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ICELAND

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

May 30, 2023

KEY ISSUES

Iceland has recovered from the shocks of recent years faster than envisaged and scarring from the pandemic is expected to be minimal. The recovery reflects pent-up demand from the pandemic, a rebound of the tourism industry, rapid immigration, and the fact that, unlike most European countries, Iceland experienced an improvement in its terms of trade in 2022. The economy is currently operating above potential. Absent an adjustment in policies, imbalances are likely to increase. Risks are tilted to the downside.

With the economy overheating, macroeconomic policies need to be tighter. Under the baseline, tighter policy settings are warranted to rein in elevated inflation and external imbalances, and to restore policy buffers in the medium term. Should downside risks materialize, policymakers should stand ready to reassess the required amount of policy tightening or loosen in case of severe shocks. Structural reforms are necessary to bolster the economy's competitiveness and resilience to shocks.

Fiscal policy. A contractionary fiscal stance is warranted to help reduce macroeconomic imbalances. Reactivating the fiscal rules in 2025, one year earlier than envisaged, would set public debt firmly on a downward path and rebuild fiscal buffers which are crucial given Iceland's exposure to large shocks.

Monetary policy. Further monetary policy tightening may be needed and the real policy rate should be kept well above its neutral rate as long as needed to bring inflation and inflation expectations close to target over the monetary policy horizon.

Financial policies. Following recent tightening, macroprudential policies should remain on hold, but the materialization of systemic risk or a disorderly correction in the housing market may call for releasing capital buffers. Providing additional resources to regulatory agencies, improving pension fund governance, and finalizing the Emergency Liquidity Framework would strengthen financial sector resilience.

Structural policies. Now is the time to accelerate implementation of structural reforms to diversify the economy and reduce Iceland's vulnerability to shocks. At the same time, policies are needed to improve the sustainability and productivity of traditional export sectors and accelerate the transition to a low-carbon economy. The upcoming wage negotiations provide an opportunity to better align real wages and productivity growth.

Approved By
Laura Papi (EUR) and
Peter Dohlman (SPR)

The mission took place in Reykjavik during April 25–May 9, 2023. The team comprised Magnus Saxegaard (head), Mahir Binici, Jorge Iván Canales Kriljenko, and Yen Mooi (all EUR). Kelly Gao, Rafaela Jarin, Kelly MacKinnon, and Rachelle Vega (all EUR) supported the mission. Alpa Shah (FAD) attended some meetings virtually. Guðrún Ögmundsdóttir (OED) and Etienne Yehoue (MCM; FSAP head) joined the discussions. The mission met with Prime Minister Katrín Jakobsdóttir, Central Bank Governor Ásgeir Jónsson, Minister of Finance Bjarni Benediktsson, and other representatives of the public and private sectors.

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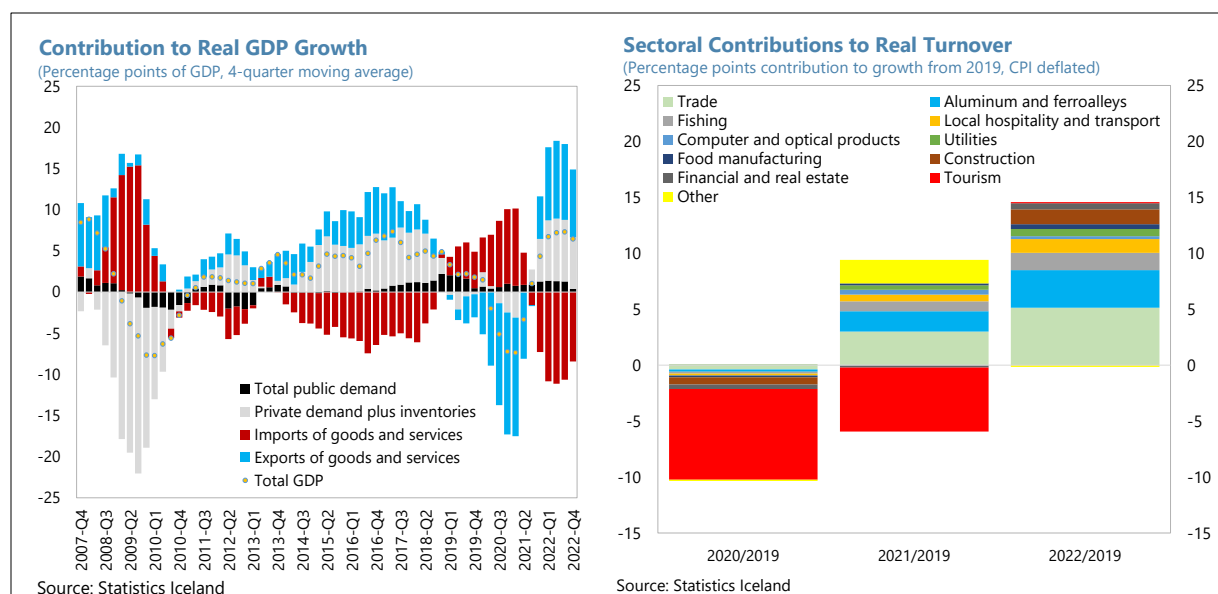
CONTEXT

1. **The Icelandic economy has recovered from the pandemic.** The pandemic brought the tourism sector—the engine of growth since 2012—to a sudden stop, triggering a sharp recession. A range of macroeconomic policy measures helped cushion the downturn and set the stage for a rapid recovery once travel restrictions eased. By the second half of 2022, tourism was operating at pre-pandemic levels while domestic demand was significantly higher, as households in Iceland and abroad used pandemic-era savings to satisfy pent-up demand, including for travel, and immigration contributed to record-high population growth.
2. **An improvement in Iceland’s terms of trade offset the negative impact of Russia’s war in Ukraine, though higher global commodity prices pushed up inflation.** An abundant supply of renewable energy shielded households from the increase in global energy prices, while the fish industry and aluminum sector benefitted from higher food and commodity prices. These positive effects more than offset the impact of slower trading partner growth. However, the disruption to global commodity markets pushed up import prices, contributing to inflation.
3. **Implementation of past Article IV recommendations has been mixed.** The Central Bank of Iceland (CBI) raised policy rates in response to rising inflation, reduced its presence in the foreign exchange market, and tightened macroprudential policies to contain housing market imbalances. The judiciary took steps to reduce uncertainty surrounding the legal status of variable rate loans, and the government approved a strategy to improve housing affordability. However, limited progress has been made on legal protection for supervisors.

RECENT ECONOMIC DEVELOPMENTS

4. **Real GDP grew by 6.4 percent in 2022, the fastest since 2007 (Figure 1).** Unlike most other European countries, Iceland experienced a 3 percent terms of trade improvement in 2022. The resulting boost to incomes combined with pent-up demand from the pandemic and immigration supported a significant increase in domestic demand, which was 12 percent higher in real terms in 2022 than in 2019. Leakages to imports were significant, however, and only partly offset by higher exports. Real GDP in 2022 exceeded its pre-pandemic level by 3 percent, and the economy is currently operating above capacity with an output gap of about 1 percent. Nevertheless, the economy remains about 2 percent below its pre-pandemic trajectory.¹

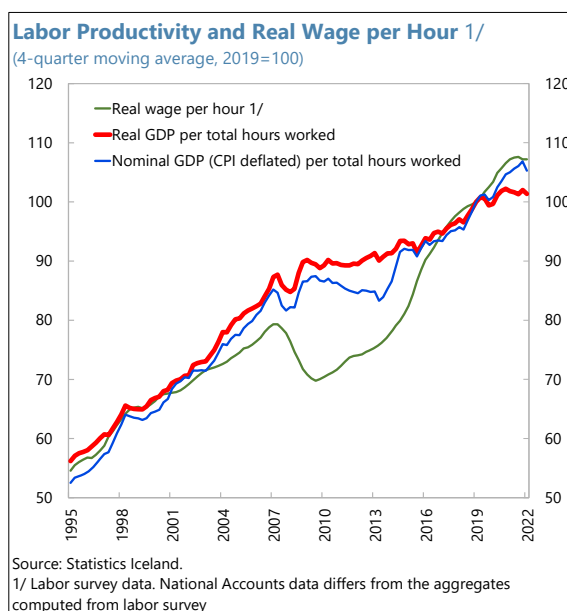
¹ As reported in the staff report for the 2019 Article IV consultation, IMF Country Report No. 19/375.



