INTERNATIONAL MONETARY FUND

IMF Country Report No. 21/106

ICELAND

June 2021

2021 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; STAFF STATEMENT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ICELAND

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2021 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 4, 2021 consideration of the staff report that concluded the Article IV consultation with Iceland.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 4, 2021, following discussions that ended on April 16, 2021, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 12, 2021.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Staff Representative** for Iceland.
- A **Statement by the Executive Director** for Iceland.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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PRESS RELEASE

PR21/164

IMF Executive Board Concludes 2021 Article IV Consultation with Iceland

FOR IMMEDIATE RELEASE

Washington, DC – **June 8, 2021:** On June 4, 2021, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Iceland.

Iceland entered the COVID-19 crisis from a position of strength and stands favorably in its handling of the pandemic. Net and gross public debt have declined by more than 50 percentage points of GDP since the Global Financial Crisis, private and external debt have declined by 200 percent of GDP, and international reserves have reached around 30 percent of GDP. Banks' balance sheets have been strong, with significant capital and liquidity buffers. The available policy space allowed for a prompt and substantial policy response to the pandemic, with fiscal, monetary, and macroprudential measures alleviating the impact on households and firms. The COVID-19 cases were contained fast, and vaccinations have progressed as planned, with more than 60 percent of the population above age 16 having received at least one dose.

Nonetheless, the impact of the pandemic on the economy has been significant. The collapse in global tourism flows has affected Iceland's engine of growth, which relies heavily on contact-intensive sectors. Real GDP declined by 6.6 percent, unemployment rose sharply, the current account surplus declined, and inflation rose above the notification band in 2020. A modest recovery is projected to take hold in 2021, with GDP projected to reach its 2019 level the following year. Scarring arising from an expected slow tourism recovery is projected to keep GDP below its pre-COVID trend by 3 percent in 2026. Risks to the outlook are significant, mainly stemming from uncertainty in the path of the pandemic domestically and abroad and the prospects for global tourism revival.

Executive Board Assessment[2]

Executive Directors commended Iceland's handling of the severe impacts of the COVID-19 pandemic, thanks to the strong policy framework and prudently accumulated buffers. Looking ahead, Directors highlighted the challenging medium-term economic outlook, and encouraged sound macroeconomic policies and structural reforms to enhance sustainable growth, financial stability, and economic diversification.

Directors concurred that the budgeted fiscal support this year would help prop up domestic demand, mitigate scarring, and provide insurance against downside risks. Directors also

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

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

assessed that Iceland's medium-term fiscal policy plans would balance well the ongoing need for support to the economy with fiscal sustainability considerations. They noted these plans appropriately refocused fiscal policy from lifeline support toward active labor market policies and investments in physical and human capital. Maintaining the highest fiscal transparency will be crucial to preserve confidence in the fiscal framework.

Directors stressed that data-driven monetary policy rate decisions would remain essential to support confidence and mitigate inflation risks given the high degree of uncertainty. With the external position aligned with fundamentals and desirable policies, Directors advised the CBI to continue reducing its foreign exchange market presence as the effects of the pandemic subside. They also called for completion of the ongoing foreign exchange legislation reform to solidify the liberalization of the foreign exchange system and clarify the conditions for a potential use of capital flow management measures.

Directors stressed that emerging corporate vulnerabilities and housing market risks should be addressed to preserve the strength of the financial system. They recommended close monitoring of pandemic impacts on corporate and bank balance sheets and deploying macroprudential measures to mitigate risks from rapid bank mortgage credit growth.

Directors underscored that the upcoming review of the financial oversight architecture should ensure that the CBI's powers and resources are commensurate with its expanded responsibilities. They stressed that the forthcoming bank privatization required vigilance to preserve high-quality ownership. Directors commended the authorities for swiftly completing the actions required for Iceland to exit FATF's grey-list and encouraged them to continue improving AML/CFT effectiveness.

Directors stressed that Iceland's post-pandemic growth strategy should strive to further diversify and strengthen the resilience of its economy. The strategy should aim to promote safe and sustainable tourism, support innovation, enhance human capital, reduce regulatory burdens, seek to better align wages and productivity, and ensure timely achievement of Iceland's climate goals.

Iceland: Selected Economic Indicators, 2015–21

	2015	2016	2017	2018	2019	2020	2021
						Prel.	Proj.
National Accounts (constant prices)							
Gross domestic product	4.4	6.3	4.2	4.7	2.6	-6.6	3.7
Total domestic demand	6.1	7.7	7.6	4.4	0.2	-1.3	2.0
Private consumption	4.5	6.7	8.0	4.8	1.9	-3.3	3.0
Public consumption	-0.1	0.9	2.9	4.7	3.9	3.1	0.6
Gross fixed investment	21.5	18.0	10.6	1.2	-3.7	-6.8	4.4
Net exports (contribution to growth)	-1.1	-0.8	-2.9	0.7	2.1	-5.4	1.7
Exports of goods and services	8.9	11.0	5.1	1.7	-4.6	-30.5	16.3
Imports of goods and services	13.5	14.6	11.8	0.5	-9.3	-22.0	11.8
Output gap (percent of potential output)	-1.1	0.9	1.3	3.0	2.4	-4.5	-2.3
Selected Indicators							
Gross domestic product (ISK bn.)	2,311	2,512	2,642	2,840	3,045	2,941	3,132
Gross domestic product ($ bn.)	17.5	20.8	24.7	26.2	24.8	21.7	24.2
GDP per capita ($ thousands)	53.2	62.5	73.1	75.3	69.6	59.6	65.3
Private consumption (percent of GDP)	49.7	49.3	50.1	50.3	49.9	51.4	51.5
Public consumption (percent of GDP)	23.4	23.0	23.7	24.2	24.4	27.5	26.8
Gross fixed investment (percent of GDP)	19.3	20.9	21.8	21.6	20.6	21.1	21.8
Gross national saving (percent of GDP)	25.0	29.2	26.0	25.7	27.0	22.7	22.8
Unemployment rate (percent of labor force)	4.5	3.3	3.3	3.1	3.9	6.4	6.0
Employment	3.9	4.1	1.0	1.8	0.9	-3.0	0.8
Labor productivity	1.1	4.2	2.8	1.8	1.6	-3.8	3.0
Real wages	5.9	7.2	5.6	3.7	1.8	3.4	0.7
Nominal wages	7.6	9.0	7.5	6.5	4.9	6.3	4.3
Consumer price index (average)	1.6	1.7	1.8	2.7	3.0	2.9	3.6
Consumer price index (end period)	2.0	1.9	1.9	3.7	2.0	3.6	3.0
ISK/€ (average)	146	134	121	128	141	157	…
ISK/$ (average)	132	121	107	108	123	135	…
Terms of trade (average)	6.8	2.7	1.5	-3.7	-0.7	-2.3	-3.0
Money and Credit (end period)							
Base money (M0)	27.8	3.0	37.9	-1.7	-9.2	11.8	6.2
Broad money (M3)	5.6	-4.6	5.0	7.0	6.6	7.4	8.4
Bank credit to nonfinancial private sector	3.5	4.4	9.2	11.9	2.9	10.5	3.5
Central bank 7 day term deposit rate 1/	5.75	5.00	4.25	4.50	3.00	0.75	0.75
General Government Finances 2/							
Revenue	43.2	59.1	45.4	44.9	41.9	42.4	40.3
Expenditure	43.6	46.5	44.5	44.0	43.4	49.7	49.4
Overall balance	-0.4	12.5	1.0	0.9	-1.5	-7.3	-9.1
Structural primary balance	3.4	3.6	2.0	0.8	-1.4	0.3	-2.5
Cyclically-adjusted primary balance	3.8	15.0	3.3	1.6	-0.7	-2.4	-5.8
Gross debt	97.2	79.9	69.4	61.1	68.3	79.9	80.0
Net debt	78.0	65.2	57.9	48.6	55.4	63.8	67.2
Balance of Payments							
Current account balance	5.6	8.1	4.2	3.8	6.4	1.0	0.7
of which: services balance	8.9	10.5	10.6	9.0	8.5	2.5	3.4
Capital and financial account (+ = outflow)	4.8	8.5	1.7	5.5	6.8	5.4	0.6
of which: direct investment, net (+ = outflow)	-4.0	-3.5	-0.7	1.7	3.1	2.5	2.3
Gross external debt	174.8	125.1	90.3	73.3	76.5	86.0	75.4
Central bank reserves ($ bn.)	5.0	7.2	6.6	6.1	6.7	6.4	5.9

Sources: CBI; Ministry of Finance; Statistics Iceland; and IMF staff projections.
1/ For 2021, rate as of end-April.
2/ In 2020, the definition of the general government was expanded to include 24 new entities, of which the largest are the IL Fund and the Student loan Fund.

INTERNATIONAL MONETARY FUND

ICELAND

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION

May 12, 2021

KEY ISSUES

The Icelandic economy has been severely affected by the pandemic. Sharp tourism contraction and containment measures caused real GDP to plummet by 6.6 percent in 2020. A modest recovery will take hold in 2021. Recovery prospects in the tourism sector depend on control of the epidemic and progress in global and domestic vaccine distribution, spelling a challenging outlook with possibly deep medium-term scarring.

Fiscal policy should continue to support the economy for now. Policy buffers accumulated over the last decade provided space for a large fiscal support and accommodated substantial automatic stabilizers. Additional stimulus is planned in 2021 to address still large slack in the economy, mitigate scarring, and provide confidence in the event of downside risks. Medium-term policies should ensure that public debt is firmly on a downward path, while limiting the drag on growth.

Monetary easing has supported confidence and smooth market functioning, but no further easing is needed for now. Policy rate cuts and unconventional monetary policy have provided ample liquidity to the economy. With inflation above the target band and anchored inflation expectations, the CBI now needs to stay on hold. Foreign exchange intervention has helped address disorderly market conditions in the shallow foreign exchange market but should taper off as the economy recovers.

Financial policies should address emerging financial sector risks. Banks' large capital buffers position them well to support the economy. Close attention should be paid to classification and provisioning for impaired corporate borrowers. Addressing rising risks in the housing market would help avoid overheating and crowding-out of corporate loans. Vigilance in vetting new owners of privatized banks should help ensure high-quality ownership.

Structural reforms should facilitate economic diversification and mitigate scarring. A comprehensive recovery plan should lay the ground for new sources of growth, including by addressing rigidities in the labor and product markets, embracing digitalization, and enhancing human capital. Efforts to revive the tourism sector should focus on health safety and a sustainable business model. Iceland's environmental sustainability is also critical to preserve traditional sectors and achieve the country's emission reduction commitments.

Approved By
Philip Gerson (EUR) and Guillaume Chabert (SPR)

A virtual mission took place during March 29–April 16, 2021. The team comprised Iva Petrova (head), Chikako Baba, Jorge Canales-Kriljenko, Nujin Suphaphiphat, and Chun Jin (all EUR). The mission met with Prime Minister Katrín Jakobsdóttir, CBI Governor Ásgeir Jónsson, Minister of Finance Bjarni Benediktsson, Minister of Education Lilja Alfreðsdóttir and other representatives of the public and private sector. Jon Sigurgeirsson (OED) joined the discussions. Indra Mahadewa (EUR) assisted.

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ANNEXES

CONTEXT

1. **Iceland enjoyed a decade of strong economic growth prior to the COVID-19 pandemic**. Emerging from a deep recession during the Global Financial Crisis (GFC), Iceland quickly embraced a new growth opportunity. The tourism sector saw a boom that doubled its value added in 2010–18. Tourism arrivals increased fivefold, propelling growth in construction, retail trade, entertainment, and other economic sectors. Real GDP growth averaged almost 4 percent, and the current account surplus averaged 5½ percent of GDP in the 7 years prior to the pandemic.

2. **However, financial, production, and other challenges for some of Iceland's largest companies put an end to the boom in 2019**. The collapse of low-cost carrier WOW air in March 2019 and the global grounding of Boeing 737 Max significantly undercut Iceland's tourism capacity and called into question the tourism-led growth model. An accident in a large aluminum smelter cut production for many months. Concerns over the environmental sustainability of the tourism sector and corporate governance had also surfaced. In 2019, Iceland was grey-listed by the Financial Action Task Force. These challenges made economic growth more vulnerable to major shocks.

3. **Prudent policies held over the high-growth decade delivered significant policy space.** Public debt declined by more than 50 percentage points of GDP since the GFC, private and external debt shrank by almost 200 percentage points of GDP, and the net international investment position (NIIP) has been positive since 2016. Iceland's investment-grade credit ratings allowed market access at favorable terms. Banks' balance sheets had been repaired, with significant capital and liquidity buffers. Substantial policy space has allowed the authorities to respond decisively to the string of shocks that has hit the economy since 2019.

4. **Parliamentary elections are scheduled for September 2021**. While the approval rating of individual coalition parties has diverged, approval rating of the incumbent coalition overall has remained strong, partly reflecting the widespread policy support in response to the pandemic. Therefore, while changes in government composition are possible, no significant changes are expected in the direction of economic policies.

THE PANDEMIC: POLICY RESPONSES AND OUTCOMES

5. **Iceland has been highly exposed to health, economic, and financial contagion from the COVID-19 pandemic.** Although Iceland stands out favorably in its handling of the pandemic, with a low fatality rate and fast containment of COVID-19 cases (Figure 1), the collapse in global tourism flows has affected Iceland's engine of growth (Figure 2). A prompt and substantial policy response, alongside low global interest rates and oil prices, provided some respite (Figure 3).

A. A Robust Policy Response

6. The authorities introduced significant fiscal measures. They eased the strain on households and firms, supporting an eventual recovery (Annex I). Total above-the-line measures of about 3 percent of GDP and automatic stabilizers of about 3.6 percent of GDP contributed to an increase in the primary general government deficit of 5½ percentage points in 2020. Parliament facilitated the fiscal easing by suspending temporarily Iceland's fiscal rule.[1]

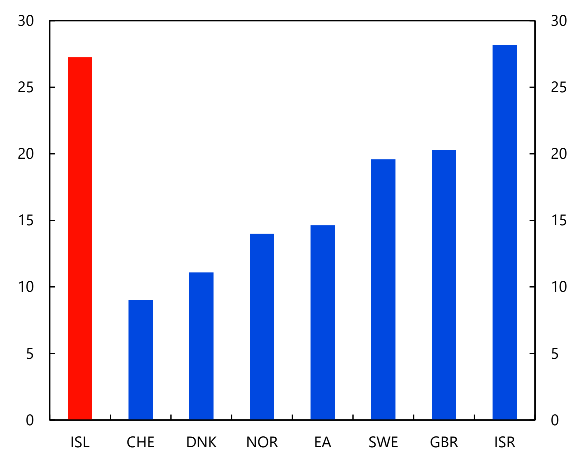
Pandemic-Related Fiscal Support in 2020
(Percent of GDP)

Affecting Fiscal Balances	Implementation
Above the line measures	3.0
Health	0.5
Households (wages and allowances)	1.0
Company grants	0.9
Refunds and tax offsets	0.0
Other	0.5
Automatic stabilizers	3.6
Unemployment	1.8
Other	1.8
Total	6.6
Not affecting Fiscal Balances	2.5
Tax deferrals	0.4
State Guarantees	1.1
Pension withdrawals	1.0
Total Support	**9.1**

Sources: Ministry of Finance and IMF staff estimates and calculations.

7. The CBI deployed its ample monetary policy space. It lowered policy rates by 200 basis points, reduced reserve requirements by one percentage point, and discontinued the one-month depositauctions. It also launched a treasury bond purchase program of up to ISK150 billion (5 percent of GDP, 20 percent of the 2019 treasury debt stock), of which ISK8 billion was utilized in 2020. Overall, money supply increased by about 30 percent, one of the highest growth rates among advanced economies.

M1 Growth: 2020
(Percentage change Q4/Q4)



Sources: Haver Analytics.

8. The CBI intensified foreign exchange intervention, while preserving a flexible exchange rate. With collapsing export revenues and capital outflows, the króna depreciated by 15 percent against the euro in 2020, amid significant volatility partly attenuated by CBI's foreign exchange intervention (FXI). Iceland's pension funds' decision to suspend foreign investments for a six-month period also helped contain currency pressures. In September, the CBI announced a program of daily FX sales of €3 million to accommodate demand in the thin foreign exchange market, while reserving the possibility to conduct discretionary intervention as needed. The CBI sold €230 million through the program and conducted discretionary intervention selling on net an additional €600 million (total of 4.5 percent of GDP) in 2020.

9. The authorities eased macroprudential and supervisory measures. The newly established financial stability committee decreased the countercyclical capital buffer (CCyB) from 2 percent to

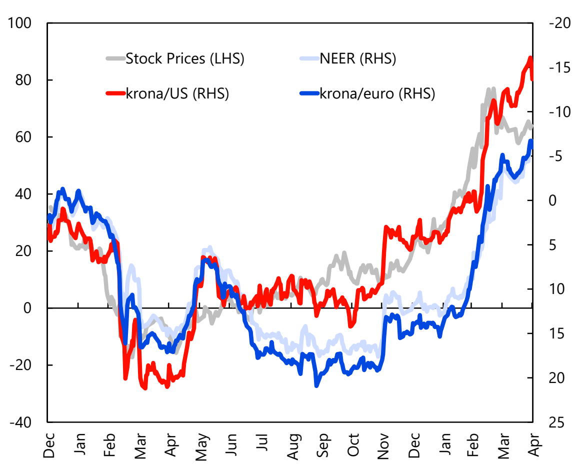
[1] The fiscal rule requires the overall fiscal balance to be above-2.5 percent of GDP and positive on average over a 5-year period. It also sets a cap on net debt of 30 percent of GDP and requires any excess to be reduced by 5 percent per year. The fiscal rule was temporarily suspended in 2019 after the bankruptcy of WOW air. In 2020, the suspension was extended through 2025.

zero. The CBI reclassified required reserves as high-quality liquid assets for computing liquidity coverage ratios. Private loan moratoria agreements, consistent with EBA guidelines, provided temporary breathing space to households and firms on their scheduled loan service, covering at their peak up to 18 percent of the loan portfolio. Parliament also approved simpler temporary rules for financial restructuring of companies.

B. A Deep Recession

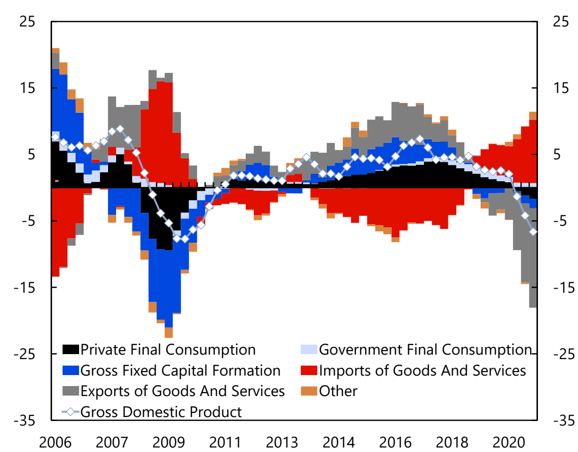
10. The authorities' policy announcements helped rebuild confidence and stabilize financial markets. The sharp increase in global risk aversion at the onset of the pandemic led to a temporary 11-percent drop in the stock exchange and 20-percent króna depreciation y/y in April 2020. With the prompt announcement of support measures globally and in Iceland, risk aversion quickly subsided, and the stock market resumed its upward trend, although the króna remained prone to recurrent bouts of instability.

Stock Prices and Exchange Rates: 2020-21
(Percentage change, Y/Y)



Sources: Haver Analytics.

Contributions to Growth: 2006-20Q4
(Percentage points (y/y), 4 quarter moving average)



Sources: Haver Analytics.

11. Real GDP plummeted by 6.6 percent in 2020 (Figure 4). Tourism, trade, and business disruptions led to a 31-percent reduction in exports of goods and services and a 7-percent decline in investment. Real wage increases of over 3 percent under the current wage agreement and policy support to households dampened the decline in private consumption to about 3 percent.

12. Contact-intensive sectors suffered the most. Passenger arrivals, hotel stays, and foreign credit card spending dropped by almost 80 percent, leading to a decline in tourism turnover of almost 60 percent. The ban on capelin catch[2] and lower international aluminum prices affected the fishing and aluminum industries. On the positive side, aquaculture had another good year.

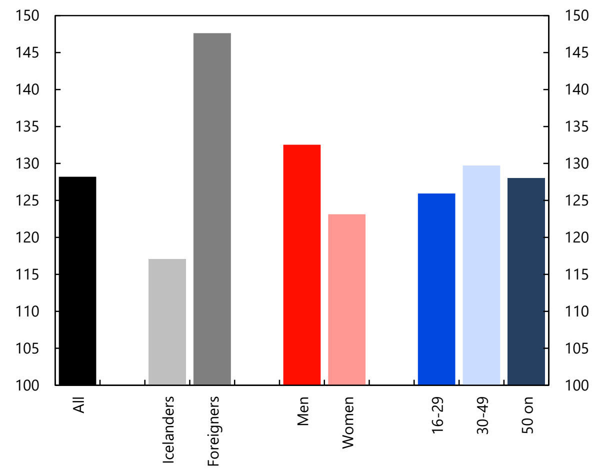
[2] Based on scientific recommendations, issuance of capelin catch quotas was suspended in 2019–20 to protect the sustainability of the capelin stock. It resumed in early 2021.

Real Value of Turnover[1]: 2020Q1-Q4
(Percentage change y/y; percentage points)

	% change	pp contribution
Total	-10.6	-10.6
Tourism	-59.7	-8.2
Aluminum	-6.9	-0.3
Construction	-9.2	-0.7
Real estate	-5.4	-0.1
Wholesale	-5.8	-1.0
Other	-2.5	-0.9
Fishing	-2.2	-0.2
Government Services	5.1	0.0
Retail	6.8	0.7
Aquaculture	19.2	0.1

1 Deflated by the CPI. Includes effect of change in relative prices.
Source: STATICE.

Increase in Number of Unemployed by Type, 2020
(Percentage change y/y, annual average)



Sources: Haver Analytics.

13. Labor market slack emerged due to the collapse in tourism. Survey unemployment rose by 2½ percentage points to 6.4 percent in 2020. Extending unemployment benefits to employees with reduced working hours allowed affected firms to retain workers. The tourism sector contributed more than 90 percent of the decline in employers and employees, with unemployment affecting foreign workers, who are overrepresented in the tourism industry, disproportionately.

14. Despite rising inflation, inflation expectations remained anchored. The pass-through from the króna depreciation,[3] and inflation pressures from abundant domestic and global liquidity, robust nominal wage growth, and fiscal stimulus more than offset the sharp deceleration in trading partner inflation and the net decline in oil prices. Nonetheless, 12-month inflation expectations remained near target, reflecting confidence in the monetary policy framework.

15. The trade balance deteriorated sharply in 2020. The surplus in service exports vanished with the collapse in the tourism and transport exports, which represented around 40 percent of total exports in 2019. FXI cushioned market volatility related to exit of about half of the remaining offshore króna assets and sales of government bonds by foreign investors. International reserves remained adequate at $6.4 billion—about 150 percent of the Fund's reserve adequacy metric (ARA). Based on 2020 data, Iceland's external position is broadly in line with fundamentals and desired policies. This assessment reflects adjustments to the current account for the transitory impact of the pandemic and is subject to very significant uncertainty (Annex II).

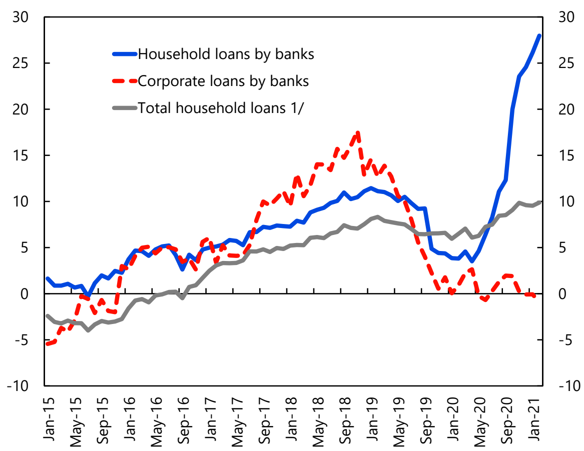
16. Banks have ample capital and liquidity buffers in the face of worsening asset quality. With the issuance of new equity capital and suspension of dividends, total capital ratios rose to 24.9 percent on average at end-2020. Liquidity ratios also remain well above the requirements. The expiration of the industry-wide payment moratoria in September 2020 led to a reclassification of

[3] The exchange rate pass-through implies a 0.1–0.3 increase in consumer prices per 1-percent depreciation.

tourism-related loans, and banks' corporate NPL and forbearance ratio rose to 18 percent at end-2020 from 5 percent at end-2019, with 35 percent of NPLs provisioned. Loan impairment losses and shrinking interest margins dented banks' already declining profitability in 2020.

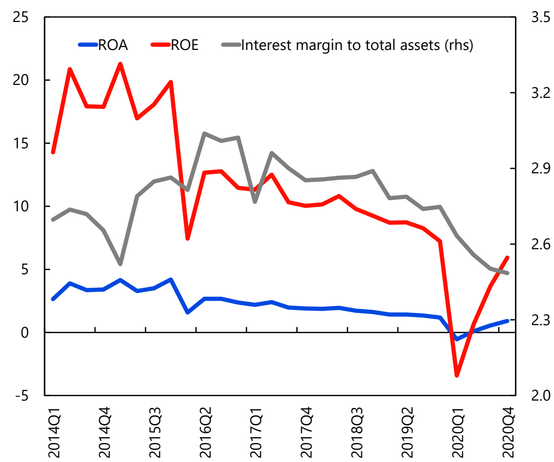
17. Mortgage credit growth regained momentum. Household debt grew by 9½ percent in 2020, as households shifted from pension fund and House Financing Fund (HFF) borrowings to bank loans—which rose by 25 percent—to refinance at lower rates. Housing market buoyancy drove real prices up by 4 percent and turnover by 40 percent. Corporate and commercial real estate loans stagnated, reflecting looming insolvency risks in tourism-related sectors.

Credit Growth
(Percentage change y/y)



Sources: Haver Analytics; CBI; IMF staff calculations.
1/ Include loans extended by pension funds and HFF.

Bank Profitability
(Percent)



Sources: IMF FSI.

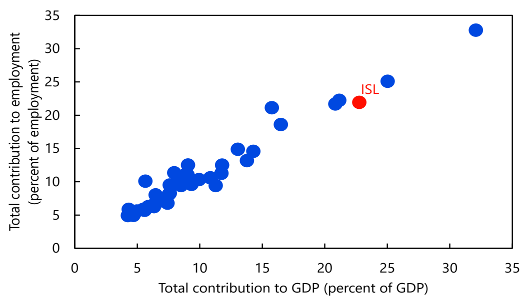
OUTLOOK AND RISKS

A. Slow Recovery and Deep Scars

18. A modest recovery is projected to take hold in 2021. The baseline envisages growth to resume in 2021 at 3.7 percent, with real output still about 6 percent below its pre-COVID trend. In the near term, growth will be driven mainly by the ongoing fiscal and monetary stimulus with domestic demand contributing the most to economic activity. Net exports will have a small contribution due to a moderate growth in maritime and aluminum exports.

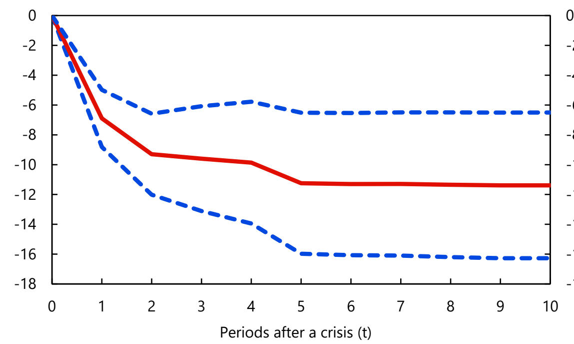
19. Given uncertainties in the recovery of the tourism sector, medium-term growth will continue to depend on domestic demand. Tourism has been one of the largest contributors to Iceland's economy, accounting for more than 20 percent of GDP and employment in 2019. The pandemic, through domestic and global containment measures and social distancing, is likely to leave significant scars on the sector. UNWTO estimates that international tourism could take 2½–4 years to return to 2019 levels.[4] Evidence from previous health crisis episodes suggests a 10-percent loss of value added in tourism and related sectors after five years (Annex III). Overall, real GDP is projected to catch up with its 2019 level only in 2022 and remain below its pre-COVID trend by 3 percent in 2026. The output gap will gradually close by 2026.

