CONCLUDING STATEMENT

Iceland: Staff Concluding Statement of the 2023 Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC: An International Monetary Fund mission, led by Magnus Saxegaard, and comprising Mahir Binici, Jorge Iván Canales Kriljenko, Yen Mooi, conducted discussions for the 2023 Article IV consultation with Iceland during April 25–May 9, 2023. Etienne Yehoue, Financial Sector Assessment Program (FSAP) mission head, joined the concluding meeting. At the conclusion of the visit, the mission issued the following statement:

Iceland has shown remarkable resilience to multiple shocks since 2019. The growth outlook is broadly favorable though accompanied by imbalances and subject to significant risks. These risks include more persistent inflation, tensions around the upcoming wage negotiations, and tighter global financial conditions.

With the economy overheating and inflation well above target, macroeconomic policies need to be tightened, while protecting the most vulnerable. Structural reforms should facilitate diversification, and improve the sustainability and productivity of traditional export industries, including tourism. The upcoming wage negotiations provide an opportunity to better align real wages and productivity growth.

The economy has rebounded quickly from the shocks in recent years, with economic growth in 2022 the fastest since 2007. GDP growth reached 6.4 percent in 2022 on the back of rebounding tourism and strong domestic demand, and higher incomes from an improvement in the terms of trade. The economy is operating well above potential which, together with high import and house prices, has pushed inflation significantly above target, and contributed to external imbalances.

Slowing domestic demand is expected to reduce imbalances, while favorable medium-term growth prospects suggest scarring from the pandemic will be minimal. 2023 growth is projected around 3 percent while inflation is forecast to decline modestly to around 7 percent. The ongoing macroeconomic policy tightening coupled with headwinds from deteriorating terms of trade will dampen domestic demand and reduce imbalances, though private consumption growth is likely to remain robust on a further drawdown of household savings and strong employment growth supported by continued immigration. Over the medium term, exports will be the main growth driver, while continued policy tightening brings domestic demand to sustainable levels. Inflation is projected to moderate as a result of tighter macroeconomic policies and approach the target by end-2025. The current account is projected to gradually strengthen on lower import prices and tighter policies, and revert to a surplus over the medium term.

Risks to growth are tilted to the downside, while risks to inflation are to the upside. Tighter global financial conditions could increase financing costs for Icelandic banks that rely on international capital markets. Monetary policy miscalibration in advanced economies could keep imported inflation high and require further policy tightening. Domestically, risks include further labor market tensions that could disrupt economic activity, and a collective wage bargaining outcome that adds to inflationary pressures. Attacks on Iceland's digital infrastructure could impact financial stability and economic activity, and a disorderly correction in the real estate market could depress domestic demand and stress financial institutions. Implementation of the EU's FIT for 55 package, without adequate adaptations, could affect the cost and availability of flights to Iceland, and adversely affect tourism and other export sectors. Potential upsides for growth stem from breakthroughs in the pharmaceutical industry and other non-traditional industries, and commercialization of climate mitigation technologies.

Macroeconomic Policies: Securing a Safe Landing and Building Resilience

Tighter and well-coordinated policies should aim to steer domestic demand toward sustainable levels and bring inflation close to target, reduce external imbalances, while containing financial stability risks. Structural reforms should facilitate economic diversification, while bolstering the competitiveness and sustainability of traditional export sectors.

Fiscal Policy: Faster Consolidation Warranted

The 1.7 percent deficit for 2023 envisaged in the draft MTFS is appropriate, but faster consolidation in later years is needed to speed up disinflation and rebuild buffers. The 2.4 percentage points of GDP deficit reduction in 2023 in the medium-term fiscal strategy (MTFS) submitted to parliament will help reduce macroeconomic imbalances and contribute to disinflation, thereby supporting monetary policy. If revenues fall short of MTFS estimates, as the revenue forecasts of the IMF mission imply, additional fiscal savings will be needed though care should be taken to protect the most vulnerable from the impact of tighter policies. After 2023, it would be prudent to frontload the fiscal consolidation further by bringing the budget to balance and reinstating the fiscal rules in 2025, one year earlier than envisaged, to signal Iceland's strong commitment to fiscal prudence and rebuild fiscal space to face future shocks. Achieving this will likely require a cumulative 1–2 percent of GDP in additional fiscal savings over the next two years, some of which is already included in the MTFS but not yet enacted. To this end, the authorities should also consider: (i) reversing the 3-6 percent increase in the real spending envelope relative to last year's MTFS; (ii) reducing the number of items subject to reduced VAT rates; and (iii) reviewing other tax expenditures.

