CONCLUDING STATEMENT

Iceland: Staff Concluding Statement of the 2022 Article IV Mission

FOR IMMEDIATE RELEASE

Reykjavik, Iceland – May 11, 2022:

Iceland's economy has weathered multiple shocks since 2019 relatively well. The economic outlook is positive but subject to significant uncertainty. The risks are associated with the global impact of a potential escalation of the war in Ukraine, tightening of global financial conditions, and the still ongoing pandemic.

Careful policy coordination is required to entrench the recovery, stem rising risks, and rebuild fiscal buffers. Policies should mitigate inflationary pressures and surging housing prices, while protecting the most vulnerable. Structural reforms should facilitate economic diversification and make the economy more resilient to shocks.

1. Iceland has weathered recent shocks to the economy relatively well. A range of well-designed policy measures and a solid health system eased the impact of the pandemic, allowing real GDP and employment to recover strongly. Robust domestic demand and favorable terms of trade boosted output growth to 4.3 percent in 2021, despite slower recovery in tourism. With net general government debt of 60 percent of GDP, international reserves of 29 percent of GDP, and a sound banking system, the Icelandic economy remains well positioned to handle potential negative shocks, including from the global impact of the war in Ukraine.

2. Growth is expected to remain moderate in 2022 and the medium term. Despite Iceland's low direct exposure to Russia and Ukraine, the country will face an environment of lower external demand, supply chain disruptions, and higher foreign inflation. In 2022, GDP growth is projected at 3.5-4 percent, partly driven by domestic demand, and to a lower degree by net exports, while average inflation is projected to reach 7.4 percent. With tourism recovering gradually, real GDP is projected to remain about 2 percent below its pre-COVID trend by 2027. Inflation—albeit persistent due to external factors and a positive output gap—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 and fiscal policies. Over the medium term, export-oriented industries are expected to be the main source of growth. The current account is projected to revert to a surplus as tourism continues to recover.

3. Risks to the recovery arise from the war in Ukraine, the pandemic, and economic disruptions. A potential escalation of the war in Ukraine could further dampen confidence and the global outlook and demand. The evolution of the pandemic remains a significant risk due to possible new highly contagious and/or lethal variants. Extensive global supply chain disruptions could cause greater inflationary pressures and adversely impact economic activity. Tightening global financing conditions could increase the cost of servicing Icelandic debt. Among domestic risks, a potential impasse in the negotiations for a new collective bargaining agreement could result in labor market tensions and economic dislocation. On the upside, tourism and new innovative industries could help the economy recover faster.

Macroeconomic Policies: Maneuvering a Safe Takeoff in Stormy Weather

4. Discussions focused on the appropriate policy mix for achieving sustainable growth amidst a highly uncertain global environment. With the resumption of GDP growth, receding unemployment, and rising inflation, the need for policy support has rapidly declined. The policy mix should aim to steer inflation to target, mitigate financial stability concerns and reduce imbalances, while protecting the most vulnerable. Structural reforms should facilitate economic diversification and make the economy more resilient to shocks.

Restoring Fiscal Buffers

5. The authorities' fiscal objectives will support macro-stabilization in 2022 and 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. The authorities' medium-term fiscal strategy envisages a 4-percentage points of GDP reduction in the overall deficit in 2023–2027, which is both appropriate and feasible. Savings could be achieved by streamlining VAT expenditures public consumption, and the transfer system. Recognizing the large uncertainty surrounding the outlook, the government should also follow through on its commitment to saving any fiscal revenues above the expected in the budget.

6. Iceland's fiscal framework has performed well during the pandemic. Regular and rigorous medium-term fiscal planning has focused policy discussions on economic priorities in a prudent, predictable, transparent, and fiscally sustainable way. The temporary suspension of the fiscal rules allowed the authorities to provide substantial fiscal policy support (3.4 percent of GDP per year in 2020–21) and protect the most vulnerable during the pandemic. With net general government debt projected by staff to decline by 18 percentage points of GDP from its peak in 2020, and the overall fiscal position projected to approach a balance by 2027, the fiscal rules could be reactivated in 2026 as envisaged by law. The holistic approach of the organic budget law—covering the deficit and debt of the entire general government—has been key to building buffers and resilience in government finances in the last decade and should be preserved. The introduction of margins of uncertainty has also proven useful during the crisis, but a formal process for their implementation needs to be established.

