

Assessment and recommendations

Fostering economic recovery

Iceland is a very small resource-based economy. It is highly volatile and has the smallest floating currency in the world. The labour market is flexible, reducing the costs of coping with this volatility. Icelanders are generally well educated, although the high school drop-out rate is a concern, and typically enjoy good health outcomes. Income inequality is among the lowest in the OECD. Government administration is efficient, especially when allowing for the absence of economies of scale in service delivery, and the overall tax burden is moderate.

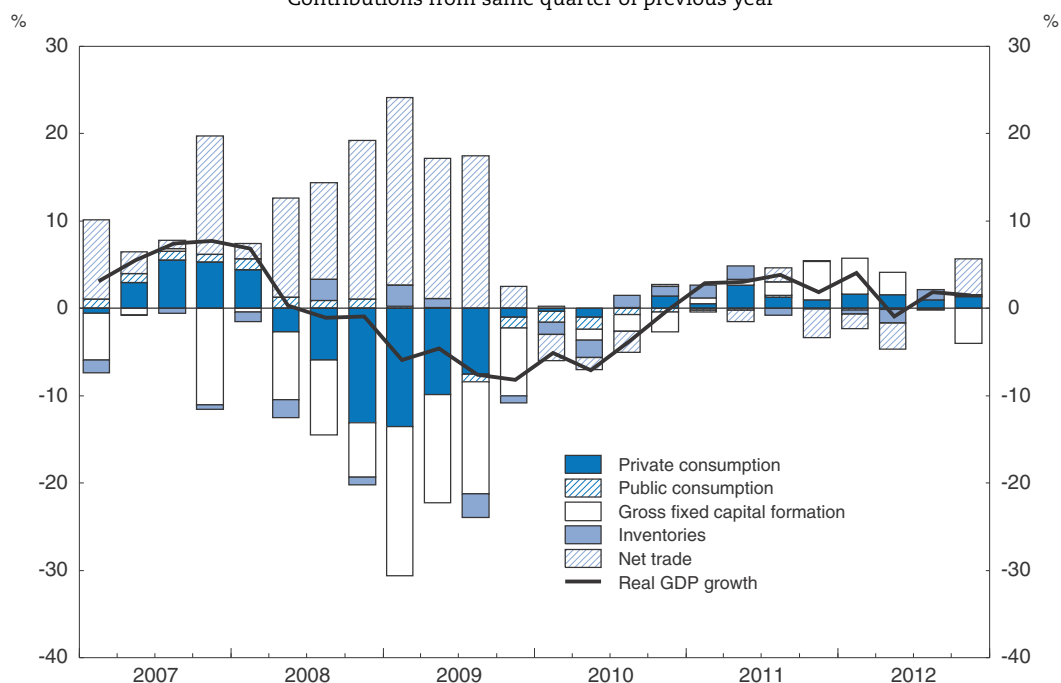
Policymaking in recent years has been dominated by the need to work through the legacy left by the collapse of Iceland's three main banks in 2008. This includes an over leveraged private sector, high levels of nonperforming loans, financial stability arrangements that had been found to be wanting, high levels of government debt and capital controls. Considerable progress has been made in deleveraging and reducing non-performing loans as well as in improving financial stability arrangements, although more remains to be done. Government debt has started to decline, but remains high. The biggest risk facing the economy is that the removal of capital controls unleashes a rush for the exit, driving down the exchange rate and weakening the financial system. There is also a risk that Icelandic entities may not be able to roll over the substantial amount of foreign currency debt reaching maturity over the next few years. This risk could be exacerbated if the creditors of the old banks are forced to finance a proposed across-the-board write down of mortgage debt.

The economy is recovering at a moderate pace

The Icelandic economy continues to recover following the deep recession caused by the collapse of the country's three main banks in October 2008, although growth weakened in 2012 to 1.6% (Figure 1, Table 1). Economic recovery was initially led by private consumption, which has been temporarily boosted by write-downs of household debt, households drawing down their third-pillar pension assets and special payments from banks and government, and residential and business investment. Private consumption expenditure and residential investment continued to expand in 2012 and into 2013, supported by employment growth, wealth gains from rising house prices and the temporary factors mentioned above, but business investment has slowed sharply mainly owing to declines in shipping and aircraft investment and energy-intensive industry investment.

In retrospect, the surge in output during the 2005-07 economic boom was unsustainable because it was based on a very large credit-financed expansion in demand which was itself unsustainable (Figure 2). If a discrete reduction in potential output is assumed following the crisis, production-function based estimates, such as by the Central Bank of Iceland (CBI), indicate that output has now almost recovered to potential. The CBI estimates the

Figure 1. **The domestic demand-led recovery has moderated**
Contributions from same quarter of previous year¹



1. Contribution to real GDP growth. The sum of the contributions does not add up to the GDP growth rate because the data are chain-linked.

Source: Statistics Iceland.

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output gap to be minus 1% of potential GDP in 2013. A similar conclusion is reached when output is compared with its trend. These conclusions are corroborated by the unemployment rate, which is 5¼ per cent (harmonised rate) and close to the OECD's estimate of the point at which labour-market slack will be exhausted. Nevertheless, estimates of the amount of remaining economic slack are subject to considerable uncertainty, not least because an unknown amount of physical and human capital that was valuable during the boom became redundant following the crisis. Moreover, while estimates of potential output allow for migration flows, which are relatively large in Iceland, these too are highly uncertain.

The share of long-term (6 months or more) unemployed in total unemployment has risen from around 7% in 2008 to 38% in 2012 (Statistics Iceland). A programme has recently been launched to offer subsidised temporary jobs to the large numbers of jobseekers who lost rights to unemployment benefits at the end of 2012, when the extension of unemployment benefit rights (to a fourth year) expired. Such programmes have been successful in leading to stable employment in Iceland in the past (*OECD Economic Survey of Iceland*, 2011). The extent to which the long-term unemployed will eventually re-enter employment is unclear, adding to the uncertainty surrounding potential output estimates.

The 12-month rate of wage increases has fallen from 11-12% early in 2012, when large negotiated increases were being implemented, to 5.0-5.5% early in 2013. However, the slowdown in growth in unit labour costs has been less marked because productivity growth has also slowed, to only 0.3% in the 12 months to the fourth quarter of 2012. The OECD assumes that the outcome of wage negotiations in November is compatible with ongoing

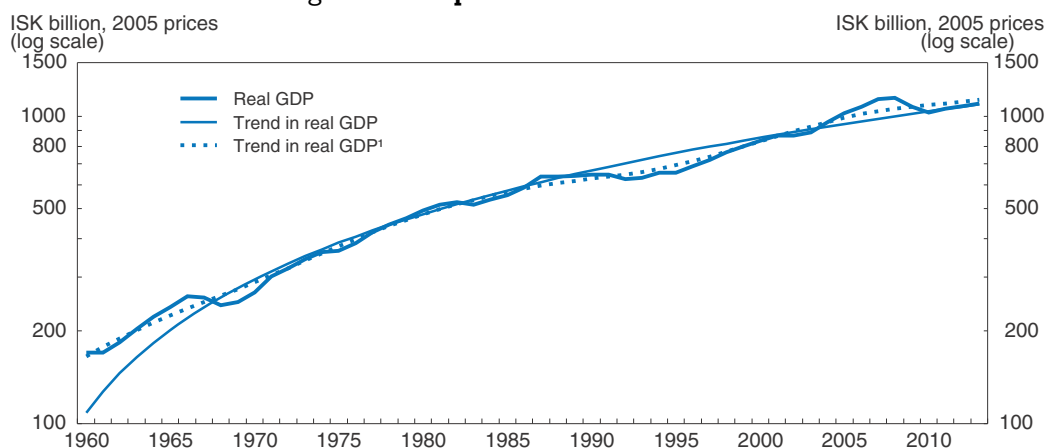
Table 1. The short-term economic outlook

	2009	2010	2011	2012	2013	2014
	Current prices ISK billion	Percentage changes, 2000 prices				
GDP	1 497.9	-4.1	2.9	1.6	1.9	2.6
Private consumption	764.5	0.0	2.6	2.7	2.2	2.9
Government consumption	396.9	-3.4	-0.2	-0.2	0.2	0.0
Gross fixed capital formation	207.0	-9.4	14.3	4.4	-3.7	15.3
Business investment	117.2	-1.3	27.9	8.6	-11.6	18.5
Residential construction	40.1	-18.0	5.4	6.9	11.0	16.2
Government investment	49.7	-21.8	-17.1	-17.0	18.7	1.2
Final domestic demand	1 368.4	-2.5	3.5	2.2	0.7	3.9
Stockbuilding ¹	0.7	-0.2	0.6	-0.2	0.0	0.0
Total domestic demand	1 369.1	-2.7	4.1	1.9	0.2	3.9
Exports of goods and services	791.4	0.6	4.1	3.9	2.0	2.1
Imports of goods and services	662.6	4.5	6.8	4.8	0.0	4.5
Net exports ¹	128.8	-1.7	-0.8	-0.1	1.2	-1.0
Memorandum items						
Consumer price index		5.4	4.0	5.2	4.0	3.2
Unemployment rate		7.7	6.9	5.9	5.3	4.8
General government financial balance ²		-10.1	-5.6	-3.4	-0.2	0.8
General government gross financial liabilities ^{2, 3}		125.1	133.8	131.8	128.6	124.4
Adjusted current account balance ^{2, 4}		7.1	3.0	3.1	3.5	2.8

- Contributions to GDP growth, actual amount in the first column.
- As a percentage of GDP.
- Includes funding shortfalls in pension funds for government employees of about 25% of GDP. These liabilities are excluded from the Maastricht definition of general government gross financial liabilities.
- Excluding calculated income and expense of DMBs in winding-up proceedings but including the effects of the settlement of their estates, and excluding the effects of pharmaceuticals company Actavis on the income account balance.

Source: Statistics Iceland and Central Bank of Iceland for data; OECD, *Economic Outlook 93 Database*.


Figure 2. Output is near its trend level



- Using Hodrick-Prescott filter.

Source: OECD, *OECD Economic Outlook 93 Database*.

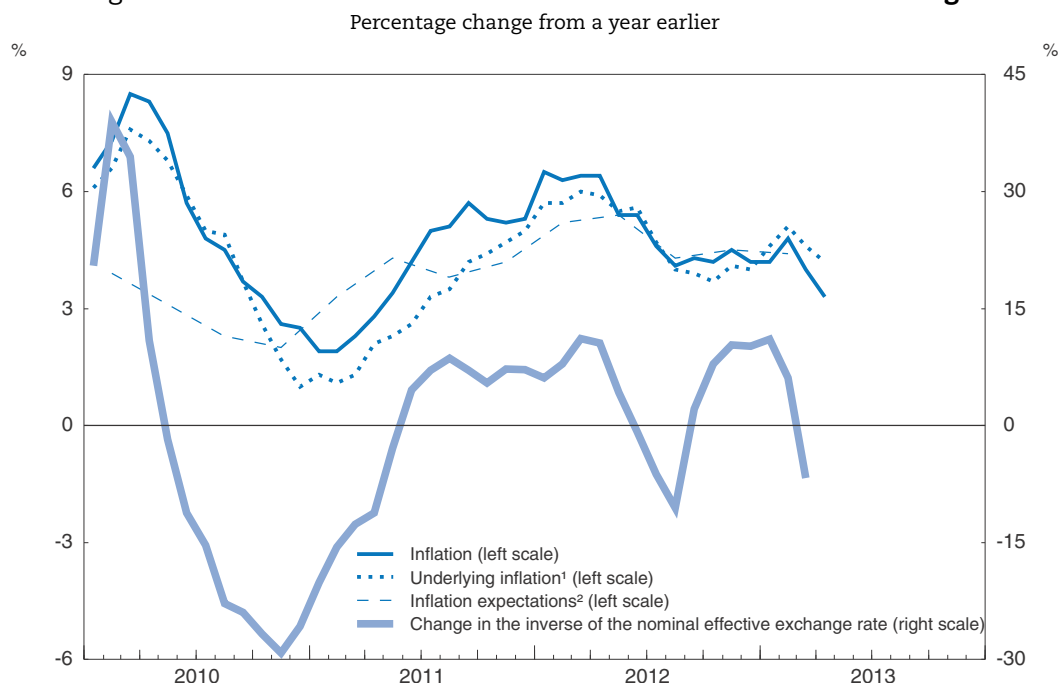
How to read this figure: The difference between real GDP and trend GDP is an indicator of economic slack. Real GDP was well above trend during the economic boom of 2005-07, suggesting overheating. Since then, real GDP has returned to near its long-term trend. The flattening slope of the trend real GDP lines indicates that the sustainable economic growth rate has declined.

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wage moderation and declines in the growth of unit labour costs, although again there is considerable uncertainty about these outcomes.


Inflation has continued to be buffeted by developments in the exchange rate and in commodity prices. A strengthening of the exchange rate since early in 2013 and a decline in oil prices contributed to a decline in the twelve-month headline inflation rate from a recent peak of 6.5% early in 2012 to 3.3% in April 2013 (Figure 3). However, the underlying inflation rate (CBI core index 3 excluding tax effects) has declined less, to 4.2% in April 2013, which remains well above the CBI's 2.5% inflation target. Expectations for inflation one and two years ahead have declined to 4% according to the CBI's market expectations survey carried out in May 2013, slightly below long-term inflation expectations.

Figure 3. **Inflation remains above the Central Bank of Iceland's target**



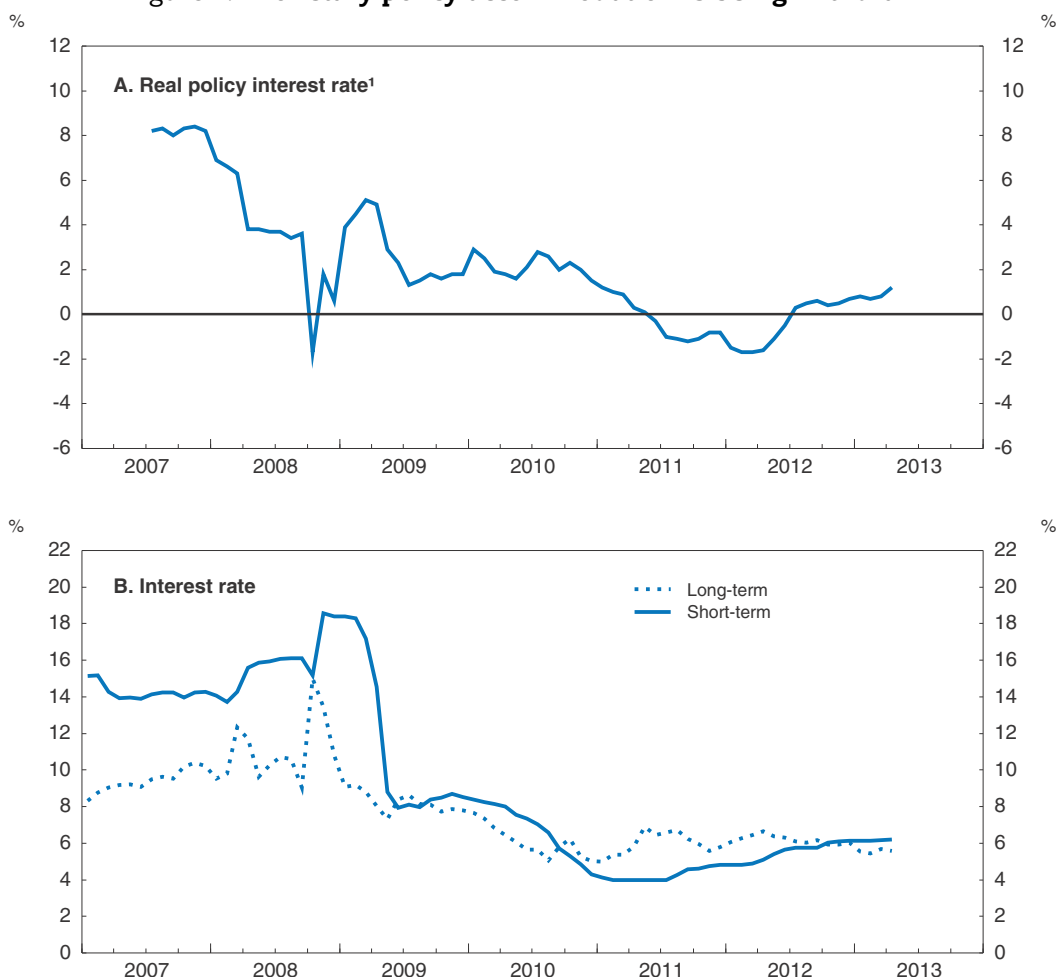
1. Core index 3 excluding tax effects. Core index 3 excludes from the CPI prices of agricultural products, petrol, public services and the effects of changes in real interest rates on the housing component of the CPI.
2. Based on the median of corporate, household, and breakeven inflation expectations one year ahead and the Central Bank inflation forecast one year ahead.

