transition and maintaining regulatory and operational independence.

Directors welcomed the authorities' recent decision to halve the special reserve requirement on selected debt inflows with many Directors supporting a gradual lifting as conditions permit, while a few Directors favored an immediate removal. Noting the authorities' intention to renew the legal basis for the reserve requirement, Directors observed that capital flow management measures can have a useful role to play under certain conditions, although they advised that such measures should not substitute for warranted macroeconomic adjustment.

Directors supported ongoing initiatives to reform the wage bargaining system and anchor it on productivity growth and competitiveness while also increasing public spending on education. They suggested that further tourism development would benefit from a comprehensive strategy, including contingency plans. Directors called for ongoing international efforts to ensure sustainable management of migratory marine species.

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

APPROVAL: April 10, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***Iceland is among the few countries where GDP level regained rapidly, and later surpassed, the pre-crisis level and we would appreciate staff elaborations on any lessons from the Icelandic experience?***

- Staff agrees that Iceland's recovery from one of the worst financial crises in recent history is a success story. Having in place a well designed, well sequenced, and well implemented macroeconomic program played a big role—and as staff has highlighted in the past, strong national ownership was the single most important factor. Also, Iceland has benefitted from the rapid increase in tourism in recent years.

2. ***Could staff elaborate on the factors behind the expected deceleration of private investment?***

- The expected deceleration in private investment in 2018 is driven by the investment schedule of a few large companies in specific sectors (notably aluminum and silicon, ships, and airplanes). Private investment growth is expected to pick up in 2019.
- A breakdown of staff's investment projections is provided below.

Gross Fixed Investment

	2015	2016	2017	2018	2019	2020	2021	2022	2023
	(Percentage point contributions to growth y/y)								
Fixed investment	**19.7**	**21.7**	**9.5**	**4.8**	**7.9**	**4.3**	**2.6**	**3.0**	**2.5**
Business investment	**20.5**	**18.1**	**3.6**	**1.0**	**4.2**	**0.8**	**-0.2**	**2.3**	**1.0**
Aluminum	*4.2*	*3.8*	*-0.4*	*-1.6*	*-1.2*	*0.6*	*0.0*	*-0.1*	*0.2*
Aircraft & ships	*11.0*	*-2.4*	*-1.3*	*-3.2*	*2.5*	*-1.5*	*-3.5*	*-0.5*	*-0.2*
Other	*5.3*	*16.7*	*5.2*	*5.8*	*2.8*	*1.8*	*3.4*	*2.8*	*1.0*
Residential investment	**-0.3**	**3.6**	**2.9**	**2.9**	**2.0**	**2.1**	**1.9**	**1.6**	**0.8**
Public investment	**-0.4**	**0.0**	**3.0**	**0.9**	**1.8**	**1.4**	**0.9**	**-0.8**	**0.8**
	(Percentage change y/y)								
Fixed investment	**19.7**	**21.7**	**9.5**	**4.8**	**7.9**	**4.3**	**2.6**	**3.0**	**2.5**
Business investment	**31.2**	**25.1**	**4.8**	**1.4**	**6.1**	**1.2**	**-0.3**	**3.5**	**1.5**
Aluminum	*46.4*	*34.8*	*-2.9*	*-14.9*	*-13.2*	*8.2*	*-0.6*	*-0.9*	*2.6*
Aircraft & ships	*168.8*	*-16.6*	*-12.9*	*-40.6*	*55.1*	*-23.3*	*-73.9*	*-39.4*	*-24.5*
Other	*10.6*	*36.0*	*10.1*	*11.1*	*5.1*	*3.3*	*6.4*	*5.0*	*1.7*
Residential investment	**-3.2**	**26.4**	**18.4**	**22.1**	**13.3**	**11.4**	**9.7**	**7.4**	**3.5**
Public investment	**-2.6**	**-0.1**	**26.9**	**7.2**	**13.1**	**9.7**	**5.9**	**-5.1**	**5.7**

3. ***Does staff have any scenario analysis on Iceland's growth projection when the risks mentioned in the staff report materialize?***

- Staff prepared and discussed with the authorities some back-of-the-envelope sums on the potential impacts of disruptions in the tourism sector. These suggested that discontinuities in, for instance, airline services could result in sizable macroeconomic costs, although findings varied widely with assumptions applied. It is in this vein that staff notes, in the supplement, that the planned merger of Iceland's two major international air carriers would mitigate a risk identified in the staff report.

