INTERNATIONAL MONETARY FUND

ICELAND

FOURTH POST-PROGRAM MONITORING DISCUSSIONS

June 20, 2014

KEY ISSUES

Context: The recovery is continuing and the growth outlook is positive, but crisis legacies continue to weigh on the economy. The government is undertaking efforts to address them but this entails significant risks. Sound macroeconomic and financial sector policies are key to mitigating these risks and facilitating strong, durable growth.

Capital account liberalization: The authorities are taking welcome initial steps to update the 2011 liberalization strategy. A comprehensive approach consistent with macroeconomic and financial stability and conditioned on balance of payments prospects and maintaining adequate reserve buffers will best support macroeconomic and financial stability.

Monetary policy: The current stance is appropriate. The central bank should stand ready to respond to possible pressures stemming from factors such as 2015 wage formation, the fiscal stance, and a closing output gap. Maintaining a financially sound, independent, and accountable central bank is important for policy credibility and anchoring inflation expectations, which in turn supports stability and growth.

Fiscal policy: The government's objectives of a balanced budget and lower debt are appropriate. Achieving them will require some 1 to 1½ percent of GDP in measures and a well-formulated medium-term fiscal plan. Their firm implementation will help ease budding wage and inflation pressures, lower borrowing costs, and rebuild fiscal buffers. The draft organic budget law now before Parliament will underpin these efforts.

Financial sector policy: Prudent financial sector policies and practices—including maintaining capital and liquidity buffers and enhancing supervision—are needed to safeguard financial stability as capital controls are eased. The proposal to put the loss-making Housing Financing Fund in an orderly runoff mode is welcome.

Approved By
Jorg Decressin and Thanos Arvanitis

Mr. Dohlman (Head), Mr. Antoshin, and Ms. Bordon (all EUR), Mr. McHugh (FAD), Ms. Bouza (SPR), and Ms. Croitoru Nedelescu (MCM) visited Reykjavik during May 12–23. Mr. Decressin (EUR) joined the mission for the final two days. The mission met with senior government and central bank officials, members of parliament, representatives from the trade unions and business community, and academics. Ms. Boranova and Ms. Ilagan (EUR) assisted the mission. Ms. Jonsdottir (OED) participated in some of the policy discussions.

CONTENTS

ANNEXES

RECENT DEVELOPMENTS AND OUTLOOK

Domestic demand will gradually overtake exports as the main driver of the economy in the medium term. With respect to economic policies, the timing and pace of capital account liberalization—including its uncertain impact on market confidence—will critically shape the outlook.

A. Context

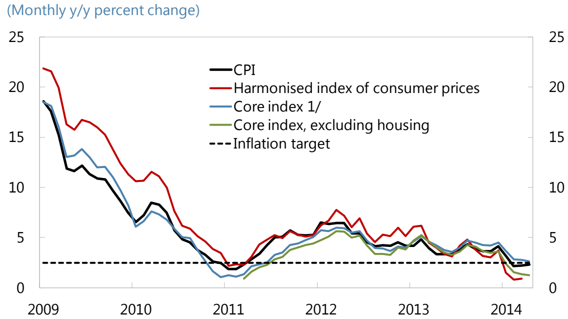
1. One year into its term, the coalition government is renewing Iceland's efforts to address crisis legacies and usher in a more normal economic environment. Against a backdrop of good growth prospects, the authorities are broadly maintaining the post-crisis course of reform and taking steps to more decisively tackle long-standing crisis-legacy issues—notably capital controls—that continue to weigh on the economy. The government is also pursuing core institutional reforms, including to the fiscal and central bank legislative frameworks.

B. Recent Developments: Export-Driven Growth

2. The economy has grown strongly on the back of booming tourism (Figure 1). Real GDP grew 3.3 percent in 2013, despite a drop in investment spending. Net exports were the primary driver. High frequency indicators suggest strong net exports—including steady growth in "off-season" tourism—have continued in Q1 2014, along with rising private consumption. Unemployment is trending down, with the seasonally-adjusted rate reaching 3.9 percent in April—low by international standards but above Iceland's 30-year average of around 2 percent. The share of long-term unemployment remains elevated.

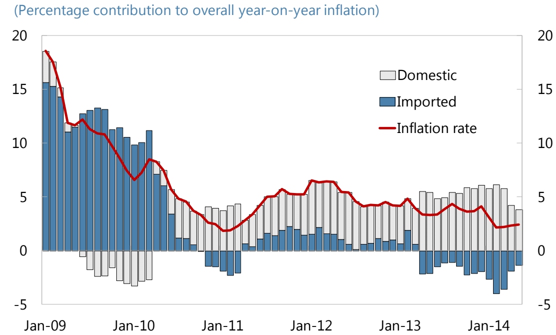
3. Inflation has fallen below the Central Bank of Iceland's (CBI) 2.5 percent target but long-term inflation expectations remain noticeably above this level (Figure 2). CPI inflation fell rapidly to 2.4 percent in May from 4.2 percent at end-2013, helped by an appreciating krona and lower imported inflation. Domestic inflation outside the housing sector softened as well, with the Harmonized Consumer Price Index (excluding housing) rising only 1.3 percent year-on-year in April. While near-term inflation expectations have fallen close to the CBI target, long-term inflation expectations have been slower to adjust.

Measures of Inflation
(Monthly y/y percent change)



Source: Central Bank of Iceland.
1/ Core index is the CPI excluding prices of agricultural products, petrol, public services, the cost of real mortgage interest, and tax effects.

Components of Inflation
(Percentage contribution to overall year-on-year inflation)

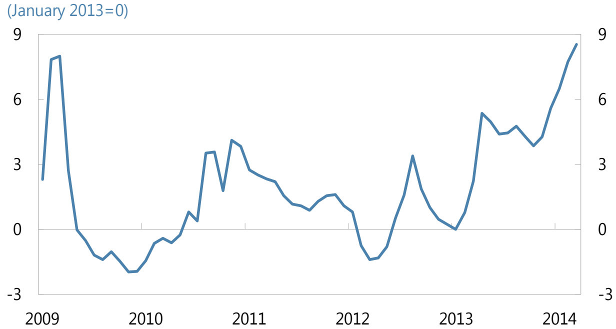


Source: Statistics Iceland.

4. Monetary and fiscal conditions are tightening (Figures 3 and 4). The CBI has kept its policy rate on hold since November 2012, but overall monetary conditions have tightened as falling inflation and short-term inflation expectations have pushed real interest rates up and the exchange rate has appreciated. The general government fiscal balance narrowed to -2.1 percent of GDP in 2013 from -3.8 percent of GDP in 2012 and is in surplus so far this year. Government debt remains high at 90 percent of GDP (with another 70 percent of GDP in guaranteed debt) and gross financing needs are elevated. But debt is on a downward, sustainable trajectory (Annex I). In May, Parliament approved a four-year program of household debt relief (HHDR), with a broadly neutral fiscal impact (Annex II).

Monetary Conditions Index 1/

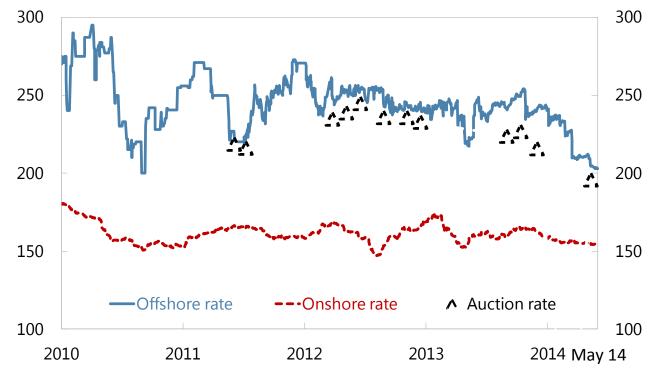
(January 2013=0)



Sources: Central Bank of Iceland; IMF INS database; and IMF staff calculations.

1/ The MCI is the weighted sum of the changes in the ex-ante real lending interest rates and in the real effective exchange rates, with weights equal to 0.75 and 0.25, respectively.

ISK/EUR Onshore, Offshore, and Capital Control Liberalization Auction Rates

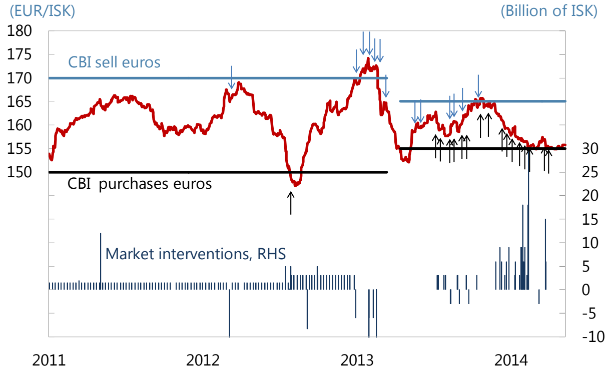


Sources: Thomson Reuters; and Central Bank of Iceland.

5. A strong trade balance has supported the krona and facilitated reserve accumulation (Figure 5). Since January, the onshore krona rate has appreciated by 2.3 percent against the euro and the real exchange rate has appreciated 5 percent. The offshore rate has appreciated even more. The krona is estimated to be undervalued by 8 to 16 percent using standard metrics, which may in part reflect uncertainties over capital account liberalization. Further depreciation pressures could emerge if the liberalization process is uneven or disorderly. The CBI has been successfully intervening to dampen exchange rate volatility since Q2 2013 and has taken advantage of appreciation pressures to increase non-borrowed reserves. Gross reserves stood at $4.2 billion as of end-2013, or about 90 percent of short-term debt. External debt remains on a downward trajectory and the net international investment position is within the range of peer countries (Annex I).

Exchange Rate and CBI Interventions

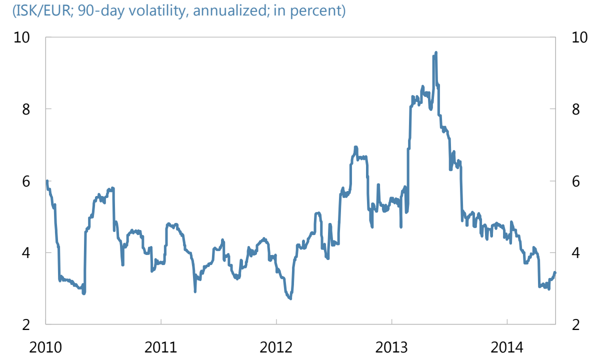
(EUR/ISK) (Billion of ISK)



Sources: Central Bank of Iceland; Arionbank.

Exchange Rate Volatility

(ISK/EUR; 90-day volatility, annualized; in percent)



Sources: Central Bank of Iceland; Haver Analytics; and IMF staff calculations.

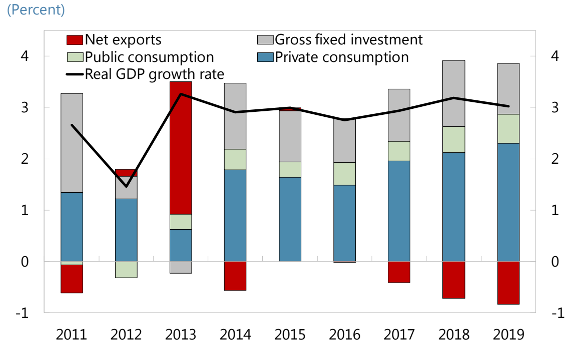
6. The potential for crisis legacy-driven balance of payments (BOP) pressures remains significant and capital controls are firmly in place (Annex III). Nonresident holdings of liquid krona (18 percent of GDP; 67 percent of gross reserves) are slowly being released via the established FX auction mechanism. The old bank estates—which control an estimated 44 percent of GDP in (net) domestic assets and another 84 percent of GDP in (net) FX assets held overseas owed to nonresident creditors—remain locked up. Residents also remain locked in. Their portfolio rebalancing preferences could result in an estimated BOP outflow of 20–45 percent of GDP, with increasing concerns expressed by pension funds and key corporations.

7. Bank lending remains subdued amidst ongoing deleveraging, while the state-owned mortgage fund registered further losses (Figures 6–8). Bank lending was negative in real terms in 2013 in a context of ongoing corporate and household deleveraging and low investment. The aggregate capital ratio reached 26 percent at end-2013, banks are meeting new liquidity coverage ratios, and nonperforming loans (NPLs) are down to 12.5 percent (cross-default). However, banks have announced large dividend distributions in 2014 that will erode buffers and profitability is weakening. The government-owned Housing Financing Fund (HFF) registered further losses in 2013, requiring a capital injection of 0.3 percent of GDP to prevent a further erosion of capital adequacy (currently at 3.4 percent).

C. Outlook and Risks

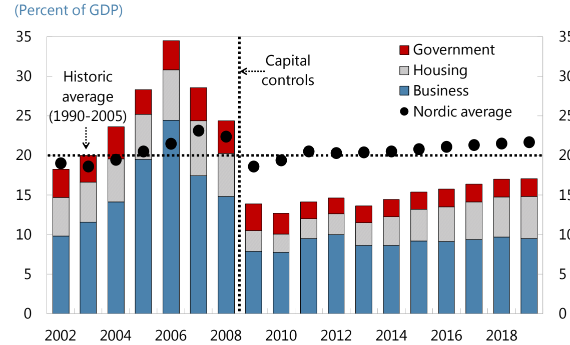
8. Medium-term growth prospects are positive, driven by rising domestic demand. Staff projects real GDP growth of 3 percent on average over the medium term as private sector balance sheets recuperate and consumer and investment sentiment improves. The CBI is more optimistic, projecting a stronger rebound in domestic demand, though tempered by a more conservative outlook on net exports. The authorities and staff agreed that inflation will be on target this year and then rise above 3 percent next year as the output gap turns positive. The authorities expressed concern about rising wage pressures given difficulties experienced this year with the collective wage bargaining framework.

Contributions to Growth
(Percent)



Sources: Statistics Iceland; and IMF staff estimates.

Investment
(Percent of GDP)



Sources: Statistics Iceland; and IMF staff estimates.

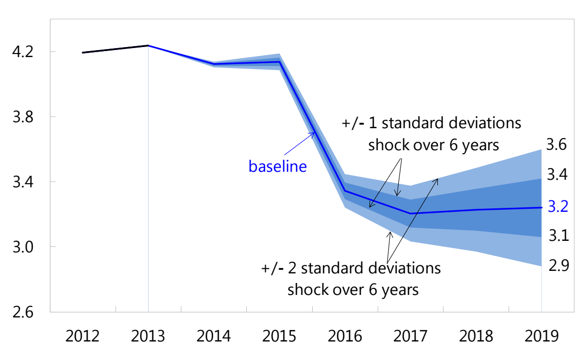
9. The external sector outlook is generally positive, though subject to uncertainty.

- *Staff projects a positive but gradually shrinking current account surplus (as a percent of GDP) over the medium-term.* Rising imports tied to export-oriented investment are expected to offset rising exports, but this investment could lay a foundation for future exports. The CBI forecasts a weaker trade balance based on slower real growth in net exports and more pessimistic terms of trade.

- *Staff's baseline scenario assumes a paced release of nonresident and resident krona positions while maintaining adequate reserve buffers.* Consistent with the authorities' 2011 capital account liberalization strategy, staff assumes a gradual release of all offshore liquid krona holdings by end-2016. Beginning 2017, the authorities begin a gradual easing of controls on residents and the old bank estates. The central government is assumed to fully rollover its maturing debt except for the 2016 bond which is assumed to have a 50 percent rollover and the remainder paid down. The central government is also assumed to issue Eurobonds in 2015–16 to cover 100 percent of maturing central bank debt (Fund repurchases). By the end of the medium-term forecast, staff estimates that potential nonresident and resident BOP outflows remain significant. Both staff and the authorities cited the importance of smoothing 2016 external payments.

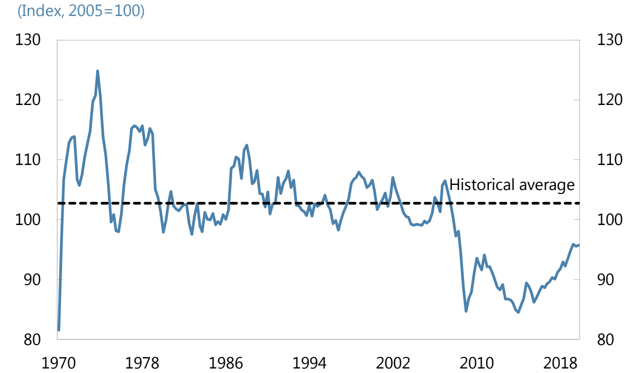
- *Staff and the CBI agree the BOP forecast is subject to significant risks and uncertainty.* This includes the uncertain evolution of risk premia and financing prospects in the context of capital control liberalization, but also uncertainties about key projections such as the terms of trade and FDI inflows (which can drive significant differences in reserve accumulation) and assumptions relating to the liberalization strategy (which are under review and likely to change).

Sensitivity of Central Bank Reserves to Terms of Trade
(Billions of USD)



Source: IMF staff calculations.

Terms of Trade
(Index, 2005=100)



Sources: Central Bank of Iceland; and IMF staff calculations.

10. Staff and the authorities agreed that risks are tilted to the downside. A protracted period of slower global growth could dampen exports and foreign direct investment. Surges in global market volatility have so far had only muted direct effects on Iceland but a sharp deterioration in external financing conditions could complicate refinancing of large external payments coming due during 2015–16 and delay the easing of capital controls. Efforts to resolve the old bank estates could result in faster capital account liberalization, boosting confidence and investment and raising long-term growth. However, missteps could result in a more protracted impasse leading to a weaker business climate, lower investment, asset bubbles from locked in liquidity, eroding competitiveness, and weaker growth. Lifting capital controls before the necessary conditions are in place could destabilize the krona, lead to higher inflation and reserve losses, and lower confidence and growth. Even without liberalization steps, deeper depreciation pressures could emerge that could be difficult to counteract.

POLICIES TO ENSURE EXTERNAL VIABILITY

11. Discussions focused on calibrating policies to address crisis legacies and manage risks in support of external viability and economic growth. Adjusting the capital account liberalization strategy to new realities, while maintaining Iceland's growth-enhancing economic integration with the rest of the world, will be critical. This should be supported by sound macroeconomic and financial sector policies that maintain stability and rebuild buffers.

A. Capital Account Liberalization Strategy: Adapting to New Realities

Addressing potential BOP outflows by nonresidents and residents ("overhang") while safeguarding macroeconomic and financial sector stability are key challenges for Iceland. A revised liberalization strategy is needed that takes a transparent, comprehensive approach consistent with stability and conditioned on BOP prospects, and backed by supporting macroeconomic and financial policies.

Background

12. The authorities are revisiting their 2011 liberalization strategy. There has been some good progress in addressing the liquid ISK overhang via the existing FX auction mechanism. Significant payments have also been made to priority creditors of the old bank estates from recovered external assets. But progress through existing mechanisms has slowed while the understanding of the size and complexity of the overhang has changed—most notably the challenges posed by the domestic assets of the old bank estates, but also the fuller recognition of portfolio rebalancing pressures from residents. Mechanisms in the existing strategy are not well-suited for addressing these additional challenges without further adjustments. The authorities are now reassessing their options, and there has been some important preparatory work and developments:

- *The CBI is refining its long-range BOP forecast to help assess potential BOP pressures under different liberalization scenarios.*
- *The government is putting in place a new framework to facilitate analysis, decision-making and communication regarding liberalization.* This includes inter-governmental working groups and advisory bodies, as well as hiring external financial and legal advisors.
- *There is a preliminary agreement to restructure the FX-denominated bond owed by state-owned Landsbankinn, to the Old Landsbanki estate.* The agreement would reduce BOP pressures over the next several years by extending the bond's average duration and payment schedule, but is contingent on receiving a capital control exemption for FX payouts.
- *There is an active public debate about the circumstances under which assets of the old bank estates might be released from capital controls, including the possibility of a voluntary*

reduction in the size the domestic overhang. Two broad legal avenues are being discussed, one involving composition agreements that would provide an agreed roadmap for exit and the other involving bankruptcy proceedings (liquidation) with an uncertain exit from controls.

Policy Discussion

13. Staff and the authorities discussed general principles that could guide the capital control liberalization strategy. Staff encouraged a transparent, comprehensive strategy that addresses all potential outflows. The approach should be consistent with macroeconomic and financial stability, and conditioned on BOP prospects. Staff noted the importance of carefully considering the legal and reputational risks surrounding the strategy for addressing potential BOP pressures now locked in by capital controls, including the resolution of the old bank estates. Staff emphasized the benefits of a cooperative approach that would minimize risks to long-term growth, the prospects of which remain closely tied to economic and financial links with the rest of the world. In this context, staff welcomed the authorities' recent organizational changes and planned engagement of advisors, which could help facilitate a resolution. Consistent with past advice, staff noted that appropriate use of incentives could help encourage lasting solutions. The authorities generally agreed with these points. They noted the Landsbankinn bond restructuring could be a useful development, but needs to be assessed in the context of a more comprehensive plan. With respect to the old bank estates, they stressed they would move on to other approaches (e.g., bankruptcy proceedings (liquidation)) should a cooperative settlement not materialize.

14. Staff and the authorities agreed that the liberalization strategy should be anchored on a credible balance of payments analysis. Staff welcomed the CBI's ongoing BOP work and urged that it be the basis for discussion with key stakeholders. While acknowledging forecasting uncertainties, staff and the authorities agreed that a baseline BOP forecast is a useful starting point for considering options. Staff reiterated that a revised liberalization strategy should be paced to maintain adequate reserve coverage and that supporting debt management—including Eurobond issuances to maintain FX reserves as repurchases to the Fund take place—will be a necessary component. The government expressed concern with the higher debt and interest costs from such issuances. Staff emphasized the precautionary role of reserves and noted that public sector debt levels would not change.

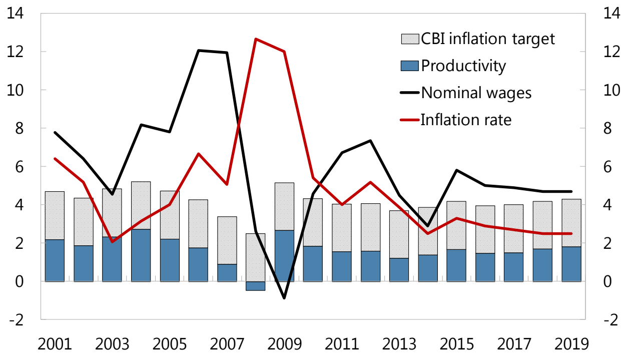
B. Monetary Policy: Containing Inflation and Reinforcing Credibility

The current monetary policy stance is appropriate. The CBI should stand ready to respond to possible inflation pressures stemming from domestic and external factors. Maintaining the CBI's financial health, independence, and accountability is key for policy credibility and anchoring inflation expectations.

Background

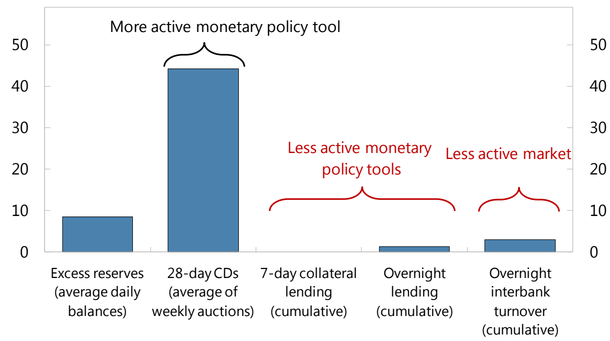
15. Inflation has dropped below the CBI's target this year, but inflationary pressures are expected to build into 2015. Some driving factors include the following: (i) rising wage pressures in 2015 in the context of a closing output gap, after modest hikes in 2014; (ii) a shift to an expansionary fiscal stance in 2015 if further fiscal measures are not taken; and (iii) a projected increase in traded goods prices next year that would reverse a key contributor to disinflation. This will take place in a context of still above-target medium- to long-term inflation expectations.

Wages and Labor Productivity
(Annual y/y percent change)



Sources: Central Bank of Iceland; and IMF staff estimates.

Monetary Operations and Interbank Market Activity
(Billions of ISK, April 2014)



Sources: Central bank of Iceland; and IMF staff calculations.