Contribution of Tourism to GDP and Employment in Europe, 2019



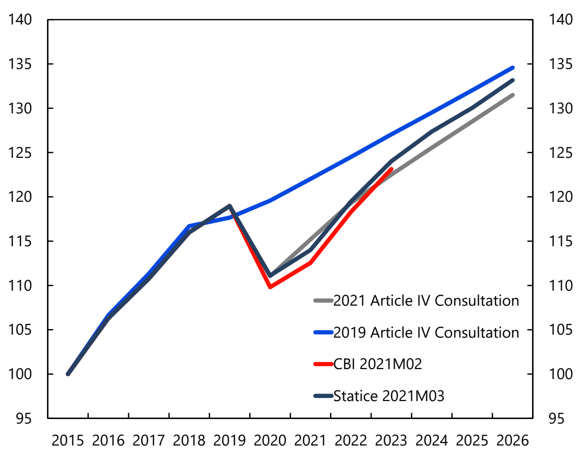
Note: Tourism contribution to GDP is calculated by the WTTC. According to WTTC/ Oxford Economics methodology, tourism contribution to GDP is the sum of direct and indirect contribution of travel and tourism. Direct contribution reflects total spending on travel and tourism by residents and non-redisents for business and leisure purposes as well as government spending directly linked to visitors less domestic and imported purchases made by the different tourism sectors. Indirect contribution includes GDP supported by travel and tourism investment spending, government spending which helps travel and tourism activity, and domestic (non-imported) supply chain purchases of goods and services by the sectors dealing directly with tourists.
Sources: World Travel and Tourism Council (WTTC) and IMF staff calculations.

Impact of Health Crises on Tourism
(% deviation from pre-crisis trend)



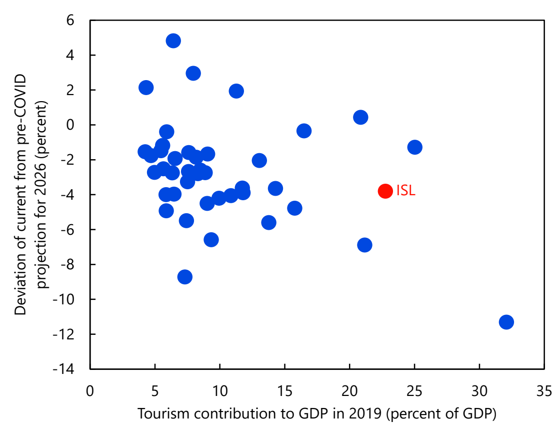
Notes: The red line indicates a point estimate of an impulse response function based on a local projections method, covering 42 European countries during 1990-2019. The dashed blue lines are standard-error bands drawn from a thousand Monte Carlo simulations.
Sources: IMF staff calculations.

Growth Forecasts: 2020-21
(Percentage change, Y/Y)



Sources: Haver Analytics.

Tourism Share in GDP and Medium-Term Real Output



Sources: IMF WEO, WTCC, IMF staff calculations.
Note: Pre-COVID projection refers to imputed 2026 real output using January 2020 WEO projections and applying 2024 projected growth rates.

B. Unprecedented Risks to the Outlook

20. In the near term, risks to the recovery stem from the path of the pandemic and the prospects for global tourism revival (Annex IV). Abundant vaccine availability may allow herd

[4] World Tourism Organization (UNWTO), 2020, Impact assessment of the COVID-19 outbreak on international tourism.

immunity to be reached faster, boosting confidence, and opening a door for a more buoyant tourism season. A significant pent-up demand after the prolonged lockdowns in partner countries could also invigorate tourism activity, especially if carefully designed, managed, and promoted health precautions support confidence in tourism safety in Iceland. However, a resurgence in the pandemic—due to new virus strains or short-lived vaccine effectiveness—could dash hopes for recovery, reduce the policy space, and erode political capital. Risks of other adverse shocks are also significant and tilt the balance of risks to the downside. A sharp rise in risk aversion, deglobalization, social discontent and political instability abroad could derail the expected recovery. Under the baseline scenario, the evolution of public and external debt is sustainable (Annex VI and VII), but a sharp rise in global risk premia could reduce the scope for supportive policies domestically. Iceland's economy also remains exposed to the risk of natural disasters, including those related to volcanic activity and climate change.

Authorities' Views

21. The authorities broadly agreed with staff's views on the outlook and risks. They were less optimistic about 2021 but concurred that private consumption was likely to remain a main driver of growth, given uncertain prospects for recovery in the tourism sector this year. They were more optimistic about growth prospects in 2022 and the medium-term although they saw long-term unemployment—especially among tourism employees—as a potential channel of scarring. The authorities recognized that uncertainty remains large but saw risks as balanced. They expect the vaccination campaign to engender a positive impact on economic activity, including tourism. They emphasized that consumer surveys still placed Iceland among top global travel destinations and the recent volcanic activity was also likely to boost tourism.

MACROECONOMIC POLICIES: HEALING THE SCARS

22. Discussions focused on the appropriate policies to support the recovery and mitigate the potentially large scarring. The main challenge for Iceland in the next few years will be the reallocation of physical and human resources during the expected gradual recovery in cross border tourism flows. Close coordination across policies and a careful policy mix are required to support the economic recovery, while avoiding a flare-up in inflation, external imbalances, or financial stability concerns. Structural reforms should facilitate economic diversification and make the economy more resilient to shocks.

A. Fiscal and Public Debt Management Policy

23. The fiscal policy response to the pandemic was timely, sizeable, and appropriately targeted. The bulk of spending—beyond automatic stabilizers— supported employees with reduced working hours and struggling SMEs. Slow implementation of public investment allocations may have created some drag on the economy but mostly reflected the disruption created by containment measures. Critical health-related spending was unconditionally extended. Sunset clauses of key support measures—e.g., retention and wage-linked unemployment benefits, and value-added-tax rebates—were extended into 2021 and 2022. Iceland has some fiscal space that allowed smooth financing of the large 2020 budget deficit at favorable terms.

24. The 2021 budget adequately allows fiscal support to continue while the recovery takes hold. The primary fiscal deficit is expected to reach 7.1 percent of GDP in 2021, adding about 3 percentage points of GDP in further fiscal support relative to 2020. This includes an upfront increase in public investment, which should contribute to the recovery—given its higher multipliers—and mitigate scarring, crowd-in private investment, and prop up potential growth.[5] The fiscal support also includes previously planned reductions in personal income taxes and an advanced cut in the bank tax. This provides significant boost to demand in the face of a still depressed tourism activity and sizeable output gap. In view of the great uncertainty to the outlook, the fiscal easing also allows room to accommodate spending if downside risks materialize.[6] Nonetheless, the authorities should save any windfall revenues if the economy recovers faster than projected.

25. Medium-term fiscal policies should ensure that public debt is firmly on a downward path, while limiting the drag on growth. As the recovery takes hold, urgent support will taper off, and a primary deficit reduction of about 3 percentage points is projected to take place already in 2022. The authorities' medium-term fiscal strategy (MTFS) targets a positive primary balance by 2025, supported by fiscal measures of 2–3 percentage points of GDP that are yet to be specified, pending the upcoming elections (Figure 5). While the MTFS seeks to preserve fiscal space, the fiscal policy mix should mitigate risks to the fragile recovery and avoid deeper scarring. The fiscal consolidation measures ultimately to be adopted should focus on low-multiplier items, such as streamlining the application of the low VAT rate and identifying savings through the ongoing spending review.

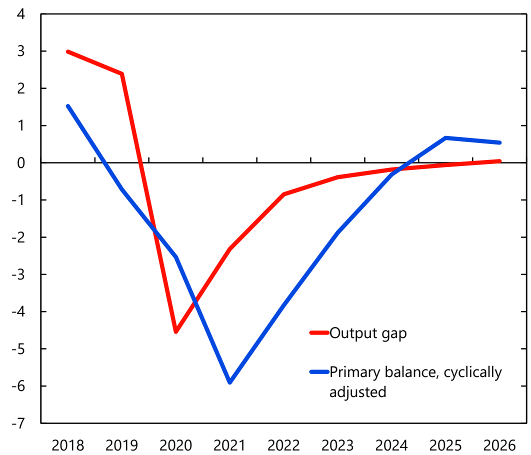
26. The medium-term fiscal path could help preserve Iceland's fiscal rule, which is critical to rebuild buffers. Suspending the rule for a 5-year period by invoking its escape clause during the pandemic was warranted given the magnitude of the shock. The MTFS is projected to bring the fiscal accounts as close as possible to compliance with the fiscal rule by reducing the overall deficit below 2.5 percent of GDP and net debt at the pace required by the fiscal rule. An assessment whether any additional fiscal effort will be needed in the long term to achieve a forward-looking 5-year average positive overall balance should be made closer to the expiration of the fiscal rule

[5] Public investment has the highest short-term multiplier among spending measures. See Batini, Nicoletta, Luc Eyraud, Lorenzo Forni, and Anke Weber, 2014. "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections," IMF technical notes and Manuals (Appendix II). See also "Public Investment for the Recovery", Fiscal Monitor, October 2020.

[6] To deal with uncertainty, the medium-term fiscal policy statement envisages a 3-percentage point uncertainty margin over the baseline for 2021 and 2022. After the 2021 parliamentary elections, the new cabinet is expected to draft a new statement.

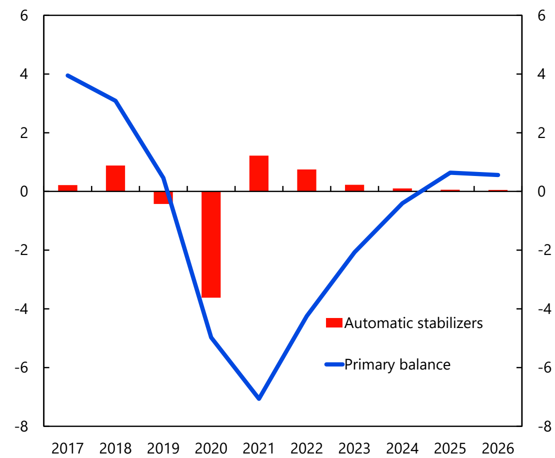
suspension in 2025. Reverting to the fiscal rule would help rebuild fiscal buffers and ensure adequate fiscal support in the event of future shocks.[7]

Fiscal Position and Output Gap
(Percent of GDP and Potential GDP)



Sources: Haver Analytics.

Primary Balance and Automatic Stabilizers
(Percent of GDP)



Sources: IMF staff estimates and calculations.

27. Preserving fiscal transparency is important given the sensitivity of Iceland's gross debt to shocks. Pandemic related fiscal deficits and adverse interest-growth dynamic will raise public debt by about 12 percentage points of GDP by end-2021 relative to end-2019 (Annex VI). A statistical reclassification of the HFF and other financial institutions into the general government has also raised net debt by 29 percentage points of GDP relative to the 2019 Article IV Staff Report (Annex V), although winding down their financial assets would keep debt on a gradually declining path. The sensitivity of gross debt to fluctuations in these assets calls for maintaining utmost transparency of the annual fiscal accounts of the reclassified entities, reflecting them fully in the authorities' medium-term fiscal deficit and debt planning. The large increase in pandemic-related government spending also calls for highest standards in timeliness and coverage of fiscal reporting to preserve Iceland's high standing in fiscal transparency.

Authorities' Views

28. The authorities concurred that fiscal support to aggregate demand remains crucial in 2021 and for the medium-term recovery. Fiscal resources are now being channeled to investment in public infrastructure and human capital through education and innovation. The authorities' pragmatic approach aims to achieve a balance between fiscal support and debt sustainability in the medium term. While the fiscal rules remain suspended through 2025, fiscal policy will be guided by the principles of fiscal sustainability, prudence, stability, predictability, and highest standards of fiscal transparency, embedded in the framework. However, the authorities noted that reassessing the fiscal rule parameters may be considered in due course. They also argued for preserving the clarity

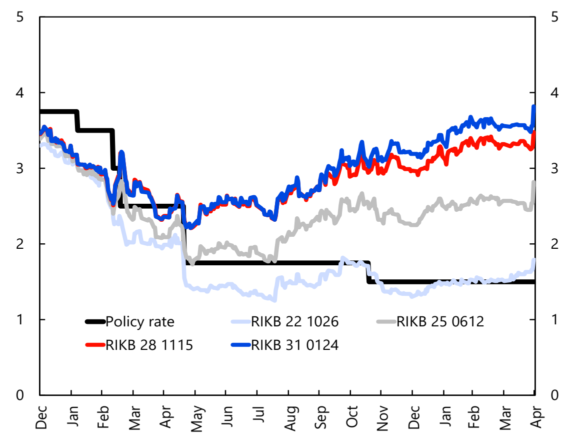
[7] IMF, 2019, Iceland—Selected Issues Paper.

of medium-term fiscal policy planning by excluding the reclassified entities—and temporary fluctuations in their asset valuations—from the fiscal framework. They stated that more work would be needed before considering changes to the fiscal framework.

B. Monetary, Exchange Rate, and Reserve Management Policy

29. The inflation targeting framework has played a crucial role in the policy response to the pandemic. CBI's policy rate cuts have supported economic activity in the context of stable inflation expectations. Monetary policy transmission resulted in lower mortgage rates and bond rates with shorter maturities (Figure 6). Unconventional tools were—rightly—used to a much lesser extent mainly to ensure the functioning of financial markets. The announcement of a government bond purchasing program supported confidence and low long-term rates early in the pandemic when uncertainty was high.

Policy Rate and Bond Yields: 2020-21
(Percent a year)

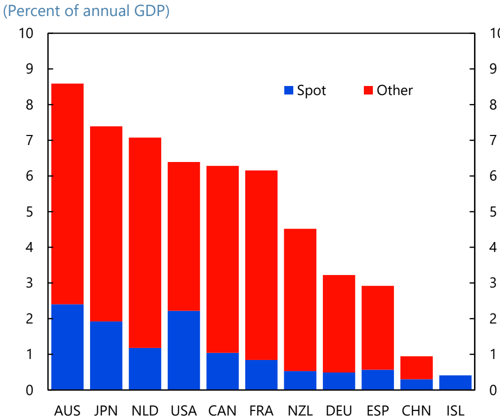


Sources: Haver Analytics.

30. Monetary policy should now be kept on hold unless significant risks materialize. The discontinuation of NBFI deposits at the CBI[8] and of one-month deposit auctions, combined with policy rate easing, accelerated money growth, and temporarily put pressure on the króna and prices. Although inflation is expected to return to target without further policy action, vigilance and data driven policy rate decisions would be warranted given the strong fiscal policy support and high degree of uncertainty about the size of the output gap. The use of unconventional monetary policy measures does not appear warranted as the policy rate is still positive.

31. The CBI's presence in the shallow Icelandic foreign exchange market has ensured orderly market conditions and needs to taper off gradually. CBI's FX sales have helped smooth various large external shocks: they provided reliable foreign exchange liquidity in the face of the pandemic-related collapse in export revenues, facilitated the exit of about half of the 2 percent of GDP in offshore króna remaining at end-2019, smoothed FX market functioning during periods of significant global financial volatility, and helped absorb the resumption of foreign investment by pension funds in mid-2020. Going forward, as the effects of the pandemic subside, the CBI should continue reducing its presence in the market.

Spot FX Market Turnover: April 2019
(Percent of annual GDP)



Notes: The data for Iceland corresponds to the spot interbank foreign exchange market. No data is available for derivative operations, which are severely restricted by regulations.
Sources: Bank of International Settlements and Central Bank of Iceland.

[8] The discontinuation of NBFI deposits was announced in October 2019.

32. The large current and projected fiscal deficits and financing needs require careful coordination of fiscal, monetary, and exchange rate policies. Government borrowing requirements, estimated at 17 percent of GDP in 2021, may impact monetary conditions. A well-balanced composition of new public debt issuances would make gross financing needs easily absorbed by domestic institutional investors. Iceland's good standing in international markets also allows securing external financing at low rates. CBI's government bond purchase program should be managed carefully, as the currently authorized purchases could potentially inject about 2 percent of GDP in króna liquidity, putting significant pressure in the FX market and on inflation.

Authorities' Views

33. The authorities agreed that the current monetary policy accommodation was appropriate, but that policy should adjust to changing circumstances. They expected inflation to subside given the recent króna appreciation and remaining slack in the economy. However, the CBI feared that the large fiscal support in 2021 could create inflationary pressures, requiring monetary policy action to keep inflation expectations anchored. The CBI considered that unconventional monetary policy currently played a limited role but believed that the government bond purchasing program should be in the monetary policy arsenal in the long term.

34. The authorities viewed foreign exchange interventions as an essential part of the monetary framework. While committed to exchange rate flexibility, they considered FXI necessary at times to maintain price and financial stability and preserve confidence given Iceland's shallow FX market. The CBI considered that the large international reserves are a source of policy strength, helping Iceland to weather the pandemic and the CBI to manage systemic liquidity, prevent disorderly market conditions, maintain market functioning, and keep inflation expectations anchored. The authorities noted that they have already discontinued the regular sale of foreign exchange in the market.

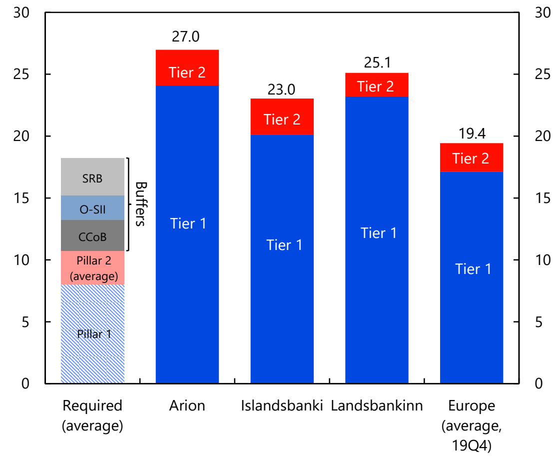
C. Macroprudential and Capital Flow Management Policy

35. Iceland's financial system has entered the pandemic in a strong position. Multiple policy levers have been eased since the onset of the pandemic crisis—releasing the CCyB, lowering the bank levy, and delaying a phase-in of liquidity coverage requirements in Icelandic krónur. The banks proactively provisioned for expected losses by reclassifying all exposures against the tourism sector, which represent about 10 percent of their total loans, as forbearance, yet managed to improve their capital ratios in 2020.

36. Pockets of risk have emerged:

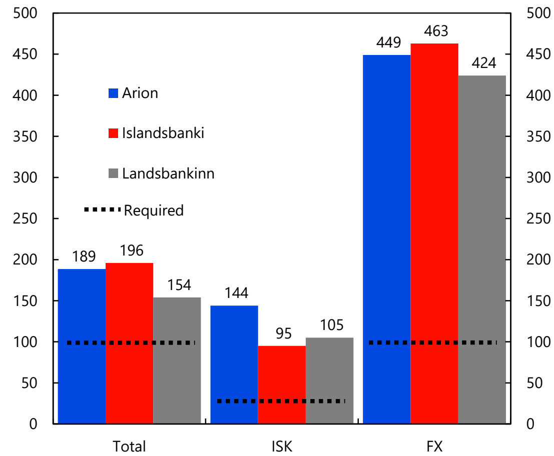
- *Mortgage lending***.** The shift of high-quality borrowers from pension funds and the HFF to banks has improved banks' average loan-to-value (LTV) and debt-service-to-income (DSTI) ratios. An overwhelming majority of new loans carry variable—rather than CPI-indexed—interest rates, lowering the debt service burden in the current low interest rate environment. However, debt service sensitivity to interest rate hikes has likely increased, and uncertainties around the reference rate for these loans could be legally challenged in the future. The mortgage lending expansion has also squeezed banks' capacity to extend corporate credit.

Required and Total Capital Ratios, 2020Q4
(Percent)



Sources: Three banks' financial statements; IMF FSI; and IMF staff calculations.
Notes: SRB = systemic risk buffer; O-SII = other systemically important institutions buffer; CCoB = capital conservation buffer.

Liquidity Coverage Ratios, 2020Q4
(Percent)



Sources: Three banks' financial statements and IMF staff calculations.

- *Corporate sector vulnerabilities***.** Despite the sharp slowdown in the economy, corporate defaults have remained limited, reflecting government support policies and extension of payment moratoria by banks. However, corporate vulnerabilities may rise, especially in the tourism and commercial real estate sectors, due to the erosion of profitability pre-COVID, which has worsened during the pandemic.

37. Stress tests suggest that the banks are likely to remain resilient. Staff's analysis shows a decline in the common equity Tier 1 (CET1) capital ratio of about 6 percentage points from end-2019 to end-2021 under a scenario with a sharp rise in corporate illiquidity and insolvency.[9] The authorities' support measures are expected to have contained the impact to about 5.5 percentage points. The potential losses reflect large write-offs of corporate loans and the cyclical increase of impairments across all asset types, which would increase the NPL ratio by 5 percentage points. CBI's scenario analysis finds a fall in CET1 capital of 1.5–5.7 percentage points from end-2019 to end-2021 with a cyclical rise in NPLs of 7 percentage points.[10] In both assessments, all systemic banks remain well above the required capital levels.

38. Financial sector policies should remain focused on supporting the economy and mitigating risks. Banks' high capital buffers could be used to absorb shocks and support lending capacity. If needed, additional capital buffer requirements—e.g., the systemic risk buffer—could be released. At the same time, mortgage lending risks should be addressed, by (i) clarifying the

[9] The analysis based on granular data updates Aiyar et al. (2021).

[10] CBI, 2020, Financial Stability Report.

uncertainty around the reference rate for flexible-rate loans, and (ii) requiring banks to cautiously assess borrower's repayment capacity. Banks could raise risk weights on loans with a high DSTI ratio calculated using higher interest rate assumption or cap such exposures.[11] Tightening the LTV limit, introducing a DSTI cap, or applying a speed limit on mortgage loan growth or a cap on mortgage exposures would also avoid overheating in the housing markets and crowding-out corporate loans. Addressing corporate vulnerabilities through rehabilitation of viable firms could take advantage of the recent temporary adjustments to the corporate insolvency framework.

39. Pension funds continued expanding. Their assets grew to 200 percent of GDP in 2020, reflecting market valuation and króna depreciation gains. During the pandemic, pension funds became important shock mitigators, as temporary suspension of new foreign investments eased currency depreciation pressures, and temporary access to private pension savings eased household liquidity difficulties. Their large presence in retail lending— 23 percent of total mortgage loans— underscores the importance of adequate regulatory and supervisory frameworks.

40. The foreign exchange legislation reform should be completed. A new foreign exchange bill—currently discussed in parliament—aims to solidify the liberalization of the FX system and clarify the conditions for a potential use of capital flow management (CFM) measures during times of heightened risk of excessive short-term capital inflows and in emergency situations. A provision allowing the CBI—with agreement by the Minister of Finance and under conditions clearly defined in the legislation—to introduce temporary CFMs on outflows could be an effective tool to support macroeconomic adjustments in imminent crisis circumstances (see IMF (2012)).[12] The bill also gives powers to the CBI to determine the degree of restrictiveness of controls on derivative transactions, providing scope for their eventual easing and deepening of Iceland's foreign exchange market.

Authorities' Views

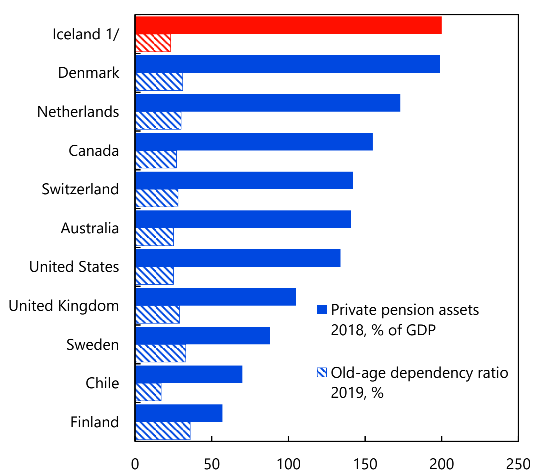
41. The authorities welcomed staff's views on the strength of the financial system but had a more sanguine view of systemic risks. They emphasized that the improvements in banks' financial positions and corporate and household balance sheets since the GFC have helped avoid a sharp rise in bankruptcies. The CBI indicated that while tourism-related asset impairments are expected, banks are well positioned to accommodate corporate debt restructurings. The authorities did not see a significant housing price misalignment from fundamentals—especially wage growth—with improvements in LTV and DSTI ratios of new loans offering additional comfort. However, they shared concerns about mortgage-related interest rate risks and the need to monitor them carefully. The authorities considered restrictions on derivative transactions to be a helpful tool for stemming

[11] Given the large share of variable rate mortgages, a "stressed" DSTI ratio is preferable to ensure that housholds' capacity to repay them would remain resilient in the event of higher interest rates.

[12] A number of countries provide statutory rights to the central bank and/or the government to introduce emergency CFMs for a few months, while often requiring parliamentary approval of extending them beyond the initial period. Given the reputational and economic costs of CFM, their introduction should be allowed only under very well-defined conditions, as specified in the IMF's Institutional View on the Liberalization and Management of Capital Flows.

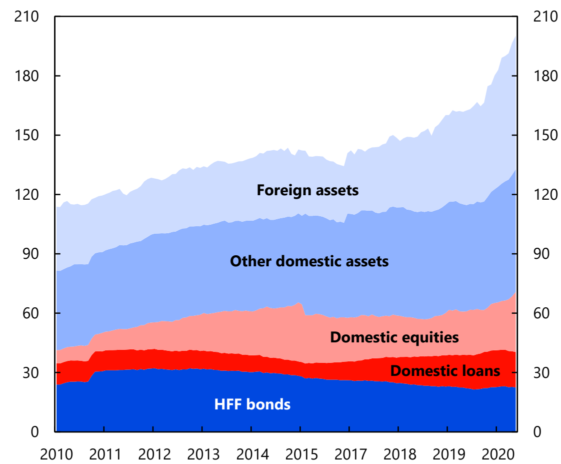
FX market speculation but also a bottleneck to Iceland's FX and bond market development and noted an intention to gradually ease them. They also underscored the importance of the CBI and the Minister of Finance having powers to introduce temporary CFM to temper speculative capital flows, while acknowledging the political sensitivities in a legal provision on introducing more wide-ranging controls on capital outflows.

Pension Statistics



1/ Iceland pension data is up to 2020.
Sources: CBI; Iceland Chamber of Commerce; OECD; STATICE; World Bank.

Pension Fund Assets
(Percent of GDP)



Sources: CBI.

D. Financial Sector Oversight

42. Strengthening the financial stability framework remains a key priority. Since the merger of the financial regulator and the CBI in January 2020, the new three-committee structure has worked smoothly. However, while the pandemic underscored the urgency of policy coordination, it delayed some organizational reforms, including resource reallocation. The upcoming first review of the new architecture is a good opportunity to assess whether its objectives (supervisory independence, adequate resources and powers, and improved synergies) are fully realized. In this regard, the resource adequacy and legal protection of CBI staff should be reviewed:

- Potential demands on supervisors have increased due to the forthcoming bank privatization, the implementation of a new FX law, a revised AML/CFT framework, and planned integration of liquidity and solvency supervision. Supervisory resources should be adequate for their new responsibilities, especially as pandemic-related activities have also intensified.

- As some new responsibilities potentially involve sensitive interactions with non-financial entities and individuals, an adequate legal protection of CBI staff, including supervisors, along with an accountability framework, would ensure effective policy implementation.

43. Close attention should be paid to the quality of bank ownership. The authorities plan to offer 25–35 percent of Islandsbanki's shares through public offering in the domestic market in summer-2021 if market conditions are favorable. The state will maintain a controlling stake, and smaller subscriptions will be met in full to diffuse ownership. It is critical that supervisors have sufficient resources to assess the suitability of shareholders, including small owners and their ultimate beneficial owners. CBI's vigilance in the assessment of qualified holdings–supplemented with assessments based on quantitative thresholds—would help ensure high-quality ownership.[13]

44. Iceland has strengthened the effectiveness of its AML/CFT framework and exited the "grey-list" of the Financial Action Task Force (FATF). In line with an action plan agreed with the FATF in October 2019, the authorities operationalized a register of beneficial ownership, introduced an automated system to collect suspicious transaction reports, and have continuously applied fines for non-compliance. They have also continued to enhance the legal framework in line with international agreements, initiated a national risk assessment review, and increased the AML/CFT supervision resources. Work needs to continue to demonstrate sustained improvement in AML/CFT implementation, including to ensure the effectiveness of the beneficial ownership registry, especially during the current period of much higher crisis-related government spending and procurement.