5. The recovery has been driven by domestic-oriented trade and traditional export sectors. Trade sectors generated significantly higher turnover in real terms (CPI-deflated) in 2022 than in 2019, but so did traditional export sectors that benefited from high international prices. While there were 15 percent fewer tourists arriving to Iceland in 2022 than in 2019, tourism sector turnover is already back at pre-pandemic levels (Figure 2).

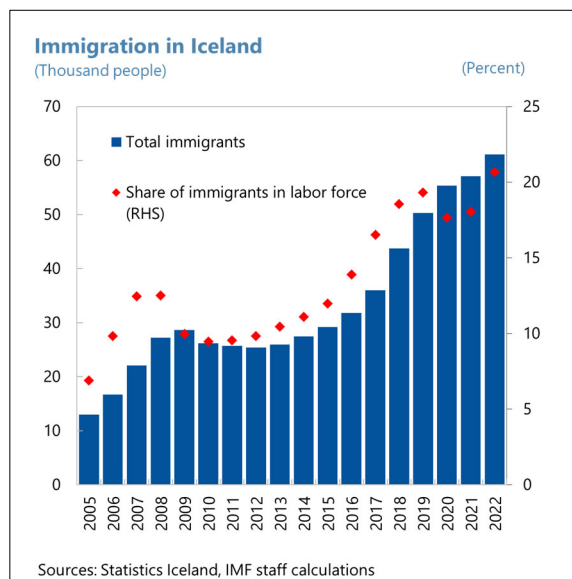
6. Labor markets have tightened.

- Unemployment in 2022 fell to pre-pandemic levels, below the estimated 4 percent neutral rate. The labor force and employment were about 7 percent higher than in 2019, supported by immigration (Figure 3). Nominal wages grew in line with inflation in 2022, but real wages are about 7 percent higher than in 2019. While wage increases have outpaced productivity growth since 2019, the level of real wages in 2022 is consistent with the value of real GDP per hours worked once the positive terms of trade is taken into account.
- The wage bargaining round in late 2022 did not yield the usual multi-year agreement due to extreme uncertainty. Instead, two thirds of private sector workers agreed to a one-year settlement, which (according to staff estimates) broadly kept wages constant in real terms and frontloaded the economic growth bonus usually paid in the middle of the year.



Negotiations for the rest of the private sector concluded in March 2023 following isolated strikes, resulting in higher wage increases for some low-income workers.

7. Immigration has supported economic growth over the past decade. Foreign workers have satisfied the increasing demand for labor in the tourism and construction sectors and on the margin helped contain wage pressures, despite some boost also to domestic demand. By end-2022, foreign workers accounted for about 20 percent of the labor force (about 40 percent in the tourism industry). Immigration has also contributed to pressures in the rental housing market and on government services. However, the fiscal impact is estimated to be neutral to slightly positive.²

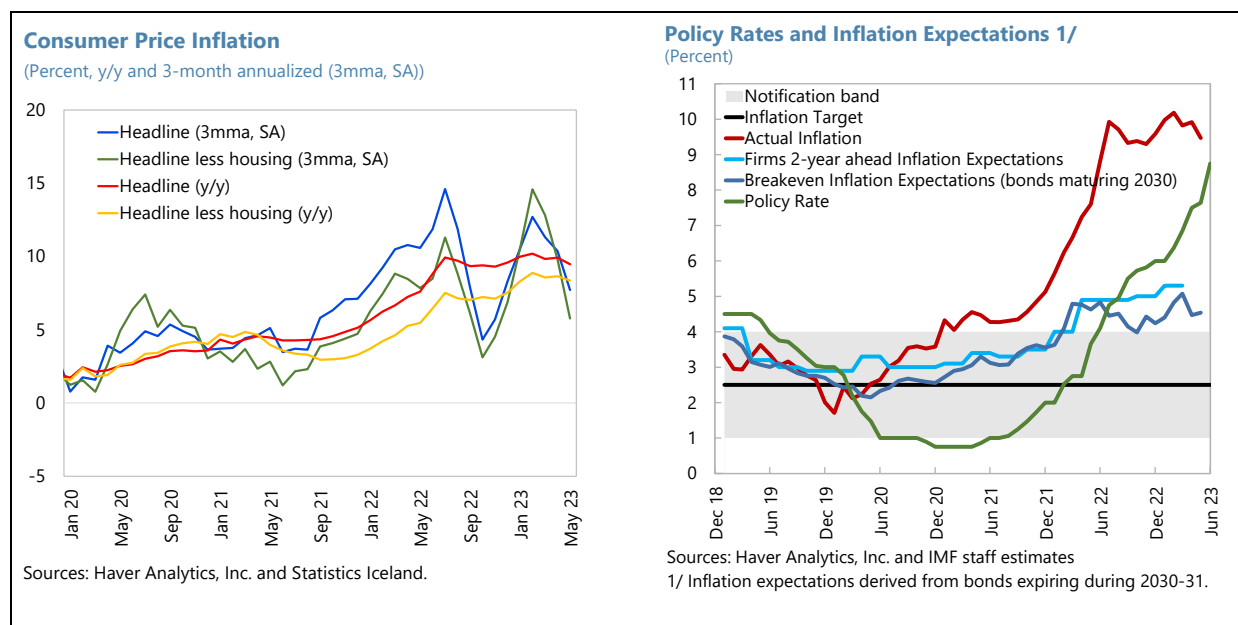


8. Inflation in 2022 was primarily driven by housing and global food and energy prices. Average CPI inflation reached 8.3 percent in 2022, significantly above the CBI's 1–4 percent notification band.³ After cooling in late 2022, inflation momentum (as measured by the three-month seasonally-adjusted moving average) increased to 13.2 percent in February before receding to 7.7 percent in May. Housing remains the largest component of inflation on a y/y basis, but inflation is increasingly broad based (Figure 4, Annex V). Market-based long-term inflation expectations increased to over 5 percent in early 2023, raising concerns about de-anchoring, but have since come down to about 4 percent.

9. The CBI has tightened monetary policy substantially. It raised policy rates by 800 basis points between April 2021 and May 2023, and real policy rates estimated from breakeven inflation expectations became positive in the second half of 2022. In May 2023 the CBI also raised the reserve requirement from 1 to 2 percent, back to pre-pandemic levels. Bank lending rates and bond yields have increased broadly in line with the policy rate.

² OECD, 2023, Economic Survey for Iceland. While foreign workers tend to be overrepresented in social housing and unemployment benefits, they are underrepresented in other fiscal benefits and their contribution through labor and personal income taxes tends to balance their impact on the fiscal accounts.

³ 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 how it intends to bring inflation back to target.



10. Fiscal policy was contractionary in 2022, but the underlying fiscal stance deteriorated.

The 2022 overall general government deficit was 4.3 percent of GDP, about 4 percentage points better than the 2021 outturn. The cyclically-adjusted primary balance improved by 2.6 percentage points, suggesting that fiscal policy was contractionary.

However, on a structural basis (excluding one-offs

related to the pandemic), staff estimates that the primary balance deteriorated by 1.6 percentage points, suggesting that the underlying fiscal stance weakened.

Iceland: General Government Balances, 2018–22					
	2018	2019	2020	2021	2022
	(Percent of GDP)				
Overall balance	0.9	-1.5	-9.0	-8.4	-4.3
Primary balance	3.1	0.5	-6.8	-6.3	-1.9
Cyclically-adjusted primary balance	1.3	-1.3	-3.9	-5.1	-2.5
Structural primary balance ¹	0.5	-2.0	-0.8	-1.5	-3.1
	(Percentage points of GDP)				
Change in cyclically-adjusted primary balance	-1.9	-2.6	-2.6	-1.2	2.6
Change in structural primary balance ¹	-1.3	-2.5	1.2	-0.7	-1.6

Sources: Ministry of Finance, Statistics Iceland; and IMF estimates.
1/ Excluding one-offs.

