Iceland—2014 Article IV Consultation and Fifth Post-Program Monitoring Discussion: Concluding Statement of the IMF Mission

Reykjavik, December 19, 2014

Advancing Iceland's financial reintegration with the rest of the world is the major economic policy challenge. Addressing this challenge is critical to support stronger domestic growth and better investment opportunities for Iceland's households and firms. Within a still volatile global economy, there will be a premium on proceeding carefully with liberalization, while maintaining strong policies and frameworks, including an independent central bank, strong fiscal rules, and sound prudential policies and practices.

A generally positive economic outlook should facilitate good progress with capital account liberalization. Growth slowed this year but domestic demand remains robust. Looking ahead, consumption will be boosted by household debt relief and lower import prices and private investment should continue to recover from the crisis.

But vulnerabilities remain and risks are tilted to the downside. Crisis legacies are still being unwound, weighing on external stability and growth. Domestic risks include uncertainties surrounding capital account liberalization, significant wage pressures heading into the next collective bargaining round, legal challenges of financial sector taxation and CPI indexation, and weaknesses in the HFF. The external environment remains uncertain, including risks of slower demand from trading partners and deflationary pressures.

External sector – a renewed push on capital account liberalization

We welcome the significant efforts that have been undertaken on capital account liberalization in recent months, resulting in the LBI agreement and a greater understanding of the issues. The path chosen for the revised liberalization strategy will shape Iceland for years to come. To help secure a long-term positive impact on the economy, the strategy should: (i) emphasize stability; (ii) remain comprehensive and conditions-based; (iii) be based on credible analysis; and (iv) give emphasis to a cooperative approach, combined with incentives to participate, to help mitigate risks.

Greater policy focus on enhancing balance of payments prospects would help support the pace of liberalization. Iceland's current account received a boost following the sizable depreciation at the onset of the crisis and subsequent rebalancing towards exports, and also the boom in tourism. These competitiveness gains should be nurtured through supporting policies to facilitate higher investment and savings—including infrastructure improvements—and efforts to defuse wages pressures in excess of productivity gains.

Monetary policy—a challenging juncture

The monetary policy stance is in line with the central bank's inflation objective. The recent nominal rate cut is appropriate given a tightening real policy rate amidst falling inflation and expectations and somewhat weaker growth. Future rate actions should carefully weigh wage pressures and a closing output gap against deflationary pressures from the external environment. The Central Bank of Iceland's **(**CBI) foreign exchange purchase program to build up reserve buffers should continue as conditions permit, ahead of capital account liberalization.

Preserving the independence and accountability of the central bank is critical. The CBI legislative framework review should maintain the key 2009 governance reforms, including the Monetary Policy Committee framework and transparency and accountability of decision-making. A financially sound, independent, and accountable central bank enhances policy credibility, which in turn promotes economic stability and growth, and supports capital account liberalization.

Fiscal policy—from consolidation to growth

The 2015 budget is consistent with Iceland's debt reduction objective, but faces downside risks. The budget targets a general government surplus of 0.2 percent of GDP, consistent with Iceland's balanced budget target. This reflects the unwinding of one-off revenues from the financial sector that will push the 2014 surplus to around 2 percent of GDP. Additional fiscal contingency measures should be identified given downside risks. These risks include potential for litigation over bank taxation and higher HFF losses, and reliance on restraint in wages and other current spending that could come under pressure in the upcoming collective bargaining round. Continued fiscal discipline over the medium-term, coupled with strong growth, will help rebuild buffers, boost confidence, and lower interest rates. Approval of the bill on Organic Budget Law before Parliament would mark an important strengthening of Iceland's fiscal framework and ability to meet objectives, which, in turn, should support trust among international investors.

With the major phase of fiscal consolidation broadly over, attention should turn to adjusting budget composition in support of growth. Further measures will be needed to provide fiscal space for public investment, including for roads and the health sector, and shifting the burden from direct to indirect taxation. Careful assessment of distributional consequences is needed.

The government has begun an important reform of the VAT system. The main rate is among the highest—and the reduced rate one of the lowest—in the OECD, while numerous exceptions weaken its revenue efficiency. The reform proposals will have some distributional effects, but other fiscal policy measures that are more efficient in achieving distributional objectives should be used in combination. Over the medium term, further VAT reforms should be undertaken to address structural weaknesses in the tax.

Financial sector policy—reinforcing resilience

Banks remain strong, but should maintain high capital and liquidity buffers to weather capital account liberalization, while coping with elevated risks. Uncertainties surrounding the unwinding of crisis legacies and legal risks, including challenges to CPI indexation, call for prudent dividend distribution and pursuit of more long-term funding. We encourage the CBI and FME to continue improving macrofinancial and supervisory stress tests.

Good progress has been made in improving the financial stability framework. The CBI has strengthened foreign currency liquidity regulations and adopted an FX Net Stable Funding Ratio based on Basel III. Legislative amendments have been enacted to enhance supervision of related parties and improvements in the FME's risk assessment system are underway. The newly created financial stability framework has steered discussions on capital buffers. Further steps are needed to develop operational instruments to address cyclical and structural systemic risks.

Further strengthening of safety nets and supervision and addressing the HFF remain priorities. Government should implement plans to bring deposit insurance and bank resolution frameworks in line with enhanced international standards. A clear and transparent emergency liquidity assistance framework should be established while cross-agency cooperation on crisis preparedness and simulations could be improved. The authorities should put HFF into an orderly runoff to minimize fiscal costs and financial stability risks, and seek consensus on the main social objectives of mortgage lending before a successor program is put in place.

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