



ICELAND

2022 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

June 2022

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 2022 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis following discussions that ended on May 11, 2022, 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 June 3, 2022.
- An **Informational Annex** prepared by the IMF staff.

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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>
Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.



ICELAND

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

June 3, 2022

KEY ISSUES

Iceland's economy has weathered multiple shocks since 2019 relatively well. The economic outlook is positive but suggests long-term scarring. The risks are tilted to the downside and are associated with the global impact of a potential escalation in the war in Ukraine, the pandemic, economic disruptions, and tighter global financial conditions. On the upside, tourism and new innovative industries could help the economy recover faster.

Careful policy coordination is required to entrench the recovery, stem risks and rebuild buffers to pre-pandemic levels. Policies should mitigate the flaring-up in inflation, external imbalances, and house prices. Structural reforms should facilitate economic diversification and make the economy more resilient to shocks.

- **Fiscal policy.** The planned fiscal consolidation aims to restore fiscal buffers and reactivate the existing fiscal rules. Contingency margins are appropriately planned and should be used in a targeted manner if downside risks materialize, while potential windfall revenues should be saved. The fiscal framework has served Iceland well, and its integrity should be preserved.
- **Monetary policy.** The tightening cycle in monetary policy should steer inflation expectations back toward the target. It needs go along with tighter systemic liquidity management. The policy rate will also help address housing price pressures, which feed directly into inflation.
- **Housing policies.** Further macroprudential tightening through binding and effective debt service-to-income caps is needed to contain growing housing risks. Housing affordability should also be a priority and should be addressed with structural measures increasing housing supply and better targeted fiscal incentives to low-income households.
- **Macro-structural policies.** Diversification efforts should focus on easing regulatory burdens on start-ups and spurring innovation by leveraging Iceland's human capital and advanced digital infrastructure. The new collective wage agreement can also foster diversification and resilience through better alignment of wage and productivity growth. Achieving Iceland's climate goals requires well-balanced fiscal incentives and environmental trade-offs in expanding renewable energy capacities.

Approved By
**Laura Papi (EUR) and
 Guillaume Chabert
 (SPR)**

The mission took place in Reykjavik during April 28–May 11, 2022. The team comprised Iva Petrova (head), Mahir Binici, Jorge Iván Canales Kriljenko, and Nujin Suphaphiphat (all EUR). The mission met with Prime Minister Katrín Jakobsdóttir, CBI Governor Ásgeir Jónsson, Minister of Finance Bjarni Benediktsson, and other representatives of the public and private sector. Guðrún Ögmundsdóttir (OED) joined the discussions. Kelly Gao, Indra Mahadewa, and Rachelle Vega (EUR) supported the mission.

CONTENTS

CONTEXT	4
THE ECONOMIC AFTERMATH OF THE PANDEMIC	5
OUTLOOK AND RISKS	8
A. Moderate Growth with Significant Inflationary Pressures	8
B. Elevated Uncertainty from Diverse Sources of Risk	9
MACROECONOMIC POLICIES: MANEUVERING A SAFE TAKEOFF IN STORMY WEATHER	10
A. Restoring Fiscal Buffers while Retaining Targeted Support	10
B. Guiding Inflation Expectations Back to Target	13
C. Preserving Financial Stability	14
D. Fostering Economic Diversification and Innovation	19
STAFF APPRAISAL	23
FIGURES	
1. Key Macroeconomic Developments	25
2. COVID-19 Developments	26
3. Tourism Developments	27
4. Labor Developments	28
5. Fiscal Developments and Issues	29
6. Inflation and Monetary Developments	30
7. External Sector Developments	31
8. Banking Sector Developments	32
9. Housing Market Developments	33
TABLES	
1. Selected Economic Indicators, 2016–27	34
2. Money and Banking, 2016–27	35

3. Financial Soundness Indicators, 2018Q1–2021Q4	36
4. General Government Operations, 2016–27	37
5. General Government Financial Balance Sheet, 2016–27	38
6. Balance of Payments, 2016–27	39
7. International Investment Position, 2011–21	40

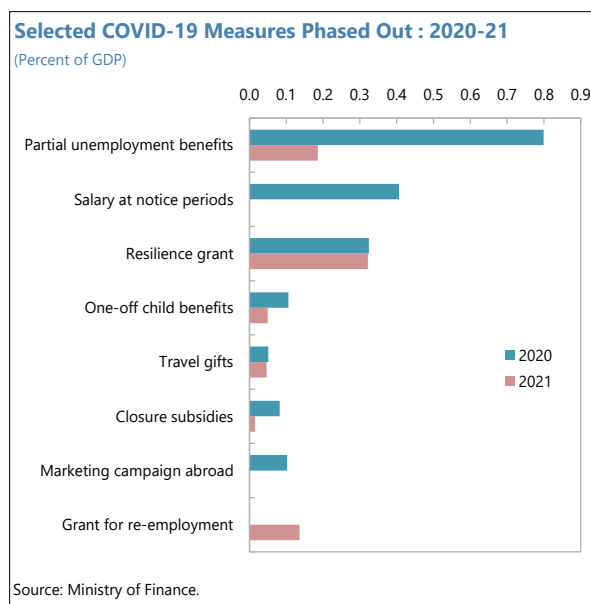
ANNEXES

I. External Sector Assessment	41
II. Iceland's Pension Funds' Assets	43
III. Risk Assessment Matrix	49
IV. Public Sector Debt Sustainability Analysis	51
V. External Debt Sustainability Analysis	60
VI. Islandsbanki's Privatization	63
VII. The Role of Collective Bargaining in Fostering Macroeconomic Resilience	66

CONTEXT

1. Iceland has weathered the challenges of the pandemic relatively well. The country experienced one of the lowest fatality rates among advanced economies due to an effective strategy that included vaccination, testing, isolating and periodic restrictions on social interaction (Figure 1). However, the pandemic paralyzed the tourism sector—the engine of growth since 2012—and left it significantly underperforming its pre-pandemic levels. A range of monetary, fiscal, and macroprudential measures eased the burden on households and the most affected sectors of the economy.

2. The recovery has alleviated the need for policy stimulus. Confidence in the effectiveness of vaccines contributed to a gradual normalization of activity, including tourism, despite recurrent and increasingly large infection waves. With the resumption of GDP growth, receding unemployment, and rising inflation, the need for policy support rapidly declined in 2021.



3. However, the war in Ukraine has worsened the global economic environment and slowed the growth momentum. Rising prices of energy, commodities, and food, as well as significant supply chain disruptions—including due to the war in Ukraine and related sanctions on Russia and Belarus—are likely to have a profound impact on the global economic outlook.¹ While the impact on Iceland is contained due to low direct exposures and high reliance on renewable energy, the country will face slower trading partner growth and higher import prices. Although smaller than their pre-pandemic levels, Iceland's buffers remain significant. With net general government debt of 60 percent of GDP, net international reserves (NIR) of 29 percent of GDP, and solid capitalization of the banking system, the Icelandic economy remains well positioned to handle a negative shock.

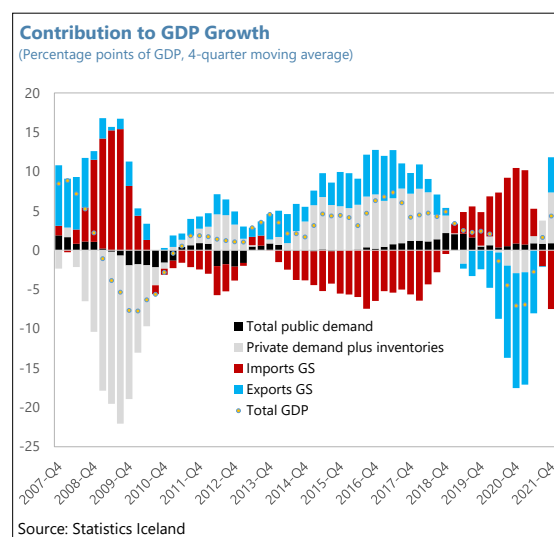
4. The three-party coalition led by PM Katrin Jakobsdóttir commenced a second term after the September 2021 parliamentary elections. Partly a recognition of the good handling of the pandemic, and with larger parliamentary representation, the three-party coalition was successfully reinstated in power. The government's policy priorities include maintaining macroeconomic and financial stability, further strengthening health services, increasing support for old-age, disability, and housing, and meeting Iceland's ambitious climate change commitments.

¹ With a regulation under the Act on the Implementation of International Sanctions No. 93/2008, Iceland adopted into law the five EU sanction packages imposed on Russia and Belarus following Russia's invasion of Ukraine. The impact of the sanctions on the global economy was discussed in the April 2022 World Economic Outlook.

5. Implementation of the 2021 Article IV recommendations has been mixed. The CBI reduced its presence in the foreign exchange market and facilities for unconventional monetary policies were largely untapped and tightened macroprudential policies. Parliament completed the foreign exchange legislation reform. Plans for divestiture of bank state ownership need to be further strengthened to ensure quality ownership. Efforts to provide legal protection to supervisors need to come to fruition and the uncertainty about the legal status of flexible rate loans needs to be resolved.

THE ECONOMIC AFTERMATH OF THE PANDEMIC

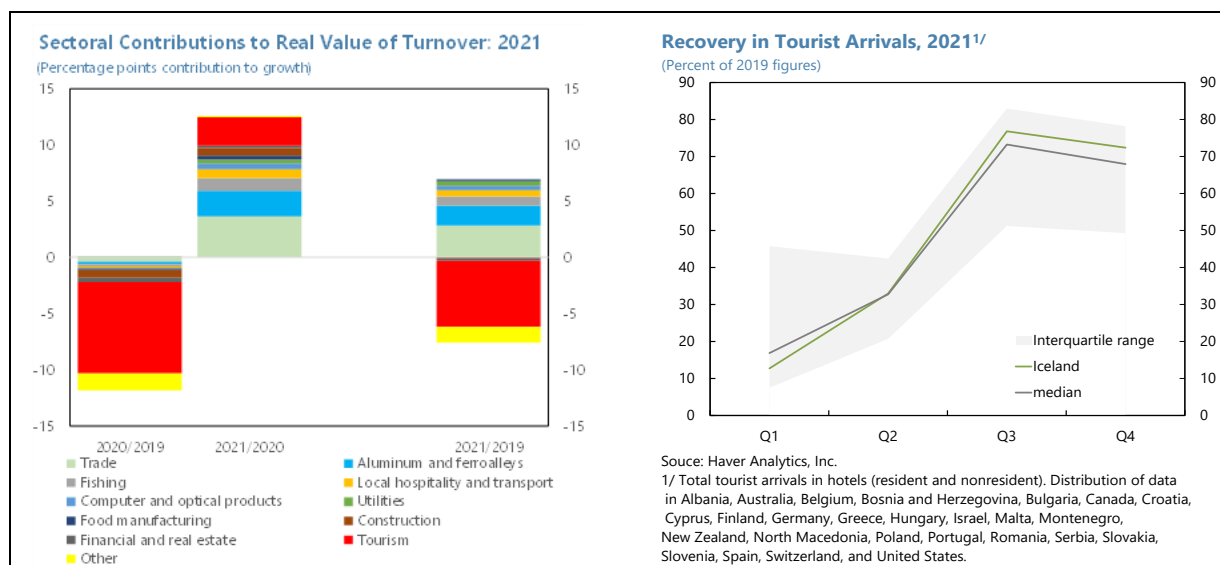
6. Real GDP growth of 4.3 percent in 2021 was driven by strong domestic demand. Economic activity bottomed in the first quarter of 2021, and despite recovering, the annual real GDP remained 3 percent below its 2019 level (Figure 2). Private demand exceeded its 2019 level by 4.5 percent, but real imports of goods and services also picked up, while exports recovered slowly. Investment recovered across main categories except residential construction. Slow recovery in tourism suppressed potential output, and the output gap—on average negative in 2021—swung to positive in 2021H2.



7. Turnover data show some recovery in traditional exports and green shoots in new sectors. In 2021, tourism turnover recovered to about half its 2019 level (slightly less than in other countries) and remained around that level in early 2022. Foreign tourist arrivals were lower—at about 35 percent of the 2019 levels—but tourists stayed longer and spent more during the year (Figure 3). Manufacturing of high-end computer and optical products also experienced substantial growth. The large turnover growth in aluminum exports reflects mainly favorable external prices.

8. With the recovery taking hold, labor market slack diminished. Rising demand for labor spurred labor force participation (LFP) and net immigration, with labor force growing by 3 percent (y/y) in 2021 (Figure 4). Employment grew by 3.8 percent y/y by year end—about 0.5 percent above its end-2019 level.² Unemployment fell to near 2019 levels. Nominal hourly wages grew by more than 8 percent on average in 2021, exceeding their 2019 level by 15 percent. The high wage growth reflects strong labor demand and the 2019 collective agreement that linked wages to positive historical GDP growth.

² However, national accounts data shows that hours worked were about 6 percent below their 2019 level.

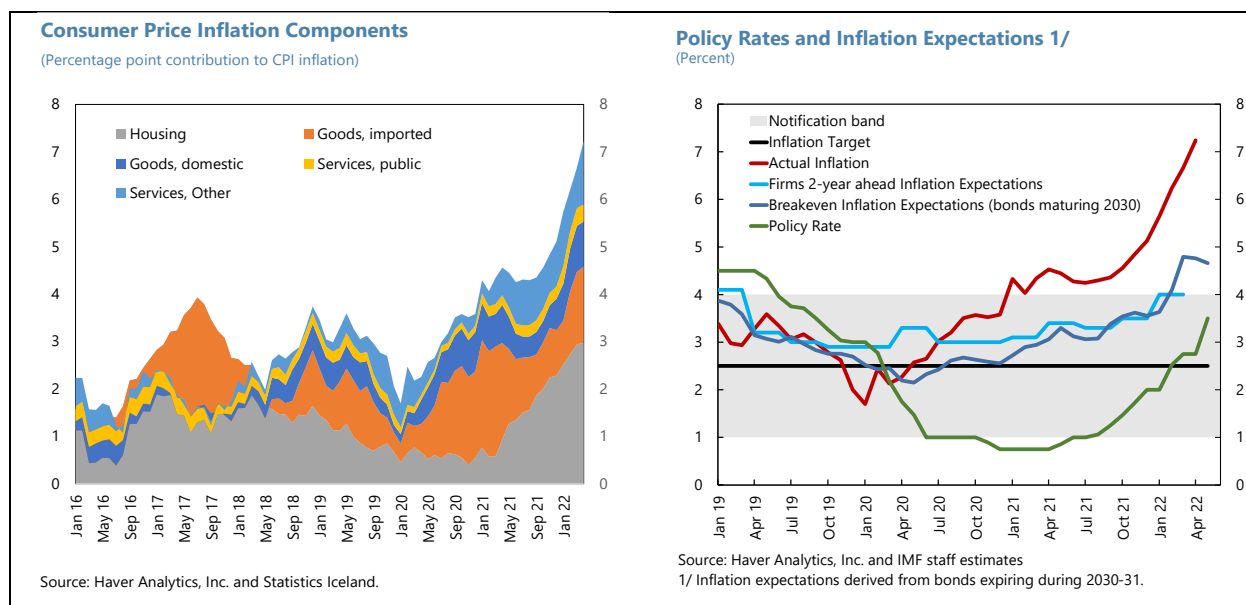


9. The fiscal outcome was better than projected. The 2021 general government deficit, at 8.9 percent of GDP, was 0.2 percent lower than envisaged in the 2021 Article IV consultation (Figure 5). The relatively mild impact of the pandemic on economic activity during most of the year resulted in lower transfers.³ Expiring support measures were partly offset by stronger government consumption and active labor market policies, including hiring incentives. Public debt growth moderated due to a favorable growth-interest dynamic and the partial privatization of Islandsbanki, with net debt ending 7 percentage points of GDP lower than envisaged, at 59.9 percent of GDP.

10. Rising inflation expectations prompted policy rate hikes (Figure 6). Inflation was above the CBI's 1–4 percent notification band throughout 2021 and exceeded 7 percent in early 2022.⁴ With domestic inflation in the lead, core inflation traced headline closely. The effect of currency appreciation was largely offset by rapidly rising housing prices and their effect on imputed rents. Strong domestic demand, rising housing costs and global energy and food prices fueled inflation and inflation expectations. The CBI raised policy rates 6 times by a total of 300 basis points between April 2021 and May 2022, reversing most of the 3.8 percentage point reduction in nominal policy rates since the easing cycle started in May 2019 (following the collapse of domestic airline WowAir). Bank lending interest rates and bond yields have moved roughly in the direction of policy rates. Despite the higher inflation, by March 2022 real M1 balances remained 45 percent above their March 2019 levels.

³ Some fiscal measures were reactivated or extended in 2022 due to the spread of the Omicron variant.

⁴ The CBI has an inflation target, with price stability defined as a twelve-month inflation rate of 2½ percent. If the inflation rate deviates by more than 1½ percentage points from the inflation target, the CBI must submit a public report to the Government, explaining the reasons for the deviation and the means by which it intends to bring inflation back to target.



11. The current account balance recorded a large deficit in 2021. Sharp deterioration in the merchandise balance and weak service and primary income balances led to a current account deficit of 2.8 percent of GDP in 2021, reversing a decade-long trend of persistent surpluses (Figure 7). Staff assesses Iceland's external position as weaker than the level implied by fundamentals and desirable policies (Annex I). The króna fluctuated during the year but appreciated on average by 6 percent in nominal (4 percent in real) terms in 2021.

12. The banking system has remained resilient so far. Banks' capital and liquidity ratios are well above regulatory minima. Their profitability improved reflecting lower required provisions, increase in fees and commissions, and a declining cost-to-asset ratio (Figure 8). Non-performing loans were contained due to the economic recovery, although many tourism loans were placed under forbearance at the expiration of the loan deferral program in September 2020. Bank credit increased reflecting a 25-percent rise in household mortgages, while businesses continued deleveraging.

13. Pension funds' assets reached 208 percent of GDP by end-2021, benefiting from high returns on domestic and external investments (Annex II). Pension funds hold 18 percent of the mortgage market, 25 percent of bank shares, and are a major source of financing for non-financial corporates. They are also key players in the FX market, with foreign exchange exposures reaching 75 percent of GDP.

14. The authorities tightened macroprudential measures. On the back of increasing household debt and house prices, the CBI introduced a debt-service-to-income (DSTI) limit of 35 percent (40 percent for first-time buyers). The loan-to-value ratio (LTV) for consumer mortgages was lowered from 85 percent to 80 percent (keeping at 90 percent for first-time buyers), and the countercyclical capital buffer (CCyB) was raised from 0 to 2 percent.

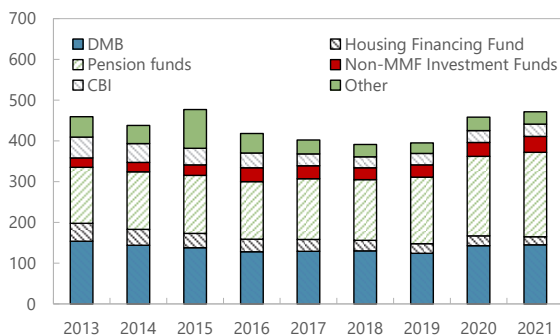
Financial System Developments

The financial system continued to expand

...with pension funds' assets exceeding 200 percent of GDP.

Financial System Assets

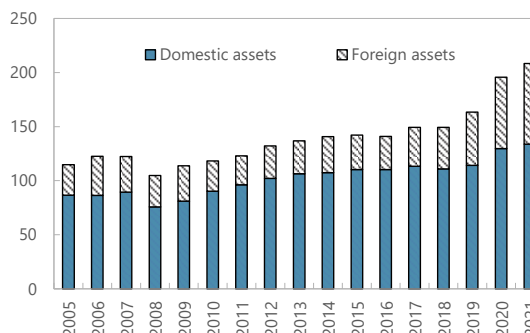
(% of GDP)



Source: CBI and Staff calculations.

Pension Funds' Assets

(% of GDP)



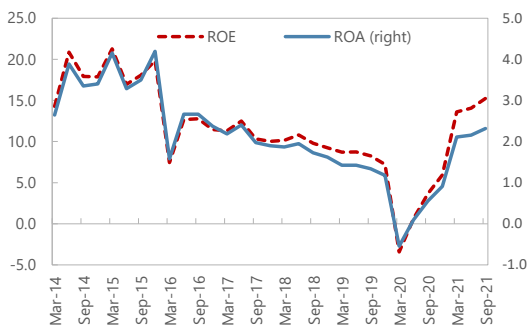
Sources: Statistics Iceland, CBI, Staff calculations.

Banks' profitability improved...

...as household mortgages took a larger share of their portfolio.

Bank Profitability- ROA and ROE

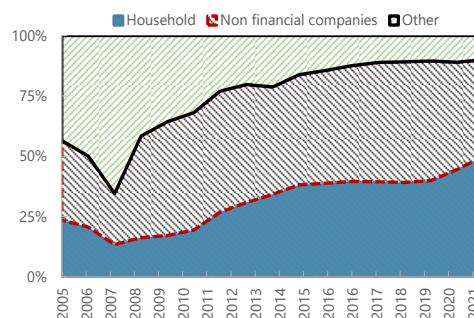
(%)



Source: IMF FSI and Staff calculations.

Household and Corporate Loans

(Percent of total)



Sources: CBI and IMF Staff Calculations

OUTLOOK AND RISKS

A. Moderate Growth with Significant Inflationary Pressures

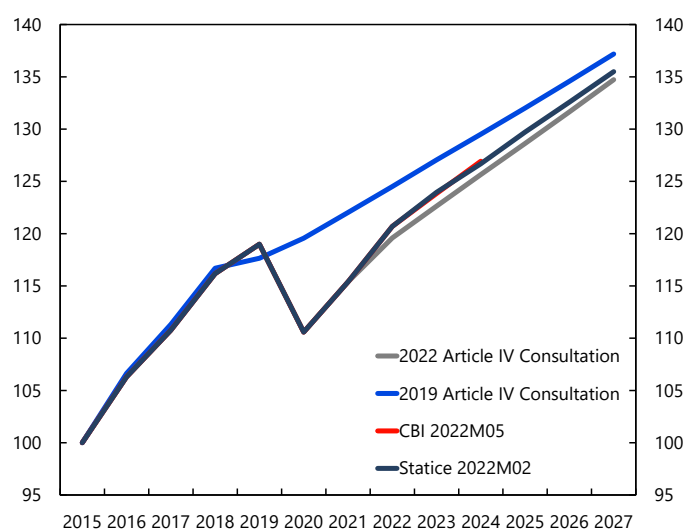
15. Growth in 2022 is likely to be affected by the global impact of the war in Ukraine.

Iceland's direct external trade exposure to Ukraine and Russia is relatively small (under 0.9 percent of GDP) and most of its electricity and heating consumption are from domestic renewable sources. Nonetheless, the country will face an environment of lower external demand, supply chain disruptions, and higher foreign inflation. With strong momentum, the tourism recovery is expected to provide significant growth support in the near term, but higher energy prices and slower external demand are projected to dampen the pickup later in the year. GDP growth will be partly driven by domestic

demand— despite some drag from the ongoing fiscal consolidation—and to a lower degree by net exports and is projected to reach 3.6 percent, with the war in Ukraine estimated to have a negative impact of about $\frac{3}{4}$ percentage points. Inflation is expected to continue to accelerate to 7.4 percent in 2022, driven by the tightening slack in the economy and import prices but moderated by the CBI's ongoing tightening cycle. The output gap is projected to be positive in 2022. Higher aluminum and fish prices are expected to more than offset the higher oil bill used in the fishing fleet and land transportation. With terms of trade further improving, Iceland's current account is projected to swing to a small surplus.

Growth Forecasts: 2015-27

(Percentage change, Y/Y)



16. Growth will likely remain moderate over the medium term, with the output gap gradually closing over the forecast horizon. With average growth of 2.4 percent, real GDP is projected to remain about 2 percent below its pre-COVID trend by 2027, mainly due to the pandemic. Inflation—albeit persistent—is projected to gradually fall back to target by 2025, steered by the ongoing monetary policy tightening. Private consumption growth is expected to moderate with the tightening of monetary, fiscal, and macroprudential policies. Over the medium term, the export-oriented—tourism, marine, and aluminum—sectors are expected to be the main sources of growth. The emergence of nontraditional exports like data processing, film production, computer programming, and intellectual revenue from innovation in pharmaceutical products is expected to continue contributing to diversification. The authorities' efforts in promoting innovation are also expected to yield fruit in these and other sectors. The current account is projected to remain in surplus in the medium term as tourism continues to recover.

B. Elevated Uncertainty from Diverse Sources of Risk

17. Risks to the recovery arise from the ongoing pandemic, potential escalation of the war in Ukraine, economic disruptions, and natural disasters (Annex III). A potential escalation of the war in Ukraine could further dampen confidence and the global outlook, leading to lower demand from trading partners, significant commodity price shocks and inflationary pressures. The evolution of the pandemic remains a risk to the tourism sector, including from possible new highly contagious and/or lethal variants. Tightening global financial conditions could cause exchange rate depreciation and higher risk premium on Icelandic debt. Natural disasters, particularly due to volcanic activity in Iceland and global warming, could cause economic damage and require government support. Iceland's public and external debt are sustainable and well placed to face a range of shocks (Annex IV and V). Among domestic risks, a potential impasse in the negotiations for a new collective bargaining agreement—due to be completed in November 2022—could result in labor market tensions and

economic dislocation. An agreement with high wage growth inconsistent with lowering inflation back to target can result in a persistent rise in inflation and a sharp monetary policy reaction that slows down economic activity. Upside risks are also possible, with tourism recovering faster than expected.

18. The authorities broadly agreed with staff's views but were slightly more optimistic about the growth outlook in 2022 and over the medium term. They noted that the initial impact of the war in Ukraine appears to be relatively mild and that prospects for tourism recovery over the summer appeared very encouraging. They noted that the terms of trade had improved with the increase in aluminum and seafood prices, offsetting the effect of higher commodity prices. While recognizing that the uncertainty was high, the authorities viewed risks for real activity as being balanced. Among domestic risks, they noted that contentious wage bargaining negotiations could slow the recovery, if wage increases do not align with the inflation target and productivity growth.

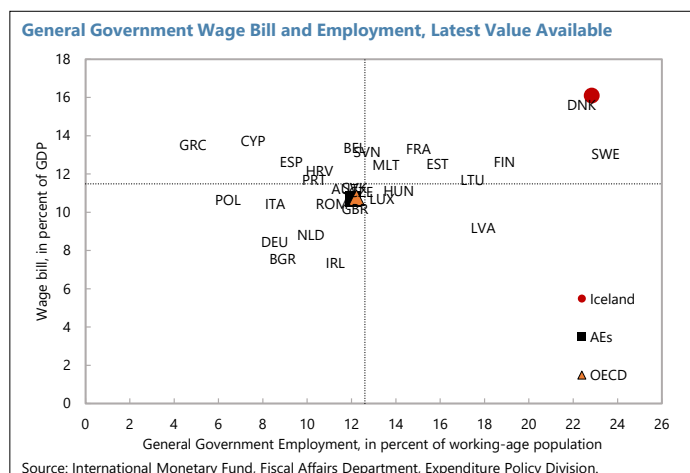
MACROECONOMIC POLICIES: MANEUVERING A SAFE TAKEOFF IN STORMY WEATHER

19. Discussions focused on the appropriate policy mix for achieving sustainable growth amidst a highly uncertain global environment. Close coordination across policies and a careful policy mix are required to entrench the economic recovery, while steering inflation to target and mitigating external imbalances and financial stability concerns. Deploying Iceland's fiscal buffers has helped support the economy since 2019; rebuilding them, while protecting the most vulnerable, is crucial given the country's frequent exposure to large shocks. Structural reforms should facilitate economic diversification and resilience.

A. Restoring Fiscal Buffers while Retaining Targeted Support

20. The contractionary fiscal stance in 2022 will appropriately contribute to lowering inflation and start the process of rebuilding fiscal buffers. The planned 4-percentage point of GDP reduction in the overall fiscal balance largely reflects the expiration of support measures and associated lower social benefits. The 2022 budget still contains some 2 percent of GDP in support measures, including a continuation of the investment campaign, further contributions to health care, and continued vaccine deployment. A supplementary budget also extended some targeted subsidies for firms affected by constraints arising from the spread of the Omicron variant. Beyond the unwinding of fiscal support, the budget envisages a reduction in spending on goods and services from its high levels during 2020 and 2021. The cyclically adjusted primary balance (CAPB) is thus envisaged to improve by 4 percentage points of GDP, imparting a slowdown on domestic demand through public consumption. Nonetheless, the 2022 budgeted spending contains a contingency buffer of 1 percent of GDP, which should provide support in case downside risks materialize by allowing automatic stabilizers to operate and, if necessary, reactivating targeted support measures. In this context, in May 2022, the government raised social security, child, and housing benefits to protect the vulnerable population from the effects of rising inflation.