Source: Central Bank of Iceland.

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Remaining monetary policy accommodation should be withdrawn

Monetary policy has become less accommodative since late 2011. In real terms, the CBI's intervention rate had increased to around 1¼ per cent by April 2013 (slightly more if financial market participants' inflation expectations, which are only available since February 2012, and the CBI's 12-month inflation projection are included in the calculation of average inflation), from minus 1½ per cent a year earlier (Figure 4). This is still below the CBI's 2 per cent or so estimate of the neutral real policy rate. Taylor rule estimates of the appropriate policy rate, which provide guidance for policy rate decisions by adjusting the neutral rate for deviations in inflation from the target and in output from potential, indicate that a real policy rate above the neutral rate would be required to reduce inflation to the target level (CBI, 2013a). Remaining monetary policy accommodation should be

Figure 4. **Monetary policy accommodation is being withdrawn**

1. Average of the deposit rate and the maximum bid for 28-day CB notes as from September 2009, deflated by the average of consumer price index, business and household quarterly inflation expectations, and, as from January 2009, one-year breakeven inflation expectations based on the difference between the nominal and indexed government bond yield curves.

Source: Central Bank of Iceland; Statistics Iceland; OECD, *Main Economic Indicators*.

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withdrawn over the coming months and, if necessary, monetary policy should subsequently be tightened further to reduce inflation to the target level and to help to anchor inflation expectations. Exchange rate and wage rate developments will have an important bearing on the degree of monetary policy tightening required to meet the CBI's inflation target. Higher interest rates would also make króna assets more attractive to hold, providing a more supportive environment for progressively lifting capital controls.

Economic growth should pick up momentum next year

Economic growth is projected to remain near 2% in 2013 but to increase to around 2½ per cent in 2014 (see Table 1). Private consumption expenditure should continue to grow, and residential investment is expected to remain strong due to the buoyant property market and the large backlog of unfinished projects from before the crisis that are now profitable to complete. Business investment, on the other hand, is set to fall sharply, reflecting a decline in investment in ships and aircraft from the very high level in 2012, the

deferral of large energy-intensive investment and a decline in general business investment (excluding ships, aircraft and the energy-intensive industry). Much of the effect of this fall on GDP, however, will be offset by a decline in imports of the investment goods themselves. The pick-up in growth in 2014 is led by a large increase in energy-intensive industry investment. Growth in private consumption expenditure should also strengthen, buoyed by higher growth in employment and real wage rates. Unemployment is projected to fall to 4½ per cent by the end of 2014, leaving little pressure for further disinflation.

The main downside risks to these projections are that in 2014 the delayed energy-intensive investments do not get underway, general business investment does not strengthen or that Iceland's main trading partners do not recover as assumed. With more than half of exports going to the EU, Iceland is particularly dependent on developments in Europe and, therefore, on the course of the euro crisis. The global aluminium industry appears to be suffering from structural oversupply problems, raising questions about the timing of capacity expansion in Iceland. This is less likely to occur in the near future if Europe remains mired in recession or stagnation. Moreover, such overcapacity could cause aluminium prices to decline further, depressing Iceland's terms of trade. If access to finance does not improve, the projected strengthening in general business investment may not occur.

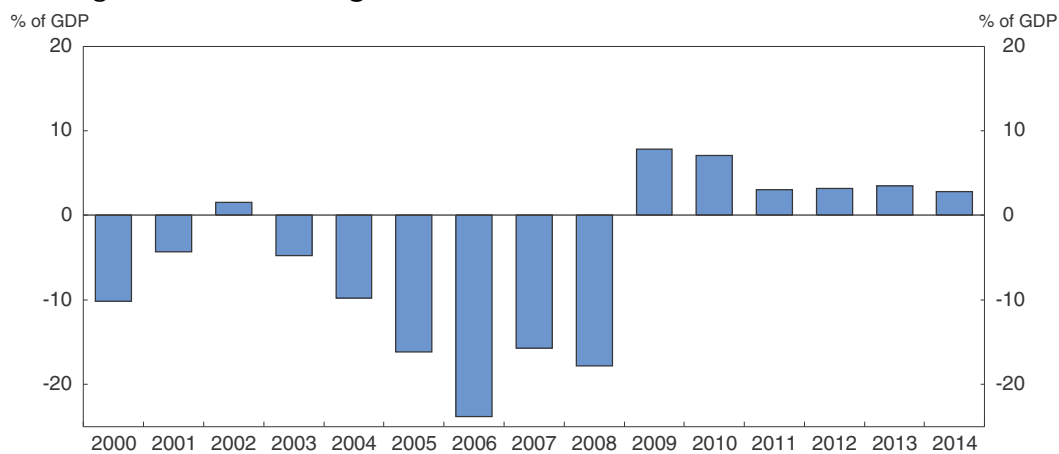
The main upside risks are that the global economy recovers more vigorously and global energy prices rise more than assumed, increasing the attractiveness of adding aluminium smelting capacity in Iceland and boosting Iceland's terms of trade. Inflation could also fall more rapidly than projected if the recent strength in the exchange rate is sustained and importers pass through the resulting price reductions, reducing the degree of monetary policy tightening, and hence the short-term drag on economic activity, required to achieve the CBI's inflation target.

There are a number of domestic factors that increase uncertainty about the economic outlook. First, the proposed across-the-board write-down of mortgage debt financed by creditors of the old banks could boost consumption but discourage foreign investment in Iceland and make it more difficult for Icelandic entities to roll over maturing foreign-currency liabilities. Second, the November 2013 wage negotiations could deliver higher increases than assumed, boosting consumption but weakening employment, increasing inflation and obliging the CBI to run a tighter monetary policy than otherwise. Third, there may be less fiscal consolidation than assumed, increasing risk premiums in Icelandic interest rates, obliging the CBI to run a tighter monetary policy than otherwise and reducing fiscal space to stabilise the economy when adverse shocks occur.

Economic rebalancing

The economy is adjusting to a more sustainable balance between aggregate demand and national output

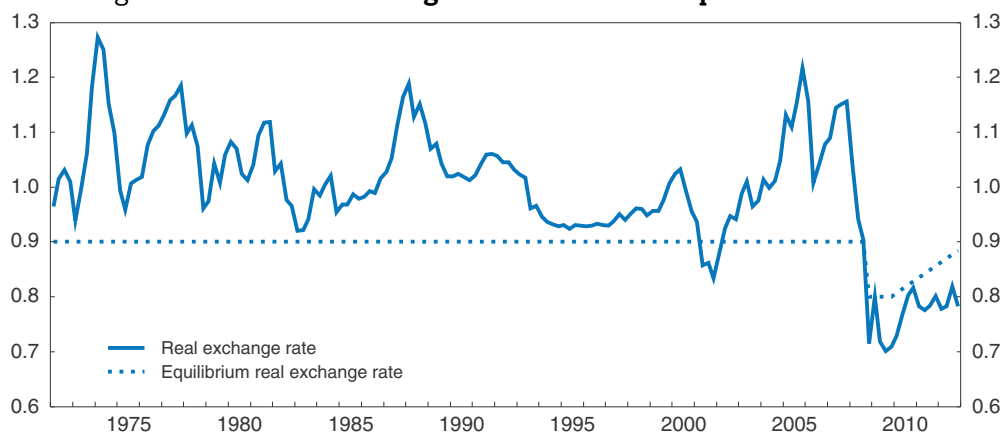
During 2003-07, aggregate demand ran well ahead of output. The current account deficit increased to a peak of 24% of GDP in 2006 (Figure 5). Even after adjusting for investment-good imports for the energy-intensive industry (10% of GDP in 2006), the remaining deficit was clearly unsustainable. The real exchange rate rose far above the CBI's estimate of its equilibrium value (i.e., the rate compatible with a sustainable current account deficit) (Figure 6), encouraging the transfer of resources from the traded to the non-traded sector. Financial and insurance activities (mainly financial), which were the core of the boom, expanded strongly. Construction and real estate activities also expanded,

Figure 5. **Iceland's large current account deficits have been eliminated**¹

1. Excluding calculated income and expense of Domestic Money Banks (DMBs) in winding-up proceedings, but including the effects of the settlement of their estates; excluding the effects of the pharmaceuticals company Actavis on the income account balance.

Source: Central Bank of Iceland.


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Figure 6. **The real exchange rate is below its equilibrium value**¹

1. Real exchange rate based on consumer prices in Iceland relative to those in competitor countries, all expressed in a common currency. The equilibrium real exchange rate is the rate compatible with a sustainable external position.

Source: Central Bank of Iceland, Quarterly macroeconomic model (QMM).

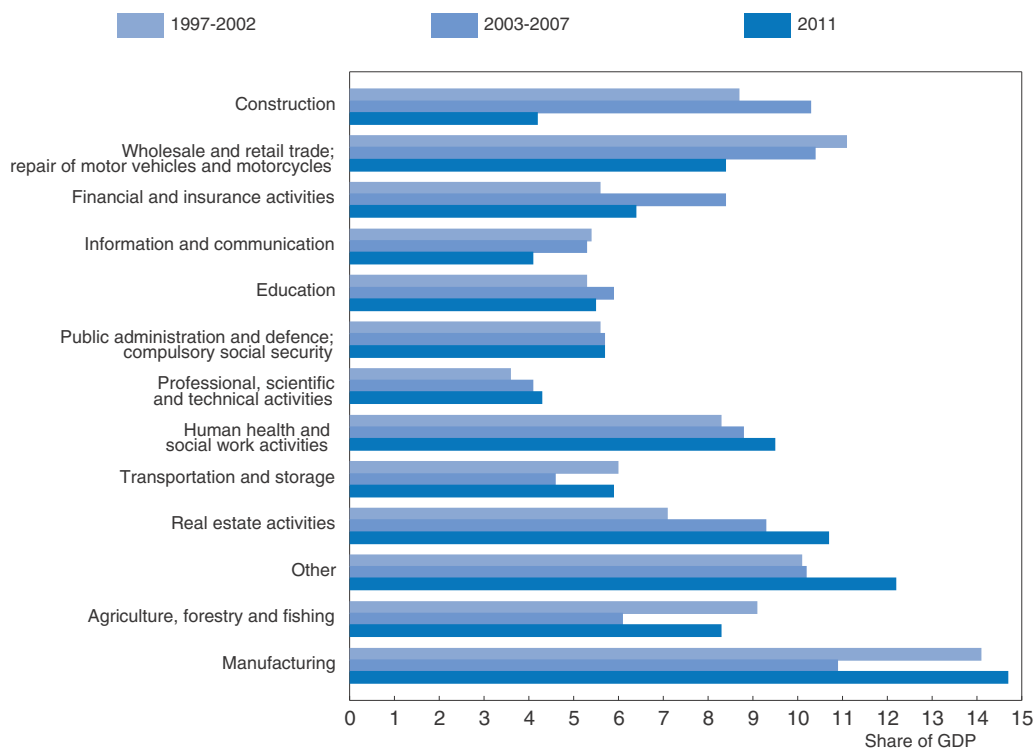
How to read this figure: Real exchange rate values above the equilibrium rate are not compatible with a sustainable external position whereas rates below the equilibrium, as has been the case since the 2008 banking crisis, are compatible with a sustainable external position.

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while agriculture, forestry and fishing (mainly fishing) and manufacturing (mainly aluminium production) shrank as a share of value added (Figure 7).


As the banking sector's difficulties grew in 2008, the real exchange rate dropped. Following the collapse of the main banks in October 2008, the real exchange rate fell further, to well below the CBI's estimate of the equilibrium real exchange rate (see Figure 6) and domestic demand fell sharply. The current account balance (excluding net factor income of pharmaceuticals company Actavis and of banks in winding-up proceedings but including the effects of the settlement of their estates) moved into substantial surplus (see Figure 5). While some of the real exchange rate depreciation and current account

Figure 7. **Traded sectors' share of value added has expanded since the crisis while that of non-traded sectors' has shrunk¹**



1. Sectors are ranked from the largest post-crisis contraction to the largest expansion. Preliminary data for 2010 and 2011.

Source: Statistics Iceland.

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surplus have since been reversed, the real exchange rate remains well below its equilibrium value and the adjusted current account is still in surplus to the tune of 3 to 3½ per cent of GDP. The turnaround in the current account since before the crisis reflects a greater increase in exports as a share of GDP than imports. A major factor driving the increase in exports has been the coming on-stream of production capacity in energy-intensive industries created by the earlier large investments made. Service exports have grown faster than goods exports, reflecting their greater price elasticity. Transport and tourism services have grown particularly rapidly. The increase in the value of imports as a share of GDP caused by the depreciation of the real exchange rate has been partially offset by a decline in import volumes.

The structure of the economy is adjusting to a lower level of aggregate demand in relation to output (i.e., a stronger current account balance). This adjustment entails the transfer of resources from non-traded sectors, where there has been a relative contraction in demand, to traded sectors, where there has been a relative expansion. Non-traded sectors that now account for a smaller share of GDP include construction and distribution while (mainly) traded sectors that now account for a larger share include manufacturing, fishing and transportation, although the increase in manufacturing mainly reflects the expansion in production capacity that took place in the years leading up to the financial crisis.

Iceland's adjusted net international investment position (NIIP) appears to be sustainable (CBI, 2013b). The CBI estimates that the adjusted NIIP at the end of 2012 was negative 60% of GDP (Table 2), which is comparable to the NIIPs in many other OECD

Table 2. **Iceland's net international investment position, end 2012**

	Króna, billions	Per cent of GDP
Net international investment position (NIIP)	-8 922	-522
NIIP excluding old banks in winding-up proceedings	-1 042	-61
NIIP Including calculated settlement of old banks in winding-up proceedings	-1 839	-108
Underlying NIIP including calculated settlement of old banks in winding-up proceedings but excluding Actavis	-1 133	-66
Underlying NIIP including calculated settlement of old banks in winding-up proceedings, but excluding other firms in winding-up proceedings or firms that have concluded composition agreements and Actavis	-1 016	-60

Source: Central Bank of Iceland (2013b), "Iceland's Underlying External Position and Balance of Payments", *Special Publication*, No. 9, 18 March.

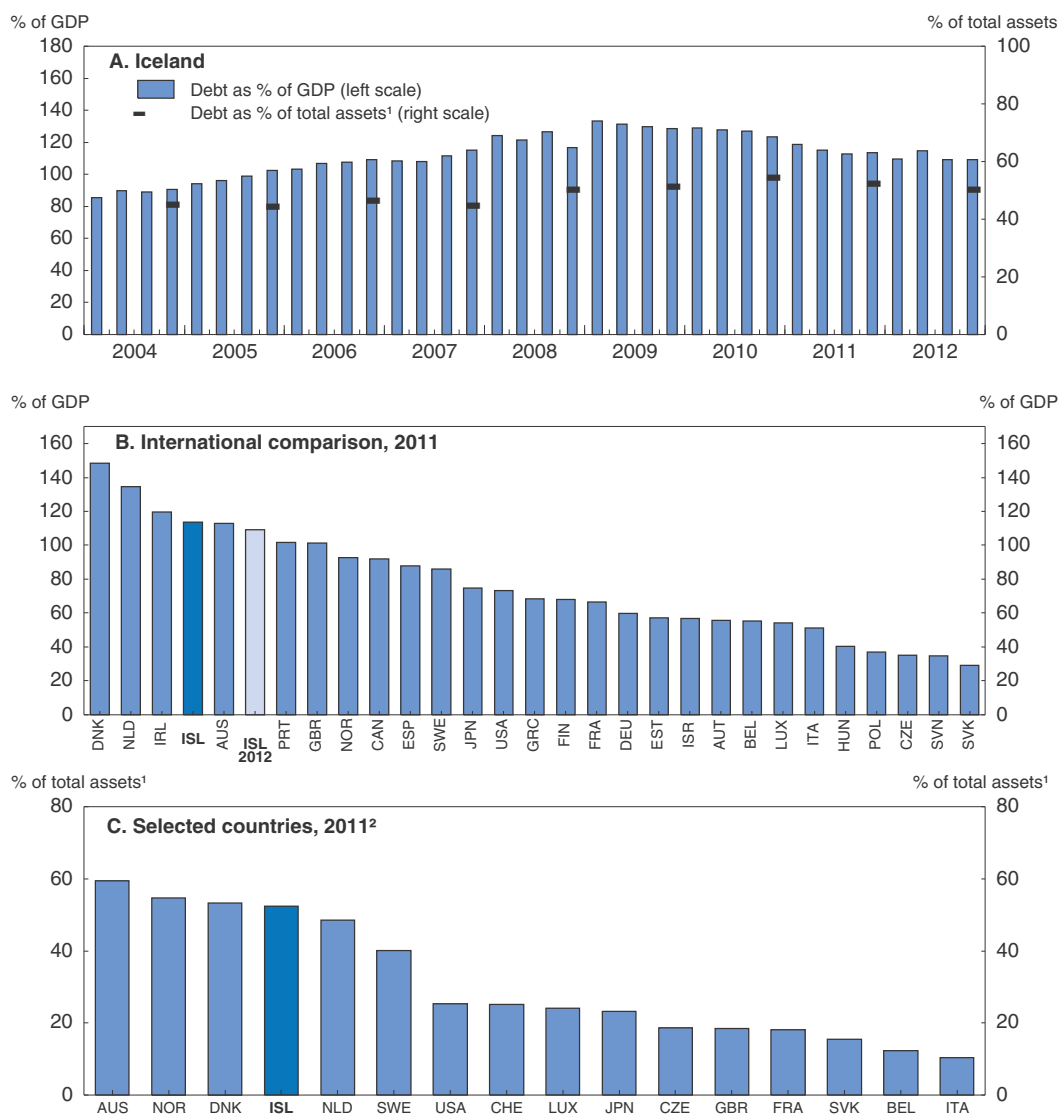
countries. This calculation excludes the NIIP of the old banks but includes the estimated outcome of their winding-up proceedings, and excludes Actavis and non-financial firms (mainly holding companies) in winding-up proceedings or that have concluded composition agreements (i.e., where creditors of bankrupt businesses have already accepted write-downs of liabilities). Provided that at least part of the heavy foreign debt repayment schedule over the next few years can be refinanced, the CBI estimates that the net IIP will improve to negative 42% of GDP by the end of 2017.

