INTERNATIONAL MONETARY FUND

Iceland: Staff Concluding Statement of the 2018 Article IV Mission

September 25, 2018

The gradual slowdown of Iceland's economy from the unsustainable pace of previous years is welcome. Risks have increased, but buffers have strengthened and policies should continue to build resilience. Fiscal plans lay out necessary increases in public spending on infrastructure, healthcare, and education, but careful prioritization and execution are needed to meet the fiscal targets. Monetary policy should remain focused on price stability. Financial stability policy needs to pull on both micro- and macroprudential levers. Further strengthening financial sector oversight remains a top priority, where the tenth anniversary of Iceland's crisis should be a time for decisive action. Finally, better wage bargaining is vital for competitiveness; further tourism development requires a comprehensive policy strategy; and sustainable fishing calls for continued efforts at international cooperation.

1. **Iceland's growth slowdown has reduced overheating concerns**. The strengthening of the króna in 2014–16 has, with a lag, dampened tourism growth and cooled domestic demand. An increasing supply of new homes has slowed house price appreciation. Credit growth is accelerating, but from a low level. The króna has been broadly stable since mid-2017—a more manageable situation for exporters than if the strong appreciation of recent years had continued. Inflation has been near the official target for five years, a remarkable achievement given Iceland's history of price instability. IMF staff expects growth to slow gently, eventually settling at a more sustainable rate of about 2½ percent.

2. **But new risks have become evident**. Strong oil prices and mounting air transport competition are challenging the airline business. Escalating world trade tensions threaten to hurt export prices for aluminum and other items. And uncertainty around Brexit negotiations raises the risk of weaker export demand from one of Iceland's biggest markets and could further complicate North Atlantic fishing cooperation. Finally, the coming wage rounds could once again deliver excessive remuneration, hurting Iceland's competitiveness.

3. **Policies therefore need to focus on maintaining resilience**. Iceland's household, corporate, and public balance sheets have strengthened dramatically in recent years. Given the economy's small size, openness, and exposure to shocks, it is vital to preserve buffers—low public debt, strong bank capital and liquidity, and adequate official reserves—while also pursuing policies to lift growth potential, enhance competitiveness, and modulate risk taking.

4. **IMF staff supports Iceland's new fiscal targets, but calls for greater clarity in the underlying fiscal plans**. Those plans are likely to deliver a broadly neutral fiscal stance going forward, which is appropriate given the growth trajectory. They are also consistent with further debt reduction, which would create more space for countercyclical policies if risks crystallized. Staff supports the emphasis on infrastructure, health, and education, but calls for careful prioritization. Saving measures should be spelled out, reliance on unpredictable dividend flows reduced, and tax reforms considered carefully to support budget planning and stay within the spending envelope, ensuring observance of the overall surplus targets.

5. **Monetary policy should remain focused on price stability as its primary objective**. The inflation target should adequately capture households' spending patterns, including their spending on housing. Interest rate increases would be warranted if inflationary pressures mounted—spurred, for instance, by excessive wage growth—or in a scenario of large capital outflows. Foreign exchange interventions should be limited to countering disorderly market conditions, with a strong emphasis on maintaining adequate reserves.

6. **IMF staff supports the authorities' plans to renew the legal basis for the special reserve requirement on selected debt inflows**. Such capital flow management measures can be useful in certain circumstances provided they do not substitute for warranted macroeconomic adjustment. Nonetheless, staff also notes that narrowing interest rate differentials between Iceland and the major currency zones provide further grounds for rolling back the special reserve requirement on selected inflows at this time.

7. **As advised, Iceland is working to further strengthen financial sector oversight**. The overarching goal should be to have a structure that is independent, well resourced, and vested with all necessary rulemaking and enforcement powers. The structure should also ensure that there are no unnecessary overlaps or potential gaps.

8. **The tenth anniversary of the financial crisis should be seized as a time to move from debate to decisive action**. IMF staff sees merit in unifying all financial sector oversight, lender-of-last-resort, and resolution duties at the central bank. This would harness synergies, eliminate unwanted overlaps, better integrate micro- and macroprudential policies, reflect the systemic importance of Iceland's pension funds, and enhance preparedness for future challenges. By pursuing what would essentially be a merger of the regulatory agency into the central bank, the approach would also minimize transition issues.

9. **IMF staff strongly supports Iceland's efforts to improve its wage bargaining system and anchor it on productivity growth and competitiveness**. With purchasing power having increased by a remarkable 25 percent over the last four years—and even more if viewed in foreign currency terms—wage agreements should be in line with productivity gains to avoid further growth in unit labor costs.

10. **Strengthening economic and environmental sustainability is also a priority**. In tourism, the growth slowdown adds urgency to adopting a holistic strategy and taking concrete actions, including to improve tourism services at popular sights and the accessibility of destinations farther afield from Reykjavík. In fisheries, careful management of marine resources remains central to success—this should include further efforts to secure durable fishing agreements with other North Atlantic fishing nations for several migratory species.

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