21. The authorities' planned further consolidation will continue to support macro-stabilization over the medium term. Amidst a positive output gap, a tightening fiscal stance would help bring inflation back to target and rebuild fiscal buffers, which are crucial given Iceland's exposure to large shocks.⁵ The authorities' 2023–2027 medium-term fiscal strategy envisages that a 4-percentage point of GDP reduction in the overall deficit will be achieved with about 3 percent of GDP in fiscal measures. Staff considers that the planned fiscal path is both appropriate and feasible but would require additional measures of about 0.7–1 percent of GDP. Fiscal savings could be secured by streamlining VAT expenditures, public consumption, and the transfer system and completing the ongoing spending reviews. Iceland's public wage bill is substantially larger than the average in advanced economies and could be a source of savings. Recognizing the large uncertainty surrounding the medium-term macroeconomic outlook, the government should also follow through on its commitment to saving any fiscal revenues above the expected in the budget.⁶



22. Iceland's fiscal framework has performed well during the pandemic.⁷ Regular and rigorous medium-term fiscal planning has focused policy discussions on economic priorities, while preserving the principles of fiscal sustainability, prudence, stability, predictability, and transparency. The activation of the escape clause allowed the authorities to provide substantial fiscal policy support (3.4 percent of GDP per year in 2020–21) and protect the most affected households and firms. With net general government debt projected by staff to decline by 17 percentage points of GDP from its peak in 2020, and the overall fiscal position projected to approach a balance by 2027, the existing fiscal rules could be reactivated in 2026. The authorities have announced an intention to thoroughly reassess the adequacy of the existing rules in the next few years and have already excluded government credit funds from the definition of government for which the fiscal rules apply.⁸ The

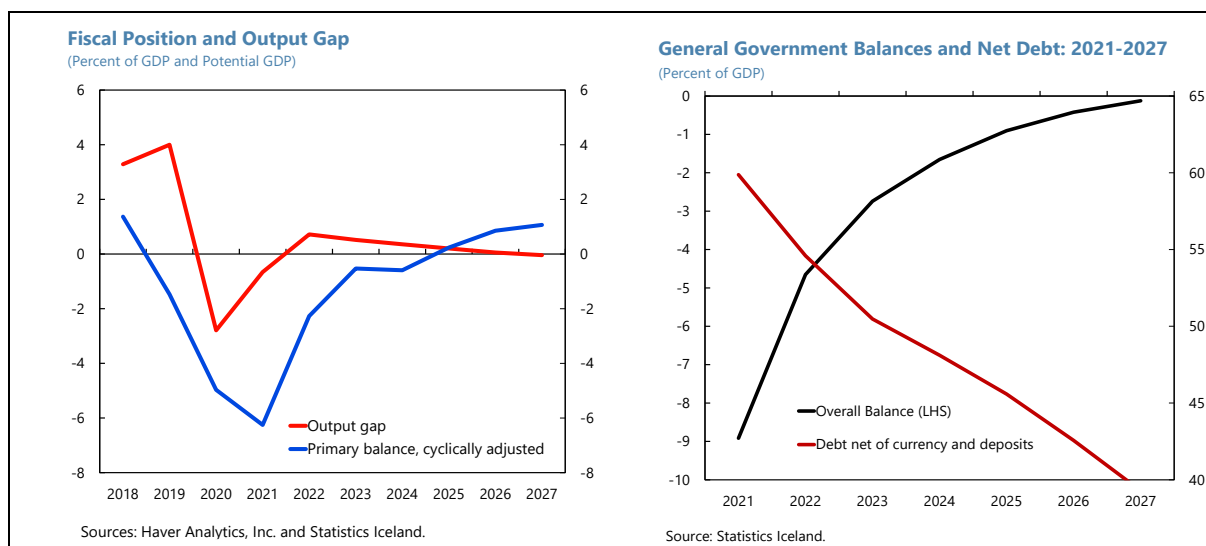
⁵ See IMF 2019, "Scope for Improving Iceland's Fiscal Framework", Selected Issues Paper, Country Report 19/376.

⁶ Each new administration is required to submit a medium-term fiscal policy statement, which is approved by parliament. The 2022–2026 fiscal policy statement introduced increasing margins of uncertainty around the fiscal deficit that could be reached should actual GDP growth deviate substantially from projected. This also avoids the need for parliamentary approval of a new fiscal policy statement if the outlook deteriorates, although parliament still needs to approve a new medium-term fiscal strategy and budget every year.

⁷ The fiscal rules require 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 WowAir. At the start of the pandemic in 2020, parliament passed legislation to extend the suspension through 2025.

⁸ Parliament approved taking government credit funds, most notably IL Fund (formerly HFF), out of the definition of government subject to fiscal rules on the basis that the value of credit funds depends on market developments making their impact on public sector performance unpredictable. Although in principle the value of public credit funds could add noise to the measurement of the fiscal stance, the net present value loss of the IL Fund is already part of the debt obligations of the Treasury and should be considered as such in the debt sustainability analysis and factored into the overall framework for policy decision under the fiscal rules. (See IMF Country Report No. 21/106).

holistic approach of the organic budget law—covering the deficit and debt of the entire general government, which has been key to containing fiscal risks and building buffers and resilience in government finances in the last decade, should be preserved. The use of the margins of uncertainty has proven useful during the crisis, but a formal process for their implementation needs to be established. The authorities should also complete the strengthening of the Fiscal Council and its powers to assess fiscal policy independently and objectively.



23. Despite sizeable fiscal deficits, general government debt is set to decline to precrisis levels over the medium term. The proceeds of the recent sale of 22.5 percent of Islandsbanki's equity share (1.4 percent of GDP) will be used to meet some of the government funding needs in 2022 (Annex VI). Under the medium-term fiscal plan, government debt is sustainable (Annex IV), resilient to shocks, and projected to be 14 percentage points of GDP lower in 2027 than its 2019 level. The medium-term margins of uncertainty add two-way flexibility to the debt level envisaged in the baseline but within the range of the standard DSA shocks. With the normalization of economic activity, the average maturity of public debt securities has increased but remains low and exposes Iceland to liquidity risk under extreme scenarios.

The authorities agreed that fiscal policy should contribute to reducing inflationary pressures and rebuilding fiscal buffers over the medium term. They stressed that the 2022 budget and the medium-term fiscal plan aimed at these goals and were consistent with reactivating the fiscal rules in 2026 as envisaged in the law. The authorities agreed that consolidation measures would be needed and saw room for streamlining the VAT expenditures, public consumption, and the transfer system. They saw less scope for reducing the government wage bill in the near term given the politically mandated level of public service and the centralized wage bargaining structure. They reiterated their commitment to saving fiscal windfalls, allowing automatic stabilizers to operate in the event of adverse shocks, and continuing to protect the vulnerable population in a targeted manner. The authorities were also keen on resuming bank privatization quickly to prevent deviations from their funding plans.

B. Guiding Inflation Expectations Back to Target

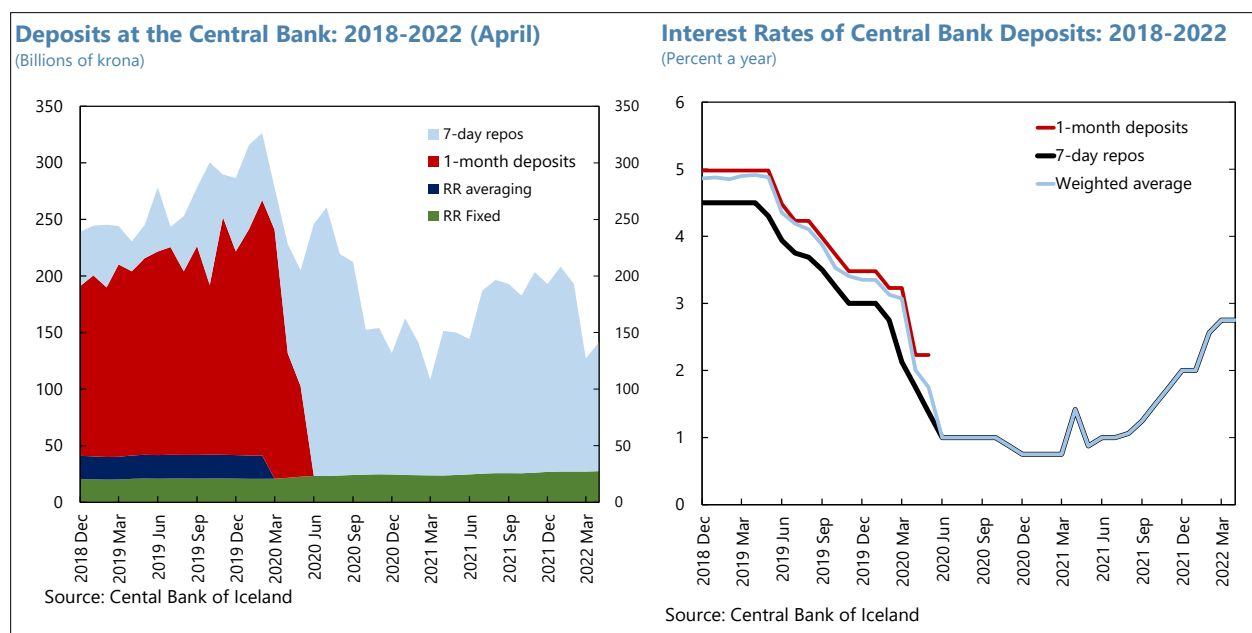
24. Additional withdrawal of monetary policy stimulus is needed but vigilance of downside risks is also warranted. Real policy rates have increased from their lows, reversing about 30 percent of the earlier real policy rate easing by mid-May 2022. Nonetheless, at -1 percent, real rates remain significantly below the estimated steady-state neutral rate, which is estimated in the 1.3–1.7 percent range, and the historical average.⁹ Breakeven inflation expectations at 4.8 percent are above CBI's target. With a positive output gap, steering inflation and inflation expectations back to target will likely require further policy rate hikes to close the gap between the real and neutral rates. Given the great extent of uncertainty, vigilance and data driven policy rate decisions would be required, considering the inflation outlook, the evolution of inflation expectations, prospects for economic recovery, wage developments, the evolution of housing prices, exchange rate behavior, and imported inflation. In addition, the policy tightening could foster capital inflows that accelerate the reduction in inflation and inflation expectations but could hamper the recovery.

25. Steering inflation expectations back to target may also require tighter systemic liquidity management. Real money balances have increased by 45 percent since the start of the pandemic. This was due to easing the policy rate, the discontinuation of NBFIs deposits and the one-month deposit facility at the CBI, and the lowering of the reserve requirement rate by 1 percentage point. The use of these quantitative tools implied an additional easing of an estimated 40 bps.¹⁰ The CBI should thus urgently strengthen the liquidity management framework to absorb the excess supply in real money balances and improve monetary policy transmission. Alternatively, policy rates above their steady-state level may be required to neutralize the inflationary impact of the excess systemic liquidity.

26. The CBI remained active in the foreign exchange market. Its net sales reached about \$158 million in 2021, with two-sided intervention aiming at mitigating volatility and improving price formation in the market. Despite a widening current account deficit, the foreign exchange reserves improved marginally by end-2021 supported by a Eurobond issuance (750 million euros, 3.5 percent of GDP) and the SDR allocation (about 1.7 percent of GDP), which the authorities intend to retain in reserves. At about 146 percent of the Fund's ARA metric and 7 months of import coverage, reserves are adequate for precautionary purposes, and the authorities should use foreign exchange interventions only to address disorderly market conditions.

⁹ The real policy interest rate averaged 1.5 percent during January 2012–April 2019.

¹⁰ Estimated as the difference between the policy rate and the weighted average of the policy rate and the 1-month auction rate over the period June 2019–May 2020, the year before the 1-month auction was discontinued.



27. The authorities reiterated their commitment to steering inflation back to target. Their objective is to bring inflation expectations down by continuing monetary policy tightening. They also agreed on the need to review the systemic liquidity framework. The authorities noted that housing prices had a large effect on Iceland's consumer price index and expected macroprudential policies to play a complementary role to policy rate hikes in containing house price and consumer price increases. They also emphasized that foreign exchange market stability is key to price stability in a small open economy, and the CBI would remain present in the foreign exchange market to maintain orderly market conditions and expectations. They concurred that the 2021 current account balance was smaller due to temporary factors, and as the influence of the pandemic on the tourism sector subsides, the current account balance would strengthen again.

C. Preserving Financial Stability

28. While the financial system is able to absorb adverse shocks, risks have increased due to the rapidly rising housing prices and deepening interlinkages between financial institutions. Tightening of macroprudential regulations and monetary policy would help contain the risks related to the housing market. Bolstering the CBI's supervisory capacity and powers to face rising risks is also critical.

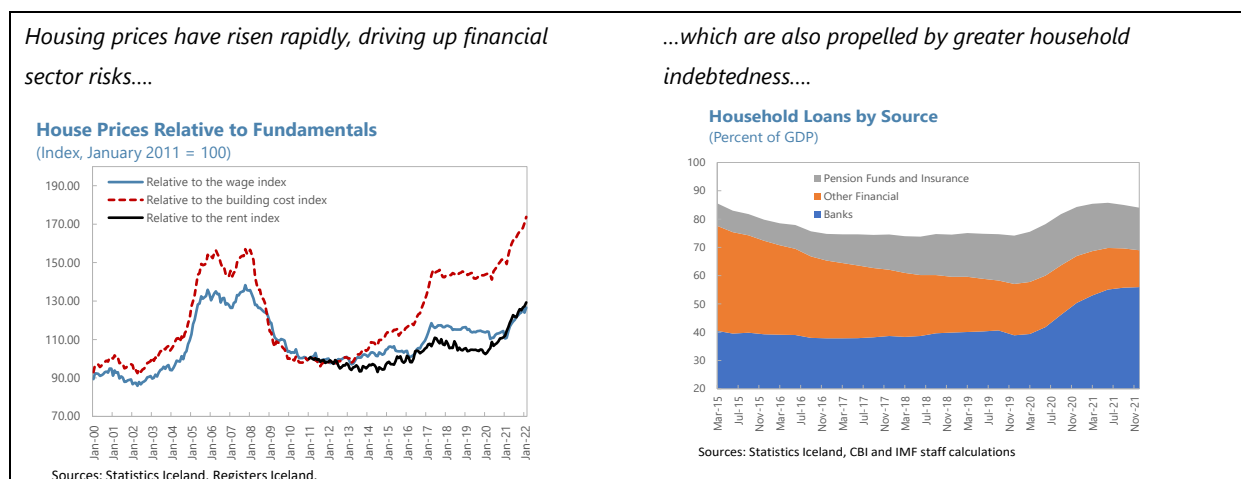
29. Iceland's financial cycle is in an upswing. Strong economic recovery, supported by accommodative monetary and macroprudential policies, has contributed to an increase in asset prices and household debt. While the credit-to-GDP gap remains negative—due to the deep post-GFC cycle—it is closing at a fast pace, mainly driven by increasing mortgage loans.

30. The banking system has shown resilience so far. Banks' profitability has improved on the back of loan valuation adjustment and increase in fees and commission. While the majority of loans previously under loan repayment moratoria (12.6 percent of corporate loans and 1.2 percent of loans

to individuals) have been classified under forbearance, the amount is manageable. Many forbore loans are currently performing, although sectoral variation requires cautious surveillance.¹¹ An increase in the countercyclical capital buffer (CCyB) from 0 to 2 percent as of September 2022 will lock in banks' large excess capital buffers. In November 2021, the Financial Stability Committee confirmed the resolvability of the systemically important commercial banks. The CcyB and MREL requirements contribute to the stability of the banking system and avoid potential public funding in case of a systemic crisis. A modification to the minimum net stable funding ratio (NSFR) to support banking system liquidity entails broader applicability to all currencies. The CBI's 2021 stress test results suggest that the domestic systemically important banks would remain well capitalized after a fall of the capital ratio by 2.8 percent under an adverse scenario.

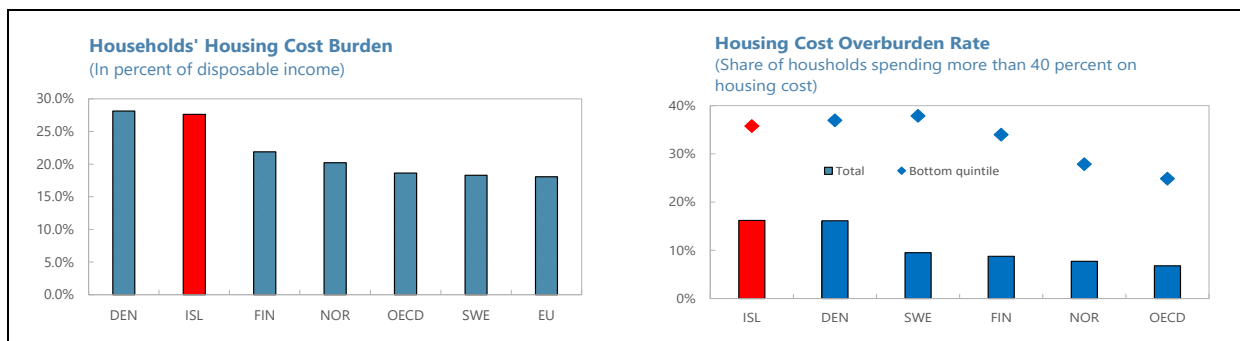
Addressing Housing Market Risks and Affordability

31. Housing prices put pressure on macroeconomic and financial stability. The house price to wage index increased by 14 percent yoy by February 2022, reaching a historically high value. While construction costs have also risen by 6, they explain the rise in housing prices only partially. The price-to-income and price-to-rent ratios suggest a price misalignment, potentially ranging from 12–17 percent, which if corrected could result in financial losses to households and financial institutions. (Selected Issues Paper).



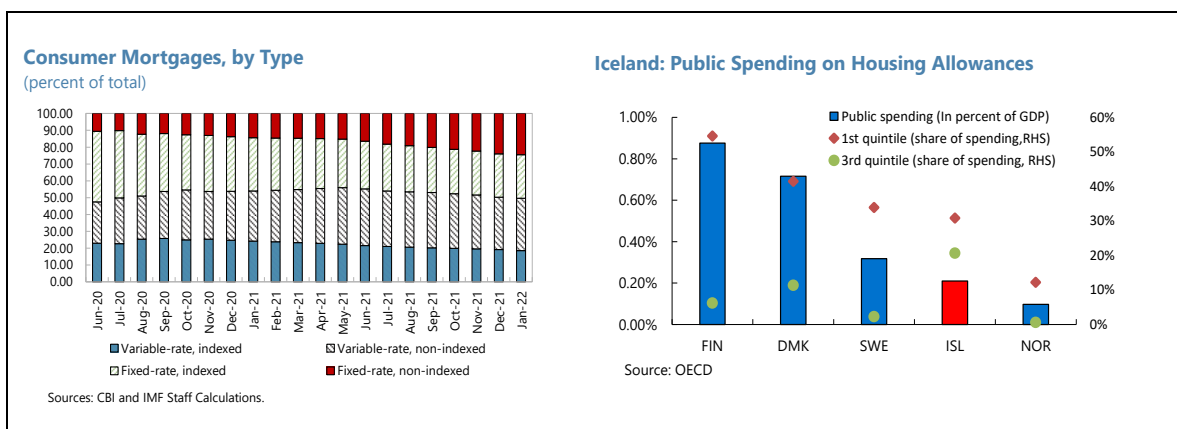
32. The house price surge has also put pressure on housing affordability, particularly for young and lower-income households. Housing affordability in Iceland is relatively low compared to other OECD countries, particularly for renters and low-income households. In 2018, households spent almost 30 percent of total disposable income on mortgage and rent, compared to an OECD average of less than 20 percent. The burden is significantly higher for the bottom-quintile households. In addition, the share of population spending more than 40 percent of disposable income on housing costs is the highest among OECD countries.

¹¹ Despite a large increase in the ratio of non-performing (NPL) based on cross-default, the NPL ratio based on the conventional measure has not increased significantly in 2020–21. According to the cross-default method, the outstanding balance of all of a customer's loans is defined as non-performing if a single loan is non-performing.



33. Well calibrated and coordinated policies are crucial to navigate the house price cycle, minimize adverse feedbacks, and reduce affordability risk. Staff analysis suggests that monetary policy is an effective tool to mitigate price pressures, as easy liquidity tends to sharply increase asset price inflation, which later affects consumer prices through the direct impact of house prices on CPI.¹² At the same time, effective macroprudential measures and structural policies are needed to contain house price and affordability risks.

- Addressing the systemic risks related to the housing market.** Banks' share in the mortgage market has increased, by extending long-term mortgages at variable rates, whose legal validity in Iceland has been questioned and needs to be clarified. While the recent tightening of macroprudential measures is welcome, additional measures will be needed. The existing DSTI regulation should further require mortgage lenders to apply a premium over the contractual rate in the analysis of borrowers' debt-service capacity.¹³ Further consideration could also be given to the risk profile of mortgage loans in calculating the risk-weighted assets and standard capital adequacy, as well as to introducing a debt-to-income cap.¹⁴



¹² IMF Staff Country Reports Volume 2018 Issue 319: Iceland: Selected Issues (2018).

¹³ For example, mortgage lenders should apply an interest rate stress test that assesses whether borrowers could still afford their mortgages through the cycle if their mortgage rate were to be significantly higher than the interest rate specified at loan origination.

¹⁴ For example, the banks' internal risk rating models estimating the probability of default and loss-given default could be revisited to assess whether higher risk weights for mortgage loans are needed, especially for loans originated at the height of the cycle with high loan-to-value, loan-to-income and DSTI ratios.

- **Promoting housing affordability.** Priority should be placed on improving productivity in the construction sector and increasing the supply of housing by simplifying and clarifying planning regulations, easing administrative burdens and the lengthy process of obtaining building permits, and introducing one-stop shop for permits and inspections. Phasing out regressive fiscal incentives could alleviate housing pressures. More targeted rental housing assistance and continued investment in social housing should promote long-term rent affordability.¹⁵

34. The authorities broadly concurred with staff on the need to address housing market risk and housing affordability. They shared the view that house prices exceeded fundamentals. They considered that tightening monetary and macroprudential policies, together with policies for increasing housing supply should ease price pressures in the housing market in the medium term. On housing affordability, they noted that the targeting of housing assistance should not be considered in isolation, but in the context of a comprehensive framework of household taxes and transfers.

Strengthening Financial Sector Oversight

35. The merger between the central bank and the financial regulator has supported financial stability, but challenges remain. With better coordination and synergies, the integrated institution provided timely and swift policy responses at the onset of the pandemic. But a recent Appraisal Committee’s report calls for giving greater powers to the Financial Stability Committee by transferring decisions on liquidity management and micro-prudential regulation from the Monetary Policy and the Supervisory Committees, which in staff’s view could hamper their effectiveness.¹⁶ Given the external members’ majority in the Supervisory Committee, the report also recommends that the CBI Governor chair the Committee—currently only for select decisions—or align better its decision making with CBI’s supervisory responsibilities and accountability. Furthermore, the supervisory budget remains dependent on the general government budget, which could undermine the CBI’s autonomy. A broader review of the integrated central bank—including in the context of the upcoming FSAP—should assess its operational and supervisory independence and adequacy of supervisory resources and powers, especially in view of Iceland’s rapidly changing financial sector landscape.¹⁷

36. The supervision of pension funds should be strengthened. With assets reaching 208 percent of GDP, pension funds have become systemically important and closely interlinked with other financial institutions (Annex II). Leveling the playing field in the financial system has progressed with the adoption of uniform macroprudential rules for pension funds and other financial institutions. However, the small scale of Iceland’s financial markets and pension funds’ high real reference yield of 3.5 percent may incentivize them to enter increasingly riskier asset classes. As new regulations are set to gradually allow higher limits for pension funds’ foreign exchange exposures, the CBI should monitor their risks closely, including through appropriately designed

¹⁵ Iceland spends about 20 percent of housing allowances on households with income in the third quintile.

¹⁶ [Appraisal Committee: The Experience of the Monetary Policy Committee, Financial Stability Committee, and Financial Supervisory Committee of the Central Bank of Iceland, 2020-2021.](#)

¹⁷ Iceland’s FSAP is expected to commence in the second half of 2022.

stress tests. Furthermore, CBI's powers to oversee pension funds' governance and risk management practices should be significantly strengthened.

37. Ensuring the quality of bank ownership should remain a key government objective and supervisory responsibility of the CBI. With the sale of 57.5 percent of Islandsbanki's equity share in 2021–22 (Annex VI), the state has significantly reduced its ownership in the banking sector. Domestic pension funds and an international investment company are the key private stakeholders in Islandsbanki, but controversy about the suitability of some small investors may delay further sales, originally planned to be completed by end-2023.¹⁸ Participation and ownership criteria for investors in the sale of state-owned banks should aim to mitigate potential reputational and stability risks for the state and the financial system. The CBI should review future divestiture plans to ensure that fitness and probity of potential investors are adequately considered, and other potential prudential issues are adequately addressed.

38. The 2021 foreign exchange legislation has entered into force. The exchange rate act removed remaining CFMs introduced in 2008, including the special rules on offshore króna, and liberalized derivative transactions.¹⁹ The act also gave the CBI powers to impose macroprudential and protective measures to maintaining macroeconomic and financial stability.²⁰ The use of any measures that may be designed to limit capital flows would require an assessment and justification depending on the prevailing circumstances.

39. Further progress has been made in strengthening AML/CFT effectiveness. The authorities conducted regular risk-based supervision and on-site inspections of obliged entities' compliance with the AML/CFT Act—focusing on their IT systems—and implemented the EBA Guidelines on ML/TF risk factors. CBI data of FX transactions and cross-border flows is now available for other government entities to fulfill their AML/CFT roles. The risk-based control and monitoring of designated non-financial businesses and professions has been strengthened. Upcoming legal amendments aim to address ML/TF risks related to virtual assets and asset providers and authorize the business registry to liquidate unregistered companies. Further efforts are needed to ensure that the accuracy of beneficial ownership information of legal persons is monitored, tested, and verified.

40. The authorities' views on financial oversight reflected the challenge of balancing trade-offs related to the deep reform efforts they have undertaken. Their views differed on the recommendations of the Appraisal Committee, with the CBI welcoming the report, while the MoF found some of the recommendations lacked clarity and required further elaboration. The authorities consider the upcoming reviews of the integrated CBI as an opportunity to guide further improvements

¹⁸ Domestic private investors owned about 24 percent and international investors owned 11 percent of Islandsbanki's share following the June 2021 IPO. As of April 29, 2022, the private stakeholders with owning shares above 1 percent of total were domestic pension funds (23. percent), other domestic banks (3.6 percent) and other domestic investors (2.2 percent) and an international investment company (6.3 percent).

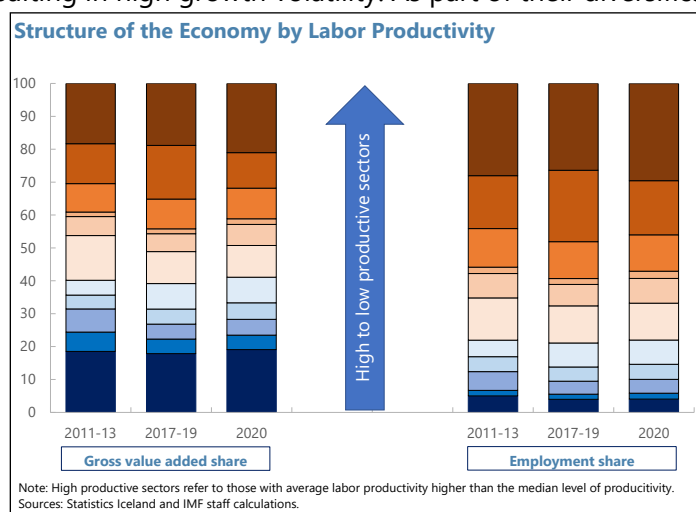
¹⁹ The new rules on derivatives transactions expand the authorizations for derivatives trading involving the Icelandic króna, while limits on the total amount of such trading by domestic commercial banks remain in place.

²⁰ Macroprudential measures include reserve requirements on inflow of foreign currency, rules on credit institutions' foreign currency-linked lending to unhedged borrowers, and limitations on derivatives transactions. Protective measures include restrictions on specified categories of capital movements, cross-border payments, and foreign currency transactions, and foreign currency repatriation requirements.

in its institutional architecture. They also agreed that there is a need to strengthen the CBI's powers to oversee pension funds' governance and risk management practices, while the MoF emphasized social and political sensitivities, given the role of social partners within the pension system. The authorities agreed that the quality of bank ownership is a key objective of the privatization of state-owned banks while the MoF emphasized price trade-offs and constraints laid out in European legislation regarding the criteria for and assessment of bank ownership.

D. Fostering Economic Diversification and Innovation

41. The multiple external shocks that have affected Iceland since 2019 underscore the need for further efforts to diversify the Icelandic economy. Iceland's high reliance on the tourism sector made it vulnerable to external shocks, resulting in high growth volatility. As part of their diversification strategy, the authorities doubled R&D spending to almost 1 percent of GDP in 2021.²¹ However, the shares of high-productivity sectors, such as ICT, in total gross value added and employment are relatively low, albeit increasing. Continued diversification efforts and transitioning toward higher productivity and knowledge-based sectors would strengthen Iceland's sustainable recovery and resilience to shocks.



42. Improving competition and promoting innovation are key to supporting economic diversification, mitigating the pandemic scarring, and building a more resilient economy.