Balance sheet repair is well advanced

Household debt has fallen significantly from the crisis peak relative to both GDP and total assets (excluding claims on pension funds), mostly owing to debt write-downs (Figure 8). Household deleveraging has progressed more rapidly in Iceland than in many previous crises in other countries (Ólafsson and Vignisdóttir, 2012). Nevertheless, the current debt-to-income and debt-to-assets ratios remain higher than before the economic boom of 2005-07 and are high by international comparison (partly owing to high house ownership rates and the widespread use of index-linked mortgages, which enable households to borrow at fixed real rates with no inflation risk-premium). Recent changes to the mortgage interest tax deduction, which focuses it more on low-income households, should encourage further deleveraging by reducing incentives for large mortgages. Further deleveraging would be encouraged by removing the government repayment guarantee for new debt issued by the Housing Finance Fund (HFF), which is the principal mortgage lender. This measure, which would discourage borrowing by increasing interest rates on new mortgages from the HFF, should only be implemented when household finances are again sound.

The large decline in household debt has not, however, translated into a large reduction in the proportion of households in financial difficulty, which has only come down from a peak of 52% in 2011 to 48% in 2012 (Statistics Iceland, Annual living standards survey). This reflects the fact that much across-the-board debt relief, such as the 2010 measure to write down mortgages to 110% of current property value, goes to households not experiencing financial difficulties. Ólafsson and Vignisdóttir (2012) estimate that for a hypothetical 20% reduction of the principal of indexed mortgages, 75% of the write-offs would be granted to households not in financial distress while two-thirds of distressed households would remain in distress. Financial distress (i.e., insufficient disposable income to cover debt service and minimum living costs), and hence loan defaults, could be reduced more effectively by using transfers to target debt relief on households in financial distress, which are mainly low-income households. Transforming mortgage interest tax relief for owner occupiers into housing cost subsidies for low-income households, independently of

Figure 8. Household debt has fallen but remains high by international comparison



1. Liabilities as a percentage of total assets excluding equity in pension funds.

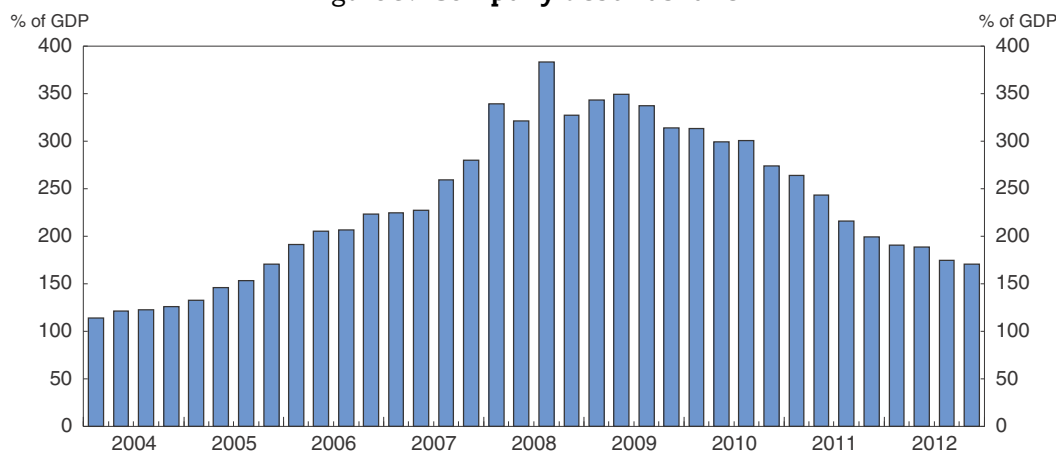
2. Or latest year available.

Source: Central Bank of Iceland (2013c), *Financial Stability Report, 2013-1*; OECD, *National Accounts: Volume IIIb – Financial Balance Sheets*.

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whether they are owner occupiers or tenants, would also help to reduce financial distress as well as reducing the bias in favour of being an owner occupier instead of a tenant. Such a measure would also enhance equity.

Non-financial sector corporate debt has fallen markedly as a share of GDP, also mostly owing to debt write-downs, but it too remains significantly higher than before the boom (Figure 9). Icelandic companies report that access to finance is one of the top three factors that present barriers to their doing business (World Economic Forum, 2012). Indeed, banks are cutting credit to companies (Figure 10). At the same time, they are expanding it to households, which are partly using the proceeds to refinance CPI index-linked HFF mortgages. While the reduction in corporate credit partly reflects ongoing debt restructuring (insofar as loans are written down below already heavily discounted book

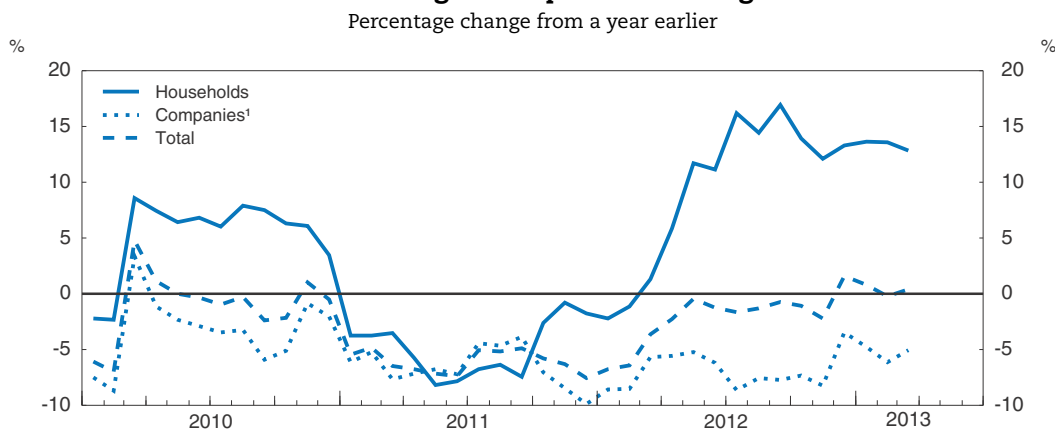
Figure 9. **Company debt has fallen**

1. Data exclude loans from connected companies. No figures are available for domestic connected companies, but at year-end 2012 loans from foreign connected companies amounted to ISK 1 082 billion (63% of GDP), two thirds of which are attributable to the pharmaceutical company Actavis (CBI, 2013c).

Source: Central Bank of Iceland (2013c), *Financial Stability Report*, 2013-1.

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values), it may also be attributable to higher credit risk as perceived by banks. Many firms that have come out of debt restructuring report doubts about being able to meet their current debt obligations (Icelandic Competition Authority, 2012). Even though more foreign-exchange linked debt is likely to be written off following a series of Supreme Court judgements, non-financial sector companies nevertheless may be obliged to go further in deleveraging. Judging by the results of the CBI's recent survey of the 134 largest firms' investment plans, which show that only 20% of planned investment over the coming two years is to be externally financed through borrowing, as in 2011, firms appear to be intent on achieving further deleveraging (CBI, 2013a). This is likely to constrain growth in general business investment.

Figure 10. **Banks are expanding lending to households but lending to companies is falling¹**

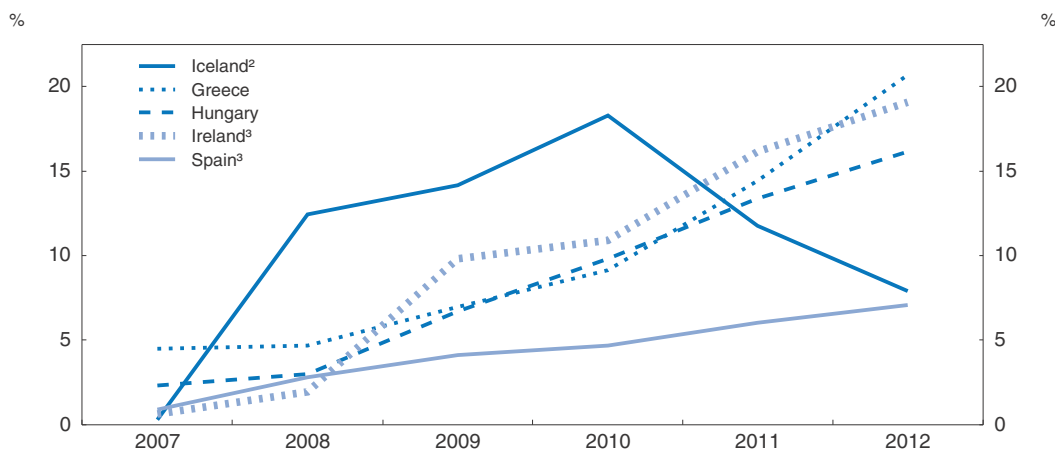
1. Lending at book (not claim) value. Companies including holding companies.

Source: Central Bank of Iceland.

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Banks have made considerable progress in debt restructuring but more remains to be done to reduce the share of non-performing loans (NPLs) in total loans to the 1-2% share for a bank with a good loan portfolio. NPLs (excluding performing loans of a customer that has a loan in default) fell from a peak of 18% of all loans in late 2010 to 8% at the end of 2012 (Figure 11). This decline is in contrast to the experience of a number of other countries where severe financial pressures developed more recently. The Financial Supervisory Authority (FME) has maintained pressure on banks to restructure NPLs, notably by setting high capital adequacy risk weights on NPLs.

Figure 11. **The ratio of non-performing loans has fallen significantly in Iceland¹**



1. Year-end figures 2007-11. 2012; 3rd quarter unless otherwise stated. Banks' non-performing loans as a percentage of gross loan portfolio without write-downs. Non-performing loans are gross loans in default (based on the facility method, which excludes loans not in default to a customer with a loan in default) and not only the amount in default.
2. 2007: Figures estimated from the annual accounts of the failed banks. 2008: Central Bank estimates. 2012: Figures from 4th quarter.
3. 2012 data for Q2.

Source: Central Bank of Iceland (2013c), *Financial Stability Report 2013-1*; Financial Supervisory Authority.

StatLink  <http://dx.doi.org/10.1787/888932855278>

Box 1. Recommendations to support economic rebalancing

Key recommendations

- Continue to tighten monetary policy as activity recovers to reduce inflation to the target rate and anchor inflationary expectations.
- Focus household debt relief on households in financial distress to reduce default risk most effectively. Replace the mortgage interest tax deduction by housing cost subsidies for low-income households to further reduce financial stress, reduce the bias towards owner-occupied housing and enhance equity.
- Remove the government repayment guarantee for the HFF once household finances return to good health to reduce incentives for household leverage.
- Continue to apply high capital adequacy risk weightings on non-performing business loans to maintain pressure on banks to write-off or restructure them.

Capital controls, monetary policy framework and financial stability

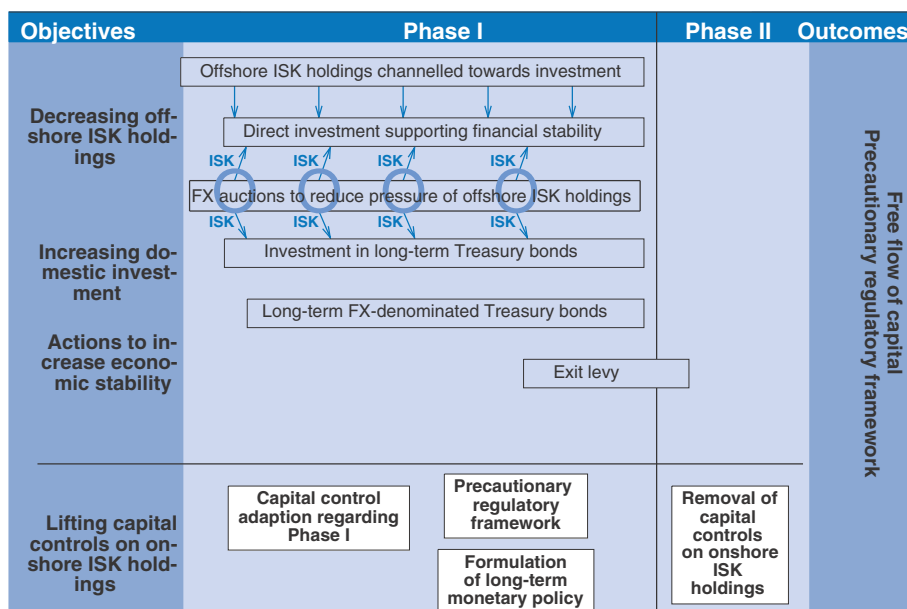
Removing capital controls is a major policy challenge

In November 2008, after the country's three largest banks failed, the Icelandic government imposed capital controls. The new rules: i) restricted the conversion of funds owned by residents and non-residents into foreign currencies; ii) banned the conversion of króna-denominated bonds and other similar instruments to foreign currency upon maturity; and iii) required that residents repatriate all foreign currency that they acquire. Businesses must repatriate foreign earnings, although certain companies, including major exporters and firms with large international operations, have been given full or partial exemption from the rules after fulfilment of certain criteria. Since late 2009, all payments linked to the distribution of goods or services and to new inward foreign direct investment (FDI) have been exempt from the rules.

Although the capital controls went against Iceland's existing agreement to abide by the OECD Codes of Liberalisation, given the circumstances at the time the OECD Council and the domestic authorities agreed that the re-introduction of restrictions was justified and necessary for preventing a collapse of the króna, and the OECD Council approved Iceland's request to temporarily derogate from the Codes of Liberalisation. The EFTA court similarly concluded that Iceland had met the necessary conditions for a temporary derogation from its commitment to the free movement of capital under the EEA agreement. The imposition of capital controls enabled Iceland to regain exchange rate stability and hold real interest rates at lower levels than otherwise would have been possible, limiting the extent of the economic contraction and subsequently supporting the economic recovery and government finances. At the same time, capital is not able to flow to investments with the highest returns, reducing permanent income. This problem is most acute for Iceland's pension funds, which provide most retirement income and cannot diversify their investment portfolios when confined to such a tiny domestic capital market. In the *Global Competitiveness Report for 2012-13*, foreign currency regulations were far and away the most problematic factor cited by Icelandic business owners (World Economic Forum, 2012). Icelandic firms wanting to invest abroad must first seek permission from the CBI. The IMF considers the measures were a judicious response to highly disruptive outflows, but that they should be lifted as soon as the country's macroeconomic conditions allow (IMF, 2012b). In its October 2012 post-programme monitoring report, the IMF assumed that capital controls will remain in place through 2015.

The Icelandic authorities agree that the capital controls cannot be lifted immediately but would be economically harmful if maintained for too long. Accordingly, they have approved a programme for their removal (Althingi, 2012a). The programme consists of two phases (Figure 12). The objective of the first phase is to reduce the remaining offshore króna holdings via CBI-intermediated auctions and foreign investment programmes. Following these purchases, a temporary exit surcharge will be levied on capital outflows. The second phase entails lifting controls on resident outflows while encouraging direct investment and reducing the exit surcharge in stages until capital movements are fully liberalised.