4. ***We take note that the authorities stand ready to adjust policies in case that wage increases are once again excessive. Could staff share their views on possible policy responses if it materializes?***

- In the event that wage awards are once more excessive, rekindling domestic demand pressures and affecting inflation prospects, the authorities' policy response would likely include raising policy interest rates while allowing the exchange rate to appreciate; tightening fiscal policy in the event of significant deviations from the baseline; and taking macroprudential policy measures if credit related stability risks were to arise. Should such developments be accompanied by an inflow surge, the authorities might also tighten (or reactivate) the special reserve ratio on selected debt inflows in current or future form. These responses would be consistent with staff advice, as noted in the risk assessment matrix (staff report, Annex III).

5. ***We would be grateful if staff could comment on the big Icelandic airlines' strategies in dealing with increased oil prices, including an assessment of their current and projected profitability.***

- As noted in the supplement, the planned merger of Iceland's two major international airlines would mitigate the risk of a disruption in the tourism sector. WOW air has been pursuing further expansion, including the opening of a route to India, and hopes to return to profitability by 2019. Icelandair benefits from having some deep-pocket owners, including at least one domestic pension fund, and was protected for a time from rising fuel costs by having entered into fuel price hedges. WOW air reportedly has more flexible staffing arrangements than Icelandair and benefits from a lower wage structure. The merged entity would in principle be able to tap into some synergies across the two airlines and would enjoy somewhat increased pricing power—although competition from other airlines would remain fierce.

6. ***Our understanding is that this new activity has caused the electricity consumption to skyrocket over the recent years. Given the current appetite for cryptocurrencies, we would all but overlook in the next consultations the upturn of this activity that***

some say to be in the process of exceeding the consumption of all Iceland's homes. We would be pleased to listen for staff's feedback on this issue.

- Earlier this year staff had sought to explore the issue with the authorities but came away with little new insight as to what, if any, export earnings or corporate income tax revenues are generated by so called cryptocurrency mining.
- Electricity consumption outside of the energy intensive industries (aluminum and silicon) was growing at an annual rate of 3.6 percent as of June 2018, after a 3.4 percent contraction in 2016 and a modest expansion in 2017. Electricity consumption by the energy intensive industries has over the last few years increased broadly in tandem with the expansion in aluminum output.

External Sector Assessment

7. ***Could staff provide the underlying components of the calculated norm and how they changed between the 2017 and 2018 assessments? Did staff make any adjustments to the norm this year?***

- The cyclically adjusted current account norm under the EBA-lite assessment in Iceland fell between the 2017 and 2018 assessments to reflect the evolution of the underlying components. Among the policy components, the cyclically adjusted fiscal balance (an important determinant of the norm) was lowered, from 2.5 percent of GDP in the 2017 assessment to 1.1 percent of GDP this year. The change in reserves was set to zero—for consistency with the assessment of reserves as adequate—and the capital account was assumed to be liberalized further. The underlying variables for the non-policy components reflect the latest available data.

8. ***Could staff provide more detail on the underlying drivers of the deterioration in the trade balance and whether this is expected to be permanent?***

- With the economy expanding on the back of tourism, goods imports as a share of GDP have fallen by about 3 percentage points over 2011–17, while goods exports have fallen by about 15 percentage points. Tourism, as the largest export earner now, has reduced the relative importance of export earnings from the aluminum and silicon and marine product sectors, while strong domestic demand has buoyed goods imports. Denominator effects have also played a role.

- Going forward, future expansion of aluminum and silicon export volumes will likely remain constrained by Iceland's limited appetite to tarnish its natural environment by building ever more hydroelectric dams (despite the attention given to geothermal energy, hydro remains the main electricity generator); fishing too will remain capped by natural factors. At the same time, the economy is projected to cool in the baseline. Staff projects the merchandise trade balance remaining steadily negative.