- **Easing regulatory burdens:** Iceland's product market regulations are relatively stringent compared to peers, particularly in startups and trade and investment. Barriers to competition are also high in key services and network sectors. For instance, compared to other Nordic countries, Iceland has more burdensome administrative procedures and fees to establish a startup, while regulations on FDI are high.²²

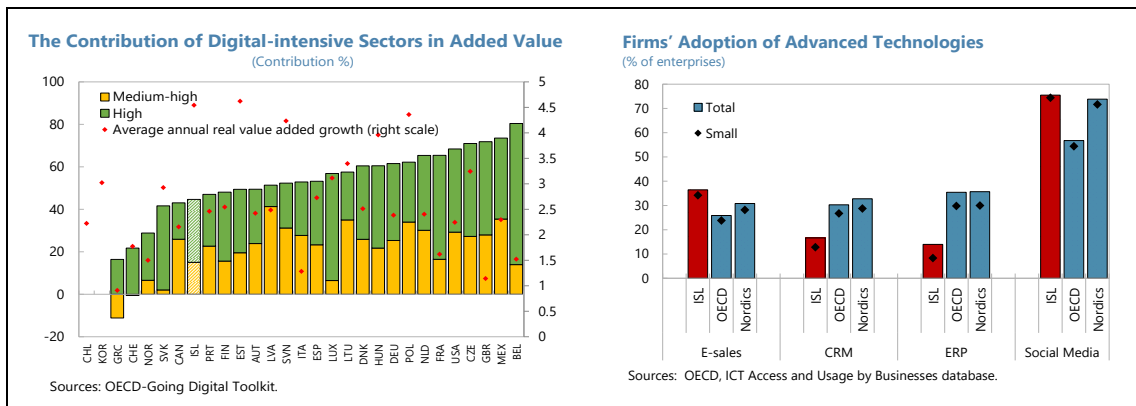
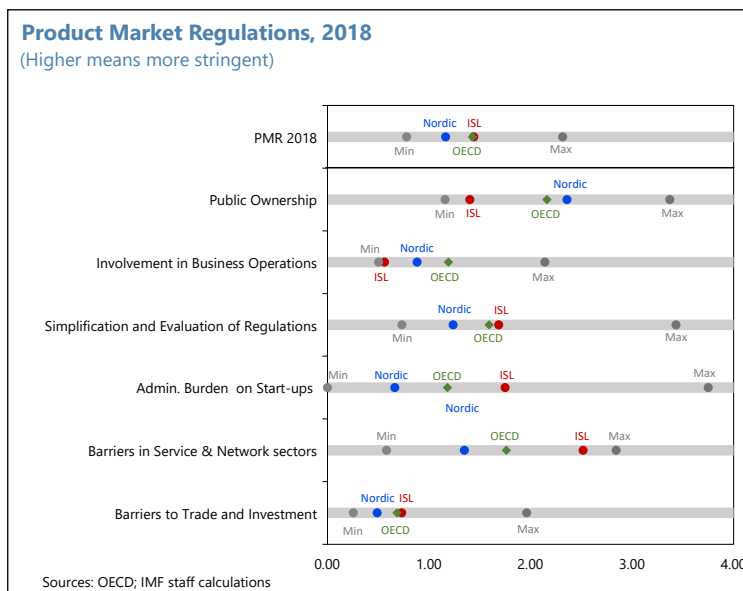
²¹ Iceland and the Fourth Industrial Revolution (2019) and Science and Technology Policy 2020–22 (2020) and Medium-term Fiscal Strategy Plan 2023–2027.

²² The legislation limits investment of foreign companies domiciled outside of the European Economic area in the many industries, including fishing, energy, and aviation. The Minister of Tourism, Industries, and Innovation is authorized to stop foreign investment in systematically important companies if it entails systematic risk and is authorized to compel the foreign person or entity in question to sell if investment has already taken place. Investment in the real estate sector by foreigners is also prohibited. (OECD, 2021).

- The experience of other advanced economies has shown that deregulation of retail trade, professional services, and network sectors, could raise GDP by more than 2¼ percent.²³

- **Expanding the potential for innovation:** Iceland has a strong foundation for nurturing innovation, including a highly educated labor force and an advanced digital and network infrastructure. Nonetheless, digital-intensive sectors

contribute less to value-added growth in Iceland than in other OECD countries, suggesting that there is scope to widen digital penetration in the production process and increase the innovation potential in the economy. Incentives to promote innovation, including tax rebates and R&D spending funds, have been effective and should be continued. Additional measures to promote digitalization of small businesses—e.g., easing access to finance—should be considered.^{24,25} Continued effort to improve education outcomes and relevant skills would also be essential to support innovation.²⁶

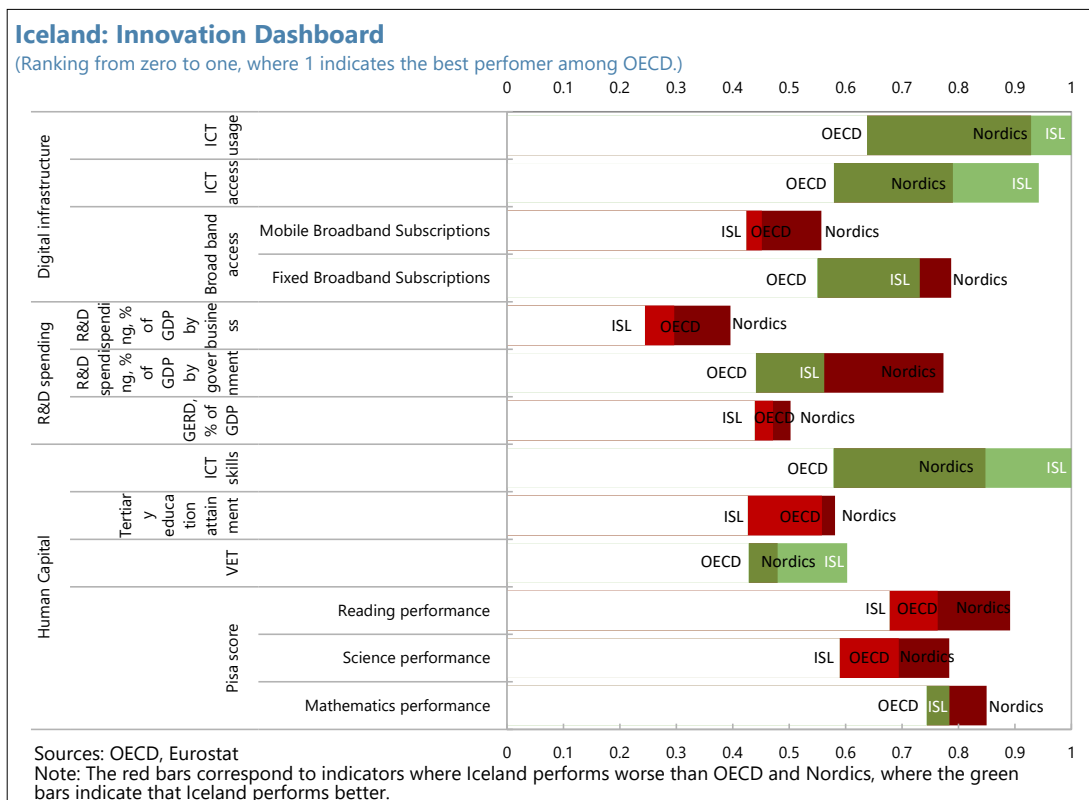


²³ See Banjeri et al, 2017. The study uses an IMF database that identifies major policy changes in key reform areas, including product market regulation, for 26 advanced economies over the past 40 years. The analysis traced out the average evolution of output and other key variables in the aftermath of major policy changes.

²⁴ The government set a Gross Domestic Spending on R&D (GERD) target of 3 percent of GDP by 2024. Based on the latest data available, GERD expenditure was at 2.47 percent of GDP in 2020. In order to reach the target, it is estimated that Iceland needs to spend at least additional ISK 40 billion per year (Iceland and the Fourth Industrial Revolution, 2019).

²⁵ According to the EBRD Transition report 2021–22, larger, better-managed, innovative, and foreign-owned firms are more likely to have increased their use of digital technologies during the COVID-19 crisis.

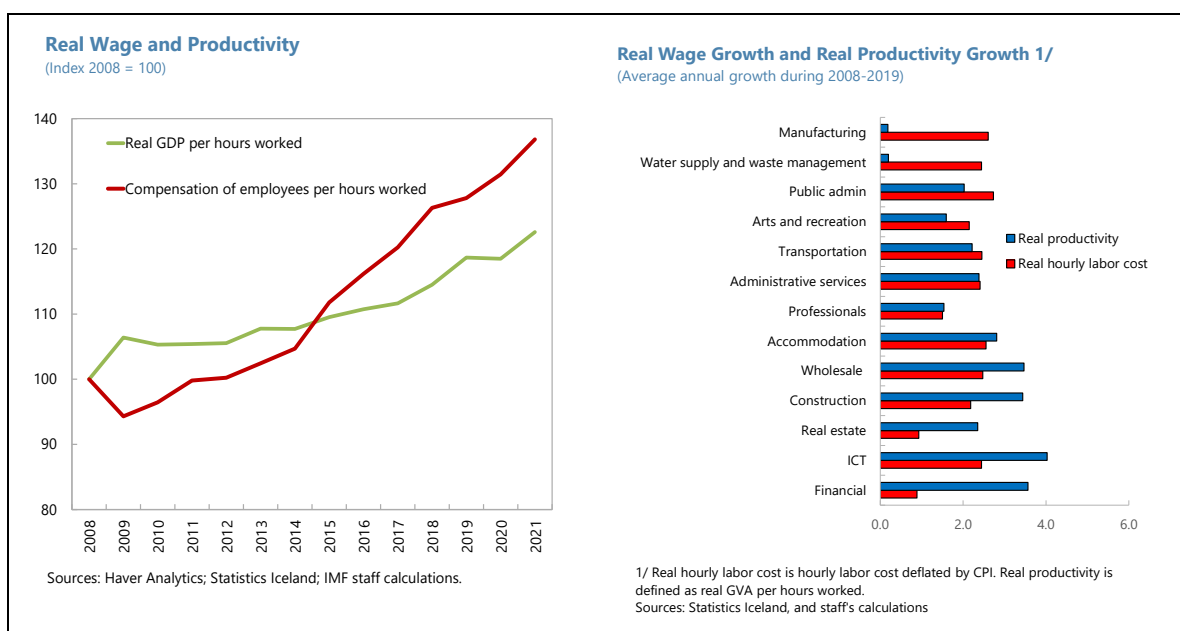
²⁶ See IMF Country Report No. 21/106.



43. The upcoming collective agreement negotiations provide an opportunity for Iceland to preserve equity, promote competition, and facilitate diversification (Annex VII).

- Supporting inclusiveness:** Iceland's collective agreement mechanism plays an important role in promoting inclusiveness, reducing the risk of poverty, and providing high job security, making Iceland one of the countries with the lowest inequality in the world. The share of workers earning less than two-thirds of median earnings is also among the lowest in the OECD. Nonetheless, the gender wage gap remains high in Iceland. Preserving inclusiveness and narrowing the gender wage gap should be a key feature in the upcoming agreement.
- Aligning wages and productivity growth:** Iceland's real labor cost growth has outpaced labor productivity growth since 2015. In 2020, labor productivity growth stalled, while real wages continued to rise amid the pandemic. To a great extent, this is a direct result of the 2019 collective wage agreement that linked wage premium with growth in historical GDP per capita, without downward wage adjustment during recessions. The new collective wage agreement should address this drawback by curtailing wage growth during economic downturns.²⁷

²⁷ See IMF Country Report No. 21/106, Annex VIII.



- Fostering diversification:** Wage and productivity growth dynamic also varies across sectors. Wage growth significantly exceeded productivity growth in the manufacturing sector, while the opposite is true for ICT and financial sectors. Product market reforms could help narrow the gap. Nonetheless, the new collective agreement should allow firms and workers to negotiate wages that reflect overall macroeconomic and employment conditions, as well as firm-specific factors. Introducing additional scope for firms to deviate from national agreements under certain conditions would help facilitate labor market adjustment.

44. Meeting Iceland's ambitious climate goals will be challenging (Annex IX). Based almost entirely on hydroelectric and geothermal production, Iceland's energy sector is one of the cleanest among advanced economies. Nonetheless, Iceland still faces significant challenges to reduce greenhouse gas emissions of other sectors, especially industrial processes, transportation, and fishing. Reducing emissions in a growing economy, especially one with relatively fast population growth through immigration, would require a combination of fiscal incentives, government regulation, and technological improvements. Carbon pricing helps align relative prices to climate goals but needs to be broadened and increased to offset demand arising higher incomes and a growing population. Other fiscal incentives, for example, promoting the use and registration of electric over gasoline vehicles would need to be carefully designed and calibrated to preserve the revenue base. Expanding the use of renewable energy would require investments in infrastructure that may entail environmental tradeoffs, such as the risks of environmental damage that may arise from the construction of hydroelectric dams. Technological improvements, including those that allow carbon sequestration, may become viable in the future but may require R&D support.

45. The authorities broadly agreed with staff's recommendations on structural policies. They emphasized that significant progress has been made to diversify the economy, particularly on implementing policies to promote innovation. They noted that reducing administrative burdens, particularly in the construction sector and improving flexibility and efficiency in hiring foreign specialists, is critical. The authorities foresee the difficulty of the upcoming wage negotiations, given elevated inflation, surging house prices, and low housing affordability. They reiterated their

commitment to their ambitious climate goals and noted the efforts currently in train to refine and operationalize the climate action plan, including to make carbon pricing more effective.

STAFF APPRAISAL

- 46. Iceland's economic outlook is positive but subject to substantial risks.** Careful policy coordination is required to entrench the recovery, contain rising housing risks, rebuild fiscal buffers while supporting the most vulnerable, and stem external imbalances, as the external position is assessed as weaker than fundamentals and desirable policies.
- 47. The authorities' planned fiscal consolidation is appropriate as it would help bring inflation back to target and rebuild fiscal buffers.** These are crucial given Iceland's exposure to large shocks. Measures to achieve the consolidation could include streamlining VAT expenditures, public consumption, and the transfer system. The authorities should save any potential windfall fiscal revenues and reactivate the fiscal rules on time.
- 48. The monetary tightening is welcome, and the CBI should continue withdrawing monetary policy stimulus.** Steering inflation and inflation expectations back to target will require further policy rate hikes and strengthening liquidity management to improve monetary policy transmission. Vigilance and data driven policy rate decisions are required, considering the evolution of inflation and inflation expectations, prospects for economic recovery, wage and house price developments, capital flows, and imported inflation.
- 49. The banking system has weathered the pandemic well, but rising systemic risks call for additional action.** Surging house prices require further tightening of macroprudential measures. Reducing administrative burdens in the construction sector, redesigning regressive home ownership incentives, and providing more targeted rental assistance should address housing affordability. The merger between the central bank and the financial regulator has supported financial stability. However, there is a need to further review the CBI's committees, budgetary independence, and microprudential powers and capacities, including to oversee pension funds' governance and risk management practices.
- 50. Ensuring the quality of bank ownership should remain a key government objective and supervisory responsibility of the CBI.** Participation and ownership criteria for investors in state-owned banks should mitigate potential reputational and stability risks for the state and the financial system. The CBI should review future divestiture plans to ensure that fitness and probity of potential investors is adequately considered, and other potential prudential issues are adequately addressed.
- 51. Further efforts are needed to diversify the economy and to achieve Iceland's climate goals.** The focus should be on reducing burdens on start-ups, easing business regulations, promoting R&D investment, easing access to finance for small firms, and furthering education reforms. Ensuring inclusiveness and aligning wage and productivity growth should be key features in the upcoming collective bargaining agreement. Carbon pricing should be broadened and increased, and tax

ICELAND

incentives for electric vehicles should be revenue neutral. Expanding the use of renewable energy would require infrastructure investments, and technological improvements may need R&D support.

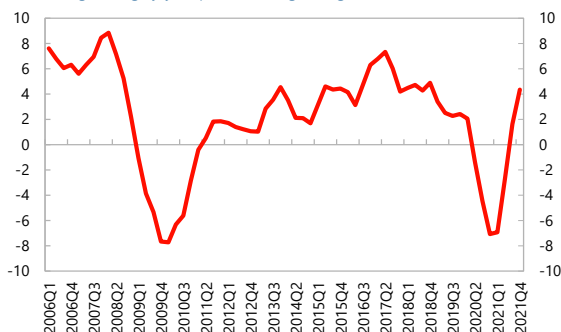
52. It is proposed that the next Article IV consultation with Iceland take place on the standard 12-month cycle.

Figure 1. Iceland: Key Macroeconomic Developments

Growth bottomed out in 2021Q1 and has since recovered strongly.

GDP Growth

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

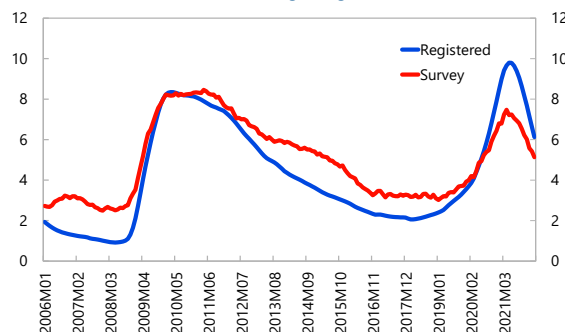


Sources: STATICE.

The labor market revived, and unemployment declined.

Unemployment Rate

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

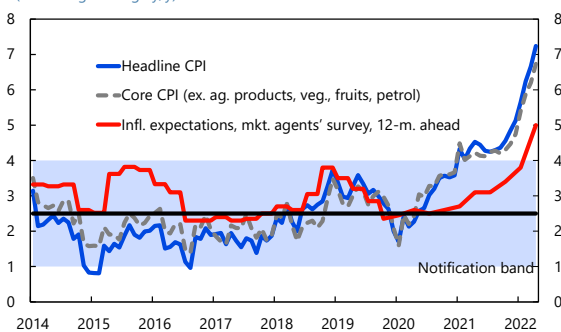


Sources: STATICE; Directorate of Labour.

Inflation has been above the notification band since early 2021 and has recently accelerated.

Inflation and Inflation Expectations

(Percentage change y/y)

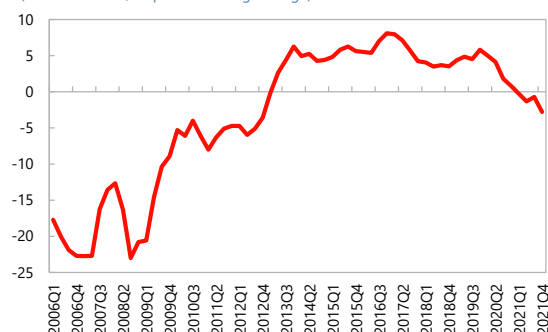


Sources: STATICE

The current account balance has turned into a deficit.

Current Account Balance

(Percent of GDP, 4-quarter moving average)

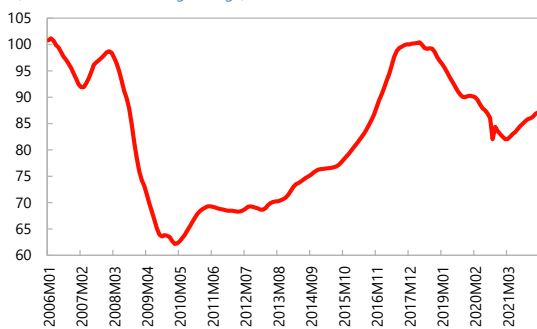


Sources: STATICE; CBI.

The real exchange rate has returned to long-term levels

Real Exchange Rate

(Index, 12-month moving average)

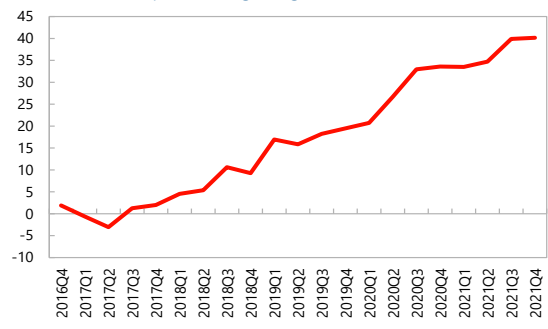


Sources: CBI.

With strong returns abroad, the external investment position has strengthened.

Net International Investment Position

(Percent of GDP, 4-quarter moving average)



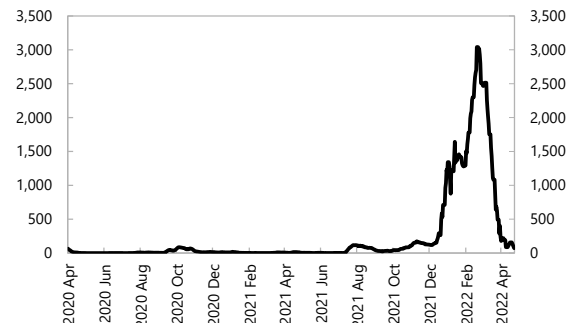
Sources: STATICE; CBI.

Figure 2. Iceland: COVID-19 Developments

With the proliferation of the more contagious but less lethal Omicron variant ...

New Weekly COVID Infections: 2020-2022

(Number of persons)

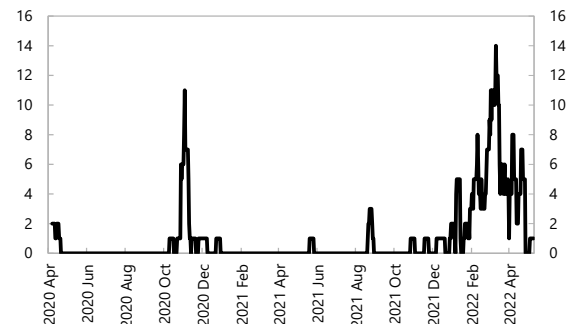


Source: Iceland's Ministry of Health

Nevertheless, the overall death toll of the most recent wave was substantial.

New Weekly COVID Deaths: 2020-2022

(Number of persons)

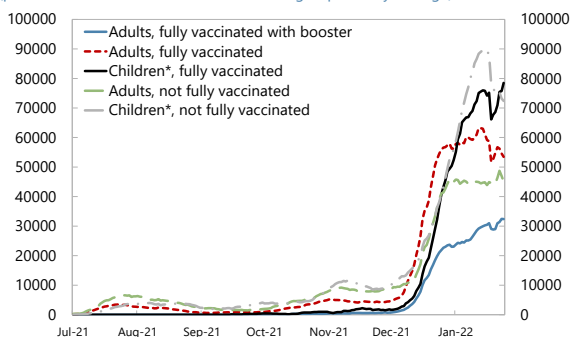


Source: Iceland's Ministry of Health

And reduce infections and hospitalizations.

Infection Rates by Age and Vaccination Status

(per 100 000 individuals in each vaccination group, 14-day average)

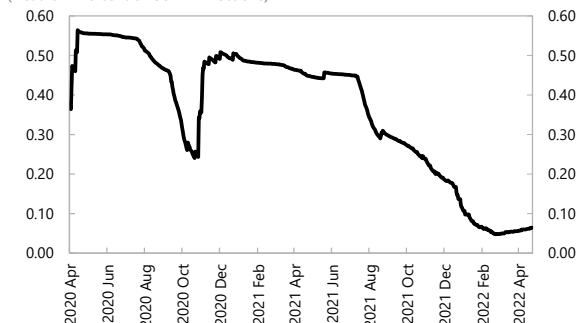


Source: Ministry of Health of Iceland

The already low fatality rate in Iceland has further declined.

COVID Fatality Rate and New Weekly Cases: 2020-2022

(Deaths in Percent of COVID infections)

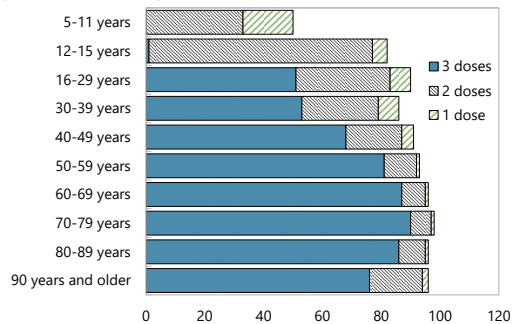


Source: Iceland's Ministry of Health

The high degree of vaccination helped protect the vulnerable population ...

Vaccination Doses by Age

(Percent, as of March 15)

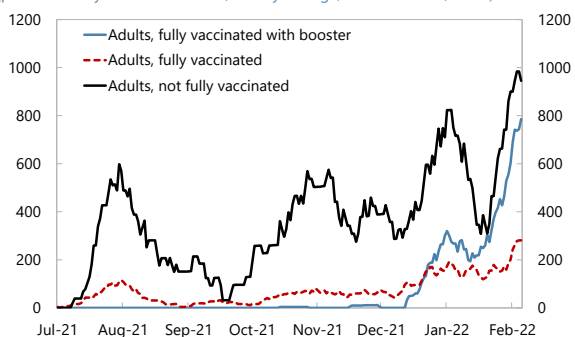


Source: Ministry of Health of Iceland

But the vaccine protection seems to have declined with the Omicron variant.

Incidence of Hospitalisation

(per 100 000 by vaccination status, 14-day average, as of March 15, 2022)



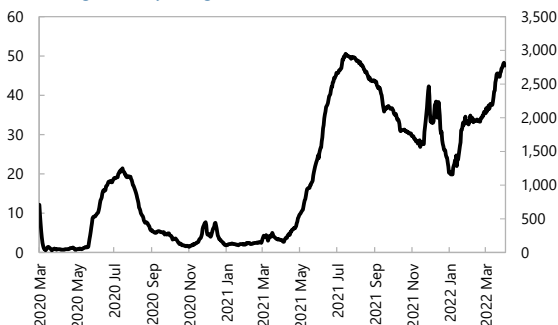
Source: Ministry of Health of Iceland

Figure 3. Iceland: Tourism Developments

Flight arrivals recovered strongly in the second half of 2021, as vaccine deployment expanded.

Flight Arrivals in Keflavik Airport: 2020-2022

(Number of flights, weekly average)

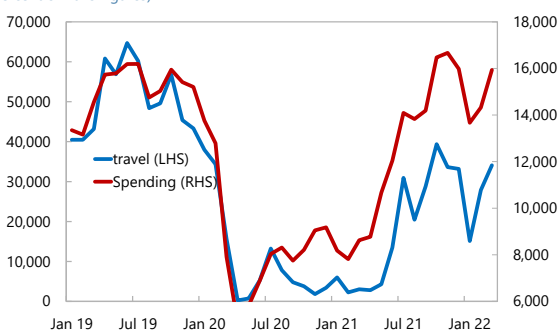


Source: ISAVIA

Travel by Icelanders abroad exhibited a similar pattern.

Icelanders' Travel and Spending Abroad: 2019-2022

(Percent of 2019 figures)

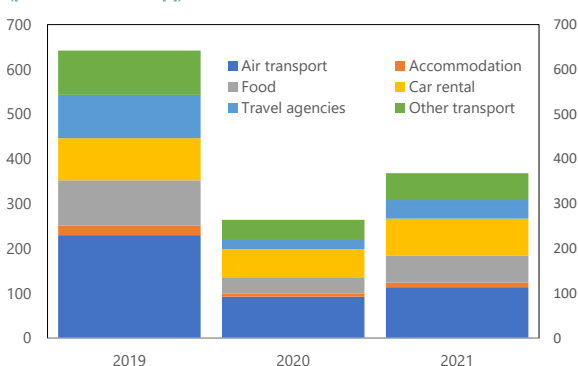


Source: Haver Analytics, Inc., Statistics Iceland, Tourism Board, Icelandair.

Although for the year as a whole turnover in 2021 reached about half the 2019 level...

Real Turnover in Tourism: 2019-2021

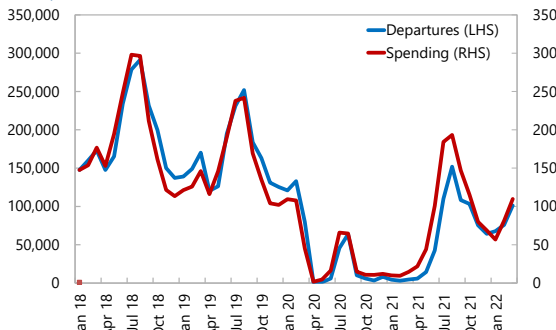
(Millions of kronas of [x])



With tourist spending increasing faster than tourist flows, as tourists tended to stay longer and spend more.

Tourist Departures and Spending: 2018-2022

(Persons per month)



Source: Haver Analytics, Inc., Statistics Iceland, Tourism Board, Icelandair.

The recovery in tourism activity led to the recovery in tourism employment.

Employees in Tourism: 2019-2022

(Number of persons)

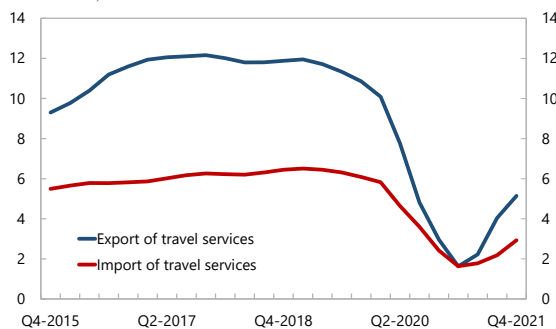


Sources: Haver Analytics, Inc., Statistics Iceland, Tourism Board, Icelandair.

the travel balance has contributed positively to the current account balance.

Travel Balance: 2015-2021

(Percent of GDP)



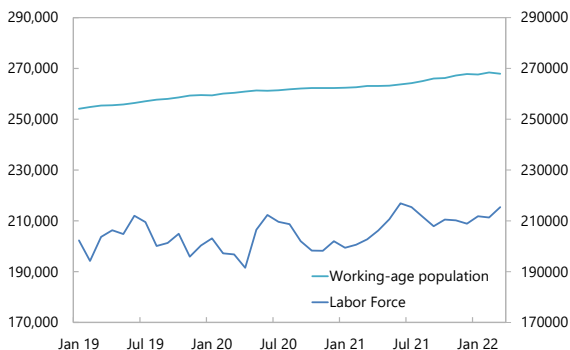
Source: Haver Analytics, Inc. and Central Bank of Iceland.

Figure 4. Iceland: Labor Developments

The working age population and labor force have continued their trend increase, partly due to immigration.

Working Population and Labor Force: 2019-2022

(Number of persons)



Source: Haver Analytics, Inc., Statistics Iceland, Tourism Board, Icelanadair.

...improving the employment rate.

Employment Rate: 2019-2022

(Percent of estimated population 16-74 years old)

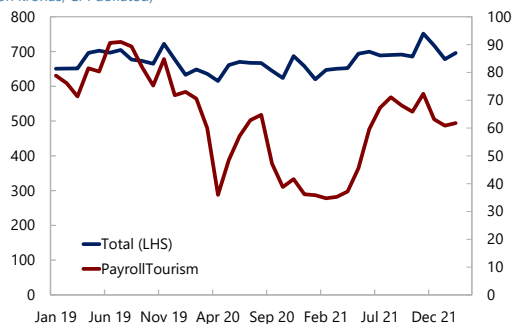


Source: Haver Analytics, Inc. and Statistics Iceland.

The overall payroll has remained stable, and the one in the tourism sector recovered significantly by mid-2021.

