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Iceland—Concluding Statement of an IMF mission for the 2013 Article IV Consultation and the Third Post-Program Monitoring Discussion

Reykjavik, June 14, 2013

Iceland's economy is on a path to recovery and the outlook is for continued gradual expansion. The overarching challenge is to create a foundation for durable growth by resolving legacy problems from the previous boom and crash. This will require lifting capital controls without disrupting the external position, implementing durable measures to complete the fiscal adjustment, and further increasing the resilience of the financial sector.

1. **The recovery continues, but crisis legacies are restraining growth.** Unemployment is still declining but growth has slowed amid private sector deleveraging and weak external demand. Financial conditions have improved but legacy risks are still holding back credit expansion. Uncertainty concerning the lifting of capital controls is weighing on confidence and investment. Competitiveness gains have been sustained, which should help attract investment and support the recovery. We project growth of around 2 percent a year over the next five years.

2. **Legacy vulnerabilities need to be addressed.** A clear and comprehensive roadmap is needed to safely lift capital controls and remove the associated growth-hindering distortions. The monetary policy stance and framework should be geared toward bringing inflation down to target. Fiscal consolidation needs to be completed in order to reduce public debt and protect growth. Financial sector risks must be tackled so as to safeguard stability.

Capital controls—putting in place a credible roadmap

3. **An orderly lifting of capital controls requires a comprehensive approach.** First, the winding up of the old banks, including the servicing of the Landsbanki bond, should be handled in a manner consistent with external and financial stability. Second, incentives to participate in the authorities' strategy to release liquid offshore krona need to be strengthened. This can be done by publishing an elaborated strategy that sets a clear implementation timeline, clarifies the treatment of holdouts, and ensures enforcement. Third, potential resident outflows following the easing of controls can be contained by imposing "speed limits" on outflows or by phasing liberalization by asset type. This should be supported by strong prudential regulations and supervision.

Monetary policy—securing progress on reducing inflation

4. **The monetary policy stance is in line with the central bank's inflation objectives.** With the recent softening of economic activity, little change in the policy interest rate is needed to gradually bring inflation to target. The foreign exchange interventions conducted in the winter helped smooth a depreciation stemming from temporary factors. Looking forward, foreign exchange purchases to build up non-borrowed reserves should resume.

Fiscal policy—ensuring sustainable consolidation

5. **Iceland's existing fiscal targets remain appropriate.** The targets—including a balanced budget in 2014 and a 5 percent of GDP primary surplus in 2016—strike a good balance between supporting growth, ensuring that debt is on a downward trajectory, and increasing fiscal buffers in the face of new risks, including from the Housing Finance Fund (HFF). Staying the course will help maintain market confidence. This will contain borrowing costs and support continued market access, which is crucial for a successful lifting of capital controls.

6. **Meeting the targets, however, will require additional measures.** On current trends, the 2013 budget deficit target (1.3 percent of GDP) will be missed by about 1 percent of GDP, owing to expenditure overruns, the reversal of some planned revenue increases, and slower growth. While the 2014 target could reasonably be adjusted to allow for the effects of slower growth (0.2 percent of GDP), meeting the adjusted target would still require new measures of some 1½ percent of GDP in the next 18 months.

7. **There is little fiscal space for additional household debt relief.** Any new measures should be targeted on distressed households falling through the cracks of existing programs. There is also scope to intensify debt restructuring efforts at the HFF. In addition, the authorities should identify and address bottlenecks in order to speed up resolution within the Debtors' Ombudsman framework.

8. **There is scope to improve the quality of the adjustment.** The reliance on one-off measures—such as asset sales and exceptional dividends—should be curtailed. In this regard, cross-country analysis suggests that substantial savings can be achieved in health and education without compromising outcomes. Consideration should also be given to reducing agricultural subsidies and better targeting social transfers. More broadly, budgetary discipline and accountability would be strengthened by enacting the draft Public Finance Act.

Financial sector policy—tackling legacy risks

9. **Still-substantial risks call for strengthening financial sector oversight.** The progress in addressing nonperforming loans needs to continue, guided by strict prudential treatment of restructured loans and intensive onsite supervision. Banks should continue to maintain strong capital and liquidity buffers and improve their funding profile. The financial safety net should be reinforced and the proposed inter-agency framework for tackling systemic risks should be implemented.

10. **The HFF should be reformed.** Given the risks emerging from the fund, its mandate and institutional set-up need to be reviewed, preferably by independent experts, to find a permanent and financially viable solution. The Financial Supervisory Authority (FME) should be closely involved, starting with a review of capital adequacy.

We thank the authorities and other counterparts for candid and constructive discussions.