CONCLUDING STATEMENT

Iceland: Staff Concluding Statement of the Virtual 2021 Article IV Mission

FOR IMMEDIATE RELEASE

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

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

Washington, DC – April [19], 2021: W*ith strong policy support, the Icelandic economy has performed better than was expected at the outset of the pandemic. However, the outlook remains challenging. A modest recovery is projected to take hold this year, but uncertainty remains large. Recovery prospects in the tourism sector and the economy depend on control of the epidemic and progress in global and domestic vaccine distribution.*

Economic policies should continue to support the recovery and mitigate emerging risks.

- *The stimulus planned for this year will help address still-large slack in the economy, mitigate scarring, and provide confidence in the event of downside risks. Medium-term policies should facilitate the transfer of resources to more productive sectors and rebuilding of fiscal buffers.*
- *With inflation above the target band and anchored inflation expectations, the CBI now needs to stay on hold and remain vigilant. Foreign exchange intervention should continue to taper off.*
- *Macroprudential measures should address emerging financial sector risks, including those related to the real estate market.*
- *Structural reforms should facilitate economic diversification and limit scarring and be embedded in a comprehensive recovery plan to lay the ground for growth of new sectors.*

Iceland's dependence on tourism has made it highly exposed to health, economic, and financial contagion from the COVID-19 pandemic. Iceland stands out favorably in its handling of the pandemic, with fast containment of COVID-19 cases. Nonetheless, the collapse in global tourism flows has significantly affected Iceland's engine of growth, which relies heavily on contact-intensive sectors. Real GDP contracted by 6.6 percent and unemployment reached 6.4 percent in 2020.

Iceland entered the crisis from a position of strength. Prudent policies over the last decade delivered significant policy space. Net and gross public debt have declined by more than 50 percentage points of GDP since the Global Financial Crisis, private debt has halved, and international reserves have reached around 30 percent of GDP. Banks' balance sheets have been strong, with significant capital and liquidity buffers.

The ample policy space has allowed the authorities to respond decisively to the pandemic shock:

- *Fiscal policy*: The government provided unconditional support to the health sector to fight the pandemic, raised unemployment benefits and dismissal-related transfers, extended grants to companies, eased the tax burden, offered state guarantees, increased public investment allocations, and encouraged domestic tourism. A total of 9.2 percent of GDP in pandemic-related fiscal measures are expected to continue to support the economy into the medium term.

- *Monetary policy*. The Central Bank of Iceland (CBI) lowered policy rates by 200 basis points, reduced reserve requirements, discontinued the one-month term deposit auctions, and launched a treasury bond purchase program. It also intervened in the foreign exchange market to prevent disorderly market conditions in the face of a sharp drop in export revenue.

- *Financial sector policy*. The authorities lowered banks' countercyclical capital buffer from 2 percent to zero, eased liquidity requirements, facilitated the extension of loan moratoria, and approved simpler temporary rules for financial restructuring of companies.

The policy measures were critical to rebuild confidence. Financial markets stabilized quickly, household incomes were largely protected, and businesses were able to sustain the loss of revenue. While the output decline was substantial, the recession was smaller than initially feared.

The outlook remains uncertain

Nonetheless, Iceland's economic outlook remains challenging. A modest recovery is projected to take hold this year, with real GDP growth remaining significantly below its pre-COVID trend. The ongoing fiscal stimulus will support domestic demand, while exports will grow only modestly. With border controls still in place in Iceland and its main trading partners in 2021, tourism revenue is expected to remain subdued in the near term. Tourism is expected to recover gradually and experience sizable persistent output losses. Overall, real GDP is projected to return to its 2019 level only in 2022 and remain below its pre-COVID trend even in 2026.

Risks to the outlook are substantial and tilted to the downside. In the near term they stem from the path of the pandemic. Abundant vaccine availability may allow reaching herd immunity faster, boosting confidence, and opening a door for a more buoyant tourism season. However, a resurgence in the pandemic—due to new virus strains or short-lived vaccine effectiveness—could dash hopes for recovery and reduce policy space. Other adverse risks are related to a potential sharp rise in global risk aversion, deglobalization, and natural disasters.

The policy mix in the coming years should support people and the economy, protect macroeconomic stability, and facilitate the reallocation of economic resources.

The 2021 budget allows fiscal support to continue while the recovery takes hold. The fiscal stimulus will support demand given the slack in the economy, help mitigate economic scarring, and provide insurance in the event of further downside risks. It adequately supports spending on health and to protect the most vulnerable in society. The planned public investment is well placed for the recovery given its high impact on short-term economic activity and its emphasis on boosting the economy's potential.