Payroll: 2019-2022

(Million kronas, CPI deflated)

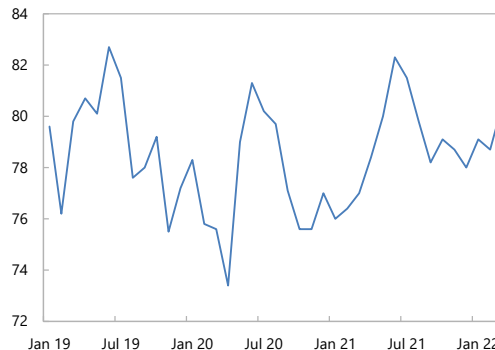


Source: Haver Analytics, Inc. and Statistics Iceland.

The activity rate recovered from its decline at the start of the pandemic...

Activity Rate: 2019-2022

(Percent of estimated population 16-74 years old)

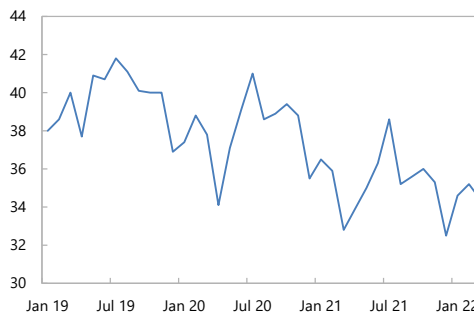


Source: Haver Analytics, Inc. and Statistics Iceland.

Partly reflecting labor market agreements, the hours worked per week have declined over time.

Hours Worked per Week: 2019-2022

(Hours)

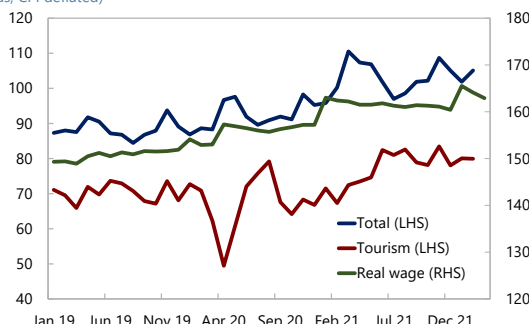


Source: Haver Analytics, Inc. and Statistics Iceland.

Real wages and remuneration per hour have experienced a significant increase.

Payroll per Employee per Hour and Real Wage: 2019-2022

(kronas, CPI deflated)



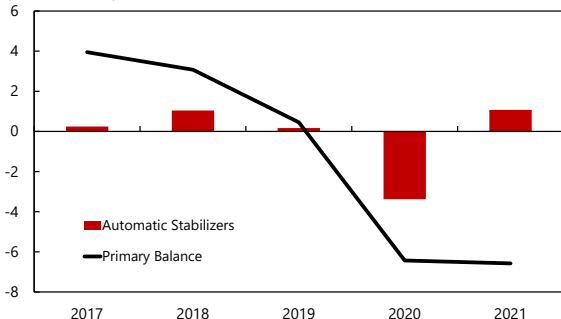
Source: Haver Analytics, Inc. and Statistics Iceland.

Figure 5. Iceland: Fiscal Developments and Issues

With the recovery under way, automatic stabilizers reversed course in 2021...

Primary Balances and Automatic Stabilizers: 2017-2021

(Percent of GDP)

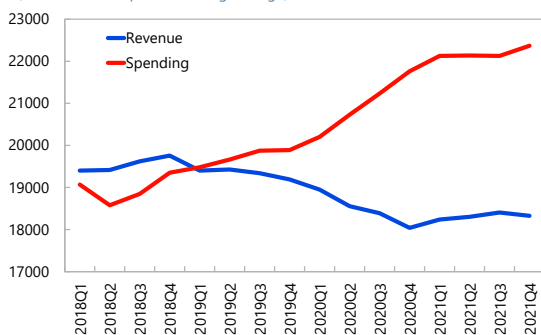


Source: Statistics Iceland.

The overall deficit rose, reflecting discretionary spending...

Real General Government Revenue and Spending

(CPI deflated, 4-quarter moving average)

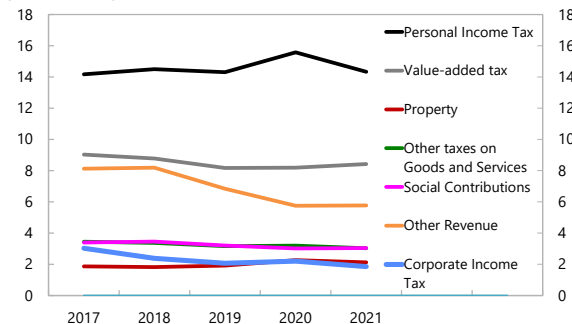


Sources: STATICE.

Revenues declined—despite strong consumption—as taxation of one-off pension saving withdrawals ended.

General Government Revenue: 2017-2021

(Percent of GDP)



Source: Statistics Iceland.

And COVID-related wage support gave way to growth-enhancing investment.

Covid-Related Fiscal Support Measures: 2020-2022

(Percent of GDP)

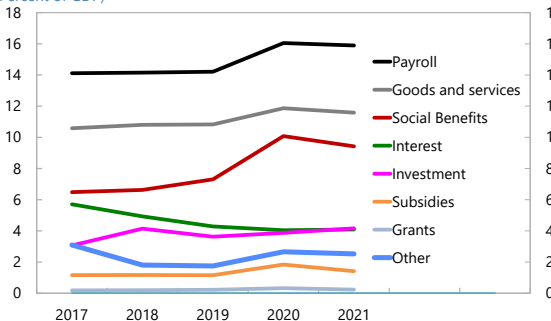


Source: Ministry of Finance

which included not only investment, but also public sector wages due to a recent public sector wage agreement.

General Government Spending: 2017-2021

(Percent of GDP)

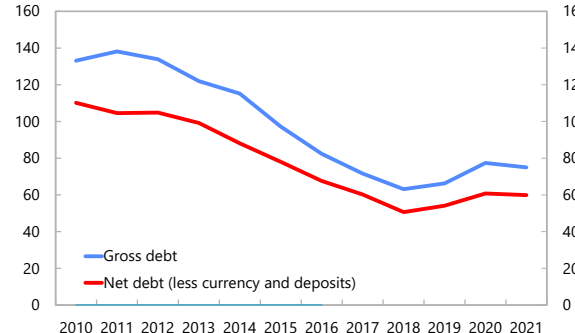


Source: Statistics Iceland.

Nonetheless, government debt dropped with the sale of 57.5 percent equity share in Islandsbanki in 2021–22.

General Government Debt: 2010-2021

(Percent of GDP)

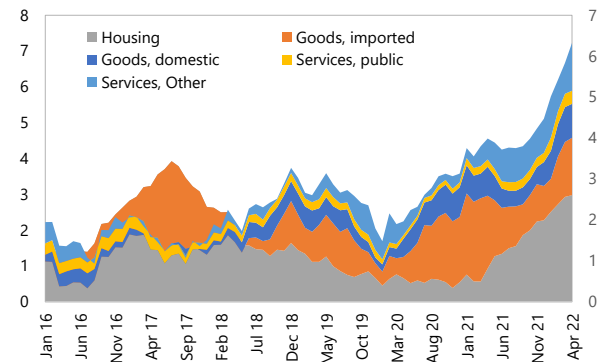


Source: Statistics Iceland.

Figure 6. Iceland: Inflation and Monetary Developments

Rising housing prices offset the effect of appreciation and kept inflation above target...

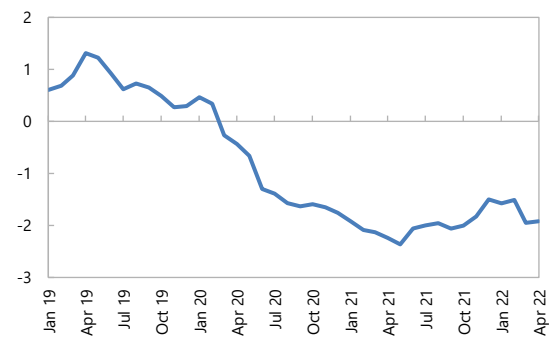
Consumer Price Inflation Components
(Percentage point contribution to CPI inflation)



Source: Haver Analytics, Inc. and Statistics Iceland.

Real policy rates remain negative but have recovered from their low mid-2021 levels.

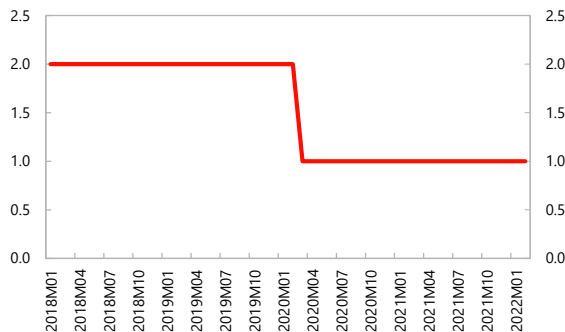
Real Policy Rate
(Percent)



Source: Haver Analytics, Inc. and IMF staff estimates

...with the lower reserve requirements...

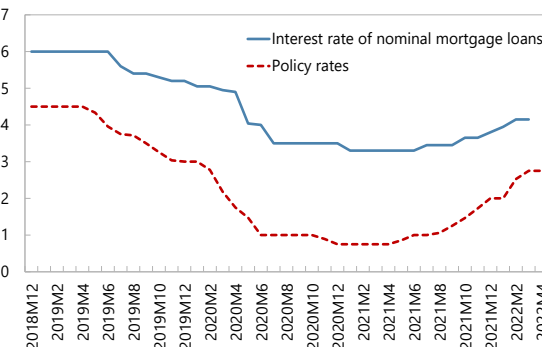
Total Reserve Requirements
(Percent of deposit base)



Sources: CBI.

...raising inflation expectations and prompting policy rate hikes.

Interest Rate Transmission
(Percent)

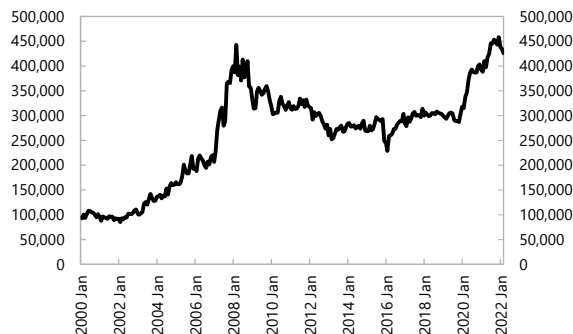


Sources: CBI

Real balances are at a historically high level...

Real M1 Balances: 2000-2022

(Million krona of January 2008, CPI deflated)

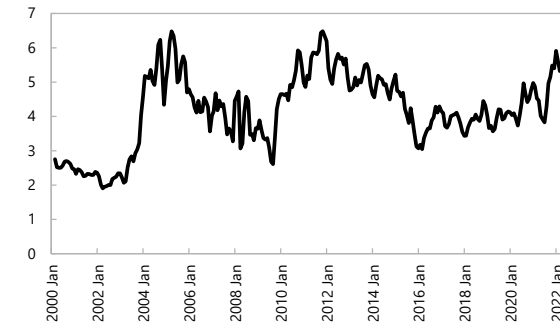


Source: Central Bank of Iceland

contributing to a rising money multiplier.

M1 Money Multiplier: 2000-2022

(M1 divided by the Money Base, 3-month moving average)



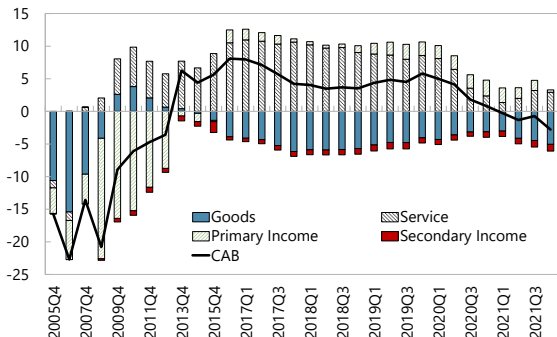
Source: Central Bank of Iceland

Figure 7. Iceland: External Sector Developments

The current account balance recorded a large deficit in 2021, with a weaker trade and primary income balance.

Current Account Balance

(Percent of GDP; 4-quarter moving average)

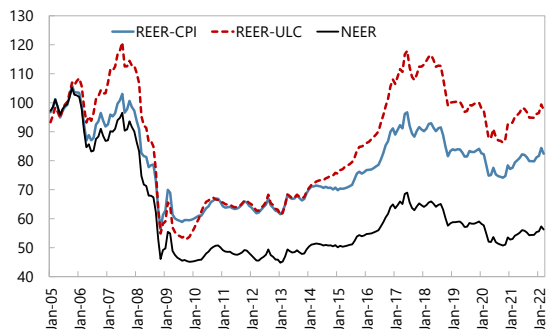


Sources: CBI.

The REER appreciated, on average, in 2021.

Real Effective Exchange Rate

(Index, 2005=100)

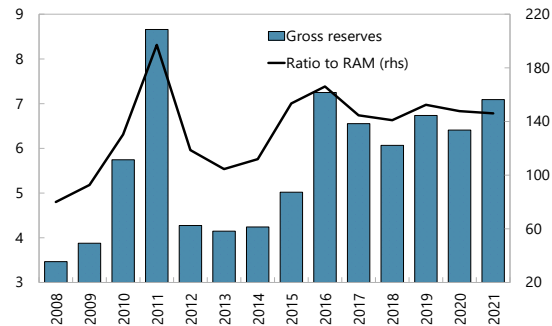


Sources: CBI and IMF INS Database

The CBI maintains strong stock buffers with adequate reserves...

Gross Reserves

(Billions of dollars, percent)

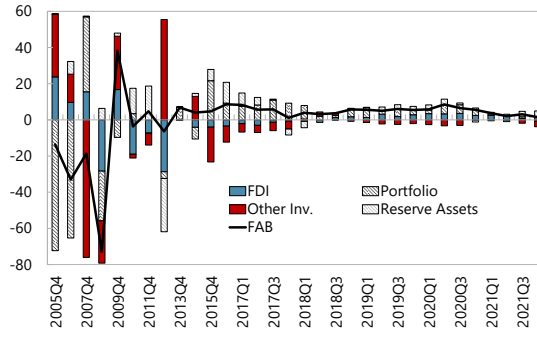


Sources: CBI and IMF Staff Calculations.

The net capital outflow was smaller compared to recent years.

Financial Account Balance

(Percent of GDP; 4-quarter moving average)

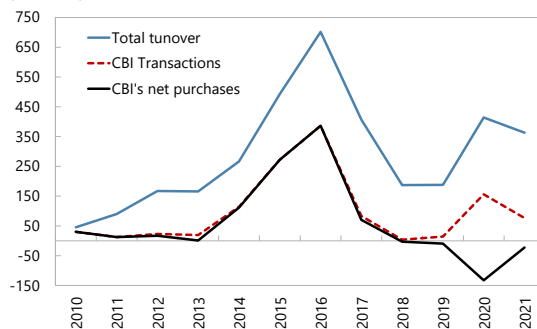


Sources: CBI.

The FX market turnover declined marginally, with a smaller share of CBI transactions.

FX Market Turnover and Interventions

(Billion ISK)

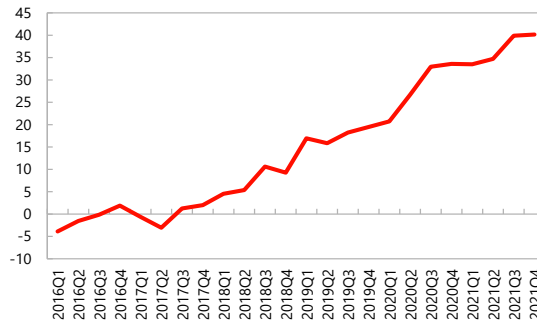


Sources: CBI.

...and a strong positive NIIP.

Net International Investment Position

(Percent of GDP; 4-quarter moving average)



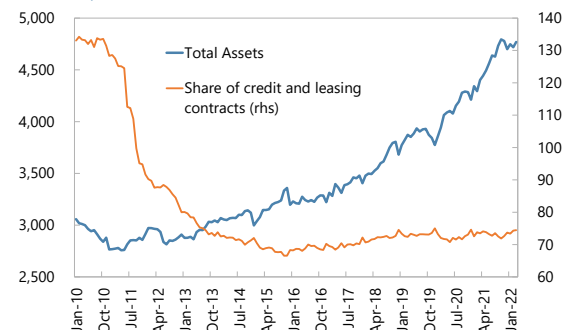
Sources: STATICE; CBI.

Figure 8. Iceland: Banking Sector Developments

Deposit money banks' total assets continued expanding.

Banking System Asset and Share of Credit

(Bill ISK and percent)

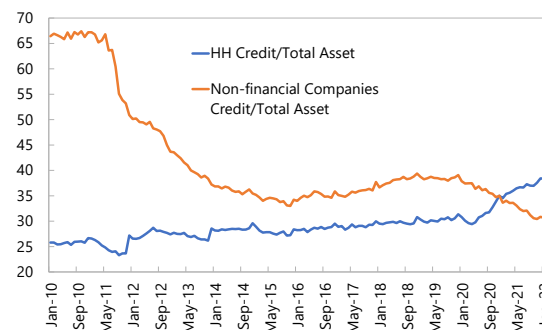


Sources: CBI.

The share of loans to households has exceeded that of non-financial corporates.

Household and Non-Financial Corporate Credit

(Percent of total assets)

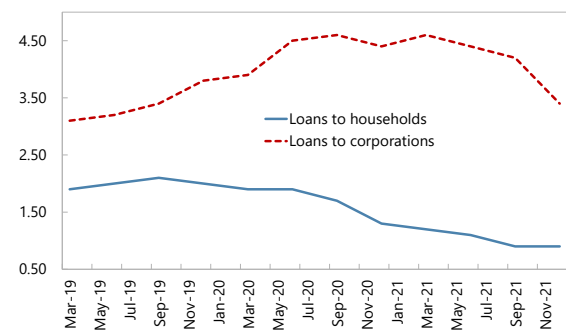


Sources: CBI.

Asset quality has improved due to declining household and corporate NPL ratios.

Non-performing Loan Ratios

(Percent)

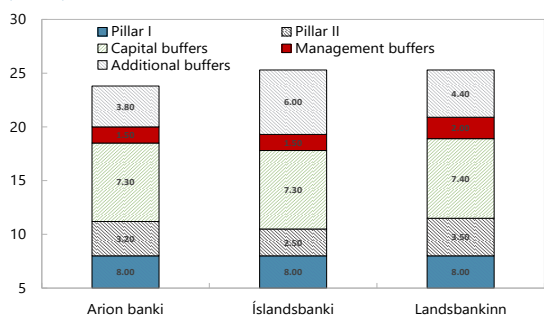


Sources: CBI

D-SIB's capital ratios are well above regulatory minima...

Capital Requirement and Adequacy

(Percent)

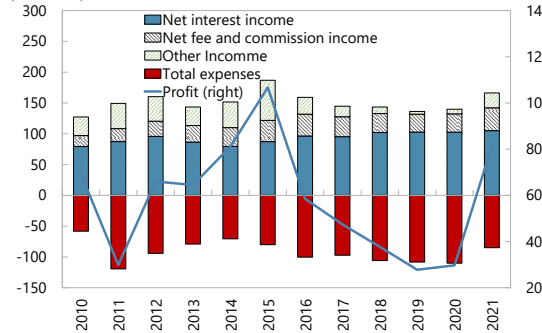


Sources: CBI

And bank profitability has recovered significantly since the beginning of the pandemic.

Banks' Income and Expenses, and Net Profit

(Billion ISK)

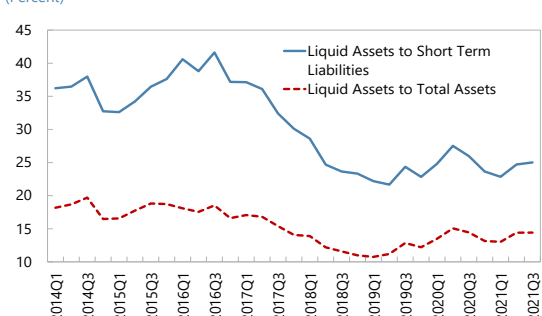


Sources: CBI

...and liquidity buffers are ample.

Banks' Liquid Asset Ratio

(Percent)



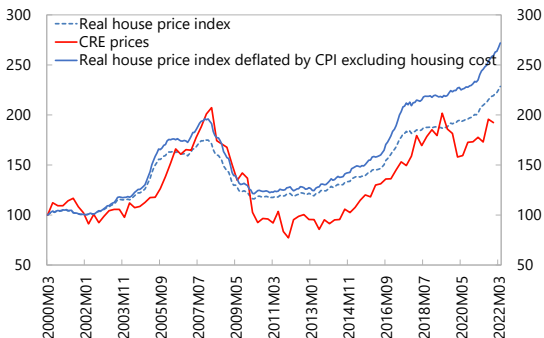
Sources: CBI

Figure 9. Iceland: Housing Market Developments

Housing prices have increased significantly in real terms...

Real Estate Indices

(Index, 2000M3=100)

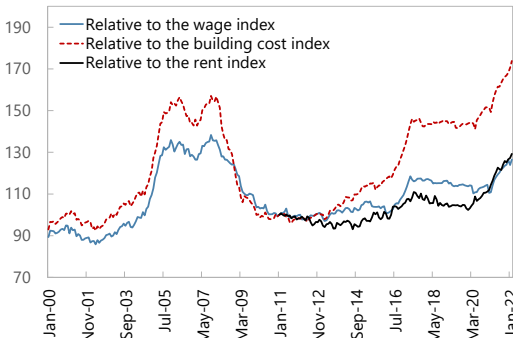


Sources: Statistics Iceland, CBI and IMF staff calculations.

relative to fundamentals, ...

House Prices Relative to Fundamentals

(Index, January 2011 = 100)

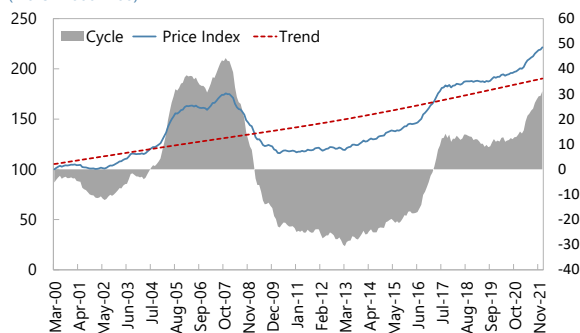


Sources: Statistics Iceland, CBI and IMF staff calculations.

and historical trends.

Real House Price Index

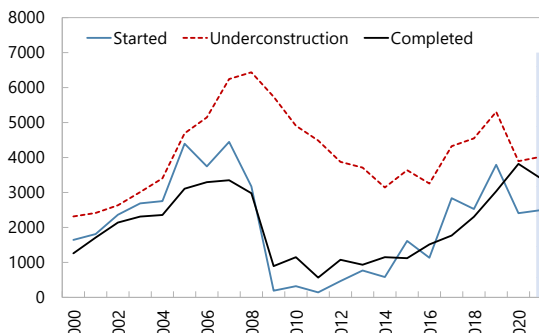
(March 2000=100)



Sources: Statistics Iceland, CBI and IMF staff calculations.
Note: Hodrick-Prescott (HP) filter is used to construct trend.

House supply is estimated to have recovered in 2021, after a drop in 2020.

Construction of Residential Buildings

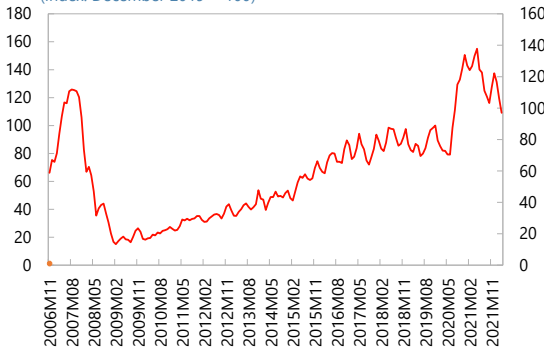


Sources: Federation of Icelandic Industries, Registers Iceland, Reykjavik Economics, Statistics Iceland, CBI and IMF staff own calculations.

Turnover in real estate has surged after an initial deceleration at the onset of the pandemic.

Real Estate Turnover

(Index, December 2019 = 100)

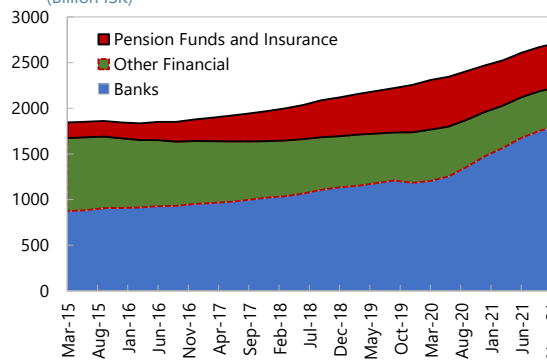


Sources: Registers Iceland and IMF staff calculations.
Notes: Three-month moving average and deflated by the CPI.

Strong house demand has led to increasing household indebtedness sourced from the banks.

Household Loans by Source

(Billion ISK)



Sources: Statistics Iceland, CBI and IMF staff calculations.

Table 1. Iceland: Selected Economic Indicators, 2016–27

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(Percentage change unless otherwise indicated)												
National Accounts (Constant Prices)												
Gross domestic product	6.3	4.2	4.9	2.4	-7.1	4.3	3.6	2.5	2.5	2.4	2.3	2.3
Total domestic demand	7.7	7.6	4.8	0.9	-1.7	7.3	2.5	1.6	1.8	2.0	2.0	2.0
Private consumption	6.7	8.0	4.8	1.9	-2.9	7.6	2.8	2.5	2.3	2.1	1.9	2.0
Public consumption	0.9	2.9	4.7	3.9	4.2	1.8	1.0	0.7	1.0	1.7	1.7	1.7
Gross fixed investment	18.0	10.6	3.1	-2.4	-9.5	13.6	3.6	3.1	2.4	2.5	2.4	2.4
Net exports (contribution to growth)	-0.8	-2.9	0.5	1.7	-5.4	-3.0	0.6	0.9	0.7	0.4	0.4	0.4
Exports of goods and services	11.0	5.1	1.7	-4.7	-30.2	12.3	17.9	4.5	3.7	3.4	2.8	2.7
Imports of goods and services	14.6	11.8	0.9	-8.5	-21.6	20.3	15.2	2.4	2.2	2.6	1.9	1.9
Output gap (percent of potential output)	0.8	1.2	3.3	4.0	-2.8	-0.7	1.0	0.8	0.6	0.4	0.2	0.0
Selected Indicators												
Gross domestic product (ISK bn.)	2,512	2,642	2,844	3,043	2,928	3,233	3,640	3,906	4,122	4,322	4,545	4,787
Gross domestic product (\$ bn.)	20.8	24.7	26.3	24.8	21.6	25.5	28.0	29.8	31.7	33.3	34.9	36.5
GDP per capita (\$ thousands)	62.5	73.1	75.4	69.5	59.4	69.0	74.8	78.4	82.1	86.4	90.7	95.2
Private consumption (percent of GDP)	49.3	50.1	50.3	49.9	51.6	51.7	50.7	51.2	51.4	51.3	51.0	50.6
Public consumption (percent of GDP)	23.0	23.7	24.1	24.5	27.8	27.4	25.3	24.4	24.3	24.7	25.3	25.8
Gross fixed investment (percent of GDP)	20.9	21.8	22.0	21.3	21.2	22.9	22.6	23.0	23.3	23.3	23.2	23.0
Gross national saving (percent of GDP)	29.2	26.0	25.8	26.9	22.2	20.2	23.0	23.5	23.6	23.4	23.1	23.0
Unemployment rate (percent of labor force)	3.3	3.3	3.1	3.9	6.4	6.0	4.7	4.0	4.0	4.0	4.0	4.0
Employment	4.1	1.0	1.8	0.9	-3.0	3.6	1.9	1.3	0.6	0.6	0.6	0.6
Labor productivity	2.8	3.8	2.7	1.5	-4.2	0.7	1.7	1.2	1.9	1.8	1.7	1.7
Real wages	6.8	7.4	3.7	1.8	3.4	3.7	1.8	1.8	1.8	1.8	1.8	1.8
Nominal wages	8.6	9.3	6.5	4.9	6.3	8.3	9.3	7.5	5.5	4.4	4.3	4.3
Consumer price index (average)	1.7	1.8	2.7	3.0	2.9	4.5	7.4	5.6	3.6	2.6	2.5	2.5
Consumer price index (end period)	1.9	1.9	3.7	2.0	3.6	5.1	8.0	4.6	2.9	2.5	2.5	2.5
ISK/€ (average)	134	121	128	141	157	148	...	...	...	...	...	...
ISK/\$ (average)	121	107	108	123	135	127	...	...	...	...	...	...
Terms of trade (average)	2.7	1.5	-3.7	-0.8	-1.2	3.7	6.2	-1.8	-2.1	-1.6	-1.1	-0.7
Money and Credit (End Period)												
Base money (M0)	3.0	37.9	-1.7	-9.2	11.8	9.0	13.2	7.1	5.4	4.8	5.1	5.3
Broad money (M3)	-4.6	5.0	7.0	6.6	7.4	10.9	14.6	7.5	5.7	5.0	0.3	0.4
Bank credit to nonfinancial private sector	4.4	9.2	11.9	2.9	10.5	10.3	12.6	7.3	5.5	4.9	5.2	5.3
Central bank 7 day term deposit rate 1/	5.00	4.25	4.50	3.00	0.75	2.00	3.75	...	...	...	...	...
(Percent of GDP unless otherwise indicated)												
General Government Finances 2/												
Revenue	59.0	45.4	44.8	41.9	42.1	40.4	42.0	42.2	41.7	41.8	41.7	41.4
Expenditure	46.4	44.4	43.8	43.4	50.7	49.3	46.8	45.0	43.4	42.8	42.2	41.7
Overall balance	12.5	1.0	0.9	-1.5	-8.7	-8.9	-4.8	-2.8	-1.8	-1.0	-0.5	-0.2
Structural primary balance	3.7	2.0	0.7	-2.2	-1.8	-2.7	-3.2	-1.0	-0.7	0.2	1.0	1.4
Cyclically-adjusted primary balance	15.0	3.3	1.4	-1.5	-4.8	-6.2	-2.2	-0.3	-0.3	0.6	1.2	1.4
Gross debt	82.4	71.6	63.1	66.2	77.4	75.0	68.3	63.3	60.5	57.5	57.8	51.4
Net debt	67.6	60.2	50.7	54.1	60.8	59.9	55.2	51.1	48.9	46.4	43.5	40.3
Balance of Payments												
Current account balance	8.1	4.2	3.5	5.8	1.0	-2.8	0.3	0.5	0.3	0.2	0.2	0.2
of which: services balance	10.5	10.6	9.0	8.6	2.4	2.9	3.0	3.8	4.3	4.7	5.1	5.5
Capital and financial account (+ = outflow)	8.5	1.1	5.7	5.4	5.5	1.4	0.1	0.3	0.2	0.0	0.0	0.1
of which: direct investment, net (+ = outflow)	-3.5	-0.7	1.7	2.8	2.5	-0.6	-2.1	0.3	0.3	0.2	0.2	0.2
Gross external debt	125.1	90.3	73.3	77.9	89.9	82.9	80.5	75.3	70.6	67.0	63.7	60.7
Central bank reserves (\$ bn.)	7.2	6.6	6.1	6.7	6.4	7.1	6.9	5.8	5.2	4.5	4.0	3.9

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

1/ For 2022, rate as of end-May.