16. The CBI is adjusting its liquidity management strategy to address several challenges. Since 2010, the CBI has relied on weekly 28-day CD auctions to drain surplus liquidity and maintain the interbank overnight market rate close to the CBI's effective policy rate. An indicator of success is that key financial market borrowing rates have closely tracked the effective policy rate. However, interbank market turnover remains low. The CBI is now shifting towards shorter term deposits while limiting access to collateralized loans as part of an effort to encourage banks to more actively manage liquidity and to participate more frequently in the interbank market. The CBI views this as an important preparatory step as the CBI moves to sell legacy assets on its balance sheet (totaling around 15 percent of GDP) and in anticipation of possible liquidity shifts in the context of capital control liberalization (e.g., movement of old bank deposits).

17. The authorities have launched a review of the CBI's legislative framework and financing mechanism. A bill amending the CBI's capital and financing framework has been submitted to Parliament and is expected to be considered in the fall session. While the restructuring of the CBI's recapitalization bond will reduce the country's gross debt, the provision of a pool of callable, marketable bonds should ensure the CBI's continuing financial strength. The government also recently established a working group to review the legislative framework of the CBI and to consider means to enhance cooperation between the financial supervisor (FME) and the CBI.

Policy Discussion

18. Staff supported the central bank's monetary stance and liquidity management strategy. The recent real tightening in monetary conditions is appropriate given building inflationary pressures. Future nominal rate decisions should consider developments such as wage growth, the 2015 fiscal stance, and perceptions of CBI credibility. Staff supported the CBI's liquidity management efforts, and advised careful consideration to both monetary conditions and financial stability. Staff supported the CBI's ongoing efforts to smooth exchange rate volatility—which the authorities believe has helped dampen inflation expectations—and to take advantage of favorable BOP conditions to build up non-borrowed reserves. The CBI noted the challenge of communicating these reserve management goals to the public, particularly given a thin FX market.

19. Staff urged the authorities to maintain the financial health, independence, and accountability of the CBI. This will preserve policy credibility, help anchor longer term expectations, and facilitate economic stability and growth. The review of the CBI's legislative framework 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 authorities agreed, and noted broad consensus that the CBI's independence should be preserved and key reforms from 2009 maintained. Staff welcomed efforts to strengthen cooperation between the FME and CBI.

C. Fiscal policy: Completing the Adjustment

The government's fiscal objectives of a balanced budget and lower debt are appropriate. Achieving them will require specific, durable measures undertaken in the context of a medium-term fiscal plan. Firm implementation will help ease inflation pressures, lower borrowing costs, and rebuild fiscal buffers. The draft organic budget law now before Parliament will underpin these efforts. Contingency measures should be prepared to address fiscal risks.

Background

20. The authorities are strengthening the medium-term fiscal framework and objectives. A new medium-term policy statement is nearing completion. The key policy elements are to (i) maintain a general government overall balance; (ii) reduce net debt to 45 percent of GDP; and (iii) gradually reduce revenue- and expenditure-to-GDP ratios. A draft organic budget law has been submitted to Parliament that will help institutionalize the balanced budget and debt objectives, with adjustment mechanisms. This legislation would also establish a new system of fiscal rules, improve reporting, transparency and accountability—including establishment of a fiscal council and requirements for a medium-term statement of fiscal policies and annual updates.

21. The government will run a budget surplus in 2014, but under current policies a deficit will open up in 2015.

- *The government is projected to run a surplus of close to 2 percent of GDP this year.* While the budget envisages balance, higher tax revenues from strong consumption growth and unprogrammed dividend transfers of about 2 percent of GDP are contributing to a surplus. The structural adjustment over 2013 is projected to be about ½ percent of GDP.

- *Deficits are expected to open up in 2015–16, implying an expansionary fiscal stance.* The unwinding of wealth and energy taxes and small cuts in employer social security contributions will only be partially offset by gradual cuts in current expenditures and modification of the VAT. Combined with the unwinding of one-off developments, these policies will push government to deficits of ½ percent of GDP next year and 1.3 percent of GDP in 2016, before reversing course as planned expenditure cuts take over. However, there are downside risks from expenditure slippages, as seen in the past.

- *Recently approved HHDR will strengthen household balance sheets but poses fiscal risks.* The mortgage debt relief is composed of a budget expenditure component funded by an earmarked bank levy and a Pillar III component that allows tax-free draw downs of pension savings. The authorities are considering making the Pillar III debt relief mechanism permanent (or to allow its use for first time home purchases). Fiscal risks from HHDR stem from possible losses at the HFF from principal reductions and prepayments and possible legal challenges over the bank levy.

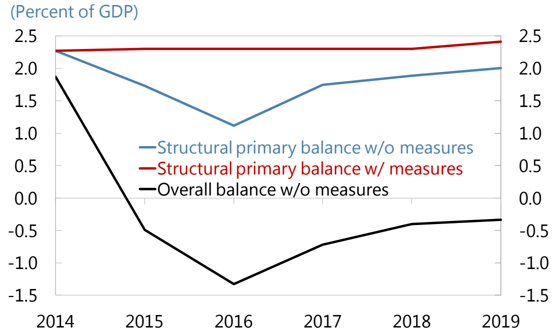
Policy Discussions

22. Staff expressed support for the authorities' fiscal objectives. The implied fiscal consolidation would ease inflationary pressures, bring down debt, lower the cost of borrowing, and rebuild fiscal buffers to address unexpected shocks. Staff welcomed submission of the draft organic budget law and urged support in Parliament. The authorities expressed hope that the organic budget law will be approved in the fall and that it would provide a strong fiscal framework and reduce risks of slippages.

23. These fiscal objectives are achievable if supported by specific, durable measures in the context of a medium-term fiscal plan.

- *Staff urged additional measures in the range of 1 to 1½ percent of GDP during 2015–16.* Measures could include spending restraint on subsidies, goods and services, and public sector wages. The authorities indicated there is strong political and social consensus for maintaining budget balance. They expect the 2015 budget to deliver this, which would ease pressure on the CBI and help 2015 wage negotiations. This could come from further expenditure restraint—including social benefits and shrinking some government offices.

Fiscal Adjustment
(Percent of GDP)



Source: IMF staff estimates.

Iceland: Potential Fiscal Measures

Measure	Yield (in percent of GDP)
Wage growth ≤ 3 percent	≤ 0.9
Subsidies kept at 2014 level	≤ 0.1
Goods & services growth ≤ inflation	≤ 0.5
Total	≤ 1.5

Source: IMF staff estimates.

- *Staff pointed out the need to create space for investment.* Government investment has been around 2 percent of GDP since the crisis—below the 4 percent of GDP historical average. The authorities noted that high levels of investment in the boom years provides some room for reduced spending levels now, but agreed on the importance of gradually freeing up budget space for investment. They hope to do this in part by selling government assets to lower debt and interest payments, and are exploring public-private partnerships.

- *Staff stressed that fiscal risk from HHDR need to be addressed.* The authorities agreed that potential losses at the HFF from debt relief pose risks to the budget, but argued that this should be addressed in the context of a more permanent solution for the HFF. They added that the debt relief program would be scaled back if funding is deficient. Staff noted that fiscal resources used for HHDR could have been better used for other priorities such as lowering debt, and advised against making the Pillar III-funded debt relief permanent—as future pension contributions should be preserved for their intended purpose. The authorities took note, and indicated interest in alternative means to facilitate long-term savings towards home purchases.

D. Financial Sector: Preparing for Capital Account Liberalization

The core financial system is stable, but supervisory oversight needs to be strengthened, capital and liquidity buffers maintained, and legacies addressed to reduce risks ahead of capital account liberalization. The proposed HFF resolution is a step in the right direction.

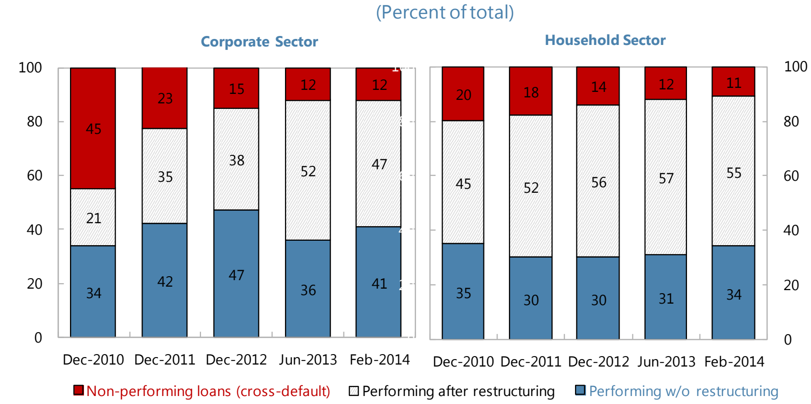
Background

24. The core financial sector is stable, but significant challenges remain. Bank balance sheets have improved on the back of progress in loan restructuring, falling NPLs, high capital adequacy ratios, and good liquidity indicators. However, earnings are coming under pressure as net interest margins are compressing, bank taxes are increased, and there is less room for further positive loan book revaluation. Banks have regained access to international capital markets and deposits are growing, but a prevailing part of funding is short term. The recent establishment of a Financial Stability Council (FSC) is expected to help enhance systemic risk oversight.

25. An orderly runoff of the struggling HFF has been proposed. The intergovernmental working group on housing finance proposed that the HFF be put in a runoff mode, which would entail a discontinuation of its lending activities. An asset quality review performed by the FME is underway.

26. The supervisory reform program is at risk. In 2011, the FME launched a comprehensive reform program focused on five key areas, including the supervisory framework, IT infrastructure, management structure, and human resource management. While some advances have been made, especially in the area of implementing the regular Supervisory Review and Evaluation Process, progress in other areas (i.e. setting industry rules for risk management and asset classification) has been slow and the continuation of some important internal projects (i.e. IT development) have been hindered by funding cuts (the FME's recently lost EU pre-accession funding). Calls for increased funding through industry fees have not been approved.

Loans to the Corporate and Household Sectors
(Percent of total)



Source: Central Bank of Iceland.

Policy Discussions

27. Staff called for prudent financial sector policies in the run-up to further capital account liberalization.

- *Staff and the authorities agreed that capital and liquidity buffers should be maintained, given the risks surrounding the easing of capital controls*. The authorities are taking steps to preserve buffers, including by limiting the distribution of dividends and more conservative liquidity rules. Staff and authorities agreed that banks should seek more term funding.

- *Staff recommended that the supervisory reform program be continued and prudential supervision strengthened*. Staff stressed that the FME should enhance internal procedures and industry rules for risk assessment, set stricter asset classification and provisioning rules, and invest more in staff training and systems development. To achieve this, the FME should have increased regulatory and corrective action powers and sufficient resources. The authorities recognized the FME's important role, but saw room for greater efficiency within the agency.

- *Staff advised that macro-prudential supervision and safety nets should be strengthened ahead of capital account liberalization*. Staff and the authorities agreed that a number of regulations (i.e., setting systemic buffers) should be enacted promptly. Staff welcomed plans to bring deposit guarantee legislation in line with EU directives and recommended good public communication in the process of moving to an explicit limited guarantee. Staff also advised that the deposit insurance fund (TIF) should be operationally strengthened. The FSC will become a useful platform for enhancing systemic risk oversight.

- *Staff welcomed the proposal to orderly resolve the HFF*. The HFF mandate during runoff should be confined to conducting an orderly dismantling at minimum fiscal costs. The authorities should estimate further losses based on, among others, the asset quality review now underway. Staff also recommended that the social mortgage lending objective be better targeted and state involvement be carefully delineated in line with this objective. The authorities took note and indicated that work is still pending on the objectives and mechanisms and the state's involvement and further proposals may be put forth in the fall.

POST-PROGRAM MONITORING

28. Iceland's reserve buffers are projected to be at adequate levels, but risks remain. The BOP outlook, which reflects IMF repayments in 2015–16, shows reserves above 100 percent of short-term debt, but falling over the medium term as capital controls are eased. Gross external debt is projected to decline. Risks arise mainly from the external environment and the uncertainty surrounding capital account liberalization. Strong macroeconomic and financial sector policy implementation would help mitigate these risks. A comprehensive approach to capital account liberalization that is conditioned on BOP prospects and enhances Iceland's close economic and financial links with the rest of the world will help safeguard external viability. Buttressing non-borrowed reserves through foreign exchange purchases will help support reserve buffers.

STAFF APPRAISAL

29. Iceland's economy is recovering well and the outlook is positive, but risks are tilted to the downside. Strong growth in 2013 looks set to be sustained over the medium term, with strong growth in tourism and recovering domestic demand. Inflation pressures can be contained if supporting policies are in place. Public and external debt ratios are on a downward path and the financial sector is stable. However, risks of slower trading partner growth could dampen exports and investment, and reduce growth. Global market volatility could increase Iceland's cost of borrowing and complicate the capital account liberalization process. A disorderly unwinding of capital controls could weaken the krona, lower reserves, and bring down market confidence and growth.

30. An updated strategy for capital account liberalization is needed. A deliberate, transparent, and comprehensive approach, anchored by BOP prospects and backed by sound macroeconomic and financial policies, will enhance prospects of success. Emphasis should be given to cooperative 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. The pace of liberalization should be calibrated on maintaining adequate reserve buffers and safeguarding macroeconomic and financial sector stability.

31. Monetary policy has been appropriate. The CBI should stand ready to respond to possible pressures from 2015 wage formation, the fiscal stance, the closing output gap, and the evolution of tradables prices. Maintaining a financially sound, independent, and accountable central bank is important for policy credibility and anchoring inflation expectations. The CBI should take advantage of favorable BOP conditions to build up non-borrowed FX reserves.

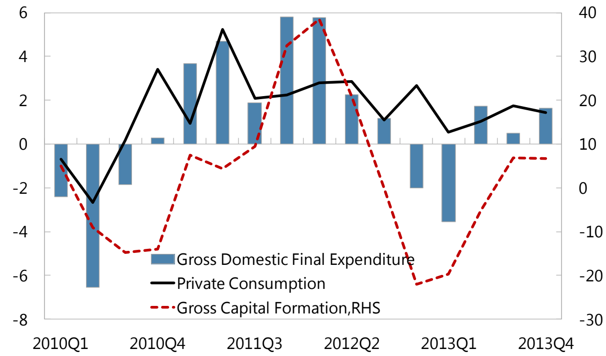
32. The government's medium-term fiscal objectives deserve support, but further effort is needed to achieve them. Achieving a balanced budget in 2015–16 will require specific and durable measures, placed in the context of a well-specified medium-term fiscal plan. Given downside risks and uncertainties—including from potentially higher losses at the HFF—additional contingency measures should be specified. The draft organic budget law now before Parliament would give the authorities a solid framework to formulate, implement, and assess their medium-term fiscal policies.

33. The core financial sector is stable, but steps are needed to strengthen supervision and prepare for the eventual easing of capital controls. Uncertainties surrounding the unwinding of crisis legacies demand that capital and liquidity buffers be maintained. Supervision needs to be reinforced, particularly enhancing internal procedures and industry rules for risk assessment and investing in staff training and systems development. The proposal to put the HFF on a runoff mode is welcome but implementation should be mindful of fiscal and financial stability risks. Agreement should be reached on social objectives of mortgage lending before any government-sponsored successor program is put in place.

Figure 1. Iceland: Recent Developments in Demand and Labor

Domestic demand growth slowed last year…

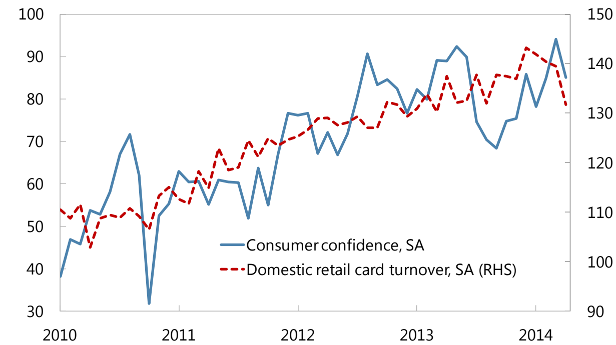
Domestic Demand Growth
(Percent, year-on-year)



Sources: Statistics Iceland; and Haver Analytics.

…on the back of weaker consumer spending.

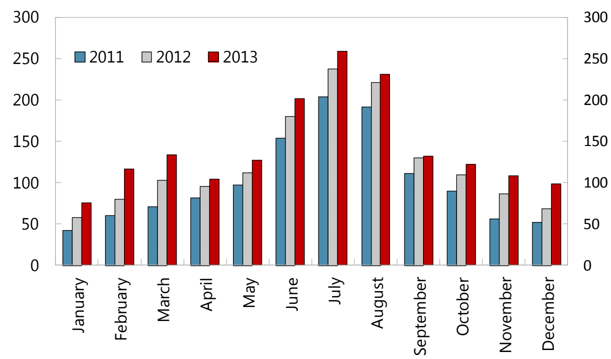
High Frequency Indicators
(Index, 2007=100)



Source: Statistics Iceland.

But a surge in tourism has boosted net exports…

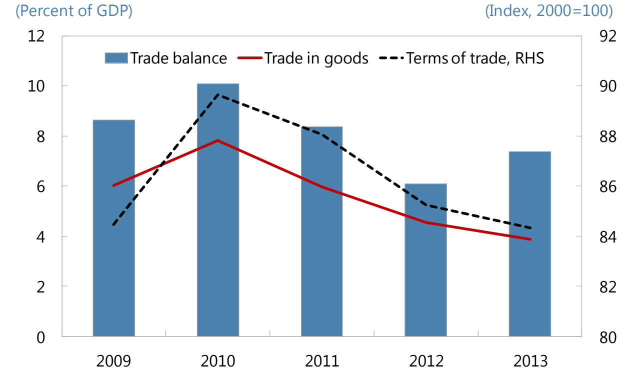
Overnight Stays of Foreigners in Hotels
(Thousands)



Source: Statistics Iceland.

…and raised the trade balance, despite weaker terms of trade.

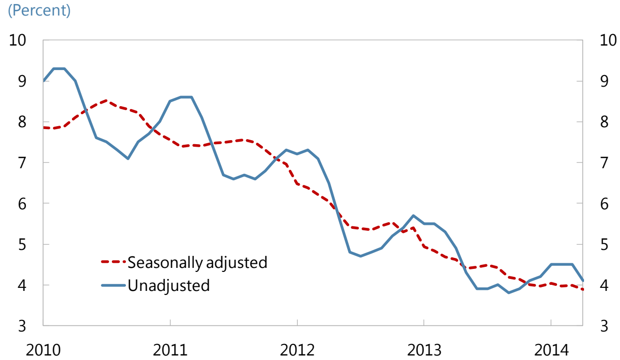
Trade Balance and Terms of Trade
(Percent of GDP) (Index, 2000=100)



Sources: Central Bank of Iceland; Haver Analytics; and Statistics Iceland.

The unemployment rate is trending down…

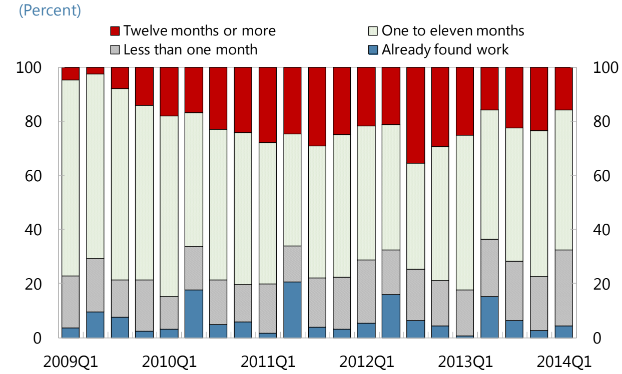
Unemployment Rate 1/
(Percent)



Sources: Department of Labor; and Haver Analytics.
1/ Based on registered unemployment.

…but long-term unemployment remains above pre-crisis levels.

Unemployment Duration
(Percent)

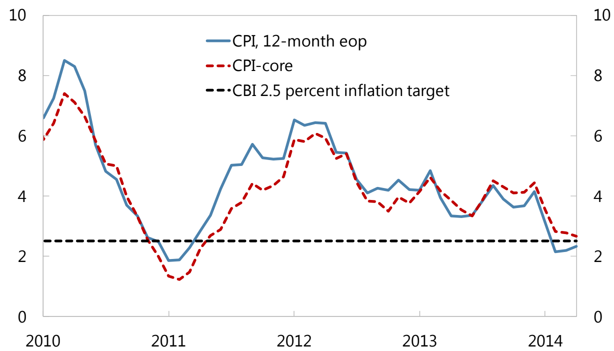


Source: Statistics Iceland Labor Market Survey.

Figure 2. Iceland: Price and Exchange Rate Developments

Headline inflation eased below the CBI's target…

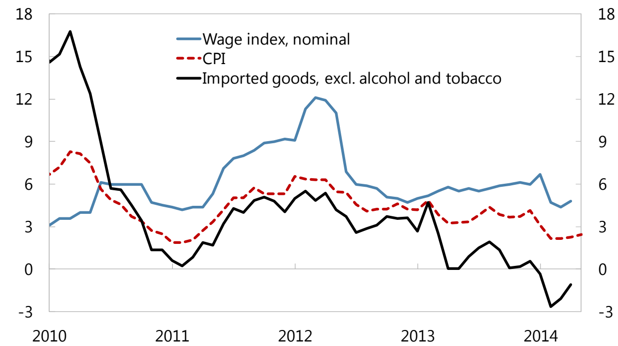
Inflation Rates
(Percent)



Sources: Central Bank of Iceland; and Statistics Iceland.

…helped by lower import prices and slower wage growth.

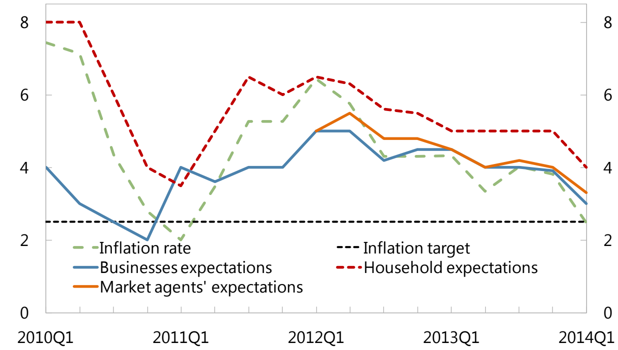
CPI, Wages, and Import Prices
(Percent, 12-month growth)



Source: Statistics Iceland.

Near-term inflation expectations are trending down…

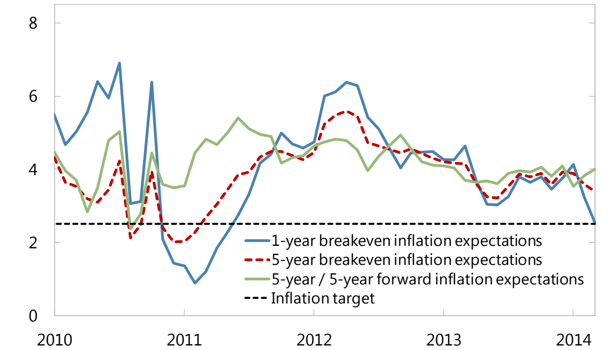
Inflation Expectations (Surveys) 1/
(Percent)



Source: Central Bank of Iceland.
1/Based on 12-month horizon.

…although longer-term expectations are mixed.

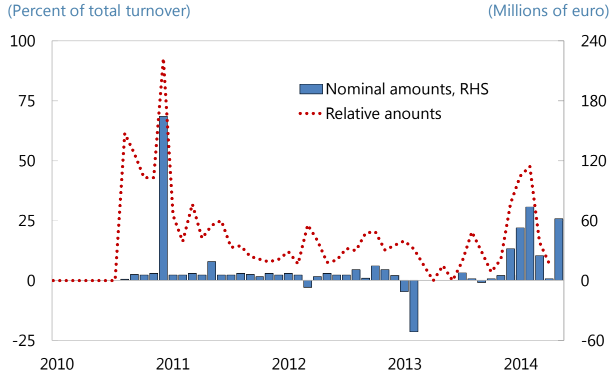
Inflation Expectations (Market-based)
(Percent)



Source: Central Bank of Iceland.