The plan does not include a commitment to a specific time frame, and indeed, recently passed legislation removed the expiration date of end-2013 that had been in place. The authorities have specified several conditions that must be met in order to remove the controls without causing financial disruption. Various factors such as the success of the CBI auctions and other programmes in releasing off-shore króna, the strength of the

Figure 12. **The authorities' programme for the removal of capital controls**

Source: Althingi (2012a), *Future Structure of the Icelandic Financial System*, Report of the Minister of Economic Affairs to the Althingi, March 2012.

balance of payments outlook and reserve adequacy will determine the pace of progress toward liberalisation. Given the fact that Iceland's financial risks will be particularly high during the transition period, this cautious and conditional approach is welcome.

Rapid and substantial capital outflows could renew instabilities in the currency market, especially as non-residents still hold a sizable portion of króna-denominated assets that are locked in by the controls. Estimates of non-resident holdings have fallen from almost 50% of GDP in 2008 to approximately 23% of GDP in 2012. However, these figures understate the full scale of potential outflows because they do not take into account any anticipated outflows of currency arising when overseas creditors eventually receive króna-denominated assets as their share in the winding-up settlements of the failed banks. Although subject to great uncertainty, the current value of the estates of the failed banks has been estimated to be as much as 22% of GDP, with the bulk owned by overseas creditors. Although there is some possibility that domestic entities could acquire the assets and thus prevent currency outflow pressures, this outcome is far from certain, and it would leave the portfolios of such entities very concentrated in domestic assets. Furthermore, although the real exchange rate is quite low relative to its historical average, there is still a risk that, when given the opportunity, some of Iceland's residents may choose to reduce their exposure to the domestic currency.

Since 2011, the CBI has conducted several auctions to reduce non-resident króna holdings. Other significant steps have also been taken toward meeting the conditions required for removal of the controls. Monetary tightening is under way and restrictions on new capital inflows have been lifted. A sizable improvement in the government's fiscal position (see below) is helping to increase net saving and to support confidence in Iceland's financial system. In addition, the authorities have accumulated foreign-exchange reserves amounting to about $\frac{1}{3}$ of annual GDP, enabling them to intervene, if necessary, to counter

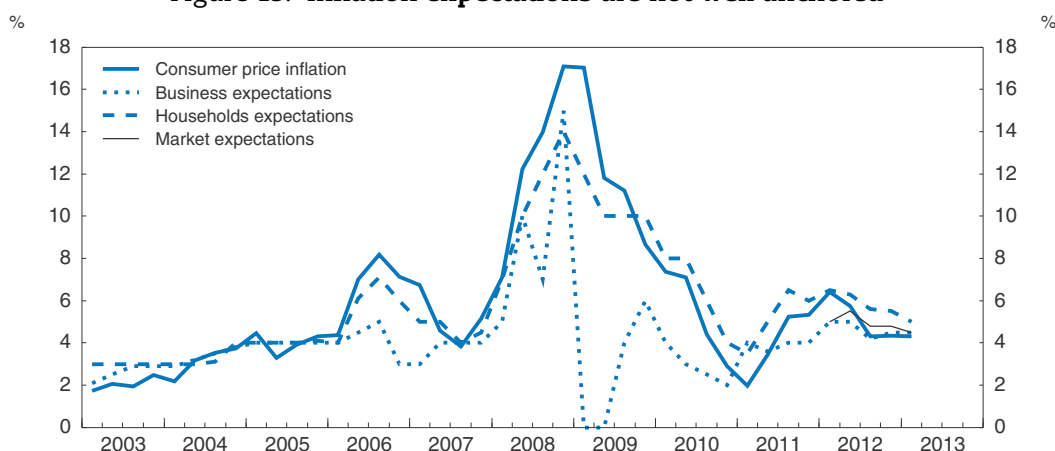
moderate depreciation pressures. The outcome in the Icesave case was favourable to Iceland. The government is not liable for unpaid debts of the Icelandic Depositors' and Investors' Guarantee Fund (DIGF), notably including to the UK and Netherlands governments. This ruling removed an important source of uncertainty, which will improve investor confidence and make it easier to remove the controls. The domestic banks' financial strength has improved, and they appear better able to withstand competition from global capital markets than before.

Nevertheless, some important conditions have yet to be satisfied. While by no means easy, completing the economic re-balancing and strengthening the current account balance will go far in helping Iceland to meet the requirements of its programme for removal of the controls. Additional progress is also needed in making króna assets more attractive to hold. This will entail not only tightening monetary policy further and continuing fiscal consolidation but also building credibility around the government's intent to maintain capital mobility over the long term. In addition, the authorities need to further strengthen prudential supervision and regulation and develop a sound monetary strategy that encourages exchange rate stability. This approach will help fortify financial stability and mitigate the heightened risks of unstable capital flows when the capital controls are ultimately removed.

Inflation targeting after the capital controls have been lifted

Iceland has had long-standing difficulties in balancing its policy objectives within the context of the “impossible trinity” – exchange rate stability, monetary independence and capital mobility. Inflation performance has been uneven throughout a varied history of fixed and floating exchange-rate regimes, in large part reflecting a strong pass-through of exchange-rate movements to domestic price inflation. It is evident that monetary policy lacks credibility and inflation expectations, while fairly accurate in tracking actual inflation, are not well anchored (Figure 13). This will present significant challenges for monetary policy after the restrictions on capital flows have been removed.

Figure 13. Inflation expectations are not well anchored¹



1. The figure depicts actual inflation as measured by the per cent change in the consumer price index (solid line) along with inflation expectations as measured from surveys of businesses (dotted line) and households (dashed line). Surveys of businesses were conducted on an irregular basis before Q3/2006, so observations for that period have been imputed from available data.

Source: Central Bank of Iceland.

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Iceland had only seven years of experience with the inflation targeting (IT) framework for monetary policy before the financial crisis erupted, and as such it would be premature to call the approach a failure. Indeed, after adopting IT framework with a floating exchange rate in 2001, Iceland was able to bring inflation down to the CBI target remarkably quickly. But toward the end of 2004, as Iceland's economy began to seriously overheat, inflation moved up above the target and remained there until the financial crisis. The CBI raised its rate considerably but, as was emphasised in previous *Economic Surveys* and as acknowledged by the Icelandic authorities themselves, this proved too little and too late to contain the imbalances in the economy (CBI, 2012). As also mentioned in previous *Surveys*, the effectiveness of monetary policy was weakened by its lack of credibility, political interference in central bank decisions, impaired transmission mechanisms, and large-scale exogenous shocks. There was also a lack of co-ordination between fiscal and monetary policy and insufficient prudential regulation and supervision, which resulted in the massive boom in credit markets that ultimately led to the collapse.

Drawing on these lessons, several steps have been taken in past years to strengthen central bank independence, improve co-ordination with fiscal policy and revamp bank supervision. The CBI has also proposed a modified inflation-targeting approach that it has dubbed "IT-plus" (CBI, 2010). Under the proposed framework, interest rates remain the main policy tool for achieving the inflation target, and the exchange rate is allowed to float, but the central bank conducts interventions in the currency market in order to cushion the impact of short-term capital flows on the exchange rate. The hope is that, by damping swings in the exchange rate, the currency-market interventions will help to stabilise inflation expectations and contribute to financial stability.

The authorities have stated that during the on-going process of removing capital flow restrictions Iceland's monetary policy will keep a heightened focus on exchange-rate stability, and as such it has not yet fully adopted the "IT-plus" framework. Nevertheless, the CBI already has begun conducting active interventions in the foreign-exchange market. Following a pronounced depreciation in the króna in the latter half of 2012, the CBI suspended its programme of regular foreign currency purchases and began supporting the króna with sterilised interventions in the foreign exchange market. In announcing the policy in February, the Monetary Policy Committee highlighted the risk "that self-fulfilling expectations of a depreciation will further weaken the currency" (CBI, 2013). Since that time, the value of the króna has more than reversed its decline over the preceding six months.

So long as the CBI avoids trying to defend a fixed level of the exchange rate, such a strategy of interventions could be beneficial, as it may help stabilise inflation expectations and thereby ease pressures on domestic prices arising from movements in the exchange rate. However, the approach should be undertaken with caution, since even limited interventions can expose taxpayers to risk of significant losses. Moreover, the Icelandic government's resources available for intervention will be limited in relation to those of parties on the opposite side of the market after the capital controls are lifted.

Bearing in mind these limitations, it may be necessary to make additional adjustments to the inflation-targeting framework. In particular, owing to its small size and narrow production base, Iceland will almost certainly continue to experience volatility in economic activity, terms of trade and the exchange rate. As a result, actual inflation is also likely to remain more volatile and therefore to fall outside the tolerance range in Iceland than in other inflation-targeting countries (Breedon et al., 2012). The CBI may therefore

have to tolerate longer-lived deviations from the inflation target. Greater co-ordination between monetary and fiscal policy objectives would also improve the ability of government to promote price stability, although the currently high level of public debt will limit the scope for fiscal policy to be used to stabilise aggregate demand. Most importantly, the credibility of monetary policy must be strengthened, so as to increase its effectiveness, which requires strict respect of the central bank's independence, especially when interest rates have to be increased as inflationary pressures mount.

Even under the best policy framework, a micro-currency such as that of Iceland will always be difficult to manage in a world of large and volatile capital flows. Indeed, Iceland is by far the smallest jurisdiction in the world with its own floating currency. In the longer term, outsourcing monetary policy to the European Central Bank by adopting the euro is an option worth considering. This would stabilise inflation and reduce the exchange-rate risk premium against the euro in domestic interest rates, fostering increased capital intensity and productivity, an area where Iceland has lagged behind the OECD average (OECD, 2013a). On the other hand, Iceland does not appear to be part of an optimal currency area with the euro area, and it would lose the contribution of the exchange rate in absorbing shocks, a role that has been especially important during the post-crisis recovery. Moreover, euro adoption would require joining the EU, which will not be possible until – among others – the capital controls are removed, and which poses challenges of its own unrelated to monetary policy.

Prudential tools as the third pillar of macroeconomic policy

One of the central lessons arising out of the financial crisis is that effective prudential regulation and supervision are essential for maintaining macroeconomic and financial stability. Macro-prudential supervision, which focuses on the stability of the financial system as a whole, rather than individual financial institutions, and sound micro-prudential supervision and regulation are both important. As analysed in detail in the *Economic Surveys* of 2009 and 2011, in the run-up to the financial crisis, the size and complexity of Iceland's banking sector increased at a dangerously rapid pace owing in large part to inadequate prudential regulation.

In the years since the crisis, Iceland has addressed many of these shortcomings. The FME has been granted much broader discretionary powers and has put in place measures for improved risk management and governance of banks. The FME also has imposed strict standards for capital adequacy on the banks. The 16% minimum capital ratio that was imposed temporarily after the crisis has since been replaced based on the results of the ICAAP/SREP process for individual banks in accordance with Pillar 2 of the Basel II/CRD III rules. In its 2012 annual report, Iceland's largest bank reported a capital ratio of 19.5%. New liquidity requirements are tighter than those based on the rules issued by the CBI before the banking crisis.

The CBI and the FME are currently working together on new regulations that will be in compliance with the Basel III and the European Capital Requirements Directive (CRD IV). Given the small size and high concentration of the Icelandic financial market, the authorities should continue to treat the Basel III requirements as a minimum standard. In addition, measures related to capital adequacy and liquidity could be further strengthened by including counter-cyclical components in their design; for example, the size of banks' required capital buffers could be higher when the economy is strong, but could be allowed

to run down when the economy is weak. Such counter-cyclical characteristics would be useful in reducing systemic risks arising from the banking sector.

The incorporation of prudential policies into a broader framework for monetary and financial stability will entail significant operational challenges. While Iceland has made good progress in implementing new regulation and supervisory procedures, there is still insufficient collaboration between the entities involved, most importantly, the CBI and the FME (Althingi, 2012b). Going forward, it is important that the links between the CBI and the FME be strengthened. Furthermore, to minimise the potential for politically-driven incentives to affect policy decisions, the government should establish an explicit mandate for fostering financial stability, define clearly the areas of responsibility for the CBI, the FME and other involved entities, and furnish each of these entities with the statutory authority and instruments necessary to carry out their responsibilities. The authorities have indicated that they are currently working toward organising a framework with many of these features. The proposed Financial Stability Council (FSC) would have oversight responsibilities for all aspects of financial stability policy, including crisis prevention, management and resolution. The new Council would be comprised of the Minister responsible for the Treasury and fiscal policy, the Minister responsible for financial markets, the Governor of the CBI and the Director General of the FME.

Legislation enacted during the 2008 crisis gave the Icelandic authorities important and useful powers for resolving financial institutions in distress, including the ability to intervene in the affairs of a failing institution and put it into resolution. Most of these provisions were transferred into the Act on Financial Undertakings, but on an interim basis only. Permanent legislation still needs to be enacted and its scope expanded to apply to all financial undertakings, not just banks. In addition to establishing well-defined resolution arrangements, the authorities must work to ensure that financial institutions can be wound down easily and without causing disruption to the provision of essential financial services. Financial institutions should be structured and operated such that any critical functions such as investment banking and commercial banking are separable in resolution.

During the financial crisis, the government announced a blanket guarantee of retail deposits when the new Icelandic banks were created. This policy was enacted in an effort to head off a bank run, and it was successful in that regard. However, a blanket guarantee entails many distortions. First, competition between financial institutions is distorted if all institutions do not benefit from the guarantee. This situation may have contributed to the demise of non-bank financial institutions (finance companies) in Iceland. Second, savers generally do not discriminate between banks on the basis of their riskiness, and this has the effect of weakening incentives for banks to control their risks. To reduce such costs, the blanket guarantee should be replaced with deposit insurance with a limit on coverage. Given Iceland's membership in the EEA, the system would have to conform to EU regulations, including the forthcoming EEA directive on deposit guarantees.

The Housing Finance Fund (HFF) is an independent, state-owned agency that has a 50% share of the housing mortgage market. In the run-up to the financial crisis, the HFF's loan portfolio expanded rapidly as the government guarantee enabled the HFF to borrow at lower interest rates than its competitors. In addition to creating distortions and undermining competition, these policies expose taxpayers to the risk of significant losses, and indeed, the HFF incurred significant losses on its loan portfolio during the crisis and has since required financial assistance from the government. Going forward, the best way

for Iceland to address these issues would be to develop a comprehensive housing policy from the ground up and then to re-evaluate the HFF's mandate and institutional setup within the context of this policy. For instance, the HFF's current public-policy objectives could be achieved instead by directly subsidising housing loans for low-income households, irrespective of the financial intermediary making the loans. Phasing out the HFF's policy-related competitive advantages would entail charging the HFF for the value of its loan guarantee on all new HFF bonds or eliminating the guarantee on new bonds, subjecting the HFF to ordinary bankruptcy laws and to corporate and property taxation, increasing the HFF's capital-asset ratio to the levels applying to other financial institutions, and making it subject to prudential regulation and supervision by the FME.

Box 2. **Recommendations for promoting financial stability and effective monetary policy**

Key recommendations

- Macro-prudential policies, such as maximum loan-to-value ratios or cyclically varying loan-loss provisioning requirements, should be used to mitigate risks to financial stability, dampen credit cycles and complement monetary policy.
- Proceed with the established programme for removal of the capital controls at a pace that is conditioned upon economic developments.
- Once capital controls are lifted, maintain an inflation targeting framework for monetary policy with a floating exchange rate. A heightened emphasis on exchange rate stability is warranted, but limit the scope of currency market interventions to smoothing erratic fluctuations.
- Strengthen co-ordination and communication between financial sector authorities. Establish an explicit mandate for maintaining financial stability that clearly defines areas of responsibility and gives supervisors the statutory authority and instruments to carry out their responsibilities.

Other recommendations

- Establish a permanent resolution regime with well-defined procedures that conform with EU regulations.
- To reduce economic distortions, replace the existing blanket deposit guarantee with deposit insurance that is consistent with EU rules.
- Develop a comprehensive housing policy, and pursue public-policy objectives by directly subsidising housing costs for low-income households. Reform the HFF by phasing out its policy-related advantages.