2/ Since 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, 2016–27
(Billions of krónur, unless otherwise indicated)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Central Bank												
Net foreign assets	587	565	604	636	563	524	506	506	504	507	513	520
Assets	817	687	737	822	817	923	894	895	893	895	1,074	963
Liabilities	230	122	133	186	254	399	388	389	388	388	561	443
<i>of which: central government foreign currency deposits</i>	185	81	87	151	214	305	293	294	293	293	466	348
<i>of which: bank estates' foreign currency deposits 1/</i>	0	0	0	0	0	0	0	0	0	0	0	0
Net domestic assets	-479	-417	-458	-505	-416	-363	-324	-311	-299	-292	-287	-282
Central government, net	-30	-23	-108	-82	-134	-46	-46	-46	-46	-46	-46	-46
Assets	41	56	0	0	8	22	22	22	22	22	22	22
<i>of which: recapitalization bond</i>	29	0	0	0	0	0	0	0	0	0	0	0
Liabilities (current account)	71	79	108	82	142	68	68	68	68	68	68	68
Credit institutions (incl. nonbanks), net	-407	-378	-302	-351	-137	-189	-278	-265	-253	-247	-241	-236
Assets	2	6	6	6	8	8	8	8	8	8	8	8
Liabilities	410	384	308	357	145	197	286	273	261	254	249	244
<i>of which: term deposits and CDs</i>	339	303	231	299	145	196	178	178	176	180	185	192
Other items, net	-42	-16	-48	-72	-144	-128	-173	-169	-165	-161	-156	-152
ESI (asset management company)	36	9	5	3	2	1	0	0	0	0	0	0
Capital	44	22	58	82	151	134	129	124	120	115	111	106
Base Money	107	148	145	132	147	161	182	195	205	215	226	238
Currency issued	62	68	73	75	81	82	131	140	147	154	165	177
Deposit money banks' deposits at the central bank	45	80	72	57	66	79	51	55	58	61	61	61
Deposit Money Banks												
Net foreign assets	-257	-277	-270	-302	-323	-353	-347	-347	-348	-346	-343	-341
Assets	251	324	414	366	423	428	434	434	434	435	438	441
Liabilities	508	601	684	668	745	781	781	781	781	781	781	781
<i>of which: bonds</i>	406	504	577	569	634	666	666	666	666	666	666	666
Net domestic assets	1,845	1,942	2,052	2,203	2,362	2,621	2,909	3,102	3,259	3,403	3,400	3,397
Central bank, net	385	379	293	328	208	279	234	238	239	246	251	258
Assets	385	379	294	330	213	282	237	240	242	248	253	260
Liabilities	0	0	1	2	5	2	2	2	2	2	2	2
General government, gross	184	91	59	63	262	235	241	239	241	241	254	238
<i>of which: bonds</i>	164	70	38	42	234	202	208	207	209	208	222	206
Private sector, gross	2,285	2,483	2,781	2,873	3,187	3,507	3,946	4,232	4,463	4,678	4,916	5,174
Nonfinancial	2,133	2,328	2,606	2,681	2,964	3,270	3,681	3,951	4,169	4,372	4,597	4,841
Corporations	1,174	1,302	1,464	1,492	1,483	1,453	1,635	1,755	1,852	1,942	2,042	2,151
Households	959	1,027	1,142	1,189	1,481	1,817	2,046	2,195	2,317	2,430	2,555	2,690
Financial	152	154	175	192	222	237	265	282	294	306	318	332
Other items, net	-1,009	-1,011	-1,081	-1,062	-1,295	-1,400	-1,512	-1,607	-1,685	-1,761	-2,021	-2,272
Domestic deposits	1,588	1,665	1,782	1,901	2,039	2,268	2,562	2,755	2,911	3,056	3,056	3,056
Krona deposits	1,448	1,502	1,560	1,664	1,803	1,994	2,251	2,421	2,559	2,686	2,686	2,686
Foreign currency deposits	140	164	222	237	236	275	310	334	353	370	370	370
Consolidated Banking System												
Net foreign assets	330	289	334	335	241	171	159	158	157	161	170	179
Net domestic assets	1,314	1,437	1,513	1,633	1,872	2,172	2,526	2,728	2,894	3,041	3,044	3,046
General government, net	154	68	-49	-19	128	189	195	193	195	195	208	192
Private sector, gross	2,285	2,483	2,781	2,873	3,187	3,507	3,946	4,232	4,463	4,678	4,916	5,174
Other items, net	-1,125	-1,113	-1,219	-1,222	-1,442	-1,524	-1,615	-1,697	-1,764	-1,831	-2,080	-2,320
Broad money	1,643	1,726	1,846	1,968	2,113	2,343	2,684	2,887	3,051	3,203	3,213	3,225
<i>of which: currency in circulation</i>	55	60	64	67	74	74	123	132	139	146	157	169

Sources: CBI; and IMF staff projections.

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

Table 3. Iceland: Financial Soundness Indicators, 2018Q1–2021Q4 1/
(Percent)

	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4
Regulatory capital to risk-weighted assets 2/	23.3	22.6	22.9	23.2	22.4	22.6	22.9	24.2	24.5	24.8	24.5	24.9	24.3	24.9	24.8	25.4
Regulatory tier 1 capital to risk-weighted assets 2/	22.9	22.3	21.8	21.8	21.0	20.9	21.0	21.8	22.0	22.3	22.0	22.4	21.9	22.5	22.4	23.1
Net interest margin 2/	2.9	2.9	2.9	2.9	2.8	2.8	2.7	2.7	2.6	2.6	2.5	2.5	2.4	2.4	2.4	2.4
Return on assets 2/	1.9	1.9	1.7	1.6	1.4	1.4	1.3	1.2	-0.5	0.1	0.6	0.9	2.1	2.2	2.3	2.3
Return on equity 2/	10.1	10.8	9.8	9.2	8.7	8.7	8.3	7.2	-3.4	0.6	3.7	5.9	10.8	11.5	12.4	12.4
Net interest income to total income 2/ 3/	52.3	52.9	55.6	64.5	60.2	62.4	64.9	66.8	90.8	75.1	73.3	69.5	60.4	60.9	59.8	60.0
Noninterest expense to total income 2/ 3/	67.0	68.7	68.3	65.2	61.4	62.4	64.2	65.9	76.1	62.2	58.4	56.3	52.3	51.6	48.4	49.3
Liquid assets to total assets 2/ 4/	13.9	12.2	11.6	11.0	10.8	11.2	12.8	12.2	13.5	15.1	14.5	13.2	13.0	14.4	14.4	15.3
High-quality liquid assets to total assets	12.8	11.9	11.3	10.8	10.7	11.0	12.6	12.0	13.3	14.7	14.2	12.8	12.4	13.6	13.6	14.5
Net open foreign exchange position to capital 2/	0.3	2.2	0.0	0.3	0.0	0.7	1.0	2.1	-0.4	0.0	0.2	0.3	1.3	0.3	-0.4	-0.7
Total nonperforming loans (NPLs), facility level 5/	3.0	2.5	2.3	2.2	2.2	2.2	2.7	2.6	3.6	3.3	3.3	2.9	2.8	2.6	2.4	2.1
Household NPLs, cross default basis 6/ 7/	2.7	2.4	2.3	2.1	2.0	2.2	2.3	2.1	2.2	2.7	2.4	2.9	2.8	2.5	2.2	1.8
Corporate NPLs, cross default basis 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	17.8	17.6	16.7	14.2
Household and corporate NPLs, cross default basis 6/	5.1	5.0	4.7	4.7	4.2	3.5	3.6	3.6	4.6	6.0	6.1	10.9	10.5	10.0	9.3	7.8
Loan loss provisions to household loans in default	23.5	25.5	25.2	22.4	20.7	19.0	17.9	17.5	19.0	18.1	17.6	17.7	16.6	15.4	16.4	16.3
Loan loss provisions to corporate loans in default	37.9	40.5	42.6	31.4	32.5	35.7	33.3	31.5	34.1	33.6	34.2	34.1	33.1	28.1	28.4	27.9
Loan loss provisions to total loans in default	32.7	35.5	37.1	28.6	29.1	30.6	28.6	27.6	30.3	29.1	29.2	29.7	29.8	25.6	26.2	25.4

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, 2016–27 1/
(Percent of GDP)

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total Revenue	59.0	45.4	44.8	41.9	42.1	40.4	42.0	42.2	41.7	41.8	41.7	41.4
Taxes	46.9	33.7	33.0	31.7	33.2	31.5	32.9	33.4	33.0	33.3	33.3	33.1
Taxes on income and profits	17.1	18.3	18.0	17.4	18.5	17.1	17.7	18.0	18.0	18.0	18.0	17.9
Personal income tax	13.4	14.2	14.5	14.3	15.6	14.3	14.4	14.6	14.6	14.7	14.6	14.6
Corporate income tax	2.5	3.0	2.4	2.1	2.2	1.9	2.3	2.4	2.4	2.3	2.3	2.3
Capital gains tax and rental income	1.2	1.1	1.1	1.0	0.7	0.9	1.1	1.0	1.0	1.0	1.0	1.0
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	17.0	1.9	1.8	1.9	2.3	2.1	2.4	2.4	2.3	2.2	2.2	2.1
Taxes on goods and services	11.7	12.5	12.1	11.3	11.4	11.4	11.9	12.2	11.9	12.3	12.3	12.2
Value added tax	8.4	9.0	8.8	8.2	8.2	8.4	8.4	8.7	8.4	8.8	8.9	8.8
Other taxes on goods and services	3.3	3.4	3.4	3.2	3.2	3.0	3.4	3.5	3.5	3.5	3.5	3.4
Taxes on international trade	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other taxes	0.6	0.6	0.6	0.6	0.7	0.4	0.5	0.4	0.4	0.4	0.4	0.4
Social contributions	3.4	3.4	3.5	3.2	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
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	8.6	8.1	8.2	6.8	5.8	5.8	5.9	5.6	5.4	5.4	5.2	5.2
Property income	5.1	4.3	4.3	3.5	2.7	2.9	2.8	2.5	2.4	2.3	2.2	2.2
<i>of which: interest income</i>	3.2	2.7	2.8	2.3	1.8	1.8	1.0	1.0	0.9	0.9	0.9	0.9
Total Expenditure	46.4	44.4	43.8	43.4	50.7	49.3	46.8	45.0	43.4	42.8	42.2	41.7
Current Expenses	46.0	43.4	41.8	41.9	49.3	47.5	45.1	43.4	41.8	41.2	40.6	40.1
Compensation of employees	13.5	14.1	14.2	14.2	16.0	15.9	15.0	14.6	14.5	14.4	14.2	14.1
Use of goods and services	10.4	10.6	10.8	10.8	11.9	11.6	11.2	11.1	11.2	10.9	10.7	10.6
Consumption of fixed capital	2.2	2.1	2.1	2.1	2.4	2.4	2.2	2.1	2.0	2.0	1.9	1.9
Interest	6.1	5.7	4.9	4.3	4.0	4.1	4.2	4.0	2.7	2.7	2.7	2.6
Subsidies	1.2	1.2	1.2	1.2	1.8	1.4	1.9	1.5	1.5	1.5	1.4	1.4
Grants	0.2	0.2	0.2	0.2	0.3	0.2	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	5.9	6.5	6.6	7.3	10.1	9.4	8.0	7.5	7.5	7.4	7.3	7.3
Other expense 2/	6.6	3.1	1.8	1.7	2.7	2.5	2.3	2.2	2.1	2.0	1.9	1.9
Nonfinancial Assets	0.5	1.0	2.1	1.5	1.4	1.8	1.7	1.6	1.6	1.7	1.6	1.6
Nonfinancial assets, acquisition	2.6	3.1	4.1	3.6	3.9	4.2	3.8	3.7	3.7	3.7	3.5	3.4
Consumption of fixed capital (-)	-2.2	-2.1	-2.1	-2.1	-2.4	-2.4	-2.2	-2.1	-2.0	-2.0	-1.9	-1.9
Net Lending/Borrowing	12.5	1.0	0.9	-1.5	-8.7	-8.9	-4.8	-2.8	-1.8	-1.0	-0.5	-0.2
Financial Assets, Transactions	5.6	-6.7	-1.2	-1.3	1.2	-5.3	-3.1	-3.3	-1.4	-1.3	2.6	-3.5
Currency and deposits	-4.8	-5.6	-0.3	0.4	4.1	-2.3	-0.3	0.0	0.0	0.0	3.8	-2.5
Securities other than shares	1.2	1.3	1.3	-2.4	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Loans	1.3	-4.9	-3.0	0.1	-3.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Shares and other equities	7.0	-5.6	-1.1	-0.4	0.1	0.0	-2.1	-2.5	-0.5	-0.5	-0.4	-0.4
Other accounts receivable	0.8	8.0	1.9	1.0	-0.2	-3.2	-0.9	-0.9	-1.0	-1.0	-0.9	-0.8
Liabilities, Transactions	-6.9	-7.7	-2.1	0.2	9.9	3.6	1.7	-0.3	0.5	-0.2	3.1	-3.3
Securities other than shares	-2.8	-4.8	-2.9	-3.5	6.3	-1.7	-0.2	-0.9	-0.1	-0.7	2.7	-3.8
Loans	-5.5	-3.2	-0.4	3.4	2.4	5.3	1.9	0.5	0.6	0.5	0.4	0.3
Krona denominated	-2.8	0.2	-0.7	1.2	0.2	5.3	1.0	0.5	0.6	0.5	0.4	0.3
Foreign currency denominated	-2.7	-3.4	0.3	2.1	2.2	0.0	0.9	0.0	0.0	0.0	0.0	0.0
Insurance technical reserves	0.1	0.2	0.2	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.2
Other accounts payable	1.2	0.1	1.1	0.1	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Debt	82.4	71.6	63.1	66.2	77.4	75.0	68.3	63.3	60.5	57.5	57.8	51.4
Krona denominated	74.2	67.1	58.7	60.0	68.9	65.5	58.9	54.6	52.2	49.6	50.3	44.3
Foreign currency denominated	8.2	4.5	4.5	6.2	8.5	9.5	9.4	8.8	8.3	7.9	7.5	7.2
Net Debt 3/	67.6	60.2	50.7	54.1	60.8	59.9	55.2	51.1	48.9	46.4	43.5	40.3
Memorandum Items:												
Primary revenue	55.8	42.7	42.0	39.6	40.3	38.7	40.9	41.2	40.7	40.9	40.8	40.5
Primary expenditure	40.4	38.7	38.9	39.1	46.7	45.2	42.6	41.1	40.8	40.1	39.5	39.0
2/ In 2020, the definition of the general government	15.5	3.9	3.1	0.5	-6.4	-6.6	-1.7	0.1	0.0	0.8	1.3	1.5
Structural balance	0.7	-1.0	-1.6	-4.3	-3.9	-5.0	-6.3	-4.0	-2.5	-1.6	-0.8	-0.4
Structural primary balance	3.7	2.0	0.7	-2.2	-1.8	-2.7	-3.2	-1.0	-0.7	0.2	1.0	1.4
Gross domestic product (ISK bn)	2,512	2,642	2,844	3,043	2,928	3,233	3,640	3,906	4,122	4,322	4,545	5

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, 2016–27
(Percent of GDP)

	2016	2017	2018	2019	2020 Prel.	2021 Proj.	2022 Proj.	2023 Proj.	2024 Proj.	2025 Proj.	2026 Proj.	2027 Proj.
Financial Assets	86.7	83.7	78.9	74.2	82.2	75.2	63.7	56.1	51.7	48.0	48.2	42.3
Currency and deposits	14.8	11.4	12.5	12.1	16.7	15.1	13.1	12.3	11.6	11.1	14.3	11.1
Other assets	104.4	95.2	89.2	86.1	65.5	60.1	50.6	43.8	40.1	36.9	33.9	31.1
Securities other than shares	4.7	5.8	6.7	4.3	4.7	4.3	3.8	3.6	3.4	3.2	3.1	2.9
Loans	35.8	29.1	24.0	23.0	20.8	17.5	15.7	14.7	14.1	13.6	13.0	12.5
Shares and other equities	21.0	27.8	27.5	27.6	32.2	31.9	26.2	22.0	20.3	18.9	17.5	16.3
Other accounts receivable 1/	42.9	32.5	31.0	31.2	7.7	6.4	4.8	3.5	2.4	1.3	0.3	-0.6
Liabilities	116.4	105.0	95.6	98.8	114.0	109.7	99.2	92.1	87.7	83.5	82.5	75.0
Gross debt	82.4	71.6	63.1	66.2	77.4	75.0	68.3	63.3	60.5	57.5	57.8	51.4
Securities other than shares	62.4	54.6	47.8	48.2	56.3	50.5	44.6	40.7	38.5	36.0	36.9	31.2
Loans	20.0	17.0	15.3	18.1	21.1	24.5	23.7	22.6	22.0	21.5	20.9	20.2
Krona denominated	11.7	12.4	10.8	11.7	12.3	13.5	12.9	12.6	12.5	12.5	12.3	12.0
Foreign currency denominated	8.3	4.6	4.5	6.4	8.8	11.0	10.7	10.0	9.5	9.0	8.6	8.2
Other liabilities	34.0	33.4	32.4	32.6	36.6	34.7	30.8	28.7	27.2	26.0	24.7	23.6
Insurance technical reserves	27.7	26.9	26.2	27.0	29.2	26.6	23.6	22.0	20.8	19.9	18.9	18.1
Other accounts payable	6.3	6.4	6.2	5.6	7.4	8.1	7.2	6.7	6.4	6.1	5.8	5.5
Net Financial Worth 1/	-29.7	-21.3	-16.6	-24.6	-31.8	-34.5	-35.5	-36.0	-36.0	-35.5	-34.3	-32.8
Memorandum Item:												
Net debt 2/	67.6	60.2	50.7	54.1	60.8	59.9	55.2	51.1	48.9	46.4	43.5	40.3

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, 2016–27

	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Billions of dollars)											
Current account	1.7	1.0	0.9	1.4	0.2	-0.7	0.1	0.1	0.1	0.1	0.1	0.1
Trade balance	1.4	1.1	0.9	1.1	-0.2	-0.5	0.4	0.4	0.3	0.2	0.2	0.2
Balance on goods	-0.8	-1.5	-1.5	-1.0	-0.7	-1.3	-0.5	-0.7	-1.0	-1.4	-1.6	-1.8
Merchandise exports f.o.b.	4.5	5.0	5.7	5.3	4.6	6.0	7.4	7.4	7.3	7.2	7.2	7.3
Merchandise imports f.o.b.	5.3	6.5	7.2	6.3	5.3	7.3	7.9	8.1	8.3	8.6	8.8	9.1
Balance on services	2.2	2.6	2.4	2.1	0.5	0.7	0.8	1.1	1.4	1.6	1.8	2.0
Exports of services, total	5.4	6.3	6.5	5.7	2.8	3.7	5.4	5.9	6.3	6.7	7.1	7.5
Imports of services, total	3.2	3.7	4.2	3.6	2.3	2.9	4.5	4.7	4.9	5.1	5.3	5.5
Primary income balance	0.4	0.1	0.3	0.5	0.5	0.1	0.0	0.0	0.0	0.1	0.1	0.1
Receipts	1.1	0.8	0.7	0.7	0.5	0.5	0.4	0.5	0.5	0.5	0.6	0.6
of which: dividends and reinvested earnings	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4
of which: interest receipts	0.5	0.3	0.2	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Expenditures	0.7	0.7	0.4	0.2	0.0	0.4	0.4	0.5	0.4	0.4	0.4	0.4
of which: dividends and reinvested earnings	0.0	0.0	-0.2	-0.4	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
of which: interest payments	0.6	0.6	0.5	0.4	0.4	0.3	0.3	0.3	0.4	0.3	0.4	0.4
Secondary income balance	-0.1	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Capital and financial account (+ = outflow)	1.8	0.3	1.5	1.3	1.2	0.4	0.0	0.1	0.1	0.0	0.0	0.0
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)	1.8	0.3	1.5	1.4	1.2	0.4	0.1	0.1	0.1	0.0	0.0	0.1
Direct investment (+ = outflow)	-0.7	-0.2	0.5	0.7	0.5	-0.2	-0.6	0.1	0.1	0.1	0.1	0.1
Portfolio investment ("+" = outflow)	1.9	2.3	1.2	0.6	0.9	0.1	0.7	1.1	0.7	0.7	0.7	0.5
Assets (+ = outflow)	1.0	1.0	1.1	1.0	0.6	1.5	1.5	1.4	1.4	1.4	1.1	1.1
Liabilities (+ = inflow)	-1.0	-1.3	-0.1	0.4	-0.3	1.3	0.8	0.3	0.7	0.7	0.4	0.6
of which: net borrowing (+ = inflow)	-1.0	-1.7	-0.3	-0.3	-0.3	1.5	0.6	0.0	0.4	0.4	0.0	0.1
Other investment (+ = outflow)	-1.8	-1.1	-0.2	-0.5	-0.1	-0.8	0.1	-0.1	-0.1	-0.1	-0.3	-0.4
Assets (+ = outflow)	-5.5	-0.8	0.2	-1.0	0.2	0.0	0.0	-0.1	-0.2	-0.2	-0.3	-0.4
Liabilities (+ = inflow)	-3.7	0.3	0.4	-0.4	0.2	0.8	-0.2	0.0	-0.1	-0.1	0.0	0.0
of which: net outflows related to bank estates' compositions	0.1	0.0	-0.3	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	N.A.
Change in reserve assets (+ = increase/outflow)	2.4	-0.8	0.0	0.6	-0.2	1.1	-0.2	-1.1	-0.7	-0.7	-0.5	-0.2
Net errors and omissions (+ = inflow)	0.1	-0.7	0.6	-0.1	1.0	1.1	0.0	0.0	0.0	0.0	0.0	0.0
	(Percent of GDP)											
Current account	8.1	4.2	3.5	5.8	0.8	-2.8	0.3	0.5	0.3	0.2	0.2	0.2
Trade balance	6.6	4.5	3.3	4.5	-0.8	-2.1	1.3	1.4	1.0	0.6	0.5	0.6
Balance on goods	-3.9	-6.1	-5.7	-4.1	-3.1	-5.1	-1.7	-2.4	-3.2	-4.1	-4.6	-4.9
Merchandise exports f.o.b.	21.7	20.2	21.8	21.5	21.4	23.6	26.4	24.9	23.0	21.8	20.8	20.1
Merchandise imports f.o.b.	25.6	26.3	27.5	25.5	24.5	28.7	28.2	27.3	26.3	25.8	25.4	25.0
Balance on services	10.5	10.6	9.0	8.6	2.4	2.9	3.0	3.8	4.3	4.7	5.1	5.5
Exports of services, total	25.8	25.6	24.9	22.9	12.9	14.5	19.2	19.6	19.8	20.2	20.3	20.5
Imports of services, total	15.3	14.9	15.8	14.3	10.6	11.6	16.2	15.9	15.6	15.5	15.2	15.0
Primary income balance	2.0	0.5	1.1	2.1	2.4	0.4	0.0	0.1	0.2	0.3	0.4	0.4
Receipts	5.1	3.2	2.7	2.7	2.4	1.9	1.6	1.6	1.6	1.6	1.6	1.6
of which: interest receipts	2.4	1.1	0.6	0.6	0.3	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Expenditures	3.2	2.7	1.7	0.6	0.0	1.5	1.6	1.5	1.4	1.3	1.3	1.2
of which: interest payments	2.9	2.3	1.8	1.7	1.7	1.0	1.2	1.2	1.1	1.0	1.1	1.0
Secondary income balance	-0.5	-0.8	-0.8	-0.8	-0.9	-1.0	-1.0	-0.9	-0.8	-0.8	-0.7	-0.7
Capital and financial account (+ = outflow)	8.5	1.1	5.7	5.4	5.5	1.4	0.1	0.3	0.2	0.0	0.0	0.1
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)	8.6	1.2	5.8	5.5	5.6	1.5	0.2	0.4	0.3	0.1	0.1	0.2
Direct investment (+ = outflow)	-3.5	-0.7	1.7	2.8	2.5	-0.6	-2.1	0.3	0.3	0.2	0.2	0.2
Portfolio investment ("+" = outflow)	9.3	9.2	4.5	2.4	4.1	0.4	2.4	3.7	2.2	2.1	2.0	1.5
Assets (+ = outflow)	4.6	4.0	4.1	4.1	2.6	5.7	5.4	4.6	4.3	4.1	3.2	3.0
Liabilities (+ = inflow)	-4.6	-5.2	-0.4	1.7	-1.4	5.3	3.0	0.9	2.1	2.0	1.1	1.6
of which: net borrowing (+ = inflow)	-4.6	-6.9	-1.1	-1.2	-1.3	5.8	2.3	0.1	1.4	1.3	-0.1	0.2
Other investment (+ = outflow)	-8.8	-4.4	-0.8	-2.1	-0.2	-3.2	0.5	-0.2	-0.2	-0.3	-0.9	-1.2
Assets (+ = outflow)	-26.4	-3.3	0.9	-3.8	0.9	0.0	-0.1	-0.3	-0.6	-0.7	-0.9	-1.2
Liabilities (+ = inflow)	-17.6	1.2	1.7	-1.8	1.1	3.2	-0.6	-0.1	-0.3	-0.4	0.0	0.0
Change in reserve assets (+ = increase/outflow)	11.5	-3.3	0.2	2.2	-0.9	4.5	-0.7	-3.5	-2.1	-2.0	-1.4	-0.4
Net errors and omissions (+ = inflow)	0.6	-3.0	2.3	-0.3	4.8	4.4	0.0	0.0	0.0	0.0	0.0	0.0
Central bank reserves (\$ bn)	7.2	6.6	6.1	6.7	6.4	7.1	6.9	5.8	5.2	4.5	4.0	3.9
(Percent of GDP)	34.9	26.5	23.1	27.1	29.6	27.9	24.7	19.6	16.4	13.6	11.6	10.6
Memorandum item:												
Gross domestic product (\$ bn)	20.8	24.7	26.3	24.8	21.6	25.5	28.0	29.8	31.7	33.3	34.9	36.5

Sources: CBI; and IMF staff projections.

Table 7. Iceland: International Investment Position, 2011–21
(Percent of GDP)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Assets	265.2	278.2	276.4	250.6	213.0	157.1	115.5	119.4	127.6	152.3	157.7
Direct investment	88.7	95.4	109.4	99.4	91.2	63.7	25.8	26.3	26.4	28.6	25.0
Portfolio investment	52.2	59.0	62.5	63.9	40.1	37.4	43.7	46.1	57.7	75.8	86.9
Equity and investment fund shares	32.5	34.8	34.6	36.8	35.3	34.9	40.1	40.5	51.7	69.5	80.2
Debt securities	19.7	24.2	27.9	27.1	4.8	2.5	3.5	5.6	5.9	6.3	6.8
Financial derivatives	0.0	0.1	0.2	0.6	0.5	0.3	0.5	0.4	0.4	0.6	0.2
Other investment	64.9	94.4	79.6	61.3	53.0	23.3	19.5	20.7	16.1	19.5	17.0
Reserve assets	59.3	29.3	24.7	25.4	28.3	32.5	26.0	25.9	27.0	27.9	28.6
Liabilities	789.4	724.4	661.2	623.4	218.1	155.2	113.5	110.1	108.1	118.7	117.6
Direct investment	96.6	81.9	97.0	96.4	92.4	80.7	45.0	40.6	38.8	38.6	35.5
Portfolio investment	326.0	324.2	285.9	289.1	41.8	49.0	42.9	42.6	44.5	50.8	51.0
Equity and investment fund shares	3.2	3.2	3.5	3.6	4.0	3.6	4.8	5.7	10.8	13.1	12.8
Debt securities	322.7	320.9	282.5	285.5	37.8	45.4	38.0	36.9	33.7	37.7	38.3
Financial derivatives	0.2	0.1	0.3	0.8	0.6	0.4	0.4	0.2	0.1	0.2	0.5
Other investment	366.5	318.3	278.0	237.1	83.3	25.2	25.2	26.7	24.7	29.1	30.5
Net International Investment Position	-524.2	-446.2	-384.8	-372.9	-5.1	1.9	2.0	9.3	19.5	33.6	40.2

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. External Sector Assessment

Overall Assessment: The external position of Iceland in 2021 was weaker than the level implied by fundamentals and desirable policies. The current account balance recorded a large deficit in 2021 due to a sharp deterioration in the merchandise trade balance and primary income balance, despite an improvement in the service trade compared to 2020. The assessment reflects the adjustment to the current account for the transitory impact from the pandemic, due mainly to the tourism balance. A strong positive net international investment position and its trajectory, and adequate foreign exchange reserve buffers supports the external sustainability and mitigates potential adverse risks due to the cyclical position of the economy.