Fiscal Policy and Public Debt Sustainability

9. ***Could staff elaborate more on how much the spending on healthcare, education, and environment will be increased and how it will be financed?***

- According to the government's Fiscal Strategy Plan, the authorities intend to increase spending on healthcare, education, and the environment by the equivalent of 0.9 percent, 0.2 percent, and 0.1 percent of 2019 GDP, cumulatively, over 2019–23, relative to the previous baseline. They intend to finance the increase in total expenditures (including investment measures) through both higher dividends from the state-owned banks and yet-to-be-identified expenditure savings under other heads.

10. ***Could staff comment on the drivers behind the substantial and continuous increase in disability spending, which appears to have doubled as a share of GDP between 2001 and 2016 (Fig. 15), and to what extent this is attributable to demographic change alone?***

- Figure 15 in the staff report shows that general government disability expenditure has doubled from 2001 to 2016, but at 2016 prices, i.e., in real terms. As a share of GDP, the ratio has increased from 1.7 percent of GDP in 2001 to 2.7 percent in 2016.

- The underlying reasons for this increase are complex. As in many other OECD countries, Iceland has experienced a profound change in the composition of its disabled population with around one-third of recipients suffering from mental health related problems, and another one-third from musculoskeletal difficulties. For more details, please refer to staff's 2016 selected issues chapter on expenditure policy.

11. ***Could staff provide information on how Iceland compares to peer countries in terms of its labor tax wedge and overall tax-to-GDP ratio? Also, since the tax cuts are motivated in part by improving the incentive to work (para. 23), we were wondering how that squares with an unemployment rate of 2.8 percent.***

- The labor tax wedge in Iceland is lower than those of its peers. According to the OECD, the tax wedge as a share of total labor cost for an average married worker with two children was 24 percent in Iceland in 2017, below the comparable OECD average of 26 percent.

- Iceland's overall tax to GDP ratio tends to be higher than those of its peers. Total tax revenue in Iceland amounted to 37 percent of GDP in 2016, higher than the OECD average of 34 percent. However, social security contributions, at 4 percent of GDP in Iceland in 2015, were lower than the OECD average of 9 percent of GDP.

- The Icelandic labor tax system has been successful in encouraging strong labor force participation of both men and women, and the strong tourism led recovery has lowered unemployment rates even after attracting significant labor from abroad. One of the strengths of the Icelandic economy is the flexibility in its labor force, characteristics that the authorities are keen to maintain. But the labor tax system also strives to tackle income distribution aspirations that involve progressivity in taxation, which is periodically revisited.

12. ***More concerning is the indication in Box 3 that "recent dividend payments appear to have been funded in part by borrowing". In this regard, is there a risk that these "excess" dividends could also be considered as quasi-bank financing of the government? Staff elaborations would be welcome.***

- Staff in its analysis has purged from the structural fiscal balance the nonrecurrent portion of the government's dividend income. As noted in the staff report, the one-off nature of these revenues suggests that they should not be relied upon for recurrent public spending, even if they could play a role in funding high quality, well prioritized nonrecurrent fiscal spending. Staff has advised the authorities to reduce reliance on dividend income in their public financial management.

13. ***Gross public debt is projected to fall about 14 pp to 23.6 percent of GDP by 2023. In view of this development, we wonder whether it would be desirable to aim for a higher debt ratio given the need of pension funds for króna-denominated long-term assets to match their liabilities.***

14. ***While the authorities plan to further reduce debt to better prepare for potential shocks, staff cautions against cutting gross debt to sub-optimally low levels, given its benchmarking role in financial markets. We appreciate staff further elaboration, including by indicating what it regards as the lowest optimal debt-to-GDP ratio in Iceland's case.***

- As stated in the IMF's Revised Guidelines for Public Debt Management, the debt ratio objective should take into account the costs and risks associated with issuing public debt, which would generally tend to favor a lower public debt level. However, complementary objectives such as domestic financial market functioning or development can also be considered, and these would tend to favor maintaining some minimum level of gross debt (see for instance "The Development of Local Capital Markets: Rationale and Challenges," IMF WP/14/234).