Well managed asset-liability management operations could help reduce public debt. Privatization of the remaining shares in Islandsbanki will help increase fiscal buffers but must be completed in a manner that respects the importance of high-quality bank ownership. Ongoing efforts to clarify the government's obligations with respect to the securities issued by the Housing Finance Fund now on the government's balance sheet should take care not to undermine investor confidence in the sovereign's creditworthiness.

Monetary Policy: Staying the Course

The Central Bank of Iceland (CBI) should maintain a tight policy stance until there is clear evidence that inflation will return to, and expectations are re-anchored at, the 2.5 percent target. Achieving this may require that the policy rate be raised further from its current level and that the real policy rate be kept well above the neutral rate for as long as needed to steer inflation back to target, especially in an overheating economy with more persistent and broad-based inflation. Nevertheless, given high uncertainty, the CBI should stand ready to reassess the amount of tightening needed if shocks that significantly alter the inflation outlook materialize.

Maintaining a Robust Financial System

The Financial Sector Assessment Program (FSAP)—an in-depth review of the financial sector—suggests that the sector is resilient, while identifying some vulnerabilities and gaps. The FSAP bank solvency stress tests show adequate levels of capital that can withstand severe but plausible macro-financial shocks. Bank liquidity stress tests also show adequate levels of liquidity but suggest banks' reliance on non-resident FX funding is a potential vulnerability. This vulnerability is attenuated in part by the large domestic institutional investor base with large foreign assets and the comfortable level of international reserves. Financial regulation and supervision are broadly adequate though the framework should be enhanced for pension funds, while for banks national guidance is needed in some risk domains.

The macroprudential stance is broadly appropriate, but the CBI should remain attentive to the materialization of systemic risk. The tightening of borrower-based measures on households and the increase in the counter-cyclical capital buffer have bolstered resilience to a disorderly correction in the housing market and tighter financial conditions. Developments in commercial real estate (CRE) should be carefully monitored given the high sensitivity of CRE firms to interest rate increases, as well as banks' significant exposure to the sector. The authorities should also consider adding to their toolbox temporary risk weight floors or risk weight add-ons on CRE exposures and borrower-based measures for highly leveraged CRE firms. Regulators should stand ready to adjust macroprudential policies if systemic risk materializes.

The FSAP suggests financial resilience could be further bolstered by ensuring that regulatory agencies have adequate powers, resources, and independence.

- The CBI should have full discretion over all prudential banking supervision decisions. Removing Ministry of Finance and Economic Affairs staff from the Financial Supervision Committee would further safeguard the independence of supervisory decisions and avoid potential conflicts of interest. Implementing a formal delegation of authority for supervisory decision-making within the CBI would ensure accountability and enhance operational effectiveness. In addition, adequate legal protection for CBI staff in the exercise of their functions is needed.

- To safeguard the CBI's independence and the effectiveness of financial sector supervision, an independent budgetary process should be developed to ensure the funding needs of banking supervision performed by the CBI are always met. Additional resources are needed to enhance risk-based supervision in some key risk areas including operational risks, cybersecurity, and the oversight of climate-related financial risks.

- The systemically important pension fund sector requires stronger governance and supervision. The legal framework for governance (especially board nominations and oversight) and internal controls of pension funds could be further strengthened. The CBI's pension fund supervisory and sanctioning powers should be expanded. The green paper being prepared by the working group on the pension system represents an opportunity to start the process of addressing these challenges.

Refinements to the crisis management, safety nets, and bank resolution frameworks are warranted. Improvements in systemic liquidity management including the development of a secured repo market could alleviate pressure on the Central Bank for backstopping interventions, including during a crisis. The Deposit Guarantee Fund should be strengthened in line with the International Association of Deposit Insurers Core Principles. Additional resources are needed to enhance the effectiveness of the resolution authority. Implementation of resolution decisions could be facilitated by establishing a coordination body involving the Ministry of Finance and Economic Affairs, while preserving the independence of the resolution authority. Development of alternative domestic retail payment solutions would alleviate financial stress in the event of a payment system disruption.