Authorities' Views

45. The authorities are committed to continue strengthening the financial oversight architecture. They plan to appoint three external experts to conduct the first review of the merger. They assess favorably the work and action of the CBI's committees and active dialogues with supervised entities, while recognizing that the urgency deriving from the pandemic accelerated the integration process. The authorities emphasized their careful approach to Islandsbanki's privatization, maintaining high supervisory standards in assessing the quality of new owners. They stressed their significant achievements and ongoing efforts in strengthening the AML/CFT framework, including through the effective use of the beneficial ownership registry.

E. Macrostructural Policies

46. 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 authorities have long recognized the need to diversify growth and transition to a knowledge-based economy, emphasizing biotechnology, aquaculture, and information technology and communication. The digitalization trends accelerated by the pandemic and other structural transformations fostering green recovery, provide an opportunity to prioritize a new growth agenda. A comprehensive plan for economic recovery should support diversification to make the economy more resilient in the face of large shocks.

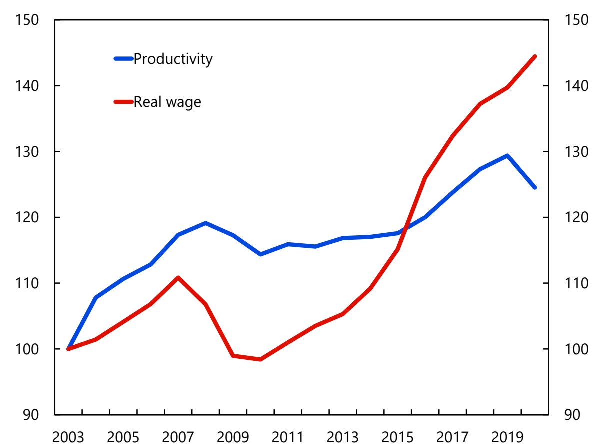
47. The pandemic presents an opportunity to develop a sustainable business model for the tourism sector. Iceland's strict health and hygiene measures, including screening protocols for international travelers, requirements for negative PCR test and vaccination certificates, and quarantines with double testing aim to promote the country as a safe travel destination. Compared

[13] Iceland's 2014 Basel Core Principles (BCP) assessment found that most processes, systems, monitoring, and supervisory actions related to bank ownership are exclusively based on the quantitative thresholds.

to peer countries, Iceland's tourism sector attracts visitors with longer length of stay and higher spending per tourist and its overall competitiveness fares well.[14] Nonetheless, improvements in price competitiveness, ground infrastructure, and environmental sustainability could help speed its recovery. Promoting green tourism should be fostered by encouraging broader usage of certification systems for tourism-related companies that engage in sustainable activities such as waste management, energy efficiency, and water conservation.

48. Enhancing wage flexibility would foster labor market resilience and help preserve inclusiveness and external competitiveness. Iceland's labor market is mobile with diverse labor force and low gender employment gap. Nonetheless, Iceland's highly centralized collective bargaining, which has proven to be swift and flexible at times, could reduce labor market resilience during recessions. Allowing wages to grow faster than productivity for extended periods could be a drag on competitiveness. Aligning wage growth with productivity growth in future wage agreements would help the economy better respond to large shocks (Annex VIII).

Real Wage and Productivity
(Index 2003 = 100)

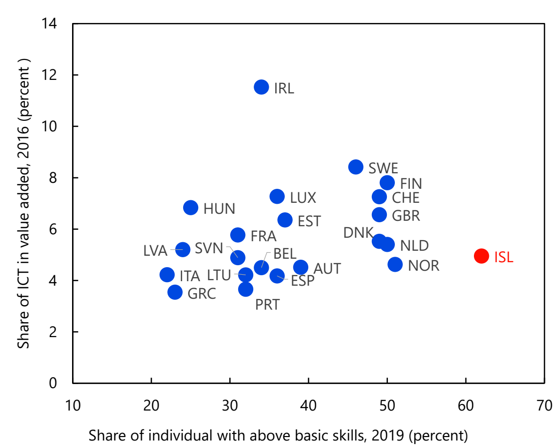


Sources: Haver Analytics; IMF staff calculations.

49. Embracing digitalization and innovation, reducing regulatory burdens, and strengthening human capital would open new growth avenues.

- *Embracing digitalization*. Compared to other advanced European countries, Iceland has prepared well for the digital age, with good access to digital infrastructure, labor force with digital skills, and ICT adoption. Given the extensive diffusion of digitalization, there is scope to boost the value-added share of ICT sectors in the economy through the R&D tax incentives and grants introduced during the pandemic. The authorities' 10-year innovation strategy and recently approved publicly-owned venture capital fund "Kría"[15] also help support innovation.

Value Added in ICT and Labor Force with Above Basic Digital Skills in Europe



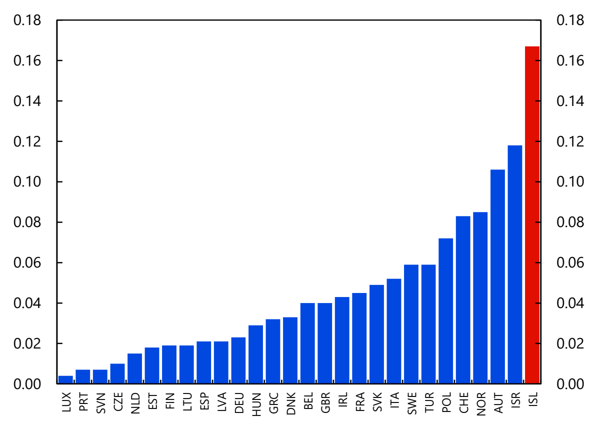
Sources: OECD and Eurostat

[14] World Economic Forum, The Travel and Tourism Competitiveness Report 2019.

[15] The purpose of the fund is to increase liquidity and activity in the venture capital sector by investing in other, privately-owned, venture funds.

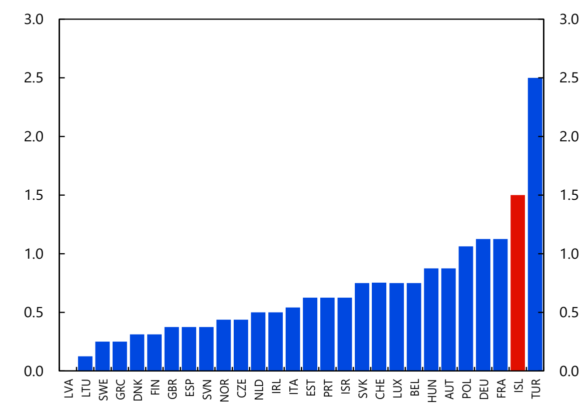
- *Easing product market regulations*. Iceland's relatively high administrative burdens on start-ups and restrictiveness of foreign direct investment, could hinder innovation and knowledge transfer and dampen employment. Barriers in network and service sectors, particularly in construction and air transport, are among the highest in Europe. The authorities' engagement with the OECD on a competitiveness review of the construction and tourism sectors is welcome. Continued efforts to address regulatory burdens could yield a significant growth benefit.[16]

FDI Restrictiveness, 2018
(Index)



Notes: Zero indicates the least restrictive, and 1 indicates the most restrictive.
Sources: OECD Economic Survey 2019.

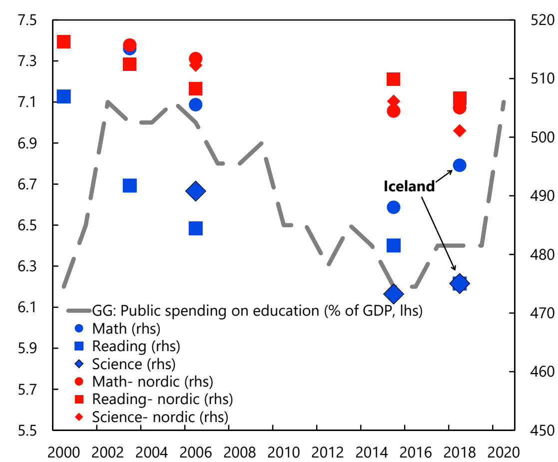
Administrative Burden on Start-ups, 2018
(Index)



Notes: Lower scores indicate lower administrative burden.
Sources: OECD 2018 PMR database.

- *Enhancing human capital*. The pandemic has resulted in a rising number of inactive population and job losses in contact-intensive sectors. The recently announced retraining and upskilling program will facilitate reallocation of workers to new sectors. Efforts should continue to implement the ongoing education reform aiming to improve education outcomes, including policies in train to attract and retain qualified teachers and to align the school curriculum with future labor demands (IMF, 2019).[17]

Education Spending and PISA Scores
(Percent of GDP) (PISA score)



Sources: Statistics Iceland; PISA.

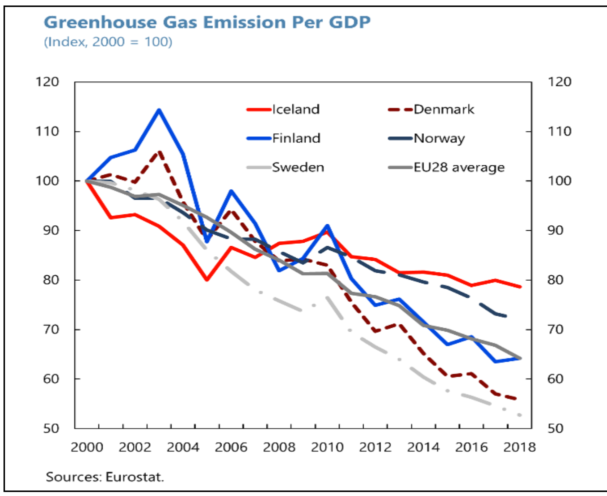
50. Policies to protect the environment will preserve the sustainability of Iceland's traditional sectors:

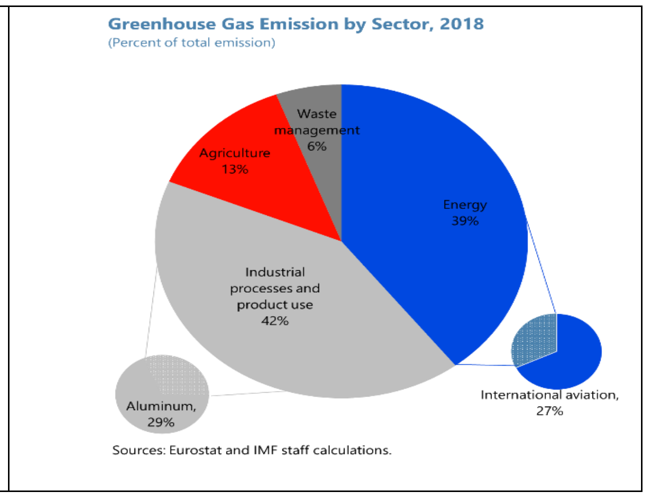
[16] OECD, 2020, OECD Competition Assessment Reviews: Iceland.

[17] IMF, 2019, Iceland: 2019 Article IV Consultation—Staff report.

- **Fisheries**: The Icelandic individual transferable quota system has been successful in balancing growth, efficiency, and sustainability in the fishing industry. However, international coordination remains critical to ensure environmental sustainability.[18] The recent agreements among North-East Atlantic coastal states on setting sustainable quotas for herring, mackerel, and blue whiting are welcome,[19] but further coordination is needed to ensure adherence to the quotas and to support the long-term management of other pelagic species.

- **Climate change**: Iceland has pledged to fulfil the EU emission reduction targets of 55 percent below 1990 levels by 2030 and achieve carbon neutrality by 2040. Nonetheless, in 2018, the country still had higher greenhouse gas (GHG) emission in percent of GDP compared to other European countries. Aluminum smelting and ferroalloy production were the largest contributors of GHG emissions, followed by energy (including air transport and fisheries), agriculture, and waste management.[20] The recently adopted climate action plan emphasizes increasing clean infrastructure, developing carbon capture technologies, and continuing to provide tax incentives for low-and zero emission vehicles[21] and afforestation, revegetation, and wetland reclamation. These efforts are welcome, and further action would be needed, including promoting cost-effective and economically viable abatement technology to address the main sources of GHG emissions. A periodic review of the action plan would ensure that the authorities' goals will be achieved in a timely manner.





Authorities' Views

51. The authorities agreed that mitigating economic scarring and facilitating diversification should be key policy priorities. They emphasized that given the country's low

[18] OECD, 2017, Sustaining Iceland's fisheries through tradeable quotas and IMF, 2018, Iceland-Selected Issues Paper.

[19] The United Kingdom is now a party of the North-East Atlantic coastal states.

[20] Excluding land use, land-use change and forestry

[21] Iceland's feebate-like system also imposes higher fees on high-emission vehicles. The climate action plan aims to ban new registrations of diesel and petrol vehicles by 2030.

population density and ample outdoor sites, Iceland would likely be viewed as a safe travel destination after the pandemic. Their action plan aims to ensure sustainable tourism in the long term. The authorities underscored that the ongoing reforms in education, innovation, and administrative burdens aim to facilitate growth in knowledge-based sectors and make the economy more resilient. While acknowledging the misalignment between wage growth and productivity growth, the authorities emphasized that the next collective wage agreement should continue to support social cohesion and reflect the consensus among social partners. They stressed the need for continuing international cooperation to address overfishing of shared stocks in the NE-Atlantic. They underscored their commitment to achieving their climate goals, noting the effectiveness of the emission-based tax incentive system in promoting low-emission vehicles.

STAFF APPRAISAL

52. Iceland stands out favorably in its handling of the pandemic, but the outlook remains challenging. A modest recovery is projected in 2021 on the back of domestic demand, with lagging export performance. Tourism is expected to recover only gradually and to experience persistent output losses. Real GDP is likely to remain significantly below its pre-COVID trend even in 2026. Downside risks to the outlook are substantial.

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

54. The Medium-Term Fiscal Plan is a welcome anchor amidst still-high uncertainty about the outlook. It appropriately refocuses fiscal policy from lifeline support to households and businesses toward active labor market policies and investments in public infrastructure and human capital to help reallocate resources and diversify the economy. It also balances well the ongoing need for support to the economy with fiscal sustainability considerations, aiming to gradually reduce the fiscal deficit and guide fiscal policy toward resumption of the fiscal rule. Maintaining the highest fiscal transparency is crucial to preserve confidence in the fiscal framework.

55. Monetary policy should be kept on hold unless significant risks materialize. The recent rise in inflation poses a challenge, and vigilance and data driven policy rate decisions would continue to be essential given the high degree of uncertainty. The use of unconventional monetary policy measures does not appear warranted at the current juncture. The external position is in line with fundamentals and desirable policies. As the effects of the pandemic subside, the CBI should continue reducing its presence in the foreign exchange market. The foreign exchange legislation reform should be completed, to solidify the liberalization of the FX system and clarify the conditions for a potential use of capital flow management measures.

56. The financial system entered the pandemic in a strong position, but emerging risks need to be addressed. Close attention needs to be paid to the classification and provisioning for impaired corporate borrowers, especially in the tourism sectors. Macroprudential measures targeting borrowers' repayment capacity and banks' mortgage exposures should mitigate risks related to rapid growth of bank mortgage credit and prevent crowding out of corporate lending.

57. The transformation of the financial oversight architecture should continue. The upcoming review of the merger between the financial supervisor and the CBI is an opportunity to ensure that the CBI's powers and resources are commensurate with its expanded responsibilities. The partial privatization of Islandsbanki also requires vigilance to preserve high-quality ownership. Work also needs to continue to demonstrate the effectiveness of the AML/CFT framework.

58. A more diversified and sustainable growth strategy is needed for the post-pandemic period. A comprehensive plan for economic recovery should aim to make the economy more resilient by promoting a safe and sustainable tourism sector, supporting innovation, enhancing human capital, reducing regulatory burdens on start-ups and foreign investment, reviewing the collective bargaining framework to better align wages and productivity, and protecting the environment. The authorities' ongoing efforts in these areas are welcome. A periodic review of the climate action plan would ensure that Iceland's climate goals are achieved in a timely manner.

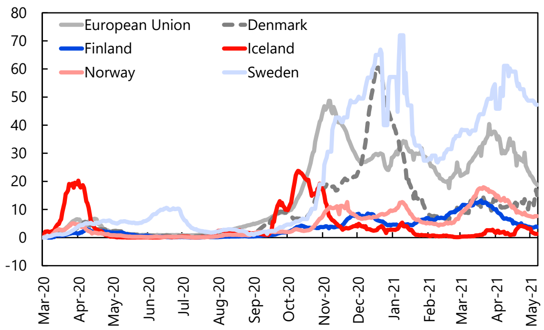
59. It is proposed that the next Article IV consultation with Iceland take place on the standard 12-month cycle.

Figure 1. Iceland: COVID-19 Developments

Iceland suffered two large COVID infection waves in 2020,…

Daily New Confirmed Cases

(Per 100,000 inhabitants; 7-day moving average; data as of May 8, 2021)

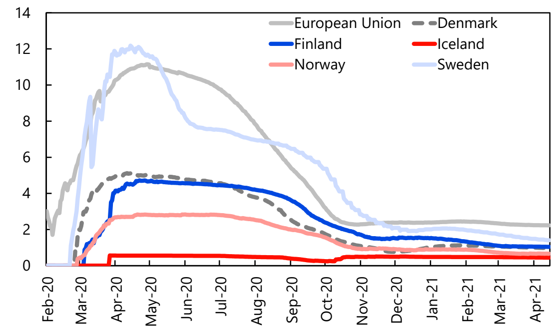


Sources: Johns Hopkins University CSSE / CCI.

which were contained rapidly, with a relatively low fatality rate,…

Cumulative COVID-19 Case Fatality Rate

(Percent of total cases; data as of May 8, 2021)

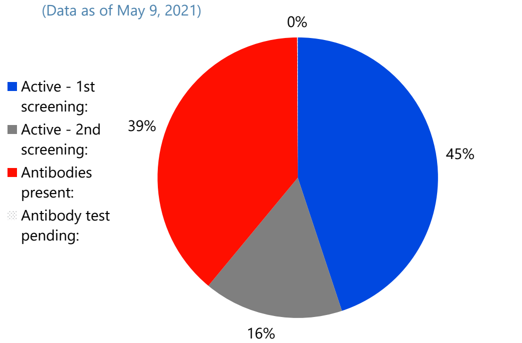


Sources: Johns Hopkins University CSSE / CCI.

keeping hospitalization well below the available ICUs…

Cumulative Number

(Data as of May 9, 2021)

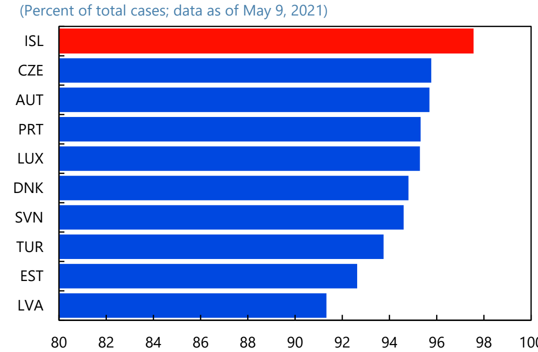


Sources: The Directorate of Health and The Department of Civil Protection and Emergency Management.

and leading to one of the highest recovery rates in Europe.

Recovery Rates in Patients

(Percent of total cases; data as of May 9, 2021)

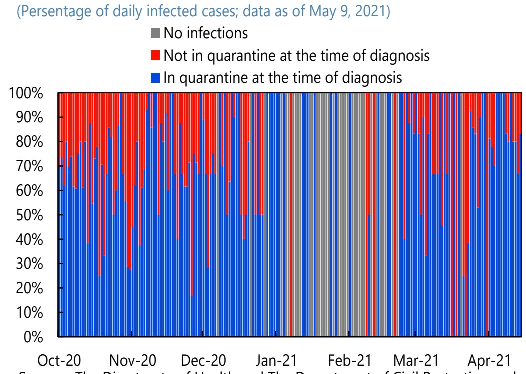


Sources: Bloomberg and IMF staff calculations.

The containment strategy, with domestic and border testing and quarantine, was successful

Infected Persons Diagnoised in Quarantine (Domestic)

(Persentage of daily infected cases; data as of May 9, 2021)

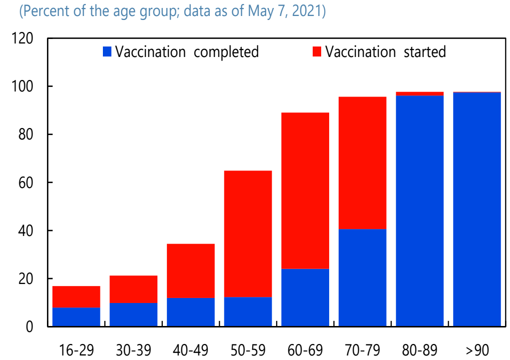


Sources: The Directorate of Health and The Department of Civil Protection and Emergency Management.

especially in the face of slower than expected vaccine deployment due to low vaccine availability.

Vaccinated Persons by Age

(Percent of the age group; data as of May 7, 2021)

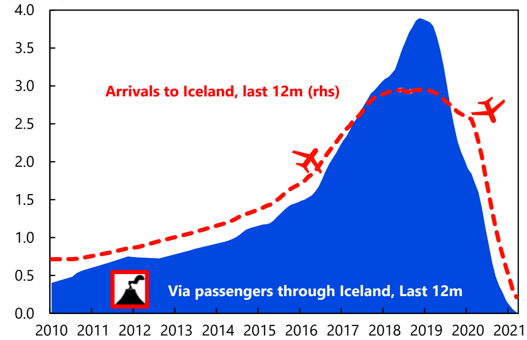


Sources: The Directorate of Health and The Department of Civil Protection and Emergency Management.

Figure 2. Iceland: Tourism Developments

Tourist traffic, which had risen rapidly until 2019, plummeted with the pandemic…

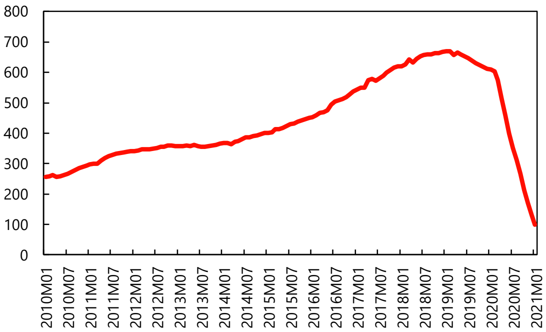
Air Traffic through Iceland: 2010M1-2021M3
(Million)



Sources: CBI; Isavia; STATICE.

including for Icelanders traveling abroad.

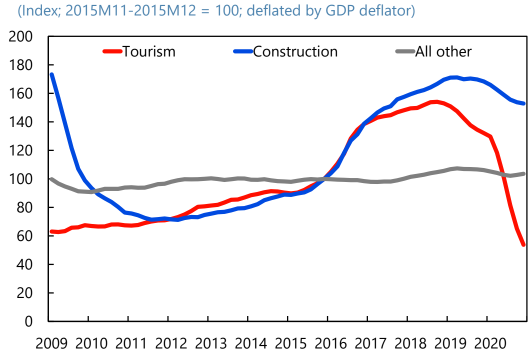
Icelanders Travel Abroad
(Thousands of persons)



Sources: Ferðamálastofa; Isavia.

Turnover in the tourism sector receded sharply.

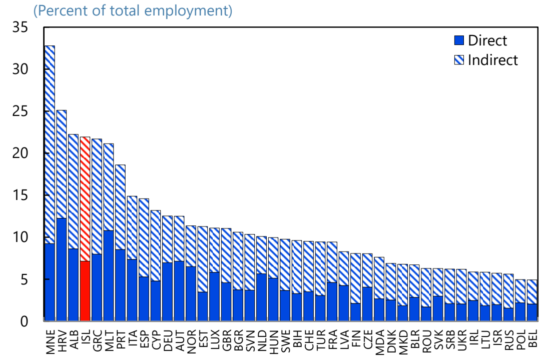
Real Turnover from VAT Returns
(Index; 2015M11-2015M12 = 100; deflated by GDP deflator)



Source: STATICE.

…affecting a larger share of employment than in other European countries,…

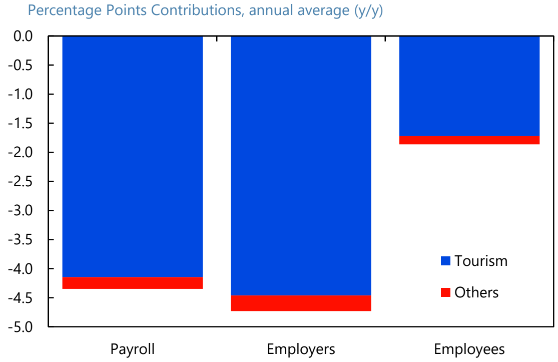
Contribution of Tourism Related Industries, 2019
(Percent of total employment)



Sources: World Travel and Tourism Council and IMF staff calculations

and contributing to significant employer, payroll, and employee losses,…

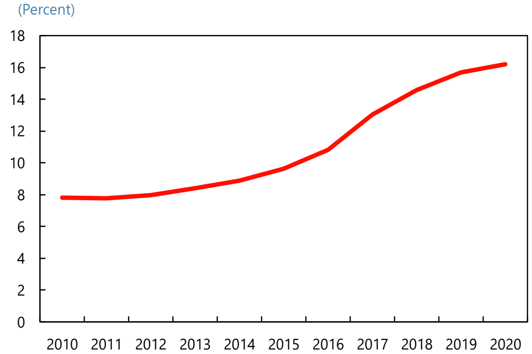
Change in Payroll: Tourism and Other, 2020
Percentage Points Contributions, annual average (y/y)



Sources: STATICE.

although immigration, filling job vacancies in Iceland, remained on an upward trend.

Share of Foreign Citizens in Population
(Percent)

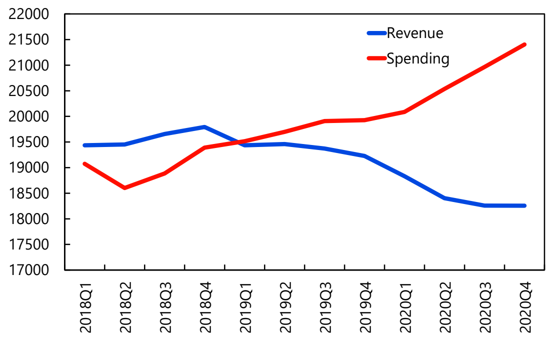


Sources: STATICE.

Figure 3. Iceland: Policy Mix and Key Policy Developments

The authorities accommodated the drop in revenue and provided additional spending in response to the pandemic,

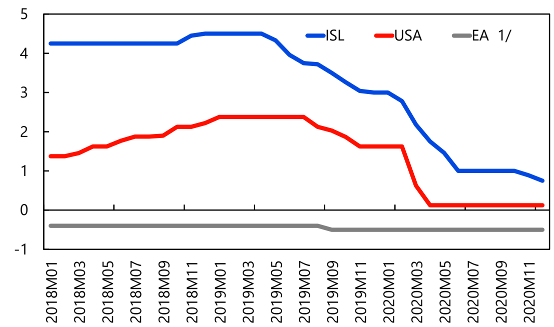
Real General Government Revenue and Spending
(CPI deflated, 4-quarter moving average)



Sources: STATICE.

The policy rate was cut by 200 basis points…

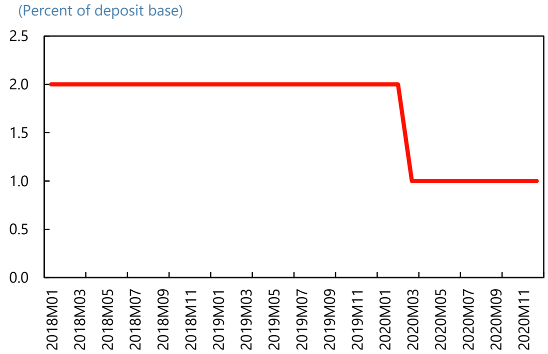
Policy Rates
(Percent p.a.)



1/ Deposit rate.
Sources: DBI; ECB; and U.S. Federal Reserve.

and reserve requirements by 1 percent,

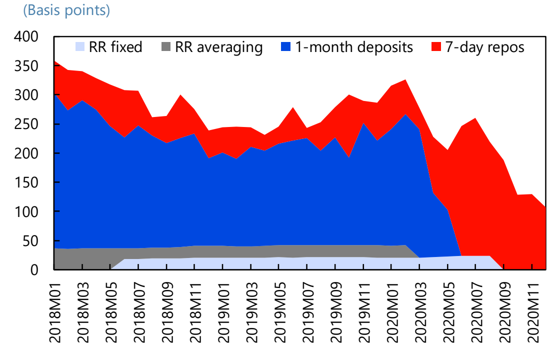
Total Reserve Requirements
(Percent of deposit base)



Sources: CBI.

which together with suspension of one-month deposits at the CBI led to a significant liquidity injection.