Potential Policy Responses: Medium-term fiscal consolidation by gradually removing stimulus, at a pace dependent on economic developments, in coordination with a tighter stance on monetary and macroprudential would support improvement in the current account balance in the near term. Structural reforms to diversify exports and encourage firm digitalization and innovation, and to minimize economic scarring will be critical to maintaining external competitiveness and the recovery in the current account. The flexible foreign exchange rate should act as the main shock absorber, with interventions limited to disorderly market conditions.

Foreign Assets and Liabilities: Position and Trajectory

Background. The net international investment position (NIIP) climbed to 40.2 percent of GDP in 2021 from 33.6 percent in 2020, continuing a steady rise since it turned positive in 2016. Despite a negative impact from the current account, the NIIP benefitted from valuations and returns on investments abroad. Gross assets represent 158 percent of GDP in 2021, with 73 percent of the positions in portfolio investment funds, mostly held by pension funds, and 25 percent in FDI. Gross liabilities stood at 118 percent of GDP, with mostly from portfolio investments in debt securities (about 38 percent) and FDI (about 36 percent). Among debt securities, more than half were Eurobonds issued abroad by banks and 28 percent were nonresidents' holdings of government bonds issued abroad.

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

2021 (% GDP)	NIIP: 40.2	Gross Assets: 157.7	Debt Assets: 30.1	Gross Liab.: 117.6	Debt Liab.: 82.6
--------------	------------	---------------------	-------------------	--------------------	------------------

Current Account

Background. The current account (CA) balance sharply deteriorated in 2021 to a deficit of 2.8 percent of GDP, compared to an average surplus of 5.5 percent of GDP in 5 years preceding the pandemic, and 0.8 percent in 2020. The deterioration was largely driven by a large merchandise trade deficit, due mainly to a strong import demand, and a much weaker than expected primary income balance. Increases in imports were concentrated in industrial supplies, capital goods, especially transport equipment, and consumer goods, all exceeding the pre-pandemic levels. Despite a marginal improvement from 2020, the pandemic continued to derail the service trade balance in 2021, which remained significantly below the pre-pandemic. The weakening of primary income balance was due mainly to improved performance among foreign-owned companies classified as direct investment. The CA balance is projected to return to surplus in 2022 and hover around 0.2 percent of GDP over the medium term with the dissipation of the impact of COVID-19 pandemic and a stronger export performance.

Assessment. The EBA-lite cyclically adjusted CA balance stood at -3.0 percent of GDP in 2021. The EBA-lite CA regression estimates a norm of 3.7 percent of GDP, thus implying a CA gap of -6.7 percent. Additional cyclical considerations factor in the transitory impacts of the COVID-19 pandemic on tourism balance (2.3 percent of GDP), and transportation (-0.5 percent of GDP), durable goods (0.6 percent of GDP) and medical supplies (0.8 percent of GDP). Thus, with the additional cyclical considerations, the IMF staff-assessed CA gap is assessed to be -3.5 percent. Negative contribution mainly from the relative fiscal policy gap (larger than the world average) is offset by the other policies leaving most of the gap unexplained (model residuals).

	CA model	REER model
CA-Actual	-2.8	
Cyclical contributions (from model) (-)	0.2	
COVID-19 adjustor (+) 1/	3.1	
Natural disasters and conflicts (-)	-0.1	
Adjusted CA	0.2	
CA Norm (from model) 2/	3.7	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	3.7	
CA Gap	-3.5	7.1
o/w Relative policy gap	0.7	
Elasticity	-0.31	
REER Gap (in percent)	11.1	-22.7

1/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism (2.3 percent of GDP) medical goods (0.8 percent of GDP), transportation (-0.5 percent of GDP) and household consumption (0.6 percent of GDP).

2/ Cyclically adjusted, including multilateral consistency adjustments.

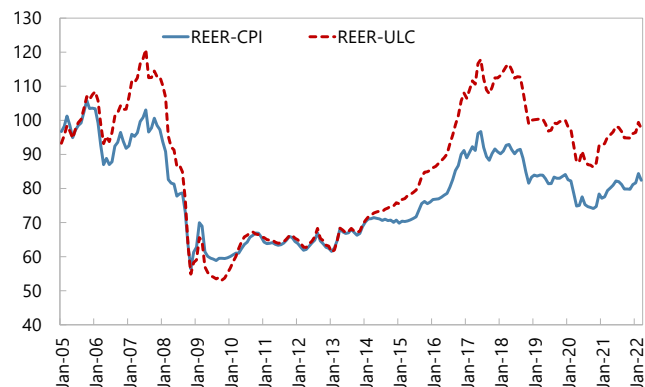
Real Exchange Rate

Background. The REER based on the consumer price and the unit labor cost appreciated by 4.2 and 5.9, respectively, on average from 2020 to 2021. The appreciation in 2021 reversed the weakening of the real exchange rate after three consecutive years, after reaching the lowest point during the pandemic from the post-GFC appreciation peak in 2017. In the first quarter of 2022, compared to the 2021 average, the CPI based REER appreciated further by 3.4 percent.

Assessment. The IMF staff CA gap implies a 11.1 percent real overvaluation (applying an estimated elasticity of 0.31). The EBA-lite REER model suggests an undervaluation of 22.7 percent. The REER gap implied by the CA model tends to be more reliable, especially in the presence of a large divergence from the REER model, and therefore serves as a basis to the staff assessment.

Real Effective Exchange Rate

(Index, 2005=100)



Sources: CBI and IMF INS Database

Capital and Financial Accounts: Flows and Policy Measures

Background. Gross capital inflows increased sharply (at about 8.6 percent of GDP) in 2021, marking a significant departure from a persistent reduction in financial account liabilities since the GFC. Increases in liabilities were mainly due to portfolio investment (long-term debt securities) and other investments, of which 1.7 percent of GDP accounts for SDR allocation. Gross outflows were excessive in 2021 (at 10.1 percent of GDP) compared to the recent past, driven mostly by portfolio investment. The net outflows, in turn, were about 1.5 percent of GDP. The discrepancy between financial account and the CA balance has resulted in a large net error and omission for the second year in a row. With the exchange rate act of 2021, the remaining capital flow management measures (CFM) introduced in 2008 were removed, and no new CFMs have been introduced.

Assessment. Capital inflows to Iceland remain dependent on global market conditions, however, vulnerabilities related to external financing are contained, given the positive stock position and adequate foreign exchange reserve buffers. The removal of CFMs was in line with the Fund’s institutional view on capital flow management.

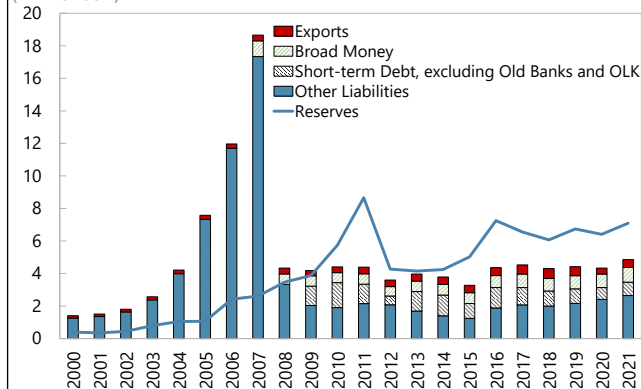
FX Intervention and Reserves Level

Background. Under the floating exchange rate regime, the CBI uses interventions to counter disorderly market conditions. The CBI’s share in the foreign exchange market was 21 percent in 2021 (down from 38 percent in 2020). The CBI’s foreign exchange market activities included direct interventions, regular and pre-announced sales, and discretionary interventions mainly in connection with the public offering of a major public bank (Íslandsbanki). Interventions were two-sided with net sales at about 0.7 percent of GDP in 2021. Foreign exchange reserves increased to US\$7.1 billion by the end-2021 from US\$6.4 billion at the end-2020, due also to the SDR allocation. This level was equivalent to 28 percent of GDP and about 7 months of prospective goods and services imports.

Assessment. At 146 percent of the Fund’s ARA metric, the end-2021 level of reserves remained adequate for precautionary purposes.

Iceland: RAM Decomposition

(In Bil of USD)



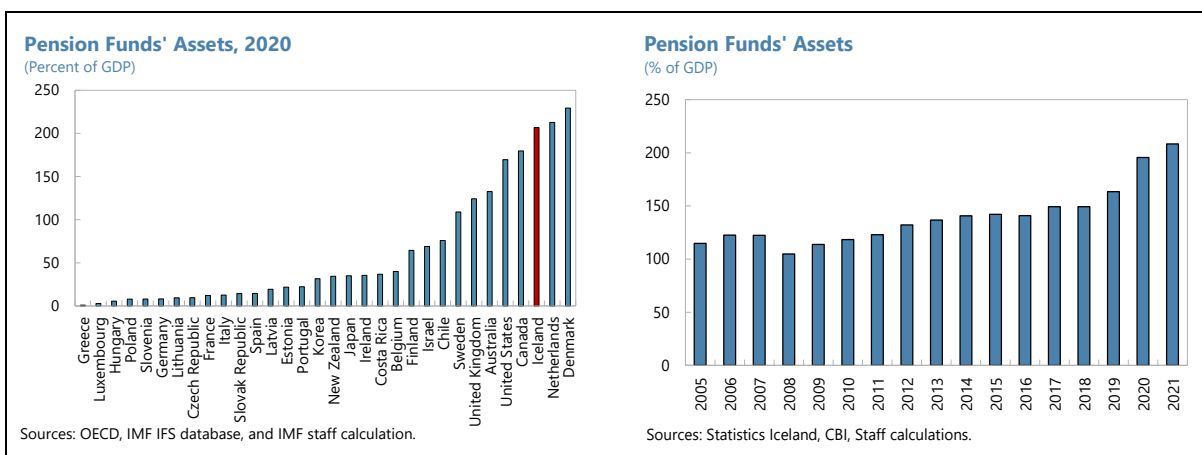
Sources: CBI and IMF staff calculations

Annex II. Iceland's Pension Funds' Assets¹

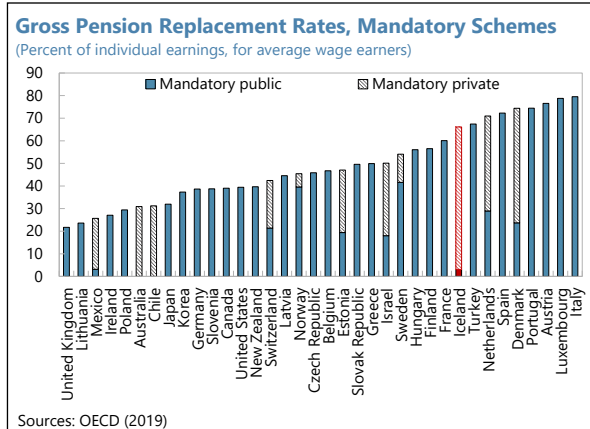
Iceland's pension system has grown significantly in recent years, taking the lion's share in the country's financial system. Pension funds' asset allocation and interconnectedness with the banking system imply increasing systemic importance for macroeconomic and financial stability. Thus, closer monitoring and assessment of the pension funds' risks and sustainability are important to mitigate the impact of an adverse shock and its spillover on the financial system and the real economy.

Overview of the Pension System

1. The assets of Iceland's pension funds are among the largest globally, when measured relative to GDP. They reached above 200 percent of GDP by end-2021, doubling their size since the Global Financial Crisis.² Various factors such as the prevalent high effective retirement age of Icelanders and the fully funded occupational pension funds (OPFs) along with favorable macroeconomic performance in the last decade have contributed to growth in the pension system.



2. Among the three pillars, assets managed for mandatory public and occupational schemes represent most of the assets. The other pillar constitutes a voluntary scheme, representing about 15 percent of total pension fund assets. Characterized by strong mandatory occupational pensions (with a minimum mandatory contribution of 12 percent), the system represents a hybrid of defined benefit and defined contribution schemes, with a

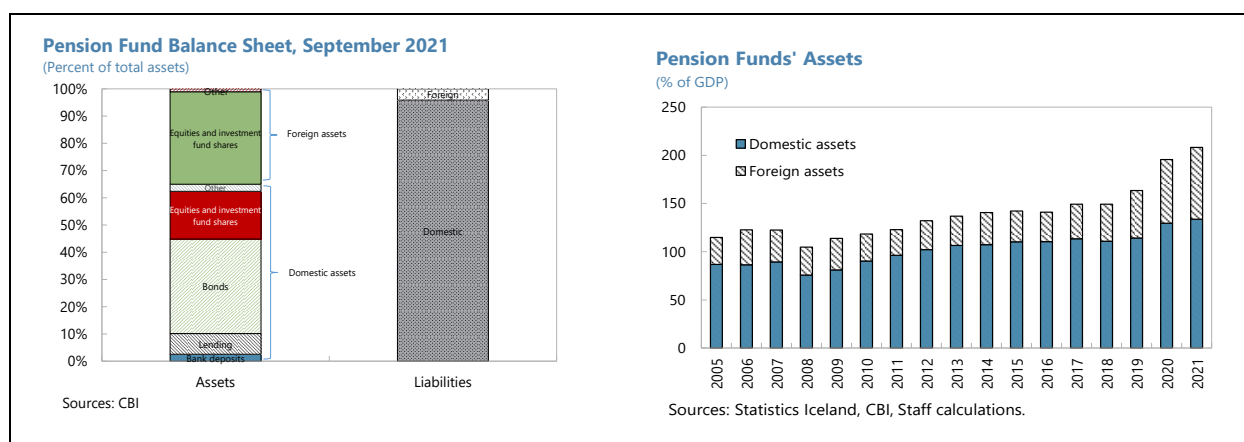


¹ Prepared by Mahir Binici and Chikako Baba.

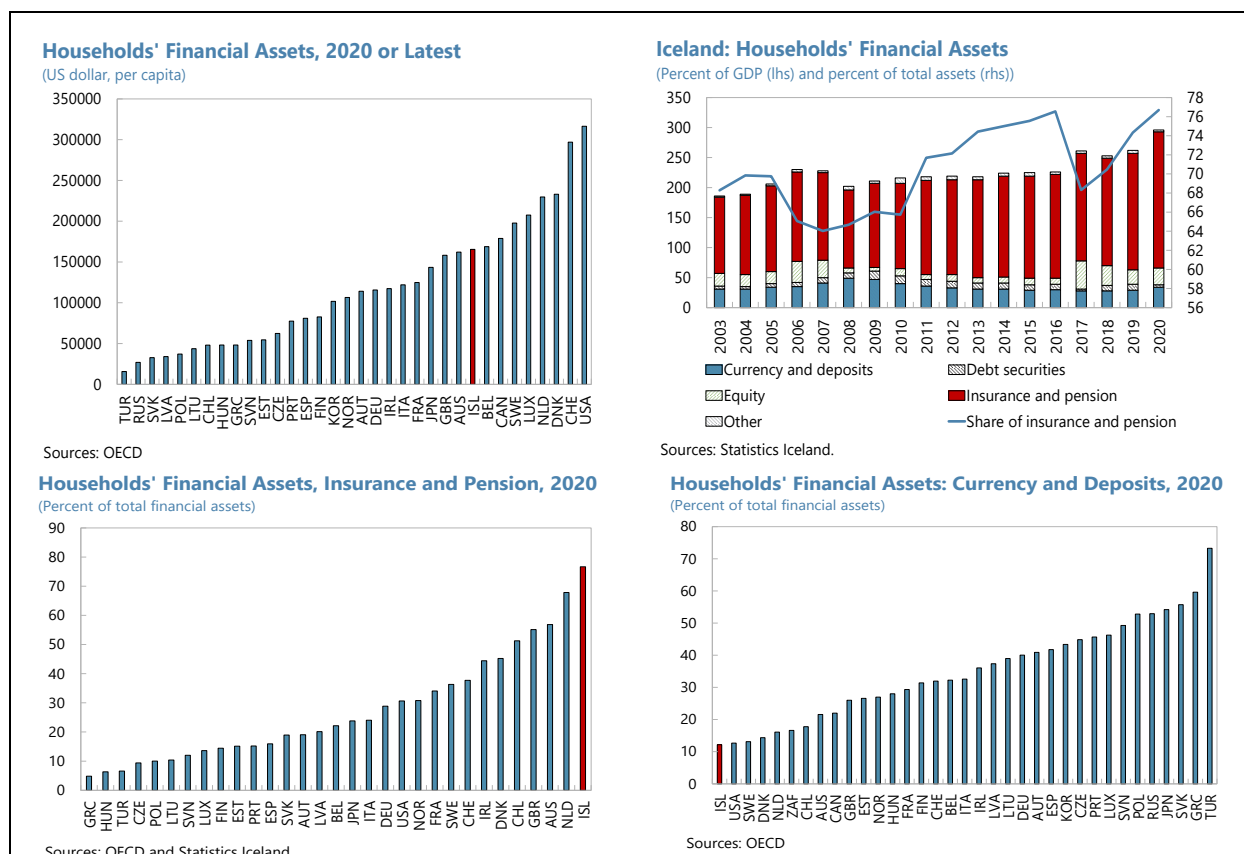
² There is a discrepancy in the size of pension fund assets in the nominal ISK term between the authorities' statistics and OECD statistics. Pension fund assets represent 194 percent of GDP with the CBI data, and 206 percent of GDP in OECD's data.

replacement rate of the defined contribution scheme of at least 56 percent for pensioners contributing for more than 40 years. In addition to the mandatory pension schemes, 60 percent of Icelanders participate in voluntary private pensions that are usually defined contribution. A new pension fund regulation, submitted to parliament, will increase the mandatory contribution rate to 15.5 percent from 12 percent, with employers' contribution at 11.5 percent. The targeted replacement rate is 72 percent, which implies a high real return requirement, currently at 3.5 percent.

3. The majority of assets are invested domestically. The average share of foreign assets rose to about 30 percent ahead to the GFC but dropped after the crisis. The share has been rising since the liberalization of capital controls in 2016, and foreign assets represent about 36 percent of total assets by end-2021, and 75 percent of GDP. The regulatory limit on foreign exchange exposure of pension funds is 50 percent of total assets. Large pension funds also seem to invest more in FX assets. Some funds are close to the 50 percent exposure limit, while other funds (typically personal pension savings) invest mostly in ISK. New regulations are set to gradually allow higher limits for pension funds' foreign exchange exposures (up to 65 percent over a period of 12 years), which would imply a further liberalization of the capital account, the risk and benefit of which should be evaluated as guided by the integrated approach in the Fund's institutional view on capital flows.



4. Compared to other advanced economies, households in Iceland own relatively large financial assets. About $\frac{3}{4}$ of household assets are in the form of insurance and pension funds, and the rest are currency and deposits. The household asset composition, therefore, has important implications for the systemic importance of the pension sector in the financial system, and the commercial banks' funding structure.



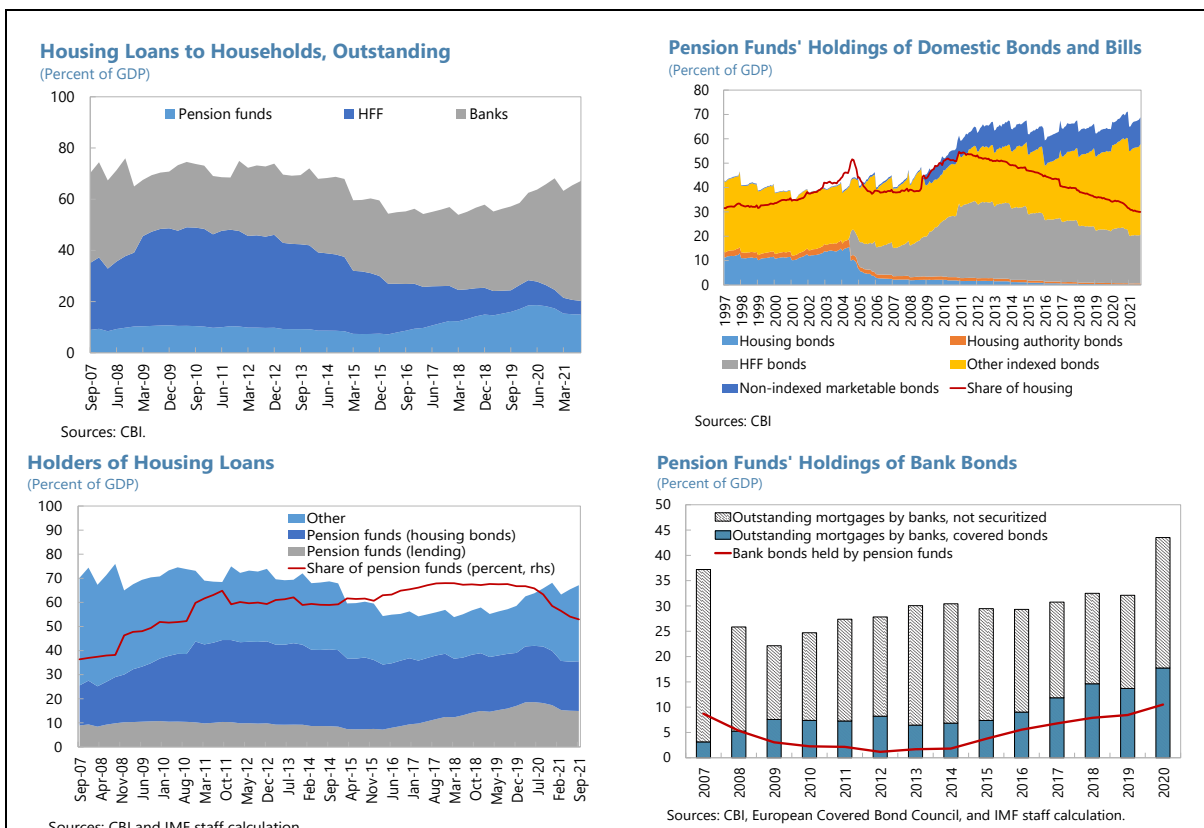
Pension Funds' Footprint in the Icelandic Financial Landscape

a. Housing Loans and Bonds

5. Pension funds have significant direct and indirect exposures to their members. As of September 2021, pension funds represent 22 percent of lending to households, after declining recently from a peak of about 30 percent in early 2020, reflecting the recent expansion in mortgage lending by commercial banks. In addition to the direct lending to households, pension funds' indirect exposures to household debt are through holdings of housing related bonds (including HFF bonds and covered bonds issued by commercial banks). About 30 percent of the domestic bonds held by pension funds finance mortgages. If this exposure corresponds to the outstanding housing loans, pension funds finance in total about a half of the mortgage market.

6. Pension funds are also large holders in the bond market. Assuming that all of pension funds' holdings of domestic bonds issued by deposit taking corporations represent covered bonds, pension funds hold about 60 percent of outstanding covered bonds, which is about 1/4 of outstanding mortgage lending by banks.³

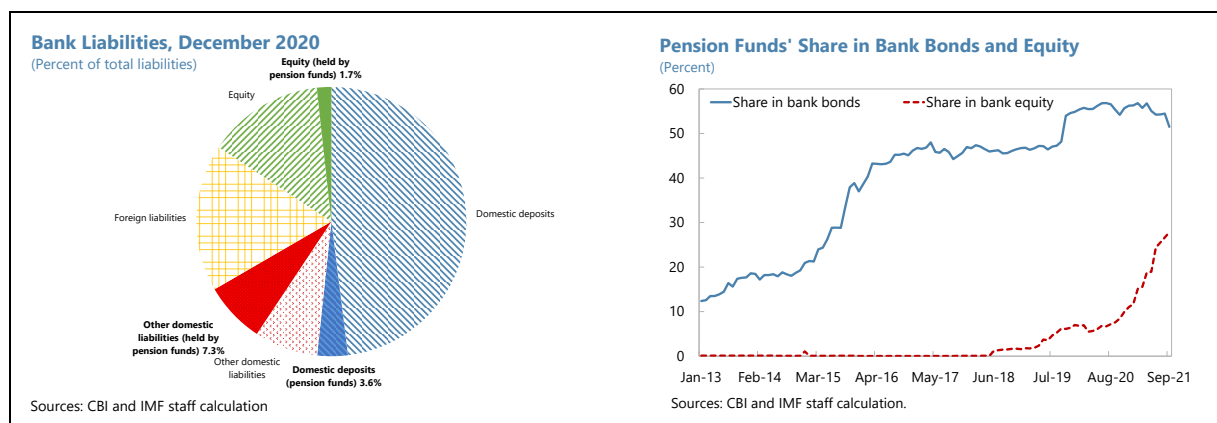
³ Icelandic banks typically issue covered bonds in the domestic market and senior unsecured debt in the international market. Charts in this note assumes all covered bonds are issued domestically, and all unsecured bonds and subordinated loans are issued externally for foreign investors.



b. Importance in Bank Funding

7. Pension funds account for about 13 percent of total bank liabilities. This includes (1) deposits with commercial banks (accounting for 3½ percent of bank liabilities), (2) holding of bank bonds (accounting for 7¼ percent of bank liabilities) and (3) holding of bank equity (accounting for 1¾ percent of bank liabilities).

8. Pension funds account for a sizable portion of banks' non-deposit funding. About a half of domestic bonds issued by banks are held by pension funds. On the other hand, pension funds represent only about 6–10 percent of total domestic deposits. Pension funds increasingly invest in bank equity since the bank privatization started. In aggregate, pension funds own about 25 percent of bank shares in 2021.



Oversight of the Pension System

9. Macroprudential regulations are uniform across pension funds and other financial institutions, especially those engaging in lending to the households. For instance, loan-to-value (LTV) and the recently introduced debt-service-to-income (DSTI) ratios are applied equally to all mortgage lenders in Iceland, including banks, pension funds, the housing and construction authority and other registered lenders. This limits the scope for leakages and regulatory arbitrage, improving the efficacy of the macroprudential measures in mitigating cyclical systemic risk. The intention to include pension funds in the CBI's recently launched lending survey of financial institutions is also welcome.

10. However, better oversight of the pension funds is needed given their increasingly systemic role and close interlinkages within the financial system. While the pension funds could be shock absorbers in times of financial stress, they could also become shock transmitters. Pension funds' large real reference rate of 3.5 percent—exceeding Iceland's real long-term growth rate—could force them to enter increasingly risky asset classes. Large losses in foreign or domestic markets could trigger margin calls, sending shockwaves to the Icelandic foreign exchange market and domestic funding markets. Cuts to pension benefits in the mandatory DC system below the expected replacement rate could cause social tensions and calls for government and CBI's intervention. Furthermore, as the Icelandic population ages, pension funds will need to make greater benefit payments, gradually squeezing funding in the Icelandic bond, equity, and mortgage markets.

11. The CBI's power to oversee the pension funds' governance and risk management practices should be strengthened. A comprehensive review of the existing pension fund regulations is needed to ensure their coherence with the latest regulatory developments in the banking and the rest of the financial system, especially with regards to the CBI's role in overseeing the governance and risk management of the pension funds. The issues around the governance that needs further considerations include fitness and probity of nominee committee members, which body nominates the boards of pension funds, assessment of board members' conflict of interests in relation to investment decision making and independence from stakeholders' interests. Further supervisory powers should also be given to oversee pension fund actuaries. The CBI's overall

supervisory power over the pension funds should be further strengthened and the split of powers between the CBI and the government should be better clarified.

12. The CBI could also conduct regular stress-testing of pension funds. A framework for this exercise could follow the recently published EIOPA framework, which could assess spillovers from and to other financial institutions and the economy.⁴ The 2019 EIOPA stress-test, which did not include Icelandic pension funds found that an instantaneous and adverse market scenario could generate a significant asset-liability gap in pension funds' balance sheets.⁵ While pension funds are able to withstand short-term market volatility and downturn for longer period than other financial institutions, this could have a long-term negative impact on future retirement income. A stress-test would thus also be important to gauge potential government contingent liabilities, especially should an adverse shock reduce the replacement rate below the socially sustainable level.⁶

⁴ EIOPA, 2021, [Methodological Framework for Stress Testing IORPS](#).

⁵ EIOPA, 2019, Occupational Pensions Stress Test 2019.

⁶ ILO's minimum standard requires that the replacement rate be at least 40 percent of previous earnings after 30 years of contributions for at least those beneficiaries with earnings lower than prevailing or average levels.

Annex III. Risk Assessment Matrix¹

Risks	Relative Likelihood	Impact if Realized	Policy Response
<p>Russia’s invasion of Ukraine leads to escalation of sanctions and other disruptions. Sanctions on Russia are broadened to include oil, gas, and food sectors. Russia is disconnected almost completely from the global financial system and large parts of the trading system.</p>	<p>High</p> <ul style="list-style-type: none"> • Further escalation of the war in Ukraine causes severe supply chain disruptions, commodity price shocks, and a global slowdown. 	<p>High</p> <ul style="list-style-type: none"> • Worldwide tourism flows are further subdued. • Spillovers from lower than envisaged trading partner activity. • Deanchoring inflation expectations. 	<ul style="list-style-type: none"> ▪ Reassess potential growth, given the prospects for tourism recovery. ▪ Provide targeted fiscal support to vulnerable households. ▪ Adjust monetary policy, factoring the output gap, inflation expectations, and exchange rate developments.
<p>Outbreaks of lethal and highly contagious Covid-19 variants. Rapidly increasing hospitalizations and deaths, caused by vaccine-resistant variants, force increased uncertainty about the course of the pandemic.</p>	<p>Medium</p> <ul style="list-style-type: none"> • Volatile growth with increased divergence across countries. 	<p>Medium</p> <ul style="list-style-type: none"> • Worldwide tourism flows remain subdued. • Spillovers from lower than envisaged trading partner activity. 	<ul style="list-style-type: none"> ▪ Allow the exchange rate to adjust. ▪ Ease monetary policy if inflation and inflation expectations fall below target. ▪ Reopen targeted pandemic-related fiscal support measures.
<p>De-anchoring of inflation expectations in the U.S. and/or advanced European economies. Worsening supply-demand imbalances, higher commodity prices (in part due to war in Ukraine), and higher nominal wage growth lead to persistently higher inflation and/or inflation expectations, prompting central banks to tighten policies faster than anticipated.</p>	<p>Medium for the US and Medium-low for the Euro Area</p> <ul style="list-style-type: none"> • Tightening of global financial conditions and spiking risk premia due to rising policy rates in the U.S. 	<p>Medium</p> <ul style="list-style-type: none"> • Currency depreciation puts pressure on inflation; high premium complicates government financing. 	<ul style="list-style-type: none"> ▪ Allow the exchange rate to adjust, with foreign exchange intervention to prevent disorderly market conditions. ▪ Tighten monetary policy to prevent a widening interest differential. ▪ Strengthen government liquid buffers to ensure smooth financing of government financing needs.