- In the case of Iceland, staff has not discussed a specific minimum desired level of gross public debt, although it has supported efforts to maintain a low and stable debt ratio. In principle, the numbers will be driven by the need to maintain regular debt issuance at selected points along the yield curve, where ideally auctions should be predictable and secondary market trading sufficiently active, so that price discovery can flourish.

- As noted in the staff report, having in place a sovereign wealth fund facilitates decoupling the gross debt level from considerations around fiscal space, which include the concepts of net debt and net financial worth. These concepts are elaborated on in Table 5 of the staff report.

- It is correct to note that market liquidity, in turn, is affected by the prevalence of pension funds in the financial system, as these tend to be buy and hold investors of longer-term government debt. As staff notes, recent mortgage lending by pension funds reflects in part a paucity of króna-denominated financial assets, especially now that the Housing Financing Fund is no longer issuing debt. But, equally, it seems plausible that the pension funds may be somewhat overweight on domestic assets at this point, as a legacy of Iceland's recent period of capital controls. The overall arithmetic thus depends on a raft of country-specific features.

15. ***Do the authorities have a timeframe as to when the sovereign wealth fund will be created?***

16. ***Could staff comment on the status of the legislation to establish a wealth fund that could serve as a disaster relief reserve?***

- In August this year, the government announced its intention to submit a bill on establishing the wealth fund for consideration by the Althing during the spring 2019 session, with a view to having the fund operational by early 2020.

Monetary Policy

17. ***We appreciated staff's interesting analysis on excluding some or all of housing costs from the inflation target. We think that it is important for any inflation target to be transparent, clearly understood by all, and easy to communicate. Did staff discuss these potential revisions to the CPI basket with the central bank?***

- The analysis in the selected issues chapter on the inflation target and housing costs was discussed with both the central bank and the national statistics office.

Capital Flow Management Measures

18. ***Could staff comment on the elasticity of these debt inflows vis-à-vis changing interest rate differentials?***

- It is difficult to take such a view for Iceland given the recent history of capital controls and, since mid 2016, the special reserve requirement on selected debt inflows. Moreover, in principle, such elasticity may not be constant over time, potentially varying with changes in global liquidity conditions, risk appetite, and the expected future value of the local currency in question.

19. ***Staff mentions that they did not detect an inflow surge in 2017 to justify the 40 percent reserve ratio. Could staff comment whether this could be attributed to the introduction of the CFM?***

- As noted in the supplement to the 2016 staff report, staff did not detect an inflow surge at the time of the introduction of the CFM in June 2016. Nor has it detected any surge subsequently. This absence of a surge in inflows is the fundamental reason why, from the outset, staff has seen no compelling reason for the CFM.

- Whether the absence of an inflow surge since mid 2016 is attributable to the CFM is difficult to establish—what has been observed is a decline in debt inflows, and some increase in equity inflows, against a backdrop of narrowing policy rate differentials.

20. ***We wonder if lifting the Capital Flow Management Measure (CFM) on inflows at this juncture is a prudent decision, given lingering concerns about financial sector oversight. Pending reforms to financial regulation and supervision would eventually support a healthy two-way cross border flow of funds. Staff's comments on this issue would be welcome.***

21. ***We would like to know whether staff considers that in the current context of rising external (financial) risks the appropriate level for the SRR would be 0 percent?***

- As noted, staff has not supported the CFM because it has not detected any surge in inflows and thereby undue stability risks. If inflows were to increase, staff would favor an approach where the authorities undertook warranted macroeconomic adjustment while at the same time deploying micro- and macroprudential policy tools to control risk taking at home—a focus on intermediaries and borrowers and the use of funds before any resort to stopping inflows "at the gates."

- Noting that it considers that there remains some room for warranted macroeconomic adjustment, and cognizant of the decisive steps underway to further strengthen financial sector oversight, staff considers that conditions are in place for cutting the special reserve ratio to zero at this time. It therefore welcomes the authorities' recent decision to halve the ratio as a step in the right direction.