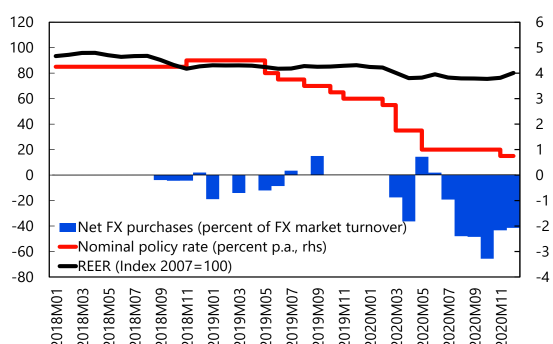
Deposits and Reserve Requirements at CBI
(Basis points)



Notes: Fixed reserve requirements are not available before June 2018.
Sources: CBI.

FXI intensified with the introduction of a regular fx sales program.

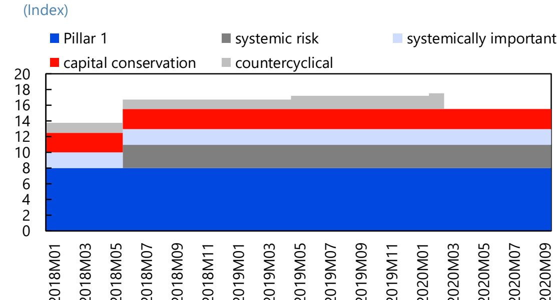
FX Intervention, Policy Rate, and REER



Source: CBI.

Countercyclical buffers were lowered.

Capital Buffers for Systemically Important Banks
(Index)



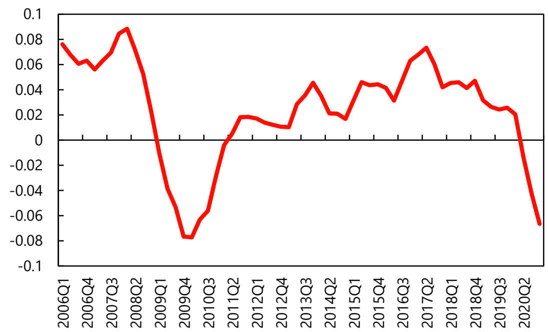
Notes: Pillar II requirements and management buffers vary by bank over time depending on their risk profile and internal policies. Total requirements averaged about 20 percent in 2019Q4.
Sources: CBI.

Figure 4. Iceland: Key Macroeconomic Developments

The pandemic has led to the largest recession since the Global Financial Crisis…

GDP Growth

(Percentage change y/y, 4-quarter moving average)

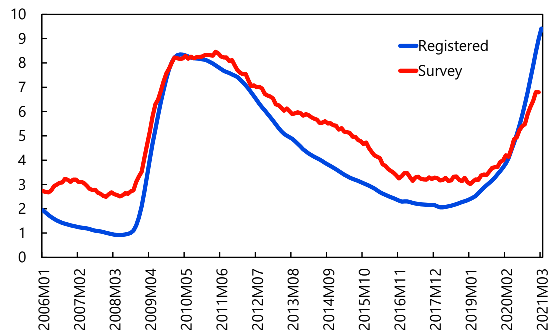


Sources: STATICE.

and a significant increase in unemployment.

Unemployment Rate

(Percent of labor force, 12-month moving average)

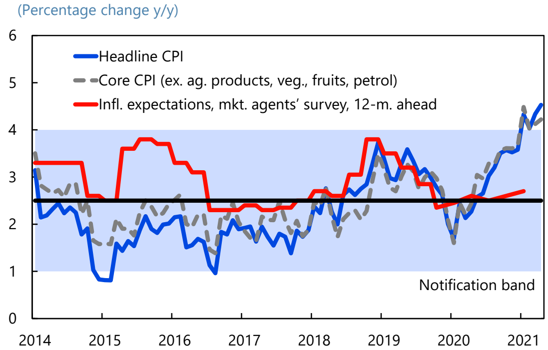


Sources: STATICE; Directorate of Labour.

Inflation has recently exceeded the notification band.

Inflation and Inflation Expectations

(Percentage change y/y)

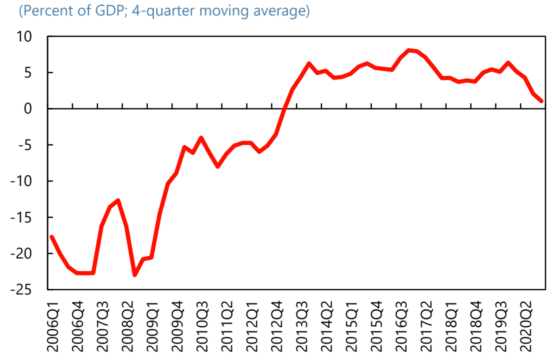


Sources: STATICE

The sharp export revenue decline rapidly eroded the current account surplus…

Current Account Balance

(Percent of GDP; 4-quarter moving average)

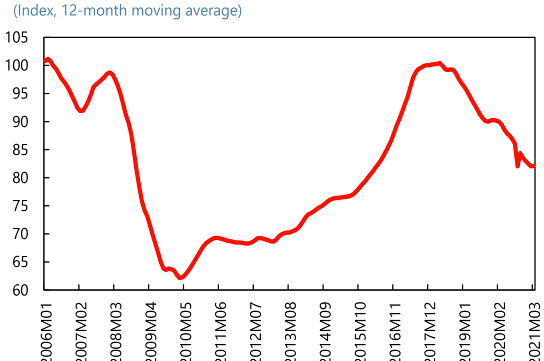


Sources: STATICE; CBI.

and led to real króna depreciation

Real Exchange Rate

(Index, 12-month moving average)

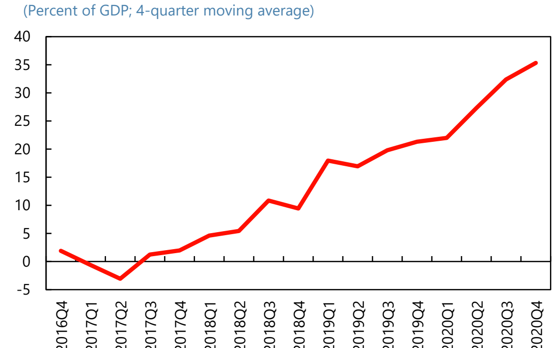


Sources: CBI.

while the net international investment position improved, reflecting capital gains.

Net International Investment Position

(Percent of GDP; 4-quarter moving average)



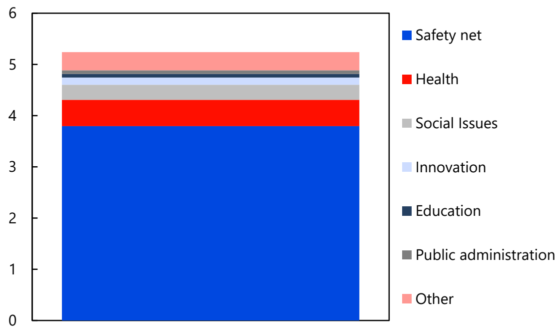
Sources: STATICE; CBI.

Figure 5. Iceland: Fiscal Developments and Issues

Supplementary budgets accommodated pandemic-related spending in 2020 …

Supplemental Spending in 2020 Budget

(Percent of GDP)

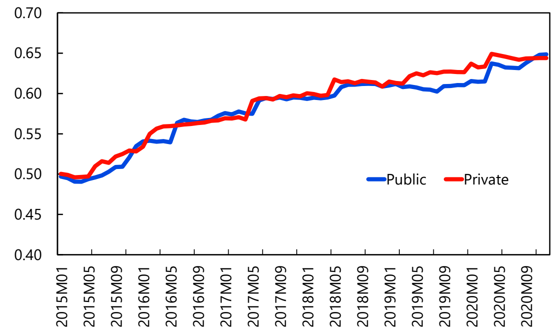


Sources: Icelandic Parliament

…and the new public sector wage agreements that were concluded during the year.

Real Wages

(Level, CPI deflated)

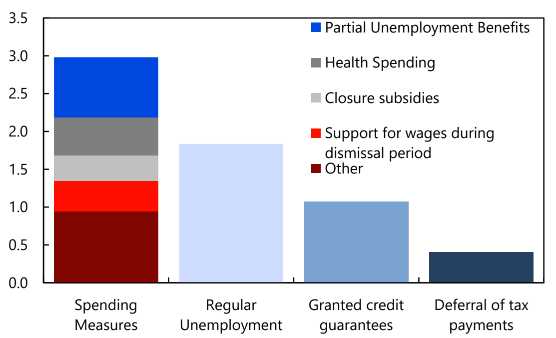


Sources: STATICE.

Fiscal measures provided support to households and firms.

Selected Pandemic-Related Fiscal Measures, 2020

(Percent of GDP)

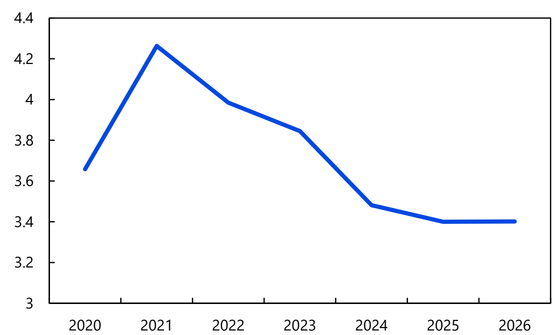


Sources: STATICE; Ministry of Finance and Economic Affairs; IMF staff calculations.

An upfront increase in public investment in 2021 will help jump start the economy.

Public Investment

(Percent of GDP)

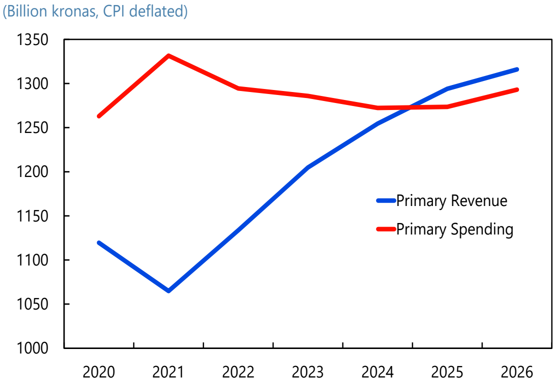


Sources: 2021 Budget and 2022-2026 Medium-term Fiscal Strategy Plan.

The medium-term fiscal plan envisages gradual reduction in primary spending while revenue recovers…

Real Primary Balance, Treasury and Municipalities

(Billion kronas, CPI deflated)

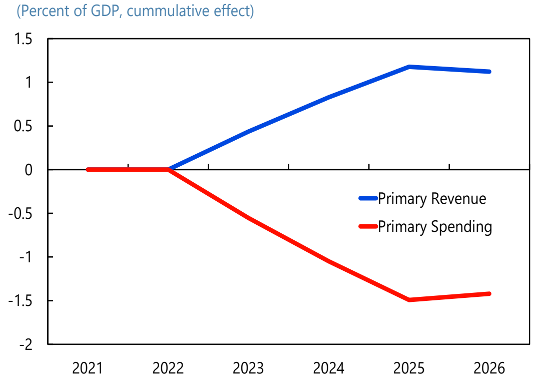


Sources: 2021 Budget and 2022-2026 Medium-term Fiscal Strategy Plan.

…and requires fiscal measures of about 3 percent of GDP.

Unidentified Fiscal Measures

(Percent of GDP, cummulative effect)

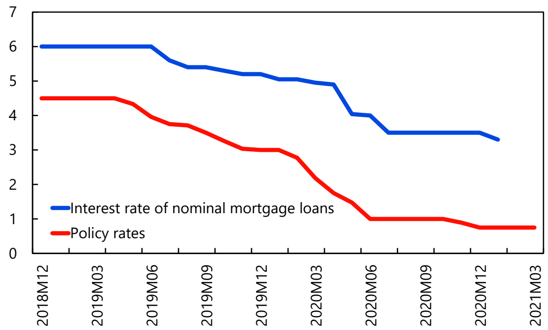


Sources: 2021 Budget and 2022-2026 Medium-term Fiscal Strategy Plan.

Figure 6. Iceland: Monetary and Foreign Exchange Market

The monetary policy transmission worked well…

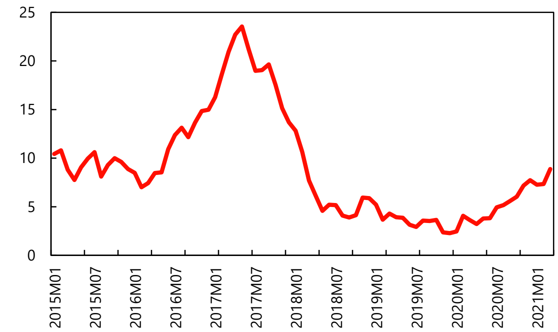
Interest Rate Transmission
(Percent p.a.)



Sources: CBI.

…encouraging mortgage refinancing and a pickup in housing prices.

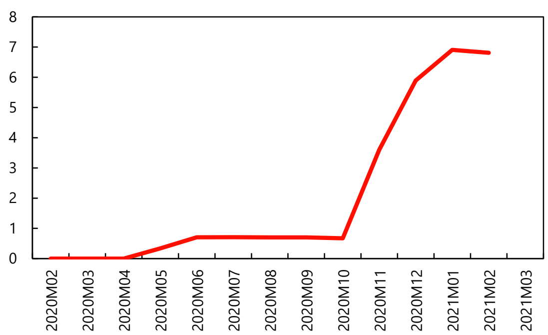
Residential Housing Prices
(Percentage change y/y)



Sources: National Registry.

Unconventional policies included launching purchases of government bonds.

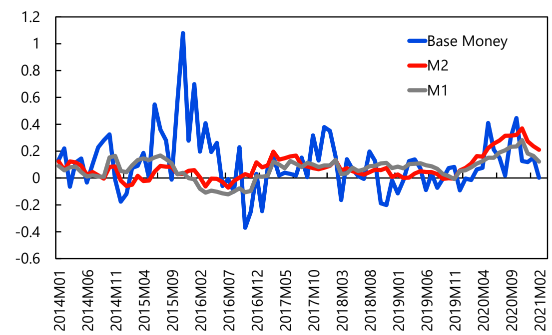
Monetary Effect of Purchasing Government Bonds
(Percent of 2019M12 base money)



Sources: CBI.

Monetary policy easing created a rise in money aggregates,

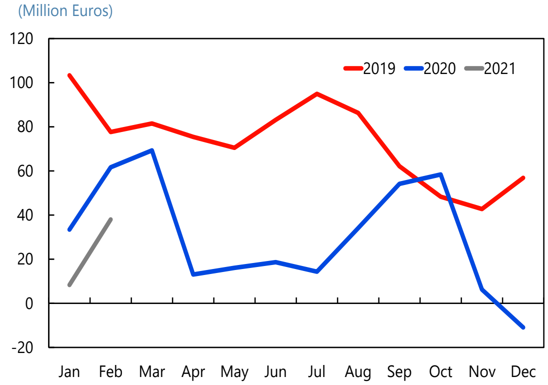
Money Growth
(Percentage change y/y)



Sources: CBI.

which together with the expiration of the informal pension fund agreement to suspend foreign investments,

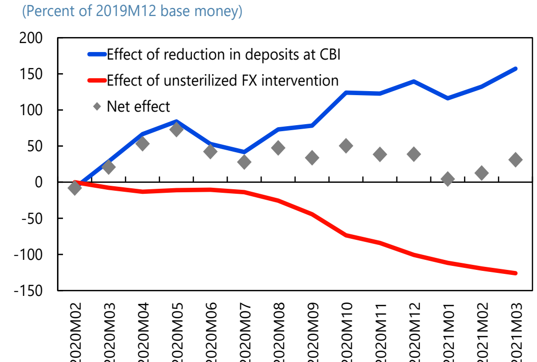
Pension Funds FX Purchases
(Million Euros)



Sources: CBI.

… led to exchange rate pressures and unsterilized FXI to prevent depreciation from passing through to inflation.

Money Effect of Lower CBI Deposits and FX Intervention
(Percent of 2019M12 base money)



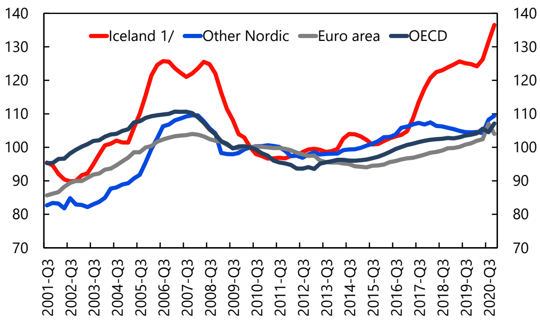
Sources: CBI.

Figure 7. Iceland: Real Estate Markets

Residential real estate prices are rising relative to income…

Real Estate Price to Income Ratio

(Index, 2010Q1 =100)

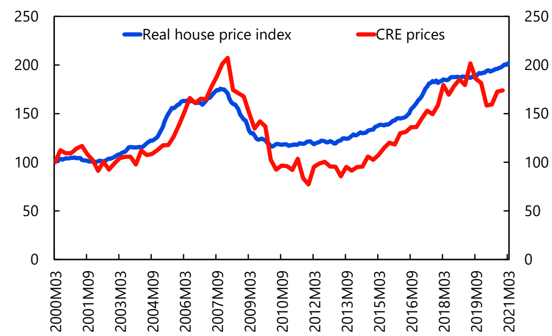


1/ Four-quarter moving average of housing prices relative to GDP per capita.
Sources: OECD, Global Property Guide and IMF staff calculations.

…while commercial real estate prices have slumped.

Real Estate Indices

(Index, 2000M3=100)

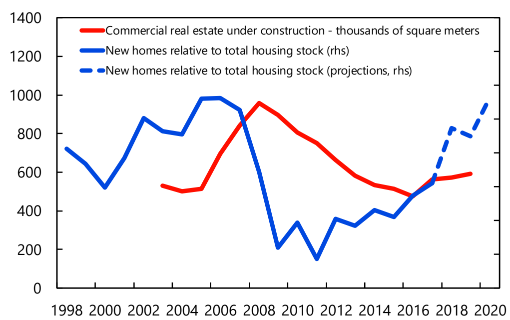


Sources: Statistics Iceland, CBI and IMF staff calculations.

Housing supply has increased…

Supply of Housing and Commercial Real Estate

(1998-2020)

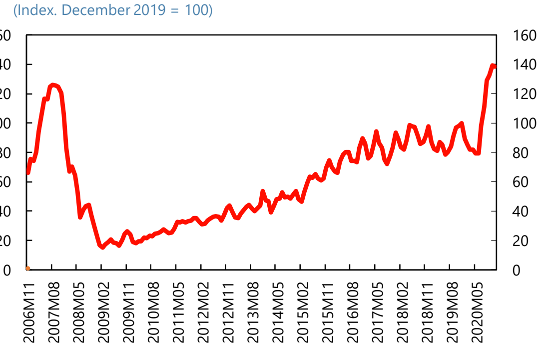


Sources: Federation of Islandic Industries, Registers Iceland, Reykjavik Economics, Statistics Iceland, CBI and IMF staff own calculations.

…leading to a surge in the real estate turnover.

Real Estate Turnover

(Index. December 2019 = 100)

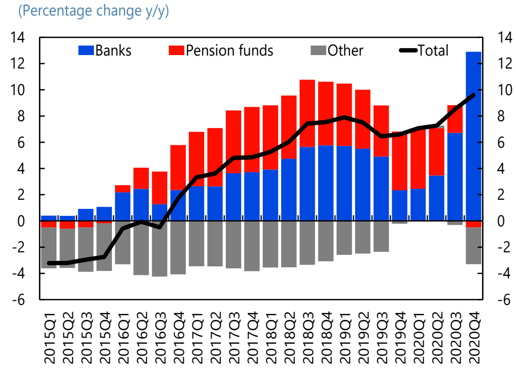


Sources: Registers Iceland and IMF staff calculations.
Notes: Three-month moving average and deflated by the CPI.

The boom is supported by active lending by banks, which grab shares from nonbank lenders…

Household Debt by Lender

(Percentage change y/y)

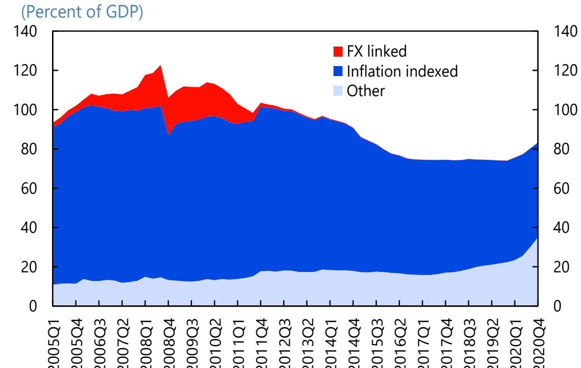


Sources: CBI and IMF staff calculations.

…with rising prevalence of non-indexed floating-rate loans.

Household Debt

(Percent of GDP)



Sources: CBI; and Statistics Iceland.

Table 1. Iceland: Selected Economic Indicators, 2015–26

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Percentage change unless otherwise indicated)											
National Accounts (constant prices)												
Gross domestic product	4.4	6.3	4.2	4.7	2.6	-6.6	3.7	3.6	2.7	2.5	2.4	2.3
Total domestic demand	6.1	7.7	7.6	4.4	0.2	-1.3	2.0	2.0	2.5	2.3	2.2	2.2
Private consumption	4.5	6.7	8.0	4.8	1.9	-3.3	3.0	2.5	3.5	3.2	2.3	2.3
Public consumption	-0.1	0.9	2.9	4.7	3.9	3.1	0.6	0.6	0.7	1.0	2.2	2.2
Gross fixed investment	21.5	18.0	10.6	1.2	-3.7	-6.8	4.4	3.5	2.4	1.8	2.1	2.2
Net exports (contribution to growth)	-1.1	-0.8	-2.9	0.7	2.1	-5.4	1.7	1.6	0.3	0.2	0.2	0.2
Exports of goods and services	8.9	11.0	5.1	1.7	-4.6	-30.5	16.3	8.2	7.5	7.1	3.1	3.1
Imports of goods and services	13.5	14.6	11.8	0.5	-9.3	-22.0	11.8	4.4	7.5	7.2	2.9	3.0
Output gap (percent of potential output)	-1.1	0.9	1.3	3.0	2.4	-4.5	-2.3	-0.8	-0.4	-0.2	-0.1	0.0
Selected Indicators												
Gross domestic product (ISK bn.)	2,311	2,512	2,642	2,840	3,045	2,941	3,132	3,325	3,485	3,654	3,846	4,065
Gross domestic product ($ bn.)	17.5	20.8	24.7	26.2	24.8	21.7	24.2	25.2	25.9	27.1	28.6	30.1
GDP per capita ($ thousands)	53.2	62.5	73.1	75.3	69.6	59.6	65.3	67.1	67.9	70.1	73.9	78.0
Private consumption (percent of GDP)	49.7	49.3	50.1	50.3	49.9	51.4	51.5	51.0	51.4	51.9	51.7	51.3
Public consumption (percent of GDP)	23.4	23.0	23.7	24.2	24.4	27.5	26.8	26.1	25.8	25.8	26.2	26.9
Gross fixed investment (percent of GDP)	19.3	20.9	21.8	21.6	20.6	21.1	21.8	21.7	21.5	21.2	20.9	20.7
Gross national saving (percent of GDP)	25.0	29.2	26.0	25.7	27.0	22.7	22.8	23.1	23.2	23.0	22.8	22.7
Unemployment rate (percent of labor force)	4.5	3.3	3.3	3.1	3.9	6.4	6.0	5.0	4.0	4.0	4.0	4.0
Employment	3.9	4.1	1.0	1.8	0.9	-3.0	0.8	1.7	1.7	0.6	0.6	0.6
Labor productivity	1.1	4.2	2.8	1.8	1.6	-3.8	3.0	1.9	1.0	1.9	1.8	1.7
Real wages	5.9	7.2	5.6	3.7	1.8	3.4	0.7	1.6	2.1	1.8	1.8	1.8
Nominal wages	7.6	9.0	7.5	6.5	4.9	6.3	4.3	4.2	4.3	4.3	4.3	4.3
Consumer price index (average)	1.6	1.7	1.8	2.7	3.0	2.9	3.6	2.5	2.1	2.5	2.5	2.5
Consumer price index (end period)	2.0	1.9	1.9	3.7	2.0	3.6	3.0	2.5	2.5	2.5	2.5	2.5
ISK/€ (average)	146	134	121	128	141	157	…	…	…	…	…	…
ISK/$ (average)	132	121	107	108	123	135	…	…	…	…	…	…
Terms of trade (average)	6.8	2.7	1.5	-3.7	-0.7	-2.3	-3.0	0.0	0.0	-0.1	-0.2	-0.1
Money and Credit (end period)												
Base money (M0)	27.8	3.0	37.9	-1.7	-9.2	11.8	6.2	5.9	4.7	4.7	5.2	5.6
Broad money (M3)	5.6	-4.6	5.0	7.0	6.6	7.4	8.4	6.5	5.1	5.1	5.4	0.4
Bank credit to nonfinancial private sector	3.5	4.4	9.2	11.9	2.9	10.5	3.5	6.1	4.8	4.9	5.3	5.7
Central bank 7 day term deposit rate 1/	5.75	5.00	4.25	4.50	3.00	0.75	0.75	…	…	…	…	…
	(Percent of GDP unless otherwise indicated)											
General Government Finances 2/												
Revenue	43.2	59.1	45.4	44.9	41.9	42.4	40.3	40.2	40.7	40.5	40.2	40.0
Expenditure	43.6	46.5	44.5	44.0	43.4	49.7	49.4	48.3	46.5	43.4	42.0	41.9
Overall balance	-0.4	12.5	1.0	0.9	-1.5	-7.3	-9.1	-8.1	-5.8	-2.9	-1.8	-1.9
Structural primary balance	3.4	3.6	2.0	0.8	-1.4	0.3	-2.5	-4.4	-2.5	-0.7	0.3	0.5
Cyclically-adjusted primary balance	3.8	15.0	3.3	1.6	-0.7	-2.4	-5.8	-3.8	-1.9	-0.3	0.7	0.5
Gross debt	97.2	79.9	69.4	61.1	68.3	79.9	80.0	81.6	82.4	80.3	77.1	70.5
Net debt	78.0	65.2	57.9	48.6	55.4	63.8	67.2	70.0	71.3	69.7	67.0	64.3
Balance of Payments												
Current account balance	5.6	8.1	4.2	3.8	6.4	1.0	0.7	1.4	1.6	1.8	1.9	2.0
of which: services balance	8.9	10.5	10.6	9.0	8.5	2.5	3.4	3.2	3.4	3.4	3.5	4.0
Capital and financial account (+ = outflow)	4.8	8.5	1.7	5.5	6.8	5.4	0.6	1.2	1.5	1.6	1.8	1.9
of which: direct investment, net (+ = outflow)	-4.0	-3.5	-0.7	1.7	3.1	2.5	2.3	2.3	0.9	0.9	1.1	1.1
Gross external debt	174.8	125.1	90.3	73.3	76.5	86.0	75.4	71.2	68.6	64.8	60.9	57.2
Central bank reserves ($ bn.)	5.0	7.2	6.6	6.1	6.7	6.4	5.9	5.7	5.7	5.6	5.6	5.6

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

1/ For 2021, rate as of end-April

2/ In 2020, the definition of the general government was expanded to include 24 new entities, of which the largest are the IL Fund and the Student loan Fund.

