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IMF Executive Board Concludes 2014 Article IV Consultation and Fifth Post-Program Monitoring Discussion with Iceland

On March 9, 2015 the Executive Board of the International Monetary Fund (IMF) concluded the 2014 Article IV consultation¹ and Fifth Post-Program Monitoring Discussion with Iceland².

Iceland has reached a relatively strong macroeconomic position with good growth prospects. Unemployment continues to trend down, now at 4 percent. Growth slowed last year but is expected to pick up to around 3 percent over 2015–17, supported by robust domestic demand and tourism. Consumption will be boosted by household debt relief and—together with net trade—will benefit from favorable commodity prices.

Against this positive economic backdrop, vulnerabilities remain and risks are tilted to the downside. Crisis legacies are still being unwound, including a large balance of payments (BOP) overhang contained by capital controls. The authorities expect significant progress this year in finalizing and implementing an updated capital account liberalization strategy. The current account balance is forecast at around 6 percent of GDP this year—boosted by falling oil prices—and is expected to gradually decline over the medium term to 2 percent of GDP.

Inflation has fallen to 0.8 percent—well below the 2.5 percent target—pulled down by imported deflation and a stronger exchange rate. However, real wages accelerated to almost 6 percent, and the outcome of 2015 wage negotiations is highly uncertain. Inflation is expected to move closer to the target by the end of 2016. The Central Bank of Iceland (CBI) paused in February and continued foreign exchange accumulation. The CBI legislative framework review is currently in progress.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

² 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.

The general government recorded a surplus of 1.8 percent of GDP last year—its first surplus in seven years—helped by one-off revenues. The fiscal stance, measured by the change in the structural primary balance, tightened 0.2 percent of potential GDP in 2014 and is projected to tighten further by about 0.5 percent of GDP over the medium term. Household debt relief became operational, and more frontloaded to 2014, though the overall costs are broadly as expected. General government gross debt remains high but on a downward sustainable path. The draft budget framework bill now before Parliament—when approved—will strengthen Iceland’s fiscal framework. The government has begun an important reform of the VAT system.

Good progress has been made in improving the financial stability framework, but gaps remain. Banking sector buffers are strong but uncertainties surrounding the unwinding of crisis legacies and legal risks, including challenges to CPI indexation, remain high. The CBI and the Financial Supervisory Authority (FME) are making progress in improving macrofinancial and supervisory stress tests, but gaps remain in bank supervision and financial safety nets. The authorities are working on permanent solutions for the loss-making government-owned Housing Financing Fund (HFF) and are developing mechanisms for a successor lender.

Executive Board Assessment³

Executive Directors welcomed the improving economic conditions and progress in addressing crisis legacies. Directors noted that with sound policies, the outlook is for sustained growth, price stability, and declining debt ratios. However, downside risks remain, including from lower global growth, wage pressures, and uncertainty surrounding capital account liberalization. It would therefore be important to maintain macroeconomic and financial stability, while enhancing growth, rebuilding confidence, and preparing for the eventual removal of capital controls.

Directors agreed that the strategy for liberalizing the capital account should remain conditions-based, be well communicated, and benefit from the support of sound macroeconomic and financial sector policies. In this context, they recommended that greater focus be placed on policies to strengthen Iceland’s balance of payments and on structural reforms to boost labor productivity and competitiveness.

Directors agreed that the monetary policy stance appropriately focuses on price stability. They encouraged the central bank to remain vigilant and stand ready to respond to opposing pressures from external deflationary developments and potentially large wage increases. Directors supported ongoing efforts to accumulate foreign currency reserves to smooth eventual outflows,

³ 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>

as conditions permit. They stressed the importance of maintaining an independent and accountable central bank, and looked forward to the outcome of the review of legislation in this area.

Directors welcomed progress in consolidating public finances and the early repayment to the Fund. They saw merit in developing contingency measures to achieve the 2015 fiscal targets. Directors supported the medium-term objectives of pursuing a balanced budget and further reducing public indebtedness. They noted that, with Iceland on track to achieve core objectives, fiscal policy is well positioned for a transition toward boosting potential growth, particularly through public investment, while being mindful of the distributional consequences of any reforms. Directors underscored the importance of adopting the organic budget law to provide an institutional anchor for fiscal policy, thus reinforcing market confidence ahead of capital account liberalization. Improving the efficiency of the tax system also remains a priority.