The CBI has been purchasing foreign currency…

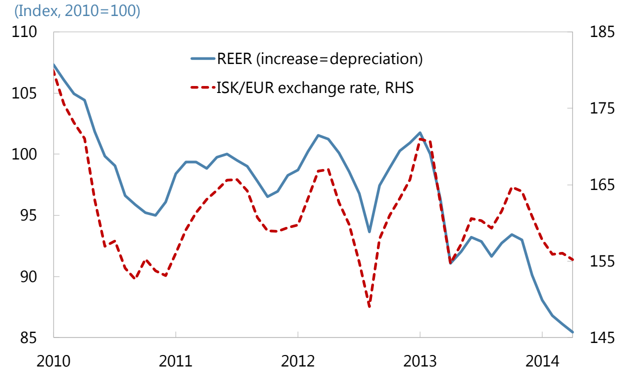
CBI Monthly Foreign Exchange Interventions
(Percent of total turnover) (Millions of euro)



Sources: Central Bank of Iceland; and IMF staff calculations.

…as the krona has appreciated.

Exchange Rates
(Index, 2010=100)



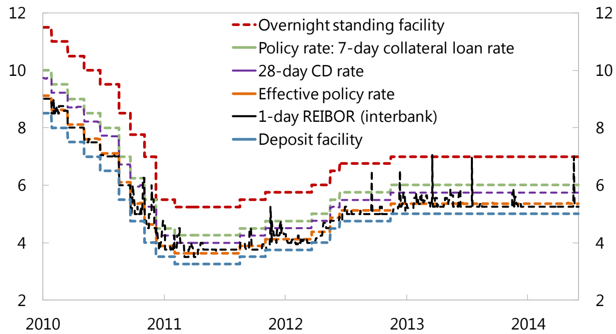
Sources: Central Bank of Iceland; IMF INS database; and Haver Analytics.

Figure 3. Iceland: Monetary Policy Developments

The central bank has kept policy rates unchanged…

Policy and Interbank Rates

(Percent)



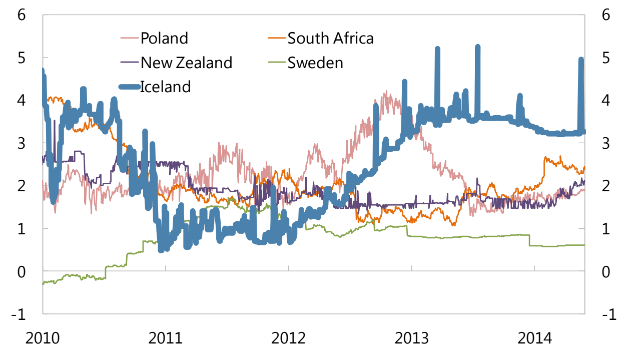
Source: Central Bank of Iceland.

1/ The effective policy rate is the average of the 28-day CD and deposit facility rates.

…and risk-adjusted nominal rates have stayed flat…

Risk-adjusted Policy Rates

(Percent)

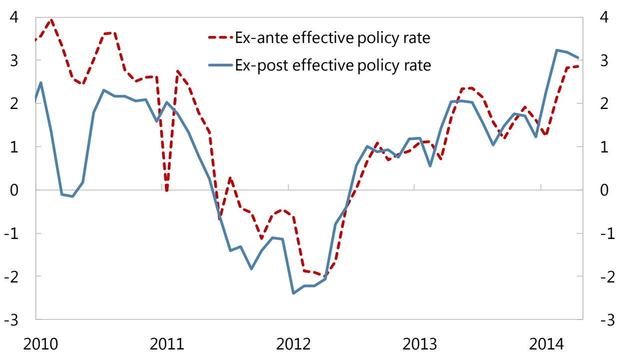


Sources: National Authorities; Thomson Reuters; and IMF staff calculations.

…while monetary policy has tightened in real terms.

Real CBI Policy Rates

(Percent)

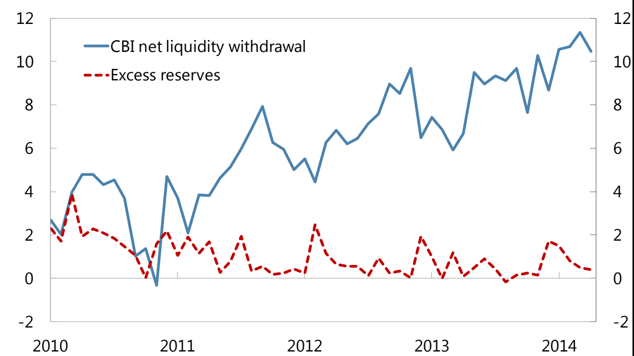


Sources: Central Bank of Iceland; and IMF staff calculations.

The CBI has mopped up excess liquidity …

CBI Liquidity Management and Excess Reserves

(In percent of domestic deposits)

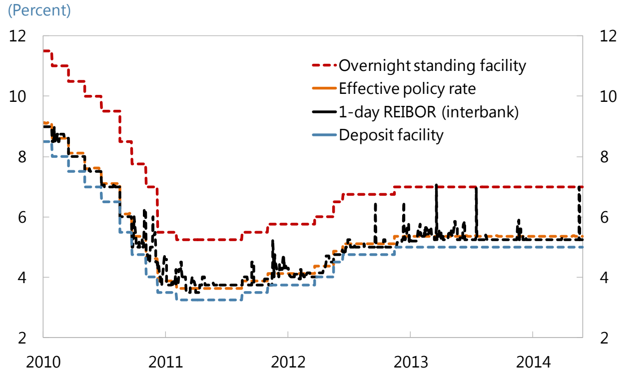


Sources: Central Bank of Iceland; Haver Analytics; and IMF staff calculations.

…keeping the overnight rate near the CBI's effective policy rate.

The Interest Rate Corridor

(Percent)

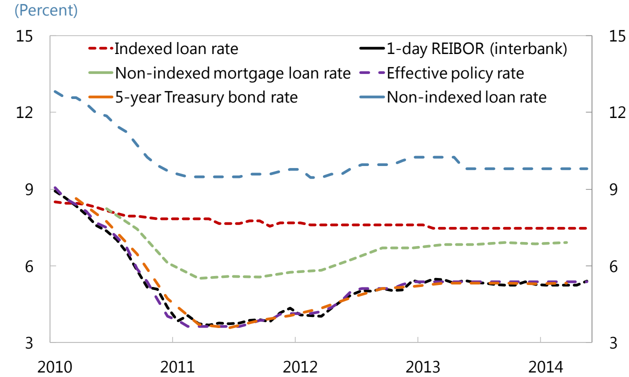


Source: Central Bank of Iceland.

Market rates have closely tracked the effective policy rate.

Market and Lending Rates

(Percent)

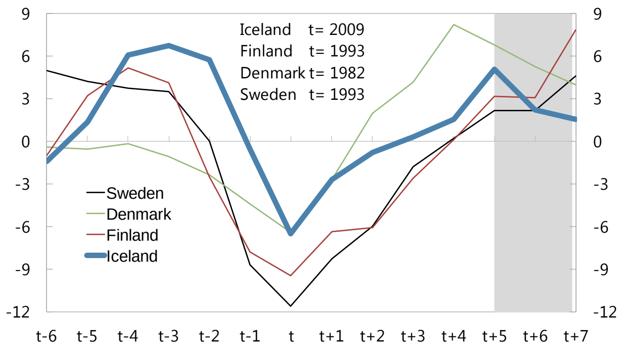


Sources: Central Bank of Iceland; Statistics Office of Iceland; and Haver Analytics.

Figure 4. Iceland: Fiscal Policy Developments and Outlook

Fiscal adjustment remains in line with the Nordics' experience...

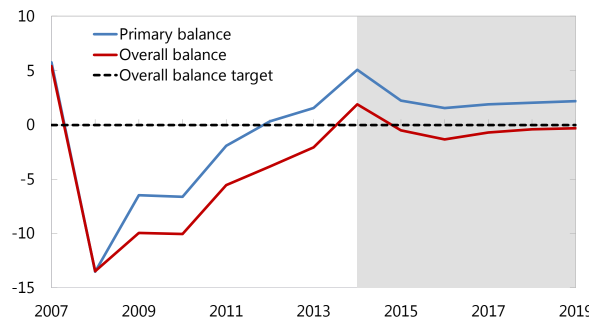
Primary Balances
(Percent of GDP, t=primary balances trough)



Source: IMF WEO; and IMF staff estimates.

...though the adjustment is expected to slow.

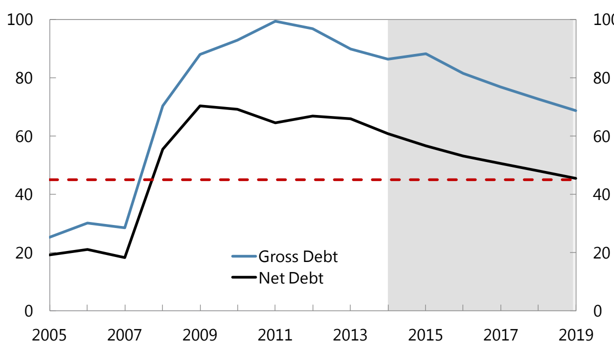
Primary and Overall Balances in Relation to the General Goverment Fiscal Target
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates (shaded area).

General government debt is on a declining path.

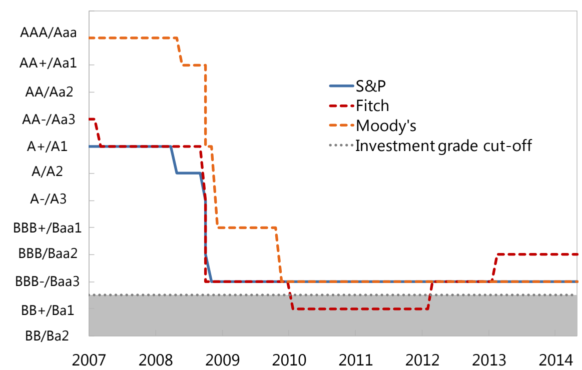
Gross and Net Debt
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates (shaded area).

Iceland has enjoyed rating upgrades....

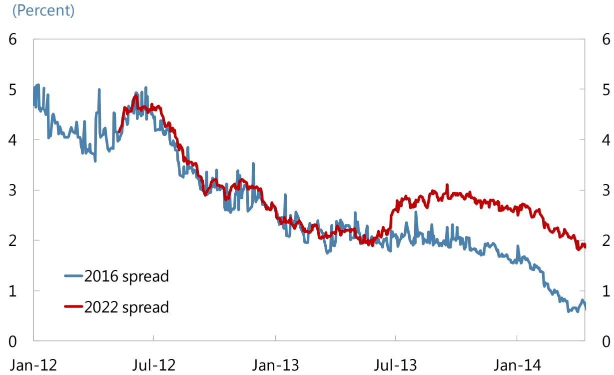
Long-Term Sovereign Credit Ratings



Source: Bloomberg.

...and falling sovereign spreads...

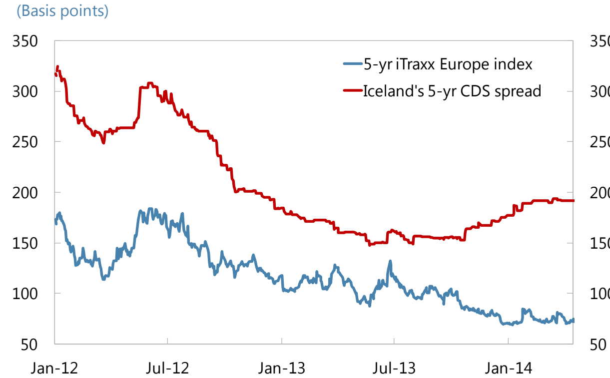
Spreads on Icelandic USD-bonds against US Treasuries
(Percent)



Source: Thompson Reuters.

...though CDS spreads have inched up.

Iceland's CDS spread and the iTraxx Europe Index
(Basis points)

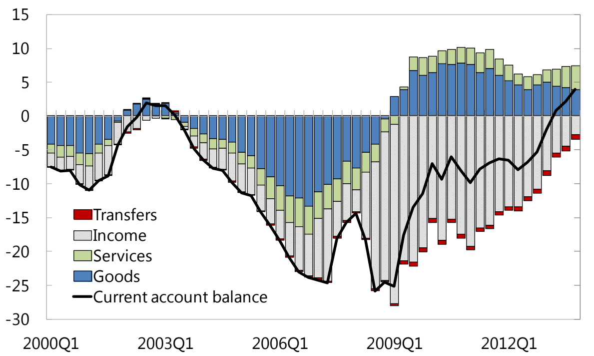


Source: Thompson Reuters.

Figure 5. Iceland: External Sector Developments and Outlook

Improving trade and income balances have supported the current account surplus…

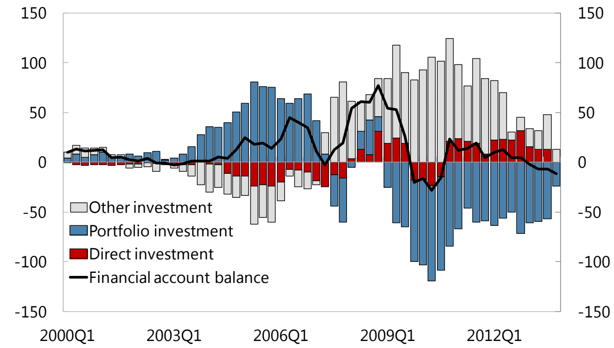
Current Account Balance
(Percent of GDP, 4-quarter rolling sum)



Sources: Central Bank of Iceland; and Haver Analytics.

…though the financial account has weakened, driven by deleveraging.

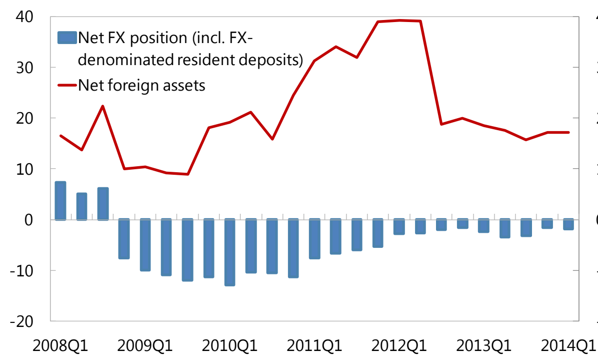
Financial Account Balance (Net Flows)
(Percent of GDP, 4-quarter rolling sum)



Sources: Central Bank of Iceland; and Haver Analytics.

The central bank's net FX position remains negative.

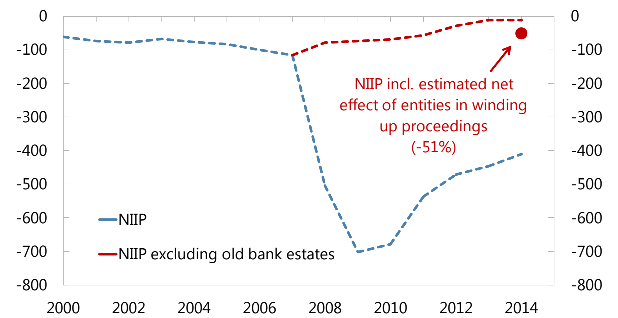
Central Bank Net Foreign Assets and Net FX position
(Percent of GDP)



Sources: Central Bank of Iceland; and IMF staff calculations.

The NIIP has improved but liabilities to the old bank creditors remain large…

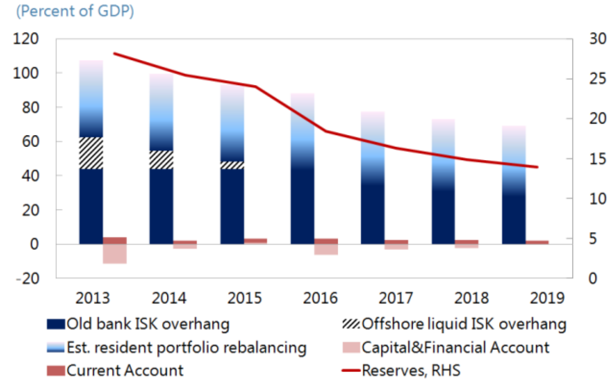
Net International Investment Position 1/
(Percent of GDP)



Sources: IMF's WEO & BoPS databases; Central Bank of Iceland; and Haver Analytics.
1/ See CBI Press Release 17/2014 for a discussion of NIIP definitions.

…putting potential pressure on the balance of payments.

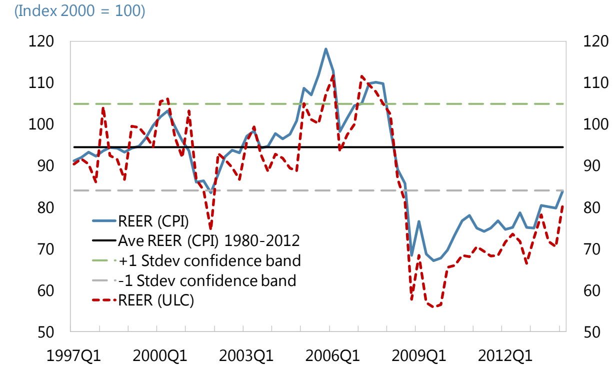
The Overhang Relative to the Balance of Payments
(Percent of GDP)



Source: IMF staff estimates.

The real effective exchange rate remains below the historical average.

Real Effective Exchange Rate
(Index 2000 = 100)

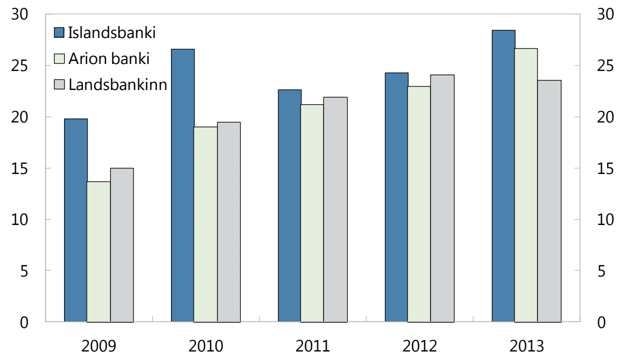


Source: Central Bank of Iceland.

Figure 6. Iceland: Banking Sector Developments

Capital buffers remain high...

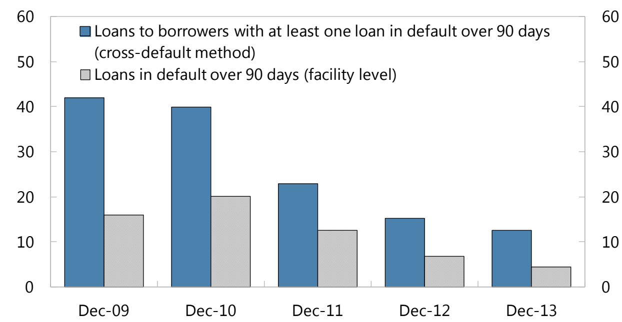
Capital Adequacy Ratios of Commercial Banks
(Percent)



Source: Central Bank of Iceland.

...and asset quality is improving.

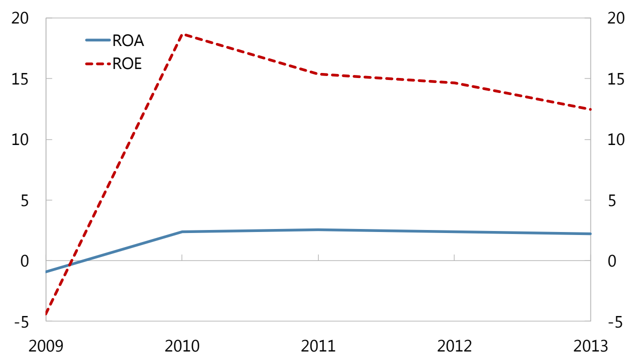
Default Ratio of the Three Largest Commercial Banks 1/
(Percent)



Sources: Financial Supervisory Authority; and Central Bank of Iceland.
1/ Parent companies; book value.

Banks are profitable...

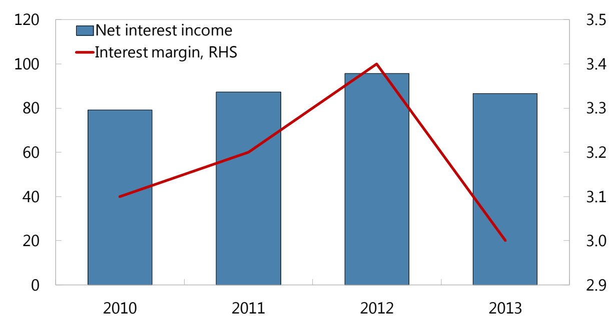
Profitability
(Percent)



Source: Cental Bank of Iceland.

...but interest margins are shrinking.

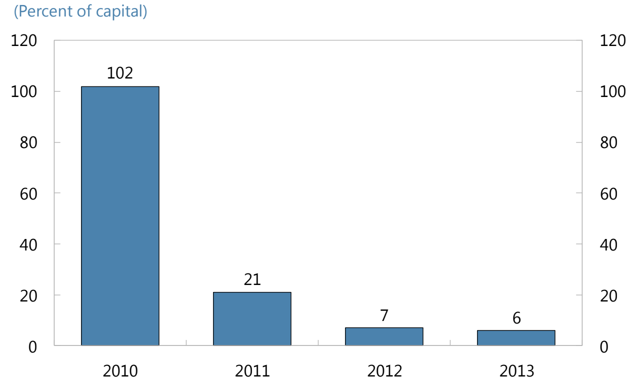
Three Largest Commercial Banks' Net Interest Income and Interest Margin
(Billions of ISK) (Percent of average total assets)



Source: Central Bank of Iceland.

Net open positions are favorable...

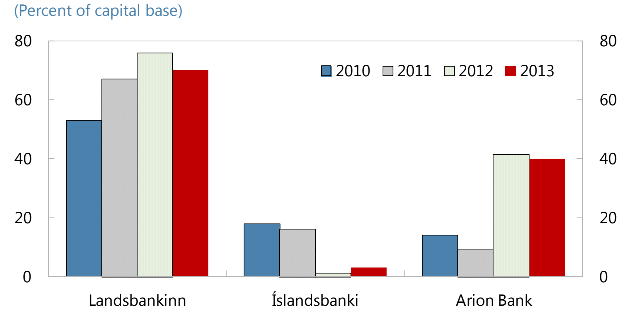
Foreign Exchange Net Balance
(Percent of capital)



Source: Central Bank of Iceland.

...but indexation imbalances remain large.

Indexation Imbalances of the Three Largest Commerical Banks 1/
(Percent of capital base)

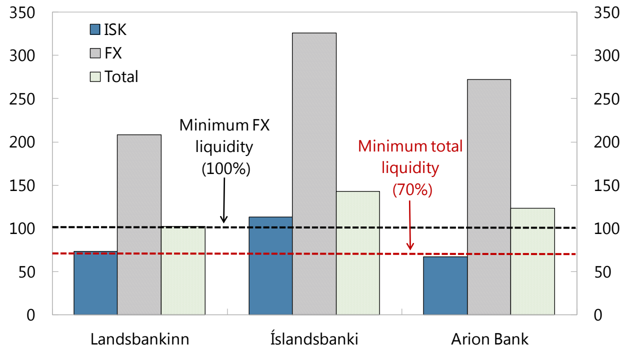


Source: Central Bank of Iceland.
1/ Indexation imbalance reflects the difference between CPI-indexed assets and liabilities.

Figure 7. Iceland: Financial Sector Developments

Banks are meeting the new liquidity requirements…

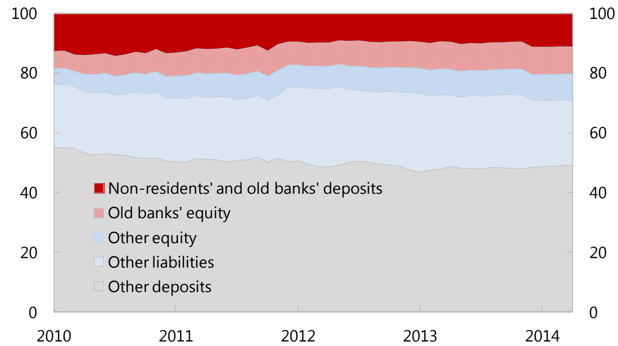
Liquidity Coverage Ratios, 2013
(Percent)



Source: Central Bank of Iceland.

…but funding continues to rely on captive deposits.

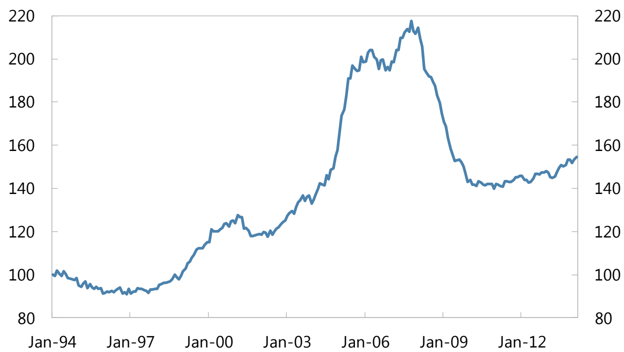
Banks Funding
(Percent of total)



Source: Central Bank of Iceland.