Table 2. Iceland: Money and Banking, 2015–26
(Billions of krónur, unless otherwise indicated)

	2015	2016	2017	2018	2019	2020	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.	2025 Proj.	2026 Proj.
Central Bank												
Net foreign assets	295	587	565	604	636	563	590	597	603	603	604	606
Assets	653	817	687	737	822	817	771	766	772	772	772	638
Liabilities	358	230	122	133	186	254	180	168	170	169	169	33
of which: central government foreign currency deposits	301	185	81	87	151	214	140	128	130	129	129	-7
of which: bank estates' foreign currrency deposits 1/	18	0	0	0	0	0	0	0	0	0	0	0
Net domestic assets	-191	-479	-417	-458	-505	-416	-434	-432	-429	-421	-413	-404
Central government, net	7	-30	-23	-108	-82	-134	-134	-134	-134	-134	-134	-134
Assets	98	41	56	0	0	8	8	8	8	8	8	8
of which: recapitalization bond	91	29	0	0	0	0	0	0	0	0	0	0
Liabilities (current account)	91	71	79	108	82	142	142	142	142	142	142	142
Credit institutions (incl. nonbanks), net	-216	-407	-378	-302	-351	-137	-300	-297	-295	-287	-278	-270
Assets	58	2	6	6	6	8	8	8	8	8	8	8
Liabilities	274	410	384	308	357	145	307	305	303	294	286	277
of which: term deposits and CDs	242	339	303	231	299	145	172	179	184	184	185	187
Other items, net	17	-42	-16	-48	-72	-144	-194	-192	-189	-185	-181	-178
ESI (asset management company)	127	36	9	5	3	2	0	0	0	0	0	0
Capital	79	44	22	58	82	151	148	145	141	137	133	129
Base Money	104	107	148	145	132	147	157	166	174	182	191	202
Currency issued	56	62	68	73	75	81	113	119	125	130	137	148
Deposit money banks' deposits at the central bank	48	45	80	72	57	66	44	47	49	51	54	54
Deposit Money Banks												
Net foreign assets	66	-257	-277	-270	-302	-323	-310	-301	-297	-297	-296	-295
Assets	349	251	324	414	366	423	435	445	449	448	449	450
Liabilities	283	508	601	684	668	745	745	745	745	745	745	745
of which: bonds	175	406	504	577	569	634	634	634	634	634	634	634
Net domestic assets	1,608	1,845	1,942	2,052	2,203	2,362	2,495	2,628	2,744	2,867	3,006	3,004
Central bank, net	238	385	379	293	328	208	213	223	231	233	237	239
Assets	295	385	379	294	330	213	218	228	236	238	242	244
Liabilities	56	0	0	1	2	5	5	5	5	5	5	5
General government, gross	231	184	91	59	63	262	283	306	324	331	335	324
of which: bonds	210	164	70	38	42	234	255	279	297	304	307	296
Private sector, gross	2,217	2,285	2,483	2,781	2,873	3,187	3,303	3,503	3,670	3,845	4,045	4,272
Nonfinancial	2,043	2,133	2,328	2,606	2,681	2,964	3,068	3,257	3,414	3,579	3,767	3,982
Corporations	1,128	1,174	1,302	1,464	1,492	1,483	1,535	1,629	1,708	1,791	1,885	1,992
Households	915	959	1,027	1,142	1,189	1,481	1,533	1,627	1,706	1,788	1,882	1,989
Financial	174	152	154	175	192	222	235	247	256	266	277	290
Other items, net	-1,078	-1,009	-1,011	-1,081	-1,062	-1,295	-1,304	-1,404	-1,482	-1,543	-1,611	-1,830
Domestic deposits	1,674	1,588	1,665	1,782	1,901	2,039	2,184	2,328	2,447	2,571	2,709	2,709
Krona deposits	1,393	1,448	1,502	1,560	1,664	1,803	1,932	2,059	2,164	2,273	2,396	2,396
Foreign currency deposits	281	140	164	222	237	236	253	269	283	297	313	313
Consolidated Banking System												
Net foreign assets	361	330	289	334	335	241	280	297	306	306	307	311
Net domestic assets	1,362	1,314	1,437	1,513	1,633	1,872	2,009	2,143	2,258	2,387	2,531	2,539
General government, net	238	154	68	-49	-19	128	148	172	190	197	200	189
Private sector, gross	2,217	2,285	2,483	2,781	2,873	3,187	3,303	3,503	3,670	3,845	4,045	4,272
Other items, net	-1,093	-1,125	-1,113	-1,219	-1,222	-1,442	-1,442	-1,533	-1,602	-1,655	-1,714	-1,923
Broad money	1,723	1,643	1,726	1,846	1,968	2,113	2,289	2,439	2,564	2,693	2,839	2,849
of which: currency in circulation	49	55	60	64	67	74	105	111	117	123	129	140

Sources: CBI; and IMF staff projections.

1/ Deposits of successor holding companies to the bank estates from 2016.

Table 3. Iceland: Financial Soundness Indicators, 2017Q1–20Q4 1/

(Percent)

	2017Q1	2017Q2	2017Q3	2017Q4	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4
Regulatory capital to risk-weighted assets 2/	26.2	26.6	25.6	25.1	23.3	22.6	22.9	23.2	22.4	22.6	22.9	24.2	24.5	24.8	24.5	24.9
Regulatory tier 1 capital to risk-weighted assets 2/	25.8	26.1	25.2	24.3	22.9	22.3	21.8	21.8	21.0	20.9	21.0	21.8	22.0	22.3	22.0	22.4
Net interest margin 2/	2.8	3.0	2.9	2.9	2.9	2.9	2.9	2.9	2.8	2.8	2.7	2.7	2.6	2.6	2.5	2.5
Return on assets 2/	2.2	2.4	2.0	1.9	1.9	1.9	1.7	1.6	1.4	1.4	1.3	1.2	-0.5	0.1	0.6	0.9
Return on equity 2/	11.3	12.5	10.3	10.0	10.1	10.8	9.8	9.2	8.7	8.7	8.3	7.2	-3.4	0.6	3.7	5.9
Net interest income to total income 2/ 3/	50.4	51.9	53.8	53.7	52.3	52.9	55.6	64.5	60.2	62.4	64.9	66.8	90.8	75.1	73.3	69.5
Noninterest expense to total income 2/ 3/	63.5	58.9	62.2	64.2	67.0	68.7	68.3	65.2	61.4	62.4	64.2	65.9	76.1	62.2	58.4	56.3
Liquid assets to total assets 2/ 4/	25.4	24.5	23.9	21.9	21.8	21.6	23.1	18.7	20.2	19.9	19.8	18.0	21.1	21.1	21.6	18.6
High-quality liquid assets to total assets	17.6	16.1	14.6	13.2	12.8	11.9	11.3	10.8	10.7	11.0	12.6	12.0	13.3	14.7	14.2	12.8
Net open foreign exchange position to capital 2/	0.2	0.3	1.2	0.5	0.3	2.2	0.0	0.3	0.0	0.7	1.0	2.1	-0.4	0.0	0.2	0.3
Total nonperforming loans (NPLs), facility level 5/	1.6	1.7	2.5	2.7	3.0	2.5	2.3	2.2	2.2	2.2	2.7	2.6	3.6	3.3	3.3	2.9
Household NPLs, cross default basis 6/ 7/	4.3	4.0	3.2	3.0	2.7	2.4	2.3	2.1	2.0	2.2	2.3	2.1	2.2	2.7	2.4	2.9
Corporate NPLs, cross default basis 6/	6.0	6.6	7.3	6.6	7.1	7.0	6.6	6.7	5.9	4.6	4.7	4.8	6.2	8.5	9.1	18.0
Household and corporate NPLs, cross default basis 6/	5.0	5.2	5.5	4.9	5.1	5.0	4.7	4.7	4.2	3.5	3.6	3.6	4.6	6.0	6.1	10.9
Loan loss provisions to household loans in default	36.5	36.0	32.1	32.3	23.5	25.5	25.2	22.4	20.7	19.0	17.9	17.5	19.0	18.1	17.6	17.7
Loan loss provisions to corporate loans in default	43.5	43.3	43.1	44.2	37.9	40.5	42.6	31.4	32.5	35.7	33.3	31.5	34.1	33.6	34.2	34.1
Loan loss provisions to total loans in default	42.1	42.2	39.9	40.9	32.7	35.5	37.1	28.6	29.1	30.6	28.6	27.6	30.3	29.1	29.2	29.7

Sources: CBI; IMF FSI database; and IMF staff calculations.

1/ Three largest deposit money banks unless otherwise indicated.

2/ Data for 2017Q1 through 2020Q4 are IMF staff estimates.

3/ Total income is total gross income.

4/ Liquid assets comprise cash and balances with the central bank, claims on credit institutions, and bonds and debt instruments.

5/ Over 90 days in default. From 2017Q4 EBA definition for non-performing loans is used, i.e. facility level, over 90 days in default or unlikely to pay.

6/ Over 90 days in default or deemed unlikely to be paid.

7/ Includes loans from the Housing Financing Fund.

Table 4. Iceland: General Government Operations, 2015–26 1/

(Percent of GDP)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total revenue	**43.2**	**59.1**	**45.4**	**44.9**	**41.9**	**42.4**	**40.3**	**40.2**	**40.7**	**40.5**	**40.2**	**40.0**
Taxes	**31.7**	**46.9**	**33.7**	**33.0**	**31.7**	**32.9**	**31.3**	**31.3**	**31.6**	**31.5**	**31.4**	**31.3**
Taxes on income and profits	16.5	17.1	18.3	18.0	17.4	18.3	17.3	17.3	17.5	17.5	17.4	17.3
Personal income tax	12.9	13.4	14.2	14.5	14.3	15.3	14.5	14.5	14.6	14.6	14.6	14.5
Corporate income tax	2.3	2.5	3.0	2.4	2.1	2.2	1.8	1.9	2.0	2.0	2.0	2.0
Capital gains tax and rental income	1.3	1.2	1.1	1.1	1.0	0.9	1.0	0.9	0.9	0.9	0.9	0.9
Taxes on payroll and workforce	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Taxes on property	1.7	17.0	1.9	1.8	1.9	2.2	1.8	1.8	1.9	1.8	1.8	1.7
Taxes on goods and services	11.3	11.7	12.5	12.2	11.3	11.3	11.2	11.2	11.3	11.4	11.4	11.4
Value added tax	8.1	8.4	9.0	8.8	8.2	8.1	7.9	7.9	8.0	8.1	8.0	8.1
Other taxes on goods and services	3.2	3.3	3.4	3.4	3.2	3.2	3.3	3.3	3.3	3.3	3.3	3.3
Taxes on international trade	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other taxes	1.7	0.6	0.6	0.6	0.6	0.7	0.6	0.5	0.4	0.4	0.4	0.4
Social contributions	**3.4**	**3.4**	**3.4**	**3.5**	**3.2**	**3.2**	**3.0**	**3.1**	**3.2**	**3.2**	**3.1**	**3.1**
Grants	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Other revenues	**7.9**	**8.7**	**8.2**	**8.3**	**6.9**	**6.2**	**5.8**	**5.6**	**5.7**	**5.6**	**5.5**	**5.4**
Property income	4.3	5.2	4.4	4.4	3.6	2.9	2.6	2.4	2.6	2.5	2.4	2.3
of which: interest income	3.3	3.2	2.8	2.9	2.4	1.7	1.1	1.1	1.0	0.9	0.9	0.9
Total expenditure	**43.6**	**46.5**	**44.5**	**44.0**	**43.4**	**49.7**	**49.4**	**48.3**	**46.5**	**43.4**	**42.0**	**41.9**
Current expenses	**43.1**	**46.1**	**43.5**	**41.9**	**41.9**	**48.6**	**47.5**	**46.6**	**45.0**	**42.3**	**41.1**	**40.9**
Compensation of employees	13.5	13.5	14.1	14.2	14.2	16.1	15.7	15.6	15.5	15.4	15.2	15.1
Use of goods and services	10.7	10.4	10.6	10.8	10.8	11.8	11.0	10.6	10.3	10.1	9.9	10.0
Consumption of fixed capital	2.4	2.2	2.1	2.1	2.1	2.4	2.2	2.2	2.1	2.1	2.0	2.0
Interest	6.9	6.2	5.8	5.0	4.4	4.0	3.2	4.9	4.7	3.4	3.4	3.3
Subsidies	1.1	1.2	1.2	1.2	1.2	2.1	2.4	1.7	1.5	1.4	1.2	1.2
Grants	0.2	0.2	0.2	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	6.1	5.9	6.5	6.6	7.3	9.9	10.0	8.9	8.1	7.4	6.8	6.7
Other expense 2/	2.1	6.6	3.1	1.8	1.7	2.0	2.5	2.4	2.4	2.2	2.2	2.2
Nonfinancial assets	**0.5**	**0.5**	**1.0**	**2.1**	**1.5**	**1.1**	**1.9**	**1.7**	**1.5**	**1.1**	**1.0**	**1.0**
Nonfinancial assets, acquisition	2.8	2.6	3.1	4.2	3.6	3.6	4.2	3.9	3.6	3.2	3.0	2.9
Consumption of fixed capital (-)	-2.4	-2.2	-2.1	-2.1	-2.1	-2.4	-2.2	-2.2	-2.1	-2.1	-2.0	-2.0
Net lending/borrowing	**-0.4**	**12.5**	**1.0**	**0.9**	**-1.5**	**-7.3**	**-9.1**	**-8.1**	**-5.8**	**-2.9**	**-1.8**	**-1.9**
Financial assets, transactions	**-8.0**	**5.9**	**-6.4**	**-0.9**	**3.2**	**-1.0**	**-3.8**	**-1.8**	**-1.3**	**-1.2**	**-1.1**	**-4.3**
Currency and deposits	-5.1	-1.4	-3.3	1.9	1.2	0.0	-2.4	-0.4	0.0	0.0	0.0	-3.3
Securities other than shares	3.5	1.2	1.3	1.3	1.6	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Loans	-5.5	-1.1	-4.9	-3.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Shares and other equities	0.0	7.0	-5.6	-1.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	-0.9	0.3	6.1	0.1	0.6	-1.8	-1.6	-1.5	-1.5	-1.3	-1.2	-1.1
Liabilities, transactions	**-7.6**	**-6.6**	**-7.4**	**-1.9**	**4.7**	**6.5**	**5.0**	**6.3**	**4.6**	**1.7**	**0.8**	**-2.4**
Securities other than shares	-0.3	-2.8	-4.8	-2.9	0.5	4.8	4.0	4.5	3.6	0.9	0.1	-5.4
Loans	-6.7	-5.5	-3.1	-0.5	3.4	1.7	1.0	1.8	1.0	0.8	0.6	3.0
Krona denominated	-2.1	-2.7	0.3	-0.8	1.3	0.6	1.0	1.0	1.0	0.8	0.6	1.0
Foreign currency denominated	-4.7	-2.8	-3.4	0.3	2.1	1.1	0.0	0.8	0.0	0.0	0.0	2.0
Insurance technical reserves	0.2	0.1	0.2	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts payable	-0.7	1.6	0.4	1.4	0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross debt	**97.2**	**79.9**	**69.4**	**61.1**	**68.3**	**79.9**	**80.0**	**81.6**	**82.4**	**80.3**	**77.1**	**70.5**
Krona denominated	83.8	71.7	64.8	56.7	62.1	72.3	72.9	74.1	75.3	73.5	70.6	62.4
Foreign currency denominated	13.5	8.2	4.5	4.5	6.2	7.5	7.1	7.5	7.1	6.8	6.5	8.1
Net debt 3/	**78.0**	**65.2**	**57.9**	**48.6**	**55.4**	**63.8**	**67.2**	**70.0**	**71.3**	**69.7**	**67.0**	**64.3**
Memorandum items:												
Primary revenue	39.9	55.8	42.7	42.0	39.5	40.7	39.2	39.2	39.7	39.6	39.3	39.1
Primary expenditure	36.7	40.4	38.7	39.0	39.1	45.7	46.2	43.4	41.8	40.0	38.6	38.6
Primary balance	3.2	15.5	3.9	3.1	0.5	-5.0	-7.1	-4.2	-2.1	-0.4	0.6	0.6
Structural balance	-0.2	0.7	-1.1	-1.4	-3.5	-1.9	-4.5	-8.2	-6.2	-3.2	-2.2	-1.9
Structural primary balance	3.4	3.6	2.0	0.8	-1.4	0.3	-2.5	-4.4	-2.5	-0.7	0.3	0.5
Gross domestic product (ISK bn)	2,311	2,512	2,642	2,840	3,045	2,941	3,132	3,325	3,485	3,654	3,846	4,065

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

1/ In 2020, the definition of the general government was expanded to include 24 new entities, of which the largest are the IL Fund and the Student loan Fund.

2/ Figure for 2016 includes a one off contribution by the central government to the state pension fund of ISK 117.2 billion.

3/ Gross debt less currency and deposits.

Table 5. Iceland: General Government Financial Balance Sheet, 2015–26

(Percent of GDP)

	2015	2016	2017	2018	2019	2020 Prel.	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.	2025 Proj.	2026 Proj.
Financial assets	**85.7**	**84.2**	**81.3**	**76.8**	**76.9**	**83.7**	**74.8**	**68.7**	**64.3**	**60.1**	**56.0**	**48.7**
Currency and deposits	19.2	14.7	11.4	12.5	12.9	16.1	12.8	11.7	11.2	10.6	10.1	6.2
Other assets	103.5	101.9	92.8	87.1	88.0	67.6	62.1	57.1	53.1	49.5	45.9	42.5
Securities other than shares	3.8	4.7	5.8	6.7	8.3	7.8	7.3	6.9	6.6	6.3	6.0	5.7
Loans	37.4	33.3	26.8	21.8	20.8	22.1	20.9	19.8	19.0	18.2	17.5	16.7
Shares and other equities	16.1	21.0	27.8	27.5	27.7	30.2	28.3	26.7	25.5	24.3	23.1	21.8
Other accounts receivable 1/	46.1	42.9	32.5	31.1	31.2	7.6	5.5	3.7	2.0	0.7	-0.6	-1.6
Liabilities	**128.3**	**113.8**	**102.6**	**93.5**	**101.2**	**115.5**	**113.4**	**113.1**	**112.5**	**109.0**	**104.3**	**96.3**
Gross debt	97.2	79.9	69.4	61.1	68.3	79.9	80.0	81.6	82.4	80.3	77.1	70.5
Securities other than shares	70.7	62.4	54.6	47.9	52.1	56.0	56.6	57.7	58.6	56.8	54.1	45.8
Loans	26.5	17.5	14.7	13.3	16.2	23.9	23.4	23.9	23.8	23.5	22.9	24.7
Krona denominated	13.0	9.3	10.2	8.7	9.8	15.1	15.2	15.3	15.6	15.7	15.6	15.7
Foreign currency denominated	13.6	8.3	4.6	4.5	6.4	8.7	8.2	8.5	8.2	7.8	7.4	9.0
Other liabilities	31.1	33.9	33.3	32.4	32.9	35.6	33.4	31.5	30.0	28.6	27.2	25.7
Insurance technical reserves	25.2	27.7	26.9	26.2	27.0	28.3	26.5	25.0	23.8	22.7	21.6	20.4
Other accounts payable	5.9	6.3	6.4	6.1	5.9	7.3	6.9	6.5	6.2	5.9	5.6	5.3
Net financial worth 1/	**-42.6**	**-29.6**	**-21.3**	**-16.8**	**-24.3**	**-31.7**	**-38.6**	**-44.4**	**-48.2**	**-48.9**	**-48.3**	**-47.6**
Memorandum item:												
Net debt 2/	78.0	65.2	57.9	48.6	55.4	63.8	67.2	70.0	71.3	69.7	67.0	64.3

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

1/ Assumes all assets of the institutions reclassified into the general government are financial.

2/ Gross debt less currency and deposits.

Table 6. Iceland: Balance of Payments, 2015–26

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
				(Billions of dollars)								
Current account	**1.0**	**1.7**	**1.0**	**1.0**	**1.6**	**0.2**	**0.2**	**0.3**	**0.4**	**0.5**	**0.6**	**0.6**
Trade balance	1.3	1.4	1.1	0.9	1.3	-0.1	-0.1	0.3	0.3	0.3	0.3	0.4
Balance on goods	-0.2	-0.8	-1.5	-1.5	-0.9	-0.7	-0.9	-0.5	-0.6	-0.6	-0.7	-0.8
Merchandise exports f.o.b.	4.7	4.5	5.0	5.7	5.3	4.6	5.6	6.0	6.2	6.4	6.7	6.9
Merchandise imports f.o.b.	4.9	5.3	6.5	7.2	6.2	5.3	6.5	6.5	6.8	7.0	7.3	7.7
Balance on services	1.6	2.2	2.6	2.4	2.1	0.5	0.8	0.8	0.9	0.9	1.0	1.2
Exports of services, total	4.4	5.4	6.3	6.5	5.7	2.8	3.7	4.3	5.0	5.7	6.1	6.4
Imports of services, total	2.8	3.2	3.7	4.2	3.6	2.2	2.9	3.5	4.1	4.8	5.1	5.2
Primary income balance	0.0	0.4	0.1	0.3	0.5	0.5	0.4	0.2	0.3	0.4	0.4	0.5
Receipts	0.9	1.1	0.8	0.7	0.7	0.5	0.5	0.6	0.6	0.6	0.6	0.7
of which: dividends and reinvested earnings	0.3	0.4	0.4	0.4	0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.4
of which: interest receipts	0.4	0.5	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Expenditures	0.9	0.7	0.7	0.4	0.2	0.0	0.1	0.3	0.3	0.3	0.2	0.2
of which: dividends and reinvested earnings	0.0	0.0	0.0	-0.2	-0.4	-0.5	-0.3	-0.1	-0.1	-0.2	-0.2	-0.2
of which: interest payments	0.9	0.6	0.6	0.5	0.4	0.4	0.3	0.3	0.2	0.3	0.3	0.3
Secondary income balance	-0.3	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Capital and financial account (+ = outflow)	**0.8**	**1.8**	**0.4**	**1.4**	**1.7**	**1.2**	**0.1**	**0.3**	**0.4**	**0.4**	**0.5**	**0.6**
Capital account balance (+ = inflow)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial account (+ = outflow)	0.8	1.8	0.4	1.5	1.7	1.2	0.2	0.3	0.4	0.5	0.5	0.6
Direct investment (+ = outflow)	-0.7	-0.7	-0.2	0.5	0.8	0.5	0.6	0.6	0.2	0.2	0.3	0.3
Portfolio investment ("+" = outflow)	3.8	1.9	2.4	1.1	0.8	0.9	-0.1	-0.2	-0.1	0.0	0.0	0.0
Assets (+ = outflow)	-3.0	1.0	1.1	0.9	1.1	0.5	1.0	0.8	0.9	0.9	0.9	0.9
Liabilities (+ = inflow)	-6.8	-1.0	-1.3	-0.2	0.4	-0.3	1.1	1.0	1.0	0.9	0.9	0.9
of which: net borrowing (+ = inflow)	-6.7	-1.0	-1.7	-0.3	-0.3	-0.6	0.6	0.3	0.3	0.2	0.1	0.1
Other investment (+ = outflow)	-3.4	-1.8	-1.1	-0.2	-0.4	0.0	0.2	0.1	0.3	0.3	0.3	0.3
Assets (+ = outflow)	-0.4	-5.5	-0.8	0.2	-1.0	0.1	0.1	0.1	0.4	0.4	0.4	0.4
Liabilities (+ = inflow)	2.9	-3.7	0.3	0.4	-0.5	0.2	0.0	0.0	0.1	0.1	0.2	0.1
of which: net outflows related to bank estates' compositions	0.2	0.1	0.0	-0.3	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Change in reserve assets (+ = increase/outflow)	1.1	2.4	-0.8	0.0	0.6	-0.2	-0.5	-0.2	0.0	-0.1	-0.1	0.0
Net errors and omissions (+ = inflow)	**-0.1**	**0.1**	**-0.6**	**0.5**	**0.1**	**1.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
				(Percent of GDP)								
Current account	**5.6**	**8.1**	**4.2**	**3.8**	**6.4**	**1.0**	**0.7**	**1.4**	**1.6**	**1.8**	**1.9**	**2.0**
Trade balance	7.5	6.6	4.5	3.5	5.1	-0.6	-0.3	1.1	1.2	1.2	1.2	1.2
Balance on goods	-1.4	-3.9	-6.1	-5.5	-3.5	-3.1	-3.7	-2.1	-2.2	-2.2	-2.3	-2.8
Merchandise exports f.o.b.	26.7	21.7	20.2	21.8	21.5	21.4	23.2	23.7	23.9	23.7	23.3	23.0
Merchandise imports f.o.b.	28.1	25.6	26.3	27.4	24.9	24.4	26.9	25.8	26.1	25.9	25.6	25.7
Balance on services	8.9	10.5	10.6	9.0	8.5	2.5	3.4	3.2	3.4	3.4	3.5	4.0
Exports of services, total	24.9	25.8	25.6	24.9	22.9	12.7	15.3	17.1	19.3	21.1	21.3	21.3
Imports of services, total	16.0	15.3	14.9	15.9	14.4	10.3	11.9	13.8	15.9	17.7	17.7	17.4
Primary income balance	-0.2	1.9	0.5	1.1	2.0	2.4	1.7	1.0	1.1	1.3	1.4	1.5
Receipts	5.1	5.1	3.2	2.7	2.7	2.4	2.3	2.3	2.3	2.3	2.3	2.2
of which: interest receipts	2.5	2.4	1.1	0.6	0.6	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Expenditures	5.3	3.2	2.7	1.7	0.6	0.0	0.5	1.3	1.2	1.0	0.8	0.7
of which: interest payments	5.3	3.0	2.3	1.8	1.8	1.7	1.3	1.2	0.9	1.2	1.2	1.0
Secondary income balance	-1.7	-0.5	-0.7	-0.8	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7
Capital and financial account (+ = outflow)	**4.8**	**8.5**	**1.7**	**5.5**	**6.8**	**5.4**	**0.6**	**1.2**	**1.5**	**1.6**	**1.8**	**1.9**
Capital account balance (+ = inflow)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Financial account (+ = outflow)	4.8	8.6	1.8	5.6	6.8	5.5	0.6	1.3	1.6	1.7	1.8	1.9
Direct investment (+ = outflow)	-4.0	-3.5	-0.7	1.7	3.1	2.5	2.3	2.3	0.9	0.9	1.1	1.1
Portfolio investment ("+" = outflow)	21.7	9.2	9.9	4.2	3.2	4.1	-0.3	-0.8	-0.6	-0.1	-0.1	-0.1
Assets (+ = outflow)	-16.9	4.6	4.6	3.6	4.6	2.5	4.1	3.1	3.4	3.3	3.1	2.9
Liabilities (+ = inflow)	-38.7	-4.6	-5.2	-0.6	1.4	-1.6	4.4	3.9	4.0	3.3	3.2	3.1
2/ In 2020, the definition of the general government was exp	-38.1	-4.6	-6.9	-1.1	-1.2	-2.9	2.6	1.2	1.2	0.6	0.4	0.3
Other investment (+ = outflow)	-19.2	-8.8	-4.4	-0.7	-1.8	-0.2	0.8	0.4	1.1	1.1	0.9	1.0
Assets (+ = outflow)	-2.5	-26.4	-3.3	0.9	-3.8	0.6	0.6	0.6	1.5	1.5	1.5	1.5
Liabilities (+ = inflow)	16.7	-17.6	1.2	1.6	-2.1	0.8	-0.2	0.2	0.4	0.4	0.6	0.5
Change in reserve assets (+ = increase/outflow)	6.2	11.5	-3.3	0.2	2.2	-1.0	-2.2	-0.7	-0.1	-0.2	-0.2	-0.1
Net errors and omissions (+ = inflow)	**-0.7**	**0.5**	**-2.4**	**1.9**	**0.5**	**4.6**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Central bank reserves ($ bn)	**5.0**	**7.2**	**6.6**	**6.1**	**6.7**	**6.4**	**5.9**	**5.7**	**5.7**	**5.6**	**5.6**	**5.6**
(Percent of GDP)	28.7	34.9	26.5	23.1	27.1	29.5	24.3	22.6	22.0	20.7	19.5	18.5
Memorandum item:												
Gross domestic product ($ bn)	17.5	20.8	24.7	26.2	24.8	21.7	24.2	25.2	25.9	27.1	28.6	30.1

Sources: CBI; and IMF staff projections.