Directors emphasized the need to maintain adequate buffers in the core financial sector in light of risks surrounding the unwinding of capital controls and some legal challenges. They recommended that the authorities continue to improve the financial stability framework, including supervision, deposit insurance, bank resolution, and emergency liquidity assistance. Directors called for a swift resolution of the Housing Financing Fund to minimize fiscal costs and financial stability risks.

Iceland: Selected Economic Indicators, 2011–16

	2011	2012	2013	2014 Est	2015 Proj	2016 Proj
(Percentage change, unless otherwise indicated)						
National Accounts (constant prices)						
Gross domestic product	2.1	1.1	3.5	1.8	3.5	3.2
Total domestic demand	3.0	1.2	0.9	3.1	4.4	4.5
Private consumption	2.5	2.0	0.8	3.2	3.4	3.0
Public consumption	0.2	-1.2	0.8	1.0	1.6	1.6
Gross fixed investment	11.6	4.3	-2.2	13.4	13.2	14.1
Exports of goods and services	3.4	3.9	6.9	4.3	4.6	3.4
Imports of goods and services	6.8	4.9	0.4	9.4	7.7	7.0
Output gap 1/	-1.3	-1.0	-0.6	-1.2	-0.4	0.0
Selected Indicators						
Nominal GDP (ISK bn)	1,701	1,774	1,873	1,961	2,121	2,237
Private consumption (percent of GDP)	51.7	53.4	52.7	52.9	51.0	50.8
Public consumption (percent of GDP)	24.4	24.4	24.3	24.2	23.8	24.0
Gross fixed investment (percent of GDP)	15.5	16.0	15.1	16.4	17.2	18.8
Unemployment rate (period average) 2/	7.1	6.0	5.4	5.0	4.0	4.0
Employment	0.0	0.5	3.7	1.9	2.9	2.2
Real GDP per capita (ISK mln)	3.6	3.6	3.7	3.8	3.9	4.0
Consumer price index (period average)	4.0	5.2	3.9	2.0	0.9	2.1
Consumer price index (end of period)	5.3	4.2	4.2	0.8	0.8	2.3
Nominal wage index	7.0	7.9	3.5	5.5	6.7	5.1
Real wage	2.3	2.6	-0.3	3.5	5.8	3.0
Nominal effective exchange rate 3/	0.3	-3.3	2.3	5.9
Real effective exchange rate 3/	0.9	0.6	3.8	6.7
Terms of trade	-2.8	-3.1	-1.9	2.4	5.1	-0.2
Money and Credit						
Base Money	-20.7	32.0	0.3	-25.4	8.8	0.0
Deposit money bank credit	6.9	0.7	1.4	4.7	4.3	5.3
Broad money	8.7	-2.7	4.2	9.4	1.5	1.5
CBI policy rate	4.75	6.00	6.00	5.25
(Percent of GDP, unless otherwise indicated)						
Public Finance (General Government 4/)						
Revenue	40.1	41.8	42.5	47.9	43.9	42.9
Expenditure	45.7	45.5	44.2	46.0	43.8	42.8
Balance	-5.6	-3.7	-1.7	1.8	0.1	0.1
Primary balance	-2.5	-0.1	2.0	5.1	3.3	2.8
Balance of Payments						
Current account balance 5/	-5.2	-4.2	5.5	4.7	6.1	4.7
Trade balance	8.2	6.3	8.3	7.1	8.1	6.4
Financial and capital account	5.1	-4.9	8.2	10.1	5.9	4.5
Net errors and omissions	1.5	-0.1	0.4	0.9	0.0	0.0
Central bank reserves (USD bn)	8.7	4.3	4.1	4.2	4.5	4.2
Excluding old banks' deposits (USD bn)	5.9	4.2	4.0	4.0

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

1/ 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/ Actual data include the income receipts and expenditures of DMBs in winding up proceedings, and accrued interest payments on intra-company debt held by a large multinational, but estimated and projected data do not.