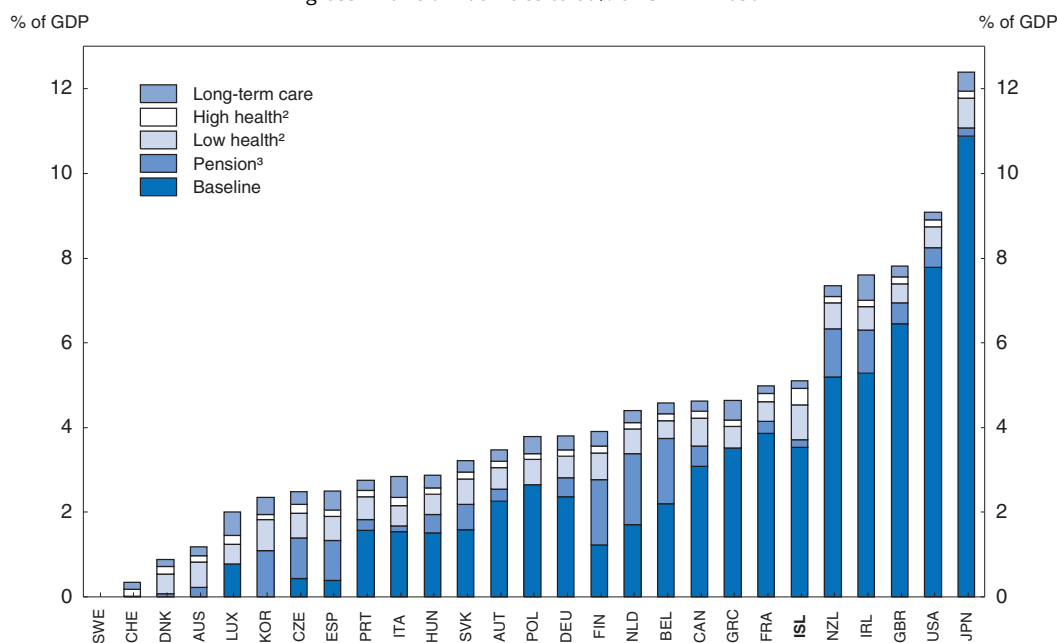
Fiscal consolidation

Budget deficits and government debt soared in the wake of the 2008 crisis. Despite a strong consolidation process, the scale of the challenge still facing Iceland can be summarised in a fiscal gap calculation, which shows the amount of immediate fiscal consolidation that would be enough to achieve a debt objective on subsequently unchanged policies. Iceland's current (2012) fiscal gap to reduce general government gross debt (including funding shortfalls in the pension fund for government employees, which were about 25% of GDP in 2012) to 60% of GDP in 2030, a widely used but arbitrary

benchmark, is around 4½ per cent of GDP in a low health-cost scenario and 5 per cent in a high health-cost scenario (Figure 14). These gaps are larger than in many other OECD countries.

Figure 14. Fiscal gaps in Iceland remain significant¹


Immediate rise in the underlying primary balance needed to reduce general government gross financial liabilities to 60% of GDP in 2030



1. Initial budget balances are underlying primary balances in 2012. For Iceland, this balance is shown in Table 2 (structural primary balance, which excludes write-offs) while for other countries OECD estimates are used.
2. Low health assumes policy action curbs health spending growth. High health is the additional cost pressure in the absence of these policy actions. In the high health-care cost scenario, underlying spending per person grows 1% faster per year than income, which is broadly in line with observed trends in OECD countries over the past two decades.
3. The pension gap for Iceland is based on IMF (2011) pension projections while for the other countries the gap is based on OECD (2011a) pension projections. For Poland, the baseline includes the pension gap.

Source: Merola, R. and D. Sutherland (2012), "Fiscal Consolidation: Part 3. Long-Run Projections and Fiscal Gap Calculations", OECD Economics Department Working Papers, No. 934, OECD Publishing; IMF (2011), *The Challenge of Public Pension Reform in Advanced and Emerging Economies*; OECD (2011a), *Pensions at a Glance 2011*.

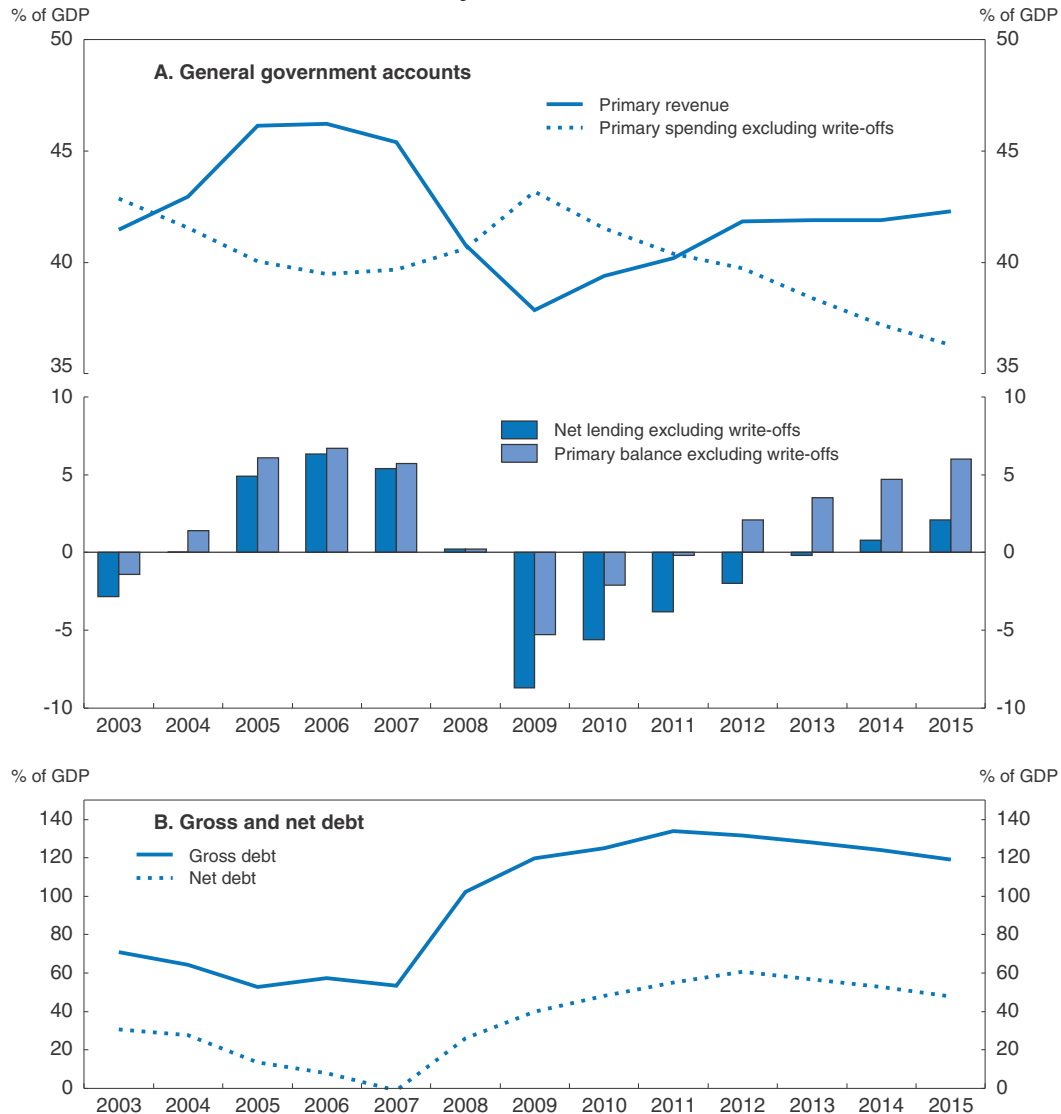
How to read this figure: The bars show the immediate increase in the underlying primary balance needed to reduce general government gross debt to 60% of GDP by 2030. The baseline contribution mainly reflects starting debt and deficit levels as well as the costs of the normalisation of interest rates. Pensions, health care and long-term care also make contributions to the required increase in the underlying primary balance because these expenditures are projected to grow as a share of GDP.

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Considerable fiscal consolidation has been achieved but further measures are still required

In the aftermath of the crisis, the general government budget balance (excluding write-offs) fell from a surplus of ¼ per cent of GDP in 2008 to a deficit of 8¾ per cent of GDP in 2009 (Figure 15 and Table 3). Most of this deterioration is estimated to have been structural. Almost half of the estimated structural deterioration in the budget balance is attributable to higher net interest payments. By 2009, the deterioration in the budget position, direct costs of the financial crisis amounting to 20% of GDP (these costs increased to 30% of GDP by 2012) and the revaluation of foreign-currency and indexed domestic debt pushed up general government debt sharply, to 40% of GDP net of financial assets and 120%

Figure 15. **Public finances are recovering from the large deterioration caused by the financial crisis**



Source: OECD, National Accounts Database; IMF (2012b), "Iceland: Second Post-Program Monitoring Discussion", IMF Country Report, No. 12/309, November, for 2013-15.

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of GDP in gross terms (both figures include funding shortfalls in pension funds for government employees of about 25% of GDP).

To put public finances back onto a sound footing, the former government adopted, initially under the aegis of the IMF Stand-by Arrangement, a demanding fiscal consolidation plan. It aimed to reduce the Maastricht definition of general government gross debt, which excludes the funding deficits in government employee pension schemes, to 60% of GDP without specifying either a timeline or intermediate targets. The plan has been updated over time, to reflect a weaker recovery than initially assumed. The updates also take account of the smaller than expected costs of honouring the unpaid liabilities of the Depositors' and Investors' Guarantee Fund's (DIGF), notably to Icesave depositors – following the recent European Free Trade Association's court decision, these latter costs are

Table 3. **Much of the former government's fiscal consolidation plan has been implemented¹**

	General government, % of GDP							
	2008	2009	2010	2011	2012	2013	2014	2015
Primary revenue	40.8	37.9	39.4	40.2	41.8	41.9	41.9	42.3
of which:								
Taxes on income, profits and capital gains	17.8	16.0	15.6	16.3	16.9	16.3	16.4	16.4
Taxes on property	2.2	2.1	2.3	2.3	2.4	2.5	2.5	2.1
Taxes on sales and services	13.2	11.7	12.0	12.0	12.4	12.5	12.5	12.5
Social security contributions	2.8	3.1	4.1	4.1	3.9	3.9	3.9	4.0
Other	4.9	5.0	5.4	5.5	6.3	6.7	6.6	7.3
Primary expenditure	54.3	44.4	46.0	42.2	41.1	38.4	37.2	36.3
Write-offs ²	13.7	1.2	4.5	1.8	1.4	0.0	0.0	0.0
Primary expenditure excluding write-offs	40.6	43.2	41.5	40.4	39.8	38.4	37.2	36.3
of which:								
Compensation of employees	14.6	15.0	14.8	14.5	14.8	14.3	14.0	13.7
Other collective consumption	11.6	12.5	12.2	11.7	11.4	11.0	10.6	10.4
Social transfers	6.1	8.1	7.9	8.5	8.0	7.6	7.4	7.2
Subsidies	1.8	1.9	1.8	1.8	1.7	1.6	1.5	1.5
Gross fixed capital formation	4.5	3.5	2.9	1.8	1.8	1.9	1.9	1.8
Other	2.1	2.2	2.0	2.1	2.0	2.0	1.8	1.7
Primary balance	-13.5	-6.5	-6.6	-1.9	0.7	3.5	4.7	6.0
Net interest payments	0.0	3.4	3.5	3.7	4.1	3.7	3.9	3.9
Net lending	-13.5	-9.9	-10.1	-5.6	-3.4	-0.2	0.8	2.1
Excluding write-offs:								
Primary balance	0.2	-5.3	-2.1	-0.2	2.1	3.5	4.7	6.0
Net lending	0.2	-8.7	-5.6	-3.8	-2.0	-0.2	0.8	2.1
Structural primary balance³	-1.0	-5.2	-0.6	0.8	2.7	3.9	4.9	5.8
Structural net lending³	-1.0	-8.6	-4.1	-2.8	-1.4	0.2	1.0	1.9

1. Data from Statistics Iceland for 2008-12, IMF projections thereafter adjusted for differences between IMF estimates for 2012 and outcomes. Projections exclude asset sales.

2. Net capital transfers paid to the non-government resident sector.

3. Cyclical adjustment has been made using Central Bank of Iceland estimated output gaps and an overall budget elasticity of 0.37 (as estimated in Girouard and André, 2005).

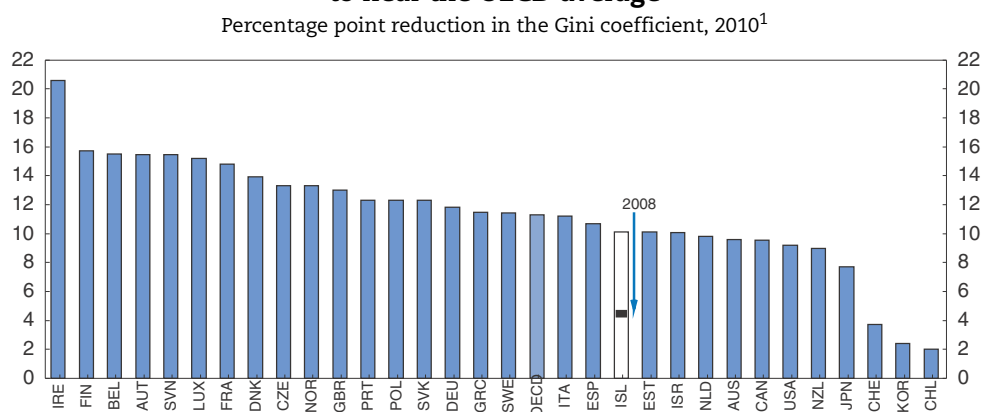
Source: Statistics Iceland; IMF (2012b), "Iceland, Second Post-Program Monitoring Discussions", *IMF Country Report*, No. 12/309, November 2012.

zero for the government. The plan now calls for a budget surplus by 2014 (see Table 3). The planned consolidation represents an increase in the primary surplus (excluding write-offs) of 11% of GDP from 2009 to 2015, approximately two thirds of which is already done. To date, deficit reductions have come slightly more from revenue increases than expenditure cuts. The main expenditure cuts have been in government investment and non-wage consumption. Fiscal consolidation has had little impact on growth because fiscal multipliers are low, as in other small open economies with flexible exchange rates, and Iceland has been able to compensate for fiscal drag by running a more accommodative monetary policy than otherwise (Pétursson, 2013). General government gross debt started to decline in 2012, but at 124% of GDP (96% of GDP on the Maastricht definition) remains uncomfortably high. Foreign currency denominated debt amounts to 27% of GDP and is matched by foreign currency assets.

In undertaking fiscal consolidation, the former government sought to shelter lower-income groups to limit the short-run impact on economic activity and increase the perception that adjustment is fair and hence would prove to be sustainable (IMF, 2012c).

Social spending was subject to much greater use of means testing and the direct tax system became more progressive, notably owing to increases in the progressiveness of the labour income tax and an increase in the flat tax on capital income as well as the reintroduction of a wealth tax. As a consequence, the contribution of the tax/transfer system to reducing income inequality increased considerably to near the OECD average (Figure 16). Inequality in disposable income has fallen to levels in line with other Nordic countries (Figure 17) despite inequality of the distribution of market incomes remaining unchanged. While the share of the population at risk of relative poverty based on current median income did not change, this reflected declines in both low-income households' incomes and in the median income (Figure 18). The anchored relative poverty rate, which provides better guidance on developments in absolute poverty during a recession by fixing median income at the pre-recession level, rose markedly.


Figure 16. **The redistributive effect of the tax/transfer system has increased to near the OECD average**



1. Percentage point difference between the Gini coefficients for market and disposable household income. The Gini coefficient is defined as the relationship of cumulative shares of the population arranged according to the level of equivalised disposable income (i.e., adjusted for the number of persons in a household taking account of economies of scale in living costs – for example, a 2 person household is counted as a 1½ person household assuming that living costs for a 2 person household are 1½ times those of a single-person household), to the cumulative share of the equivalised total disposable income received by the cumulative population shares. Population aged 18-64. 2009 for countries without 2010 data.

Source: Statistics Iceland; OECD, *Income Distribution Database*.

