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**Statement by Mr. Buissé, Mr. Rozan, and Ms. Gilliot on Iceland
(Preliminary)
Executive Board Meeting
June 4, 2021**

We thank staff for this interesting report and Mr. Sigurgeirsson for his insightful Buff statement. Iceland has entered the crisis with better fundamentals than at the time of the Global Financial Crisis and stronger position of its financial sector, creating the conditions for a greater resilience to shocks and a faster recovery. Swift fiscal and monetary policy actions have been instrumental in mitigating short-term negative effects and rebuilding confidence. Risks to the outlook are nonetheless tilted to the downside due to structural vulnerabilities related to a high concentration of production and exports. We share the overall thrust of the report including its recommendations on the need for a more diversified and sustainable growth strategy. We wish to add the following comments for consideration.

Outlook and risks

We agree with the moderate growth projections in the baseline scenario with growth relying heavily on domestic demand in a context of heightened uncertainty. The Covid-19 crisis caused a severe slump in economic activity mostly due to the impact on tourism and export of maritime and aluminum products. *We would be interested in staff's view on the effectiveness of measures taken to support hard-hit sectors like tourism and crowd-in private investment.* The risks to the outlook are significant and while we support the findings from the Risk Assessment Matrix, the policy response could take more into account issues related to the volcanic activity and more broadly natural disasters.

Fiscal policy

Fiscal policy response was generally well-designed, and the existing fiscal room should allow a prolonged fiscal support until the economy is on a firm recovery path. Overall, we welcome the fiscal and public debt management policy including an increase in public investment and unemployment benefits, and temporary tax relief measures. The authorities' medium-term fiscal strategy (MTFS) is welcome and rightly aimed at preserving fiscal space. However, given the unparallel uncertainty over the growth path and the persistent slack in the

economy, its implementation needs to be progressive and focused in priority on securing a robust recovery while avoiding scarring effects. Flexibility should remain the key point and, in this sense, it seems sensible to postpone until 2025, i.e. the end of the suspension of the fiscal rule, to assess whether additional fiscal efforts are needed to achieve a forward-looking 5-year average positive overall balance. Finally, we welcome the authorities' pledge to anchor fiscal policy on the highest standards of transparency and note that contrary to staff's advice, they prefer excluding the reclassified entities from the MTFS for the sake of clarity. Considering the impact on gross public debt of the reclassification of financial intermediation funds into the general government perimeter (as underscored in Annex V), *how would staff assess the potential effect of prepayments of the remaining mortgage portfolio in the IL Fund on the overall balance in real terms?*

Monetary, Exchange rate and macroprudential policies

Monetary authorities have used a large array of policy instruments to cushion the impact of the pandemic and support recovery. We agree that monetary policy should remain data driven, and inflationary pressures should be carefully monitored. While CBI's FXI have indeed helped mitigate the impact of the crisis, we emphasize like staff that the CBI should continue to reduce its presence as the FX market returns to normal functioning. In addition, financial sector policies including macroprudential measures should remain supportive of the recovery. We strongly encourage the authorities to finalize the FX legislation reform and clarify the operational environment for FXI and CFMs when coping with risks of excessive short-term capital inflows and outflows. Finally, financial sector oversight architecture should continue to be heightened including on AML-CFT implementation. As staff, we underscore the importance of preserving a high-quality bank ownership.

Macrostructural policies

We fully subscribe to the need to complete the structural transformation of the economy targeting greater diversification and sustainability on the long run, and we welcome the authorities' intention in this regard. Staff's recommendations seem broadly appropriate and we would like to emphasize the importance of easing product market regulations as high regulatory burdens including on FDI remain a major impediment to competitiveness and to growth. Efforts should also be intensified to ensure a greater alignment of wage and productivity growth while ensuring the inclusion of the youth and low-skilled workers. In this regard, options for reforming the highly centralized collective bargaining system, as presented in Annex VIII, are insightful and should be further explored.