Table 7. Iceland: International Investment Position, 2010–20

(Percent of GDP)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Assets	**259.3**	**265.2**	**278.2**	**276.4**	**250.6**	**213.0**	**157.1**	**115.5**	**119.3**	**127.5**	**151.0**
Direct investment	87.7	88.7	95.4	109.4	99.4	91.2	63.7	25.8	26.3	26.4	28.2
Portfolio investment	47.8	52.2	59.0	62.5	63.9	40.1	37.3	43.7	46.2	57.8	75.5
Equity and investment fund shares	33.8	32.5	34.8	34.6	36.8	35.3	34.8	40.1	40.6	51.9	69.3
Debt securities	14.0	19.7	24.2	27.9	27.1	4.8	2.5	3.6	5.6	5.9	6.2
Financial derivatives	0.0	0.0	0.1	0.2	0.6	0.5	0.3	0.5	0.5	0.4	0.6
Other investment	84.2	64.9	94.4	79.6	61.3	53.0	23.3	19.5	20.5	15.9	18.9
Reserve assets	39.5	59.3	29.3	24.7	25.4	28.3	32.5	26.0	25.9	27.0	27.8
Liabilities	**841.1**	**789.4**	**724.4**	**661.2**	**623.4**	**218.1**	**155.2**	**113.5**	**109.9**	**106.2**	**115.7**
Direct investment	89.9	96.6	81.9	97.0	96.4	92.4	80.7	45.0	40.7	38.1	37.0
Portfolio investment	349.1	326.0	324.2	285.9	289.1	41.8	49.0	42.9	42.4	43.8	50.4
Equity and investment fund shares	3.2	3.2	3.2	3.5	3.6	4.0	3.6	4.8	5.5	10.1	14.4
Debt securities	345.9	322.7	320.9	282.5	285.5	37.8	45.4	38.0	36.9	33.7	36.0
Financial derivatives	0.1	0.2	0.1	0.3	0.8	0.6	0.4	0.4	0.2	0.1	0.1
Other investment	402.1	366.5	318.3	278.0	237.1	83.3	25.2	25.2	26.6	24.2	28.2
Net international investment position	**-581.9**	**-524.2**	**-446.2**	**-384.8**	**-372.9**	**-5.1**	**1.9**	**2.0**	**9.4**	**21.3**	**35.3**

Sources: CBI; and IMF staff calculations.

Note: The large reductions in external assets and liabilities in 2017 were primarily due to changes in direct investment, driven mainly by adjustments within consolidated entities in the pharmaceuticals sector (Central Bank of Iceland, *Financial Stability Report*, Vol.22, April 2018).

Annex I. Policy Measures in Response to the Pandemic

Measure	Description of Measure
Measures Affecting Fiscal Balances on Accrual Basis	
Healthcare and civil protection	Additional funds for public healthcare and civil security, mainly to hire temporary personnel and purchase medical supplies and equipment.
Partial unemployment benefits	Unemployment benefits paid to employees and self-employed persons who have gone into reduced employment hours due to a temporary contraction in the employer's activities. Wages paid in parallel with a reduction in employment hours do not reduce unemployment benefits. The program expires in May 2021.
Temporary increase in unemployment benefits	The period of income-related unemployment benefits was extended to six from three months, provided that certain conditions are met. The amount of basic unemployment benefits was increased by 3.6 percent starting January 2021. The maximum amount of income-related unemployment benefits was increased to ISK472,835 per month conditional on full unemployment insurance.
Payment of wage costs during the dismissal period	Employers who had laid off employees between May 2020 and October 2020 due to a significant financial disruption in their business operations (operating income decreased by at least 75 percent) directly or indirectly traced to measures that have been taken or circumstances that have otherwise been created due to the coronavirus pandemic since February 2020 can receive government support for part of their wage costs during the notice period for up to 85 percent of the employee's wage, up to ISK633,000 per month for salary and ISK85,455 per month for the employer's pension fund contribution.
Closure subsidies	Small operators forced to cease operations due to the pandemic and meeting certain conditions were granted a closing subsidy grant. Initially valid for firms that stopped operating during March 23- May 3, later extended through May 25, 2020 and, with expanded benefits, during September 18-mid 2021.
Wages in quarantine	Covers payments to employers who have paid wages to quarantined employees, to quarantined employees that did not receive wages from the employer, and to quarantined self-employed persons during February 2020—December 2021.
Income subsidies	Revenue subsidies to individuals and legal entities that were engaged in self-employment before April 1, 2020 and that experienced at least a 40 percent fall in income during a reference period associated with the pandemic.
Resistance subsidies	Subsidies available to companies that have sustained at least 60 percent revenue loss in a calendar month, from November 1, 2020 to May 31, 2021, compared to the same calendar month in 2019, with the amount depending on the amount of the loss. Granted as a lump-sum amount per full-time position.
Hiring grants	Employers could use, for up to six months, the full unemployment benefit and employers' social security contribution to pay for wages of individuals who have been unemployed for more than six months, and half the benefit amount for individuals who have been unemployed for 3—6 months, through grants from the Directorate of Labor. For individuals who have been in the unemployment roster for at least one month, employers can receive up to the basic unemployment benefits plus the employers' contributions to help hire workers. Firms need to pay for the difference between the workers' wage and unemployment benefits to the worker.
Special child benefit supplement	A special child benefit supplement was paid in May 2020 in the amount of ISK42,000 per child to child support providers receiving income-related child benefits and ISK30,000 per child to those with children that due to their income level did not receive those benefits.
Front-loading of public investment.	Additional allocations to the 2020 and 2021 budgets and the medium-term strategy plan front-loaded public investment plans in transport, public construction, and technology infrastructure. Government contributions to research and science were also increased.

Measure	Description of Measure
Marketing campaign abroad in support of the tourism sector	International marketing campaign to promote Iceland as a tourist destination (when conditions are appropriate) in collaboration with the Icelandic Agency for Promotion and Marketing Offshore in the years 2020–2021.
Travel gift	All individuals legally domiciled in Iceland, born 2002 or earlier, receive a travel gift in the amount of ISK5000 (about €33 as of March 2021). The travel gift may be used as payment to eligible companies registered with the Icelandic Tourist Board. The travel gift is valid through May 2021.
Revenue Measures	
Reduction of special tax on financial companies (bank tax)	The gradual reduction in the special tax on financial companies to 0.145 percent scheduled through 2024 was accelerated to take effect as of end-2020.
VAT refund	VAT refunds increased from 60 percent to 100 percent for work performed during March 1-December 31, 2021, covering leisure housing, design and supervision of construction, maintenance of residential housing, car repairs, and NGO structures, among others.
Accommodation tax is temporarily abolished	Accommodation tax is temporarily abolished during April 1, 2020-December 31, 2021, and the fee obligation for the first three months of 2020 was postponed until February 5, 2022.
Customs clearance fee is temporarily canceled	The fee for customs clearance of aircraft and ships outside normal business hours will be abolished during April 1, 2020–December 31, 2021.
Measures Affecting Fiscal Cash Flows	
Tax Deferrals	
Deferral of tax withholding of wages and social security contributions	Employers who faced significant operational difficulties in 2020 due to a sudden and unforeseen drop in income could apply for a deferral of payment of up to three payments of withholding tax on wages and social security contributions that were due during April 1, 2020–December 1, 2020. It has also been permitted to defer payment for up to two due dates during January 1–December 1, 2021.
Deferral of payment of income tax levied in 2020	Legal entities can defer up to ISK20 million of the income tax levy in the year 2020 under certain rules and conditions.
Financial	
Support loans	Small operators who have experienced a temporary drop in revenue due to the pandemic could benefit from a loan guarantee from the Treasury for loans granted before the end of 2020 for up to 10 percent of the operator's income in the operating year 2019. The Treasury fully guarantees a support loan of ISK10 million to each operator, and 85 percent of the amount of a support loan that exceeds ISK10 million.
Bridge loans	Large companies whose wage bill was at least 25 percent of total operating costs in 2019 and suffered significant disruption in their operations due to the pandemic can benefit from a loan guarantee from the Treasury for up to a ISK1.2 billion, or twice the annual salary cost in 2019. These guaranteed loans must be granted before the end of 2020 and the maximum loan period from issue is 18 months.

Measure	Description of Measure
Other Measures	
Access to third-pillar pension savings (private pension savings)	Individuals were allowed to withdraw private pension savings of up to ISK12 million from April to December 2020. The withdrawal is spread over 15 months from the time the request is submitted and is subject to withholding tax.

Annex II. External Sector Assessment

Overall Assessment: *Iceland's external position in 2020 was broadly in line with the level implied by fundamentals and desirable policies, after adjusting for transitory impacts from the tourism sector due to the COVID-19 crisis. The current account weakened significantly in 2020, reflecting Iceland's high reliance on the crisis-hit tourism sector. The assessment reflects adjustments to the current account for transitory impacts from the pandemic. Uncertainty around this assessment is large, given the ongoing COVID-19 crisis.*

Potential Policy Responses: *Macroeconomic policies should focus on supporting the economy in the near term. The flexible foreign exchange rate should act as the main shock absorber, with interventions limited to disorderly market conditions. Structural reforms to minimize economic scarring will be critical to maintaining the external competitiveness and the recovery in the current account.*

Foreign Assets and Liabilities: Position and Trajectory

Background. The net international investment position (NIIP) climbed to 35.3 percent of GDP in 2020, continuing a steady rise since it turned positive in 2016. Although the contributions from current account surpluses weakened in 2020, the NIIP benefitted from valuation gains related to króna depreciation and high returns on investments abroad. Gross assets represent 151 percent of GDP in 2020, with 56 percent of the positions in portfolio equity investments, mostly held by pension funds, and 23 percent in FDI abroad. Gross liabilities stood at 116 percent of GDP, with portfolio investments in debt securities and FDI each representing about a third. About a half of the debt securities were Eurobonds issued abroad by banks and 30 percent were nonresidents' holdings of government bonds.

Assessment. The NIIP is projected to remain steady and positive over the medium term, in line with projected gradual recovery in current account surpluses. However, large fluctuations in valuation effects create uncertainties around the projections and pose a potential risk.

2020 (% GDP)	NIIP: 35.3	Gross Assets: 151.0	Debt Assets: 32.7	Gross Liab.: 115.7	Debt Liab.: 80.2

Current Account

Background. The current account balance sharply deteriorated in 2020 to a smaller surplus of 1 percent of GDP for 2020, compared to the average of 5.5 percent of GDP in the preceding 5 years. The deterioration was largely driven by the collapse of tourism and transport export, which represented around 40 percent of total export in 2019. While less international travel by Icelanders helps offset part of the impact, the tourism balance deteriorated by 4.2 percentage points of GDP, reflecting drops in export and import of tourism by 7.9 and 3.7 percentage points respectively. The goods trade deficit narrowed modestly, with robust fisheries export and improved fuel balance outperforming strong demand for imported goods. Over the medium term, the current account surplus is projected to gradually recover to around 2 percent of GDP with the dissipation of the temporary impact of COVID-19.

Assessment. The cyclically adjusted current account is estimated at 2.5 percent, somewhat (0.9 percentage points) below the estimated current account norm of 3.4 percent in 2020. The cyclical adjustments include a pandemic-related temporary impact on (1) the oil trade balances (0.5 percent of GDP) due to a sharp oil price contraction in 2020, and (2) tourism (1.9 percent of GDP), which is calculated with an estimated elasticity of 0.5 and an assumption that 10 percent of the loss of tourism balance in 2020 (4.2 percent of GDP) is permanent.

Iceland: Model Estimates for 2020 (in percent of GDP)

	CA model	REER model
CA-Actual	**1.0**	
Cyclical contributions (from model) (-)	0.0	
COVID-19 adjustor (+) 1/	1.4	
Adjusted CA	**2.5**	
CA Norm (from model) 2/	**3.4**	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	**3.4**	
CA Gap	**-0.9**	**8.4**
o/w Relative policy gap	3.3	
Elasticity	-0.31	
REER Gap (in percent)	**2.8**	**-26.8**

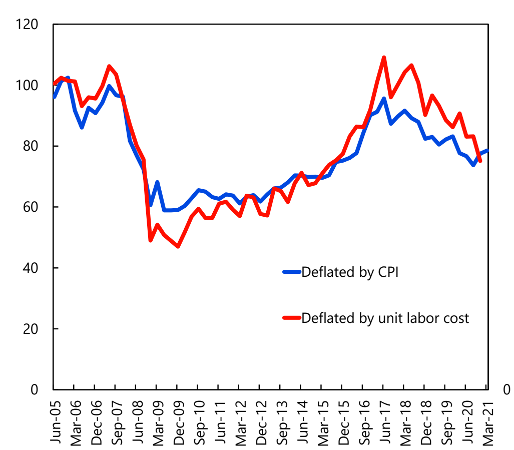
1/ Additional cyclical adjustment to account for the temporary impact of the balances (-0.5 percent of GDP) and on tourism (1.9 percent of GDP).
2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The CPI-based REER and the ULC-based REER depreciated by 7.6 percent and 9.4 percent on average from 2019 to 2020, broadly continuing a depreciation trend. The recent trend reflected slowing-down of the economy led by the tourism industry, which was further hit hard by the pandemic in 2020. By end-2020, the REER reversed about a half of the post-crisis appreciation that peaked in 2017. The CPI-based REER marked its weakest in the last 5 years in October 2020–at 11.8 percent lower than the end-2019 level—when the Icelandic pension funds resumed their foreign investments. However, it has since recovered slightly, supported by CBI's FX interventions, and ended the year with a 6.6-percent depreciation. The ULC-based REER followed a similar path and ended the year with a 16-percent depreciation.

Assessment. The EBA-lite current account gap model (adjusting for the COVID-19 shock on the tourism balance) indicates króna undervaluation of 2.8 percent on average for 2020—broadly in line with fundamentals and desired policies. The EBA-lite REER model suggested undervaluation by 26.8 percent; however, the current account gap model tends to be more reliable in the presence of a large difference between the models, and therefore serves as a basis to the assessment.

Real Effective Exchange Rates
(Index, 2015 = 100)



Sources: CBI and IMF INS database.

Capital and Financial Accounts: Flows and Policy Measures

Background. Gross capital inflows declined by 2.4 percent of GDP in 2020. While both FDI and portfolio inflows recorded reversals, sizable reductions were observed in portfolio investments into debt securities, reflecting sales by foreign investors of government bonds and offshore króna assets, with the latter declining from 2 percent of GDP at end-2019 to about 0.9 percent of GDP in February 2021. Their impact on net capital flows was mitigated by a reduction in gross capital outflows (0.6 percent of GDP) driven by a reversal by residents of some FDI abroad and smaller-than-usual outward portfolio investments. A gentlemen's agreement with pension funds to refrain from outward investments contributed to the latter between March and September 2020. Since the liberalization of capital controls in 2019, no new capital flow management measures have been introduced.

Assessment. Capital inflows to Iceland remain dependent on global market conditions. However, with the banking sector and major private entities largely pre-financing their external borrowing needs in 2020, vulnerabilities related to external financing are contained.

FX Intervention and Reserves Level

Background. Under the floating exchange rate regime, the CBI uses interventions to counter disorderly market conditions. In 2020, the CBI scaled up discretionary interventions amid high exchange rate volatility during the pandemic. Since March 2020, the CBI has been present in the FX market with discretionary interventions in about 25 percent of trading days, cumulatively selling US$0.9 billion (4.2 percent of GDP) and buying US$0.09 billion (0.4 percent of GDP) in 2020. In addition, in September 2020, the CBI initiated a daily FX sales program for a pre-announced amount (EUR 3 million per day), selling about US$0.2 billion (0.9 percent of GDP) in total by the end-2020. As a result, despite some valuation gains, gross reserves dropped to US$6.4 billion at end-2020, from US$6.7 billion at end-2019. This level was equivalent to 31 percent of GDP and about 8 months of prospective goods and services imports. Since May 3, 2021, the CBI has discontinued the FX sales program, after selling about US$0.4 billion (2.3 percent of GDP) in total.

Assessment. At 149 percent of the Fund's ARA metric, the end-2020 level of reserves remained comfortable and amply covered short-term net drains.

Annex III. Potential Channels of Economic Scarring

Economic scarring is common after large crises. It refers to a persistently lower output level compared to pre-crisis trend.[1] Iceland's high dependence on tourism, which was significantly impacted by the pandemic is a key source of concern that output losses could be persistent and sizeable. In this regard, rising long-term unemployment and corporate balance sheet vulnerabilities are the most likely potential channels of economic scarring in Iceland.

How Significant is Scarring in the Tourism Sector?

1. **We use the local projection method to assess economic scarring in the tourism sector.[2]** The approach entails estimating impulse response functions for previous health crises. To address nonstationarity in output and serial correlation in growth rates, we specify the following univariate autoregressive model in growth rates:

$$g_{i,t} = a_i + \sum_{j=1}^{4} \beta_j g_{i,t-j} + \sum_{s=0}^{4} \delta_s D_{i,t-s} + \varepsilon_{it}$$

where g is growth rate of direct and indirect contributions of tourism and related sectors of country i at time t; a is a country fixed effect; D denotes a crisis dummy taking a value of 1 when the World Health Organization announced that a country experiences a pandemic, and 0 otherwise.

2. **The results suggest that output losses in the tourism-related sectors can be persistent in the event of health crises.** The analysis covers the 1995–2019 period and uses data for 42 European countries, including 15 advanced and 27 emerging economies. The World Tourism and Travel Council (WTTC) provides data for total value of tourism and related sectors (direct and indirect contributions). Previous health crises comprise SARS (2003), H1N1 (2009), MERS (2012), Ebola (2014). The impulse response function indicates that a cumulative output loss in the tourism-related sectors from previous health crises is statistically and economically persistent with a magnitude of over 10 percent after 5 years, compared to the pre-COVID trend. Tourism-related sectors appeared to be more resilient to other types of crises (systemic banking crises and currency crises), as the cumulative output losses from these crises are not statistically significant.

3. **Robustness checks confirm these results.** Adding systemic banking crisis (Laeven and Valencia, 2018) as an additional control variable does not alter the baseline result that tourism-related sectors experience persistent losses in the event of health crises. We also reestimate the local projection using the residual derived from regressing tourism on Euro Area growth and real/nominal effective exchange rates as a dependent variable. This gauges whether external shocks from the Euro Area and other tourism-related factors (such as exchange rates) drive tourism growth

[1] Shi and Suphaphiphat (forthcoming), Blanchard and Summers (1986), Cerra and Saxena (2008), Ma et al (2020), among others.

[2] Cerra and Saxena (2008)

outcomes during health crises. The results instead confirm significant and persistent output losses in the tourism-related sectors as a direct impact of health crises.

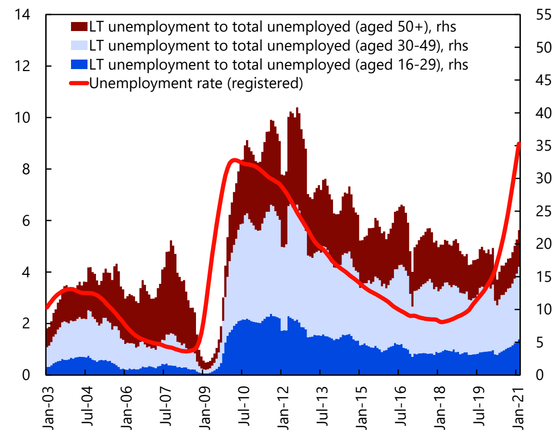
What are the Channels of Economic Scarring?

4. The empirical literature finds that scarring could be driven by supply, demand, or policy factors.[3] Supply-side channels include scarring in the labor market and persistent loss in physical and human capital accumulation. Demand factors are associated with persistently suppressed consumption and investment (such as weakening of household and corporate balance sheets or uncertainty-driven precautionary savings). Policy factors have been found to either mitigate or aggravate economic scarring.

5. Supply factors are likely to be a main driver of economic scarring in Iceland. Given ample policy support and relatively healthy household balance sheets, demand and policy factors are likely to mitigate scarring. We therefore focus on three supply-side channels of potential scarring:

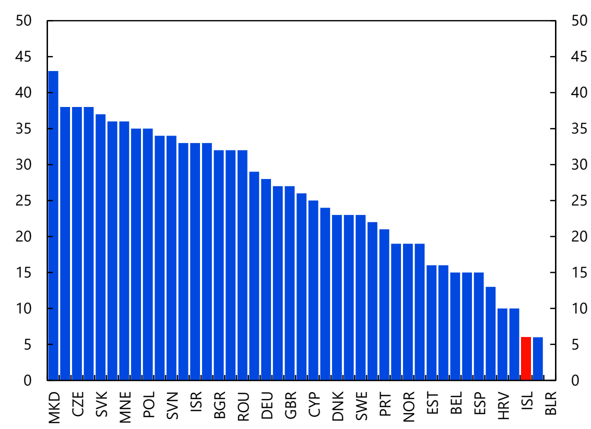
- *Labor market.* While government support has helped contain the increase in unemployment, its rate has exceeded the one observed during the GFC. High unemployment tends to reduce labor market fluidity and prolong unemployment duration, due to both weak labor demand and resource reallocation. For example, long-term unemployment—especially among prime-age workers—increased during the GFC and never reverted to its pre-GFC level. An increase in unemployment after the bankruptcy of WOW air in 2019 has already resulted in a pick-up in long-term unemployment during the pandemic. Empirical evidence also shows that labor market rigidity and acceleration of automation in recessions could be key contributors to labor market hysteresis. Iceland's heavily centralized collective bargaining framework (Annex VIII) has resulted in persistent misalignment

Unemployment
(Percent)



Sources: Statistics Iceland.
Notes: A person without work more than 12 months is defined as long-term unemployment.

Duration of School Closures in Europe
(Number of weeks; as of March 2021)



Sources: UNESCO.
Notes: The data includes both full and partial school closures.

[3] Shi and Suphaphiphat, Economic Scarring from a Sectoral Perspective: Facts, Channels, and Policy Implications (forthcoming).

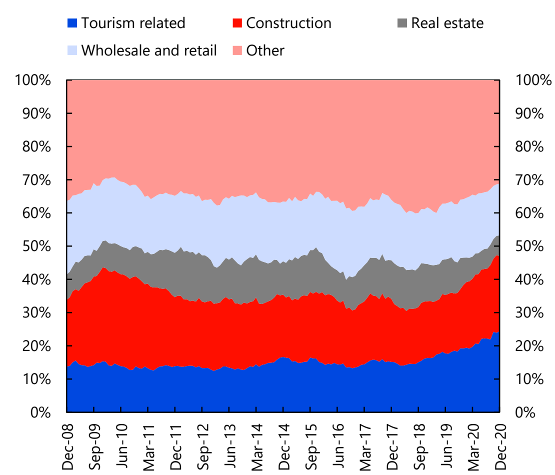
between wage growth above productivity growth since 2015. A widening gap between wages and productivity could hamper labor market adjustment during the pandemic and further worsen the unemployment outlook. Furthermore, a large share of jobs in Iceland is in sectors that are prone to automation (manufacturing, accommodations, and trade).

- *Human capital*. Historical evidence also shows that rising long-term unemployment, could lead to skill erosion and higher probability of exiting the labor market, stalling human capital accumulation. Furthermore, health crises could entail significant and protracted loss of labor productivity. Iceland is indeed facing an unusually low level of labor force participation, and the overall health consequences of the pandemic—due to delays in diagnoses, mental health, and general access to healthcare—are yet to be fully understood.[4] However, Iceland's successful handling of the pandemic has likely stemmed the long-term damage to human capital accumulation. For example, Iceland experienced a very low duration of school closures compared to other European countries. At the same time, the authorities redoubled efforts to implement the ongoing education reforms and in retrain unemployed workers. Unconditional support for the health system and stringent health and safeguard measures have also helped successfully contain the pandemic and limit potential damage to human capital.

- *Capital accumulation*. Weakening corporate balance sheets in hard-hit sectors and heightened uncertainty could slow capital accumulation through suppressed investment. Corporate balance sheets in the most vulnerable sectors (transportation and accommodation) were already weak in 2018, with a significant share of companies experiencing liquidity needs. The collapse of WOW air further weakened corporate balance sheets in the tourism-related sectors. These pre-existing vulnerabilities could exacerbate liquidity shortages, intensify insolvency rates, and dampen investment. In addition, the unprecedented uncertainty about the recovery prospects could weigh down on investment in other sectors.

Insolvency of Companies by Sector

(Percent of total insolvencies; 12m MA; Dec 2008-Dec 2020)



Sources: Statistics Iceland and IMF staff calculations.

[4] Karanikolos et al. (2016) finds evidence of increased incidence of mental health and cardiovascular diseases in the GFC aftermath in OECD countries. The impact was likely greater among vulnerable groups and in countries where the economic shock was larger.

Annex IV. Risk Assessment Matrix[1]

Risks	Relative Likelihood	Impact if Realized	Policy Response
Asynchronous progress in pandemic control: Limited access to, and longer-than-expected deployment of, vaccines in some countries prompts a reassessment of growth prospects	**Medium** • Different pace of infection control in Iceland and trading partners.	**Medium** • Tourist arrivals remain low; Icelanders travel abroad, worsening the current account.	▪ Allow the currency to adjust to FX market conditions. ▪ Conduct data-driven monetary policy.
Prolonged pandemic: proves harder to eradicate (e.g., due to new virus strains, short effectiveness of vaccines, or widespread unwillingness to take them)	**Medium** • Infection flare ups remain high in Iceland and elsewhere.	**Medium/ High** • Worldwide tourism flows remain subdued. • Spillovers from lower-than envisaged trading partner activity	▪ Reassess potential growth. ▪ Make fiscal spending cuts on low priority activities and leverage the tax base to raise fiscal revenue. ▪ Data-driven monetary policy response, factoring exchange rate developments.
Faster containment of pandemic: Pandemic is contained faster than expected due to the rapid production and distribution of vaccines, boosting confidence and economic activity	**Medium** • Rapid distribution of vaccines helps reach herd immunity and boost economic activity.	**Medium/ High** • Strong recovery in the tourism sector. • Appreciation pressure. • Mixed pressure on consumer prices	▪ Save potential windfall fiscal revenue gain to rebuild buffers and avoid overheating. ▪ Allow the currency to adjust to FX market conditions. ▪ Conduct data-driven monetary policy, with bias toward tightening.
Widespread social discontent and political instability: Social tensions erupt as the pandemic and inadequate policy response cause socio-economic hardship	**High** • Socio-economic hardship, political polarization, and instability abroad.	**Medium** • Disruptions in global economic activity and possible increase in risk aversion.	▪ Let automatic stabilizers operate ▪ Allow exchange rate to adjust ▪ Data-driven monetary policy.
Sharp rise in global risk premia exposes financial and fiscal vulnerabilities: A reassessment of market fundamentals triggers a widespread risk-off event.	**Medium** • A reassessment of market fundamentals triggers a widespread risk-off event.	**Medium** • Currency depreciation puts pressure on inflation; high premium complicates government financing.	▪ Foreign exchange intervention to prevent disorderly market conditions ▪ Secure government liquid buffers to ensure smooth financing of government financing needs.

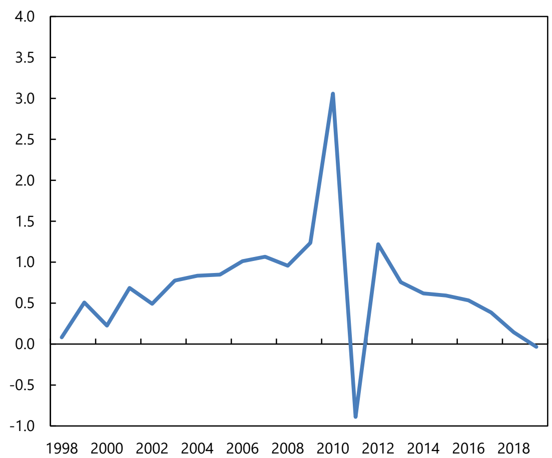
[1] Shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability of 10–30 percent, and "high" a probability of over 30 percent). Reflects the staff's views on the source of risks and overall level of concern at the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenario highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Accelerating de-globalization: Despite renewed efforts to reach multilateral solutions to existing tensions, geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	**Medium** • Geopolitical competition leads to further fragmentation. Reshoring and less trade reduce potential growth.	**Medium** • Tariff and non-tariff restrictions further dampen Iceland's export and growth prospects	▪ Reassess potential growth and new avenues for growth ▪ Participate in global initiatives supporting multilateralism
Higher frequency and severity of natural disasters related to climate change cause severe economic damage and prompt a recalculation of risk and growth prospects.	**Medium** • A sequence of severe events in large economies or in Iceland.	**Medium** • Lowers global GDP with spillovers onto Iceland. • Iceland events destroy wealth and hamper economic activity.	▪ Reassess potential growth ▪ Support affected sectors and rebuild damaged infrastructure reallocating fiscal spending as needed. ▪ Allow exchange rate to adjust with intervention to prevent disorderly markets

Annex V. General Government Reclassification

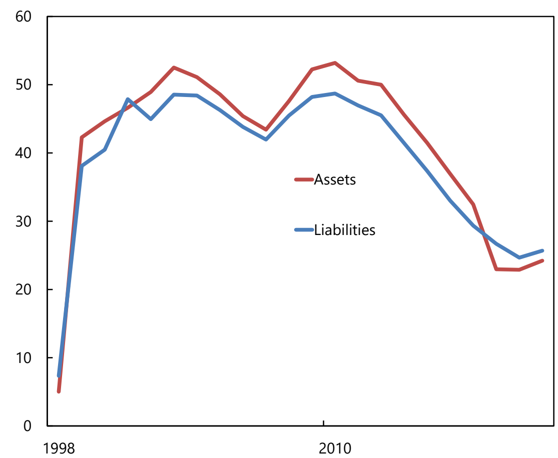
1. Per Eurostat's recommendations, the Icelandic national statistical office included 24 public entities in the definition of general government. The reclassification increased net debt by about 29 percentage points of GDP and non-Maastricht treaty assets by a similar amount, leaving the net position of the general government unchanged. The increase largely reflects the debt of the IL Fund (ILF)—a legacy fund of the House Financing Fund (HFF). The redefined fiscal accounts show stronger overall balances than the earlier definition for most of the last twenty years, although sharply deteriorating over the last five years.