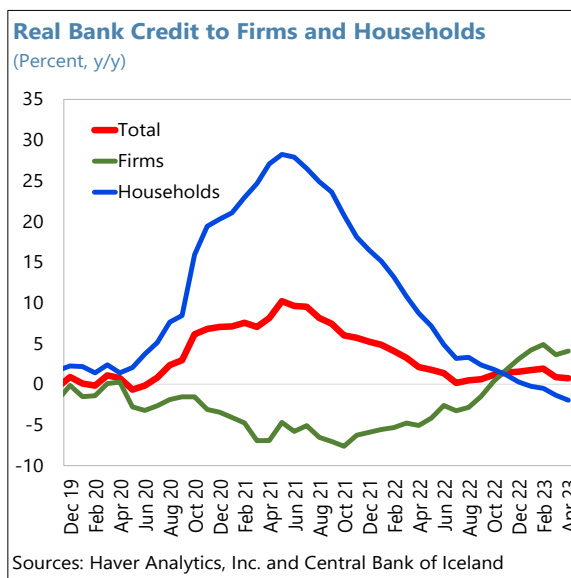
11. The current account balance improved in 2022 but remains weaker than pre-pandemic.

The current account deficit fell to 1.5 percent of GDP in 2022 due primarily to higher tourism receipts (Figure 6). However, the goods balance continued to deteriorate, as strong import demand more than offset the terms of trade improvement, while the primary income balance worsened on profit repatriation by foreign companies. Staff assesses Iceland's external position in 2022 as weaker than the level implied by fundamentals and desirable policies (Annex I).⁴ After appreciating during

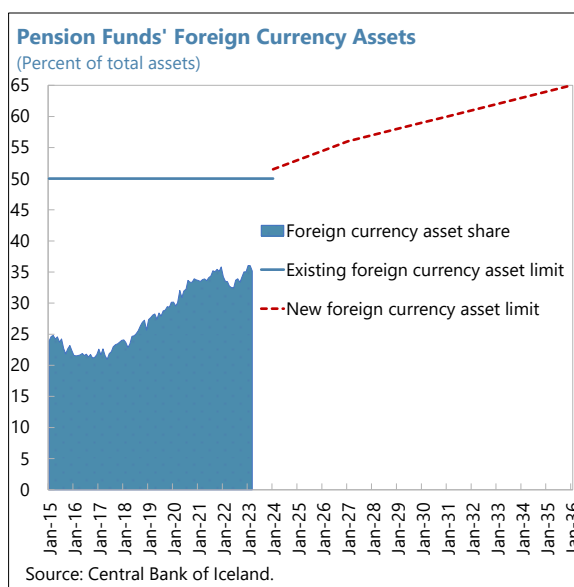
⁴ The assessment is subject to large uncertainty surrounding the treatment of the use of intellectual property in the statistics on external trade in services (about 1.3 percent of GDP for 2022), which are currently excluded from current (continued)

the first half of 2022 the krona weakened and ended the year down 8.2 percent against the U.S. dollar.

12. The banking system appears resilient. Banks' capital and liquidity ratios remain well above regulatory minima (Figure 7). Their profitability remains high on strong net interest income and fees and commissions. Non-performing loans continue to decline, supported by household and corporate resilience and the economic recovery. The number of loans under pandemic-era regulatory forbearance (mostly in the tourism sector) have declined by about 39 percent since 2021Q1 to 7.3 percent of corporate loans and 1.1 percent of household loans. Bank credit growth increased modestly to around 1.8 percent y/y at end-2022, as a post-pandemic recovery in borrowing by non-financial corporates more than offset a slowdown in household borrowing.



13. Despite a recent decline in asset valuations, pension funds remain key players in the financial system. After reaching a record high 208 percent of GDP in 2021, pension funds' assets declined to about 176 percent of GDP in 2022 due to the decline in global stock markets. However, pension funds remain the largest domestic investor class through direct and indirect mortgage lending and are a major source of funding for non-financial corporates. They are also key players in the foreign exchange (FX) market with foreign currency exposures exceeding 60 percent of GDP and accounted for 27 percent of the turnover in the interbank FX market in 2022. Effective January 2024, the regulatory limit on pension funds FX exposure will gradually increase from 50 to 65 percent of assets. While the relaxation may increase exchange rate risk for pension funds, this is more than outweighed by



account statistics pending a methodological review by Statistics Iceland. Given also the presence of domestic imbalances, the uncertainty surrounding the current account does not affect the staff's policy advice.

the benefits from increased diversification and lower concentration risk from the implicit increase in the share of pension fund assets that can be invested abroad.⁵

OUTLOOK AND RISKS

A. Moderating Growth with Persistent Inflation and Risks to the Downside

14. Macroeconomic policies are expected to remain moderately tight under the baseline.

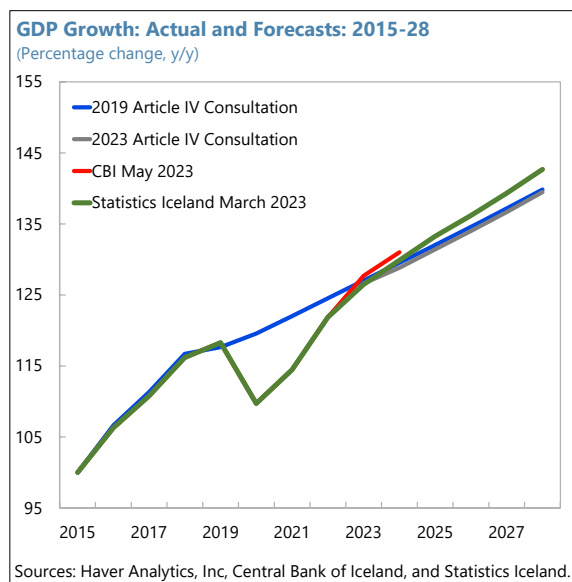
The CBI is expected to maintain a tight policy stance with policy rates expected to peak by mid-2023 (Annex V), while staff's baseline envisages a 1.7 percentage points of GDP improvement in the general government cyclically-adjusted and structural primary balances this year. The macroprudential stance is expected to remain broadly unchanged.

15. Growth is expected to fall to 3.2 percent in 2023 and 1.9 percent in 2024 on headwinds from abroad and tight macroeconomic policies, reducing imbalances. Merchandise exports are projected to moderate on slower trading partner growth, though tourism is expected to continue seeing rapid growth. The ongoing policy tightening coupled with headwinds to real incomes from deteriorating terms of trade on lower export prices will dampen domestic demand and contribute to a narrowing of the output gap to 0.9 percent by 2024. Private consumption growth is likely to remain robust on a further drawdown of household savings and strong employment growth supported by continued immigration. Inflation is projected to decline to 4.0 percent by end-2024 on lower import prices and cooling house prices, as well as tighter policies.

16. Iceland's medium-term growth prospects are broadly favorable and sufficient to avoid any significant scarring from the pandemic. With average annual growth of 2.3 percent over the forecast horizon, real GDP is projected to be less than ½ percent below its pre-pandemic trend by 2028.⁶ The envisaged fiscal consolidation will reduce public sector dissaving and, with private saving envisaged to remain at pre-pandemic levels, contribute to an improvement in the current account.

17. Risks to growth are tilted to the downside, while risks to inflation are to the upside (Annex II). Tighter global financial

conditions could increase financing costs for Icelandic banks that rely on international capital



⁵ The regulatory limit will increase gradually to 65 percent of assets by 2036. Moreover, temporary movements in the FX share due to exchange rate movements will no longer count against the limit. Effective January 2023 the mandatory contribution rate has also been raised from 12 to 15.5 percent.

⁶ Potential growth is expected to average 2.2 percent over the forecast horizon.

markets. An abrupt global slowdown, triggered for example by an escalation of the war in Ukraine or a worsening energy crisis, could reduce demand for Icelandic exports and the price of commodities including aluminum. Monetary policy miscalibration in advanced economies could keep imported inflation high and require further policy tightening. Domestically, risks include further labor market tensions that could disrupt economic activity, and a collective wage bargaining outcome that adds to inflationary pressures. Also, attacks on Iceland's digital infrastructure could have a serious impact on financial stability and economic activity, and a sudden correction in the real estate market could depress domestic demand and result in losses for financial institutions. Implementation of the EU's FIT for 55 package provisions for international aviation, without adequate adaptations, could affect the cost and availability of flights to Iceland and adversely affect tourism and other export sectors. Finally, natural disasters, particularly volcanic activity, could cause economic damage and require government support. Upside risks stem from breakthroughs in the pharmaceutical industry and other non-traditional industries, and commercialization of climate mitigation technologies.