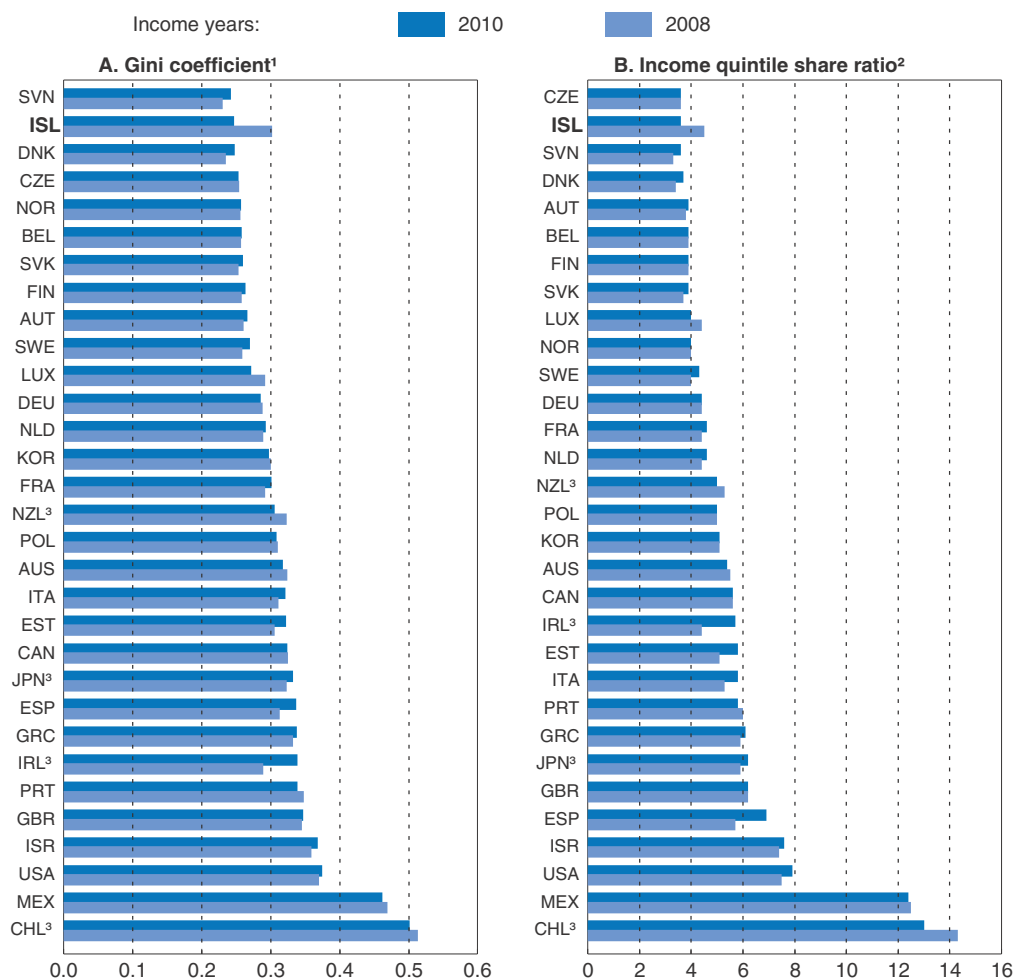
How to read this figure: The bars show the impact of the tax and cash transfers system on disposable income distribution. This impact is calculated as the difference between the Gini coefficients for market-and disposable income distribution.

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The former government's plan had a greater focus on reducing current expenditures as a share of GDP in coming years (see Table 3). International evidence suggests that this would increase the chances of success in reducing debt (Guichard et al., 2007; Alesina and Ardagna, 2010; and Baldacci et al., 2012).

The projected decline in wage compensation costs as a share of GDP was based on an assumption of far lower real wage increases in the public sector (a total increase over the three years to 2015 of 1.3%) than in the private sector (8.9% over the same period), which is unprecedented in Iceland. This assumed relative decline in public sector wage rates does not appear to be required to correct past excessive increases – public sector wage increases have somewhat lagged private sector increases since data became available in 2005. The assumed future gap is unlikely to be sustained when labour market slack disappears. This

Figure 17. Disposable income inequality has fallen to low levels in Iceland



1. See note 1 of Figure 16 for information about the Gini coefficient. Population aged 18-64.
 2. The ratio of total income received by the 20% of the population with the highest income (top quintile) to that received by the 20% of the population with the lowest income (lowest quintile). Income is equivalised disposable income. Population aged 18-64.
 3. 2009 and 2011 for Chile, 2006 and 2009 for Japan and 2008 and 2009 for Ireland and New Zealand.
- Source: OECD, *Income Distribution Database*.

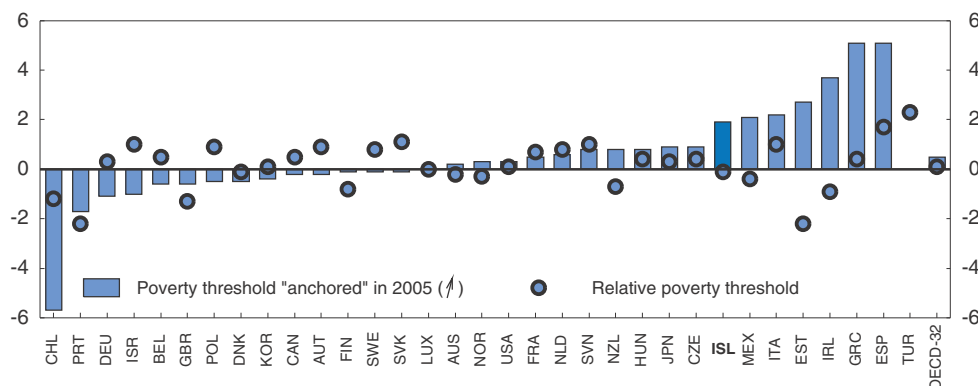
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is all the more so in view of the upcoming increase in recruitment that will be required at least partially to replace the large numbers of government employees retiring over the coming decade or so (almost 50% of government employees are aged 50 or more, one of the highest ratios in the OECD [OECD, 2011b]). The projected reduction in social transfers reflects an assumption that real increases in benefit rates remain low and the projected decline in unemployment beneficiaries. It may be difficult to hold the line on real social benefit rates as they have declined in recent years, creating pressure for catch up. Indeed, there is already a bill before Parliament to make first-pillar pensions more generous. Moreover, there is another bill partially transforming student loans into grants, which would also increase social transfers.

If it does not prove possible to restrain relative pay for government workers and growth in real social security benefits to the assumed extent, further consolidation measures, including reductions in government employment levels, would be required to

Figure 18. The anchored poverty rate increased more in Iceland than in most other countries during the global financial crisis

Percentage point changes in relative and “anchored” poverty rates between 2007 and 2010¹



1. Changes in income poverty measured using relative and anchored poverty line based on 50% of current and 2005 median income in each country, respectively. Estimates for anchored poverty are not available for Switzerland and Turkey.

Source: OECD (2013b), Crisis squeezes income and puts pressure on inequality and poverty in the OECD, New Results from the OECD Income Distribution Database.

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realise such a decline in current expenditures. As reductions in current expenditures typically have a more adverse effect on income inequality than reductions in investment expenditure or increases in revenues, the government would probably need to adjust the parameters of tax and social transfer policies if it wanted to avoid an increase in income inequality (Paulus, Sutherland and Tsakoglou, 2009).

Underlying the former government’s plan until recently was the assumption that public investment will remain at its current depressed level (1.8% of GDP), which is less than half its long-run average and much lower than in most other OECD countries. It is also less than depreciation; transport infrastructure, in particular, is already deteriorating. Maintaining government investment at these low levels could have adverse effects on the economy’s future growth potential. Since the estimates in Table 3 were made, the former government announced the 2012-15 Investment Plan, which will increase investment by approximately 0.4% of GDP per year if fully implemented. However, even if the Plan were fully implemented, government investment would still remain low by historical and international comparison. To avoid adverse effects on potential growth and keep debt reduction on track, the new government is likely to have to find further budget savings elsewhere to make room for a return to more normal levels of investment.

Keeping the budget surplus at the target of 2% of GDP will require containing health-care costs. These are projected to grow by 1.6% of GDP by 2030 in a cost containment scenario, but by 2.3% of GDP in a cost pressure scenario, which is still slightly less than the OECD average (OECD, 2012a). Public expenditure on first-pillar and disability pensions is projected to increase by only 0.4% of GDP by 2030, one of the smallest increases in the OECD owing to the low reliance on government for retirement income in Iceland (pensions mainly come from private pension funds, which had assets of 143% of GDP in 2012, similar to the pre-crisis level). Consolidation measures would also be required to compensate for a return to normal interest rates beyond the plan period (up to 2015).

The fiscal consolidation plan balances debt reduction with limiting the impact on growth. It would bring government debt down to more prudent levels, reducing economic risks should Iceland be hit by another large adverse shock, and increase the likelihood that consolidation proves to be durable. The envisaged steady consolidation would also help to restore investor confidence in Iceland, providing a more favourable backdrop for phasing out capital controls, and allow the CBI to maintain less restrictive monetary conditions than otherwise.

But there are risks that the planned consolidation will not be realised. Public sector wage and social benefit rate assumptions may be too optimistic. Realisation of the uncertain revenues – dividends from government-owned enterprises, asset sales and the special fisheries resource rent tax – that were a condition for proceeding with the former government's 2013-15 Investment Plan has become less likely now that the new government has indicated that it intends to reduce the special fisheries resource rent tax from 2013 (0.2% of GDP). Moreover, the government may incur fiscal costs in endeavouring to encourage the social partners to agree to lower wage increases than otherwise in the November 2013 negotiations.

In the event that these risks are realised, the authorities should identify concrete measures to ensure that fiscal consolidation remains on track and that the planned reductions in current expenditure are achieved. Once the budget returns to surplus, the government should resume payments to government employee pension schemes to reduce the funding deficits. Transparency and commitment to reducing debt to more prudent levels could also be enhanced by establishing a timeline with intermediate targets for debt reduction.

The proposed budget framework law would increase fiscal discipline

The prospects of achieving debt reduction objectives would be enhanced by reforming the legal budgeting framework so as to increase budget discipline. According to the IMF (2012d), the current framework (the 1997 Financial Reporting Act) has a number of weaknesses that became evident during the ten years before the crisis, when fiscal policy was characterised by pro-cyclicality, weak budget discipline, lack of co-ordination between levels of government and inadequate surveillance and management of fiscal risks.

To overcome these shortcomings, the Ministry of Finance and Economic Affairs has prepared a new Organic Budget Law (OBL) in consultation with the IMF (2012d) that the authorities expect to submit to Parliament in the autumn of 2013. It introduces a procedural fiscal rule anchored in legally binding principles (stability, sustainability, predictability, prudence and transparency), as in the Nordic countries and Australia and New Zealand. The government is required at the beginning of its term in office to submit a Fiscal Policy Statement to Parliament for approval covering both central and local government that sets out its numerical fiscal objectives (for the long-term stock of liabilities and the medium-term budget balance), which must be consistent with the permanent principles. The government must also present annually a Medium-Term Fiscal Strategy (MTFS) to Parliament for approval covering the next five years. This lays out fiscal performance targets for central and local government in line with the Fiscal Statement, other performance targets, nominal expenditure ceilings for each ministry to use in preparing its budget and a summary of the specific policy measures planned to meet the strategy's targets. Fiscal risks must also be discussed.

To facilitate efficiency gains by making it easier to relate programme/policy benefits to their costs and by enabling ministries to shift resources towards higher priority areas, appropriations are to be at the ministry level, not as now at the agency level, and policy areas will be limited to five per ministry and economic categories to two per policy area. The number of appropriations would fall from over 900 to around 300. The new framework should encourage ministerial accountability for expenditures, raise the standard of Parliamentary discussions, discourage earmarking of revenues, simplify the production and consolidation of the accounts and strengthen the comprehensiveness and integrity of auditing (IMF, 2012d). With government ministers deciding on appropriations within their domain of responsibility, parliamentarians will no longer be able to manipulate expenditures for the benefit of their constituents at the expense of the national interest. Ministries are to be given more managerial flexibility and incentives to improve efficiency. Parliament's powers to amend the budget are to be limited to changes that do not increase central government expenditure, reduce central government revenue or increase public sector liabilities. New Public Private Partnership (PPP) agreements must be approved by Parliament, fall within an annual ceiling on such agreements and conform to the MTF5.

The OBL also tightens rules on budget execution. Retained and earmarked revenues are to be scaled back, carryover of overspending is to be prohibited and carryover of underspending is to occur at the ministry level, not the agency level, and to be limited to 3% of the ministry's total budget from the previous year and to certain kinds of expenditure. Any unbudgeted expenditure that cannot be funded by reallocating resources from within ministries or the contingency reserve will have to be authorised by Parliament through a Supplementary Budget before the expenditure take place. Accounting and reporting is also to be strengthened, notably by requiring both perspective and retrospective reports to be prepared on the basis of International Public Sector Accounting Standards (IPSAS).

Box 3. Recommendations to put public finances on a sustainable path

Key recommendations

- Take immediate action to ensure that the budget remains on track to reach balance in 2014 and a surplus of 2% of GDP by 2015 to put public debt on a path to more prudent levels. Focus fiscal consolidation measures on current expenditures to increase the likelihood that consolidation is sustained and to make room for a return to stronger infrastructure investment.
- To increase transparency and credibility, adopt a timeline for debt reduction with intermediate targets.
- Pass the proposed Organic Budget Law to strengthen budget discipline.

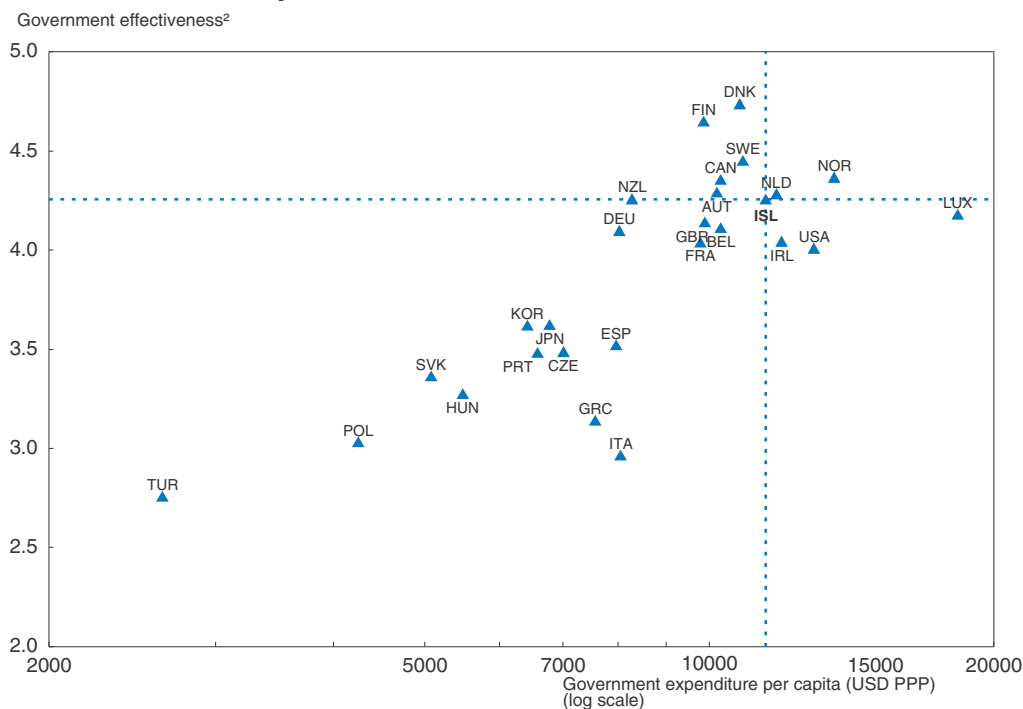
Other recommendations

- Refrain from adopting measures to facilitate wage negotiations that worsen the budget position.
- Resume payments to government employee pension funds to reduce funding deficits once the budget returns to surplus so as to smooth the budget impact of meeting government employee pension obligations.

Government expenditure efficiency

Iceland has one of the highest levels in the OECD of primary government expenditure per capita (converted to USD at PPP exchange rates) excluding social protection transfers (Figure 19). Government effectiveness, measured by the World Bank Government Effectiveness Index (which is based on surveys unlikely to be influenced by interest payments or social transfers), is also one of the highest in the OECD, suggesting that government efficiency is broadly in line with that in most other OECD countries. This is a good performance considering that Iceland benefits less from scale economies in service delivery than larger economies and that population density outside the Reykjavik agglomeration is low. Nevertheless, a number of other small countries have higher government effectiveness scores with similar or less expenditure than Iceland, suggesting that there may be room for improvement. A good place to start when looking for expenditure reductions is the big-ticket items. Education and health-care expenditures each comprise approximately one quarter of total primary expenditure excluding social transfers.


Figure 19. **The relationship between government effectiveness and expenditure¹ is broadly in line with that in other OECD countries**



1. Primary expenditure per capita (2005-10 average) converted to USD at PPP exchange rates excluding social protection transfers and, for Iceland, write-offs.
2. World Bank Government effectiveness index. The World Bank defines government effectiveness as the capacity of the government to effectively formulate and implement sound policies. The Government effectiveness index captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. A variety of surveys are drawn upon to construct this index. For more information, see World Bank (2011), *The Worldwide Governance Indicators, 2011 Update, Governance & Anti-Corruption > WGI 1996-2012 Interactive > Home*.