Revisions in Overall General Government Balance
(Percentage of GDP)



Sources: Statistics Iceland.

Revisions in General Government Assets and Liabilities
(Percent of GDP)



Sources: Statistics Iceland.

2. The HFF, a government-sponsored housing funding program, ran into financial stress with the materialization of mortgage prepayment risk. HFF provided long-term mortgage financing to individuals by intermediating long-term borrowing indexed to the domestic currency through non-callable bonds. Prepayment risk arose from the possibility that interest rates would fall, and borrowers would prepay their obligations to get funding elsewhere. Although a prepayment fee was in place to contain incentives for prepayment due to falling interest rates, the fee has recently been contested at the Supreme Court. In 2019, the HFF was split into a social housing fund (the Housing Fund) and the ILF—an institution in charge of winding down the remaining mortgage portfolio and inheriting all market liabilities of the HFF.

3. Although ILF's total assets and liabilities are roughly balanced, a significant difference in their yields and maturity structures creates a net present value gap.

- At end-2020, ILF's total bond liabilities amounted to 25.5 percent of GDP. Bonds are indexed to the domestic CPI at an average real interest rate of 4.4 percent. The average bond maturity is 18 years, with the last bond maturing on 2044. About 99 percent of the bonds are non-callable and owned domestically.

- At end-2020, ILF held about 6.6 percent of GDP (a quarter of its asset portfolio) in mortgage loans and about 10 percent of GDP in bonds and loans to other general government institutions, including treasury bonds, loans to the central administration, and a bond of the Housing Fund for social housing mortgages transferred from the HFF in 2019

- The loss associated with mortgage prepayments is estimated at 6–8 percent of GDP. The net present value of this loss can be approximated by discounting the streams of bond service and interest revenue by the current medium-term market interest rate, taking into consideration the maturity profile of the bond and mortgage portfolios.[1]

4. Additional prepayments of the remaining mortgage portfolio in the IL Fund implies an immediate cash flow gain at the expense of future losses. These prepayments would tend to increase the size of the losses but also further reduce treasury bond issuance in the next few years with respect to the baseline.

[1] Issuing callable bonds that can be prepaid may have reduced the risk and loss, although they require a premium over noncallable bonds.

Annex VI. Public Sector Debt Sustainability Analysis

Iceland's public debt vulnerabilities have increased since the onset of the pandemic and with the incorporation of new public entities into the general government (Annex V). The public debt ratio has increased significantly but is projected to be on a downward path by the end of the forecast horizon. Staff's baseline projections take the government spending projections in the medium-term fiscal plan and staff's macroeconomic framework.

1. **The reclassification of financial intermediation funds into the general government has significantly increased the level of gross public debt without changing its historical dynamic.** Under the revised classification, gross general government debt declined considerably in 2010–19, reflecting sustained primary surpluses, a positive growth–interest differential, and large irregular income receipts. After falling to 61 percent of GDP in 2018 from 138 percent of GDP in 2011, the debt ratio rose to about 70 percent in 2019, due to valuation changes in HFF debt and fiscal support to the economy in the face of the collapse of WOW air.

2. **As assets of the reclassified entities wind down, general government debt will decline.** As HFF assets become liquid either because mortgages are amortized or paid in advance in search of refinancing elsewhere for lower yields, they will become a source of funding that will either lower the borrowing requirements or allow to retire other government debt. A faster rate of prepayments may increase the net loss to the ILF but would also increase the resources available to the government to reduce public debt. The remaining mortgage portfolio in the ILF amounted to 6.6 percent of GDP in 2020.

3. **Gross financing needs (GFN) have risen significantly, but financing risks have been mitigated by the large domestic investor base and favorable global financial conditions.** GFN have risen to 14 percent of GDP in 2020 from 4.5 percent of GDP in 2019. The average time to maturity of central government debt is around 4.4 years, with 22 percent maturing in the next 12 months, implying GFN of 14 percent of GDP in 2021. As of December 2020, 94 percent of the stock of domestic treasury bills and bonds are held by domestic investors, and 80 percent of central government debt is denominated in krónur. Iceland has maintained its investment grade credit rating and enjoys market access at favorable terms. In January 2021, the government placed a €750 million bond at a 0.1 percent yield. No foreign currency denominated bonds are maturing over the next 12 months.

4. **Contingent liabilities of the general government have declined to about 4 percent of GDP from 31 percent of GDP in 2019.** The contingent guarantees on the HFF and the SLF have been incorporated into the general government public debt. In addition, contingent liabilities declined in 2020 when Landsvirkjun paid off a guaranteed loan and issued new funding without a government guarantee. New credit guarantees (1 percent of GDP) include the support loans to Icelandair and other firms provided during the pandemic.

5. **The DSA is based on staff's baseline fiscal projections.** In line with the 2021 budget and 2022-26 MTFS, the authorities aim to support economic recovery by maintaining stimulus measures

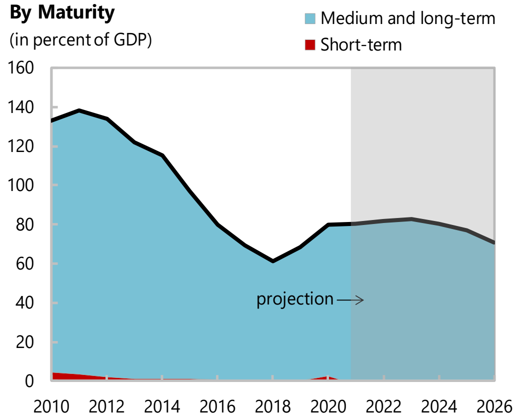
and other fiscal spending while revenue recovers with economic activity. Staff's baseline fiscal projections imply a narrowing of the primary deficit to a slight surplus by 2025, broadly in line with the debt-stabilizing primary deficit. Staff's forecast errors do not show any persistent bias**.** The debt dynamics incorporate assumptions on the rate of ILF's mortgage loan prepayments and mortgage loan amortization, liquidity from which is projected to become a source of funding.

6. The current debt level is more vulnerable to shocks. Gross debt levels are considered at risk under two of the five types of shocks considered, while gross financing needs remain in the low risk category under most macro-fiscal stress tests. Financial assets of the recently consolidated funds attenuate the high public debt level risk. External financing requirements are at about the lower-risk assessment benchmark of17 percent of GDP but elevated, with lower current account surpluses expected in the medium-term under the baseline due to subdued prospects for tourism recovery. The relatively low maturity of short-term treasury debt adds some liquidity risk, attenuated by the large domestic investor base.

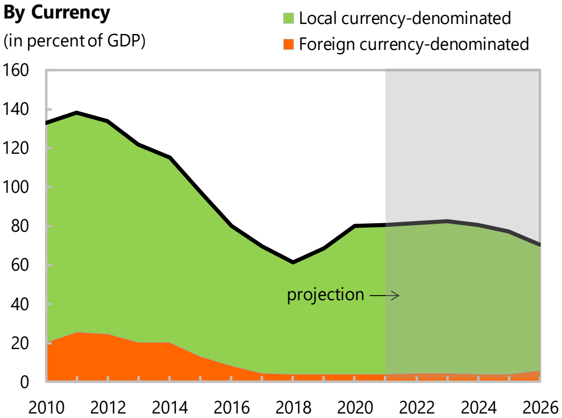
Figure 1. Iceland: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



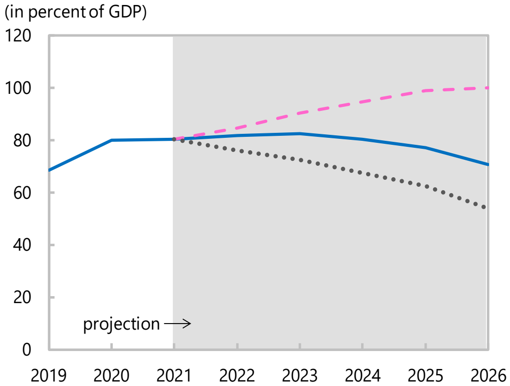
By Currency
(in percent of GDP)



Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Underlying Assumptions
(in percent)

Baseline Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	3.7	3.6	2.7	2.5	2.4	2.3
Inflation	2.7	2.5	2.1	2.3	2.8	3.3
Primary Balance	-7.1	-4.2	-2.1	-0.4	0.6	0.6
Effective interest rate	4.2	5.9	6.0	4.3	4.4	4.7
Constant Primary Balance Scenario						
Real GDP growth	3.7	3.6	2.7	2.5	2.4	2.3
Inflation	2.7	2.5	2.1	2.3	2.8	3.3
Primary Balance	-7.1	-7.1	-7.1	-7.1	-7.1	-7.1
Effective interest rate	4.2	5.9	5.8	4.1	4.3	4.8

Historical Scenario	2021	2022	2023	2024	2025	2026
Real GDP growth	3.7	2.5	2.5	2.5	2.5	2.5
Inflation	2.7	2.5	2.1	2.3	2.8	3.3
Primary Balance	-7.1	2.3	2.3	2.3	2.3	2.3
Effective interest rate	4.2	5.9	5.9	4.0	3.9	4.0

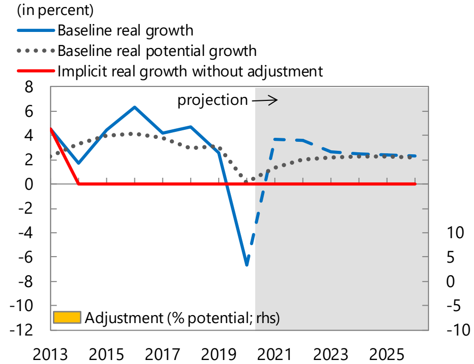
Source: IMF staff.

Figure 2. Iceland: Public DSA - Realism of Baseline Assumptions

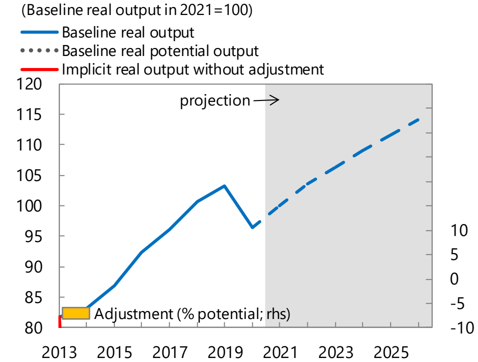
Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 1, persistence of 0.6

Real GDP Growth
(in percent)

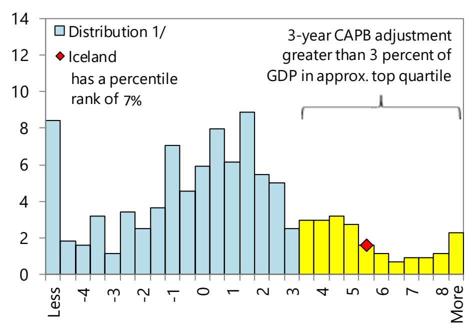


Real Output Level
(Baseline real output in 2021=100)

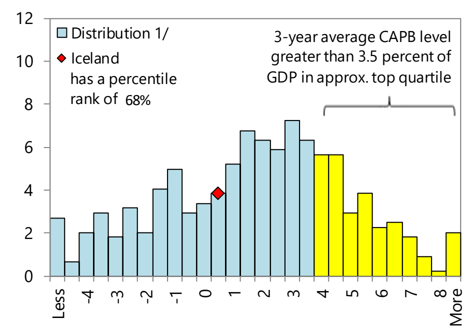


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Source : IMF staff.
1/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Iceland: Public DSA—Baseline Scenario

(Percent of GDP, unless otherwise indicated)

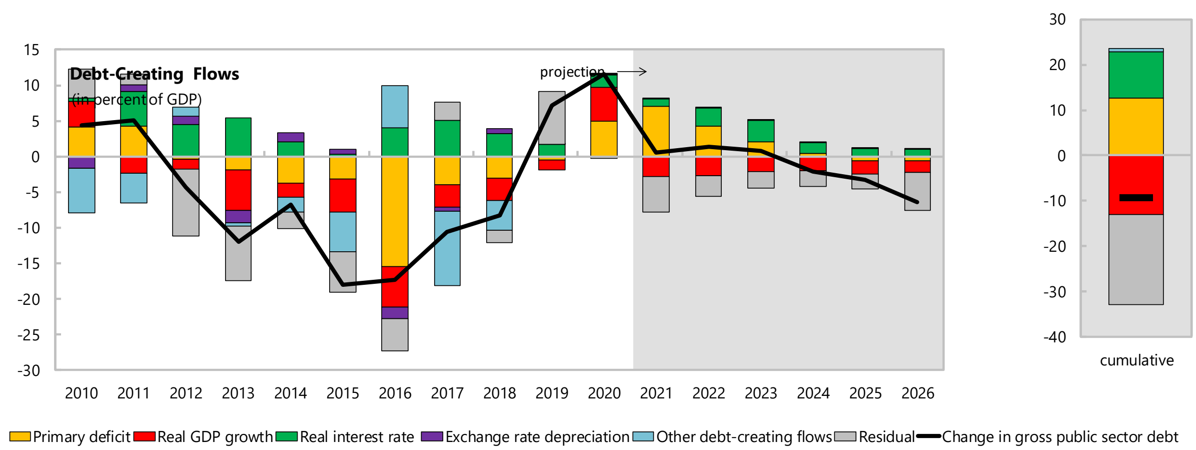
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2010-2018 [2/]	2019	2020	2021	2022	2023	2024	2025	2026
Nominal gross public debt	105.6	68.3	79.9	80.4	81.7	82.5	80.4	77.0	70.6
Public gross financing needs	7.5	4.4	11.2	15.1	10.6	9.0	6.0	6.4	12.6
Real GDP growth (in percent)	2.9	2.6	-6.6	3.7	3.6	2.7	2.5	2.4	2.3
Inflation (GDP deflator, in percent)	3.5	4.5	3.4	2.7	2.5	2.1	2.3	2.8	3.3
Nominal GDP growth (in percent)	6.4	7.2	-3.4	6.5	6.1	4.8	4.9	5.3	5.7
Effective interest rate (in percent) [4/]	6.9	7.7	5.7	4.2	5.9	6.0	4.3	4.4	4.7

As of January 31, 2021		
Sovereign Spreads		
EMBIG (bp) 3/		210
5Y CDS (bp)		69
Ratings	Foreign	Local
Moody's	A2	A2
S&Ps	A	A
Fitch	A	A

Contribution to Changes in Public Debt

	Actual			Projections							
	2010-2018	2019	2020	2021	2022	2023	2024	2025	2026	cumulative	debt-stabilizing
Change in gross public sector debt	-7.5	7.2	11.5	0.5	1.3	0.8	-2.1	-3.3	-6.5	-9.3	primary
Identified debt-creating flows	-5.0	-0.2	11.7	5.5	4.2	3.1	0.1	-1.2	-1.2	10.6	balance [9/]
Primary deficit	-2.6	-0.5	5.0	7.1	4.2	2.1	0.4	-0.6	-0.6	12.6	-0.6
Primary (noninterest) revenue and grants	41.8	39.5	40.7	39.2	39.2	39.7	39.6	39.3	39.1	236.0	
Primary (noninterest) expenditure	39.2	39.1	45.7	46.2	43.4	41.8	40.0	38.6	38.6	248.6	
Automatic debt dynamics [5/]	0.5	0.3	6.6	-1.7	-0.2	0.9	-0.4	-0.7	-0.7	-2.8	
Interest rate/growth differential [6/]	0.6	0.2	6.5	-1.7	-0.2	0.9	-0.4	-0.7	-0.7	-2.8	
Of which: real interest rate	3.3	1.7	1.8	1.1	2.5	3.0	1.5	1.1	1.0	10.2	
Of which: real GDP growth	-2.7	-1.5	4.7	-2.8	-2.7	-2.1	-1.9	-1.8	-1.7	-13.0	
Exchange rate depreciation [7/]	-0.1	0.0	0.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	-2.9	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8	
General government net privatization proceeds (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Net lending	-2.9	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8	
Residual, including asset changes [8/]	-2.6	7.3	-0.2	-5.0	-2.9	-2.3	-2.2	-2.1	-5.3	-19.8	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over U.S. bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

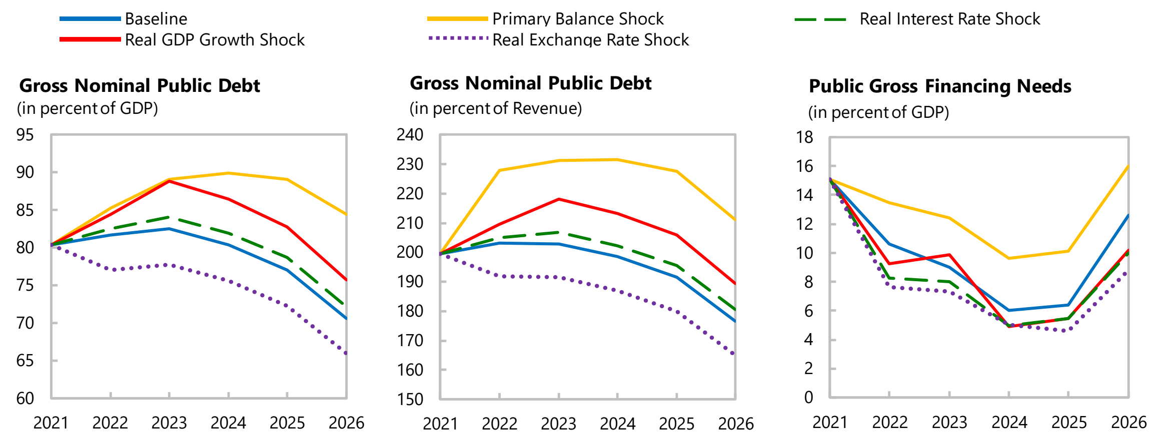
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

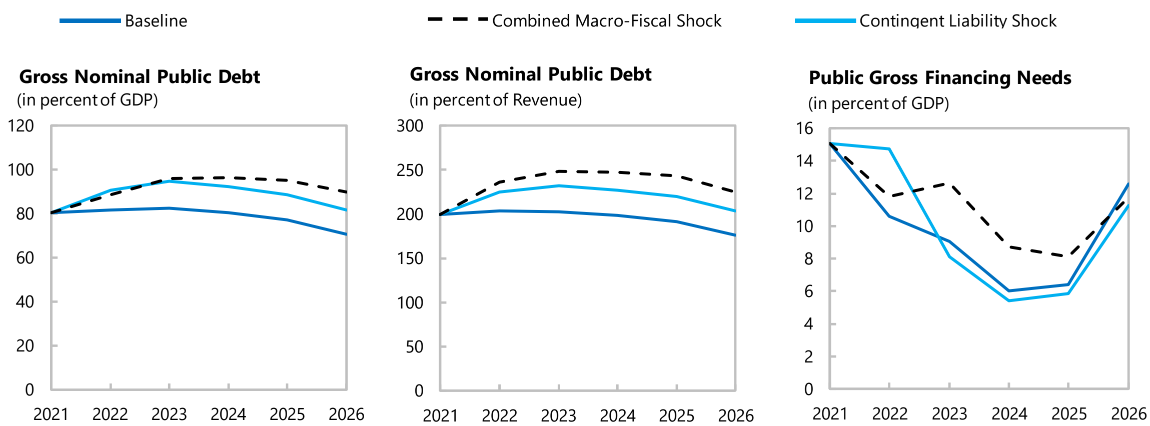
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. Iceland: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2021	2022	2023	2024	2025	2026
Real GDP growth	3.7	2.6	2.7	2.5	2.4	2.3
Inflation	2.7	2.5	2.1	2.3	2.8	3.3
Primary balance	-7.1	-7.1	-4.2	-2.1	-0.4	0.6
Effective interest rate	4.2	5.9	7.0	5.9	6.3	6.9
Real Interest Rate Shock						
Real GDP growth	3.7	2.6	1.7	2.5	2.4	2.3
Inflation	2.7	2.5	2.1	2.3	2.8	3.3
Primary balance	-7.1	-4.2	-2.1	-0.4	0.6	0.6
Effective interest rate	4.2	5.9	6.0	4.4	4.5	4.8
Combined Shock						
Real GDP growth	3.7	1.8	0.9	2.5	2.4	2.3
Inflation	2.7	2.0	1.6	2.3	2.8	3.3
Primary balance	-7.1	-8.0	-6.1	-2.1	-0.4	0.6
Effective interest rate	4.2	5.9	6.5	5.5	5.9	6.4

Real GDP Growth Shock	2021	2022	2023	2024	2025	2026
Real GDP growth	3.7	1.8	0.9	2.5	2.4	2.3
Inflation	2.7	2.0	1.6	2.3	2.8	3.3
Primary balance	-7.1	-5.2	-4.0	-0.4	0.6	0.6
Effective interest rate	4.2	5.9	5.9	4.2	4.1	4.3
Real Exchange Rate Shock						
Real GDP growth	3.7	3.6	2.7	2.5	2.4	2.3
Inflation	2.7	10.8	2.1	2.3	2.8	3.3
Primary balance	-7.1	-4.2	-2.1	-0.4	0.6	0.6
Effective interest rate	4.2	5.9	5.8	4.0	4.1	4.2
Contingent Liability Shock						
Real GDP growth	3.7	0.9	0.0	2.5	2.4	2.3
Inflation	2.7	1.8	1.4	2.3	2.8	3.3
Primary balance	-7.1	-10.5	-2.1	-0.4	0.6	0.6
Effective interest rate	4.2	6.1	6.0	4.3	4.3	4.5

Source: IMF staff.

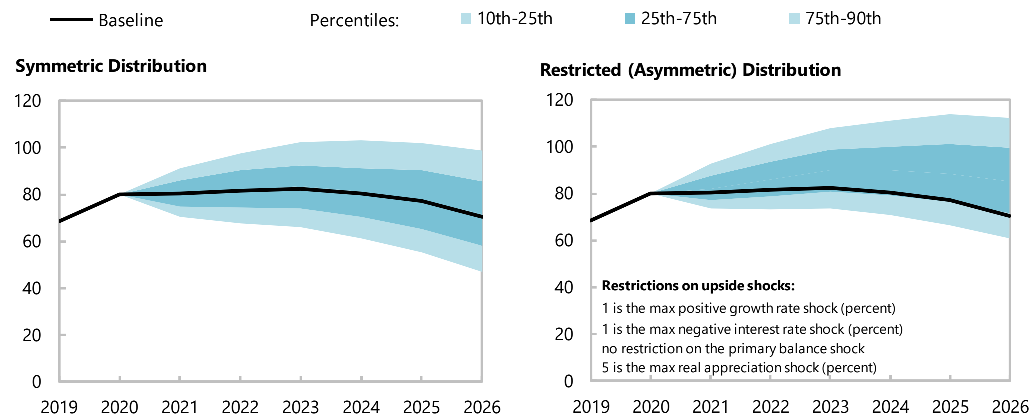
Figure 5. Iceland Public DSA—Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

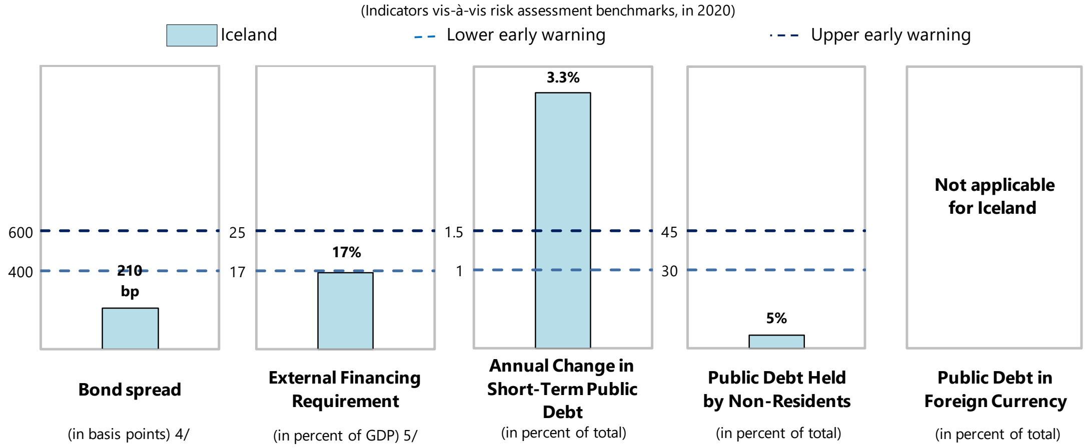
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2020)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over U.S. bonds, an average over the last 3 months, 02-Nov-20 through 31-Jan-21.

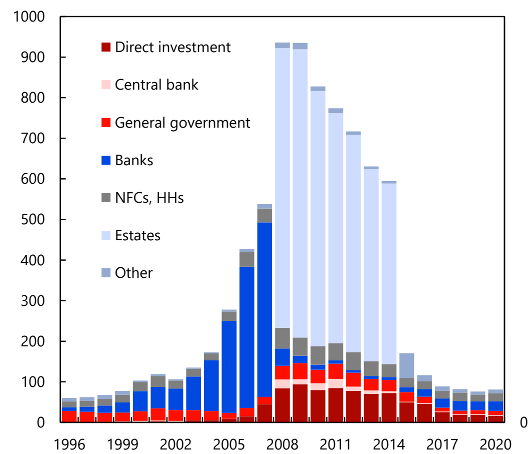
5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Annex VII. External Debt Sustainability Analysis

Iceland's external debt position has remained strong. It appears robust to most shocks, with exception of króna depreciation. Total external debt is projected to reach 57 percent of GDP by 2026 (from 125 percent in 2016), reflecting much improved solvency.

1. **Iceland's external debt increased moderately in 2019–20**. Until 2018, it was on a rapidly declining trend, falling sharply from 240 percent of GDP in 2013 to 73 percent in 2018. This is due to reductions in public and, above all, banking sector debt—the bank estates' massive external debts were cleared in the winter of 2015–16. The trend reversed in 2019 with króna depreciation. As the pandemic crisis hit the economy, the external debt further rose by 10 percentage points to 86 percent of GDP in 2020, reflecting negative GDP growth, weak current account, and further depreciation.

Gross External Debt
(Percent of GDP)



Sources: CBI and IMF staff calculations.

2. **External debt is projected to gradually decline.** Gross debt is projected to revert to around 75 percent of GDP in 2021 and to continue a gradual decline thereafter, stabilizing at around 57 percent of GDP by 2026.

3. **The maturity structure is comfortably long**. Short-term debt accounts for less than 20 percent of the total.

4. **The gross external financing requirement increased sizably but is expected to moderate**. Iceland's external financing needs were about 17 percent of GDP in 2020—almost double their size in 2019. This in part reflects banks' pre-financing of maturing debts to take advantage of market conditions and resulting in lower financing needs going forward (below 10 percent of GDP by 2026). The mix of much lower external debt, gradual recovery in the current account balance, and steady reserve levels will continue to improve the ratio of reserves to the gross external financing requirement.

5. **The projected downward path for total external debt is robust to most shocks**. Standard growth and current account shocks do not materially alter the baseline trajectory. The sensitivity of the baseline path to exchange rate shocks remains the most significant.

