INTERNATIONAL MONETARY FUND

Iceland: Staff Concluding Statement of the 2016 Article IV Mission

April 12, 2016

A concluding statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Iceland's change of leadership comes at a time of unambiguously strong economic performance. Current high growth rates were last seen before the crisis, yet rest on much firmer foundations now. The tourism boom is a fundamental development, supporting growth and bringing in foreign exchange. The recent lifting of capital controls on the bank estates was handled deftly, protecting reserves, minimizing legal risks, and generating windfall receipts for the state. These receipts, combined with the new Organic Budget Law, should see public debt falling decisively. Conditions are thus ripe for further capital account liberalization. An effort to resolve the offshore króna overhang is appropriate before attention turns to easing capital controls on residents. Lifting ceilings on pension funds' investments abroad seems a sensible step. Other steps should be cautious, well planned, and backed by commitments to further strengthen financial sector oversight and the macroprudential toolkit.

1. **The outlook is for continued good performance, with growth slowing to about 2½ percent over the medium term**. Strong private consumption, investment, and tourism will continue to drive output and job creation. Excessive wage growth will probably lift inflation above the central bank target in the near term. Further monetary tightening is assumed, striking a balance that keeps inflation in check and puts the economy on a gently decelerating glide path. Wage growth will erode competitiveness. Coupled with less favorable terms of trade, this will see the current account surplus shrinking steadily.

2. **The biggest risk is of another all-too-familiar cycle of boom and bust**. Popular demands for more fiscal spending are becoming louder after years of restraint, and election season has arrived early. If the newly reshuffled government, or indeed any successor administration, were to seek popularity through spending, this would come on top of burgeoning wages and further stoke domestic demand at a time when demand already risks being too strong. Such a development would necessitate even larger interest rate hikes than already envisaged. High interest rates, in turn, could attract carry trade inflows, exposing Iceland to potentially serious financial stability risks and further hurting competitiveness.

3. **It is timely that the Organic Budget Law is in place to help maintain fiscal discipline**. Commitment to saving the receipts from the estates must not waver. The new fiscal rules (centered on a 30 percent of GDP ceiling on net public debt and a stipulation that

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the budget be balanced or in surplus on a rolling five year basis) create a multi year guiding framework for fiscal policy. Compliance will build credibility. Importantly, the rules are set at the general government level, bringing in the municipalities also. Demand pressures call for a moderately tighter fiscal stance next year. Further reforms of value added taxes should be considered to mobilize additional revenues. These, together with significant interest savings from lower debt, would create an opportunity to rethink medium-term spending priorities, where larger allocations are needed for education, healthcare, and capital expenditures.

4. **Revamping the wage bargaining framework is central to economic stability**. The “dolphin leap” of ratcheting wage awards since early 2015 is deeply injurious to economic health. The new Macroeconomic Council, as a forum for discussions among social partners and monetary and fiscal policy makers, will be a welcome step. Reform efforts seek to anchor wage bargaining on competitiveness, with export oriented manufacturing industries expected to serve as bellwether, setting the signal for other sectors to follow.

5. **More monetary tightening will almost certainly be needed**. Iceland is enjoying an unusually long period of price stability, giving the central bank increasing credibility. Irrespective of opposition from many quarters, it is entirely correct that the central bank should stand ready to raise interest rates further and consolidate this credibility. The economy is growing rapidly, wage growth is expected to push inflation above target in the coming months, and the good luck of having import prices falling cannot be taken for granted. As before, rates hikes should be taken in measured, data driven steps.

6. **The monetary policy framework would benefit from a clearly articulated policy on foreign exchange intervention**. This should stress the primacy of the inflation target and re-emphasize that there is no exchange rate objective—resisting appreciation can, perversely, generate market expectations of further appreciation, so the best course is to focus squarely on inflation. The intervention policy should also distinguish between the separate goals of building reserves and dampening excess volatility. A conservative approach to reserve adequacy is needed, especially while capital account liberalization is ongoing, where the central bank subscribes to published IMF methodology.

7. **Further capital account liberalization should be executed cautiously**. A final effort to resolve the offshore króna overhang is appropriate before attention turns to residents. Prolonged capital controls are amplifying distortions, including undue risk taking by pension funds. Permitting significantly more outward investment by pension funds is a logical first step, and should be accompanied by measures to strengthen governance and risk management provisions in the Pension Fund Act. A comprehensive strategy should be drawn up to calibrate the easing of restrictions on households and corporations. This should embed concrete commitments to further improve banking oversight and the macroprudential toolkit.

8. **Policies need to adjust to increased state participation in the banking system**. It is vital that the government, as majority owner now of two of the three main banks and with a significant interest in the third, be a responsible steward. Dividends should not unduly drain bank liquidity. Privatization should not be rushed, with efforts focused on finding high quality buyers—ideally, reputed foreign banks. Amendments to the Act on Official Supervision of Financial Activities should be considered to strengthen the legal powers and independence of Fjármálaeftirlitid, even as work advances to develop risk based processes and enhance the quality of bank supervision. The involvement of two official bodies in bank regulation could also be revisited, not least because coordination issues can arise, bank liquidity and solvency being two sides of the same coin. One streamlining option might

be to unify all safety and soundness regulation and supervision of banks at the central bank, leaving Fjármálaeftirlitid with oversight of nonbanks and markets as well as consumer protection. This “twin peaks” solution and other options deserve further study.

9. **Efforts to strengthen the macroprudential toolkit should press forward, and could benefit from a greater delegation of powers**. Objectives include increasing the resilience of balance sheets—especially to exchange rate shocks—and reducing systemic risks arising from large and volatile capital flows. Important proposals currently before parliament include bills to establish loan to value caps on mortgages and to limit foreign currency lending to unhedged borrowers. Ideally these would be passed soon. Work to develop effective capital flow management tools, which can give monetary policy more room for maneuver and help safeguard financial stability, should also proceed apace. In future, a more integrated approach could be considered where the central bank and Fjármálaeftirlitid are given delegated authority to introduce new instruments by regulation.

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The IMF team thanks the Icelandic authorities and others with whom it met in Reykjavik and Akureyri during this visit for their hospitality, engagement, and candidness.