Asset prices are starting to pick up…

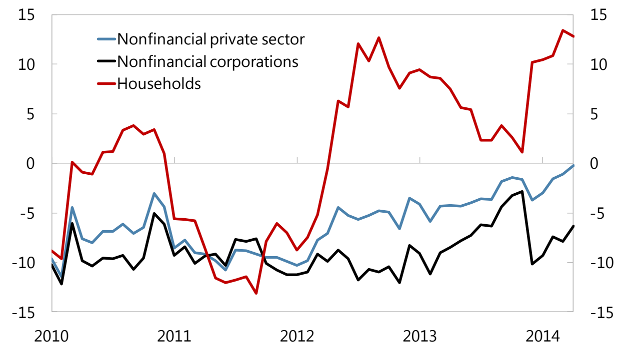
Real House Prices
(Index, January 1994=100)



Source: Central Bank of Iceland.

…even as overall real credit growth remains negative.

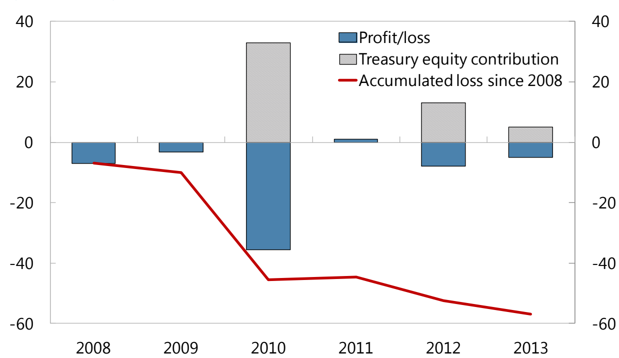
Real Credit Growth
(Adjusted for inflation; y/y percentage change)



Sources: Central Bank of Iceland; and IMF staff calculations.

The loss-making HFF requires ongoing budget support…

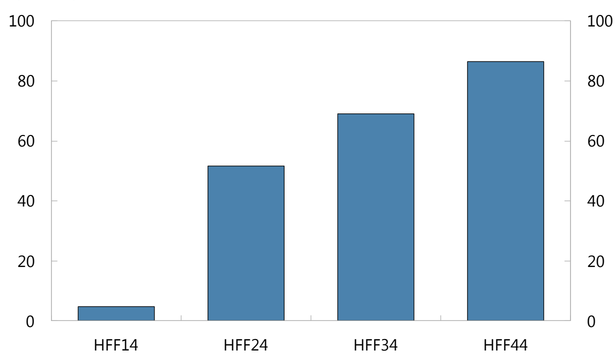
HFF Profit/Loss and Treasury Equity Contribution
(Billions of ISK)



Source: Central Bank of Iceland.

…while pension funds are exposed through their holdings of HFF bonds.

Pension Funds' Share of Outstanding HFF Bonds, 2013
(Percent)

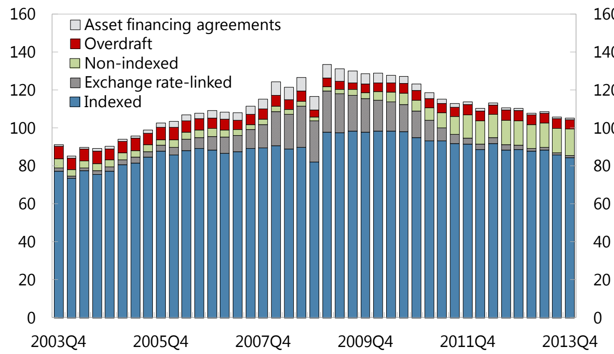


Source: Central Bank of Iceland.

Figure 8. Iceland: Private Sector Deleveraging

Household debt is declining…

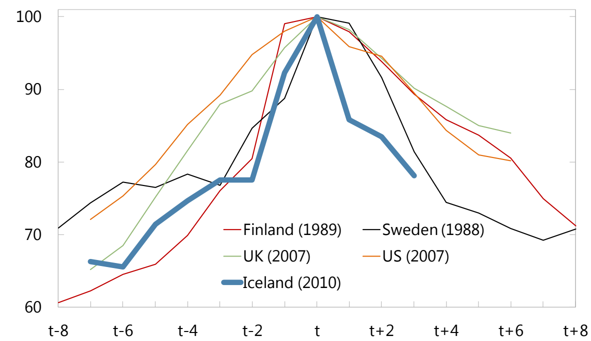
Household Debt
(Percent of GDP)



Sources: Central Bank of Iceland; Statistics Iceland.

…but further deleveraging is needed…

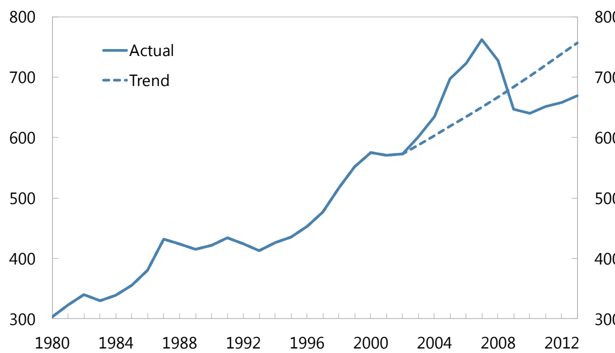
Normalized Household Debt
(Percent of disposable income)



Sources: IMF WEO; and Haver Analytics.

…before consumption rebounds further.

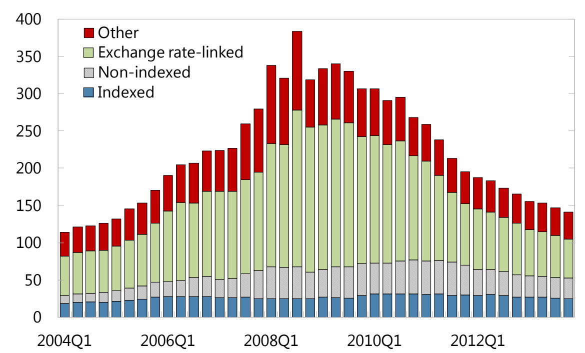
Real Private Consumption
(Billions of 2000 ISK)



Sources: IMF WEO; and IMF staff calculations.

Corporate debt has also declined…

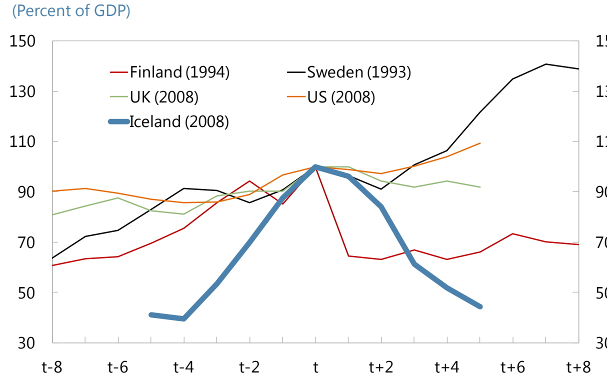
Corporate Debt
(Percent of GDP)



Sources: Central Bank of Iceland; and Statistics Iceland.

…progressing further compared to other countries…

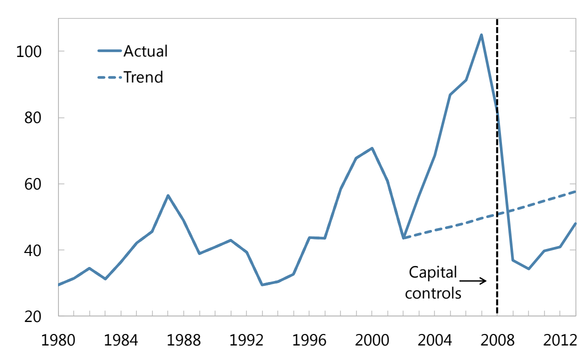
Normalized Corporate Debt
(Percent of GDP)



Sources: IMF WEO; and Haver Analytics.

…yet investment remains low.

Real Non-energy Intensive Investment
(Billions of 2000 ISK)



Sources: Central Bank of Iceland; and IMF staff calculations.

Table 1. Iceland: Selected Economic Indicators, 2008–15

	2008	2009	2010	2011	2012	2013 Prel.	2014 Proj.	2015 Proj.
	(Percentage change, unless otherwise indicated)							
National Accounts (constant prices)								
Gross domestic product	1.2	-6.6	-4.1	2.7	1.5	3.3	2.9	3.0
Total domestic demand	-8.6	-20.3	-2.2	3.3	1.8	0.5	4.2	3.9
Private consumption	-7.8	-15.0	0.1	2.6	2.4	1.2	3.5	3.2
Public consumption	4.6	-1.7	-3.4	-0.3	-1.4	1.3	1.8	1.5
Gross fixed investment	-20.4	-51.4	-9.4	14.1	5.5	-3.4	11.8	10.8
Exports of goods and services	7.0	7.0	0.5	3.8	3.8	5.3	2.7	4.0
Imports of goods and services	-18.4	-24.0	4.5	6.7	4.7	-0.1	5.4	5.3
Output gap 1/	2.2	-1.8	-4.6	-2.2	-1.9	-0.5	0.0	0.6
Selected Indicators								
Nominal GDP (billion ISK)	1,480	1,498	1,536	1,628	1,699	1,786	1,881	1,991
Unemployment rate 2/	1.6	8.0	8.1	7.4	5.8	4.4	4.0	3.5
Consumer price index	12.4	12.0	5.4	4.0	5.2	3.9	2.5	3.3
Nominal wage index	7.5	2.8	7.9	7.0	7.3	4.5	4.6	6.0
Real wage	-4.6	-8.2	2.4	2.9	2.1	0.6	2.0	2.6
Nominal effective exchange rate 3/	-40.4	-34.2	2.9	-0.1	-2.4	1.4	...	...
Real effective exchange rate 3/	-20.7	-18.7	6.4	0.9	0.6	3.7	...	...
Terms of trade	-9.3	-6.7	6.0	-1.8	-3.4	-2.4	0.6	1.0
Money and Credit								
Base Money	-31.5	1.3	-19.4	-20.7	32.0	0.3	5.3	5.9
Deposit money bank credit (end-period)	-43.7	-14.1	-1.2	6.9	0.7	1.4	2.5	3.0
Broad money (end-period)	32.1	-1.1	-9.9	8.7	-2.7	4.2	3.2	3.1
CBI policy rate (period average)	15.4	13.7	7.8	4.4	5.4	6.0	...	...
	(Percent of GDP, unless otherwise indicated)							
Public Finance								
General government 4/								
Revenue	44.1	41.0	41.5	41.8	43.6	44.2	48.7	46.0
Expenditure	57.7	51.0	51.6	47.4	47.4	46.3	46.9	46.5
Balance	-13.5	-9.9	-10.1	-5.6	-3.8	-2.1	1.9	-0.5
Primary balance	-13.5	-6.5	-6.6	-1.9	0.3	1.6	5.1	2.2
Balance of Payments								
Current account balance	-28.4	-11.6	-8.0	-6.3	-5.3	3.9	2.1	2.3
Trade balance	-2.3	8.6	10.1	8.4	6.1	7.4	6.2	6.1
Financial and capital account	-66.9	-29.9	54.1	19.7	18.5	-11.3	-2.8	1.0
Net errors and omissions	-19.5	36.2	-55.8	-36.5	-25.0	7.7	0.0	0.0
Gross external debt 5/	564.7	269.7	293.6	258.8	246.3	247.2	220.9	211.3
Central bank reserves (US$ billion)	3.6	3.6	5.8	8.5	4.2	4.2	4.1	4.1

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and IMF staff estimates.

1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ A positive (negative) sign indicates an appreciation (depreciation).
4/ National accounts basis.
5/ Including face value of old banks debt before 2009.

Table 2. Iceland: Money and Banking, 2008–15
(Billion of Krona, unless otherwise indicated)

	2008	2009	2010	2011	2012	2013	2014 Proj.	2015 Proj.
Central Bank								
Net foreign assets 1/	-122	-177	-177	-89	-28	-30	-30	-30
Assets	429	485	666	1,047	540	488	475	476
Liabilities	551	662	844	1,136	568	518	504	506
Net domestic assets	237	293	271	163	126	129	134	140
Net claims on the public sector	39	-52	28	47	43	89	4	-146
Net claims excluding recap bond	-231	-218	-142	-145	-142	-90	-141	-291
Recapitalization bond	270	165	171	192	185	180	145	145
Net claims on banks 2/	282	-17	-19	-66	-83	-73	-153	-179
Others Items, net	-84	362	262	182	166	113	283	465
Base Money 3/	115	117	94	74	98	99	104	110
Currency issued	20	26	35	39	41	42	42	42
DMB deposits at the central bank	95	91	59	35	57	57	62	68
Banking System								
Net foreign assets	-101	-24	74	202	255	304	355	407
Net domestic assets	1,707	1,607	1,341	1,334	1,236	1,250	1,250	1,250
Net claims on the central bank	-152	120	76	121	147	184	215	247
Credit to private sector	2,133	1,832	1,809	1,934	1,948	1,976	2,025	2,086
Credit to government	62	269	259	240	233	227	227	227
Other items, net	-335	-613	-803	-961	-1,092	-1,137	-1,218	-1,310
Domestic deposits	1,606	1,583	1,414	1,536	1,491	1,554	1,605	1,657
Local currency	1,473	1,464	1,327	1,462	1,391	1,428	1,453	1,479
Foreign currency	133	119	87	74	100	126	152	178
Consolidated Financial System								
Net foreign assets	-223	-201	-104	113	227	274	326	377
Net domestic assets	1,849	1,810	1,553	1,462	1,305	1,321	1,321	1,321
Net claims on the public sector	100	217	287	287	276	316	231	81
Net credit to private sector	2,133	1,832	1,809	1,934	1,948	1,976	2,025	2,086
Other, net	-384	-239	-543	-759	-919	-971	-935	-845
Broad Money (M3)	1,626	1,609	1,449	1,575	1,532	1,596	1,647	1,698
Memorandum items:								
Base money (y-o-y percentage change)	-31.5	1.3	-19.4	-20.7	32.0	0.3	5.3	5.9
Broad money (y-o-y percentage change)	32.1	-1.1	-9.9	8.7	-2.7	4.2	3.2	3.1
Credit to private sector	-43.7	-14.1	-1.2	6.9	0.7	1.4	2.5	3.0
Money velocity (GDP/base money)	12.9	12.9	16.4	21.9	17.3	18.1	18.1	18.1
Broad money velocity (GDP/M3)	0.9	0.9	1.1	1.0	1.1	1.1	1.1	1.2
Multiplier (M3 / base money)	14.1	13.8	15.4	21.1	15.6	16.2	15.9	15.4

Sources: Central Bank of Iceland; and Fund staff estimates.

1/ Foreign liabilities include fx deposits of domestic banks and the government.

2/ Net claims on banks is the difference between CBI's lending to banks and banks' holding of certificates of deposits.

3/ Base money includes currency in circulation (ex cash in vault) and DMBs deposits at the central bank in krona.

Table 3. Iceland: Medium-Term Projections, 2011–19

	2011	2012	2013 Prel.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.	2018 Proj.	2019 Proj.
				(Percentage change)					
Real economy									
Real GDP	2.7	1.5	3.3	2.9	3.0	2.7	2.9	3.3	3.0
Real domestic demand	3.3	1.8	0.5	4.2	3.9	3.2	4.2	4.8	4.5
Private consumption	2.6	2.4	1.2	3.5	3.2	2.9	3.8	4.1	4.4
Public consumption	-0.3	-1.4	1.3	1.8	1.5	1.9	1.8	2.5	2.9
Gross fixed investment	14.1	5.5	-3.4	11.8	10.8	6.1	9.2	10.1	6.7
Net exports 1/	-0.5	0.1	2.6	-0.6	0.1	0.0	-0.4	-0.7	-0.9
Exports of goods and services	3.8	3.8	5.3	2.7	4.0	3.3	3.7	3.7	3.1
Imports of goods and services	6.7	4.7	-0.1	5.4	5.3	4.4	5.9	6.5	6.1
Output gap 2/	-2.2	-1.9	-0.5	0.0	0.6	0.4	0.0	0.0	0.0
Potential output	0.2	1.2	1.9	2.4	2.4	3.0	3.3	3.3	3.0
Unemployment rate 3/	7.4	5.8	4.4	4.0	3.5	3.7	4.0	4.0	4.0
Real wages	2.9	2.1	0.6	2.0	2.6	2.3	2.1	2.1	2.1
CPI inflation	4.0	5.2	3.9	2.5	3.3	2.9	2.7	2.5	2.5
CPI inflation (excl. effect of ind. taxes)	3.8	5.0	3.7	2.2	3.1	2.9	2.7	2.5	2.5
Nominal ISK/EUR exchange rate	161.0	160.5	161.8	…	…	…	…	…	…
Nominal ISK/USD exchange rate	116.0	125.1	122.2	…	…	…	…	…	…
Real exchange rate (+ appreciation)	0.9	0.6	3.6	2.0	3.0	-1.0	0.0	2.5	3.0
Terms of trade	-1.8	-3.4	-2.4	0.6	1.0	1.4	1.8	2.5	3.1
Nominal GDP (billion ISK)	1,628	1,699	1,786	1,881	1,991	2,118	2,273	2,430	2,593
				(Percent of GDP, unless otherwise indicated)					
Balance of Payments									
Current account	-6.3	-5.3	3.9	2.1	2.3	3.4	2.6	2.3	2.1
Underlying current account 4/	3.2	2.8	4.6	2.1	2.3	3.4	2.6	2.3	2.1
Trade balance	8.4	6.1	7.4	6.2	6.1	6.3	6.1	5.8	5.7
Net income balance 5/	-14.2	-10.8	-2.8	-3.5	-3.2	-3.0	-2.9	-3.0	-3.1
Capital and financial account	19.7	18.5	-11.3	-2.8	1.0	-6.3	-3.2	-2.2	-0.4
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Direct investment, net	7.7	31.1	-0.3	1.9	2.1	2.2	2.1	3.3	3.5
Portfolio investment, net	-1.2	5.0	-7.1	-1.9	2.2	-1.5	-1.8	-2.2	-0.4
Other investment, net	13.3	-17.6	-3.9	-2.8	-3.3	-7.0	-3.4	-3.4	-3.5
Accumulation of arrears	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary financing	14.7	-20.1	0.0	0.0	-3.2	-1.4	-0.2	0.0	-1.7
Gross external debt 6/	258.8	260.2	264.2	239.3	228.5	206.9	183.2	165.8	153.0
Central bank reserves (US$ billion)	8.5	4.2	4.2	4.1	4.1	3.3	3.2	3.2	3.2
General government accounts									
Revenue	41.8	43.6	44.2	48.7	46.0	45.0	44.8	43.7	43.6
Expenditure	47.4	47.4	46.3	46.9	46.5	46.4	45.5	44.1	43.9
Overall balance	-5.6	-3.8	-2.1	1.9	-0.5	-1.3	-0.7	-0.4	-0.3
Primary balance	-1.9	0.3	1.6	5.1	2.2	1.6	1.9	2.0	2.2
Gross debt	99.3	96.9	89.9	86.4	88.2	81.4	76.9	72.7	68.7
Net debt	64.4	66.8	65.8	60.9	56.5	53.1	50.5	48.0	45.6

Sources: CBI; and IMF staff estimates.

1/ Contributions to growth.
2/ In percent of potential output.
3/ In percent of labor force.
4/ Excludes old banks transactions and accrued interest payments on intra-company debt held by a large multinational.
5/ Includes interest payments due from the financial sector and income receipts to the financial sector.
6/ Excludes old banks' total liabilities, but includes TIF's deposit liabilities, and accumulated recovered assets from both external and domestic sources before being paid out to foreign creditors. Once recovered, these assets are recorded as short-term debt.

Table 4. Iceland: Balance of Payments, 2011–19

(U.S. dollar billions)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
			Prel.	Proj.	Proj	Proj	Proj	Proj	Proj
Current Account	-0.9	-0.7	0.6	0.3	0.4	0.6	0.5	0.5	0.5
Trade Balance	1.2	0.8	1.1	1.0	1.0	1.1	1.2	1.3	1.3
Balance on Goods	0.8	0.6	0.6	0.2	0.2	0.3	0.2	0.2	0.2
Merchandise exports f.o.b.	5.3	5.1	5.0	5.0	5.4	5.7	6.1	6.6	6.7
Merchandise imports f.o.b.	-4.5	-4.4	-4.4	-4.8	-5.2	-5.4	-5.9	-6.4	-6.6
Balance on Services	0.3	0.2	0.5	0.8	0.8	0.9	1.0	1.0	1.2
Exports of services, total	2.9	3.0	3.4	3.8	4.2	4.4	4.8	5.2	5.4
Imports of services, total	-2.6	-2.8	-2.9	-3.1	-3.4	-3.6	-3.9	-4.1	-4.2
Balance on Income 1/	-2.0	-1.5	-0.4	-0.6	-0.5	-0.6	-0.6	-0.6	-0.7
Receipts	1.2	0.7	0.8	0.8	0.8	0.9	0.9	0.9	0.9
of which dividends and reinvested earnings	1.0	0.5	0.6	0.6	0.6	0.6	0.6	0.7	0.7
of which interest receipts	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Expenditures	-3.2	-2.2	-1.2	-1.4	-1.4	-1.4	-1.5	-1.6	-1.7
of which dividends and reinvested earnings	-1.0	-0.8	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
of which interest payments	-2.2	-1.4	-1.0	-1.0	-1.0	-1.0	-1.0	-1.1	-1.2
Current transfer, net	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	-0.1	-0.1
Capital and Financial Account	2.8	2.5	-1.6	-0.4	0.2	-1.1	-0.6	-0.5	-0.1
Capital transfer, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial Account	2.8	2.5	-1.6	-0.4	0.2	-1.1	-0.6	-0.5	-0.1
Direct investment, net	1.1	4.2	0.0	0.3	0.4	0.4	0.4	0.7	0.8
Portfolio investment, net	-0.2	0.7	-1.0	-0.3	0.4	-0.3	-0.4	-0.5	-0.1
Assets	-0.9	-0.6	-1.3	0.0	-0.1	-0.1	-0.3	-0.3	-0.3
Liabilities	0.7	1.3	0.2	-0.3	0.4	-0.2	-0.1	-0.2	0.2
Net borrowing	0.7	1.3	0.3	-0.3	0.4	-0.2	-0.1	-0.2	0.2
Equities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment, net 2/	1.9	-2.4	-0.6	-0.5	-0.6	-1.3	-0.7	-0.7	-0.8
Assets 3/	4.2	-2.0	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities 4/	-2.4	-0.4	-1.0	-0.5	-0.6	-1.3	-0.7	-0.8	-0.8
Net Errors and Omissions	-5.1	-3.4	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Overall Balance	-3.2	-1.6	0.0	-0.1	0.6	-0.5	-0.1	0.0	0.4
Overall Financing	3.2	1.6	0.0	0.1	-0.6	0.5	0.1	0.0	-0.4
Change in gross reserves ("-" = increase)	1.2	4.3	0.0	0.1	0.0	0.8	0.1	0.0	0.0
Accumulation of arrears ("-" = paydown)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Extraordinary Financing 4/	2.1	-2.7	0.0	0.0	-0.5	-0.3	0.0	0.0	-0.4
Fund ("+" = net disbursement)	0.9	-1.4	0.0	0.0	-0.5	-0.3	0.0	0.0	0.0
Bilateral (earmarked/ non-cash)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other identified new financing	1.2	-1.4	0.0	0.0	0.0	0.0	0.0	0.0	-0.4
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross reserves (eop)	8.5	4.2	4.2	4.1	4.1	3.3	3.2	3.2	3.2
Gross reserves (eop) excluding old bank deposits	5.8	4.1	4.1	4.1	4.1	3.3	3.2	3.2	3.2
Memo									
GDP $ bln	14.0	13.6	14.6	16.2	17.2	18.2	19.7	21.7	23.2
Underlying balance of income 5/	-0.7	-0.4	-0.3	-0.6	-0.5	-0.6	-0.6	-0.6	-0.7
Underlying current account balance 5/	0.4	0.4	0.7	0.3	0.4	0.6	0.5	0.5	0.5
Gross reserves (months of imports of G&S)	14.2	6.9	6.5	5.8	5.5	4.1	3.7	3.6	3.4
Gross reserves/S-T debt (residual basis, in percent) 6/	97.1	115.9	88.0	119.6	111.7	155.9	145.5	115.6	104.1
Gross reserves (in percent of GDP)	60.8	30.9	29.0	25.5	24.0	18.4	16.3	14.9	14.0

Sources: CBI; and IMF staff estimates.