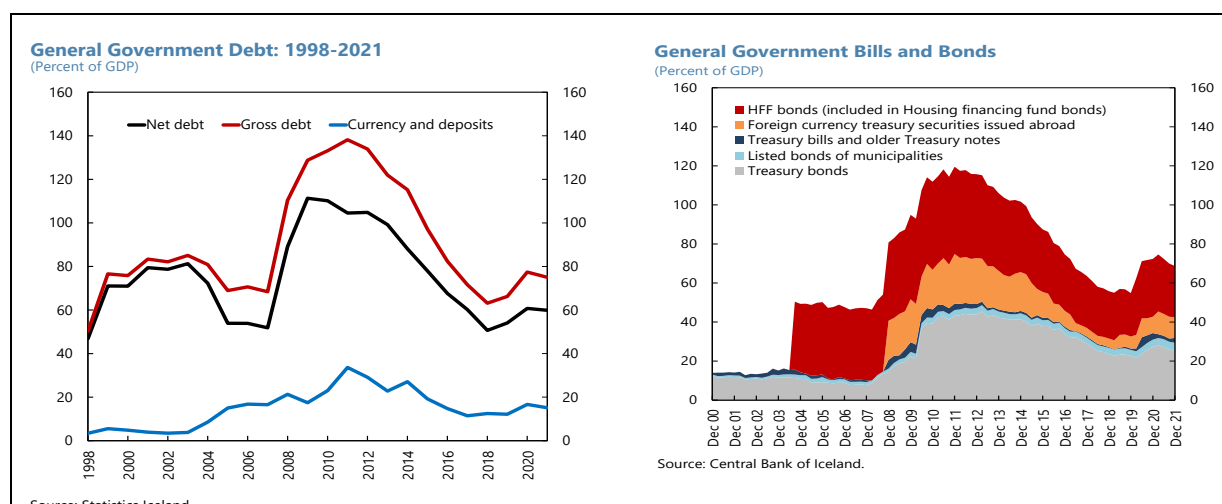
¹ Shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of the IMF staff). The relative likelihood of risks listed is the staff’s subjective assessment of the risks surrounding the baseline (“low” is meant to indicate a probability below 10 percent, “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.

Risks	Relative Likelihood	Impact if Realized	Policy Response
Rising and volatile food and energy prices.	High Rising commodity prices amid pent-up demand, supply disruptions,	Medium • Further deanchoring of inflation expectations.	<ul style="list-style-type: none"> Allow the exchange rate to adjust, with foreign exchange intervention to prevent disorderly market conditions.
	conflicts, or a bumpy energy transition.	• Iceland's favorable TOTs and low dependence on fossil fuels are mitigating factors.	<ul style="list-style-type: none"> Adjust monetary policy, factoring the output gap, inflation expectations, and exchange rate developments. Provide targeted fiscal support to vulnerable households or heavily affected companies.
Widespread social discontent and political instability: Social unrest fueled by increasing prices and shortages of essentials, rising inequality, inadequate healthcare, financial and social scars from the prolonged pandemic, and heavier household debt burdens amid rising interest rates	High • Socio-economic hardship, political polarization, and instability abroad.	Medium • Disruptions in global economic activity and possible increase in risk aversion causes capital flight, exchange rate depreciation, and deanchoring of inflation expectations.	<ul style="list-style-type: none"> Let automatic stabilizers operate. Allow exchange rate to adjust with intervention to prevent disorderly markets. Adjust monetary policy, factoring the output gap, to steer inflation and inflation expectations toward the target.
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.	<ul style="list-style-type: none"> Support affected sectors and rebuild damaged infrastructure reallocating fiscal spending as needed. Allow exchange rate to adjust with intervention to prevent disorderly markets.

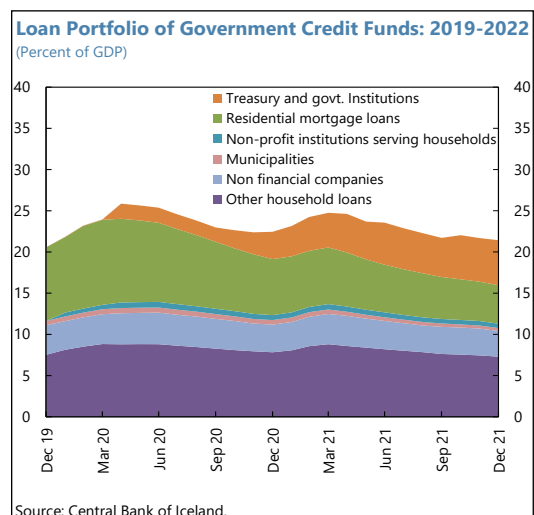
Annex IV. Public Sector Debt Sustainability Analysis

Iceland's public debt vulnerabilities remain manageable with the envisaged medium-term fiscal outlook. Nevertheless, the high uncertainty of the macroeconomic outlook itself poses some risk, especially given the relatively low maturity of public debt. Iceland's large institutional investor sector managing a mandatory pension saving scheme offers some comfort. Staff's baseline projections assume the government spending projections in the new government's fiscal policy statements adjusted for inflation differences and staff's macroeconomic framework.

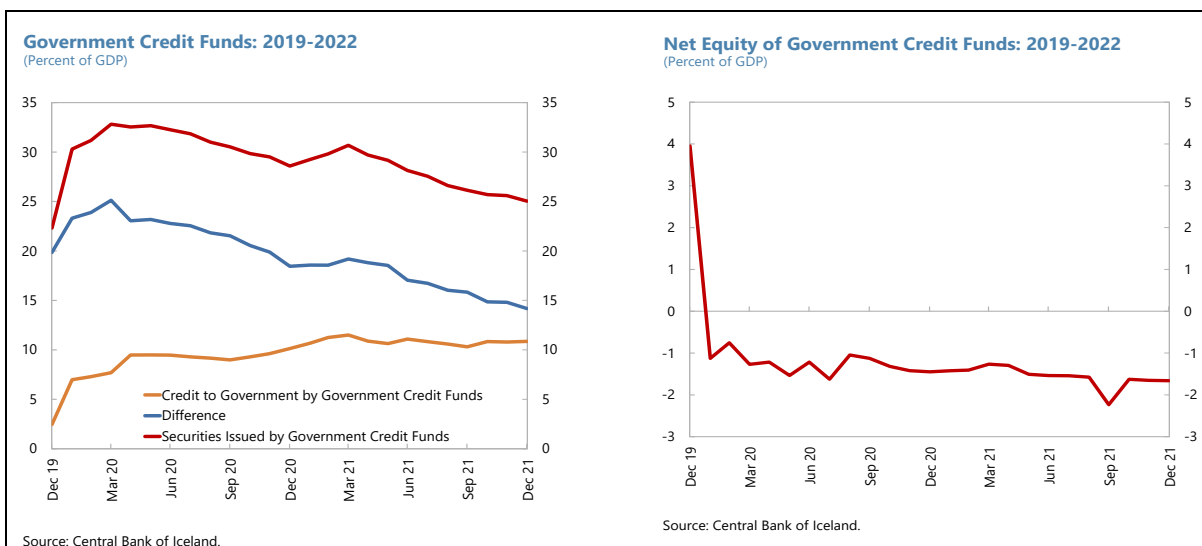
1. The size of public debt remains manageable. Gross general government debt amounted to 75 percent of GDP by end 2021, with net debt close to 60 percent of GDP after netting liquid currency and deposits. Most of the gross debt is in the form of securities issued by the Treasury and the IL Fund, formerly the Housing Financing Fund (HFF). currency and deposits. Most of the gross debt is in the form of securities issued by the Treasury and the IL Fund, formerly the Housing Financing Fund (HFF).



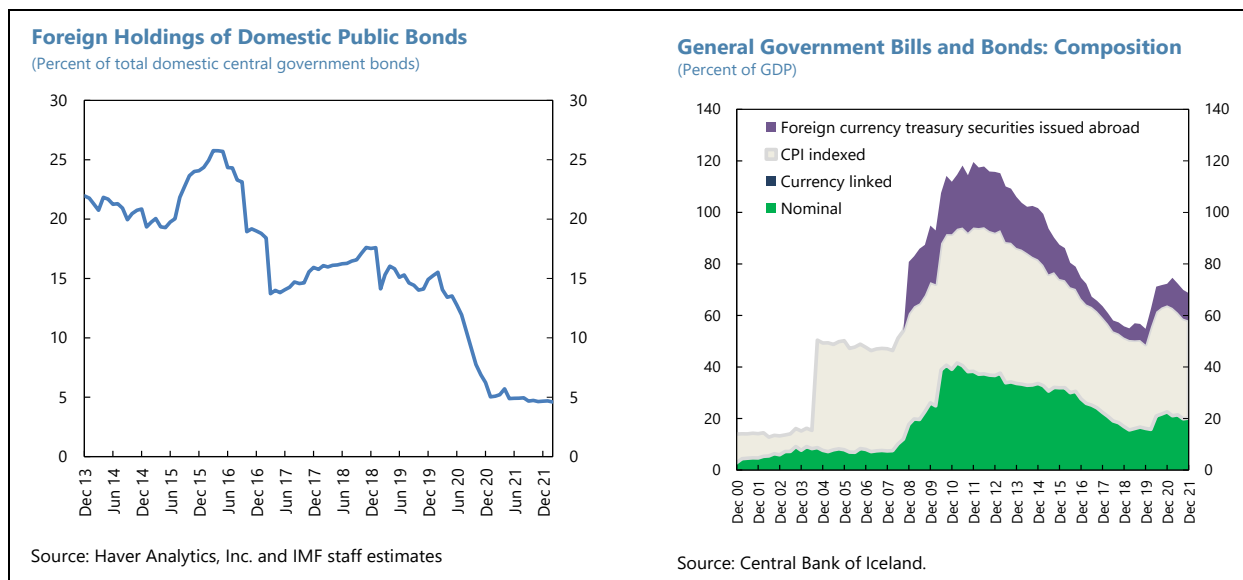
2. The public debt to GDP ratio declined in 2021 despite an 8.9 percent general government deficit. The net general government debt fell by about 1 percent of GDP on account of (i) favorable debt dynamics (nominal GDP growth being higher than the implicit nominal interest rate) and (ii) the sale of shares of state-owned bank Islandsbanki. The initial public offering of 35 percent of Islandsbanki's shares contributed 1.7 percent of GDP in deficit funding. The accelerated mortgage prepayments to the IL Fund of 2.7 percent of GDP were partly onlent to the Treasury and partly invested in government securities, reducing the net increase in securities at the consolidated general government level. By end 2021, the outstanding stock of residential mortgage loans by



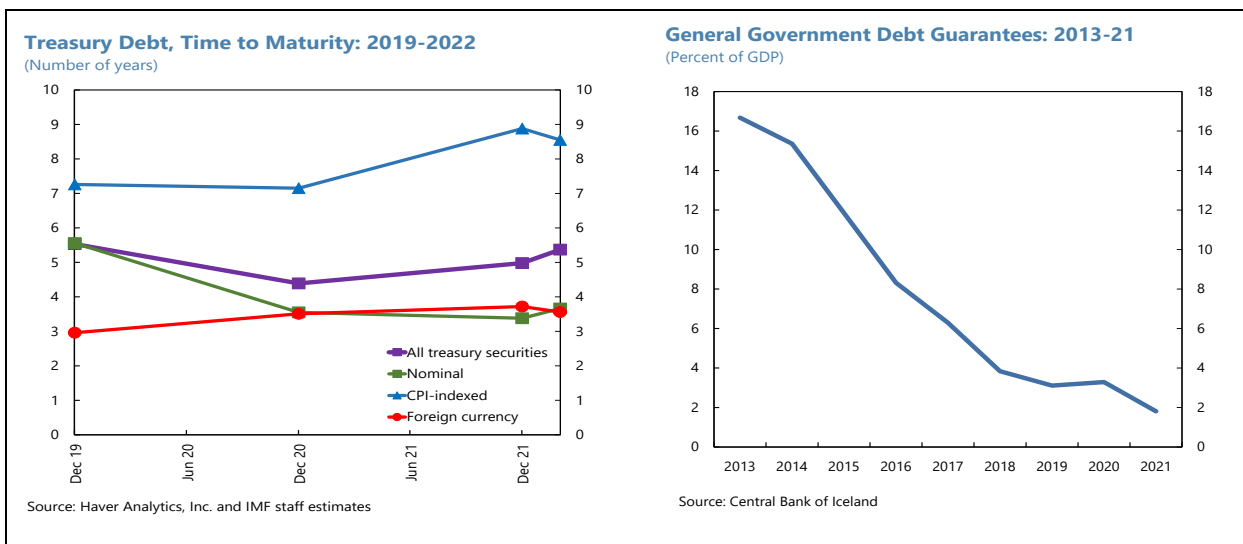
government credit funds amounted to about 5 percent of GDP. The rapid decline of the mortgage portfolio has provided liquidity to the treasury, but increased its net present value loss, as these loans were funded with indexed securities bearing interest rates that exceed those prevailing in the market. By end 2021, the net present value loss is estimated at 6 percent of GDP, while the net equity of all government credit funds is -1.7 percent of GDP. These losses are manageable and should be included in the government definition of debt subject to fiscal rules, although full incorporation of the government credit funds-as is done in this DSA-is preferable.



3. The outstanding general government debt has diversified composition but short maturity. The net government debt bears little currency risk, as most of the debt is denominated in domestic currency, while most of the foreign currency debt issued abroad is hedged with foreign currency deposits in the central bank. More than two thirds of government debt denominated in króna is CPI-indexed, so that holders bear moderate-to-low inflation risk. The share of foreign investors in krona-denominated domestic securities issued by the treasury declined substantially during the pandemic, partly reflecting a delayed effect of the liberalization of “offshore-krona” securities. Among domestic investors, pension funds hold about 40 percent and banks about 25 percent of public debt. Public debt is subject to some degree of liquidity and interest rate risk, as the average time to maturity of domestic government securities is about 5 years, with public debt issued abroad having a maturity of about 3.5 years. Iceland has enjoyed favorable market access abroad and domestically, the latter facilitated by a large institutional investor base including pension and domestic investment funds. In addition, state-owned enterprises provide at times additional sources of revenue, and the announced intention to divest a significant amount of the government’s ownership in the banking system provides a potential cushion to meet forthcoming gross financial needs.



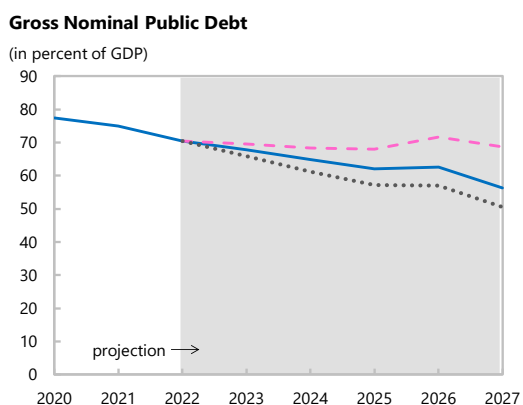
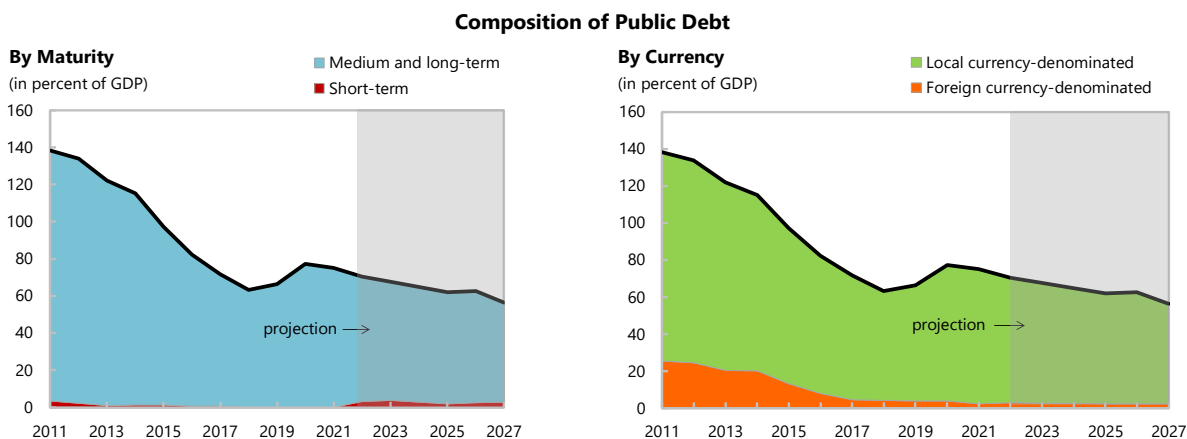
4. The general government debt guarantees are marginal. They declined to 2 percent of GDP in 2021 from 3 percent of GDP the previous year. The guaranteed debt of government credit funds is already included in general government debt. In March 2022, guaranteed debt declined further when Icelandair cancelled in advance its 0.4 percent of GDP guarantee from the Treasury. Remaining guarantees include pandemic-related support loans and debt of the national power company and the airport authority, among others.



5. The DSA is based on staff’s baseline fiscal projections. The DSA is based on staff’s baseline fiscal projections. These are in line with the 2022 budget and 2023–26 fiscal policy statement. The debt sustainability analysis suggests a debt-stabilizing primary balance of 0.4 percent of GDP, which is expected to be reached by 2026, the year in which fiscal rules are scheduled to be reactivated. This is also consistent with the authorities’ fiscal objective of stabilizing public sector debt by the end of the forecast horizon. The analysis does not raise any red flag, and the forecasts in

the framework are assessed to be realistic. The authorities' intention to divest its remaining share in Islandsbanki by end 2023 is conservatively incorporated into the forecast (2 percent of GDP), consistent with the medium-term fiscal strategy plan. This amount could be used as a source of funding instead of newly issued government securities.

Annex IV. Figure 1. Iceland: Public Debt Sustainability Analysis (DSA)—Composition of Public Debt and Alternative Scenarios



Underlying Assumptions (in percent)

Baseline Scenario	2022	2023	2024	2025	2026	2027	Historical Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	3.6	2.5	2.5	2.4	2.3	2.3	Real GDP growth	3.6	2.7	2.7	2.7	2.7	2.7
Inflation	8.6	4.7	3.0	2.4	2.8	2.9	Inflation	8.6	4.7	3.0	2.4	2.8	2.9
Primary Balance	-1.7	0.1	0.0	0.8	1.3	1.5	Primary Balance	-1.7	1.9	1.9	1.9	1.9	1.9
Effective interest rate	6.3	6.1	3.9	4.3	4.6	4.5	Effective interest rate	6.3	6.1	4.2	4.7	5.0	5.0
Constant Primary Balance Scenario													
Real GDP growth	3.6	2.5	2.5	2.4	2.3	2.3							
Inflation	8.6	4.7	3.0	2.4	2.8	2.9							
Primary Balance	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7							
Effective interest rate	6.3	6.1	4.0	4.5	4.9	4.8							

Source: IMF staff.

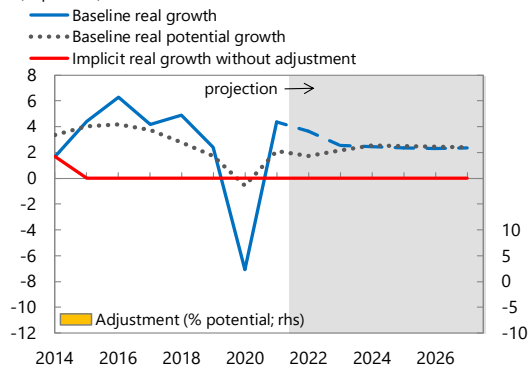
Annex IV. Figure 2. Iceland: Public Debt Sustainability Analysis (DSA)—Realism of Baseline Assumptions

Growth and Level of Output in Absence of Fiscal Adjustment

Assumed multiplier of 1, persistence of 0.6

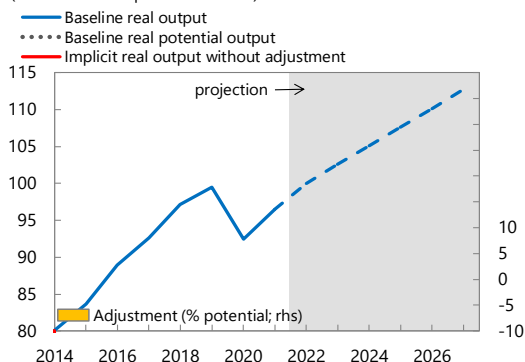
Real GDP Growth

(in percent)



Real Output Level

(Baseline real output in 2022=100)

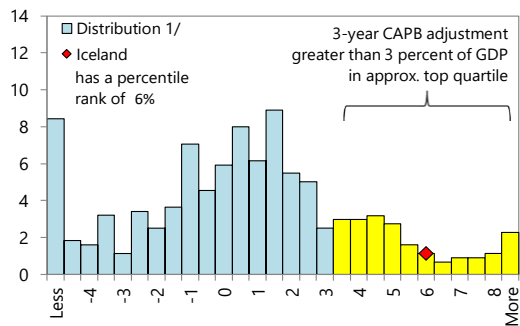


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted

Primary Balance (CAPB)

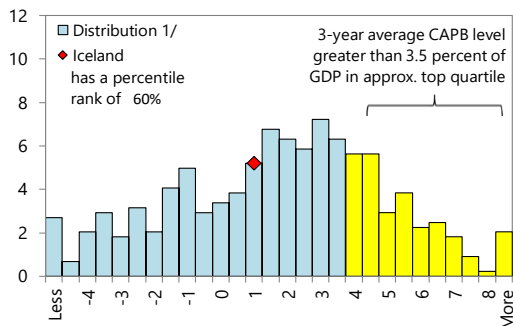
(Percent of GDP)



3-Year Average Level of Cyclically-Adjusted Primary

Balance (CAPB)

(Percent of GDP)



Source : IMF staff.

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

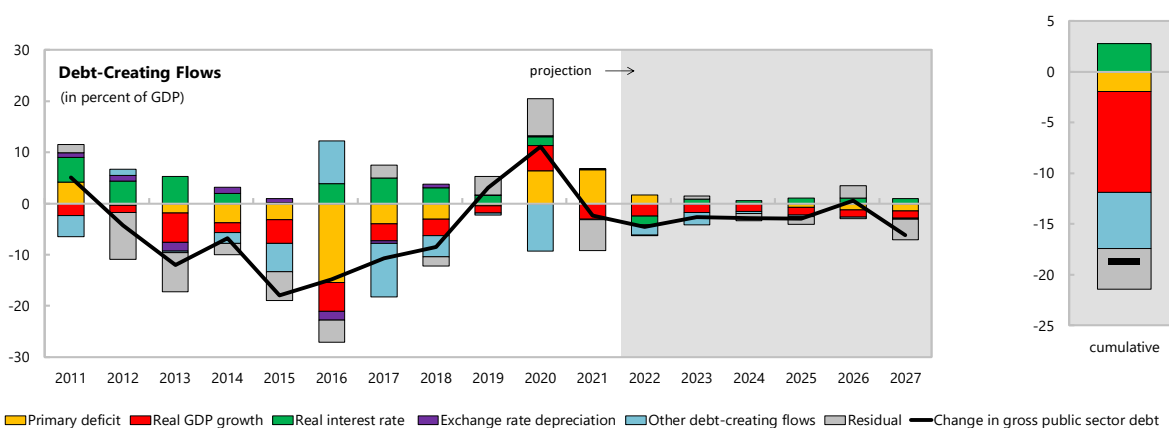
Annex IV. Figure 3. Iceland: Public Debt Sustainability Analysis (DSA) —Baseline Scenario (Percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators ^{1/}

	Actual			Projections						As of January 31, 2022		
	2011-2019 ^{2/}	2020	2021	2022	2023	2024	2025	2026	2027	Sovereign Spreads		
Nominal gross public debt	98.9	77.4	75.0	70.4	67.7	64.9	62.0	62.5	56.3	EMBIG (bp) ^{3/}	210	
Public gross financing needs	10.1	12.6	15.3	13.2	7.1	6.1	4.4	4.0	7.8	5Y CDS (bp)	69	
Real GDP growth (in percent)	3.5	-7.1	4.3	3.6	2.5	2.5	2.4	2.3	2.3	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	3.2	3.6	5.8	8.6	4.7	3.0	2.4	2.8	2.9	Moody's	A2	A2
Nominal GDP growth (in percent)	6.8	-3.8	10.4	12.6	7.3	5.5	4.9	5.2	5.3	S&Ps	A	A
Effective interest rate (in percent) ^{4/}	6.8	5.9	5.8	6.3	6.1	3.9	4.3	4.6	4.5	Fitch	A	A

Contribution to Changes in Public Debt

	Actual			Projections						cumulative	debt-stabilizing primary balance ^{9/}
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027		
Change in gross public sector debt	-7.4	11.2	-2.4	-4.6	-2.7	-2.8	-2.9	0.5	-6.2	-18.7	
Identified debt-creating flows	-4.9	3.9	3.6	-4.5	-3.3	-1.4	-1.5	-1.9	-2.2	-14.7	
Primary deficit	-3.1	6.4	6.6	1.7	-0.1	0.0	-0.8	-1.3	-1.5	-1.9	-0.7
Primary (noninterest) revenue and grants	42.1	40.3	38.7	40.9	41.2	40.7	40.9	40.8	40.5	245.1	
Primary (noninterest) expenditure	39.0	46.7	45.2	42.6	41.1	40.8	40.1	39.5	39.0	243.1	
Automatic debt dynamics ^{5/}	0.2	6.8	-3.1	-4.2	-0.8	-1.0	-0.4	-0.3	-0.5	-7.2	
Interest rate/growth differential ^{6/}	0.1	6.6	-3.2	-4.2	-0.8	-1.0	-0.4	-0.3	-0.5	-7.2	
Of which: real interest rate	3.3	1.8	-0.1	-1.8	0.9	0.6	1.1	1.0	0.9	2.7	
Of which: real GDP growth	-3.3	4.9	-3.0	-2.4	-1.7	-1.6	-1.5	-1.4	-1.4	-9.9	
Exchange rate depreciation ^{7/}	0.1	0.2	0.1	...	...	...	...	...	...	...
Other identified debt-creating flows	-2.0	-9.3	0.1	-1.9	-2.4	-0.4	-0.3	-0.3	-0.2	-5.6	
General government net privatization proceeds (negative)	0.0	-6.2	0.0	-2.1	-2.5	-0.5	-0.5	-0.4	-0.4	-6.3	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Net lending	-1.9	-3.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.8	
Residual, including asset changes ^{8/}	-2.5	7.3	-6.0	-0.1	0.6	-1.4	-1.5	2.4	-4.0	-4.0	



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 $[(r - \pi(1+g) - g + ae(1+r))/(1+g+\pi+g\pi)]$ 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 $r - \pi(1+g)$ and the real growth contribution as $-g$.

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

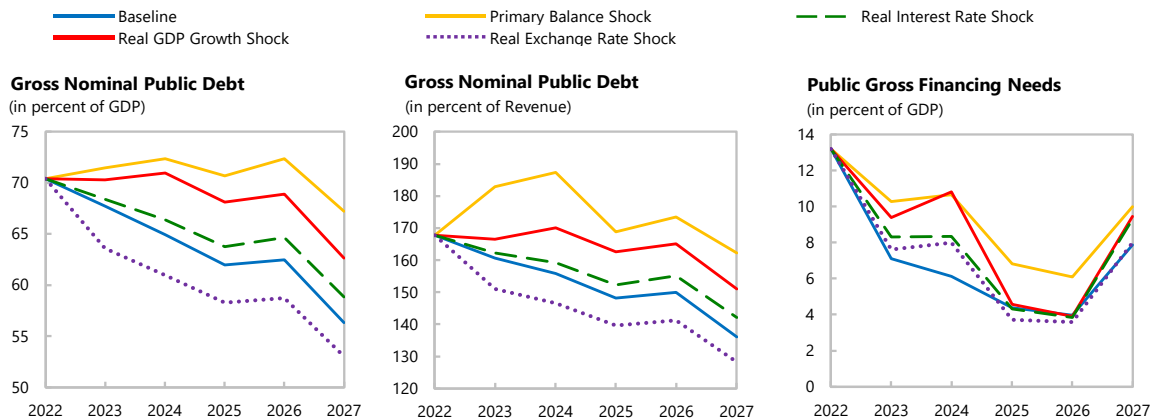
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

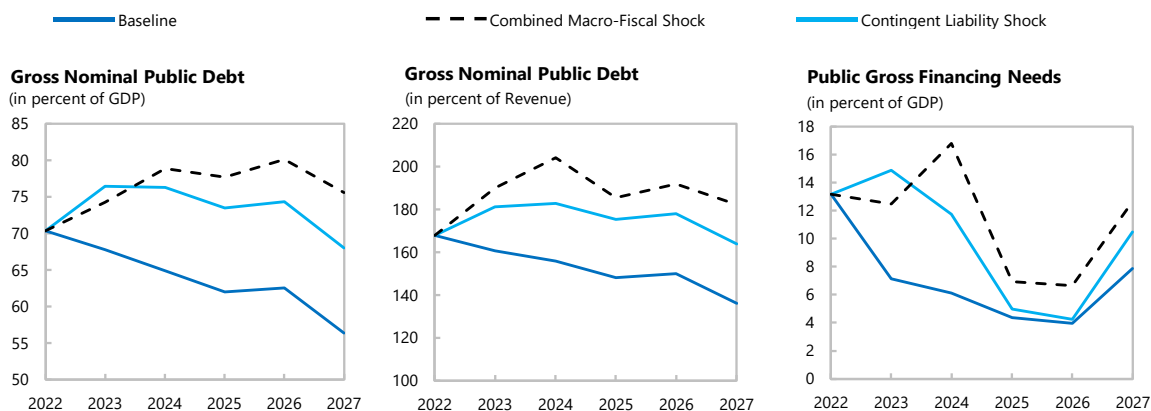
10/ Disregards flows other than the primary deficit, namely those associated to the HFF financial flows.