22. ***We would appreciate it if staff could share market reactions after the Central Bank's announcement of the reduction in the reserve requirement rate.***

- The market reaction to the authorities' decision to halve the reserve ratio should be viewed with caution as the first business day after the change took effect—this Monday—was also the day Icelandair and WOW air announced their planned merger. Government bond yields declined marginally, with yields at the long end slipping by some 20 basis points. The effect on the exchange rate was negligible, with a slight depreciation of the króna over the first two working days.

23. ***Staff highlighted about Icelandic authorities' plan to renew the legal basis for future CFMs, as part of authorities' comprehensive policy response in the event of a future inflow surge. We view the plan favorably, as it will widen the authorities' policy options and instruments to complement other macroeconomic policies. Can staff provide further details about this plan?***

24. ***We also take note of the authorities' plans to renew the legal basis for the special reserve requirement on selected debt inflows. We would appreciate it if staff could share the view on the renewal of the legislation.***

- Guided by the *Institutional View*, staff takes the position that CFMs can be useful in certain circumstances provided they do not substitute for warranted macroeconomic adjustment. As such, staff has no objection in principle to the Icelandic authorities' intention to retain the legal authority to impose CFMs as part of their policy toolkit, but reserves judgment on specific proposals—and their consistency with the *Institutional View*—until these have taken shape.

- The authorities plan to renew the legal basis for CFMs as part of a broader recast of Iceland's Foreign Exchange Act. This effort will replace the presumption of capital controls—capital account liberalization to date has taken the form of exemptions from the Act—with a presumption of full capital mobility, subject to the possibility of CFMs. As they pursue this work, the authorities are considering several design features around future powers to impose CFMs, including where the decision making should sit (i.e., at the central bank, the ministry of finance, or jointly) and whether options exist to forego imposing a holding period (some funds cannot invest, per their statutes, if they are made subject to lock-ups).

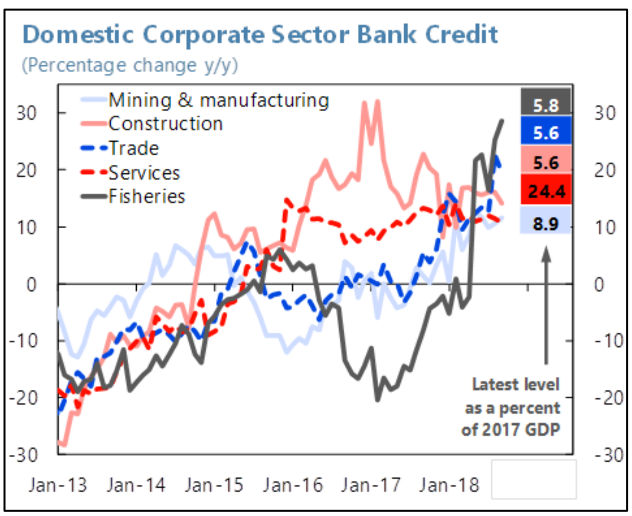
Financial Stability

25. ***Could staff shed light on to which sectors the credit flows into?***

26. ***As mentioned in the staff report, the tourism, aluminum and fisheries sectors are vulnerable to external factors. Could staff comment on the exposure of financial institutions to external risk via lending to these sectors?***

- As of June 2018, about half of the domestic banks' loan portfolios were in residential mortgages, about 14 percent in loans to real estate firms, 11 percent to fisheries, and about 10 percent to services. Direct exposure to tourism related sectors (mainly services) was about 8 percent of the loan portfolio. Exposure to aluminum companies is minimal. In the first half of 2018, credit increased to fisheries, real estate firms, services firms, and firms in retail and wholesale trade. As noted in the staff report, pension funds also have direct credit exposure through residential mortgages, as does the state-owned Housing Financing Fund.

- An updated chart on bank credit is provided below.



27. ***In the buff, it is mentioned that the NPLs is below 3 percent of the loan portfolio, while staff pointed out that NPL ratios of the three main banks stood at 4.4-5.9 percent. Could staff elaborate more on the reasons of the difference? Does it mean that small banks have better asset quality? Are the three main banks' NPLs the legacy of the crisis or recently formed?***

28. ***Given the important share of the Housing Financing Fund and pension funds in residential mortgage loans, it would be useful if staff could provide disaggregated information on credit growth and NPLs for banks and non-banks.***

- Staff quotes the NPL ratios on a cross-default basis, whereas the NPL ratios mentioned in the buff appear to be on a facility basis. The stricter cross-default method considers that if any one loan by a bank to a given customer is an NPL then all loans by that bank to that customer shall be considered NPLs.

