Iceland—Concluding Statement of the IMF Mission: Sixth Post-Program Monitoring Discussions—*Reykjavik, May 20, 2015*

Iceland has reached a very delicate juncture. On the one hand, there is a strong desire to reintegrate the economy into international financial markets to harness benefits for savers, investors, and the economy as a whole, against a backdrop of good economic prospects. On the other hand, there is a threat of distributional disagreements among social partners that could undermine the hard won growth and stability gains since the crisis. Social partners should work together to reach equitable wage agreements consistent with maintaining stability, competitiveness, and sustainable growth. However, should large wage increases well in excess of the sum of productivity and the inflation target be realized, a decisive policy response will be needed to restore stability, including tighter monetary and fiscal policy. While Iceland appears ready to finalize its updated capital account liberalization strategy, the adverse consequences of such large wage increases, not least on Iceland's competitiveness, will likely slow the pace of liberalization for the real economy.

1. **Iceland's near-term stability is threatened by significant wage pressures.** The outcome of collective wage bargaining negotiations is still uncertain, but wage growth under the expected three-year settlement looks likely to be well-above both the sum of projected productivity gains and the inflation target in Iceland and wage growth in Iceland's trading partners. In the context of a closed output gap and otherwise good economic prospects, such wage hikes will likely push inflation significantly above the Central Bank of Iceland's (CBI) 2.5 percent inflation target and will generate budget pressures, dampen confidence, and reduce competitiveness. Disruptions could be worsened if other downside risks materialize, such as from the euro area. Such developments could delay capital account liberalization for the real economy, with inhibiting effects for savers, investors, and growth. To avoid wage-related disruptions, all parties should work together towards an equitable wage agreement consistent with productivity gains, target inflation, and sustainable growth.

2. **Should large wage increases be realized, a decisive policy response will be needed.** A significant tightening of monetary policy will be needed over the next several years to bring inflation down to target. Under this scenario, GDP growth can be expected to accelerate this year—pushed by wage-fueled consumption, broad-based investment, and booming tourism—but then slow significantly in 2016-17 as the effects of tighter policies take effect. Additional output costs could result from higher wages in low profitability sectors, unless agreements provide flexibility for struggling firms. Long-term potential growth could drop somewhat due to reduced investment. Inflation would likely peak in 2016 and then fall gradually to target. Fiscal policy levers should also be employed to dampen demand.

- *Monetary policy should be tightened to levels necessary to restore inflation expectations and inflation to the target level.* Meeting this objective will in part depend on maintaining strict independence and accountability of the CBI. The CBI FX programs to smooth volatility of the exchange rate and to build up non-borrowed FX reserves, as conditions permit, should continue. In parallel, work to refine the monetary policy framework and the role of macro prudential policies should continue.
- *Fiscal policy should be tightened to help dampen demand pressures while maintaining a fiscal trajectory consistent with objectives.* While there is limited budget flexibility in 2015, the authorities should adjust the 2016-17 fiscal path to help ease demand pressures. This could include further harmonizing VAT rates, accompanied by targeted measures to mitigate the impact on the lowest income groups. The proposed medium-term personal income tax reform could be beneficial, but care should be taken to assess the distributional and budget implications. Fiscal policy is otherwise broadly on track to bring debt down to target levels, though some additional measures, along with greater specificity of planned medium-term expenditure reductions, are needed. This will help free up space for

additional capital spending, including for a new national hospital, and resuming contributions towards the public pension shortfall. Approval and implementation of the draft organic budget law will help meet these objectives. Fiscal contingency plans should be put in place in the event downside fiscal risks materialize, including from legal challenges of financial sector taxation and contingent liabilities. Any one-off revenues should be used to pay down debt and free up budget space from interest savings, following careful consideration of liquidity implications in close collaboration with the CBI.

- *Social partners and government should use the three-year wage agreement period to assess whether the collective wage bargaining mechanism can be strengthened*, aiming for future bargaining round outcomes more conducive to stability.

3. Despite some likely near-term instability, Iceland appears ready to finalize its updated capital account liberalization strategy. Considerable effort has been made to better understand the size, complexity, range of options, risks, and benefits surrounding gradual liberalization and international financial re-integration. Iceland looks ready to move ahead with a comprehensive strategy that alleviates balance of payments pressures, consistent with advancing liberalization. The strategy should maintain emphasis on a cooperative approach with incentives, which could include reliance on statutory powers, non-discriminatory measures when possible, and consistency with Iceland's international obligations. The pace of implementation should remain conditions-based, with careful calibration with external balances and macroeconomic and financial stability. Implementation should be supported by sound macroeconomic and financial sector policies and frameworks to help mitigate risks and support growth and stability. These include upgrading the fiscal, financial, and macro prudential policy frameworks and core policies that aim for lower debt, stable inflation, and adequate buffers.

4. Financial sector reforms now underway will help support financial stability. These include efforts to strengthen financial supervision, such as risk-based stress testing, and financial safety nets. Draft legislation to bring the deposit guarantee and bank resolution frameworks in line with EEA standards and to strengthen the macro prudential toolkit deserves support. Further steps to clarify the emergency liquidity assistance framework are also needed. Agreement should be reached on a new housing strategy, with the Housing Financing Fund put into run-off mode. Finally, it is also important to maintain existing financial sector capital and liquidity buffers as Iceland prepares to implement its updated capital account liberalization strategy.

We thank the authorities and other counterparts for their warm welcome, excellent cooperation, and candid and constructive discussions during the visit.