The authorities' Medium-Term Fiscal Plan is a welcome anchor amidst still-high uncertainty to the outlook. It provides clarity and continuity of fiscal policies in 2022 and forward guidance on the possible medium-term fiscal path for the administration that will take office following the September parliamentary elections. The medium-term fiscal plan appropriately refocuses measures from lifeline support to households and businesses to investments in public infrastructure and human capital that would help reallocate resources and diversify the economy. It also balances well the ongoing need for support to the economy with fiscal sustainability considerations, gradually unwinding the support as the economy recovers. The plan would thus help fiscal policy transition back to adhering to Iceland's fiscal rule and rebuilding fiscal buffers. Maintaining the highest transparency of fiscal accounts and policy implementation is crucial to preserve confidence in the fiscal framework.

Monetary policy should now be kept on hold unless significant risks materialize. The inflation targeting framework has played a crucial role in the policy response to the pandemic. However, the recent rise in inflation poses a challenge for monetary policy. Although inflation expectations remain anchored and inflation is expected to return to target without further policy action, vigilance and data driven policy rate decisions would continue be essential given the high degree of uncertainty. The use of unconventional monetary policy measures does not appear warranted currently, as room for policy rate easing still exists, if needed. As the effects of the pandemic subside, the CBI should also gradually reduce its presence in the foreign exchange market.

The financial system entered the crisis in a strong position, but emerging risks need to be addressed. Banks' capital and liquidity buffers remain well above requirements, bolstering their capacity to withstand further shocks and the expected worsening of loan portfolios. However, protecting banks' favorable financial positions requires close monitoring of emerging risks. Close attention needs to be paid to the classification and provisioning for impaired corporate borrowers, especially in the tourism sector, and viable firms should be rehabilitated efficiently. The continued rise in real estate prices and rapid growth of bank mortgage credit also pose risks that need to be mitigated with macroprudential measures targeting borrowers' repayment capacity and banks' mortgage exposures. Addressing these risks will also free space for banks to support corporate credit growth when economic uncertainty subsides.

Iceland's financial oversight architecture is undergoing a significant transformation. The effective handling of the current crisis underscores the merits of the recent merger between the CBI and the financial sector supervisor. Coordination among the monetary policy, financial stability, and financial supervision committees of the CBI has worked smoothly, supporting monetary policy credibility and effective deployment of tools to preserve financial stability. The framework should be continuously assessed, including in the upcoming first review of the new architecture, to ensure that the powers and resources of the central bank and legal protection of its employees are commensurate with CBI's expanded responsibilities.

The upcoming partial privatization of one of Iceland's state-owned banks also requires vigilance to preserve high-quality ownership. Finally, work needs to continue to demonstrate sustained improvement in the effectiveness of the AML/CFT framework.

Structural policies should aim at diversifying the economy and limiting scarring.

A more diversified and sustainable growth strategy would foster the structural transformation that has been necessitated by the pandemic. While tourism will remain systemically important, the crisis underscores the need to expand other sectors and encourage growth in knowledge-based sectors. The recently approved innovation policy is welcome. A comprehensive plan for economic recovery should aim to make the economy more resilient in the face of large shocks and should focus on three priorities:

- *Promoting a safe and sustainable tourism sector.* In the near term, confidence domestically and abroad that Iceland is a safe travel destination would help revive tourism. Iceland's strict health and hygiene measures, including screening protocols for international travelers, work toward this aim. In the medium term, improvements in price competitiveness, ground infrastructure, and environmental sustainability could help make tourism overall more resilient and sustainable.

- *Diversifying the economy*. Creating an environment conducive to new growth would help broaden Iceland's economic base. Continued support for innovation and embracing digitalization could tap and utilize better the already high digital skills of Iceland's labor force and increase the share of ICT sectors in the economy. Reducing regulatory burdens on start-ups and FDI restrictions would also encourage investment and innovation. Reviewing the collective bargaining framework could help align wage growth with productivity, fostering competitiveness and employment in more diverse economic activities.

- *Protecting the environment*. The recently adopted climate action plan aims to reduce green-house gas emissions and work toward Iceland's pledge to achieve carbon neutrality by 2040. The efforts to increase green infrastructure, develop carbon capture technologies, and incentivize green transportation and afforestation are welcome.

The IMF team would like to thank all interlocutors at the Prime Minister's Office, the Central Bank of Iceland, the Ministry of Finance and Economic Affairs, other government and nongovernment entities, and the private sector for constructive and fruitful discussions.