Authorities' Views

18. The authorities broadly agreed with staff's views on the outlook but felt that risks for real economic activity were more broadly balanced while risks to inflation were firmly on the upside. They agreed that the economy was operating well above potential, and that inflation had become more broad-based and persistent, and that it could take longer to bring inflation down to target. The authorities also agreed that uncertainty was high but viewed risks for the real economy to be relatively balanced with possible upside risks to tourism arrivals potentially offsetting the anticipated easing of growth in domestic demand. At the same time, risks to inflation were firmly on the upside, with the upcoming wage bargaining round a key risk, especially given the apparent weaker anchoring of inflation expectations.

MACROECONOMIC POLICIES: SECURING A SAFE LANDING AND BUILDING RESILIENCE

19. Discussions focused on policies for achieving a soft landing and reducing imbalances, while remaining sufficiently nimble to adjust course were downside risks to materialize. Tighter and well-coordinated policies should aim to steer domestic demand toward sustainable levels, bring inflation back to target, reduce external imbalances and contain financial stability risks. While monetary policy is the primary tool for reducing inflation, fiscal policy should play a supporting role. Were downside risks to materialize, the authorities should stand ready to reassess their policy stance. Structural reforms should facilitate economic diversification, while bolstering the competitiveness and sustainability of traditional export sectors.

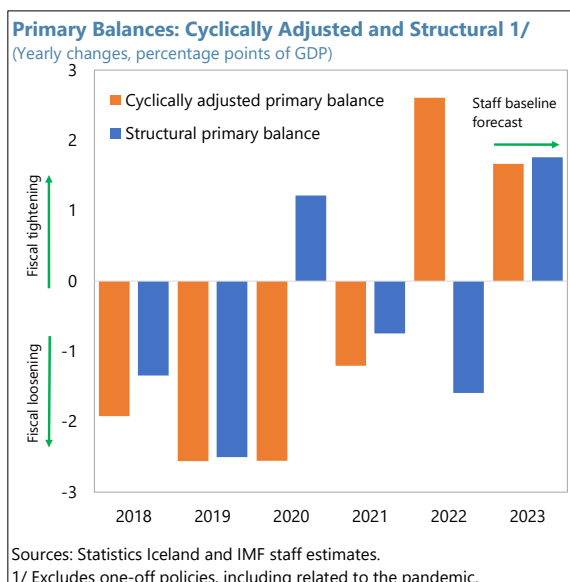
A. Fiscal Policy: Faster Consolidation Warranted

20. Ex-post, the faster-than-anticipated recovery from the pandemic and increase in inflation warranted a tighter fiscal stance in 2022. The 2022 outturn was better than anticipated,

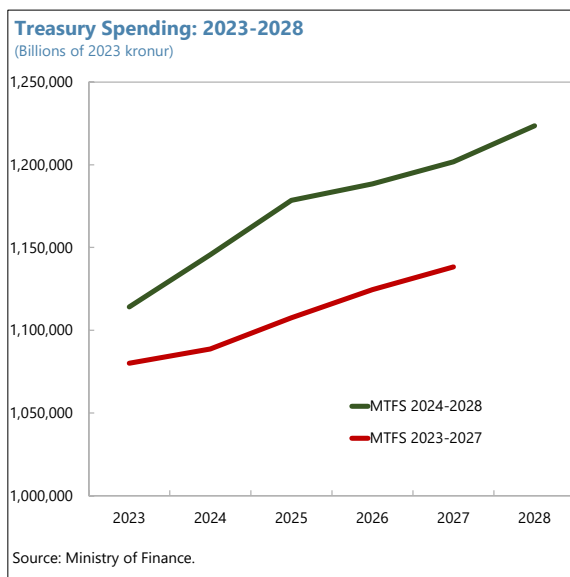
with the government appropriately containing real spending and saving the additional fiscal revenue from stronger economic activity and higher inflation. Fiscal policy was contractionary in 2022, though not enough to sufficiently slow domestic demand, and the underlying fiscal stance—as measured by the change in the structural primary balance (excluding one-offs)—deteriorated. Model simulations suggest the faster-than-anticipated decline in the private savings rate in 2022 warranted a tighter fiscal policy stance than was the case (Annex IV).

21. The authorities' fiscal plans entail a reduction in the fiscal deficit and rebuilding of buffers.

- The 2023 budget envisages continued fiscal consolidation to help contain demand growth and inflationary pressure, and improve the underlying fiscal stance. While the original budget implied an overall fiscal deficit for the general government of 4.3 percent of GDP, the authorities' draft medium-term fiscal strategy (MTFS) projects the deficit could end up below 2 percent of GDP based on a more favorable macroeconomic outlook and higher revenues. Staff's revenue forecasts are somewhat more conservative, implying an overall deficit of 2.7 percent of GDP.



- The MTFS envisages a gradual reduction in the overall fiscal deficit of the general government until balance is reached in 2027. This would be achieved by a combination of revenue and spending measures, some of which have already been identified (e.g., higher taxes on fisheries, elimination of some VAT exemptions, a temporary tax on profits in 2024, and deferment of public infrastructure plans) and others that will be introduced later. Relative to last year's MTFS, however, the projected real value of the government expenditure envelope has increased.

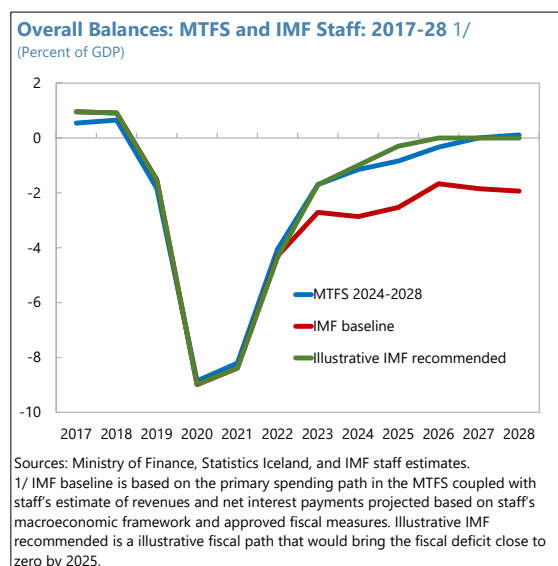


22. The authorities' fiscal targets for 2023 are appropriate, but medium-term fiscal consolidation should be accelerated to speed up disinflation and rebuild buffers.

- The envisaged 2.4 percentage points of GDP deficit reduction in the authorities' MTFS in 2023 will help bring down inflation and reduce imbalances, thereby reducing the burden on monetary

policy and improving policy coordination. If revenues this year fall short of MTFS targets (as implied by staff's baseline macroeconomic forecasts) additional fiscal savings will be needed, which could include not spending parts of this year's contingency buffer. Were significant downside risks to materialize the authorities should take advantage of any remaining contingency buffer in the budget, allow automatic stabilizers to operate, and if necessary, provide targeted support to affected sectors.

- The faster-than-expected recovery from the pandemic suggests a more rapid medium-term consolidation than targeted in the MTFS and earlier reinstatement of the fiscal rules is warranted to reduce macroeconomic imbalances and rebuild fiscal buffers. Reinstating the fiscal rules in 2025, one year earlier than envisaged, would signal Iceland's strong commitment to fiscal prudence and rebuild fiscal space to face future shocks.⁷ To that end it would be desirable to frontload the overall fiscal consolidation in the MTFS, in order to bring the deficit close to zero by 2025. According to staff's baseline macroeconomic projections this will likely require a cumulative 1–2 percent of GDP in additional fiscal savings over the next two years, some of which is already included in the MTFS but not yet enacted. To achieve that, the authorities should consider: (i) reversing the 3–6 percent increase in the real spending envelope relative to last year's MTFS; (ii) reducing the number of items subject to reduced VAT rates; and (iii) reviewing existing tax expenditures, including incentives for R&D and innovation—the second highest in the OECD—to explore the scope for efficiency gains and improvements in targeting.⁸ Ceteris paribus, this could reduce GDP by 0.6–1.3 percent relative to the baseline, but the actual impact is likely to be smaller given the resulting decline in inflationary pressures and need for monetary tightening.⁹



23. Asset-liability management operations could help reduce public debt to levels that would provide insurance against extreme adverse scenarios. At 68 percent of GDP, gross public

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 on average by 5 percent per year. The coverage of the debt subject to fiscal rules was modified in 2022 to exclude debt of government credit funds, such as the former HFF. Under this definition, net debt amounted to 40 percent of GDP in 2022. 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 For a discussion of options to reform the VAT in Iceland, see "Iceland: Modernizing the Icelandic VAT", IMF Country Report No. 14/291.