1/ Actual data include old banks' incomes but projections do not. Old bank interest payments are treated as an increase in the value of old banks' assets.

2/ Projections assume that external payments to old bank creditors against domestic claims begin in 2017.

3/ Projections exclude flows related to old banks FX assets, as they are assumed to be BOP-neutral.

4/ Debt service payments on Fund repurchases and Nordic loans appear under extraordinary financing.

5/ Excludes old banks transactions and accrued interest payments on intra-company debt held by a large multinational.

6/ Reserves and short-term debt exclude old bank-related stocks.

Table 5. Iceland: General Government Operations, 2011–19

(GFS, modified cash, percent of GDP 1/)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
			Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue	**41.8**	**43.6**	**44.2**	**48.7**	**46.0**	**45.0**	**44.8**	**43.7**	**43.6**
Taxes	**31.8**	**32.9**	**33.3**	**35.7**	**35.1**	**34.2**	**34.0**	**33.0**	**32.9**
Taxes on income and profits	16.4	16.7	17.2	17.6	17.6	17.6	17.6	17.6	17.6
Personal income tax	13.5	13.9	14.2	14.0	14.0	14.0	14.0	14.0	14.0
Corporate income tax	1.8	1.7	2.3	2.5	2.5	2.5	2.5	2.5	2.5
Capital gains tax, rental income	1.0	1.0	0.7	1.1	1.1	1.1	1.1	1.1	1.1
Taxes on payroll and workforce	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Taxes on property	2.3	2.5	2.5	2.8	2.2	2.1	2.1	2.1	2.0
Taxes on goods and services	12.1	12.5	12.4	12.3	12.5	12.3	12.3	12.3	12.3
VAT	8.0	8.0	8.4	8.5	8.5	8.5	8.5	8.5	8.5
Other taxes on goods and services	4.0	4.5	4.0	3.9	4.0	3.9	3.9	3.8	3.8
Taxes on international trade	0.4	0.5	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Other taxes	0.4	0.5	0.6	2.4	2.2	1.6	1.4	0.4	0.4
Social contributions	**4.1**	**3.8**	**3.8**	**3.9**	**3.8**	**3.8**	**3.8**	**3.7**	**3.7**
Grants	**0.2**	**0.2**	**0.2**	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Other revenue	**5.7**	**6.6**	**6.9**	**9.0**	**6.9**	**6.8**	**6.8**	**6.8**	**6.8**
Property income	2.1	2.8	3.1	5.3	3.1	3.1	3.1	3.1	3.0
o/w Interest income	1.5	1.5	1.6	1.3	1.7	1.7	1.7	1.6	1.6
Total expenditure	**47.4**	**47.4**	**46.3**	**46.9**	**46.5**	**46.4**	**45.5**	**44.1**	**43.9**
Current expense	**47.7**	**47.6**	**46.2**	**46.8**	**46.4**	**46.3**	**45.5**	**44.1**	**43.9**
Compensation of employees	14.5	14.8	14.9	14.9	14.9	14.8	14.5	14.3	14.1
Use of goods and services	11.8	11.8	11.8	11.8	11.6	11.4	11.2	11.0	11.0
Consumption of fixed capital	2.2	2.2	2.1	2.1	2.2	2.2	2.2	2.2	2.2
Interest	5.2	5.6	5.3	4.5	4.4	4.6	4.3	4.1	4.1
Subsidies	1.8	1.8	1.8	1.8	1.6	1.6	1.6	1.6	1.6
Grants	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social benefits	8.5	8.0	7.4	7.7	7.6	7.7	7.7	7.7	7.7
Other expense	3.6	3.2	2.5	3.7	3.9	3.9	3.9	3.0	3.0
Nonfinancial assets	**-0.3**	**-0.1**	**0.1**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Nonfinancial assets, acquisition	1.8	2.0	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Consumption of fixed capital (-)	-2.2	-2.2	-2.1	-2.1	-2.2	-2.2	-2.2	-2.2	-2.2
Net lending/borrowing 2/	**-5.6**	**-3.8**	**-2.1**	**1.9**	**-0.5**	**-1.3**	**-0.7**	**-0.4**	**-0.3**
Financial assets, transactions	**4.0**	**-4.4**	**-2.6**	**2.9**	**6.1**	**-2.8**	**0.3**	**0.3**	**0.3**
Currency and deposits	11.8	-4.5	-4.6	2.7	7.5	-1.4	0.0	0.0	0.0
Securities other than shares	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	-6.4	0.4	0.7	0.2	0.3	0.3	0.3	0.3	0.3
Shares and other equities	0.1	0.3	0.3	0.0	-1.8	-1.7	0.0	0.0	0.0
Other accounts receivable	-1.4	-0.6	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, transactions	**9.6**	**-0.5**	**-0.5**	**1.0**	**6.6**	**-1.4**	**1.0**	**0.7**	**0.6**
Securities other than shares	3.8	2.6	1.5	-3.1	-1.8	0.3	0.6	0.3	0.3
Loans	5.6	-3.5	-3.8	4.1	8.4	-1.8	0.4	0.4	0.4
Domestic loans	0.7	-0.6	-1.2	0.3	0.4	0.4	0.4	0.4	0.4
Foreign loans	4.9	-2.9	-2.6	3.8	8.0	-2.2	0.0	0.0	0.0
Insurance technical reserves	0.3	0.3	1.3	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	0.0	0.1	0.4	0.0	0.0	0.0	0.0	0.0	0.0
Stock of debt									
General government gross debt	99.3	96.9	89.9	86.4	88.2	81.4	76.9	72.7	68.7
Domestic	71.1	70.9	68.0	61.9	57.0	54.4	51.7	49.0	46.6
Foreign currency 3/	28.2	26.0	21.8	24.5	31.1	27.1	25.2	23.6	22.1
Of which:									
Bilateral loans to support CBI reserves	13.5	6.3	5.6	5.2	4.8	4.6	4.3	3.8	2.4
Other	16.3	21.1	18.7	22.2	31.1	29.4	28.5	26.2	25.5
General government net debt 4/	64.4	66.8	65.8	60.9	56.5	53.1	50.5	48.0	45.6
Structural Balances									
Structural balance	-3.8	-2.1	-1.9	-0.9	-1.0	-1.8	-0.9	-0.5	-0.5
Structural primary balance	-0.1	2.1	1.8	2.3	1.7	1.1	1.7	1.9	2.0
Memo Items									
Nominal GDP (billion ISK)	1628	1699	1786	1881	1991	2118	2273	2430	2593
Primary revenue	40.3	42.1	42.5	47.4	44.2	43.3	43.1	42.0	41.9
Primary expenditure	42.2	41.8	41.0	42.3	42.0	41.8	41.2	40.0	39.8
Primary balance	-1.9	0.3	1.6	5.1	2.2	1.6	1.9	2.0	2.2

Sources: IceStat; Ministry of Finance; and IMF staff estimates.

1/ Historical data are semi-accrual; projections are modified cash.
2/ Based on GFSM 2001 treatment of write-offs.
3/ Includes bilateral loans and international bond issuance to support foreign currency reserves at the Central Bank of Iceland (CBI). The loan from the Norwegian government directly to the CBI is excluded from general government debt. Does not include Fund liabilities.
4/ Gross debt minus liquid assets at the CBI (including assets to support CBI reserves, which are assumed to be liquid).

Table 6. Iceland: Financial Soundness Indicators, 2011–13

(Percent)

	2011Q1	2011Q2	2011Q3	2011Q4	2012Q1	2012Q2	2012Q3	2012Q4	2013Q1	2013Q2	2013Q3	2013Q4
Regulatory capital to risk-weighted assets	21.7	23.5	24.2	21.6	21.6	23.1	23.4	25.0	25.5	25.9	25.5	26.2
Regulatory Tier 1 capital to risk-weighted assets	19.7	21.0	21.8	19.4	19.2	20.9	21.1	22.6	23.1	23.6	23.3	24.0
Return on assets	3.0	3.3	2.7	1.1	2.5	2.5	2.1	2.4	2.0	2.3	2.2	2.2
Return on equity	19.0	20.2	15.7	6.7	16.5	15.5	12.8	13.8	11.3	13.0	12.3	12.1
Net interest income to gross income	57.2	47.1	53.4	53.9	56.7	50.3	53.3	48.8	51.7	41.7	45.1	45.2
Non interest expense to gross income	75.9	88.8	86.5	108.1	72.9	79.0	80.7	79.9	77.4	77.2	75.5	77.5
Liquid assets to total assets	19.2	18.2	21.3	18.0	18.0	17.6	19.8	20.7	21.0	20.3	20.5	21.4
Liquid assets to short-term liabilities	32.3	30.9	35.3	30.0	31.4	30.5	34.6	35.9	36.9	35.2	35.3	36.3
Net open position in foreign exchange to capital	68.1	61.1	29.1	22.6	25.9	18.2	18.4	7.7	3.7	3.6	6.4	6.3
NPLs, facility level (over 90 days in default) 1/	...	13.9	14.2	11.6	11.6	9.4	7.9	6.3	5.7	5.1	5.4	4.3
Household NPLs, cross-default (over 90 days in default or deemed unlikely to be paid) 2/	19.0	20.0	18.8	18.2	16.9	15.9	15.3	14.0	13.2	12.4	11.3	11.2
Corporate NPLs, cross-default (over 90 days in default or deemed unlikely to be paid) 1/	45.3	36.0	24.5	22.5	21.7	20.5	19.5	15.3	14.6	12.4	15.3	12.1
Corporate and household NPLs, cross-default (over 90 days in default or deemed unlikely to be paid) 1/	40.3	34.0	25.1	22.9	21.4	19.6	18.4	15.2	14.4	12.5	13.8	12.5
Coverage ratio of household loans in default	52.4	51.4	47.5	45.0	43.6	49.3	49.4	48.1	47.6	49.8	52.0	50.1
Coverage ratio of corporate loans in default	70.2	69.0	69.3	65.4	64.0	65.5	65.4	64.8	63.8	68.2	63.1	64.1
Coverage ratio of loans in default	67.9	66.2	65.1	60.9	59.4	61.6	61.4	60.2	59.2	62.9	60.3	59.8

Source: Central Bank of Iceland.

1/ The three largest commercial banks.

2/ The three largest commercial banks and the Housing Financing Fund.

Table 7. Iceland: Indicators of Fund Credit, 2008–16

(Millions of SDR)

	2008	2009	2010	2011	2012	2013	2014 Proj	2015 Proj	2016 Proj
Existing and prospective Fund credit									
Disbursements	560	105	210	525	0	0	0	0	0
Stock	560	665	875	1400	512	512	512	171	0
Obligations	0	13	18	29	914	10	10	348	172
Principal (repurchases)	0	0	0	0	888	0	0	341	171
Charges and interest	0	13	18	29	26	10	10	7	1
Stock of existing and prospective Fund credit									
In percent of quota	476	565	744	1190	435	435	435	145	0
In percent of GDP	5	9	11	15	6	5	5	2	0
In percent of exports of G&S	11.5	16.3	19.0	25.9	9.8	9.4	8.9	2.8	0
In percent of gross reserves	24.3	26.9	23.2	24.7	11.8	18.8	20.7	7.4	0
Obligations to the Fund from existing and prospective Fund arrangements									
In percent of quota	0.0	11.1	15.2	25.0	777.5	9.2	8.5	295.7	146.0
In percent of GDP	0.0	0.2	0.2	0.3	10.3	0.1	0.1	3.1	1.5
In percent of exports of G&S	0.0	0.3	0.4	0.6	17.4	0.2	0.2	5.6	2.7
In percent of gross reserves	0.0	0.5	0.5	0.5	21.0	0.4	0.4	15.1	15.6

Source: IMF staff estimates and projections.

Annex I. Iceland: Debt Sustainability Analyses[1]

1. External and public debt are on sustainable paths with downward trajectories over the medium term, but risks remain elevated. In addition to projected trajectories of macroeconomic variables and core policies, the large krona balance of payments overhang and its release are major policy challenges that will influence the path of debt.

A. External Debt Sustainability Analysis

2. The underlying assumptions for the baseline external debt path are broadly unchanged from the 2013 Article IV staff report ('previous report'), except for the following:

- **Current account.** The average medium-term projection for the current account, excluding interest payments, is slightly higher (by just under ½ percent of GDP)—as an expected drop in the trade balance is more than offset by an improvement in the income balance. The income balance deficit is improving owing to an expected neutral income balance for Actavis (a large resident multinational company). Overall interest payments are also lower, consistent with lower international interest rates and country risk premium, as reflected by Iceland's reduced long-term bond spreads, and a shift in the composition of debt to include more low-interest bearing FDI-related debt.

- **Real GDP growth.** Real growth is projected to be 1 percentage point higher (real GDP growth of around 3 percent annually) in the forecast horizon. The exchange rate is also expected to be stronger, consistent with recent trends and expected domestic and external developments.

- **Debt-stabilizing current account.** As a result, the non-interest current account needed to stabilize the external-debt-to-GDP ratio is a deficit of 2.9 percent of GDP compared to a surplus of 1.2 percent of GDP as suggested in the previous DSA.

- **Central government external borrowing.** External borrowing by the central government is assumed to be fully rolled over except for the $1 billion bond maturing in 2016 of which half is assumed to be rolled over and the remainder paid down. However, we assume that additional central government bonds are issued to cover 100 percent of CBI's external debt falling due in 2015–16. Similar to the previous report, the government is still assumed to issue two long-term Eurobonds, one in 2014 ($0.9 billion) and one in 2015 ($0.7 billion), to be swapped with short-term krona assets held by non-residents. As before, we assume these transactions use the market exchange rate.

[1] Prepared by Serpil Bouza and Jimmy McHugh.

- **Other external borrowing.** External debt rollover for the rest of the economy is assumed to be lower than in the previous report, reflecting continued deleveraging. Central government corporations are assumed to have zero rollover of their debt maturing in 2014, 20 percent rollover of debt maturing in each of the following six years. Local government corporations are assumed to have zero rollover of their debt maturing during 2014–16 and 100 percent thereafter. Local municipalities are assumed to have zero rollover of debt maturing in the next two years and 100 percent thereafter. This leads to higher net outflows, but also a faster downward trend in external debt.

- **Old banks estates.** Updated estimates of the three old banks' asset recoveries for end-2013 indicate a higher than expected level at this stage (assets of old banks are not recorded as debt until they are recovered into liquid form), leading to an upward adjustment in external debt for end-2013. Old bank payouts to foreign creditors were negligible during 2013 year. The FX-denominated prepayment (about 3 percent of GDP) on the Landbankinn bond owed to Old Landsbanki (LBI) remain locked in the Icelandic banking system as no exemption to capital controls was granted. Landbankinn and LBI have tentatively agreed to extend this bond's maturity by an average duration of three years (with final payment extended by 8 years), though this is contingent on approval of exemptions by the government. Unlike the previous report where the payments on the LBI bond maturing during 2014–18 were reflected in the amortizations schedule (outflow) in the balance of payments, the LBI bond now is treated as part of the overall domestic asset overhang to be paid out gradually starting in 2017 when the capital controls are eased. This is because of the uncertainty of whether the old or newly agreed payment structure will be adopted. The split between domestic and foreign claims against the old banks has been updated based on CBI analysis.[2] According to the analysis, foreign claims account for about 94.3 percent of total claims. Unlike in the previous report, it is assumed that recovered domestic assets will only be paid out starting in 2017, with the pace of these payouts dependent on maintaining adequate reserve coverage. Similar to the previous report, newly recovered foreign assets are assumed to be paid out immediately but the accumulated stock of liquid FX assets as of end-2013 is assumed to be released only gradually starting in 2015. The pace of release affects the path of external debt, but has a neutral effect on the BOP since the payments draw from assets held overseas to retire external debt).

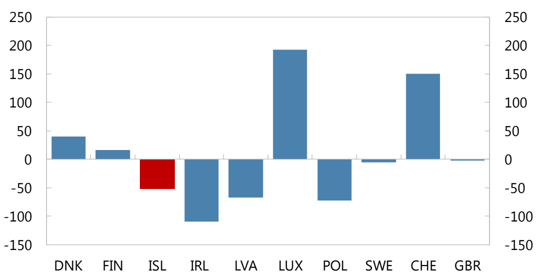
3. **External debt is expected to decline substantially over the medium term.** External debt is estimated at 264 percent at end-2013, and is expected to fall to around 153 percent of GDP by 2019. Around one-third of the 2013 external debt stock is nonresident claims subject to capital controls, although this ratio declines as offshore kronas exit and old banks' liabilities are gradually paid out. Gross external financing requirements are significant, but are largely attributable to the inclusion of old bank short-term debt obligations that are locked in by capital controls.

[2] *Financial Stability* report 2014/1, April 2014.

4. Stress tests suggest that the downward trajectory is relatively robust, but risks remain. Apart from the historical and real depreciation scenarios, standard shocks would not alter the downward trajectory of the external debt ratio (Annex I, Figure 1). The historical scenario would put the external debt ratio on an upward trend because of the large capital outflows that occurred during the crisis and sizeable pre-crisis current account deficits. An orderly lifting of capital controls, however, would prevent large capital outflows and disruptions to financial markets.

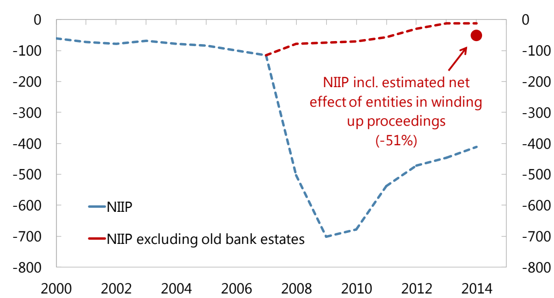
5. Iceland's net international investment position (IIP), adjusted for a settlement of the old bank estates, is estimated at about -51 percent of GDP.[3] When the adjusted net IIP is compared to other similar countries in size or by region, Iceland has a better net position than Ireland, Latvia, and Poland but a worse position than its Nordic peers.[4]

Net International Investment Position 1/
(Percent of 2013 GDP)



Sources: IMF's IFS, WEO, BoPS; and Haver Analytics.
1/ The NIIP for Iceland reflects the calculated settlement of estates in winding-up proceedings as of end-March 2014. Other countries reflect data as of end-2013.

Net International Investment Position of Iceland 1/
(Percent of GDP)



Sources: IMF's WEO & BoPS databases; Central Bank of Iceland; and Haver Analytics.
1/ See CBI Press Release 17/2014 for a discussion of the underlying NIIP.

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[3] It is assumed that the settlement of failed entity estates (old banks and others) would create net external liabilities of 40 percent of GDP (43 percent of GDP for the old bank estates), consistent with CBI estimates, as of Q1 2014.

[4] When including the nominal value of all debt and accrued interest of the failed banks and other companies being wound-up, net IIP would be –411 percent of GDP.

Annex I. Table 1. Iceland: External Debt Sustainability Framework, 2009–19

(In percent of GDP, unless otherwise indicated)

	Actual							Projections							
	2009	2010	2011	2012	2013			2014	2015	2016	2017	2018	2019		**Debt-stabilizing non-interest current account 7/**
1 **Baseline: External debt (including old banks) 1/**	269.7	293.6	258.8	260.2	264.2			**239.3**	**228.5**	**206.9**	**183.2**	**165.8**	**153.0**		**-2.9**
2 Change in external debt	81.0	23.9	-34.8	1.5	4.0			-24.9	-10.8	-21.5	-23.7	-17.4	-12.9	0.0	
3 Identified external debt-creating flows (4+8+9)	111.4	-29.5	-29.6	-19.5	-19.8			-10.3	-10.0	-10.2	-9.2	-9.4	-8.6	0.0	
4 Current account deficit, excluding interest payments	1.4	0.0	-5.7	-4.9	-10.1			-8.0	-7.9	-8.8	-7.8	-7.5	-7.4	2.9	
5 Deficit in balance of goods and services	-8.6	-10.1	-8.4	-6.1	-7.4			-6.2	-6.1	-6.3	-6.1	-5.8	-5.7		
6 Exports	52.7	56.4	59.1	59.4	57.5			54.7	55.7	55.7	55.6	54.2	52.2		
7 Imports	44.2	46.3	50.7	53.3	50.1			48.5	49.6	49.5	49.5	48.3	46.5		
8 Net non-debt creating capital inflows (negative)	26.3	-28.4	-6.0	-30.6	1.6			-1.3	-0.9	-1.0	-0.9	-1.7	-1.8	-0.2	
9 Automatic debt dynamics 2/	83.7	-1.2	-17.9	15.9	-11.4			-1.0	-1.2	-0.4	-0.4	-0.2	0.5	-2.7	
10 Contribution from nominal interest rate	10.3	8.0	11.0	10.2	6.2			5.9	5.6	5.4	5.2	5.2	5.3	6.9	
11 Contribution from real GDP growth	17.2	10.7	-7.0	-3.9	-7.9			-6.9	-6.8	-5.9	-5.6	-5.4	-4.7	-4.4	
12 Contribution from price and exchange rate changes 3/	56.3	-19.8	-21.9	9.6	-9.7			...	...	...	...	...	...	-5.2	
13 Residual, incl. change in gross foreign assets (2-3) 4/	-30.4	53.4	-5.2	21.0	23.8			-14.6	-0.8	-11.4	-14.5	-8.0	-4.3	0.0	
External debt-to-exports ratio (in percent)	511.5	521.0	438.2	438.3	459.4			437.1	410.4	371.4	329.6	306.1	292.8		
Gross external financing need (in billions of US dollars) 5/	6.6	9.6	14.1	16.5	12.6			16.3	16.7	18.7	15.5	13.9	13.4		
in percent of GDP	54.7	76.1	100.2	121.6	86.2	10-Year	10-Year	100.5	97.3	102.9	79.0	64.1	57.9		
Scenario with key variables at their historical averages 6/								**239.3**	**256.4**	**261.4**	**267.1**	**282.7**	**294.9**		**5.9**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							For debt stabilization	
Real GDP growth (in percent)	-6.6	-4.1	2.7	1.5	3.3	2.4	4.7	2.9	3.0	2.7	2.9	3.3	3.0	3.0	
GDP deflator in US dollars (change in percent)	-23.0	8.1	8.8	-4.6	4.2	1.5	13.5	7.7	3.2	2.8	5.1	7.1	3.6	3.6	
Nominal external interest rate (in percent) 8/	3.9	3.1	4.2	3.8	2.6	4.4	1.8	2.5	2.5	2.5	2.7	3.1	3.4	4.8 8/	
Growth of exports (US dollar terms, in percent)	-13.9	10.9	17.0	-2.7	4.2	9.0	12.6	5.5	8.1	5.6	8.0	7.7	2.9		
Growth of imports (US dollar terms, in percent)	-31.6	8.7	22.4	1.7	1.3	7.9	20.0	7.3	8.6	5.3	8.3	8.0	2.7		
Current account balance, excluding interest payments	-1.4	0.0	5.7	4.9	10.1	-4.7	10.2	8.0	7.9	8.8	7.8	7.5	7.4		
Net non-debt creating capital inflows	-26.3	28.4	6.0	30.6	-1.6	-4.5	28.3	1.3	0.9	1.0	0.9	1.7	1.8		

1/ External debt includes recovered domestic and foreing assets of old banks. While projections assume that newly recovered foreign assets will be distributed to creditors immediately upon recovery, the stock of foreign liquid asset in hand is assumed to be distributed only gradually starting in 2015. Domestic assets are only distributed starting in 2017 when capital controls are assumed to be lifted consistent with the balance of payments.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes, inflows of extraordinary financing (and Fund repurchases), and external asset recovery and repayments of the old bank estates.

