



Iceland: Staff Concluding Statement of the 2017 Article IV Mission

March 28, 2017

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

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

Iceland is stepping into a new era of financial openness. It should stride with confidence and care. The top priority must be a decisive strengthening of financial sector oversight. Risks associated with capital flows should be addressed by ensuring that macroeconomic policies, financial sector regulation and supervision, and macroprudential measures act in concert. Current strong growth rates—more than 7 percent last year—are driven by tourism and private consumption, not leverage. Nonetheless, overheating risks are evident. Króna appreciation is a dampening mechanism. Should further króna strength drive inflation prospects lower, there may be room for interest rate cuts. Fiscal policy should be tightened this year in response to demand pressures, but over the medium term there may be room for additional public spending on infrastructure, healthcare, and education.

1. The lifting of outflow controls on residents seizes an opportune moment.

Growth is firm, inflation is low, credit growth is moderate, the current account is in substantial surplus, foreign exchange reserves are comfortable, and the recent agreement with some of the largest holders of offshore krónur reduces risks. Over time, capital account openness should result in a healthy two-way cross border flow of funds.

2. Capital account opening heralds a new era of greater risk taking. Capital flows will bring risks as well as opportunities. Volatility will increase. The business of banking, in particular, will be transformed, with sleepy market conditions giving way to fierce competition. This, in turn, could create systemic risk and test financial stability. The recent private placement of bank equity with four foreign investors likely to pursue large dividends, divestment, and restructuring is an example of the forces that will drive competition.

3. The top priority must be to strengthen financial sector oversight. Bold steps are needed to give bank regulation and supervision strong powers and independence. One solution is to unify all safety and soundness oversight of banks at the central bank, leaving conduct of business oversight and regulation of nonbanks at another body—the so called "twin peaks" approach. Other solutions can also be found. Currently, Fjármálaeftirlitid is not sufficiently insulated from the political process, and the sharing of aspects of banking oversight between Fjármálaeftirlitid and the central bank creates a potential for conflicts, gaps, and coordination issues. Fixing these problems will require amending the *Act on Official Supervision of Financial Activities*. This item should be placed high on the legislative agenda.

4. **Policies to ensure high quality bank ownership are very important.**

Privatization of the two state owned banks should be pursued patiently, with a focus on finding strategic buyers with track records of conservatism and a long-term commitment to Iceland. In all cases, the quality of new bank owners should take priority over transaction speed or price. The recent purchase of the one privately owned pillar bank poses a test for Fjármálaeftirlitid. Financial stability considerations and fairness require that the mandatory fit and proper assessment be thorough, uncompromising, and evenhanded.

5. **The real economy, meanwhile, is being reshaped by tourism.** Fundamentally, this is a positive development. The number of foreign travelers grew by 40 percent in 2016 and the Keflavík airport authority projects a further 27 percent expansion this year. Job opportunities in services and construction have multiplied, pulling in foreign workers. This, together with króna appreciation, strong terms of trade, and prudent monetary policy, has kept inflation below target despite the large wage awards of 2015. Evidence from elsewhere suggests the shoal of tourists is not about to swim away abruptly: tourists are not herring.

6. **If the tourism shock is permanent, then the equilibrium real exchange rate needs to find a higher level.** This explains the apparent paradox of 20 percent króna appreciation and a current account surplus of 8 percent of GDP last year. Appreciation is a dampening mechanism, helping to guide the economy back to a more sustainable growth path. To be sure, there will be challenges for some export sectors, including the so called innovation sector. Fishing may see some industry consolidation, with continued success resting on embracing the best technologies. The lagged impact of króna appreciation, together with slipping terms of trade, will gradually erode the surplus on goods and services.

7. **Housing pressures could tip the economy into overheating.** Residential mortgage lending, while still moderate, is picking up, calling for a high degree of vigilance. Macroprudential tools should be deployed as needed, and should include new powers to limit foreign currency lending to unhedged borrowers and, potentially, to prohibit lending by pension funds. Construction could keep lagging demand, pushing housing prices higher. If rising living costs keep foreign workers away, labor market conditions could heat up. Another round of large wage increases would compound domestic demand pressures.

8. **Further interest rate cuts are not necessarily inconsistent with keeping inflation close to target.** The central bank has maintained a tight monetary policy stance and should continue to do so given demand pressures. At the same time, indications are that upward pressure on the króna could persist. Exchange market intervention should be more sparing than last year, with greater tolerance for short-term volatility. To the extent króna appreciation drives inflation prospects lower, there may be room for rate cuts. Of course, a capital outflow scenario is also possible, especially if policy missteps or misstatements trigger a loss of confidence. In such a scenario, the policy rate would need to rise.

9. **The inflation targeting framework is delivering positive results.** Inflation has been low for three years and inflation expectations have converged to target. Nonetheless, public support for the framework could be boosted by clearer explanations of the considerations that shape policy. Monetary operations, in turn, would benefit from the introduction of a fine-tuning instrument to better control domestic monetary conditions and neutralize the liquidity impact of changes in reserves. Placing a portfolio of treasury bills at the central bank for use as collateral seems a promising option. Effective liquidity management also requires enhanced information sharing on government cash flows.

10. **It is a victory that the Organic Budget Law has shaped the fiscal policy debate through a general election.** The new government's Fiscal Statement embodies prudence, with net public debt set to fall below 30 percent of GDP even without privatization. In contrast, the budget for 2017, passed before the new coalition took office, approves too much spending in a year when GDP growth is expected to again be very strong. Outlays must be financed responsibly, and fiscal policy should stand ready to tighten if serious overheating risks materialize. Consideration should be given to tax reforms, focusing on indirect taxes. Later in the planning horizon, there may be room for significantly more spending on infrastructure, health, and education, guided by a comprehensive review of expenditures.

11. **Capital flow surges may be difficult to manage.** Responses must ensure that all policies pull in the same direction. Microprudential oversight must prevent excessive risk taking by banks, at home or abroad. Macroprudential policies should be deployed as needed to minimize systemic risks. Capital flow management measures are best kept as a last line of defense. These should not substitute for warranted macroeconomic adjustment, which can include some further currency appreciation and reserve accumulation. This leeway, and the absence of any obvious link between capital flows and systemic risks currently, suggests the special reserve requirement on debt inflows is not needed at this time. Authority to re-impose it should, however, be retained on the statute books.

12. **Structural reforms should seek to protect competitiveness and nurture sustainable tourism.** Work to revamp wage bargaining must continue. Social partners, having outlined a new model anchored on competitiveness, should focus on implementation in the 2018 wage round. Equally, a holistic tourism strategy should be developed. The growth of tourism has stretched infrastructure and public services. It may be beneficial to establish a high level body tasked with ensuring adequate resources for and effective coordination of licensing rules, infrastructure development, and environmental protection.

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