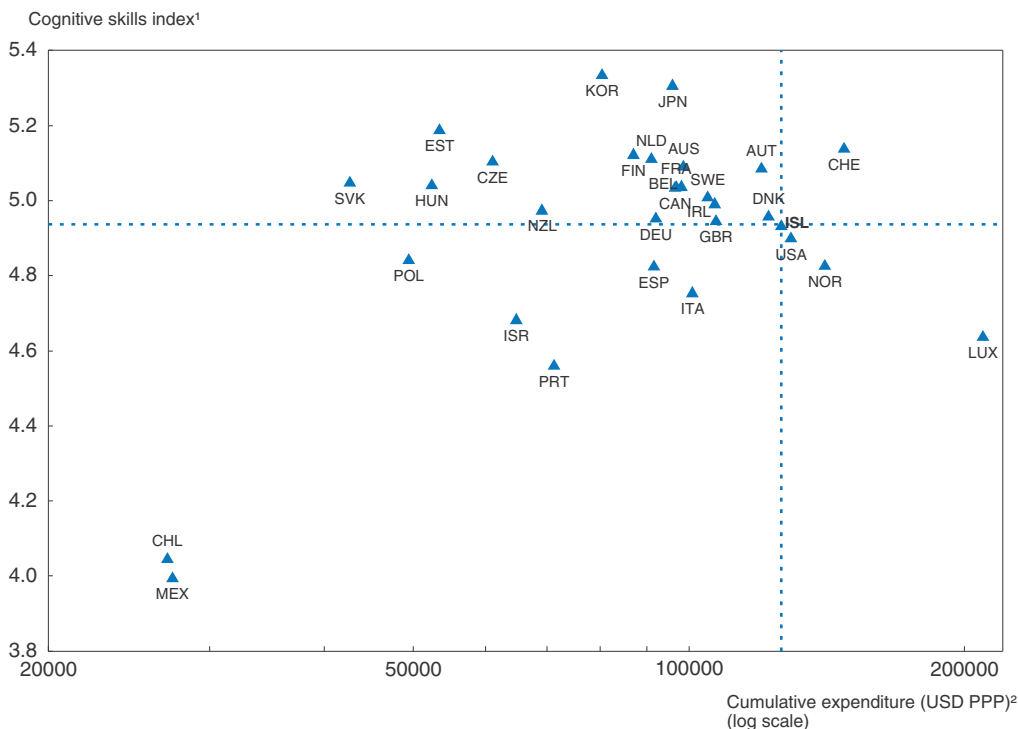
Source: World Bank (2011), *The Worldwide Governance Indicators, 2011 Update, Governance & Anti-Corruption > WGI 1996-2012 Interactive > Home*; OECD, *National Accounts Database*.

How to read this figure: The scatter points show each country's combination of government expenditure per capita and government effectiveness. The higher is effectiveness in relation to expenditure, the more efficient is that country's government.

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Cumulative expenditure (almost all of which is government expenditure) per student over the duration of primary and secondary school is one of the highest in the OECD (Figure 20). Yet students in many other OECD countries reach higher levels of achievement at less cost. One factor contributing to high cumulative expenditure is the long duration of studies, which is 7.0 years for both primary and secondary education compared with OECD averages of 5.9 and 6.5 years, respectively (OECD, 2010). In addition, annual instruction time per student is also above the OECD average.

Figure 20. **Cumulative primary- and secondary education expenditure per student is high in relation to cognitive skills¹**




1. Cognitive skills index combines the results of numerous international achievement studies.

2. 2007.

Source: Hanushek and Woessmann's (2009), "Do Better Schools Lead to More Growth? Cognitive Skills, Economic Outcomes, and Causation", *NBER Working Paper*, 14633; OECD (2010), *Education at a Glance*.

How to read this figure: The scatter points show each country's combination of cognitive skills and cumulative expenditure per student. The higher is the level of cognitive skills in relation to expenditure, the more efficient is that country's education system.

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There is widespread agreement in Iceland on the need to reduce the duration of studies toward the OECD average. Not only would this reduce costs, it would also boost private rates of return on education by enabling young people to graduate and start earning sooner, helping to counter the school dropout problem (45% of students successfully complete upper secondary education within four years compared with an OECD average of 68%); improving the quality of vocational education options could also help to reduce the dropout rate. A law passed in 2008 created the possibility of reducing the length of upper secondary school from four years to three, but concerns about job losses have resulted in few schools implementing the reform. The large numbers of teachers retiring over the coming decade or so provides an opportunity to implement this reform without having to lay off teachers. The law should also be changed to allow the duration of primary school to

be reduced by one year, and assistance should be provided to help schools restructure their education programmes accordingly.

Another factor contributing to high costs in primary education is high expenditure on wage compensation for non-teaching personnel (for teachers, annual salaries per student are near the OECD average) (Table 4). These high costs are partly attributable to the large numbers of non-teaching staff hired following the transfer of responsibility for primary education from the central government to municipalities in 1996. Other contributing factors are that many municipalities are too small to enjoy scale economies in system management, that transportation requirements are often high in rural areas and that many schools lack scale economies in the use of non-teaching staff. In general, costs per student are much higher in small schools, although some small schools have much lower costs per student than others, suggesting that there is scope to lower high costs in some small schools through improvements in management (Figure 21). Costs should be reduced by rolling back numbers of non-teaching staff, strengthening the capacity of municipalities to manage and oversee primary education collectively or shifting these responsibilities back to the central government's education ministry and by improving management in high-cost small schools.

Table 4. High compensation expenditure for non-teaching staff is a major cause of high annual primary education costs per student

Annual primary education expenditure per student for all services, 2009

	Iceland	OECD average	Difference	% difference
Total	10 099	7 719	2 380	131
Current	9 059	7 017	2 042	129
Capital	1 040	702	338	148
Compensation expenditure for all staff	7 129	5 543	1 586	129
Other current expenditure	1 930	1 473	456	131
Compensation expenditure for teachers ²	2 724	2 542	182	107
Compensation expenditure for other staff ³	4 405	3 001	1 404	147

1. Converted to USD at PPP exchange rates, based on full-time equivalents.

2. Average of 2008 and 2010.

3. Difference between compensation of all staff and teacher salary compensation.

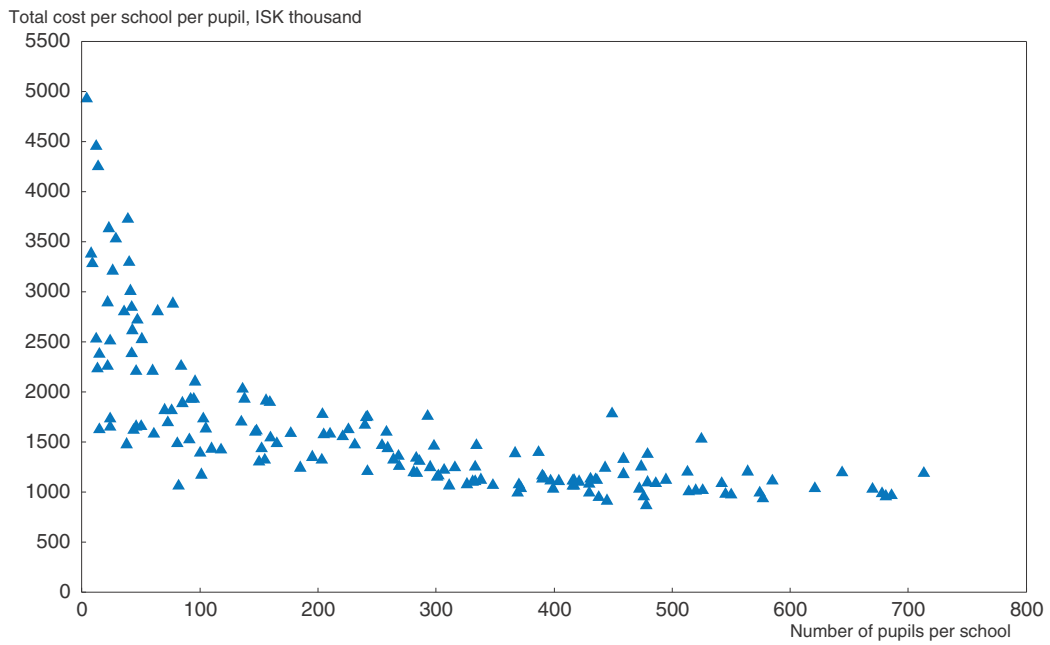
Source: OECD (2012b), *Education at a Glance*.

Health outcomes are good in relation to health expenditure, most of which is government financed in Iceland (as in most other OECD countries) (Figure 22). However, the unusually high proportion of specialists in total physician consultations points to potential savings and quality improvements from introducing gate keeping, as is being considered by the authorities (Figure 23). They estimate that one third of specialist care could be more appropriately provided by general practitioners (GPs). This reform could also help to reduce the high numbers of computer tomography (CT) and magnetic resonance imaging (MR) examinations per capita, which are expensive, as would less generous public payments for such examinations (Figure 24). As gate keeping would raise GP workloads, it might be necessary to increase funding for GPs.

The authorities also plan to increase out-of-pocket costs for annual pharmaceutical expenditure up to a cap of 70 000 króna (about EUR 440) to increase incentives for patients to economise while reducing such costs to zero beyond the cap to protect the chronically ill, whose demand for pharmaceuticals is highly insensitive to cost. This reform is intended to be budget neutral before allowing for induced changes in pharmaceuticals consumption.

Figure 21. **Costs per student are very high in small schools**¹

2011

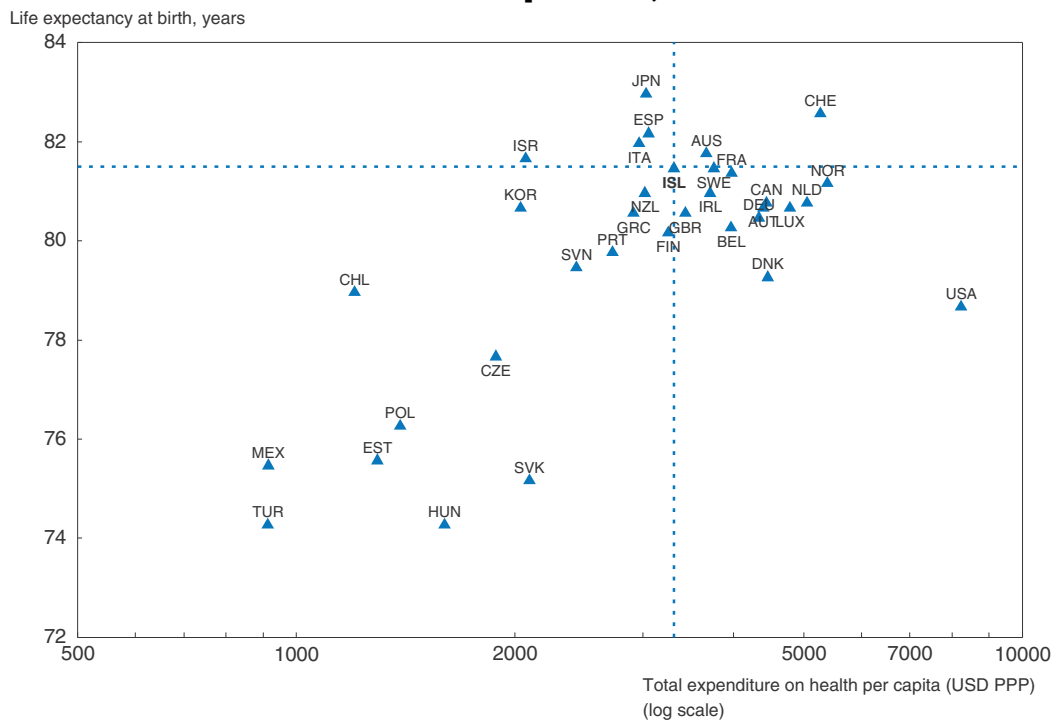


1. Primary education operated by municipalities.

Source: Association of local governments.

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Figure 22. **Life expectancy is good in Iceland in relation to health-care expenditure, 2010**¹

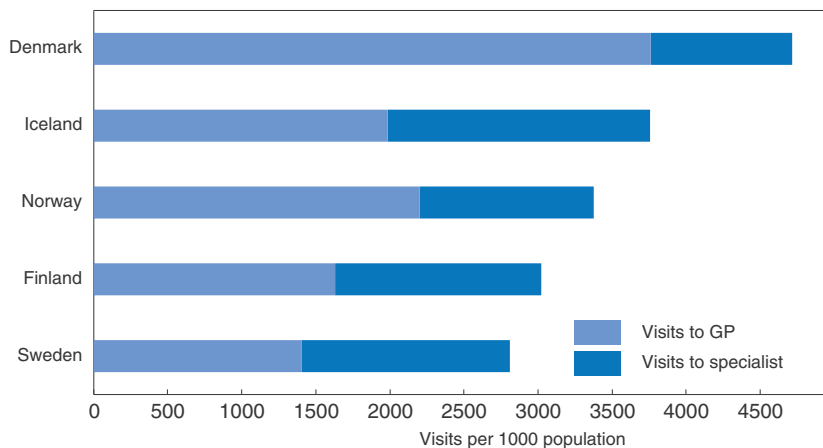


1. Or latest year available

Source: OECD, Health Database.

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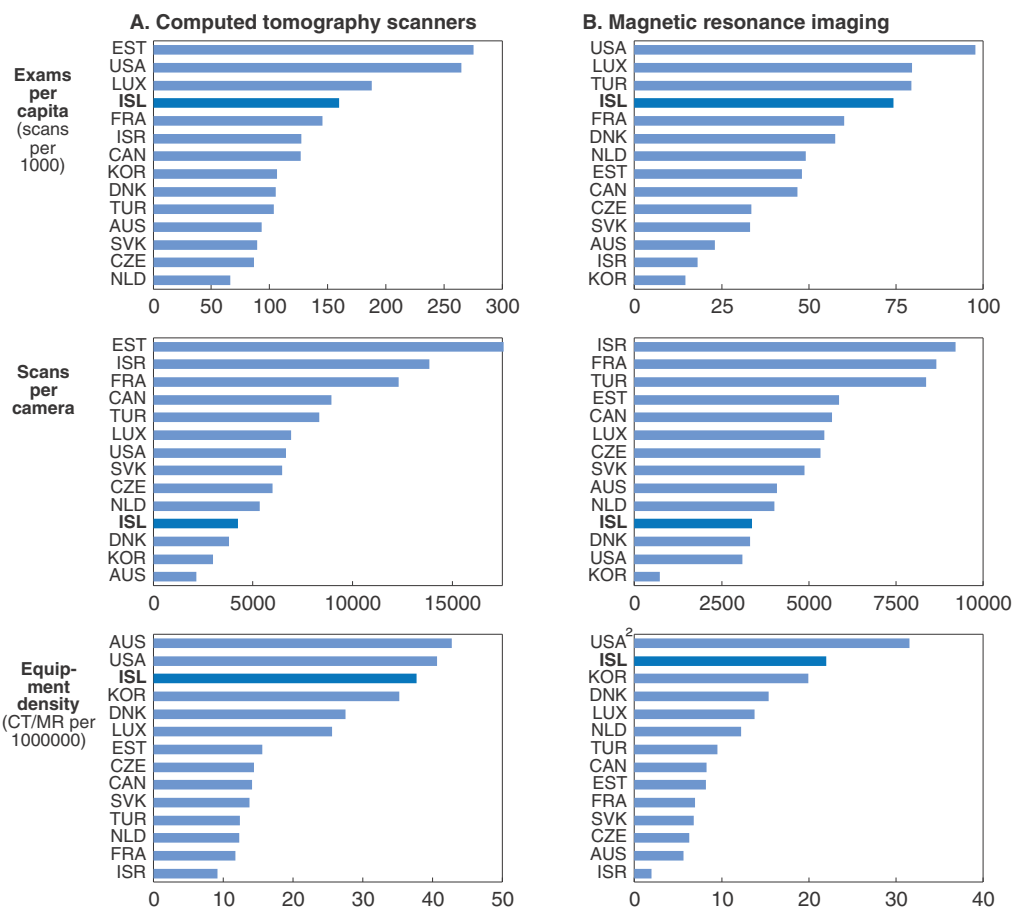
Figure 23. **Specialist consultations are high relative to GP consultations in Iceland**
2010



Source: The Boston Consulting Group (2011), *Health Care System Reform and Short-Term Saving Opportunities*, Iceland Health Care system project.