5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

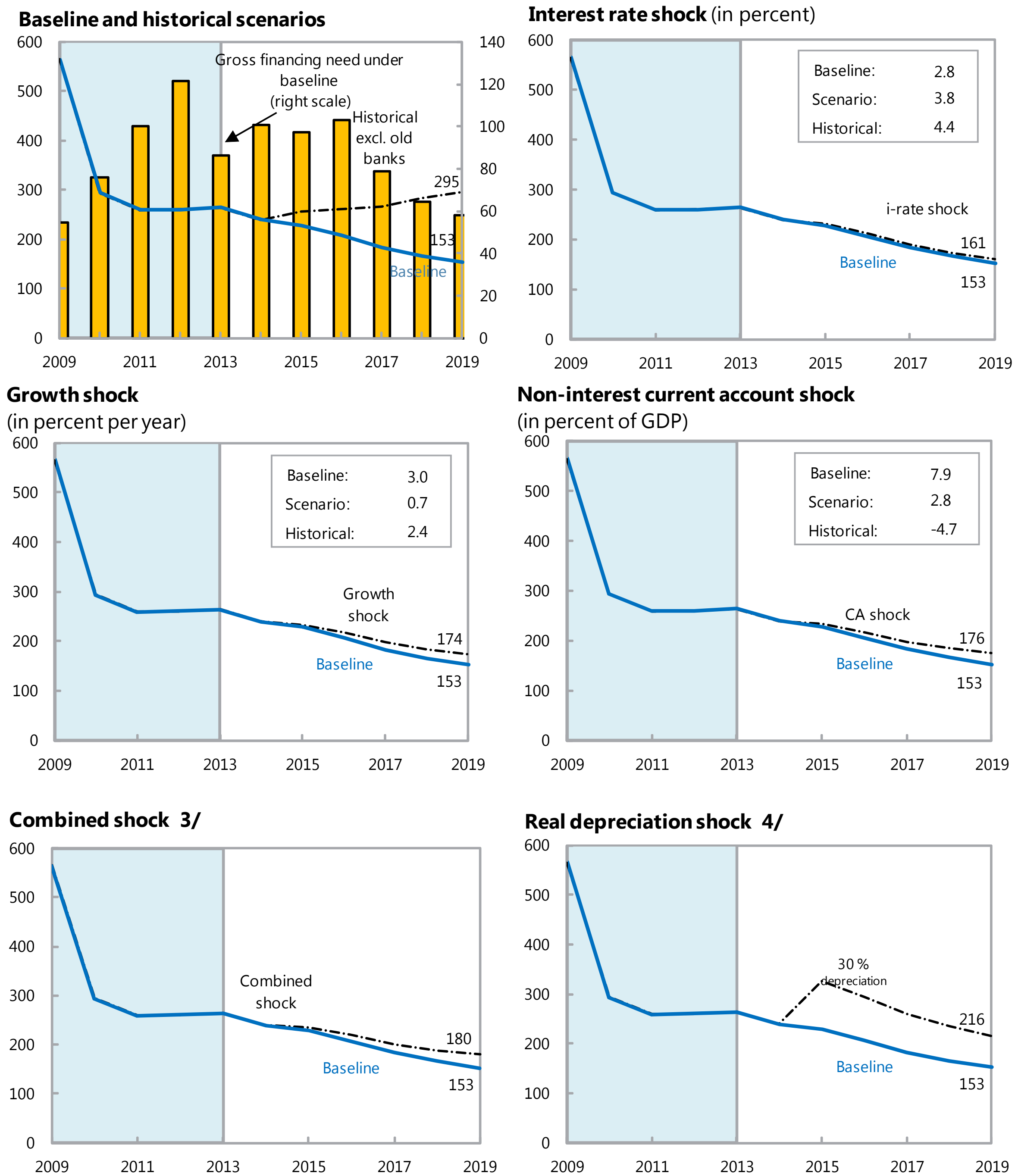
6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

8/ Since interest payment projections exclude old bank related interest payments while the external debt stock includes old bank debt, this results in an understatement of the external interest rate. Hence, for the computation of debt stabilizing current account we use the 2019 underlying interest rate that would exclude old bank debt stock as well.

Annex I. Figure 1. Iceland: External Debt Sustainability–Bound Tests [1/ 2/]

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2014.

B. Public Sector Debt Sustainability Analysis

Iceland's general government debt ratio (debt-to-GDP) is high but on a downward trajectory over the medium term. Gross financing needs are manageable given the relatively long maturities and the limited stock of short-term debt. Iceland has also accumulated a large stock of assets, which means that the net debt ratio is some 30 percentage points lower than gross debt, helping to ameliorate debt sustainability risks.

Stress tests imply that the downward trajectory is robust against most negative shocks. For all shock scenarios, sustainability indicators would deteriorate in the short run, but the downward trajectory for the debt ratio would be re-established over the medium term. Nevertheless, general government debt-to-GDP levels would remain well above the benchmark throughout the medium-term in the event of a large combined macroeconomic or a financial contingent liabilities shock. Gross financing needs over the medium term are manageable. The outstanding stock of state guarantees is 71 percent of GDP. These guarantees are concentrated in two large state owned enterprises and pose significant fiscal risks.

6. **Iceland's public debt increased sharply as a consequence of the financial crisis and remains elevated.** At the end of 2013, gross general government debt was estimated to be 89.9 percent of GDP, compared to a pre-crisis debt ratio of just 28.5 percent in 2007. Nevertheless, Iceland has made significant progress towards reducing debt vulnerability. Since the peak year of 2011, the general government gross debt ratio has fallen by around 10 percentage points of GDP.

7. **The structure of Iceland's general government debt in large part reflects the policy response to the financial crisis.** In 2009, the government issued a bond to cover capital contributions to distressed domestic financial institutions. At end-2013, the remaining obligation on this bond was estimated to be ISK 216 billion (12 percent of GDP). There is also a sizable non-marketable instrument—amounting to 10 percent of GDP—that was issued to recapitalize the CBI. There are other debts assumed by the government arising from called guarantees issued by the Treasury. Furthermore, around a quarter of the external general government debt stock is owed to Nordic governments (excluding Norway, which lent directly to the CBI) who offered bilateral financial support for FX reserve purposes during the crisis.

8. **A significant proportion of recent general government debt issuance has been used to bolster foreign exchange holdings.** The government has deposited the foreign exchange proceeds for use by the CBI and thereby has built up sizable deposits at the CBI. This is reflected in the large divergence between gross and net debt. At end-2013, net general government debt amounted to 65.8 percent of GDP.

9. **While the level of general government debt is high, the structure of the debt helps minimize fiscal risks:**

- **Domestic debt.** Around three quarters of general government debt is domestic. About 10 percent of this debt stock has been issued by local government entities. The bulk of this local government debt is held domestically.

- **Short-term debt.** The outstanding stock of short-term debt (original maturity) is small, comprising of just 2 percent of domestic general government debt. External debt amounting to 1.5 percent of GDP will be amortized in the coming year.

- **Denomination.** Around three quarters of general government debt is denominated in local currency with the remainder issued in U.S. dollars and Euros, along with negligible amounts in Sterling and Yen.

- **Fixed versus floating interest rate.** About 85 percent of the debt stock was issued using fixed interest rates.

- **Duration.** The weighted average time to maturity on central government debt is 6.25 years. The time to maturity on foreign currency debt is slightly lower at 5.2 years.

- **Ownership.** Ownership of Icelandic debt is concentrated in local banks and pension funds.

10. A significant fiscal risk is posed by the large outstanding stock of government guaranteed debt. At the end of 2013, the stock of state guaranteed debt was around ISK 1.2 trillion (71 percent of GDP). In recent years, the stock of guaranteed debt has increased only slightly in nominal terms, and the government intends to reduce the stock as soon as feasible. Around three quarters of these guarantees are denominated in domestic currency. As such, as a ratio of GDP the stock of guaranteed debt declined from a peak of 81 percent in 2009. Around 84 percent of these guarantees were issued to two enterprises—the Housing Financing Fund (HFF) and the National Power Company (Landsvirkjun)—heightening fiscal vulnerabilities. The government is expected to cover any losses related to the HHF though the budget, including any potential losses from the household debt relief program. Therefore, no impact on state guarantees is anticipated. The remaining state guarantees have been issued to other financial institutions and state-owned enterprises.

Baseline and Realism of Projections

11. The Debt Sustainability Analysis (DSA) focuses on general government gross debt and is based on the following policy assumptions.

- **Fiscal outlook.** In line with the government's Spring 2014 Economic Program, the authorities will target a general government balance of close to zero over the medium term. This implies primary surpluses in the range of 2–3 percent of GDP over the medium term, which coupled with a negative interest rate growth differential in most years, will put the debt ratio on a downward trajectory.

- **Debt management strategy.** The primary objective of the Icelandic government's debt management strategy is debt reduction, where they intend to use a net debt number (gross debt minus currency and deposits and loans) to track progress. At the same time, the authorities are trying to maintain adequate foreign exchange buffers while capital controls are liberalized. To achieve this latter objective, the baseline assumes that the government will issue Eurobonds to maintain reserve levels at the CBI (as repurchases are made to the IMF and the Nordic loans mature). Eurobond issuances for this purpose would be matched by a buildup of government FX deposits at the CBI. This debt restructuring operation will increase gross general government debt but other things being equal leave net debt (and public sector debt) constant. The baseline also assumes that the Treasury will pay down one half of the large external bond amortization due in 2016 (with the remainder rolled over). Thereafter, the DSA assumes that the government will issue sufficient external debt to rollover repayments coming due in 2017 onwards. Finally, the scenario has taken into account the government's planned asset sales in 2015-16 of about 3 ½ percent of GDP, with the resources eventually used to reduce the debt stock.

- **Macroeconomic assumptions.** Real GDP growth will be relatively robust at around 3 percent over the medium term, while inflation (GDP deflator) will be contained below 4 percent.

- **Realism of baseline assumption** The median forecast error for real GDP growth during 2004–12 is 0.6 percent. During the earlier years, staff tended to be overly pessimistic about growth and slightly optimistic during the crisis years. More recently, growth forecasts have been close to outturns. Inflation forecasts have been subject to larger error, particularly before and during the crisis. More recently, inflation forecast accuracy has improved. The median forecast error for the general government primary fiscal balance indicates that staff projections were overly pessimistic before the crisis and too optimistic during the crisis, but again forecast accuracy has improved in recent years.

12. The baseline envisages a gradual reduction in the general government gross debt ratio to around 68.7 percent of GDP by 2019. As previously indicated, the general government gross debt ratio is projected to increase significantly in 2015. This is due to the assumption that the government will issue debt to finance the IMF repurchases, which is currently held by the CBI and is therefore not currently included in the general government gross debt stock. The net debt ratio will continue its downward trajectory in 2015.

13. The heat map indicates that the current debt level poses high risks. Under the baseline general government debt breaches the high risk benchmark of 85 percent of GDP (See Figure 2, Annex I). Gross general government financing risks are more contained in the short run on account of comparatively long debt maturities and small amounts of outstanding short term debt.

14. Notwithstanding two repayments peaks in 2016 and 2018, gross financing needs are manageable over the medium term. A large external bond will come due in 2016. The authorities' current repayment plan is to roll over 50 percent of the amortized amount and repay the remainder from government deposits. A second large bond—denominated in domestic currency—will amortize in 2018. In addition, the government will also need to issue bonds to cover IMF repurchases currently held by the CBI.[5] The gross external financing requirement (including public and private obligations) is significantly above the upper benchmark of the early warning benchmark. However, this is largely attributable to the inclusion of old bank short-term external debt obligations that are locked in by capital controls.

Shocks and Stress Tests

15. The DSA baseline indicates that Iceland will be able to bring its gross debt ratio below the 85 percent "high risk" benchmark over the medium term. This conclusion assumes that the commitment to fiscal adjustment is sustained and the macroeconomic and external environment is relatively benign. Based on an asymmetric restriction of the shocks (See Annex 1 Figure 2), the debt ratio peaks at 120 percent of GDP at a 95 percent confidence interval.

- **Growth shock.** Under this scenario the real growth rate is subjected to a comparatively large 0.5 standard deviation negative shock starting in 2014–15. The scenario assumes a 0.25 percentage point decline in inflation for every one percentage point decrease in GDP. The scenario also assumes higher risk premia further worsening the primary balance. Under this scenario, the debt-to-GDP ratio increases to 92 percent of GDP in 2015 and declines thereafter. However, the debt ratio in 2019 is 8 percentage points higher relative to the baseline.

- **Interest rate shock.** This scenario assumes a 200 basis point increase in spreads throughout the projection period. The debt ratio deteriorates slightly in 2015 but given the assumption of continued fiscal adjustment, the debt ratio then returns to its downward trajectory. The debt ratio in 2019 is around 4 percentage points higher relative to the baseline.

- **Real exchange rate shock.** This scenario assumes 25 percent real exchange rate devaluation in 2014. The shock results in a comparatively small increase in the debt ratio due to the large share of domestically denominated debt.

- **Primary balance shock.** This scenario considers a 2 percentage points decline in revenues in 2014 and 2015. These shocks lead to an 8 percentage point increase in the debt ratio relative to the baseline in 2019 and adds almost one percent of GDP to gross financing needs.

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[5] IMF obligations come due in 2015 (SDR347 million) and 2016 (SDR172 million).

- **Combined macro-fiscal shock.** This scenario combines shocks to real growth, the interest rate, the real exchange rate, and the primary balance while eliminating double-counting of the effects of individual shocks. Under this scenario, the debt ratio increases sharply, peaking at 105 percent of GDP in 2016, and then resumes a downward trajectory but with an only limited reduction in the level of debt by the end of the projection period. Gross financing needs would be significant, rising to almost 20 percent of GDP in 2016 and 2018.

- **Financial contingent liabilities shock.** Reflecting the large outstanding stock of state guarantees, this scenario assumes that 10 percent of these guarantees are called upon in 2015. This assumes a significant deterioration the balance sheet of the HHF. The scenario also assumes that interest rates increase by 25 basis points for every 1 percent of GDP worsening in the primary balance. Interest rates increase by over 210 basis points. The debt ratio remains elevated throughout the projection period. In 2019, the debt ratio under this shock scenario is projected to be around 19 percentage points higher than the baseline.

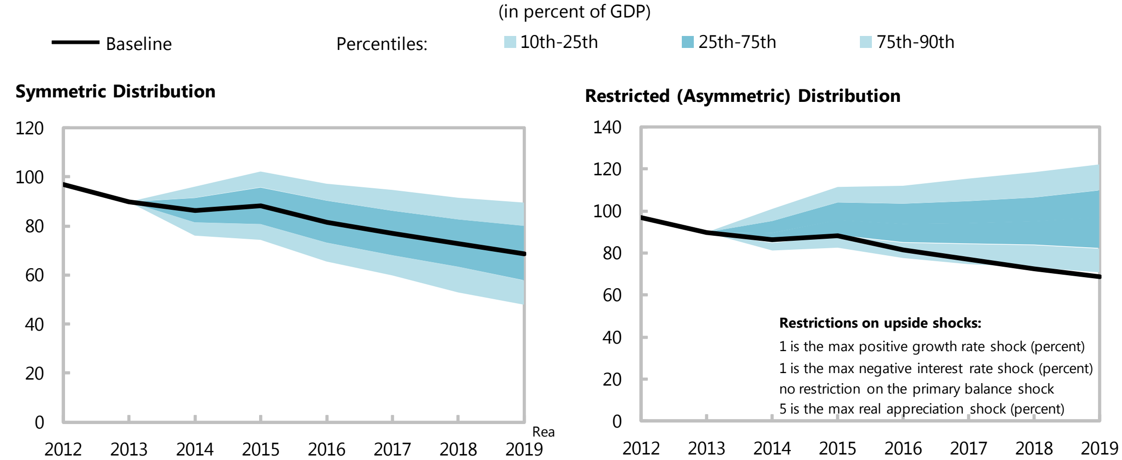
Annex I. Figure 2. Iceland: Public DSA—Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

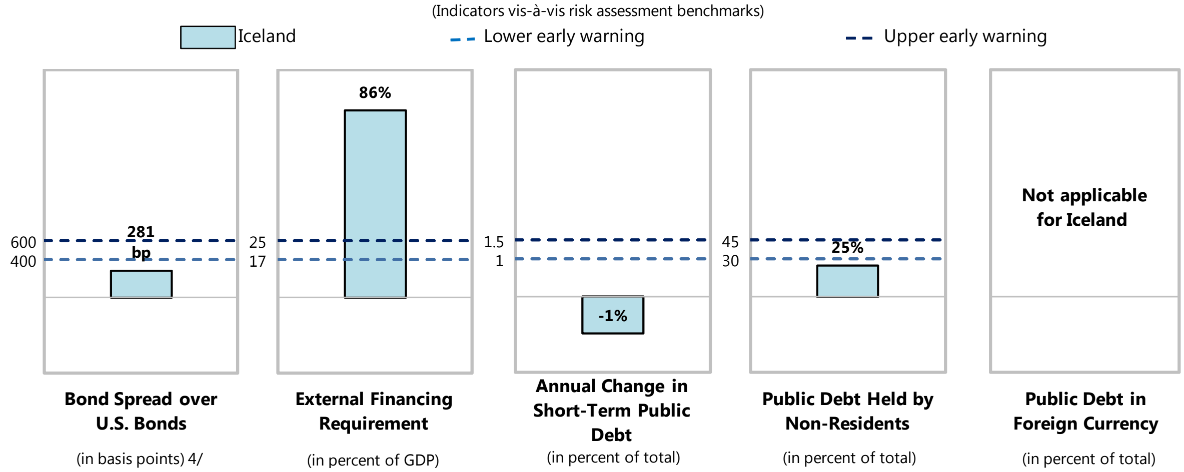
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

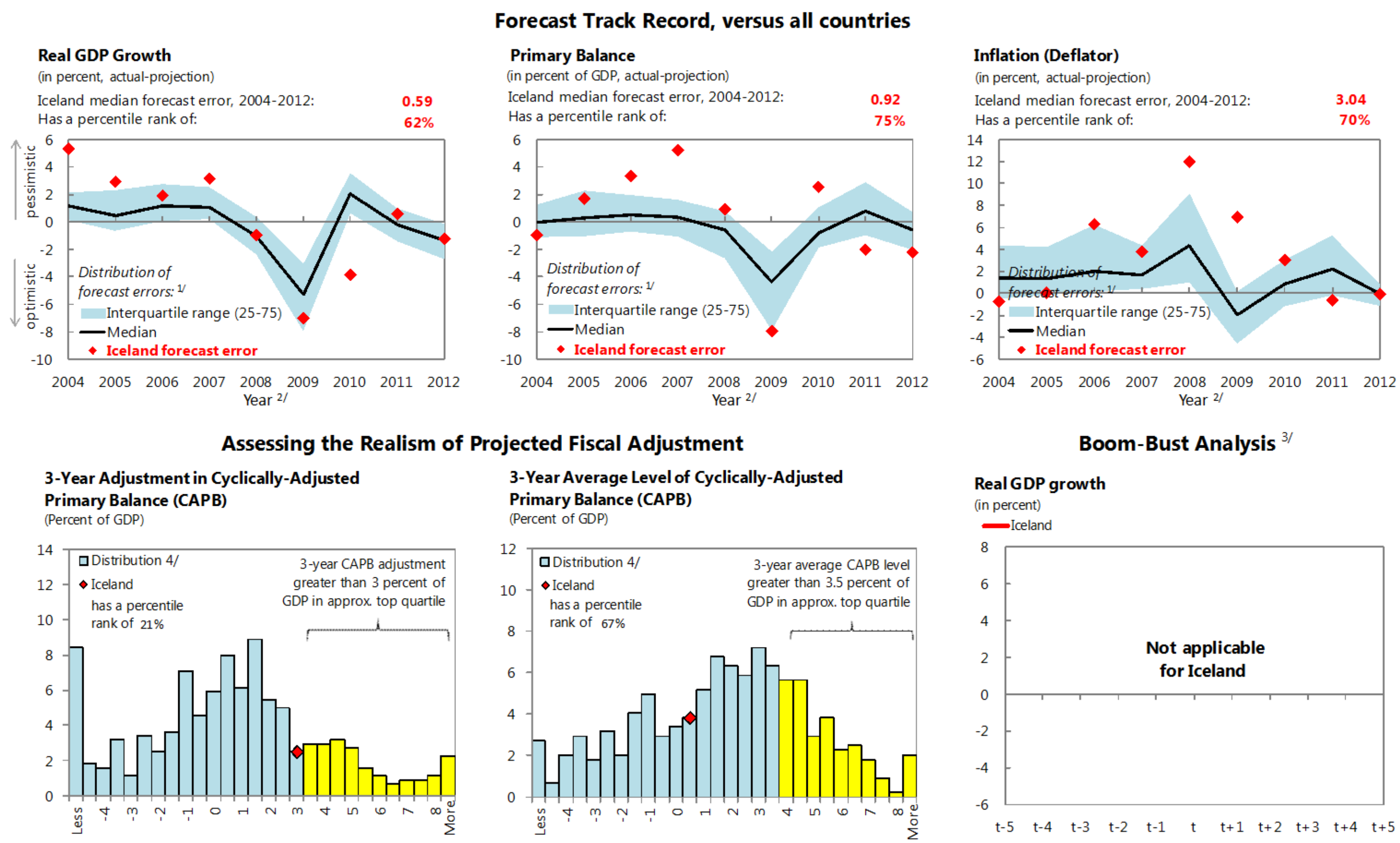
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.

Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ An average over the last 3 months, 14-Sep-13 through 13-Dec-13.

Annex I. Figure 3. Iceland: Public DSA–Realism of Baseline Assumptions



Source: IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Iceland.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex I. Figure 4. Iceland: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

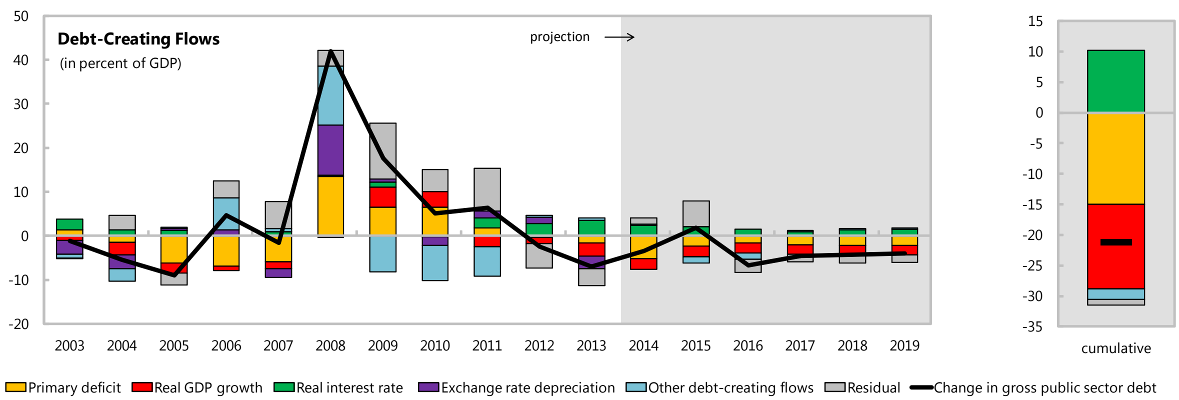
Debt, Economic and Market Indicators [1/]

	Actual		Projections					
	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	96.9	89.9	86.4	88.2	81.4	76.9	72.7	68.7
Public gross financing needs	18.4	8.7	3.4	4.0	11.2	2.1	12.2	6.5
State guarantees	78	71						
Real GDP growth (in percent)	1.5	3.3	2.9	3.0	2.7	2.9	3.3	3.0
Inflation (GDP deflator, in percent)	2.9	1.8	2.3	2.7	3.6	4.2	3.5	3.6
Nominal GDP growth (in percent)	4.4	5.1	5.3	5.9	6.4	7.3	6.9	6.7
Effective interest rate (in percent) [4/]	5.9	5.7	5.3	5.4	5.5	5.6	5.7	6.1

As of December 13, 2013		
Sovereign Spreads		
Spread (bp) 3/		265
CDS (bp)		171
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB-	BBB-
Fitch	BBB	BBB+

Contribution to Changes in Public Debt

	Actual		Projections							
	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	-2.5	-7.0	-3.5	1.8	-6.7	-4.5	-4.3	-3.9	-21.2	
Identified debt-creating flows	3.0	-3.2	-5.1	-3.4	-3.8	-3.1	-3.8	-2.7	-21.9	
Primary deficit	-0.3	-1.6	-5.1	-2.2	-1.6	-1.9	-2.0	-2.2	-14.9	-0.5
Primary (noninterest) revenue and grants	42.1	42.5	47.4	44.2	43.3	43.1	42.0	41.9	262.1	
Primary (noninterest) expenditure	41.8	41.0	42.3	42.0	41.8	41.2	40.0	39.8	247.2	
Automatic debt dynamics [5/]	2.9	-2.2	-0.2	0.3	-0.9	-1.5	-2.1	-0.8	-5.2	
Interest rate/growth differential [6/]	1.5	0.6	0.0	-0.3	-0.7	-1.3	-0.9	-0.4	-3.6	
Of which: real interest rate	2.9	3.6	2.5	2.1	1.5	1.0	1.5	1.6	10.2	
Of which: real GDP growth	-1.4	-3.0	-2.5	-2.5	-2.2	-2.2	-2.3	-2.1	-13.9	
Exchange rate depreciation [7/]	1.4	-2.8	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.4	0.6	0.2	-1.5	-1.4	0.3	0.3	0.3	-1.7	
General government net privatization proceeds (negative)	0.0	-0.1	0.0	-1.8	-1.7	0.0	0.0	0.0	-3.4	
Net lending for policy purposes	0.4	0.7	0.2	0.3	0.3	0.3	0.3	0.3	1.7	
Residual, including asset changes [8/ 10/]	-5.5	-3.8	1.7	5.2	-3.0	-1.4	-0.4	-1.3	0.7	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over U.S. Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ For projections, this line includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

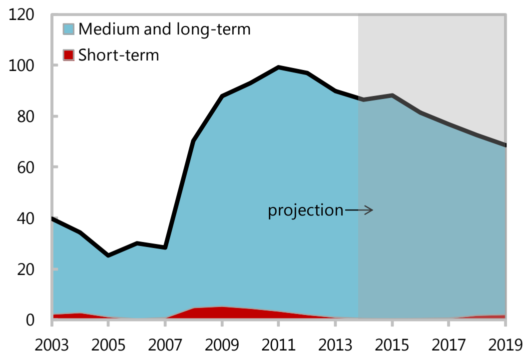
10/ The residual in 2014-17 reflects the over-financing of the fiscal balance, an initial build-up of government deposits held at the central bank, and the subsequent drawdown of deposits to finance external debt.