Structural Policies: The Time is Now

Progress on structural reforms understandably slowed during the pandemic but should now pick up pace. While past efforts to promote new industries are starting to yield results, further efforts to ease the regulatory burden and increase competition remain crucial for diversifying the economy. Nevertheless, Iceland's size limits the number of industries that can realistically flourish. Reforms to improve the productivity and sustainability of traditional export sectors where Iceland has a natural advantage should therefore proceed alongside efforts to diversify the economy. In the tourism industry, for example, the authorities are appropriately focusing on maximizing value added per tourist in a sustainable manner that protects Iceland's natural resources and limits other negative spillovers to the local population.

Achieving Iceland's ambitious climate agenda will require additional policy effort. The authorities have implemented broad measures to reduce emissions. Iceland has also made impressive technological advances in carbon capture and storage and the development of clean energy fuels, and is at the forefront of electric vehicle adoption. However, with emission cuts falling short of targets, the upcoming update to the Climate Action Plan is an opportunity to adopt policies to accelerate the transition to a low-carbon economy. These could include gradually raising the level of carbon taxes in the economy.

The upcoming collective bargaining round provides an opportunity to better align wages and productivity growth. The wage bargaining agreements in Iceland have been successful at promoting inclusiveness and reducing poverty but less effective at ensuring that wage increases do not put upward pressure on inflation nor undermine competitiveness. To better align real wages with productivity growth, the wage negotiations later this year should revisit the design of the GDP per capita bonus (*hagvaxtarauki*) implemented in the 2019–22 agreement, including by linking the bonus to the improvement in labor productivity relative to the start of the agreement. In addition, mechanisms to resolve protracted impasses should be strengthened, including by ensuring that the state mediator is able to bring negotiating parties together and make proposals to resolve disagreements.

The IMF team thanks the authorities and other interlocutors for their generous hospitality and constructive dialogue.