StatLink <http://dx.doi.org/10.1787/888932855487>

Figure 24. **Iceland has high numbers of CT- and MR examinations per capita and overcapacity in such machines**
2010¹



1. Or latest year available.
2. 2011 for the United States.
Source: OECD, Health Database.

StatLink <http://dx.doi.org/10.1787/888932855506>

The Icelandic government should also conduct regular strategic public spending reviews to identify savings. Such reviews evaluate the retrospective performance of programmes, policies or organisations to assess how successful or otherwise they have been, the extent to which efficiency could be increased to make room for expenditure cuts and how expenditures could be reallocated to better respond to the government's priorities. These reviews are necessary because line ministries have incentives to come up with good new spending proposals but not saving proposals, unless they are required to meet a binding expenditure ceiling or to make room for a new spending priority. OECD (2011c) reports considerable savings achieved or identified in countries that have undertaken spending reviews, including Australia, Canada, Finland, the Netherlands and the United Kingdom.

Given weak incentives for line ministries to come up with saving proposals, spending reviews should be managed centrally, preferably by the Ministry of Finance (MOF). Ideally, the MOF should run a multi-year cycle of reviews so that all major spending programmes have been reviewed by the year before elections. In this way, the results could feed into political parties' election platforms. A new government would then be in a position to decide on the spending review recommendations and set public expenditure ceilings for its term of office as required under the proposed OBL accordingly.

It would also be helpful to conduct pilot studies before new programmes are rolled out to see if they deliver the promised benefits and how performance could be improved. New programmes should also be subject to sunset clauses, increasing the probability that low value programmes will disappear. In addition, cash limits should be imposed on new programmes to avoid cost overruns. These programmes would be subject to ex-post evaluations, like all other expenditure, in the spending reviews. Furthermore, large government investment projects should only proceed if they pass a transparent and credible cost-benefit analysis, a condition that does not appear to have been met for the biggest infrastructure project (a tunnel in a remote area) included in the former government's 2013-15 Investment Plan.

Box 4. Recommendations to increase the efficiency of government expenditure

Key recommendations

- Undertake strategic spending reviews of all programmes to increase efficiency and reorient expenditure towards government priorities.
- To reduce costs and increase returns to education, reduce the duration of primary- and secondary education.
- Strengthen gate-keeping in health care to reduce specialist consultations, guide patients to more appropriate care and reduce examinations using expensive diagnostic equipment. As this would raise GP workloads, increase funding for GPs.

Other recommendations

- To reduce costs and improve education quality, strengthen the capacity of municipalities to manage and oversee primary education collectively or shift these responsibilities back to the central government's education ministry. Reduce the payroll for non-teaching staff in primary education. Improve management in small schools with unusually high costs.
- Restructure out-of-pocket costs for pharmaceuticals to strengthen incentives for patients with low annual expenditures to make savings while eliminating such expenditures

Box 4. Recommendations to increase the efficiency of government expenditure (cont.)

for patients with high annual expenditures, who typically have little scope to make savings as they are chronically ill.

- Aim for strategic spending reviews to be available in the year before the general election so that they can feed into the new government's expenditure ceilings for its term in office that would be required under the proposed Organic Budget Law.
- Only implement government investment projects that pass transparent, credible cost-benefit analyses.

Green growth

Incentives for efficient greenhouse gas emissions abatement should be strengthened

Iceland's Greenhouse Gas (GHG) emissions have increased by around 35% since 1990, mainly owing to the expansion of the aluminium industry. This performance nevertheless is compatible with Iceland's Kyoto commitment to increase GHG emissions by no more than 10% by 2008-12 because CO₂ emissions from new heavy industry after 1990 that complies with Decision 14/CP.7 (these emissions must not exceed 1 600 thousand tonnes per annum and the heavy industry in question must use renewable energy and the best available technology) are not included. GHG emissions in the aluminium industry have increased four-fold since 1990, a good performance considering that production increased eight times; Iceland's smelters are among the most GHG efficient in the world, mainly because they use renewable electricity. Emissions from transportation have also increased strongly.

The 2007 Climate Strategy states that Iceland will fulfil its international obligations to reduce GHG emissions, increase carbon sequestration, support research and innovation in climate mitigation and prepare for adaptation. This was followed up by the 2010 Action Plan that, amongst other things, aims to limit the change in heavy industry emissions, which represent 38% of total emissions, to between -6% and +57% over 2008-20 and to cut emissions in other sectors by 20% (38% including sequestration). If Iceland joins the EU, abatement reductions will be much more challenging: Iceland would be obliged to reduce emissions by 20% between 2005 and 2020 and could not count reductions from sequestration unless this possibility can be negotiated. Whether or not Iceland joins the EU, implementation would be facilitated by not overloading the system with programmes and initiatives. The government will also need to provide funding for many of the initiatives, which it partially proposes to do in the Investment Plan for 2013-15.

As part of the European Economic Area, the authorities have made a joint commitment with the EU to reduce emissions from sectors covered by the EU-ETS. Accordingly, these sectors will have to buy emission permits. Aviation entered the scheme in 2012 and heavy industry (aluminium, ferrosilicon, mineral wool and fishmeal production) enters this year.

For sectors not covered by the EU-ETS, the role of the carbon tax should be expanded to achieve abatement objectives efficiently. Although Iceland introduced a carbon tax in 2010, a substantial share of carbon emissions are still exempt from the tax. Moreover, the tax rate is low, which reduces its impact in encouraging abatement investments. In all, the carbon tax only raised revenues of 0.1% of GDP in 2011. To increase its impact, the carbon tax base should be broadened to include industries, such as the cement sector, that emit substantial

amounts carbon but are currently not charged for their emissions. The tax rate should also be increased to a level compatible with Iceland's abatement objectives. Separately, transport emissions could be reduced by strengthening co-ordination among municipalities in the Reykjavik area in urban planning and infrastructure development to reduce urban sprawl and commuting in private motor vehicles.

Green energy needs to be better managed

One of the pillars of Iceland's economic development strategy has been to increase hydro and geothermal electricity production to sell more electricity to energy-intensive companies. There is considerable debate about the extent to which this strategy has profited Icelanders, as electricity has been sold at low prices on long-term contracts that barely cover costs. Electricity generation should be developed for export (essentially via energy-intensive goods or services such as aluminium) only if long-term marginal costs, including environmental and capital costs, are fully covered. Any rents flowing from Iceland's relatively low-cost and clean power generation should be taxed, as has been proposed.

Improvements in electricity transmission technology may eventually create an opportunity to increase exports by laying an underwater cable to Scotland. Then, electricity could be sold at European green tariff rates, which are four times the price at which electricity is sold in Iceland to energy-intensive companies. However, this option remains some way off as there are formidable technological and financial barriers to overcome.

Iceland has an efficient fisheries management system

As discussed in the 2011 OECD Economic Survey of Iceland (Chapter 4), Iceland experienced chronic overfishing until the Individual Transferable Quota (ITQ) system was introduced progressively from 1984 to the early 1990s. Under this system each fishing entity owns or has a right to a certain percentage of the Total Allowable Catch (TAC) in various species. This gives fishers an incentive to support the setting of TACs at levels that maximise rents and hence, the value of quotas. Such levels are lower than biologically sustainable levels. TACs have been set at biologically sustainable levels in recent years, based on the recommendations of the Marine Resource Institute, ending the systematic overfishing that occurred before.

Since the introduction of the ITQ system, the industry has become much more efficient, increasing the value of the resource rent and, hence, of licences. To claw back some of this rent, the government introduced a special fisheries resource rent tax in 2012 that is scheduled to take effect in September 2013. According to the law, a tax rate of 50% will be levied on a base that is roughly equivalent to earnings before interest tax and amortisation (EBITA). Although there are some allowances for small operators and deductions for interest costs from debts assumed to acquire fish quotas, the high tax rate in this new legislation is likely to create financial stress in some fishing enterprises, especially those that are in the demersal (seabed) fisheries sector, where firms are financially more fragile than in pelagic (live and feed in open water) fisheries. While taxation of resource rents is appropriate, the tax rate should be adjusted to a more modest rate to reduce its potential adverse impact on the industry. In the context of discussions since the election about changes in tax laws and tax cuts, the new government has signalled that it intends to reduce the special fisheries resource rent tax and change its design to take into account the financial position of different types and sizes of fishing companies.

Box 5. Recommendations to support green growth

Key recommendations

- Broaden the base for the carbon tax and raise its rate to increase cost-effective abatement of GHG emissions.
- Develop exported electricity capacity (notably through energy-intensive industries) if long-run marginal costs (including the return on capital) are fully covered. If there are resource rents, tax them.
- Reduce the scheduled increases in the special fisheries resource rent tax to levels that the industry can cope with, especially in the demersal sector.

Other recommendations

- Strengthen co-ordination among municipalities in the Reykjavik agglomeration in urban planning and infrastructure development to reduce urban sprawl and private car use, thereby also reducing GHG emissions.

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ANNEX A.1

Progress in structural reform

This annex summarises recommendations made in previous *Surveys* and action taken since the last *Survey* was finalised in May 2011.

Past recommendations	Actions taken and current assessment
A. Financial markets	
The plan to adopt the Basel III framework should be implemented and the authorities should continue to phase in portions, such as the leverage ratio, more quickly than envisioned in the Basel III timeline.	The FME has imposed strict standards for capital adequacy on the banks. The 16% minimum capital ratio that was imposed temporarily after the crisis has been replaced by the results of the ICAAP/SREP process for individual banks, in accordance with Pillar 2 of the Basel II/CRD III rules. In its 2012 annual report, Iceland's largest bank reported a capital ratio of 19,5%, which is its currently required minimum.
The authorities should consider merging the FME into the CBI, thereby expanding the CBI's responsibilities to include prudential regulation and supervision, to make macro-prudential regulation and supervision more effective.	Significant steps have been taken to strengthen regulation and supervision, but the activities have involved a number of disparate authorities within the government, with insufficient collaboration between entities. The authorities are currently working toward organising a Financial Stability Council (FSC), which will have oversight responsibilities for all aspects of financial stability policy, including crisis prevention, management and resolution.
The current blanket deposit guarantee should be replaced by the more limited deposit guarantee arrangements already planned and a permanent statutory authority to intervene at an early stage in the operations of financial institutions at risk of failing should be established.	No action. The blanket guarantee that has been in force since October 2008 still needs to be replaced.
Strengthen incentives for banks to restructure non-performing loans (NPL)s by raising capital adequacy risk weights on NPLs that have not yet been restructured.	Incentives have been strengthened. Significant progress has been made in re-structuring. The percentage of NPLs (excluding performing loans of a customer that has a loan in default) fell from a peak of 18% of all loans in late 2010 to 8% at the end of 2012.
Increase the Housing Finance Fund's (HFF's) capital adequacy ratio to the levels applying to other financial institutions, subject it to prudential regulation and supervision by the FME, and charge the HFF for the value of its loan repayment guarantee.	No action. The government repayment guarantee for new debt issued by HFF is still in place. The government injected ISK 33 billion (2.1% of GDP) into the HFF in 2010 and ISK 13 billion (0.8% of GDP) in 2012 but capital remains well below the long-term target of 5% of risk-weighted assets. Continued losses from operations make it likely that further capital injections will be required. The authorities are currently conducting a comprehensive review of the HFF's operations and its role in the future financial system. Their findings are expected to be released by the middle of 2013.
Prohibit pension funds from making mortgage loans to members. Rather, pension funds should only be allowed to make such loans if they are secured against a proportion of the member's claims on the fund, thereby reducing the risk of there being insufficient collateral readily available to cover the loan in the event that it becomes non-performing.	No action.
Take steps to neutralise the overhang of non-resident liquid króna holdings so as to pave the way for the removal of capital controls as quickly as possible.	The CBI has organised several auctions to purchase domestic currency from non-residents and auction them to investors willing to buy long-term government bonds or other domestic assets and hold them for a minimum of five years. At the end of 2011, the authorities also introduced a programme that enabled foreign investors to purchase half of the króna required to perform their investment through auctions, and to finance the remainder on the Icelandic financial market (the so-called "50/50 option").

Past recommendations	Actions taken and current assessment
B. Monetary policy	
Promote low inflation by moving to an inflation-targeting regime which places greater weight on smoothing fluctuations in the exchange rate and is supported by fiscal policy and macro-prudential regulation.	The CBI has begun augmenting interest-rate policy with active interventions to support the exchange rate. Macro-prudential regulation needs to be strengthened, and there is little co-ordination between fiscal and monetary policy.
In the event that Iceland joins the EU, adopt the euro as quickly as possible.	Accession to the EU is still being debated in the Icelandic population. Although adoption of the euro still appears to be the best course for Iceland over the long run, it would be prudent for Iceland to wait until the institutional foundations of the euro are strengthened before seeking to join the EU and adopt the euro.
C. Fiscal policy	
Adopt a fiscal framework emphasising spending control and medium-term sustainability. Set debt reduction targets and adopt budget balance rules consistent with them. Back up these rules with fiscal responsibility legislation along the lines of that in Australia and New Zealand.	A new Organic Budget Law (OBL) is to be submitted to Parliament in September 2013 that implements these recommendations. It introduces a procedural fiscal rule anchored in legally binding principles, as in Nordic countries, Australia and New Zealand. Governments will have to formulate numerical fiscal objectives (for the long-term stock of liabilities and the medium-term budget balance) that are consistent with the permanent principles. Ministries will be subject to nominal expenditure ceilings. Ministers will be responsible for ministry performance.
Make the 2010 fiscal institutional reforms permanent and strengthen them by making each government minister responsible for ministry performance before Parliament.	
Reform the tax system over time to increase revenues in a growth-friendly way by widening the tax base, imposing corrective taxes and closing loopholes.	The scope for closely held corporations to shelter labour income from higher personal income taxation has been reduced but remains significant. The carbon tax has been increased but remains low. The mortgage interest tax deduction has been more tightly targeted on lower-income households but should be replaced by housing-cost subsidies for low-income households. More revenue could be raised in a growth- and equity friendly way by increasing the lowest rate of VAT (7%) and using part of the proceeds to shelter low-income earners from the effects.
Implement fiscal rules for municipalities. Nominal ceilings should be set for a specific multi-year period, rather than over an undefined business cycle. Reduce the cyclicity of local revenues in order to smooth the path of local expenditures over the business cycle.	With the exception of reducing the cyclicity of local government revenues, these recommendations were implemented in the 2011 law reforming the framework for local government finances.
D. Labour market	
Guarantee access to the traditional education system for those attempting to re-enter to complete their secondary education.	Access was made available to all such persons.
Better align job skills training programmes with the needs of the labour market.	No action taken.
Expand internship opportunities as conditions permit.	
Phase out the temporary extension of unemployment benefit duration to four years as the labour market improves.	Extension of unemployment benefit duration expired at the end of 2012.
E. Education and training	
Focus on teacher quality rather than quantity and increase class size to reduce cost pressures. Increase the focus of teaching on sciences and languages.	While teacher qualification requirements have been tightened, teacher pay remains low relative to pay for other occupations with similar qualification levels, making it difficult to attract and retain high quality candidates. Class sizes have not been increased. There is greater potential to reduce costs without harming education quality by reducing the duration of school education, which is considerably longer than in other OECD countries. A law was passed in 2008 permitting the duration of upper secondary education to be reduced but few schools have adopted this reform. There has been no change in the focus of teaching.
F. Product market competition	
Consider whether divestiture of the National Power Company's generation activities would help create a level playing field in power generation by avoiding cost-of-capital differentials between the incumbent and entrants.	No action.
Reduce agricultural support, especially in the area of policies that provide incentives to increase production, at least to EU levels.	No action.
Reduce ownership restrictions, notably in the energy and fisheries sectors.	No action.

Past recommendations	Actions taken and current assessment
F. Green growth	
<p>Make explicit use of cost-benefit analysis to improve policy effectiveness and coherence, especially in deciding on the merits of major power-intensive investments.</p>	<p>Policymakers use survey-based information to assess perceived environmental costs of projects. There needs to be a greater focus on maximising rents from energy resources. Such rents should be taxed.</p>
<p>Total Allowable Catches (TACs) should be set at levels that maximise the sustainable fisheries resource rent and the government should raise the special fisheries resource rent tax to ensure that it receives this increase in resource rent.</p>	<p>The government introduced a special fisheries resource rent tax in 2012 that increases in three steps to 50% of earnings before interest, tax and amortisation. If fully implemented, such a level of taxation would cause considerable financial stress and drastically reduce the value of ITQs, undermining the system. The new government plans to reduce the tax and change its design to take into account the financial position of different types and sizes of fishing companies.</p>
<p>The government should also raise the fisheries resource rent tax to take a larger share of current rent, although such an increase should not go so far as to undermine the Individual Transferable Quota (ITQ) system.</p>	<p>The government has not made any further such amendments.</p>
<p>The government should be cautious in making amendments to the Fisheries Act that weaken the ITQ system by issuing additional fishing rights.</p>	



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