Annex I. Figure 5. Iceland: Public DSA Risk Assessment

Composition of Public Debt

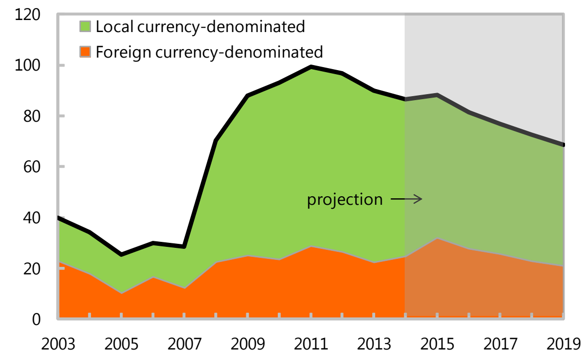
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

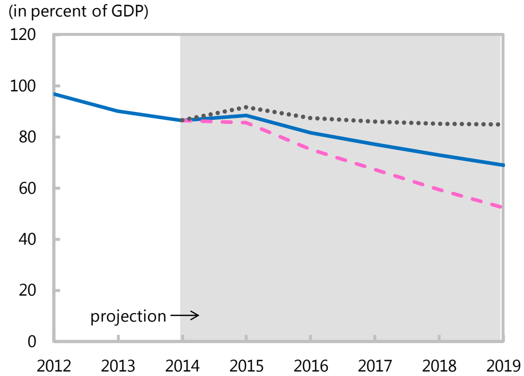


Alternative Scenarios

Baseline   Historical   Constant Primary Balance

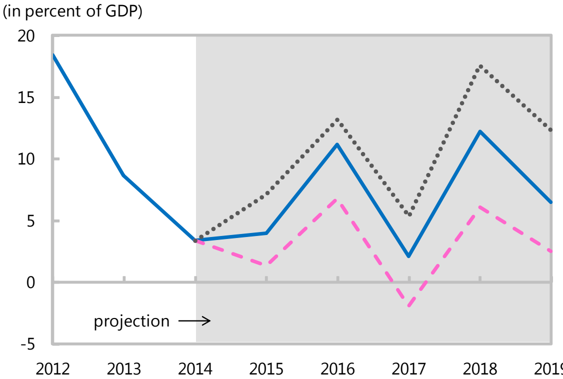
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

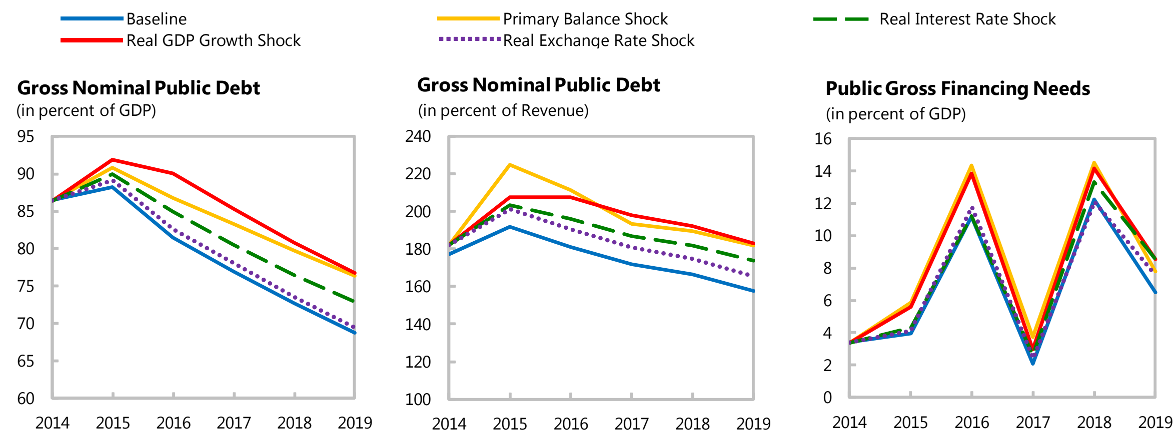
Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.9	3.0	2.7	2.9	3.3	3.0
Inflation	2.3	2.7	3.6	4.2	3.5	3.6
Primary Balance	5.1	2.2	1.6	1.9	2.0	2.2
Effective interest rate	5.3	5.4	5.5	5.6	5.7	6.1
Constant Primary Balance Scenario						
Real GDP growth	2.9	3.0	2.7	2.9	3.3	3.0
Inflation	2.3	2.7	3.6	4.2	3.5	3.6
Primary Balance	5.1	5.1	5.1	5.1	5.1	5.1
Effective interest rate	5.3	5.4	5.5	5.5	5.5	5.9

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	2.9	2.4	2.4	2.4	2.4	2.4
Inflation	2.3	2.7	3.6	4.2	3.5	3.6
Primary Balance	5.1	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	5.3	5.4	5.5	5.6	5.5	6.0

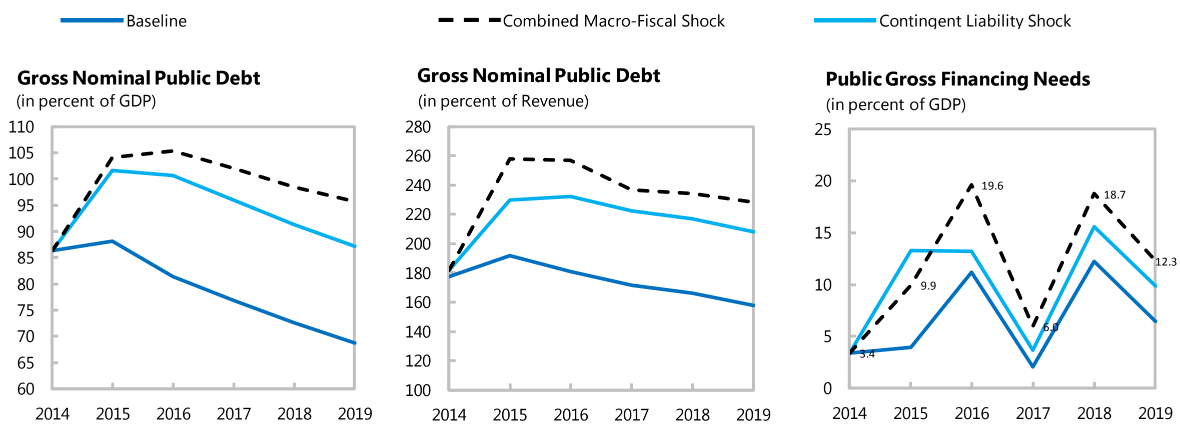
Source: IMF staff.

Annex I. Figure 6. Iceland: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2014	2015	2016	2017	2018	2019
Primary Balance Shock						
Real GDP growth	2.9	2.0	2.7	2.9	3.3	3.0
Inflation	2.3	2.7	3.6	4.2	3.5	3.6
Primary balance	5.1	0.3	-0.7	1.9	2.0	2.2
Effective interest rate	5.3	5.4	6.1	6.9	6.5	6.9
Real Interest Rate Shock						
Real GDP growth	2.9	1.0	0.7	2.9	3.3	3.0
Inflation	2.3	2.7	3.6	4.2	3.5	3.6
Primary balance	5.1	2.2	1.6	1.9	2.0	2.2
Effective interest rate	5.3	5.4	5.7	6.0	5.9	6.7
Combined Shock						
Real GDP growth	2.9	0.7	0.4	2.9	3.3	3.0
Inflation	2.3	2.2	3.0	4.2	3.5	3.6
Primary balance	5.1	-2.9	-3.2	1.9	2.0	2.2
Effective interest rate	5.3	5.8	6.2	7.1	6.8	7.5

	2014	2015	2016	2017	2018	2019
Real GDP Growth Shock						
Real GDP growth	2.9	0.7	0.4	2.9	3.3	3.0
Inflation	2.3	2.2	3.0	4.2	3.5	3.6
Primary balance	5.1	1.0	-0.9	1.9	2.0	2.2
Effective interest rate	5.3	5.4	5.6	5.7	5.6	6.0
Real Exchange Rate Shock						
Real GDP growth	2.9	3.0	2.7	2.9	3.3	3.0
Inflation	2.3	11.1	3.6	4.2	3.5	3.6
Primary balance	5.1	2.2	1.6	1.9	2.0	2.2
Effective interest rate	5.3	5.8	5.4	5.5	5.4	5.9
Contingent Liability Shock						
Real GDP growth	2.9	-1.6	-2.0	2.9	3.3	3.0
Inflation	2.3	1.6	2.4	4.2	3.5	3.6
Primary balance	5.1	-6.3	1.6	1.9	2.0	2.2
Effective interest rate	5.3	5.6	5.9	5.9	5.8	6.2

Source: IMF staff.

Annex II. Iceland: Household Debt Relief[1]

Household debt relief (HHDR) legislation recently passed by parliament envisages across-the-board reductions in household mortgages over 2014–17 in two components: one paid from the budget (about 4¼ percent of GDP) and the other from tax-free early withdrawals from Pillar III pension accounts (about 4¼ percent of GDP). The budget-financed debt relief is fully funded by an earmarked increase in the levy on banks and old banks. The pension part of the program will be funded from individuals' tax-free transfers from pension savings. This component creates a small negative annual drag on revenue that the Finance Ministry has stated it will cover during the relief period, but will also continue many years into the future. The program is estimated to have a limited impact on growth but may generate some rise in consumption and inflationary pressure, and carries downside fiscal risks, mainly attributable to possible additional costs to recapitalize the loss-making state-owned HFF. There are also risks from a possible legal challenge to the bank levy, though the government has pledged to halt the annual renewal of the program if the funding is lacking.

Context

1. **The approved household debt relief (at 8 percent of GDP) is somewhat smaller than originally promised in the election campaign (10 percent of GDP)**. Moreover, it is only partially funded through the budget, and is intended by the government as a fiscally neutral measure funded by an earmarked tax. The newly approved debt relief program was launched in May, with a sizeable initial uptake. After the one-time application process window closes in September, the government will finalize the program's costs and principal reductions will be initiated immediately thereafter. This is the second round of debt relief (principal reductions) provided to the Icelandic public, with the first amounting to 3 percent of GDP and applied only to deeply underwater mortgage holders.

Description

2. **The HHDR will consist of two parts: government-funded mortgage principle reductions and individuals' asset swaps.**

- **Budget-funded component**. The first measure, amounting to ISK 80 billion (4¼ percent of GDP) over a four-year period, envisages a 13 percent write-down of the principal of inflation-indexed mortgages to "correct" for the impact of high inflation during the crisis years of 2007–10. Write-downs from the previous debt relief programs will be netted out and the maximum benefit is capped at ISK 4 million per household. This measure will be financed by increasing the levy on the liabilities of banks and old bank estates, with the brunt of the cost borne by the old bank estates. The passed legislation caps the cost of this component at ISK 80 bn.

[1] Prepared by Sergei Antoshin, Anna Bordon, Jimmy McHugh, and Oana Nedelescu.

- **Pillar III pension savings component**. The second measure, amounting to an estimated ISK 80 billion (4¼ percent of GDP) over the next three (or five) years, will allow individuals to temporarily divert their voluntary, tax-exempt third-pillar pension contributions to prepay their mortgages (or to save towards purchasing a first house). One hundred thousand households (80 percent) are expected to benefit—both mortgagors and renters. The maximum benefits are capped at ISK 1.5 million for singles and ISK 2.25 million for couples. Estimated at ISK 80 billion, the overall size—as well as the fiscal costs—of the second component is not capped in the legislation. Though it is not clear whether the ultimate uptake will be higher, the lack of an overall ceiling for the second component poses a fiscal risk.

Economic Impact

3. **The debt relief program will contribute to a small increase in growth and inflation, now factored in staff's baseline forecast.** The measures will reduce households' debt service and improve their net worth. Private consumption is estimated to rise by around 0.5 to 1 percentage points in 2015–17 compared to the earlier baseline, peaking in 2015. Much of the associated pick-up will, however, leak through the balance of payments, given a high share of imports in Icelandic consumption. As a result, growth will only rise by 0.1 to 0.2 percentage points. The ensuing exchange-rate depreciation, together with a high pass-through to prices and increased demand for nontradables will raise inflation in 2015. Inflation will rise by 0.2 to 0.4 percentage points, compared to the baseline, assuming no policy action by the central bank.

Financial Impact

4. **The debt relief is likely to have a pronounced negative effect on the loss-making state-owned HFF.** Already faced with sizeable prepayments on mortgages and burdened with non-callable long-term liabilities, the HFF continues to generate negative carry, even in the absence of the HHDR. The program is expected to have two negative effects on the HFF. *(See Annex II Table 1)*.

- **Principal reductions.** It is expected to reduce the stock of mortgages by an estimated ISK 76 billion, which will be added to the stock of negative-carry assets, resulting in an estimated loss of ISK 5 billion over the four-year period.

- **Prepayments.** The debt relief may create additional incentives for mortgage prepayments, as improved loan-to-value ratios will allow borrowers to qualify for more competitively priced non-indexed mortgages at commercial banks. This, combined with the abolition of the stamp duty this year, could generate prepayments of 10–20 percent of all zero-penalty pre-payable assets and would trigger additional losses in the range of ISK 9–19 billion over the four-year period.

In sum, the HHDR may raise the HFF's losses by up to ISK 24 billion (1¼ percent of GDP) over the next four years (see the fiscal section below), while only ISK 9 billion has been earmarked for the HHDR's costs to the HFF. On the positive side, the program may lead to some improvement in the asset quality at the HFF, although uncertainty around the quality of the HFF's loan book remains high. (A thorough asset quality review by the supervisor was initiated only recently).

5. The commercial banks will be able to bear the costs of the HHDR. Pre-tax profits at the commercial banks (around ISK 91 billion in 2013) are expected to be sufficient to absorb the new bank levy, but post-tax profitability may decline. New bank lending is expected to expand, stimulated by rising demand from households with now bolstered balance sheets. Increased supervisory attention will be needed to monitor credit developments and lending standards.

Fiscal Impact

6. The authorities designed the new household debt relief to be fiscally neutral. Parliament recently approved the debt relief legislation, including an expanded levy on the financial sector to finance the program. Specifically, the authorities have increased the rate, from 0.15 percent to 0.38 percent, of an existing annual bank levy on financial institutions' liabilities in excess of ISK 50 billion and removed the exemption for failed banks. The authorities estimate that this levy will raise ISK 129 billion in revenues for the next four years, of which ISK 80 billion will be earmarked for the debt relief program *(see Annex II Table 2).*

7. The budget-funded component of the household debt relief is expected by be fully covered by the bank levy. Out of the ISK 80 billion envisaged in the program, ISK 72 billion will contribute to mortgage principle reductions and ISK 8 billion will cover costs associated with accrued interest, prepayments, and valuation effects.

8. The Pillar III pension savings component will result in foregone tax revenue that is covered from the budget during the relief period. The fiscal impact of this program relates to foregone revenues, and has two elements: (i) an immediate impact on income tax revenues from any marginal increase in participation in tax-free pension savings; (ii) future foregone tax revenue by the diversion of Pillar III contributions to pay down mortgages. Together, the authorities initially estimated that the *net present value* of the lost tax revenue due to the Pillar III component of the relief could be ISK 28 billion. ISK 2 billion is budgeted in 2014 and an additional ISK 10 billion will be included in the 2015–17 budget, which—in combination—are expected to fully cover the fiscal costs of the Pillar III scheme over the medium term, unless participation becomes exceptionally high. Long-term Pillar III fiscal costs will require additional annual provisioning in future budgets.

9. The program poses fiscal risks. Banks have announced that they will challenge the legality of the bank levy, and if the litigation is successful, then the anticipated revenues from the bank levy may not materialize. Under this scenario, the government has pledged to scale back the program, which could be difficult to implement. As indicated earlier, the program may also weaken the financial position of the HFF, and the government may be required to recapitalize the HFF from budget resources. Currently, only ISK 9 billion is allocated for the impact of the HHDR on the HFF, compared to staff's estimates of ISK 15–24 billion likely required to offset the effects of the program. On the expenditure side, the government-funded part of program has been designed with an explicit cap, which should in theory, prevent cost over-runs. However, in an unlikely scenario when the program becomes oversubscribed, it could be politically and technically difficult to contain fiscal expenditures within the designed caps. In the absence of contingency measures, cost over-runs will be funded directly from the budget.

Annex II. Table 1. Scenario Analysis of the HHDR's Impact on the HFF

(Billions of ISK unless otherwise specified)

		2014	2015	2016	2017	total 2014-17
(1)	Principal reductions due to the HHDR	22	44	66	76	
	Prepayable assets	408	386	364	354	
	Additional prepayments due to the HHDR					
(2)	Scenario 1 - 10 percent prepayments	41	78	112	145	
(3)	Scenario 2 - 20 percent prepayments	82	155	225	291	
(4)	Negative interest rate margin (percent)	2.5	2.5	2.5	2.5	
	Losses on:					
(5)=(1)*(4)	Principal reductions due to the HHDR	1	1	2	2	5
	Additional prepayments due to the HHDR					
(6)=(2)*(4)	Scenario 1 - 10 percent prepayments	1	2	3	4	9
(7)=(3)*(4)	Scenario 2 - 20 percent prepayments	2	4	6	7	19
	Total losses due to the HHDR					
(8)=(5)+(6)	Scenario 1 - 10 percent prepayments	2	3	4	6	15
(9)=(5)+(7)	Scenario 2 - 20 percent prepayments	3	5	7	9	24

Source: IMF staff estimates.

Annex II. Table 2. The Household Debt Relief's Fiscal Impact

(Cumulative impact over four years; Billions of ISK)

2014-17 Budget Revenues		2014-17 Budget Expenditures		Staff estimates	
Bank levy	129				
Of which:					
Earmarked for debt relief	80	Earmarked for debt relief	80		
		Principal reductions	72		
		Accrued interest, prepayments, and valuation costs	8		
		HFF recapitalization costs	9	HFF recapitalization costs 1/	15-24
Pillar III pension costs	-11			Pillar III pension costs 2/	>4

Source: IMF staff estimates.

1/ See Annex II Table 1 for calculations.

2/ Based on the CBI's estimate of ISK28 bn for the NPV of the Pillar III costs.

Annex III. Iceland: Capital Account Liberalization and the Balance of Payments[1]

Iceland's current set of capital controls have now been in place for over five years. An orderly lifting of capital controls remains crucial in preserving the stability of the exchange rate, balance of payments, and the financial system. Given the large size of nonresident domestic holdings as well as residents who may wish to rebalance their portfolios towards external holdings, liberalization of the capital account should remain conditioned on BOP prospects and macroeconomic developments.

A. Recent Developments

1. **In recent months, the authorities have formed a new steering committee and several working groups in an effort to push forward the removal of capital controls.**[2] They also issued a stock-taking progress report.[3] Nonetheless, progress on the lifting of capital controls has been limited and the last update to the liberalization strategy was published in March 2011.[4]

Box 1. March 2011 Capital Account Liberalization Strategy

The 2011 strategy has two phases to address the offshore krona overhang. At present, implementation is in phase one and release of offshore krona takes place only via the auctions channel. The 2011 strategy does not address treatment of the old bank estates.

Phase I: The following three different exit channels for releasing the offshore liquid kronas are envisaged: (i) auctions of foreign exchange, (ii) swaps of offshore krona denominated assets into long-term Eurobonds and (iii) subjecting remaining kronas to an exit tax. The exchange rate formulated in these auctions differs from the onshore (official) exchange rate and is determined by demand-supply in the auctions and the CBI.

Phase II: When the overhang has been sufficiently reduced and provided that macroeconomic developments are conducive to the lifting of controls, restrictions on capital account transactions are to be gradually eliminated.

[1] Prepared by Serpil Bouza.

[2] The steering committee is led by the Minister of Finance and Economy and includes the Governor of the Central Bank, the permanent secretaries of the Office of Prime Minister and the Ministry of Finance and Economy and the Prime Minister's economic advisor. In addition, the Prime Minister appointed a six-member advisory group that has been charged with making proposals to a ministerial committee on economic issues and its sub-committees on specific steps and a plan for the removal of capital controls.

[3] *Progress of the Plan for Removal of Capital Controls*, Ministry of Finance and Economic Affairs, 17 March 2014.

[4] *Capital Account Liberalisation Strategy*, Report to the Minister of Economic Affairs, 25 March 2011.

B. Potential Balance of Payment Pressures

2. **If capital controls were removed immediately, staff estimates that funds in the amount of 80 to 105 percent of GDP could seek to exit**. These potential outflows can be broken down into three categories: (i) domestic holdings of the old bank estates (Glitnir, Kaupthing, and Old Landsbanki) owed to nonresidents; (ii) the offshore liquid krona overhang (holdings of nonresidents), and (iii) resident portfolio rebalancing. Adding to the potential pressures are scheduled foreign exchange fixed repayments of financial and nonfinancial corporations towards foreign parties, to the degree they are not rolled over.

3. **Old bank estates (net BOP impact of about 44 percent of GDP).** The three large banks that collapsed in 2008 are currently in winding-up procedures. The winding-up boards (WuB) of two of the three bank estates (Glitnir and Kaupthing) have proposed to enter into composition agreements, whereby the creditors will become the owners of an asset management company that oversees liquidation and distribution of assets in the respective bank estate. The WuB of Old Landsbanki (LBI)—where the main creditors are Dutch and UK claimants—intends to conclude a composition agreement after its priority claims have been paid in full (about 51 percent of priority claims have been paid out so far). In May this year, the WuB of LBI and Landsbankinn reached a conditional agreement to extend the maturity of the FX-denominated LBI bond (held by Landsbankinn) by an average duration of 3 years (with final payment extended by 8 years to 2026) in an effort to mitigate the adverse impact the heavy repayment profile could pose to the balance of payments over the next several years. This agreement is conditional upon the WuB of LBI obtaining certain exemptions from capital controls.

- **Total assets.** The total assets of the old banks as of end-2013 were about 143 percent of GDP.[5] Just under 2/3 of the total assets are in FX held overseas. The remainder is domestic claims in local and foreign currencies. About half of the assets managed by the WuBs are now in liquid form. The remainder is in loans, equity in the 'new' Icelandic banks, the FX-denominated but domestically held LBI bond, and other assets.