⁹ Based on a fiscal multiplier of 0.65 estimated for Iceland using the buffer-stock model in Fournier, 2019. "A Buffer-Stock Model for the Government: Balancing Stability and Sustainability", IMF Working Paper No. 19/159.

debt is roughly at the level it was before the pandemic, sustainable and resilient to shocks (Annex III). The planned privatization of Islandsbanki, initially envisaged for 2022 and currently expected to take place by 2024, should be completed in a manner that respects the importance of high-quality bank ownership. Ongoing efforts to clarify the government's obligations with respect to the securities issued by the Housing Finance Fund (HFF) that are now on the government's balance sheet should take care not to undermine investor confidence in the sovereign's creditworthiness.¹⁰

Authorities' Views

24. The authorities agreed that fiscal policy should contribute to reducing inflationary pressure while rebuilding fiscal buffers. They noted that the draft MTFS already envisages a series of revenue measures, but acknowledged that more may be needed to meet MTFS targets. The authorities agreed that over the medium-term there could be scope to further frontload fiscal consolidation given the faster-than-anticipated recovery from the pandemic, and reiterated their commitment to saving fiscal windfalls, protecting the vulnerable from the impact of tighter policies, and allowing automatic stabilizers to operate if adverse shocks materialized. The authorities are keen on completing the privatization of Islandsbanki as soon as possible. They also reiterated their intention to ensure the orderly, timely and effective resolution of the debts issued by HFF, fully acknowledging the legal obligations of the Treasury. They pointed to legal advice suggesting the government guarantee only requires the government to repay the outstanding principal but underlined that eventually Parliament would need to determine how financial obligations stemming from the activities of the HFF are settled. The authorities' stated their preference for a negotiated and fair solution to the matter.

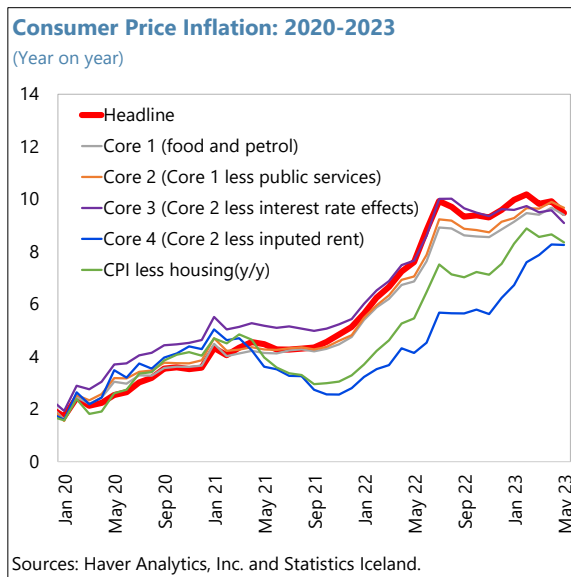
B. Monetary Policy: Tighter for Longer to Bring Inflation Back to Target

25. Inflation is projected to remain above target for an extended period. Core inflation measures (including those excluding housing) have risen in recent months, suggesting inflation is becoming more broad-based and persistent. The higher persistence has both domestic and external antecedents, with workers pushing for large wage increases to preserve purchasing power and trading partner inflation declining more slowly than anticipated. As a result, headline and core inflation are projected to remain elevated in 2023 and only approach the target by end-2025.

¹⁰ In the second half of 2022, after receiving a legal opinion that the state guarantee on HFF bonds obliges the state to pay only the principal and not to service the bonds until maturity, the Ministry of Finance submitted a draft act proposing three options to deal with the legacy debt of the HFF Fund: (i) to service its bonds until maturity; (2) to declare the fund bankrupt and repay the principal under the state guarantee; and (3) to renegotiate with bondholders. The pension funds which are the main bondholders have disputed the legal opinion and thus far declined to renegotiate, and the draft act was not passed by Parliament. There are sufficient assets in the fund to service the HFF bonds, some of which will only mature in 2044, through the early 2030s.

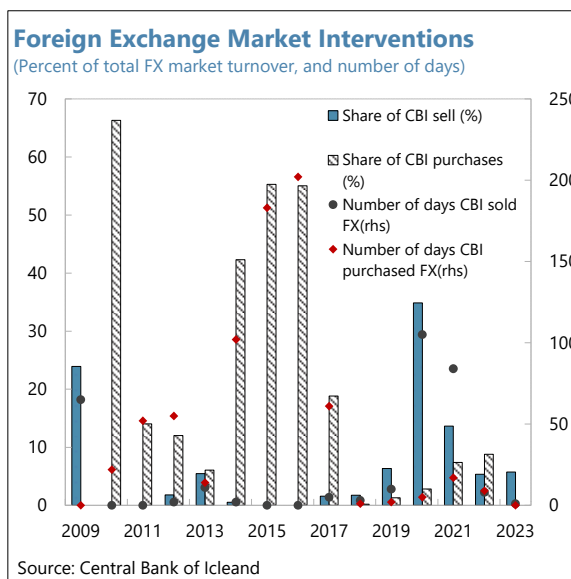
26. The CBI should maintain a tight policy stance until there is clear evidence that inflation will return to target and expectations are re-anchored at the target.

While the monetary policy tightening over the past two years was appropriate, the near-term inflation outlook continues to deteriorate and the CBI at its most recent meeting stated that the outlook is for further rate hikes to bring inflation back to target. In staff's view the policy rate may need to be raised further from its current level depending on the evolution of inflation and inflation expectations in the coming months, and the real policy rate should be kept well above the neutral rate for as long as needed to steer inflation close to target over the monetary policy horizon of about two years, especially in an environment in which the economy is operating above potential and inflation is becoming more broad-based and persistent.¹¹ Such a policy should also help guide inflation expectations back to target. Policy rates may need to increase further and remain high for longer if expectations continue increasing or inflation turns out to be more persistent (Annex V). Given high uncertainty, the CBI should stand ready to reassess the amount of tightening needed if shocks that significantly alter the inflation outlook materialize.



27. The CBI reduced its presence in the foreign exchange market in 2022.

Two-sided interventions were mainly used to counter disorderly market conditions during the initial phase of Russia's invasion of Ukraine, with the CBI's share of foreign exchange market turnover declining to 14 percent in 2022 from 21 percent in 2021. The number of days the CBI was active in the market declined from 101 to 17 days over the same period. In 2023 through end-April, the CBI has only been active in the market on one day. At about 123 percent of the Fund's ARA metric and 5 months of import coverage, reserves are adequate. While foreign exchange intervention should be used primarily as a tool to counter disorderly market conditions, the authorities could also consider insights from the IMF's work on an



¹¹ The steady state neutral real interest is uncertain but estimated to be in the range of 1.2 to 1.6 percent.

Integrated Policy Framework (IPF), including the role of foreign exchange intervention in addressing destabilizing premia in shallow FX markets.¹²

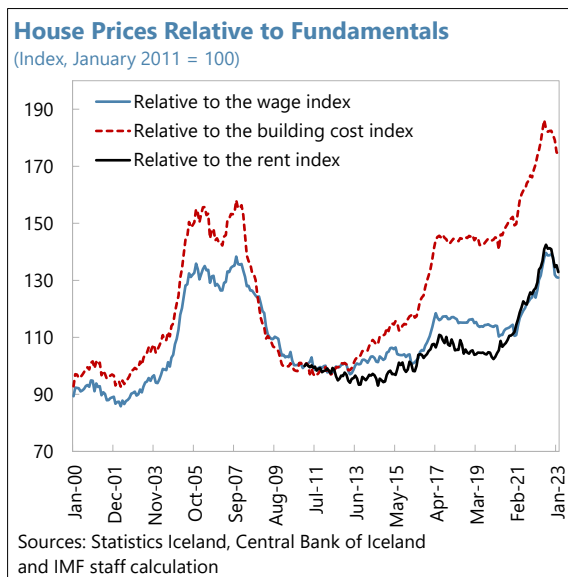
Authorities' Views

28. The authorities reiterated their commitment to steering inflation back to target. They agreed that inflation has become more broad-based and persistent, and that lowering inflation is proving more challenging than initially envisaged. At the same time, the CBI is firmly committed to its inflation-targeting framework and stands ready to raise interest rates further to ensure that inflation returns to target over the medium term. The authorities underscored the need for a wage agreement later this year that is consistent with price stability, and noted the importance of a tight monetary policy—together with contractionary fiscal policy—to help bring domestic demand growth down to sustainable levels. They reaffirmed their commitment to exchange rate flexibility and emphasized that their foreign exchange intervention policies have not changed despite a sharply reduced presence in the foreign exchange market after the pandemic. They broadly concurred with staff's assessment of the external sector for 2022, while highlighting the data uncertainty surrounding the assessment.