Anchoring Inflation Expectations

7. The authorities should continue to withdraw monetary policy stimulus. The policy rate has increased by 300 bps since April 2021, reversing most of its 3.8 percentage point reduction since the easing cycle started in May 2019. Real policy rates have thus increased from their lows—but with inflation expectations around 5 percent—still suggest a loose monetary policy. Steering inflation and inflation expectations back to the CBI's target of 2.5 percent will likely require further policy rate hikes. Given the uncertainty, 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.

8. Anchoring inflation expectations may also require tighter systemic liquidity management. The quantitative easing at the onset of the pandemic provided additional monetary policy support alongside the lowering of the policy rate. The CBI should absorb the excess money supply to help improve monetary policy transmission, which would require strengthening the liquidity management framework.

Preserving Financial Stability

9. The banking system has weathered the pandemic well, but systemic risks are rising. Banks are liquid, profitable, well capitalized, and resilient to adverse shocks. However, risks have risen due to surging house prices, exceeding fundamentals. A sharp correction in house prices could weaken balance sheets of households and the financial sector. The house price surge has also worsened housing affordability, particularly for young and lower-income households. Well calibrated and coordinated policies are crucial to navigate the house price cycle.

- **Housing market risks** should be contained with effective macroprudential measures complemented with the ongoing monetary tightening. The existing debt-service-to-income regulation should require mortgage lenders to apply a premium over the contractual rate in the analysis of borrowers' debt-service capacity. A cap on the debt-to-income ratio could also be introduced.

- **Housing affordability** could be addressed by reducing administrative burdens in the construction sector and increasing the supply of housing. This requires simplifying planning regulations, easing the process of obtaining building permits, and introducing one-stop shop for permits and inspections. Regressive fiscal incentives for home ownership should be redesigned. More targeted rental housing assistance and continued investment in social housing should promote rent affordability.

10. **The merger between the central bank and the financial regulator has supported financial stability**. With new synergies and comprehensive oversight of the financial system, the merged institution provided timely and swift policy responses at the onset of the pandemic. But challenges remain. The recent Appraisal Committee's report saw a need for further review of the responsibilities of the CBI's committees and the decision-making structure of the Supervisory Committee. Upcoming reviews of the integrated central bank should also assess its budgetary independence, as well as its microprudential powers and capacities in view of the rapidly changing financial sector landscape. Given the pension funds' increasingly systemic role and close interlinkages with other financial institutions, the CBI's powers to oversee their governance and risk management practices should be strengthened.

11. **Ensuring the quality of bank ownership should remain a key government objective and supervisory responsibility of the CBI**. 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 are critical to preserve the credibility of all stakeholders involved in the divestiture of state-owned banks. Participation and ownership criteria for investors in the sale of state-owned banks should be developed within the privatization framework to mitigate potential reputational and stability risks for the state and the financial system. In this context, the CBI should review future plans for divestiture of public bank ownership to ensure that fitness and probity of potential investors is considered, and other potential prudential issues are adequately addressed.

Fostering Economic Diversification

12. **The multiple external shocks that have affected Iceland since 2019 underscore the need for further efforts to diversify the economy**. The focus should be on improving competition, promoting innovation, and facilitating resource reallocation. Reducing burdens on start-ups and young firms and easing business regulations can improve productivity and foster growth. There is scope to widen the digital penetration in production processes and increase the innovation potential of the economy, including by promoting R&D investment and easing access to finance for small firms. The current increase in R&D spending is welcome. Continued efforts to improve education outcomes and address skill mismatches in the labor market is essential to support innovation.

13. **The upcoming collective bargaining negotiations are an opportunity to promote competitiveness and facilitate diversification**. Ensuring inclusiveness, reducing the risk of poverty, and providing high job security should remain key features in the upcoming agreement. It should also help align wage and productivity growth better. Finally, the agreement should provide flexibility for firms and workers to negotiate wages that reflect labor market conditions, and industry- and firm-specific factors.

14. Iceland’s ambitious climate goals are welcome, though more needs to be done to achieve them. Reducing emissions in a growing economy 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 from higher incomes and a growing population. Other tax incentives, such as promoting the use of electric vehicles need to be carefully recalibrated to preserve the revenue base. Expanding the use of renewable energy and facilitating energy exchange would require investments in infrastructure that may entail new environmental tradeoffs. Technological improvements, including those that allow carbon sequestration, may become viable in the future but may require R&D support.

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