- The Housing Financing Fund still has a significant legacy mortgage portfolio, which has been shrinking over the last five years with the value of loan prepayments far exceeding the limited value of new loans granted. The NPL ratio for banks, pension funds, and the Housing Financing Fund combined (using the cross-default method) has been declining faster than that for the three largest banks alone.

29. ***What measures have been taken or might be considered to dampen house prices dynamics? What macroprudential measures, in addition to the new loan-to-value ceilings on mortgages, have been implemented to guard against financial stability risks arising from the real estate sector?***

- As noted in the staff report, the authorities have introduced a comprehensive macroprudential framework under the aegis of a Financial Stability Council. Domestic banks are subject to a suite of regulatory capital buffers and currency based liquidity and funding ratios as safeguards against financial stability risks. FME has tightened the minimum countercyclical capital buffer (CCyB) to 1.75 percent effective May 2019, which will lift the combined capital buffer floor to around 9.25 percent. The capital based measures complement other macroprudential tools such as the borrower based mortgage limits on loan to value, debt to income, and debt service to income ratios, applicable to loans originated by banks and nonbanks alike.

- A table laying out the full toolkit is provided overleaf.

- In addition, a law covering foreign currency indexation of loans and granting powers to the central bank to limit foreign currency lending by domestic banks to unhedged borrowers, including households, municipalities, or corporates, was passed in June 2017 (Act no. 36/2017). The central bank has not yet issued the enabling regulations.

Measure	Description	Implemented
Liquidity coverage ratio (LCR) total	The LCR framework took effect on December 1, 2013, with the minimum total LCR was set at 0.6, increasing to 0.7 on January 1, 2014, 0.8 on January 1, 2015, 0.9 on January 1, 2016, and 1.0 on January 1, 2017. In addition to the 30-day LCR, the ratio for the next three months is also calculated, and its developments monitored during the assessment of the credit undertaking's liquidity risk.	December 2013
LCR foreign currency	A minimum LCR in foreign currency also took effect on December 1, 2013, set at 1.0. Here too, the ratio for the next three months is calculated and monitored.	December 2013
Net stable funding ratio (NSFR) foreign currency	The NSFR framework took effect on December 1, 2014, with, commercial banks' minimum 1-year funding ratio in foreign currency set at 0.8. was increasing to 0.9 on January 2016 and to 1.0 on January 1, 2017. In addition to the foreign currency ratio in, the ratio in krónur and the total funding ratio are also calculated, as well as the funding ratio in foreign currencies based on a 3-year horizon.	December 2014
Capital conservation buffer	The capital conservation buffer was introduced on July 2, 2015 to take effect on January 1, 2016 subject to a maximum of 1 percent until June 1, 2016, 1.75 percent until January 2, 2017, and 2.5 percent thereafter	January 2016
Capital buffer on other systematically important institutions (O-SII buffer)	The O-SII buffer was introduced on July 2, 2015 to take effect on April 1, 2016 at a minimum rate of 2 percent applicable to the three largest commercial banks.	April 2016
Systemic risk buffer (SRB)	The SRB was introduced on July 2, 2015 to take effect on April 1, 2016 at a rate of 3 percent for credit institutions and 1 percent for less significant credit institutions. As announced on March 2016, the SRB rate for less significant institutions increased from 1.0 percent to 1.5 percent effective from January 2017 and will rise to 2 percent on January 1, 2018 and then to 3 percent on January 2019.	April 2016
Countercyclical capital buffer	The countercyclical capital buffer was introduced on March 1, 2016 to take effect on March 1, 2017, at a rate of 1 percent. As announced on November 2016, the rate will be increased to 1.25 percent with effect from November 1, 2017 and to 1.75 percent by May 2019	March 2017

30. ***Have the authorities had any specific plans to strengthen pension fund oversight given the limited support for banning pension fund from retail lending?***

31. ***Could staff comment on the adequacy of pension funds' risk management practices; to what extent are the risks associated with mortgage lending transferred to pensioners?***

- The strengthening of pension fund oversight is to be addressed in the planned regulatory reform. Details are not available yet.