C. Maintaining a Robust Financial System

29. After an upswing following the pandemic, Iceland's financial cycle has started contracting. The upturn in the financial cycle in 2021-2022 was driven primarily by a bank-driven mortgage boom and steep rise in house prices, though the asset price and credit cycles have lost momentum in recent months.

30. Risks posed by house price imbalances have receded somewhat in recent months but remain significant. The tightening of macroprudential measures (Annex VIII) and increase in interest rates have helped reduce pressures in the housing market (Figure 8), partly offsetting the boost to housing demand from immigration.¹³ However, house prices remain high relative to standard metrics and historical trends and suggest a misalignment ranging



¹² For further details about the Integrated Policy Framework see IMF Policy Paper No. 2020/046.

¹³ As a significant portion of household mortgages are at variable rates, the increase in the policy rate and adjustment of the DSTI regulation to require mortgage lenders to apply a minimum rate of 3 percent have reduced the issuance of high-risk loans and helped constrain household leverage.

from 9–11 percent in 2023Q1.¹⁴ Hence, a sudden decline in house prices cannot be ruled out. This could depress private consumption and real estate investment and encourage some borrowers to default on their mortgage obligations, triggering losses for financial institutions.¹⁵ Also, as the FSAP notes, risk taking in the highly leveraged commercial real estate sector needs to be closely monitored given their vulnerability to interest rate increases and banks' significant exposure to the sector.

31. The 2023 FSAP gives a positive assessment of financial sector resilience, supervision, and regulation, though some vulnerabilities and gaps remain. The Basel Core principles assessment documents the significant improvements in financial supervision and regulation made since the global financial crisis. Solvency stress tests confirm the banking system is well capitalized and resilient to severe but plausible macro-financial shocks.¹⁶ The financial system also appears generally resilient to liquidity stress, but with some vulnerabilities from interlinkages with pension funds, and reliance on non-resident FX funding.¹⁷ Systemic liquidity stress tests incorporating transmission channels of FX liquidity shocks across sectors point to meaningful FX liquidity gaps in domestic banks. As a result of tighter global financial conditions Icelandic banks could face an increase in borrowing costs in international capital markets and other foreign currency funding, which accounts for about 25 percent of overall bank funding.¹⁸ In addition, higher policy rates could increase losses on banks' securities portfolio and worsen the quality of their loan portfolio. Sensitivity analysis in the FSAP suggests banks' capital positions are sensitive to interest rate increases which, in an adverse scenario, could erode the current excess over regulatory requirements.¹⁹ Nevertheless, regulations limiting banks' exchange rate exposure, the domestic institutional investor base with large foreign assets, and the comfortable level of international reserves provides some insurance against a deterioration in funding conditions.

32. The macroprudential stance is broadly appropriate, but the CBI should remain attentive to the materialization of systemic risk. The tightening of borrower-based measures and increase in the countercyclical capital buffer (CCyB) have bolstered borrowers' and lenders' resilience

¹⁴ The estimate of house price misalignment is based on a trend-cycle analysis using an index of house prices relative to CPI (as of March 2023) and house prices relative to the wage index, the building cost index, and the rent index (all as of February 2023). Using a House Price Misalignment Regression Model and Kalman and HP filters, the FSAP estimates that house prices were overvalued by between 6.2 and 17.6 percent in 2022Q2.

¹⁵ Mortgages account for about 35 percent of the overall assets of the banking system.

¹⁶ The adverse stagflation scenario in the FSAP embodies a tightening of global financial conditions and rising funding costs, inflationary pressures and protracted supply chain disruptions due to political fragmentation, rising domestic unemployment, and a fall in the value of domestic assets and depreciation of the krona.

¹⁷ FSAP stress tests suggest that pension fund assets would decline considerably in an adverse scenario, ultimately reducing future pension values. In addition, asset-side vulnerabilities could arise from pension funds' mortgage lending and concentrated exposure to domestic banks.

¹⁸ In response to rising spreads banks have increasingly shifted to domestic covered foreign currency bonds to meet rollover needs of cross-border foreign currency bonds.

¹⁹ The FSAP sensitivity analysis simulates a parallel 2 percentage point increase in the yield curve (together with a corresponding impact on the risk premium of banks' cost of funding) on top of an adverse scenario that already includes an increase in interest rates of around 4 percentage points.

to an abrupt decline in asset prices and tighter financial conditions. Borrower-based macroprudential policies are appropriate and should remain on hold for now. Regulators should stand ready to adjust macroprudential policies in the event of a materialization of systemic risk triggered for example by a sharp tightening of global financial conditions, or by a spiral of declining house prices, falling mortgage credit, and increasing defaults and foreclosures.²⁰ Finally, the authorities should consider adding to their macroprudential toolbox temporary risk weight floors or temporary risk weight add-ons on commercial real estate (CRE) exposures and borrower-based measures for highly leveraged CRE firms that can be activated if vulnerabilities persist or intensify.

33. When implemented, the housing affordability strategy should help reduce imbalances in the housing market. Housing affordability in Iceland is low compared to other OECD countries, particularly for renters and low-income households. The housing affordability strategy strengthens tenant rights, improves targeting of housing benefits, and increases the supply of land. In addition, priority should be given to simplifying planning regulations and easing the administrative burden related to planning permits and inspections.

34. Financial resilience could be bolstered by ensuring regulatory agencies have adequate powers, resources, and independence for their supervisory function (Annex VIII).

- **The CBI should have full discretion over all prudential banking supervision decisions.** Removing Ministry of Finance and Economic Affairs staff from the Financial Supervision Committee would further safeguard the independence of supervisory decisions and avoid potential conflicts of interest. Implementing a formal delegation of authority for supervisory decision-making within the CBI would ensure accountability and enhance operational effectiveness. In addition, adequate legal protection for supervisors in the exercise of their functions is needed, as well as increasing the CBI's oversight powers over commercial banks' external auditors and expanding the legal definition of related-party transactions.
- **The funding process of banking supervision needs to be streamlined and additional resources given to monitor and address emerging financial stability risks and challenges,** including market risk, interest rate risk in the banking book (IRRBB), and operational risk (including ICT and cybersecurity). To safeguard the CBI's independence and the effectiveness of banking supervision, a streamlined and independent budgetary process should be developed to ensure the funding needs of the CBI's banking supervision activities are always met.
- **The systemic importance of pension funds requires stronger governance and supervision.** Pension funds play a systemic role because of their large size and strong interlinkages with the rest of the financial and corporate sector. The legal framework for governance (especially board nominations and board oversight) and internal controls of pension funds could be further strengthened. The CBI's pension fund supervisory and sanctioning powers should be expanded.

²⁰ For a discussion of how to adjust macroprudential policy during a downturn in the housing market see Valderrama, L. (2023), "Calibrating Macroprudential Policies in Europe Amid Rising Housing Market Vulnerability", IMF Working Paper No. 23/75.

In addition, there is a need to increase the number of onsite inspections at larger pension funds. The green paper being prepared by the working group on the pension system represents an opportunity to start the process of addressing these challenges.

- **Refinements to the crisis management, safety net, and resolution frameworks are warranted.** Significant progress has been made in preparing for systemic stress in the financial system and for handling financial sector crises. Nevertheless, there is scope for improving decision-making in crisis situations, including by establishing a coordinating body on bank resolution involving the Ministry of Finance, while preserving the independence of the resolution authority. The resolution framework should be further strengthened, including by approving the crisis management handbook, and strengthening the Deposit Guarantee Fund in line with IADI Core Principles. To improve the management of systemic liquidity in crisis situations, the CBI should finalize and test the Emergency Liquidity Assistance (ELA) framework and develop an interbank secured repo market. Continued cooperation with other central banks is needed to ensure access to FX liquidity in the event of a severe crisis. Development of alternative domestic retail payment solutions would alleviate financial stress in the event of a payment system disruption.

