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**Joint Statement by Ms. Levonian, Mr. Trabinski, Ms. Kashima, Mr. Mochtar, and Mr.
White on Iceland
(Preliminary)
Executive Board Meeting
June 4, 2021**

We thank staff for the comprehensive papers and Mr. Sigurgeirsson for the complementary insights from his Buff statement. We broadly agree with the thrust of the staff appraisal and would like to highlight a few notable aspects from the consultation.

The downturn in tourism, triggered by the pandemic, indicates the need for greater economic diversification. While we agree that the prospects for the tourism industry remain very uncertain, we hope that recent acceleration in the vaccination process in EU countries increases the possibilities of easing restrictions in the second half of 2021. Notably, the tourism industry in Iceland was hit hard by the pandemic, which compounded the economic downturn also attributable to pre-existing pockets of vulnerabilities in the corporate sector. We see scope as the economy recovers for greater economic diversification and structural change to hedge against sector-specific shocks. However, we note that in small economies there is a balance to be struck between diversification and achieving the required economies of scale to ensure industries remain economically viable. In addition, in light of the important implications from climate change on the Icelandic economy, we encourage staff to closely monitor and assess progress in the climate action plan.

It is important to contain long-term unemployment and loss of human capital through government support. We agree that the structural reform, retraining and upskilling programs will help to limit scarring. We also agree that greater wage flexibility can enhance labor market resilience and assist in the reallocation of resources. These reforms will support the diversification of the economy.

While we welcome the additional fiscal support to sustain economic recovery and mitigate scarring in the near-term, we encourage the authorities to move towards fiscal consolidation once the pandemic abates. The current fiscal stance remains appropriate. Nevertheless, a clear medium-term path for fiscal consolidation and reinstatement of the fiscal rule will be important to rebuild buffers and to ensure flexibility in the response to potential future shocks. We note that the authorities are considering a reassessment of the fiscal rule parameters and that, in due course, this might lead to the exclusion of reclassified entities from the fiscal framework. At the same time, staff advice has been to fully reflect these entities in the authorities' medium-term fiscal deficit and debt planning to improve transparency. *Could staff elaborate on this divergence in views and their discussions with the authorities?*

We note that the central bank has responded swiftly to signs of inflation pressures. We encourage the authorities to further monitor inflation as outcomes are above the central bank's target. Additionally, we encourage careful central bank communication about factors that contribute to a transitory effect on inflation and those that are more entrenched. Coordination between monetary and fiscal policy appears to be warranted and needs to be responsive to new inflation developments.

The new legislation related to foreign exchange market reform and the appropriateness of external sector policies (capital flow measures and intervention) is noteworthy. We recognize that exchange rate flexibility is an important first line of defense for absorbing external shocks. However, Iceland may need a wider range of policy tools to deal with the ebb and flow of very large global capital flows. This is especially important in the context of smaller domestic financial markets. We note that in certain circumstances foreign exchange intervention might have a role in supporting financial stability. *We would be interested to learn more about how the local authorities plan to leverage off the related workstreams at the Fund on the Institutional View on Capital Flows and the Integrated Policy Framework.*

We take positive note that Iceland's financial system remains well placed to accommodate shocks and can continue to extend credit to support the economic recovery. That said, we encourage the central bank to continue to monitor risks from mortgage lending and corporate vulnerabilities. The changing composition of credit growth warrants enhanced attention as it is possible that these developments reflect the unwinding of the unanticipated pandemic-related downturn. *We are interested in staff views about the extent to which the recent shift away from pension funds by high-quality borrowers represents a source for concern, or simply a reversion to more normal outcomes following the initial acceleration in pension fund credit in 2020?* Moreover, we welcome the enhancement of the AML/CFT framework and we commend the authorities for exiting the FATF gray list.

We wish the authorities all the success in their endeavors.