- The Pension Fund Act was amended last year as regards investment allocations and risk management, but rulemaking authority remained with the ministry of finance, not FME. Staff welcomed the changes, yet urged a broader review of the regulatory framework for pension funds considering their growing position as competitors to banks in the loan origination business.

32. ***We would appreciate it if staff could share the best practice on how to ensure central bank independence and address regulatory forbearance, derived from past experiences in other countries that unified banking oversight functions to central banks.***

- These are important questions that have been discussed in the broader context of the institutional set up for macroprudential policy (see for example IMF-FSB-BIS (2016) and Nier and others (2011). Specific arrangements can vary with country circumstances, but general themes include security of tenure of key decision makers, a system of resourcing separate from the parliamentary appropriations process, and appropriate separation between the monetary policy and oversight functions.

33. ***As staff note, the government has retained controlling equity stakes in Íslandsbanki and Landsbankinn. Can staff inform of any intention of the authorities to divest from these institutions, following the successful divestment from Arion Bank?***

- As noted in the staff report, a government-appointed committee has been tasked with preparing a white paper on this and related issues. Preliminary indications are that Íslandsbanki, acquired by the state as part of the stability contributions from the bank estates in the winter of 2015–16, will be divested before Landsbankinn, where state ownership dates back to the banking crisis, and that divestment will be pursued patiently, consistent with staff advice.

Structural Policies

34. ***Could staff inform of the process of wage bargaining in Iceland and particularly the powers of the authorities to influence this process?***

35. ***In this regard, we would welcome staff's description of the wage setting mechanisms for public and private sector wages and the prospects for future wage increases to be in line with productivity.***

- Wage bargaining in Iceland takes place in the context of collective agreements, occupation by occupation, covering about 90 percent of the labor force. Wage settlements are negotiated between labor unions and employers' associations, without direct involvement of the state unless the state is the employer (or serves as mediator in the event that unions and employers cannot reach agreement). Wage negotiation rounds typically take place every three years. In the upcoming round, about 240 collective agreements will be up for renewal in late 2018 or early 2019.

- In the last few years, the state has tried to play a role in the labor relations discussion to better align wage increases with productivity developments. In this context, social partners (the state, labor unions, and employers' associations) reached an agreement to align wages growth to productivity—the so called SALEK agreement mentioned in past staff reports, which this year has come under fire from some labor unions.

- The government has kept the dialogue open, repeating the message that wage agreements need to be aligned with productivity increases, and offering to play a role by contributing through fiscal measures, namely tax schedules and social benefits. The 2019 budget entails a reduction in personal income tax and an increase in family benefits that are intended to increase the purchasing power of lower income families.

36. ***With respect to the ongoing debate on possible changes to the current profit-based fee system, we note that the option of auctioning fish rights been discarded. Could staff elaborate on the relative merits of the two options, namely collecting fees versus selling fishing rights?***

- Both options can effectively collect resource rents from the sector. Given the economic importance of fisheries and the success of Iceland's fishery management system to date, the authorities favor a cautious approach involving adjusting the existing system rather than replacing it with an auction based approach.

- The authorities argue that collecting fees is easier to administer, with less uncertainty and lower transaction costs for both fishermen and the state. They suggest that incentives to ensure the long-term sustainability of the fish stock may also be stronger—but they also acknowledge that there is a presumption that the government has good information on product value.

- Auctioning all or some part of fishing rights, on the other hand, may be the more efficient way to know the “right price.” However, there are operational challenges because bidders’ strategic behavior can affect outcomes, with risks of collusion and path-dependent pricing that may not reflect the true value of the fishing right.

- For further discussion, please refer to *The OECD Handbook for Fisheries Managers: Principles and Practice for Policy Design* (OECD, 2013).[3]

[3] http://dx.doi.org/10.1787/9789264191150-en