35. Efforts to safeguard financial integrity should continue. Integration of financial flows into the money-laundering/terrorist financing (ML/TF) risk assessment are welcome but would benefit from more granular data and refinements to the assessment methodology. Greater onsite supervisory presence would help drive improvements in bank's Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) systems. Steps should be taken to improve the beneficial ownership information that the Icelandic Register of Enterprises maintains.

Authorities' Views

36. The authorities welcomed the FSAP's positive assessment of the resilience of the financial system. They broadly agreed with staff's assessment of systemic risks and the macroprudential stance and noted that the analysis conducted on pension funds and liquidity risks was useful. The authorities appreciated IMF's effort in reviewing the legal funding framework for financial supervision and for providing their opinion on the membership of the Financial Supervision Committee. Both matters require further assessment, but the Ministry of Finance and Economic Affairs emphasized that any alteration of the funding arrangements needs to meet constitutional requirements and respect the fiscal authority of the Parliament. A structured dialogue between the Ministry and the CBI, whilst fully respecting the independence and integrity of the latter, may be warranted and necessary in that context. The authorities confirmed that continuing to strengthen the AML/CFT regime is a priority.

D. Structural Policies: The Time is Now

37. Notwithstanding recent progress, further efforts are needed to diversify the economy. The increase in R&D spending in recent years has contributed to green shoots in non-traditional

sectors including the green economy and the pharmaceutical industry. However, progress on the broader structural reform agenda, including easing the regulatory burden and increasing competition, slowed during the pandemic but should restart now that the crises of the past few years are receding.

38. Alongside diversification efforts, improving the sustainability and productivity of traditional export industries including tourism are important. Iceland's small size imposes limits on the number of industries that can realistically flourish. At the same time, Iceland possesses a natural advantage in sectors including tourism that are likely to remain important drivers of growth for the foreseeable future. However, with Iceland already among the highest recipients of tourists in the world on a per capita basis, the focus should be on maximizing the contribution of the tourism sector in a sustainable manner that protects the natural resources on which tourism depends, and limit negative spillovers (e.g., overcrowding and pressure on real estate markets) to the local population (Annex IX).

39. The Tourism Policy Framework 2030 emphasizes sustainable development as the overarching policy objective, with a focus on profitability and value creation, an enhanced quality of life for locals, a unique visitor experience, and environmental conservation. With the pandemic over, work has restarted on an action plan that aims to balance tourism growth with its social and environmental impact, to be delivered by end-year.

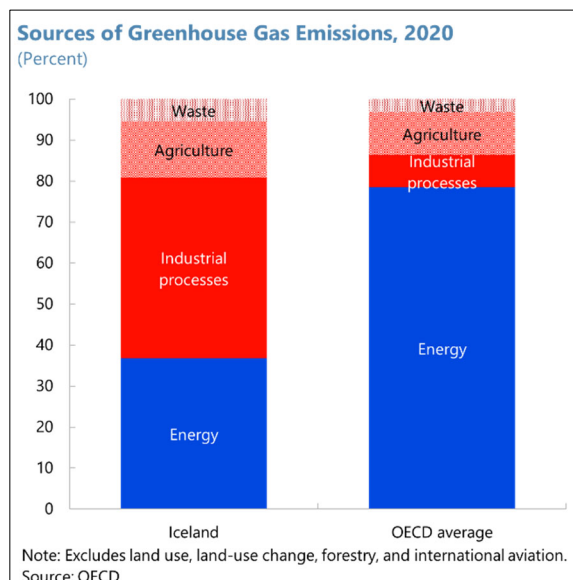
40. In addition to their current reforms, the authorities should focus on improving access by enhancing travel infrastructure and increasing the value of each tourist arrival.

- While Iceland scores well in the overall World Economic Forum Travel and Tourism Development index, it consistently underperforms in ground and port infrastructure. Infrastructure limitations, e.g., airport capacity that has not kept up with traffic growth and a lack of connectivity with regional airports, mean tourism is concentrated around the south and west of the island. Reducing regulatory barriers on transport and tourism-related services would increase productivity, while infrastructure improvements would improve accessibility and ensure that the positive and negative externalities of tourism are spread more evenly across the country.
- To strengthen the social and environmental sustainability of tourism, the authorities should explore avenues for growing the industry without necessarily increasing the already-high number of tourists. This could include targeting high-value tourists, encouraging longer stays, further developing the range of unique experiences offered to tourists, and increasing accessibility to more remote regions. These reforms would also increase resilience to a future increase in the cost and availability of flights to Iceland related, for instance, to global efforts to reduce emissions from international travel. To manage the negative externalities on natural resources, the authorities could also consider price-based measures (e.g., departure taxes,

charges on cruise ships, and entrance fees to national parks) and revisit the need for a reduced VAT rate in the tourism sector (Box 2 in Annex IX).²¹

41. Achieving Iceland's ambitious climate agenda will require additional policy effort.²²

- Carbon dioxide emissions increased by 21 percent in 2022, primarily due to increased air traffic.²³ At the same time, Iceland's greenhouse gas emissions per capita remain high compared to the EU, despite an abundant supply of renewable energy. The structure of emissions in Iceland—industrial processes and agriculture contribute a large share compared to the OECD average—complicates the process of reducing emissions.²⁴
- The inter-governmental Climate Action Plan includes measures to accelerate the clean energy transition. In addition, Iceland has pioneered technological solutions in carbon capture and storage, and the production of green hydrogen, and is at the forefront of electric vehicle adoption. However, with emissions falling short of targets, the authorities should take advantage of the upcoming update to the Climate Action Plan to adopt policies to accelerate the transition to a low-carbon economy. These could include a gradual increase in the level of carbon taxes in the economy.²⁵



²¹ The overall framework for tourism taxation is under review, as part of a commitment made in the 2021 Agreement on the Platform for the Coalition Government. The accommodation tax will be reinstated at the beginning of 2024.

²² Iceland has a goal of carbon neutrality by 2040, and in 2021 it also committed to a reduction of at least 55 per cent in net greenhouse gas emissions by 2030 compared to 1990 levels, to be achieved jointly with the European Union and Norway.

²³ Based on Statistics Iceland's data of emissions, which considers emissions of Icelandic entities regardless of where the emissions occur. It differs from data from the Environment Agency of Iceland which (consistent with UN Climate Council practice) considers emissions that occur within Iceland's territory regardless of nationality, and does not take into account international flights (which is reported separately). While final 2022 data from the Environmental Agency are not yet available, projections suggest emissions (excluding land use and forestry) in 2022 increased by 4.5 percent.

²⁴ The biggest source of emissions, aluminum production, falls under the European Emissions Trading System (EU ETS) and is produced in Iceland with significantly lower CO₂ emissions than in other countries. International aviation to and from Iceland (excluded from national totals in accordance with international reporting agreements) is another major source of emissions covered under the EU ETS.

²⁵ See "On the road to carbon neutrality, fishing for energy exchange and carbon absorption", IMF Country Report No. 22/194. The paper advocates reducing emissions under Iceland's direct regulation without losing sight of emissions covered under the EU ETS. It also proposes uniform carbon pricing policies, a favorable evolution of global technological development, and large redirection or expansion of renewable energy production. Fiscal incentives to meet climate goals need to be revenue neutral and factor other fiscal objectives.

42. The wage bargaining structure in Iceland has improved in recent years, though further reforms are needed to better align real wages and productivity growth. Coordination has improved with a decline in the number of unions. The wage statistics committee, formed in 2019, allows negotiations to start on the basis of an independent view of labor market developments. The wage negotiations later this year should revisit the design of the per capita GDP growth bonus implemented in the 2019–22 agreement (*“hagvaxtarauk”*), including by linking the bonus to the improvement in labor productivity relative to the start of the agreement, to better align real wages with productivity growth (Annex VII). In addition, mechanisms to resolve protracted impasses should be strengthened, including by ensuring that the state mediator is able to bring negotiating parties together and make proposals to resolve disagreements, while respecting the constitution and Iceland’s commitments under international human rights conventions.

Authorities’ Views

43. The authorities broadly agreed with staff’s recommendations on structural policies. On tourism policies, they underscored that significant efforts are underway to improve the sustainability of the sector. The authorities noted that without adequate adaptations, the EU’s Fit for 55 package could not only negatively impact Iceland’s economy but also lead to increased overall emissions from transatlantic flights.²⁶ The authorities underscored their strong commitment to take the necessary policy measures to achieve their ambitious climate goals. They predicted the upcoming wage negotiation would be challenging given the rising cost of living, and welcomed staff’s concrete proposals for better aligning real wages and productivity growth.