Table 1. Iceland: External Debt Sustainability Framework, 2016–26

(Percent of GDP, unless otherwise indicated)

	Actual							Projections						Debt-stabilizing
	2016	2017	2018	2019	2020			2021	2022	2023	2024	2025	2026	non-interest CA 7/
Baseline: External debt (including old banks) 1/	125.1	90.3	73.3	76.5	86.0			**75.4**	**71.2**	**68.6**	**64.8**	**60.9**	**57.2**	**-0.3**
Change in external debt	-49.7	-34.8	-17.0	3.2	9.5			-10.6	-4.2	-2.6	-3.8	-3.9	-3.7	
Identified external debt-creating flows (4+8+9)	-36.4	-38.3	-12.3	-1.2	7.9			0.2	-1.7	-2.1	-2.2	-2.2	-2.4	
Current account deficit, excluding interest payments	-11.8	-7.4	-5.8	-8.2	-2.7			-2.0	-2.5	-2.6	-3.0	-3.1	-3.1	
Deficit in balance of goods and services	-6.6	-4.5	-3.5	-5.1	0.6			0.3	-1.1	-1.2	-1.2	-1.2	-1.2	
Exports	47.5	45.7	46.7	44.4	34.1			38.5	40.7	43.2	44.8	44.6	44.3	
Imports	40.8	41.2	43.2	39.3	34.7			38.8	39.6	42.0	43.6	43.4	43.1	
Net non-debt creating capital inflows (negative)	-2.6	-16.8	-2.8	3.5	0.3			3.8	2.2	1.4	1.2	1.2	1.0	
Automatic debt dynamics 2/	-22.0	-14.1	-3.7	3.4	10.2			-1.6	-1.4	-0.9	-0.4	-0.3	-0.3	
Contribution from nominal interest rate	3.8	3.2	1.7	1.8	1.6			1.3	1.2	0.9	1.2	1.2	1.0	
Contribution from real GDP growth	-9.3	-4.4	-4.0	-2.0	5.8			-2.9	-2.6	-1.9	-1.6	-1.5	-1.3	
Contribution from price and exchange rate changes 3/	-16.5	-12.9	-1.4	3.6	2.8			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 4/	-13.2	3.5	-4.7	4.5	1.6			-10.8	-2.4	-0.5	-1.5	-1.8	-1.3	
External debt-to-exports ratio (in percent)	263.4	197.5	156.9	172.5	252.1			195.7	174.9	158.7	144.7	136.7	129.1	
Gross external financing need (in billions of US dollars) 5/	1.1	3.1	2.3	2.1	3.7			2.8	3.7	2.9	2.9	1.4	2.0	
in percent of GDP	5.5	12.5	8.9	8.4	17.0	10-Year	10-Year	11.5	14.5	11.3	10.6	4.9	6.5	
Scenario with key variables at their historical averages 6/								**75.4**	**58.5**	**43.4**	**29.0**	**15.0**	**1.7**	
						Historical	Standard							
Key Macroeconomic Assumptions Underlying Baseline						Average	Deviation							
								2021	**2022**	**2023**	**2024**	**2025**	**2026**	
Real GDP growth (in percent)	6.3	4.2	4.7	2.6	-6.6	2.5	3.6	3.7	3.6	2.7	2.5	2.4	2.3	
GDP deflator in US dollars (change in percent)	11.7	14.1	1.3	-7.7	-6.3	2.5	8.2	7.2	0.8	0.0	2.2	2.9	3.0	
Nominal external interest rate (in percent) 8/	2.6	3.1	2.0	2.3	1.8	2.7	0.8	1.7	1.6	1.4	1.9	1.9	1.8	8/
Underlying external interest rate (in percent)	2.6	3.1	2.0	2.3	1.8	2.3		1.7	1.6	1.4	1.9	1.9	1.8	
Growth of exports (US dollar terms, in percent)	9.1	14.5	8.3	-10.1	-32.8	1.5	14.5	25.7	10.3	9.0	8.6	4.7	4.7	
Growth of imports (US dollar terms, in percent)	9.8	20.1	11.1	-13.9	-22.8	3.7	14.5	24.5	6.4	8.9	8.8	4.7	4.7	
Current account balance, excluding interest payments	11.8	7.4	5.8	8.2	2.7	7.9	3.0	2.0	2.5	2.6	3.0	3.1	3.1	
Net non-debt creating capital inflows	2.6	16.8	2.8	-3.5	-0.3	5.5	9.8	-3.8	-2.2	-1.4	-1.2	-1.2	-1.0	

1/ External debt includes recovered domestic and foreign assets of old banks.

2/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

3/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

4/ For projection, line includes the impact of price and exchange rate changes, inflows of extraordinary financing (and Fund repurchases), and external asset recovery of the old bank estates.

5/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

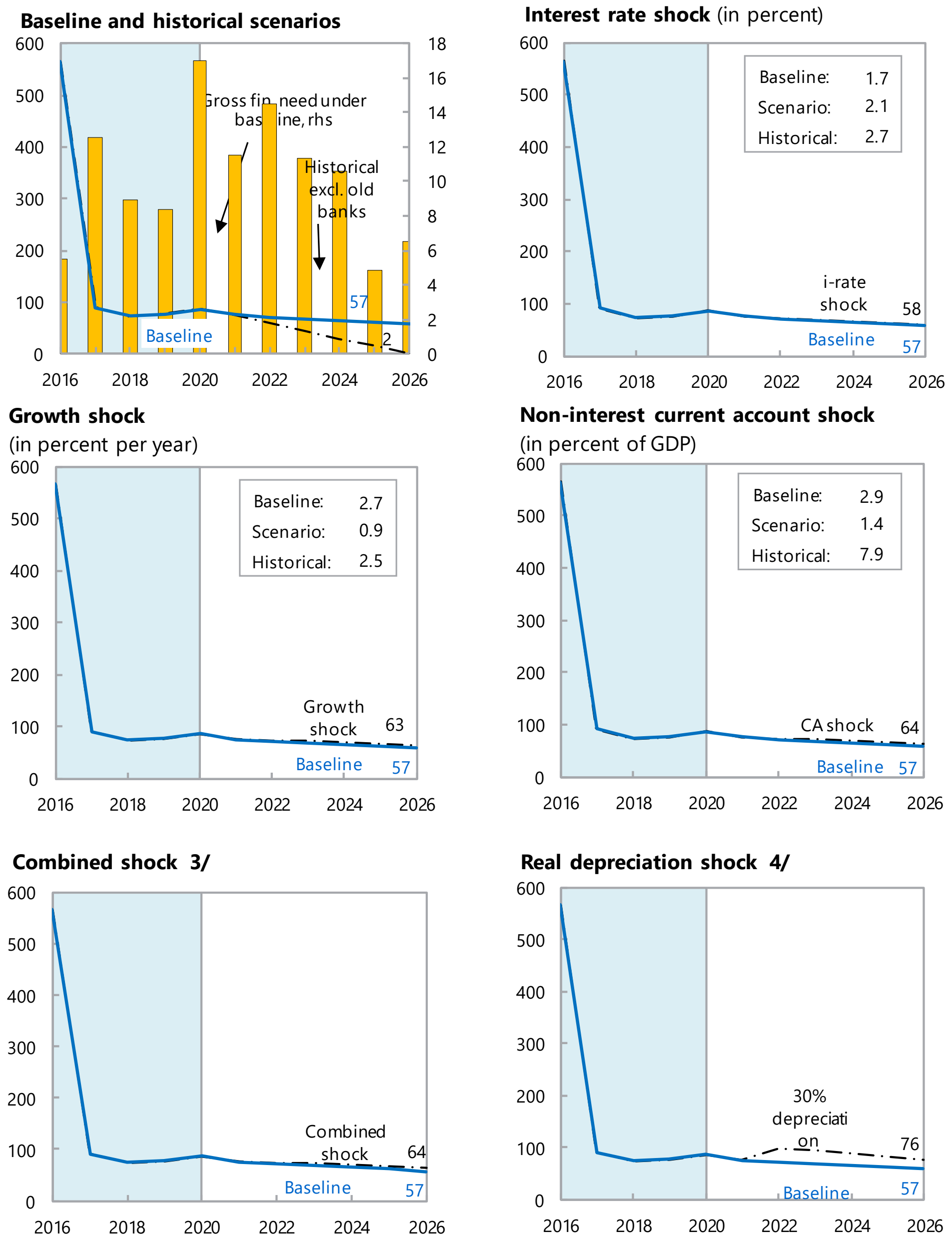
6/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

8/ Since interest payment projections exclude old bank related interest payments while the external debt stock includes old bank debt, this results in an understatement of the external interest rate. Hence, for the computation of debt stabilizing current account we use the 2024 underlying interest rate that would exclude old bank debt stock as well.

Figure 1. Iceland: External Debt Sustainability Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund; country desk data, and IMF staff projections.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2022.

Annex VIII. Making Collective Bargaining Effective: Options for Reforms

1. **Iceland has a highly centralized collective bargaining system.** Both coverage and unionization rates are among the highest in Europe. Wage agreements are predominantly set at a sectoral level while firms have little scope to modify or deviate from the terms set in the higher-level agreements. The recent agreement, concluded in 2019, linked wage increases with positive past GDP growth.

Collective Bargaining System in Europe, 2015

Wage Coordination			
	Largely decentralized	Organized decentralized	Centralized with high coordinated
High	GRC LUX SVK	AUT NOR DEN SWE DEU NLD	BEL FIN
	Fully decentralized		Centralized and weak coordination
Limited	CZE POL EST TUR HUN UK LVA LTU		SVN ESP FRA ISL ITA PRT CHE
	Decentralized		Centralized

Source: OCED

2. **Centralized collective bargaining tends to limit the ability of the economy to respond to adverse macroeconomic shocks and hinders labor market resilience.** Limited flexibility at firm level could contribute to persistent divergence between wage and productivity growth, giving rise to inflationary pressures and eroding external competitiveness (OECD, 2018)[1]. More importantly, given the unprecedented economic downturn from the pandemic, wage rigidity could hinder reemployment, particularly for the most vulnerable groups, including young and low-skilled workers (OECD, 2019)[2].

3. **Allowing some degree of wage flexibility and improving wage coordination would strengthen labor market resilience while preserving wage equality.**

- *Wage flexibility*: Studies have shown that setting a broad framework for sector-level agreements while leaving room for firms to negotiate detailed provisions would allow the economy to better respond to macroeconomic shocks and mitigate an adverse impact of wage agreements on competitiveness. For example, in the Netherlands and Denmark, firm-level bargaining can be done as long as minimum conditions set by sectoral agreements are observed. On the other hand, Germany achieves wage flexibility through general opening clauses, which set a general framework for derogations under competition, hardship, or opt-out clauses.

- *Wage coordination:* A well-coordinated wage structure could help ensure that wage agreements are safeguarded against eroding external competitiveness. For example, Denmark, Norway, and Sweden use pattern bargaining, where the tradable sector (mainly manufacturing in export industry) sets the benchmark wage by considering productivity and wage developments in other countries. In the Netherlands, using manufacturing exports as a benchmark, the main union confederations issue an annual recommendation on maximum wage increases, depending on past inflation and productivity. In Belgium, wage increases are adjusted by costs of living but are capped by a wage norm that incorporates future wage trends in neighboring countries (Germany, France, and the Netherlands) in order to maintain competitiveness.

[1] OECD Employment Outlook 2018.

[2] OECD Employment Outlook 2019.

INTERNATIONAL MONETARY FUND

ICELAND

STAFF REPORT FOR THE 2021 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 12, 2021

Prepared By	The European Department (in consultation with other departments)

CONTENTS

FUND RELATIONS

(As of March 31, 2021)

Membership Status: Joined December 27, 1945

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	321.80	100.00
Fund holdings of currency	252.00	78.31
Reserve tranche position	69.80	21.69

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	112.18	100.00
Holdings	113.10	101.14

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR Million)**	**Amount Drawn (SDR Million)**
Stand-By	Nov. 19, 2008	Aug. 31, 2011	1,400.00	1,400.00
Stand-By	Mar. 22, 1962	Mar. 21, 1963	1.63	0.00
Stand-By	Feb. 16, 1961	Dec. 31, 1961	1.63	0.00

Projected Payments to the Fund [1]
(SDR million; based on existing use of resources and present holdings of SDRs):

	2019	2020	2021	2022	2023
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not applicable

Implementation of Catastrophe Containment and Relief (CCR): Not applicable

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement and Exchange Restrictions:

The *de jure* exchange rate arrangement is free floating, and the *de facto* exchange rate arrangement under the IMF classification system is floating. The CBI publishes daily data on its foreign exchange intervention with a lag.

Iceland is an Article VIII member and maintains an exchange system free of restrictions on payments and transfers for current international transactions. Iceland maintains measures adopted for security reasons, which have been notified to the Fund for approval in accordance with the procedures of Decision 144.

Last Article IV Consultation:

Discussions for the 2019 Article IV Consultation were held in Reykjavik during October 30-November 12, 2019. The staff report (Country Report No. 19/375) was considered by the Executive Board on lapse of time basis on December 19, 2019. Article IV consultations with Iceland are currently held on a 12-month cycle.

Technical Assistance:

Department	**Purpose**	**Date**
MCM	Capital account liberalization	March 2010
MCM	Reserves building and liquidity management	June 2010
MCM	Public debt management	July 2010
FAD	Fiscal framework issues	August 2010
MCM	Capital controls liberalization	November 2010
MCM	Converging to EU regulations-credit bureaus	January 2011
MCM	Liquidity management	March 2011
FAD	Tax policy	March 2011
STA	External Sector Statistics	April 2011
FAD	Organic Budget Law	October 2011
FAD	Follow up on Organic Budget Law	May 2012
MCM	Capital account liberalization	March 2013
FAD	IPSAS in Iceland: Towards Enhanced Fiscal Transparency	December 2013
FAD	VAT reform	February 2014
MCM	Capital controls liberalization	May 2014
MCM	Banking supervision	February 2015
MCM	Banking supervision	March 2015
MCM	Stress testing	April 2015
FAD	Workshop on Distributional Effects of Tax Reforms and Expenditure Measures	April 2015
MCM	Banking supervision	September 2015
MCM	Banking supervision	March 2016
FAD	Organic Budget Law implementation	April 2016

STATISTICAL ISSUES

I. Assessment of Data Adequacy for Surveillance

General. Data provision to the Fund is adequate for surveillance purposes. The composition agreements reached by the bank estates in the winter of 2015–16 had large impacts on the fiscal, monetary, and external sectors. The estates' "stability contributions" are recorded in the general government data on an accrual basis in 2016. The monetary data have been affected in both 2015 and 2016. In the external sector, the compositions entailed a large step reduction in the estates' foreign liabilities in December 2015, and a reclassification of their remaining foreign assets and liabilities from "deposit money banks in winding up proceedings" (which no longer exists as a category) to "financial holding companies"—classified in both the balance of payments (BoP) and the international investment position (IIP) under "Other sectors—other financial corporations." The reclassification of 24 public sector entities into the definition of general government in 2020 had a large impact on the fiscal accounts (overall deficit, assets and liabilities), which have been revised back to 1998 and remain subject to further revisions.

National accounts. The existing methodological framework for producing national accounts data was replaced in September 2014 with the new *European System of Accounts 2010* and data starting in 1997 were revised. In November 2020, the Statistics Iceland published the results of a comprehensive review of the national accounts for the period 1995 to 2019, consistent with agreed policies and guidelines of Eurostat and the Statistical Office of the European Union. The base year was changed to 2015 from 2005. Expenditure-based GDP data are available by component on a quarterly basis. Nonetheless, there is still scope for improvement:

- Income accounts by sector are not sufficiently detailed and available only on an annual basis with a significant lag; and
- Production-based GDP or gross value added by industry are available only on an annual basis and only in nominal terms, with a considerable lag.

Price statistics. Data provision is adequate for surveillance.

I. Assessment of Data Adequacy for Surveillance (concluded)	
Government finance statistics. The authorities publish a treasury cash flow statement monthly, data on general government operations on an accrual basis quarterly and annually, and data on general government financial assets and liabilities annually. Iceland reports government finance statistics in accordance with the *Government Finance Statistics Manual* 2014 framework in the *Government Finance Statistics Yearbook* and is an up-to-date contributor to the *International Financial Statistics*. New series (1998 to 2020) are expected to be submitted for the annual GFS database based on the reclassification of 24 public sector entities into the general government as published by Statistics Iceland in December 2020.	
Monetary and financial statistics. The concepts and definitions conform to the guidelines of the *Monetary and Financial Statistics Manual*. The monetary and financial statistics (MFS) are reported to STA at a monthly frequency. Iceland reports the standardized report forms (SRFs) 1SR for central bank and 2SR for other depository corporations for publication in the *International Financial Statistics*. Iceland also reports data on some key series and indicators of the Financial Access Survey (FAS), including gender disaggregated data on the use of financial services and two indicators of the United Nations Sustainable Development Goals.	
Financial sector surveillance. Iceland reports quarterly financial soundness indicators to STA, with data starting from Q1:2014.	
External sector statistics. Since 2014, the CBI has compiled BoP and IIP data according to the 6th edition of the *Balance of Payments and International Investment Position Manual*. Data were back-cast to 1995 for both the BoP and the IIP. The BoP data do not provide a breakdown of services before 2009.	
II. Data Standards and Quality	
Subscriber to the *Special Data Dissemination Standard (SDDS)* since June 1996. Uses SDDS flexibility options on the periodicity and timeliness of the industrial production index.	A *Report on the Observation of Standards and Codes* data module was published in November 2005.

Table 1. Iceland: Table of Common Indicators Required for Surveillance

(as of March 31, 2021)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memorandum Items:[8] Data Quality – Methodological Soundness[9]	Memorandum Items:[8] Data Quality – Accuracy and Reliability[10]
Exchange Rates	Mar. 2021	Mar. 2021	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Feb. 2021	Apr. 2021	M	M	M		
Reserve/Base Money	Feb. 2021	Mar. 2021	M	M	M	LO, O, LO, LO	LO, O, O, O, O
Broad Money	Mar. 2021	Apr. 2021	M	M	M		
Central Bank Balance Sheet	Mar. 2021	Apr. 2021	M	M	M		
Consolidated Balance Sheet of the Banking System	Mar. 2021	Apr. 2021	M	M	M		
Interest Rates[2]	March 29, 2021	March 29, 2021	D	D	D		
Consumer Price Index	Mar. 2021	Mar. 2021	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4, 2020	Mar. 2021	Q	Q	Q	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Q4, 2020	Mar. 2021	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar. 2021	Apr. 2021	M	M	Q		
External Current Account Balance	Q4, 2020	Mar. 2021	Q	Q	Q	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	Q4, 2020	Feb. 2021	Q	Q	Q		
GDP/GNP	Q4, 2020	Feb. 2021	Q	Q	Q	O, LO, O, LO	LO, O, LO, LO, O
Gross External Debt	Q4, 2020	Apr. 2021	Q	Q	Q		
International Investment Position[6]	Q4, 2020	Mar. 2021	Q	Q	Q		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

[8] These columns should only be included for countries for which Data ROSC (or a Substantive Update) has been published.

[9] This reflects the assessment provided in the data ROSC or the Substantive Update (published in November 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).

[10] Same as footnote 7, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the Staff Representative on Iceland
June 4, 2021

This statement provides information that has become available since the staff report was issued to the Executive Board on May 14, 2021. The thrust of the staff appraisal remains unchanged.

1. The Central Bank of Iceland (CBI) raised the policy rate. The CBI increased its GDP growth forecast for 2021 from 2.5 percent to 3.1 percent, closer to staff's projection of 3.7 percent but with a smaller and more rapidly closing output gap (by late 2022). The inflation rate accelerated to 4.6 percent in April—above the CBI's notification band—and one-year-ahead inflation expectations rose to 3.1 percent in the May survey—0.6 percentage points above the inflation target. In view of these developments, the CBI raised the policy rate by 25 basis points to 1 percent aiming to keep inflation expectations anchored to the target.

2. Parliament approved an additional fiscal support package for 2021. The package extends the sunset clauses of several existing measures, including closure and resistance subsidies and authorized withdrawal of third-pillar pension savings. It also raises social security and family support benefits and expands the incentives for employment and domestic travel in the form of a new travel gift. The overall impact on the 2021 deficit is projected to be modest—about 0.2 percent of GDP—to a significant degree offset by better than expected revenue in 2021Q1.

Statement by Mr. Jon Sigurgeirsson, Alternate Executive Director to the Executive Director on Iceland
June 4, 2021

On behalf of my Icelandic authorities, I thank staff for the productive discussions in April and the well-balanced Article IV Report. My authorities broadly agree with staff's analysis. Staff considers the policy response of the Icelandic authorities in the wake of the Covid-19 pandemic to have been appropriate and well suited to supporting the economy, reducing economic scarring, boosting confidence, and promoting the functioning of markets.

My authorities achieved their main goal of supporting households and firms during the pandemic through concerted fiscal and monetary policy efforts, as well as by easing macroprudential and regulatory policy in line with EBA guidelines while preserving social, economic, and financial stability. Prior to the Covid-19 pandemic, Iceland had enjoyed a decade of strong economic growth in the aftermath of the 2008 financial crisis. Tourism was the country's fastest-growing industry and had established itself as a main export pillar of the Icelandic economy, together with fishing, the energy-intensive industry, and budding tech sectors.

The Covid-19 crisis is unique in that it brought some economic activities to a virtual standstill and profoundly affected economic activity, owing to necessary restrictions to preserve human life and avoid overburdening health systems. The pandemic-induced collapse of tourism caused Iceland's export revenues to contract by over 25 percent year-on-year in 2020. GDP subsequently contracted by 6.6 percent, after increasing by 2.6 percent in 2019. The current account surplus shrank from of 6.4 percent of GDP in 2019 to 1 percent of GDP in 2020.

Iceland was in a strong position at the onset of the pandemic. A consistent current account surplus since 2009, together with successful completion in 2017 of the liberalization of capital controls imposed during the financial crisis of 2008, had significantly improved the external debt position and enabled the country to build sizeable international reserves.

At the beginning of the Covid-19 pandemic, Iceland's foreign liabilities were at a twenty-year low, its international reserves ample, and its net international investment position (NIIP) positive and at its most favorable level since World War II. Private sector debt was also at its lowest level since the global financial crisis (GFC). Furthermore, sizeable fiscal policy buffers had been accumulated over the last decade, as public debt to GDP had declined by more than 50 percentage points since the GFC, providing ample space for significant fiscal stimulus at the onset of the pandemic. Moreover, as is noted in the report, pension fund assets were equivalent to 203 percent of GDP in 2020, greatly enhancing the resilience of the economy. The domestic economy was therefore well positioned to face deteriorating external conditions.

A modest recovery is projected to take hold in 2021. Staff's baseline envisages growth to resume at 3.7 percent in 2021, with real output still 3 percent below its 2019 level. Output growth is expected to remain below the long-run pre-pandemic trend growth rate in 2024-2026. In the near term, growth will be driven mainly by the ongoing fiscal and monetary stimulus, with domestic demand contributing the most to economic activity, whereas tourism is projected to recover gradually. Given the significant influence of the tourism sector, downside risks to the outlook emanate mainly from a possible resurgence in the pandemic; *inter alia*, due to new virus strains or short-lived vaccine effectiveness.

The recent rise in inflation poses challenges for monetary policy. However, as staff noted, 12-month inflation expectations remain near the target, indicating continued confidence in the monetary policy framework. My authorities broadly agreed with staff's views on the outlook and risks. Although they are slightly less optimistic about GDP growth in 2021, the authorities expect GDP growth to rebound more quickly in 2022 and the tourism sector to recover more rapidly. My authorities are also more optimistic about the medium-term growth prospects.

Fiscal Policy

Fiscal policy has played a key role in mitigating the economic effects of the pandemic. The overriding aim of fiscal policy has been to protect firms and households, particularly those most directly affected by the crisis. By protecting the integrity of the most affected firms, including in tourism, and by providing a significant boost to public investment, fiscal support has played a key role in preserving production capacity and laying the groundwork for a new period of sustainable growth. My authorities agree with staff's assessment that fiscal support has been sizeable and appropriately targeted.

The solid pre-pandemic foundations of public finances and a much-strengthened macroeconomic policy framework since the GFC were instrumental in providing room for such timely and sizable fiscal support. The crisis has clearly demonstrated the importance of the enhanced fiscal framework, developed in part through valuable IMF assistance, which helped to direct and focus political decision-making, while providing valuable transparency and credibility to the medium-term pathway for public finances.

My authorities agree with staff's assessment that a key medium-term target for fiscal policy is to place debt on a downward trajectory again in order to provide room to mitigate any economic and fiscal shocks that the future may hold. They also agree with staff's assessment that the fiscal policy mix should mitigate risks to the recovery and minimize scarring. Given the still ample fiscal space, the path towards debt reduction must thus be dependent on the pace of the recovery.

Monetary Policy

The main priority of monetary policy at the onset of the pandemic was to gauge the appropriate monetary stance to reduce its economic impact. The Monetary Policy Committee (MPC) lowered the Central Bank of Iceland's (CBI) key policy rate by 2.25 percentage points over the course of 2020, to 0.75 percent, and adopted special measures to provide liquidity to the market. Since the start of the pandemic, the Central Bank has intervened in the foreign exchange market in order to calm disorderly developments and reduce volatility in the wake of the decline in export revenues. This included a temporary program of regular, pre-announced currency sales with the objective of deepening the market and improving price formation. All transactions followed the Central Bank's longstanding policy of full transparency. The FX sales program was terminated in April 2021, when greater stability and liquidity had returned to the FX market and clear signs of economic recovery had emerged. Inflation rose to 4.6 percent in April, its highest level since February 2013. As a result, the MPC raised the Bank's policy rate by 0.25 percentage points at its May meeting. Inflation eased to 4.4 percent in May. It is expected to ease further over the course of the year and align with the 2.5 percent inflation target by mid-2022.

My authorities share staff's assessment that the monetary stance has been appropriate, and that further easing would not be justified at this juncture, as is evidenced by the policy rate increase in May.

Financial Supervisory Authority Merged with the Central Bank

At the beginning of 2020, the Central Bank of Iceland and the Financial Supervisory Authority were merged into one institution after a comprehensive review of the statutory framework for monetary policy, macroprudential policy, and financial market supervision. The guiding objective was to enhance trust, transparency, and efficiency in economic management and further improve the implementation of macroprudential policy and financial market supervision. Price stability and the inflation target were retained as the main monetary policy objective. Three committees – a Monetary Policy Committee, a Financial Stability Committee, and a Financial Supervision Committee – are now responsible for policy decisions to promote price stability, financial stability, and sound and secure financial sector activities. The Governor and the Deputy Governors are members of the committees whose functions align with their respective duties. The committees include external members appointed by the Minister.

My authorities agree with staff's assessment that the new structure has worked well and that the merger has strengthened financial and economic oversight. For example, the integration of data and expertise has been demonstrably beneficial during the pandemic, allowing increased oversight, improved analysis, and harmonized responses.

Financial Sector

Iceland’s financial system entered the pandemic in a strong position. Iceland’s three major banks are well capitalized, with capital and leverage ratios among the highest in Europe. Multiple policy levers have been eased since the onset of the pandemic to facilitate the banks’ use of capital in supporting firms and households through the current crisis. The banks proactively provisioned for expected losses by reclassifying all exposures against the tourism sector, which represent about 10 percent of their loan portfolio, yet they managed to remain profitable and improve their capital ratios in 2020.

My authorities agree with staff on the strength of the financial system, and they agree that improvements in banks’ financial position and corporate and household balance sheets since the GFC, coupled with targeted policy measures, helped avoid a sharp rise in bankruptcy during the pandemic. My authorities agree with staff that as fiscal and monetary policy normalize, risks related to greater exposure to interest rate risk and indebtedness must be carefully monitored.

My authorities responded swiftly and decisively in a transparent manner when the country was grey-listed by the Financial Action Task Force (FATF) at year-end 2019. In September 2020, FATF concluded that measures taken by the Icelandic authorities were adequate and subsequently removed Iceland from the grey list.

To conclude, the staff report identifies the key challenges confronting the Icelandic economy. The economy faces new risks, both internal and external. These include challenges in the tourism sector, the duration of the pandemic, and the effects of the pandemic on demand and GDP growth, but also the potential impact on long-term GDP growth and the employment outlook. In the near term, inflation needs to be brought to target, but looking further ahead, prospects for Iceland depend largely on global financial conditions and the strength of the recovery of the global economy and world trade. Some of these challenges are exogenous, while others require long-term policy considerations, including sector-specific economic, structural, and environmental reforms to strengthen long-term growth, resilience, and sustainability.

Iceland is not alone in voicing concerns about trade and protectionism. Any interruption in international trade and long-lasting travel restrictions will pose challenges for a country as globally integrated as Iceland. However, Iceland has retained the flexibility to seek bilateral and multilateral agreements and has opened its borders to vaccinated travelers. Given its reliance on renewable natural resources and its geographical situation in the Arctic region, Iceland is also acutely aware of the importance of appropriate climate-related policies.

My authorities are confident that the necessary levers are in place and that the economy is resilient enough to rebound from the pandemic, take on both short- and long-term challenges, address potential global shocks, and steer the economy towards long-term sustainable growth and stability.