- **Domestic assets.** The net impact of the domestic asset distribution on the BOP is equivalent to -44 percent of GDP,[6] well above the level of reserves (about 30 percent of GDP at end-2013) held by the Central Bank of Iceland (CBI). The domestic assets include the equity in the new banks (a combined 30 percent of total domestic assets; 16 percent of GDP) and the FX-denominated LBI bond (25 percent of domestic assets; 13 percent of GDP).

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[5] See *Financial Stability 2014/1*, Central Bank of Iceland, April 2014.

[6] Based on asset portfolios as of end-2013. This amount is based on the CBI's analysis that currently the domestic (foreign) asset share is 36.4 (63.6) percent and that foreign (domestic) claims account for 94.3 (5.7) percent. This amount includes the FX installments due on the LBI bond.

Annex III. Table 1. Book Value of Old Bank Assets, end-2013
(Percent of GDP)

	Domestic assets			Foreign assets	Total
	in ISK	in FX	Total	in FX	assets
Liquid assets	6.6	8.2	14.8	57.6	72.4
Loans	2.4	1.1	3.5	21.9	25.5
Securities and derivatives	2.7	2.6	5.3	6.7	11.9
Compensation bonds from new bank for asset transfer	0.0	13.3	13.3	0.0	13.3
Holdings in subsidiaries and affiliates	15.7	0.4	16.1	0.7	16.9
Other assets	0.5	0.5	1.0	1.9	2.9
Total	27.8	26.2	54.0	88.8	142.9

Source: Central Bank of Iceland, Financial Stability Report 2014/1.

4. **Liquid offshore krona holdings of nonresidents (about 18 percent of GDP remaining as of end-2013).** Of the three exit channels envisaged for this category in the 2011 strategy (FX auctions, Eurobond swap and exit tax), only the FX auction channel has been operational. Most of the reduction in offshore krona has been through the so-called investment route as the appetite for Treasury bonds has been weak.[7]

5. **Resident portfolio rebalancing.** When capital controls are lifted, domestic parties will likely want to rebalance their portfolios by investing abroad. Pension funds in particular may want to increase their share of foreign assets in their portfolios (23 percent of GDP as of April 2014 versus 30 percent of GDP during 2006–08). Staff has estimated that resident outflows from portfolio rebalancing could amount to 20–45 percent of GDP over a number of years.[8] Staff proposed that a strategy to limit the disruptive effect of these outflows on the balance of payment and the financial sector could include imposing "speed limits" on outflows.

C. Key Assumptions in the Balance of Payments

6. **Below is a summary of staff's key assumptions on the balance of payments projections with the main focus being the treatment of capital controls:**

- **Rollover of maturing foreign exchange debt.** External borrowing by the central government is assumed to be fully rolled over except for the $1 billion bond maturing in 2016 only ½ of which is assumed to be rolled over and the remainder paid down.

[7] The FX auction consists of matched pairs of auctions: in one auction, CBI offers to purchase euros in exchange for kronas for long-term investment in the Icelandic economy, the so called investment route, or in Treasury bonds, the so called Treasury bond route; in the other, owners of locked-in offshore kronas use these to buy euros from the CBI. The idea is to match the quantities in these two auctions so that offshore kronas exit without having an impact on the foreign exchange reserves. The exchange rate formulated in these auctions differs from the onshore (official) exchange rate and is determined by demand/supply and the CBI.

[8] See (i) *Iceland: 2013 Article IV Consultations and Third Post-Program Monitoring Discussions,* IMF Country Report No. 13/256, August 2013.(ii) *Lifting Capital Controls, the Effect of a Potential Rebalancing of Residents' Investment Portfolios*, Selected Issues Paper, IMF Country Report No. 13/257.

Additional bonds are assumed to be issued to cover 100 percent of the CBI's external debt falling due in 2015–16 (IMF repurchases). Central government corporations are assumed to have zero rollover of their maturing debt in 2014 and only 20 percent roll over in each of the following six years. Local government corporations are assumed to have zero rollover of their maturing debt during 2014–16 and 100 percent rollover thereafter. Local municipalities are assumed to have zero rollover of their maturing debt coming due in 2014–15 and 100 percent rollover thereafter. The following are rollover assumptions for the rest of the economy: (i) banks and other financial institutions will have zero rollover of maturing external debt, and (ii) other sectors will rollover 100 percent of maturing debt.

- **Release of all offshore liquid krona by end-2016.** FX auctions are assumed to remain operational until end-2016. Long-maturity Eurobonds ("Eurobond swaps"), one in 2014 ($0.9 billion) and one in 2015 ($0.7 billion) are assumed to be issued by the government to be swapped for krona-denominated assets held by nonresidents. The remaining offshore krona is assumed to be subject to an exit tax at end-2016. These steps are consistent with the March 2011 liberalization strategy laid out by the authorities, but their specific timing is based on staff assumptions. As before, we assume these transactions use the market exchange rate. This is a conservative assumption taking into consideration past FX auction rates (see Annex III, Figure 1).

- **Gradual lifting of the capital controls on residents and nonresidents beginning 2017.** The authorities' liberalization strategy as well as staff assumptions regarding the lifting of controls are conditions-based. The conditions for lifting capital controls include a sufficient reduction in the stock of offshore krona, sound public finances, access to international financial markets, and a strong financial sector. Under current staff assumptions, capital controls are assumed to start to ease beginning 2017. However, the amount of outflows related to paying down old bank estate creditor claims on domestic assets[9] and possible rebalancing of residents' portfolios is paced to maintain adequate reserve buffers (reserves-to-short-term-debt ratio above 100 percent).[10] The BOP analysis suggests that a complete removal of controls would extend well beyond our forecast horizon.

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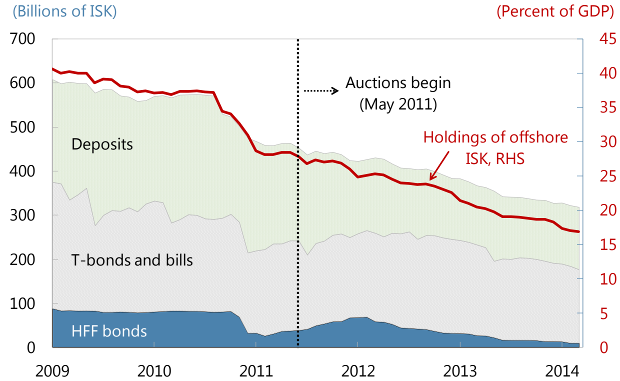
[9] Unlike the previous report where the payments on the LBI bond maturing during 2014–18 was reflected in the amortizations schedule (outflow) in the balance of payments, the LBI bond now is treated as part of the domestic asset overhang that is being paid out gradually starting in 2017 when the capital control easing begins. This is because of the uncertainty over whether the existing or conditionally agreed new payment structure will be adopted. Interest accumulated on old bank domestic assets is reflected as an increase in the value of claims on the old bank estates. In addition, the domestic assets are adjusted down by the equivalent of bank tax expected to be paid on liabilities during 2014–17. Recovered new foreign assets are paid out immediately but the accumulated stock of liquid FX assets as of end-2013 is assumed to be released only gradually starting in 2015 (the pace of release affects the path of external debt, but has a neutral effect on the BOP since the payments draw from assets held overseas to retire external debt).

[10] The balance of payments projections assume a rebalancing equivalent to 25 percent of 2011 GDP.

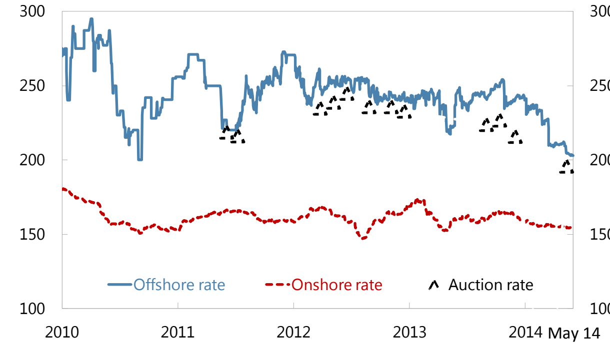
Annex III. Figure 1. Iceland: Capital Controls

Holdings of Offshore Krona



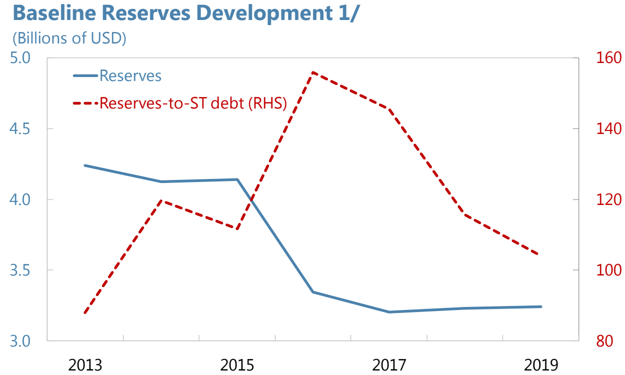
Sources: Central Bank of Iceland; and IMF staff calculations.

ISK/EUR Onshore, Offshore, and Capital Control Liberalization Auction Rates



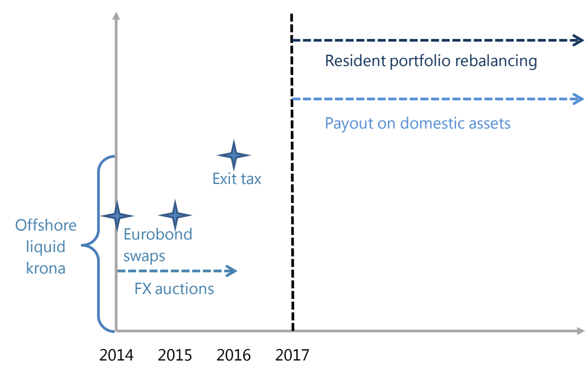
Sources: Thomson Reuters; and Central Bank of Iceland.

Baseline Reserves Development 1/



Source: IMF staff estimates.
1/ Reserves excluding old bank deposits.

Timeline of Key BOP Assumptions



Source: IMF staff assumptions.

Statement by the Staff Representative on Iceland
July 7, 2014

This supplement provides information that has become available since the issuance of the staff report. The information does not alter the thrust of the staff appraisal.

Output stagnated in the first quarter, despite strong final domestic demand, while inflation remained low. Final domestic demand picked up at a somewhat higher than expected pace of 5 percent y-o-y. However, a slower pace of inventory accumulation and weak net external demand meant that output broadly stagnated. The trade balance deteriorated in the first quarter, compared to the same period last year. Inflation came in at 2.2 percent in June.

The Monetary Policy Committee (MPC) kept policy rates unchanged at its June meeting. The MPC highlighted that final domestic demand was stronger than anticipated and economic slack is disappearing, though the real policy rate has remained elevated as inflation has been below the target. The MPC signaled that real rates will have to increase further in the near term if domestic demand grows faster.

The central bank announced resumption of regular foreign currency purchases. The central bank will purchase €3 million per week through end-September, a period of typically higher FX inflows from tourism, in the foreign exchange market in an effort to build non-borrowed reserves.

Press Release No. 14/xx
FOR IMMEDIATE RELEASE

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes the Fourth Post-Program Monitoring Discussion with Iceland[1]

On July 7, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Fourth Post-Program Monitoring Discussion with Iceland.

Iceland's recovery continues and unemployment is trending down. Domestic demand growth has continued to strengthen and exports have risen at a healthy pace. Growth is projected at 2.9 percent this year and about 3 percent over the medium term.

Potential balance of payments pressures—contained by the capital controls—remain significant. Progress has been made under the 2011 capital account liberalization strategy, notably the gradual release of nonresident holdings of liquid krona via foreign exchange auctions, but the strategy is under review, as the understanding of the nature and complexity of the overhang has improved. The current account balance is forecast at above 2 percent of GDP this year and over the medium term, though uncertainty remains high.

CPI inflation has been close to or slightly below the Central Bank of Iceland's target of 2.5 percent in the first half of 2014 and is expected to end the year in line with the target. However, long-term inflation expectations are still elevated and upward price pressures are anticipated to strengthen in 2015. The Central Bank of Iceland (CBI) left its policy rates unchanged at the June meeting and resumed regular foreign currency purchases to build up non-borrowed reserves. The authorities have launched a review of the CBI's financing mechanism and legislative framework.

The general government is on track to run a surplus of 1.9 percent of GDP this year, mainly due to one-off factors. However, under current policies, a small deficit is expected to open up next year, implying an expansionary fiscal stance. The draft organic budget law is now before Parliament that would institutionalize the government's balanced budget and debt objectives, establish a new system of fiscal rules, and improve reporting, transparency, and accountability.

[1] The central objective of PPM is to provide for closer monitoring of the policies of members that have substantial Fund credit outstanding following the expiration of their arrangements. Under PPM, members undertake more frequent formal consultation with the Fund than is the case under surveillance, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

Banks are well capitalized, liquid, and stable and have regained access to international capital markets, but earnings are coming under pressure from bank taxes and other factors. The state-owned Housing Financing Fund (HFF) continues to make losses and drain budgetary resources. The authorities are considering future options for the HFF, including a proposal to put it in a runoff mode.

Executive Board Assessment[2]

Executive Directors welcomed Iceland's continued economic recovery and efforts to address crisis legacies. Directors noted the positive medium-term outlook for growth, stable inflation, and declining debt. They emphasized, however, that risks are tilted to the downside, citing uncertainties surrounding global growth and market volatility, and still high debt ratios.

Directors welcomed steps towards updating the 2011 capital account liberalization strategy. They emphasized the need for an orderly lifting of capital controls to enhance confidence and improve potential growth. They stressed that the liberalization strategy should be consistent with maintaining adequate reserve buffers and safeguarding macroeconomic and financial sector stability. Directors underscored the importance of sound macroeconomic and financial sector policies to enhance prospects of success.

Directors commended the central bank's progress in bringing down inflation and agreed that the current monetary policy stance is appropriate. They urged the central bank to stand ready to respond to changes in price pressures stemming from factors such as wage formation, the fiscal stance, and a closing output gap. With the central bank's legislative framework currently under review, Directors urged the authorities to maintain a financially sound, independent, and accountable central bank, which is crucial to policy credibility and anchoring inflation expectations. They concurred that the central bank should take advantage of favorable balance-of-payments conditions to build up non-borrowed foreign currency reserves.

Directors expressed support for the authorities' fiscal objectives of a balanced budget and lower debt. They noted that further effort is needed to achieve them, including specific and durable fiscal measures in the context of a well-specified medium-term fiscal plan. Directors agreed that approval of the draft organic budget law now before parliament would help underpin these efforts. They urged the authorities to create fiscal space to increase investment from currently low levels and to identify contingency measures to address fiscal risks from household debt relief.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm

While recognizing that the banking sector is currently stable, Directors recommended that capital and liquidity buffers be preserved and banking supervision be strengthened to help safeguard financial stability as capital controls are eased. Directors noted that household debt relief will have a negative impact on the loss-making state-owned Housing Financing Fund (HFF). They urged the authorities to resolve the HFF in an orderly manner, while monitoring and addressing fiscal risks.

Table 1. Iceland: Selected Economic Indicators, 2008–15

	2008	2009	2010	2011	2012	2013 Prel.	2014 Proj.	2015 Proj.
	(Percentage change, unless otherwise indicated)							
National Accounts (constant prices)								
Gross domestic product	1.2	-6.6	-4.1	2.7	1.5	3.3	2.9	3.0
Total domestic demand	-8.6	-20.3	-2.2	3.3	1.8	0.5	4.2	3.9
Private consumption	-7.8	-15.0	0.1	2.6	2.4	1.2	3.5	3.2
Public consumption	4.6	-1.7	-3.4	-0.3	-1.4	1.3	1.8	1.5
Gross fixed investment	-20.4	-51.4	-9.4	14.1	5.5	-3.4	11.8	10.8
Exports of goods and services	7.0	7.0	0.5	3.8	3.8	5.3	2.7	4.0
Imports of goods and services	-18.4	-24.0	4.5	6.7	4.7	-0.1	5.4	5.3
Output gap 1/	2.2	-1.8	-4.6	-2.2	-1.9	-0.5	0.0	0.6
Selected Indicators								
Nominal GDP (billion ISK)	1,480	1,498	1,536	1,628	1,699	1,786	1,881	1,991
Unemployment rate 2/	1.6	8.0	8.1	7.4	5.8	4.4	4.0	3.5
Consumer price index	12.4	12.0	5.4	4.0	5.2	3.9	2.5	3.3
Nominal wage index	7.5	2.8	7.9	7.0	7.3	4.5	4.6	6.0
Real wage	-4.6	-8.2	2.4	2.9	2.1	0.6	2.0	2.6
Nominal effective exchange rate 3/	-40.4	-34.2	2.9	-0.1	-2.4	1.4	...	...
Real effective exchange rate 3/	-20.7	-18.7	6.4	0.9	0.6	3.7	...	...
Terms of trade	-9.3	-6.7	6.0	-1.8	-3.4	-2.4	0.6	1.0
Money and Credit								
Base Money	-31.5	1.3	-19.4	-20.7	32.0	0.3	5.3	5.9
Deposit money bank credit (end-period)	-43.7	-14.1	-1.2	6.9	0.7	1.4	2.5	3.0
Broad money (end-period)	32.1	-1.1	-9.9	8.7	-2.7	4.2	3.2	3.1
CBI policy rate (period average)	15.4	13.7	7.8	4.4	5.4	6.0	...	...
	(Percent of GDP, unless otherwise indicated)							
Public Finance								
General government 4/								
Revenue	44.1	41.0	41.5	41.8	43.6	44.2	48.7	46.0
Expenditure	57.7	51.0	51.6	47.4	47.4	46.3	46.9	46.5
Balance	-13.5	-9.9	-10.1	-5.6	-3.8	-2.1	1.9	-0.5
Primary balance	-13.5	-6.5	-6.6	-1.9	0.3	1.6	5.1	2.2
Balance of Payments								
Current account balance	-28.4	-11.6	-8.0	-6.3	-5.3	3.9	2.1	2.3
Trade balance	-2.3	8.6	10.1	8.4	6.1	7.4	6.2	6.1
Financial and capital account	-66.9	-29.9	54.1	19.7	18.5	-11.3	-2.8	1.0
Net errors and omissions	-19.5	36.2	-55.8	-36.5	-25.0	7.7	0.0	0.0
Gross external debt 5/	564.7	269.7	293.6	258.8	246.3	247.2	220.9	211.3
Central bank reserves (US$ billion)	3.6	3.6	5.8	8.5	4.2	4.2	4.1	4.1

Sources: Statistics Iceland; Central Bank of Iceland; Ministry of Finance; and IMF staff estimates.

1/ Staff estimates. Actual minus potential output, in percent of potential output.
2/ In percent of labor force.
3/ A positive (negative) sign indicates an appreciation (depreciation).
4/ National accounts basis.
5/ Including face value of old banks debt before 2009.

Statement by Audun Groenn, Executive Director for Iceland and Ragnheidur Jonsdottir, Advisor to the Executive Director July 7, 2014

The Icelandic authorities wish to thank staff for constructive discussions during the Post-Program staff visit in May. Our authorities broadly agree with the staff appraisal. The report contains useful analysis, including on debt sustainability and balance of payments (BoP) prospects that serve as valuable input into the formulation of a strategy to deal with the challenges faced by the Icelandic economy. While staff considers the general outlook for the economy positive, risks are tilted to the downside. Our authorities agree with this assessment, given how open the economy is to the external environment, as there is still uncertainty regarding demand growth among Iceland's main trading partners at this juncture.

Iceland's growth prospects for 2014 and beyond remain favorable, especially in international comparison. Recovery is also becoming more broad-based, as sectors that were hit hard by the crisis are beginning to recover. As confidence has returned, investment has taken hold in diverse sectors. The export economy remains robust, underpinned by banner years in the tourism industry. Moreover, several energy-related investment projects are on the table and are expected to be launched in coming years. The outlook is for close to 4 percent GDP growth this year and next year, according to the Central Bank's May 2014 forecast. Wide fluctuations in export inventories make Q1/2014 GDP figures hard to interpret. The steady deterioration of terms of trade since 2010 is projected to level out in 2014. Prices of fish products have increased in recent months. Despite encouraging signs of broad-based growth, the authorities realize that there is no room for complacency. A balanced budget, careful steps to abolish capital controls, and strengthened financial stability will underpin the short-term growth strategy while support for education, increased labor productivity, and entrepreneurship will form the basis for long-term sustainable growth.

Uncertainty regarding the economic outlook is related primarily to the global outlook and its effect on the Icelandic economy, the results of next year's wage negotiations, and the effects of the Government's debt relief program on household spending.

Fiscal policy

Revenue and expenditure numbers so far indicate that fiscal targets will be reached this year. Preparations for next year's budget are underway and assume a balanced budget in 2015. Staff proposes additional measures in the range of 1.0 to 1.5 percent of GDP during 2015-2016 while creating additional space for investment. Revenue is expected to increase in line with increased growth, and strict control on expenditures will be maintained. There is scope for asset sales to reduce central government debt and public-private partnerships to finance cost-effective investments. The central government's debt is on a downward trajectory and is projected to fall below 80 percent of GDP by year-end 2014. It also helps that municipal finances have improved substantially in recent years. The organic budget law submitted to Parliament is intended to support the aim of reducing public debt with a fiscal rule requiring a net debt ratio below 45 percent of GDP and is expected to receive broad support. There is scope for substantial savings in public administration, but downsizing in this area could face resistance if not well planned.

The authorities' debt relief program is intended to be fiscally neutral. The justification behind this program is to compensate for the unforeseen rise in the CPI and concomitant drop in real estate values during the crisis. The post-crisis rise in inflation, several times above the upper limit of the inflation target set by the Central Bank, can be viewed as an unreasonable burden on households that took on indexed mortgages in good faith before the crisis struck. The final outcome for each household will depend on the number of applicants and participation in the pension savings component of the debt relief package.

Staff rightly points out the risk to the Housing Financing Fund (HFF), whose finances are already on a weak foundation. A comprehensive solution to the problems of the HFF, including a definition of its future role in the housing market, is called for. The potential pressure on the HFF due to the debt relief program makes it imperative not to delay action. Constructive plans are being assessed, and our authorities believe that the challenge posed by the HFF is manageable.

Monetary policy

Inflation has fallen recently, from 4.2 percent in December 2013 to 2.2 percent in June 2014, and is expected to stay close to target the rest of this year. Inflation expectations one to two years ahead have declined in the recent term, in line with falling inflation, but long-term inflation expectations are still somewhat above target.

One of the factors that may contribute to declining inflation and inflation expectations over the medium term is the Central Bank's increased activity in the foreign exchange market since mid-2013, which has reduced exchange rate volatility. The Central Bank's real interest rate has risen in line with declining inflation and inflation expectations, although nominal interest rates have remained unchanged since November 2012. The tighter monetary stance has also contributed to the slowdown in inflation. Furthermore, the Monetary Policy Committee has indicated that increased growth in domestic demand in the near term will probably require further increases in the Bank's real interest rate, other things being equal.

The Central Bank has resumed regular purchases of foreign currency to build up its non-borrowed reserves. The timing is partly motivated by the fact that inflation is on target and the real exchange rate is not far from the level considered appropriate for the near future.

Financial sector

Preparing and adapting the financial system for an environment of free flow of capital is a key challenge going forward. Our authorities agree with staff on the need to formulate a revised strategy for capital account liberalization. Work is progressing on several fronts, and in June a process was launched to select foreign advisors to assist the Government on this issue. It was known when capital controls were imposed that the negative effects would grow faster than the benefits as time went by, and the authorities are resolute to take significant steps towards removing the controls in coming months. The steps taken will be conditions-based. However, there is no risk-free liberalization of capital controls, and the microeconomic costs are accumulating. The risks must therefore be weighed against the costs of delay.

The Icelandic banks will continue to operate with high capital and liquidity buffers and competent financial supervision will be provided, based on a key lesson learned from the global crisis in 2008, international standards and best practice. The Financial Supervisory Authority (FME) will be strengthened through efficiency gains as well as investment in technical and human resources.

Capital flow management and balance of payments

Our authorities welcome the ongoing consultations between staff and the Central Bank of Iceland regarding the analysis of balance of payments (BoP) scenarios. The authorities generally agree with staff recommendations on a revised liberalization strategy conditioned on BoP prospects. Such underpinnings will help design a comprehensive policy strategy on the liberalization process that is consistent with Iceland's economic and financial stability.