Table 1. Iceland: Selected Economic Indicators, 2017–28

	2017	2018	2019	2020	2021	2022 Prel.	2023 Proj.	2024 Proj.	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.
	(Percentage change unless otherwise indicated)											
National Accounts (constant prices)												
Gross domestic product	4.2	4.9	1.8	-7.2	4.3	6.4	3.2	1.9	2.1	2.1	2.1	2.2
Total domestic demand	7.6	4.5	0.5	-1.1	6.3	6.4	1.2	0.9	1.1	1.2	1.4	1.6
Private consumption	8.0	4.8	1.7	-3.4	7.0	8.6	1.8	0.9	1.1	1.2	1.5	1.7
Public consumption	2.9	4.7	3.9	5.1	2.4	1.6	0.8	1.0	1.0	1.0	1.0	1.0
Gross fixed investment	10.6	2.3	-4.1	-7.4	9.8	6.9	2.6	1.6	1.6	1.6	1.7	1.8
Net exports (contribution to growth)	-2.9	0.7	1.5	-6.1	-2.1	-0.2	1.6	1.0	1.0	0.9	0.7	0.7
Exports of goods and services	5.1	0.4	-5.5	-31.1	14.7	20.6	5.8	3.0	3.6	3.4	3.2	3.2
Imports of goods and services	11.8	-0.9	-9.1	-20.6	19.9	19.7	2.0	0.7	1.4	1.5	1.7	1.9
Output gap (percent of potential output)	1.5	3.6	3.5	-5.2	-2.5	0.9	1.5	0.9	0.6	0.3	0.1	0.0
Selected Indicators												
Gross domestic product (ISK bn.)	2,642	2,844	3,024	2,919	3,245	3,766	4,117	4,353	4,603	4,843	5,103	5,384
Gross domestic product ($ bn.)	24.7	26.3	24.7	21.6	25.6	27.8	29.1	31.4	33.9	36.4	39.1	42.0
GDP per capita ($ thousands)	73.1	75.4	69.1	59.2	69.3	74.0	75.2	81.6	87.1	92.4	98.3	104.5
Private consumption (percent of GDP)	50.1	50.3	50.2	52.0	52.0	52.2	52.8	52.7	52.3	51.6	50.9	50.3
Public consumption (percent of GDP)	23.7	24.1	24.6	28.1	27.6	25.9	24.6	24.3	24.4	24.8	25.1	25.4
Gross fixed investment (percent of GDP)	21.8	21.8	20.9	21.3	22.2	22.4	22.9	23.0	23.0	22.9	22.6	22.5
Gross national saving (percent of GDP)	26.0	26.4	27.2	22.3	20.0	21.1	21.5	21.7	22.3	22.8	23.3	23.7
Unemployment rate (percent of labor force)	3.3	3.1	3.9	6.4	6.0	3.8	3.3	3.6	3.7	3.8	3.9	4.0
Employment	1.0	1.8	0.9	-3.0	3.6	6.9	2.6	1.3	1.5	1.5	1.5	1.6
Labor productivity	3.8	2.6	1.6	-1.9	1.6	0.3	0.6	0.6	0.6	0.6	0.6	0.6
Real wages	7.2	3.7	1.8	3.4	3.7	0.0	0.6	0.6	0.6	0.6	0.6	0.6
Nominal wages	9.1	6.5	4.9	6.3	8.3	8.3	9.3	5.2	4.2	3.2	3.1	3.1
Consumer price index (average)	1.8	2.7	3.0	2.8	4.5	8.3	8.7	4.6	3.6	2.6	2.5	2.5
Consumer price index (end period)	1.9	3.7	2.0	3.6	5.1	9.6	7.4	4.0	3.0	2.5	2.5	2.5
Core CPI (average)	2.0	2.4	2.9	3.0	4.3	7.6	8.5	4.6	3.6	2.6	2.5	2.5
ISK/€ (average)	121	128	141	157	148	159	...	...	...	...	...	...
ISK/$ (average)	107	108	123	135	127	135	...	...	...	...	...	...
Terms of trade (average)	1.5	-3.8	-0.8	-1.3	3.8	3.0	-2.9	-1.6	-1.1	-0.9	-0.1	-0.1
Money and Credit (end period)												
Base money (M0)	37.9	-1.7	-9.2	11.8	9.0	1.5	9.3	9.9	8.8	7.4	6.9	6.6
Broad money (M3)	5.0	7.0	6.6	7.4	10.9	8.9	10.8	8.3	7.6	6.5	6.3	6.2
Credit to nonfinancial private sector	9.2	11.9	2.9	10.5	10.5	11.2	9.3	5.7	5.2	5.2	5.4	5.5
Central bank 7 day term deposit rate 1/	4.25	4.50	3.00	0.75	2.00	6.00	7.50	...	...	...	...	...
	(Percent of GDP unless otherwise indicated)											
General Government Finances 2/												
Revenue	45.4	44.8	42.1	42.2	41.4	41.8	42.8	42.8	42.4	42.0	41.4	41.3
Expenditure	44.4	43.8	43.6	51.2	49.8	46.1	45.5	45.7	45.0	43.6	43.3	43.3
Overall balance	1.0	0.9	-1.5	-9.0	-8.4	-4.3	-2.7	-2.9	-2.5	-1.7	-1.9	-1.9
Structural primary balance 3/	1.9	0.5	-2.0	-0.8	-1.5	-3.1	-1.4	-1.8	-1.2	0.0	0.0	0.2
Cyclically-adjusted primary balance	3.2	1.3	-1.3	-3.9	-5.1	-2.5	-0.8	-1.5	-0.9	0.1	0.1	0.2
Gross debt	71.7	63.2	66.6	77.8	75.6	68.7	65.1	61.2	60.0	58.2	56.5	55.2
Net debt	60.3	50.7	54.4	61.1	60.4	57.1	54.4	51.1	50.5	49.1	47.9	47.0
Balance of Payments												
Current account balance	4.2	4.3	6.5	1.0	-2.4	-1.5	-1.6	-1.3	-0.7	-0.1	0.6	1.2
of which: services balance	10.6	9.0	8.0	1.4	2.3	5.0	7.0	7.3	7.4	7.5	7.5	7.5
Capital and financial account (+ = outflow)	1.1	6.0	6.1	6.1	0.8	-2.4	-1.7	-1.5	-0.8	-0.2	0.5	1.1
of which: direct investment, net (+ = outflow)	-0.7	1.7	2.9	2.3	-0.7	-2.9	-0.8	-1.1	-1.0	-0.9	-0.9	-0.8
Gross external debt	90.3	73.3	78.4	90.4	82.8	75.2	75.2	69.3	64.1	59.6	55.4	51.5
Central bank reserves ($ bn)	6.6	6.1	6.7	6.4	7.1	5.9	6.0	6.3	6.4	6.6	7.0	7.6

Memorandum Items:

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

1/ For 2023, 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.

3/ Cyclically-adjusted balance excluding one offs.