Iceland—Concluding Statement of the Fourth Post-Program Monitoring Mission
Reykjavik, May 23, 2014

Iceland's economy is recovering well. To sustain progress, policies must continue to address the legacies of the financial crisis. Capital controls have provided room for an orderly adjustment, but weigh on Iceland's ability to take full advantage of growth-enhancing economic relations with the rest of the world. It is important to take stock of progress on this complex issue and consider adjustments in the liberalization strategy. Sound macroeconomic and financial stability frameworks and policies will be key supporting elements for this strategy and for facilitating growth. These include moving the general government accounts into balance, reducing government debt, maintaining stable inflation, and strengthening prudential policies and practices. With good progress on all these fronts, the Icelandic economy would be well set to grow at a healthy pace.

Economic Outlook and Risks

The economic outlook is positive. Domestic demand is recovering gradually and is expected to support lower unemployment. We estimate medium-term growth will average around 3 percent as private sector balance sheets recuperate and confidence is rebuilt. Inflation has fallen below the central bank target, but the economy is close to capacity and inflation is expected to pick up next year.

Risks to the outlook are tilted to the downside. Slower trading partner growth could lower exports and dampen investment, and reduce growth. Global market volatility could also increase Iceland's cost of borrowing. The liberalization of the capital account requires careful navigation, with downside risks from a disorderly unwinding of capital controls. The still-evolving system of tripartite wage agreements should serve to promote productivity and employment growth and contain inflation risks.

Capital account liberalization—moving forward

Capital controls continue to weigh on the economy, and their removal is a key priority for Iceland. Progress has been made under the 2011 strategy. However, the understanding of the size and complexity of the problem has changed and an updated strategy is needed. To this end, the authorities are undertaking careful assessments of the balance of payments prospects, outflow pressures, and the range of liberalization options. Careful attention should be given to solutions that have a long-term positive impact on the Icelandic economy, the prospects of which remain closely linked to economic and financial relations with the rest of the world. These factors will be hard to gauge, but a deliberate, constructive, and comprehensive approach, backed by sound macroeconomic and financial policies, will enhance prospects of success. Great care will be needed to execute the liberalization process in an orderly fashion that maintains stability.

Monetary policy—keeping inflation in line with the target

Monetary policy has been appropriately cautious. Inflation has fallen to the central bank target. Higher real interest rates in turn have tightened real monetary conditions. However, the output gap is closing, imported disinflation is expected to dissipate, wage pressures could build, and long-term inflation expectations remain above the target. Given these factors, along with uncertainties about the 2015 budget stance, rates should remain on hold. The Central Bank of Iceland (CBI) should aim to build up non-borrowed FX reserves over time.

The recently launched review of the CBI's legislative framework should preserve the financial health, independence, and accountability of the bank. The review should maintain the key governance reforms implemented in 2009, including the Monetary Policy Committee framework, strict criteria and procedures for selecting top officials, and transparency of decision-making. The proposed changes to the CBI's capital and financing mechanism should maintain sound finances at the bank, including automatic recapitalization should the need arise. A financially sound, independent, and accountable central bank enhances policy credibility and helps anchor longer term expectations, which in turn promotes economic stability and growth.

Fiscal policy—continuing the adjustment

Fiscal consolidation is expected to continue in 2014. Buoyant revenues and one-off factors, including expected dividends of around 2 percent of GDP, will contribute to a general government surplus of just under 2 percent of GDP. This implies a structural adjustment of just under 0.5 percent of GDP over 2013.

The government's medium-term objectives of a balanced budget and debt reduction are appropriate, but further effort will be needed to achieve them beginning next year. Hitting the government's objective of a balanced budget over 2015-16 will require another 1 to 1 ½ percent of GDP in specific and durable measures, placed in the context of a well-specified medium-term fiscal plan. There are downside risks to this scenario, including from potentially higher losses at the HFF generated by household debt relief and potential for expenditure slippages. Given downside risks and uncertainties, additional contingency measures should be identified.

The draft Organic Budget Law now before parliament broadly matches best practice and deserves support. This legislation will establish a new system of fiscal rules which will improve transparency and accountability in fiscal policy making. The legislation also contains important reforms in the area of public financial management which will address deficiencies in fiscal reporting, establish requirements for a statement of fiscal policies and an annual update of the medium-term fiscal plan. These reforms will strengthen Parliament's

role in setting and overseeing fiscal policy and, more generally, will improve budget execution.

The recently approved debt relief program will strengthen household balance sheets and is fiscally neutral, but poses budgetary risks. The budget-supported component is expected to be fully covered by earmarked revenues from the expanded bank levy, though these resources could have been used for other pressing needs. The Pillar III-funded component of debt relief provides households with some choice over the form of savings, and generates small but prolonged annual budget costs. Care should be taken to preserve future pension contributions for their intended purpose, while alternative schemes could be considered to facilitate long-term savings towards home purchases. The debt relief program poses additional risks to the budget, including from possible losses from accelerated prepayments on HFF loans and potential litigation over the bank levy.

Financial sector policy—preparing for the future

Capital and liquidity buffers in banks should be maintained. In 2013, banks progressed with the loan restructuring and regained access to international financial markets. To cope with financial uncertainties surrounding the unwinding of crisis legacies, dividend distribution should be limited and banks should seek more term funding. The financial supervisor (FME) should introduce strict rules on loan classification and provisioning, providing for a conservative prudential treatment for restructured loans.

Micro and macro-prudential supervision need to be reinforced. The FME should enhance internal procedures and industry rules for risk assessment, and invest more in staff training and systems development. To carry out its tasks effectively, the financial independence of the supervisor should be secured and supervisory powers strengthened. The establishment of a Financial Stability Council is a welcome step for enhancing systemic risk oversight and the implementation of macroprudential regulations should follow promptly. Further steps should be taken to improve the financial safety net.

Recent proposals for resolving the HFF are a positive step forward. The design of the orderly runoff of the HFF should be mindful of fiscal and financial stability risks. Pending a permanent solution, HFF lending and bond issuance should be stopped, its operational management refocused, and a thorough asset quality review completed. Agreement should be reached on the main social objectives of mortgage lending before any government-sponsored 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 this visit.