Annex IV. Figure 4. Iceland: Public Debt Sustainability Analysis (DSA)—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions (in percent)

	2022	2023	2024	2025	2026	2027
Primary Balance Shock						
Real GDP growth	3.6	1.5	2.5	2.4	2.3	2.3
Inflation	8.6	4.7	3.0	2.4	2.8	2.9
Primary balance	-1.7	-3.0	-3.1	0.8	1.3	1.5
Effective interest rate	6.3	6.1	5.0	6.2	6.3	6.2
Real Interest Rate Shock						
Real GDP growth	3.6	1.5	1.5	2.4	2.3	2.3
Inflation	8.6	4.7	3.0	2.4	2.8	2.9
Primary balance	-1.7	0.1	0.0	0.8	1.3	1.5
Effective interest rate	6.3	6.1	4.2	4.8	5.2	5.2
Combined Shock						
Real GDP growth	3.6	0.7	0.6	2.4	2.3	2.3
Inflation	8.6	4.2	2.5	2.4	2.8	2.9
Primary balance	-1.7	-3.9	-5.0	0.8	1.3	1.5
Effective interest rate	6.3	6.1	5.1	6.8	7.1	7.1
Real GDP Growth Shock						
Real GDP growth	3.6	0.7	0.6	2.4	2.3	2.3
Inflation	8.6	4.2	2.5	2.4	2.8	2.9
Primary balance	-1.7	-0.8	-1.9	0.8	1.3	1.5
Effective interest rate	6.3	6.1	4.0	4.6	4.9	4.7
Real Exchange Rate Shock						
Real GDP growth	3.6	2.5	2.5	2.4	2.3	2.3
Inflation	8.6	13.0	3.0	2.4	2.8	2.9
Primary balance	-1.7	0.1	0.0	0.8	1.3	1.5
Effective interest rate	6.3	6.1	3.9	4.5	4.7	4.6
Contingent Liability Shock						
Real GDP growth	3.6	-0.3	-0.4	2.4	2.3	2.3
Inflation	8.6	3.9	2.3	2.4	2.8	2.9
Primary balance	-1.7	-6.1	0.0	0.8	1.3	1.5
Effective interest rate	6.3	6.4	4.2	4.7	5.0	4.8

Source: IMF staff.

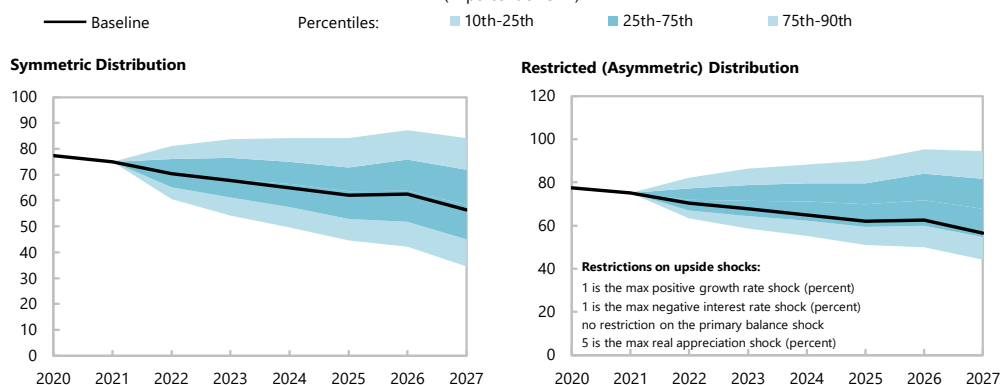
Annex IV. Figure 5. Iceland: Public Debt Sustainability Analysis (DSA) —Risk Assessment

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

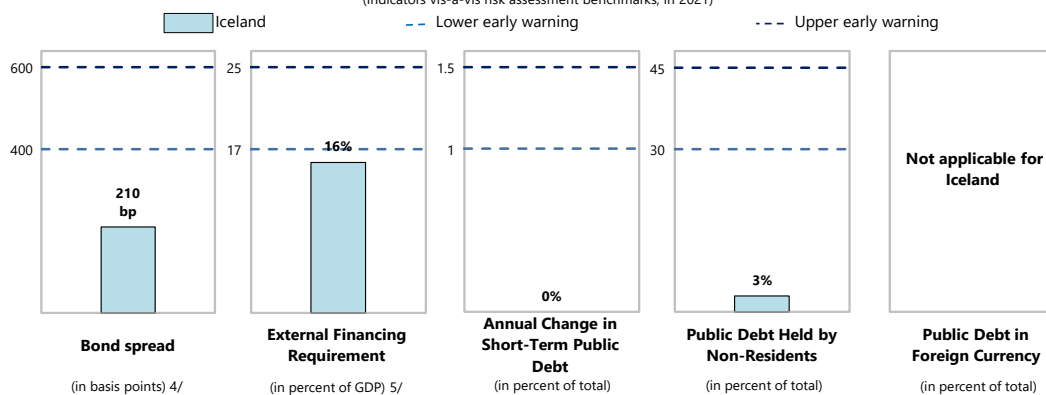
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2021)



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-21 through 31-Jan-22.

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 V. External Debt Sustainability Analysis

Iceland's external debt has remained stable, and appears robust to most shocks, with the notable exception of króna depreciation. Total external debt is projected to reach 61 percent of GDP by 2027, reflecting much improved solvency.

- 1. Iceland's external debt peaked in 2020 and declined in 2021.** After a rapidly declining trend through 2018, total external debt reached 90 percent of GDP in 2020. Improvements through 2021 were due to reductions in public and banking sector debt. The bank estates' massive external debts were cleared in the winter of 2015–16. The declining trend stalled in 2019 with króna depreciation, and external debt rose by 12 percentage points in 2020 due to the pandemic-related recession, weaker current account, and further depreciation. Debt ratio declined to 83 percent of GDP by end-2021 as a result of stronger growth.
- 2. External debt is projected to gradually decline over the medium term.** Gross debt is projected to revert to around 80.5 percent of GDP in 2022 and to continue a gradual decline, thereafter, stabilizing at around 61 percent of GDP by 2027.
- 3. Its maturity structure is comfortably long.** Short-term debt (at residual maturity) accounts for about 14 percent of total external debt.
- 4. Gross external financing requirements declined in 2021 after a spike in 2020 and are projected to improve over the medium term.** Iceland's external financing needs were about 15 and 16 percent of GDP in 2020 and 2021, respectively, reflecting banks' pre-financing of maturing debts to take advantage of market conditions. This results in lower financing need going forward (below 10 percent of GDP through 2027). 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. In the case of a 30 percent depreciation shock, the external debt to GDP ratio reaches 106 percent by 2023 and returns to only 85 percent over the medium term.

Annex V. Table 1. Iceland: External Debt Sustainability Framework, 2017–27
(Percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-stabilizing non-interest CA 7/	
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027		
Baseline: External Debt (including Old Banks) 1/	90.3	73.3	77.9	89.9	82.9	80.5	75.3	70.6	67.0	63.7	60.7	-0.2	
Change in external debt	-34.8	-17.0	4.6	12.0	-7.0	-2.4	-5.2	-4.7	-3.6	-3.2	-3.0		
Identified external debt-creating flows (4+8+9)	-38.8	-11.7	-1.4	10.4	-5.1	-1.3	0.8	0.9	1.0	-0.3	-0.6		
Current account deficit, excluding interest payments	-7.4	-5.6	-7.6	-2.4	1.6	-1.5	-1.6	-1.5	-1.2	-1.2	-1.3		
Deficit in balance of goods and services	-4.5	-3.3	-4.5	0.8	2.1	-1.3	-1.4	-1.0	-0.6	-0.5	-0.6		
Exports	45.7	46.6	44.4	34.4	38.1	45.7	44.6	42.9	41.9	41.1	40.6		
Imports	41.2	43.3	39.9	35.1	40.3	44.4	43.2	41.8	41.3	40.6	40.0		
Net non-debt creating capital inflows (negative)	-17.3	-2.6	2.9	2.1	4.5	1.7	3.2	2.9	2.8	1.3	1.1		
Automatic debt dynamics 2/	-14.1	-3.5	3.3	10.7	-11.2	-1.6	-0.8	-0.6	-0.6	-0.4	-0.4		
Contribution from nominal interest rate	3.2	2.1	1.5	1.6	1.2	1.2	1.2	1.1	1.0	1.1	1.0		
Contribution from real GDP growth	-4.4	-4.2	-1.9	6.3	-3.3	-2.7	-1.9	-1.7	-1.6	-1.5	-1.4		
Contribution from price and exchange rate changes 3/	-12.9	-1.4	3.7	2.8	-9.1	...	...	...	...	...	...
Residual, incl. change in gross foreign assets (2-3) 4/	4.0	-5.4	6.0	1.6	-1.9	-1.1	-6.0	-5.6	-4.7	-2.9	-2.4		
External debt-to-exports ratio (in percent)	197.5	157.2	175.6	261.8	217.5	176.3	169.0	164.6	159.6	154.9	149.6		
Gross External Financing Need (In Billions of US Dollars) 5/	3.5	3.0	2.4	3.3	4.1	4.1	3.6	3.9	2.6	2.4	2.0		
in percent of GDP	14.3	11.3	9.5	15.1	16.1	14.7	12.0	12.2	7.7	7.0	5.6		
Scenario with Key Variables at Their Historical Averages 6/													
						10-Year	10-Year						
						Historical Average	Standard Deviation						
Key Macroeconomic Assumptions Underlying Baseline								2022	2023	2024	2025	2026	2027
Nominal GDP (US dollars)	24.7	26.3	24.8	21.6	25.5			28.0	29.8	31.7	33.3	34.9	36.5
Real GDP growth (in percent)	4.2	4.9	2.4	-7.1	4.3	2.7	3.8	3.6	2.5	2.5	2.4	2.3	2.3
GDP deflator in US dollars (change in percent)	14.1	1.3	-7.7	-6.2	12.8	2.9	8.6	6.1	3.8	3.7	2.7	2.4	2.4
Nominal external interest rate (in percent) 8/	3.0	2.4	2.0	1.8	1.6	2.5	0.6	1.5	1.5	1.6	1.5	1.6	1.7 8/
Underlying external interest rate (in percent)	3.0	2.4	2.0	1.8	1.6	1.9		1.5	1.5	1.6	1.5	1.6	1.7
Growth of exports (US dollar terms, in percent)	14.5	8.3	-10.1	-32.5	30.6	2.9	16.6	31.7	3.8	2.3	2.8	2.8	3.3
Growth of imports (US dollar terms, in percent)	20.1	11.6	-13.1	-23.2	35.0	4.9	16.5	21.2	3.6	3.0	3.7	3.0	3.3
Current account balance, excluding interest payments	7.4	5.6	7.6	2.4	-1.6	7.1	4.3	1.5	1.6	1.5	1.2	1.2	1.3
Net non-debt creating capital inflows	17.3	2.6	-2.9	-2.1	-4.5	4.8	10.4	-1.7	-3.2	-2.9	-2.8	-1.3	-1.1

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.

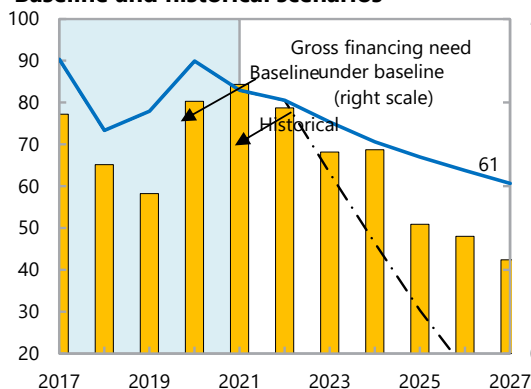
7/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

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.

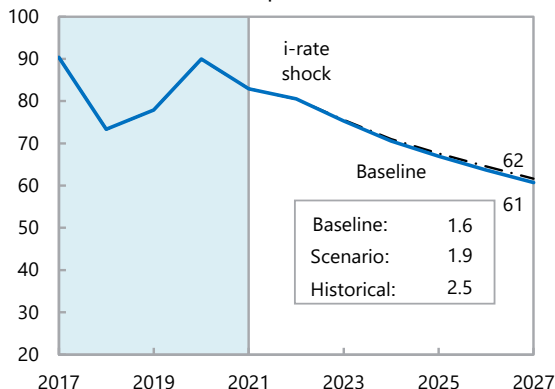
Hence, for the computation of debt stabilizing current account we use the 2024 underlying interest rate that would exclude old bank debt stock as well.

Annex V. Figure 1. Iceland: External Debt Sustainability Bound Tests 1/ 2/
(External debt in percent of GDP)

Baseline and historical scenarios

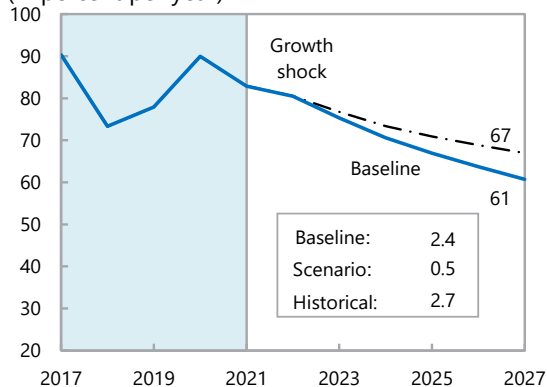


Interest rate shock (in percent)



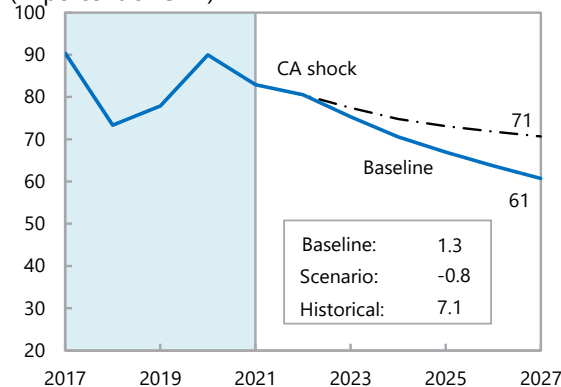
Growth shock

(in percent per year)

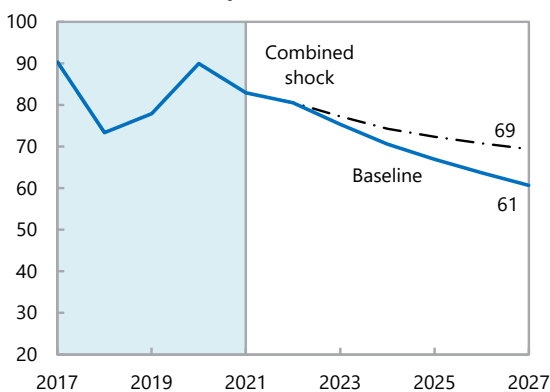


Non-interest current account shock

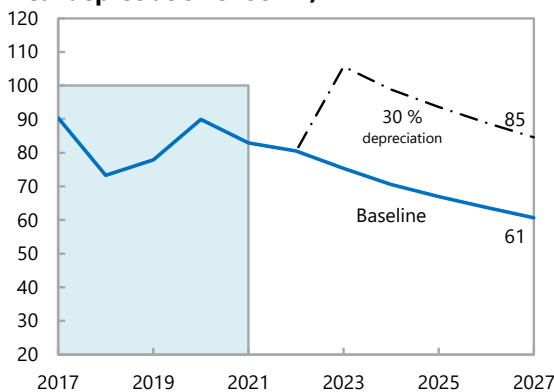
(in percent of GDP)



Combined shock 3/



Real depreciation shock 4/



Sources: International Monetary Fund, Country desk data, and staff estimates.

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 2010.

Annex VI. Íslandsbanki's Privatization

1. **Following the Global Financial Crisis, Iceland's banking system became mostly state owned.** The three largest banks (Arion banki, Íslandsbanki, and Landsbankinn) were taken under government ownership at the height of the crisis.
2. **The state's holdings in Icelandic financial undertakings have been regarded as a temporary arrangement.** In 2017, the authorities announced [The Icelandic State's Ownership Strategy for Financial Services](#), laying out their intention to sell the state's entire holding in Íslandsbanki when favorable and desirable circumstances prevail.
3. **State's holdings in financial institutions are managed by Bankasýsla Ríkisins-** Icelandic State Financial Investments (ISFI). The institution was established in August 2009 and started to operate in January 2010. Among its objectives, ISFI is required to ensure transparency in all decision-making concerning the state's participation in financial activities and provide active information disclosure to the general public. The legislative framework on the sale process involves multiple steps. After a proposal by the ISFI on whether and when specific holding should be offered for sale, the Minister of Finance and Economic Affairs seeks for authority in the annual budget. The Minister submits a report on the intended sale process to the relevant committees in parliament. The report needs to provide information on the objective and the method of sale, among others. At the same time, the Central Bank's views on the equality of bidders, the potential impact on the FX market and reserves and liquidity are sought. Once a decision is made on the preparation and execution of a sale, it needs to adhere to the key principles of an open sale process, transparency, objectivity, and efficiency.¹
4. **The first stage of Íslandsbanki privatization took place in June 2021.** At the end of 2020, ISFI recommended to the Minister of Finance and Economic Affairs to divest a portion of the state's holding. With the initial public offering (IPO) in June 2021, 35 percent of the shares were sold to retail and institutional investors from Iceland and abroad. The total value of the offering amounted to US\$457 million and Íslandsbanki's market capitalization was approximately US\$1.3 billion. The domestic private investors were estimated to own 24 percent and international investors 11 percent of the bank's share. As of March 22, 2022, the group of private stakeholders with a share above 1 percent comprised domestic pension funds (total 12.29 percent) and an international investment company (4.35 percent).
5. **The 2022 budget authorized the sale of Íslandsbanki's remaining shares.** The government's intention was to sell half of the remaining shares in 2022, and the rest by end-2023. The objective was to support funding of the government's gross financing needs in 2022–23. An accelerated book building (ABB) approach was preferred as a way of achieving the highest possible price and ownership dilution.

¹ Act no. 155/2012 on the sale process of the state's holdings in financial undertakings.

6. The ABB took place on March 22, 2022. IFSI announced an offering of at least 20 percent of Íslandsbanki's outstanding share for sale to "qualified" domestic and international investors.² The offering was finalized with the sale of 22.5 percent of the bank's capital (corresponding to 450 million shares) at 117 krona per share, in comparison to the closing price of 122 per share on the prior day.

7. The completion of the sale caused significant controversy.

According to Íslandsbanki's statement (as of April 29, 2022), among the owners with more than 1 percent of shares, the largest shares among the stakeholders were held by the Icelandic pensions funds (about 23 percent).³ Domestic investors took 85 percent of the shares, while foreign investors took 15 percent of the allocated shares from the March 22 sale. However, among the 209 investors who received shares, a significant number were very small buyers, some of whom with controversial reputation or potential conflict of interest. The social uproar to the disclosure of the participation of these small investors led to the launch of investigations by the State Auditor and the CBI. Further sales of Íslandsbanki's shares have been suspended until the completion of the investigations.

Investor Profile in the Private Sale of March 2022			
	Number	Amount (billion ISK)	Share in Total
Domestic Investors	190	44.8	85%
Pension funds	23	19.5	37%
Private investors	140	16.1	31%
Mutual funds	13	5.6	11%
Other investors	14	3.5	7%
Foreign Investors	19	7.9	15%
Foreign long-term investors	7	4.4	8%
Other foreign investors	12	3.5	7%
Total Investors	209	52.7	100%

Sources: Ministry of Finance and Economic Affairs

Íslandsbanki's Shareholders 1/		
	Number of Shares (Mil.)	Percent of Capital
Domestic Investors	1427	71.3%
Government of Iceland	850	42.5%
Pension funds	460	23.0%
Other banks	71	3.6%
Other investors	45	2.2%
International Investors	127	6.3%
Total	1553	77.7%

Sources: Íslandsbanki
1/ Table presents Íslandsbanki's shareholders who own more than 1% of the Bank's shares in accordance with Icelandic laws and regulations.

8. A new framework and a new institution will be established to manage the state's holdings in financial undertakings. On April 19, 2022, following intense public debates on the

² Qualified investor is defined in the European Union regulation (2017/1129, Article 2e), which was incorporated into the Icelandic law in 2020. The Central Bank's assessment of the investor's qualification and its approval in a sale process is a requirement when a shareholder acquires a large enough holding that would be considered as a 'qualified holding', which is defined as a direct or indirect holding in an undertaking that represents 10% or more of its share capital, guarantee capital, or voting rights, or that enables the exercise of a significant influence on the management of the company concerned.

³ The other shareholders are the two major banks (Arion banki and Landsbankinn) and other domestic investors. International investors' shares have also increased (from 4.4 percent in March prior to the second sale to 6.3 percent in April).

second stage of Íslandsbanki privatization, the government proposed that ISFI be abolished, and a new framework be introduced to manage the state's holdings in financial companies, including the remaining share in Íslandsbanki and 98.2 of shares in Landsbankinn.

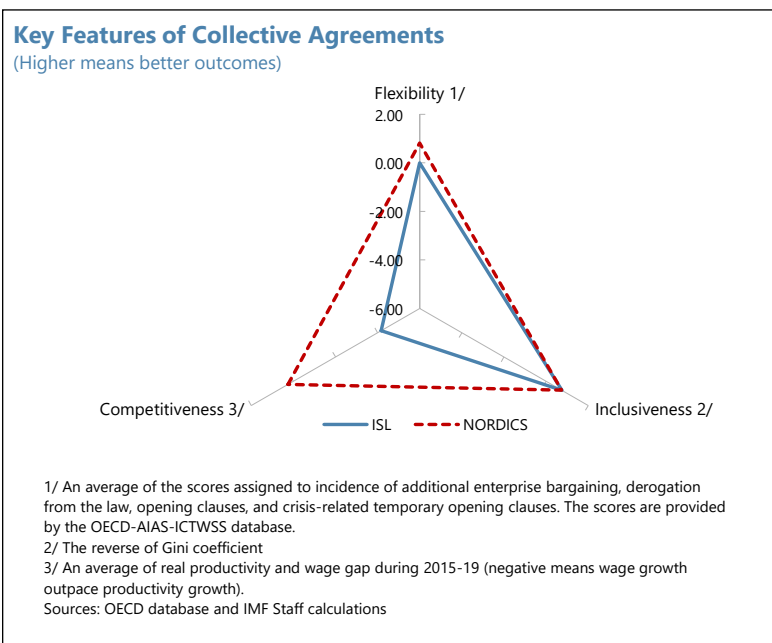
9. The recent privatization experience underscores the importance of ensuring quality of bank ownership. With the worst financial crash still in Iceland's living memory, a high premium needs to be placed on the reputation of investors and managers in the banking system. Transparency and evenhandedness should remain critical to preserve the credibility of all stakeholders involved in the divestiture of state-owned banks. Participation and ownership criteria for investors in state-owned banks should aim to mitigate potential reputational and stability risks for the state and the financial system. Balancing ownership quality with seeking a high sale price is thus a challenging task, given the potential for funding delays and financial stability risks, should reputational concerns take center stage.

10. The CBI has an important role in ensuring quality bank ownership. While the decision on selection criteria and the privatization process should be carried out by the government and the new institution, the CBI should review future plans for divestiture of public bank ownership, ensuring fitness and probity of potential investors are being adequately considered, and other potential prudential issues are adequately addressed. As gatekeeper for the probity of the Icelandic banking system, the CBI should be supported in this function. The CBI's investigation of owners of any size should be considered appropriate if there is a justified concern of their suitability.

Annex VII. The Role of Collective Bargaining in Fostering Macroeconomic Resilience³⁸

1. Collective bargaining plays a key role in influencing labor market outcomes. A number of studies show that different institutional systems of collective bargaining and degree of coordination can affect labor market inclusiveness, aggregate productivity, and adaptability.

2. Inclusiveness: Collective bargaining can support wage equality, including by increasing the bargaining power for wage earners (Jaumotte and Buitron (2015), OECD (2011), ILO (2015)), and through increasing and strengthening political voice (Acemoglu and Robinson, 2013). Across systems of collective bargaining, coordinated systems – either centralized or organized decentralized – are associated with lower unemployment rates for vulnerable groups, including youth, women, and low-skilled.³⁹ A recent study also shows that collective bargaining is correlated with lower gender wage gap (Biasi and Sarson, 2021).



3. Productivity: There are two opposing ideas regarding the relationship between collective bargaining—union density and coverage—and productivity. On one hand, collective bargaining can improve productivity because higher wage floors, as an outcome of collective bargaining, may force unproductive firms to exit the market and create incentives for firms to innovate. On the other hand, collective bargaining that results in a compressed wage structure may reduce incentives to work and hinder the reallocation of labor to more productive firms, limiting productivity. Empirical evidence appears to suggest the latter. In particular, OECD, 2018, shows that a centralized collective bargaining system is associated with a weaker alignment between wages and productivity across sectors. Collective bargaining is also associated with lower accumulation of human capital (OECD, 2017) and lower investment in tangible and R&D capital (Hirsch, 1991), which in turn could undermine productivity. Across the institutional framework of collective bargaining, decentralization of bargaining may promote productivity as a result of a more frequent use of incentive schemes, such as performance pay.

³⁸ Prepared by Nujin Suphaphiphat.

³⁹ A centralized collective bargaining may benefit those covered in the agreements “insiders” but may also raise unemployment to those “outsiders”, such as the vulnerable groups, as firms face higher cost. Wage coordination plays a key role at mitigating this by allowing wage synchronization between social partners (see flexibility).

4. Flexibility: While collective bargaining can achieve inclusiveness, it may undermine flexibility. In the event of a macroeconomic shock, firms' ability to adjust costs—including labor costs—plays an important role in reallocating resources and reducing scarring. This can be achieved by providing full flexibility to firms to negotiate labor contracts. However, firm flexibility may induce a decline in union coverage and undermine inclusiveness. Nevertheless, country experiences show that a degree of flexibility can be introduced within the collective agreements, through the so-called organized decentralization system. Flexibility can take several forms. First, the higher-level agreements provide a general framework but leave room for lower or firm-level agreements to tailor the terms of employment. The framework could include setting minimum standard, default agreement, corridor (max-min) agreement or combinations. Another form of flexibility could also be introduced under exceptional circumstances via opt-out clauses, as seen in Germany and Austria.



ICELAND

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 3, 2022

Prepared By

The European Department
(in consultation with other departments)

CONTENTS

FUND RELATIONS	2
STATISTICAL ISSUES	4

FUND RELATIONS

(As of April 30, 2022)

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	420.62	100.00
Holdings	421.92	100.31

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 Fund¹

(SDR million; based on existing use of resources and present holdings of SDRs):

	2022	2023	2024	2025	2026
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.01	0.01	0.01	0.01
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 2021 Article IV Consultation were held in virtually during March 29–April 16, 2021. The staff report (Country Report No. 2021/106) was considered by the Executive Board on June 4, 2021. 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 2021 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 2021, 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)	
<p>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 <i>Government Finance Statistics Manual 2014</i> framework in the <i>Government Finance Statistics Yearbook</i> and is an up-to-date contributor to the <i>International Financial Statistics</i>. New series (1998 to 2021) 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 2021.</p>	
<p>Monetary and financial statistics. The concepts and definitions conform to the guidelines of the <i>Monetary and Financial Statistics Manual</i>. 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 <i>International Financial Statistics</i>. 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.</p>	
<p>Financial sector surveillance. Iceland reports quarterly financial soundness indicators to STA, with data starting from Q1:2014.</p>	
<p>External sector statistics. Since 2014, the CBI has compiled BoP and IIP data according to the 6th edition of the <i>Balance of Payments and International Investment Position Manual</i>. 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.</p>	
II. Data Standards and Quality	
<p>Subscriber to the <i>Special Data Dissemination Standard (SDDS)</i> since June 1996. Uses SDDS flexibility options on the periodicity and timeliness of the industrial production index.</p>	<p>A <i>Report on the Observation of Standards and Codes</i> data module was published in November 2005.</p>

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

(as of March 31, 2022)

	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	Data Quality – Accuracy and Reliability ¹⁰
Exchange Rates	Mar. 2022	Mar. 2022	D and M	D and M	D and M		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Feb. 2022	Apr. 2022	M	M	M		
Reserve/Base Money	Feb. 2022	Mar. 2022	M	M	M	LO, O, LO, LO	LO, O, O, O, O
Broad Money	Mar. 2022	Apr. 2022	M	M	M		
Central Bank Balance Sheet	Mar. 2022	Apr. 2022	M	M	M		
Consolidated Balance Sheet of the Banking System	Mar. 2022	Apr. 2022	M	M	M		
Interest Rates ²	March 29, 2022	March 29, 2022	D	D	D		
Consumer Price Index	Mar. 2022	Mar. 2022	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	Q4, 2021	Mar. 2022	Q	Q	Q	O, LO, O, LO	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	Q4, 2021	Mar. 2022	Q	Q	Q		
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Mar. 2022	Apr. 2022	M	M	Q		
External Current Account Balance	Q4, 2021	Mar. 2022	Q	Q	Q	O, O, LO, O	LO, O, O, O, O
Exports and Imports of Goods and Services	Q4, 2021	Feb. 2022	Q	Q	Q		
GDP/GNP	Q4, 2021	Feb. 2022	Q	Q	Q	O, LO, O, LO	LO, O, LO, LO, O
Gross External Debt	Q4, 2021	Apr. 2022	Q	Q	Q		
International Investment Position ⁶	Q4, 2021	Mar. 2022	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.