STAFF APPRAISAL

44. Iceland has shown remarkable resilience to multiple shocks since 2019. Growth in 2022 was the fastest since 2007, supported by strong domestic demand, immigration, a tourism rebound, and an improvement in the terms of trade. The economy is operating well above potential, which has helped push inflation significantly above target and contributed to external imbalances. The external position in 2022 was weaker than the level implied by fundamentals and desirable policies.

45. The outlook is broadly favorable. Slowing domestic demand should reduce overheating, while favorable medium-term growth prospects suggest scarring from the pandemic will be minimal. Tighter macroeconomic policies will help lower inflation, which is projected to approach the target by end-2025, and reduce external imbalances. The outlook is subject to significant risks including more persistent inflation, tensions around the upcoming wage negotiations, and tighter global financial conditions.

²⁶ Emissions from flights transiting through Iceland are typically lower than other flights between Europe and the US given that the shorter distance between Iceland and Europe/US allows for the use of smaller and more efficient aircraft. Thus, if EU’s FIT for 55 reduces the comparative advantage of transatlantic flights via Iceland it could result in an overall increase in emissions from transatlantic flights.

46. The 1.7 percent deficit for 2023 envisaged in the draft MTFS is appropriate, but faster consolidation in later years is needed to speed up disinflation and rebuild buffers. The envisaged fiscal consolidation in 2023 will help reduce imbalances and contribute to disinflation, thereby supporting monetary policy. Over the medium term, it would be prudent to frontload fiscal consolidation further and reinstate the fiscal rules already in 2025, one year earlier than currently envisaged, to signal Iceland's commitment to fiscal prudence and build space to face future shocks. Public debt is assessed to be sustainable with high probability.

47. The CBI should maintain a tight policy stance until there is clear evidence that inflation will return to, and expectations are re-anchored at, the 2.5 percent target. Achieving this may require that the policy rate be raised further from its current level and that the real policy rate be kept well above the neutral rate for as long as needed to steer inflation back to target, especially in an overheating economy with more persistent and broad-based inflation.

48. The financial sector appears resilient to stress, though some vulnerabilities remain. The FSAP bank solvency stress tests show adequate levels of capital that can withstand severe but plausible macro-financial shocks. However, banks' reliance on non-resident FX funding is a potential vulnerability to banks' liquidity, although regulations limiting exchange rate exposure as well as significant foreign assets of domestic institutional investors and the comfortable level of international reserves are mitigating factors. The financial regulation and supervision framework should be enhanced for pension funds, while for banks guidance is needed in some risk domains. Financial resilience could be further bolstered by ensuring that regulatory agencies have adequate powers, resources, and independence, and by making refinements to the crisis management, safety nets, and bank resolution frameworks. The gradual increase in the regulatory limit on pension funds' FX exposure is a welcome development that will help pension funds better diversify their asset base and reduce concentration risk.

49. The macroprudential stance is broadly appropriate, but the CBI should remain attentive to the materialization of systemic risk. The tightening of macroprudential measures have bolstered household and banking system resilience to adverse shocks. However, risks in the CRE sector need to be carefully monitored, and the authorities should introduce sector-specific macroprudential tools that can be activated if needed.

50. Structural policies should facilitate diversification and support traditional export sectors, while further efforts are needed to achieve Iceland's ambitious climate agenda. Easing the regulatory burden and increasing competition remain crucial for diversifying the economy, while there is a need to improve the sustainability and productivity of traditional export sectors including tourism. The update of the Climate Action Plan is an opportunity to adopt policies to accelerate the transition to a low-carbon economy, including raising the level of carbon taxes. The upcoming wage negotiations provide an opportunity to better align wages and productivity growth.

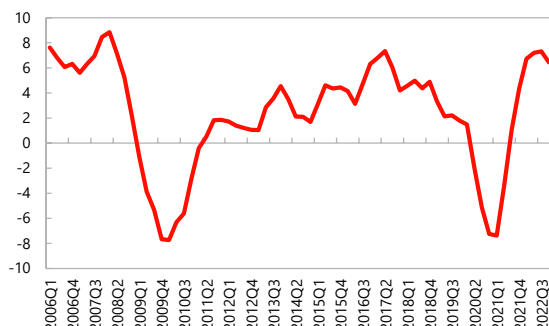
51. It is proposed that the next Article IV consultation with Iceland take place on the standard 12-month cycle.

Figure 1. Iceland: Key Macroeconomic Developments

Growth remained strong through 2022Q4.

GDP Growth

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

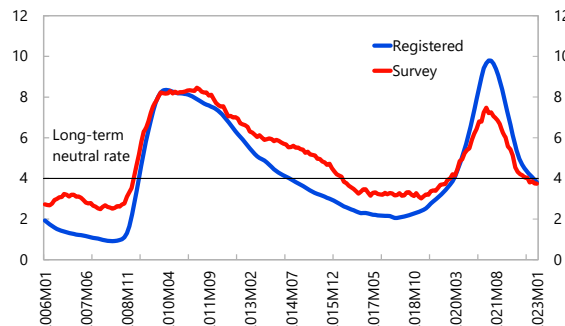


Source: Statistics Iceland.

Labor markets tightened and the unemployment rate returned to its estimated long-term neutral level.

Unemployment Rate

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

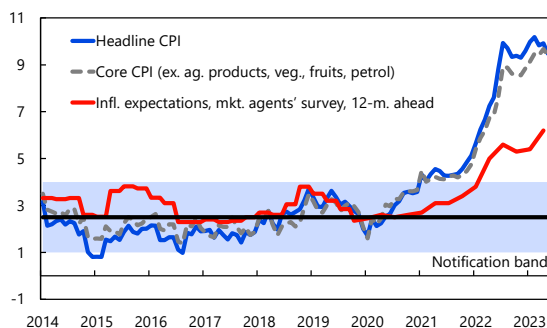


Sources: Statistics Iceland; Directorate of Labor.

Inflation jumped during 2022 and has remained at persistently high levels.

Inflation and Inflation Expectations

(Percentage change y/y)

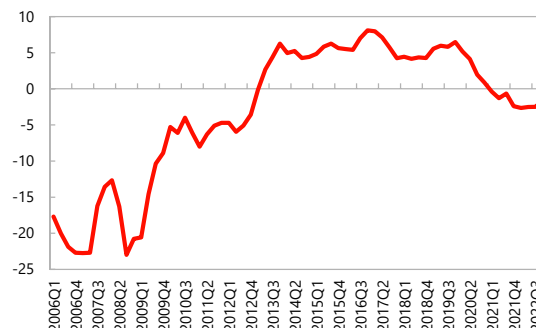


Source: Statistics Iceland.

The current account remained in deficit.

Current Account Balance

(Percent of GDP; 4-quarter moving average)

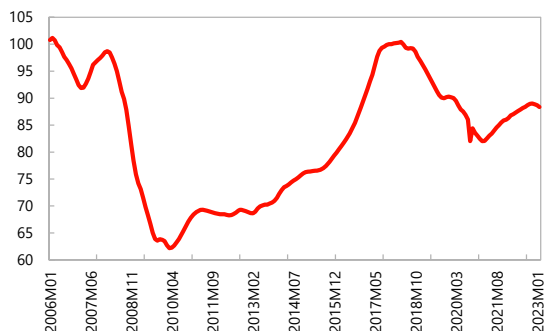


Sources: Statistics Iceland; Central Bank of Iceland.

Notwithstanding some recent depreciation, the real exchange rate ended 2022 stronger than in 2021.

Real Exchange Rate

(Index, 12-month moving average)

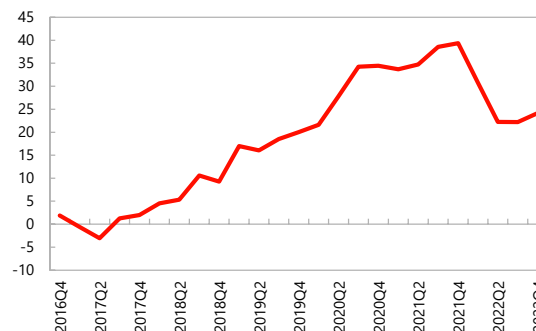


Source: Central Bank of Iceland.

With negative returns abroad, the net international investment position has weakened.

Net International Investment Position

(Percent of GDP; 4-quarter moving average)



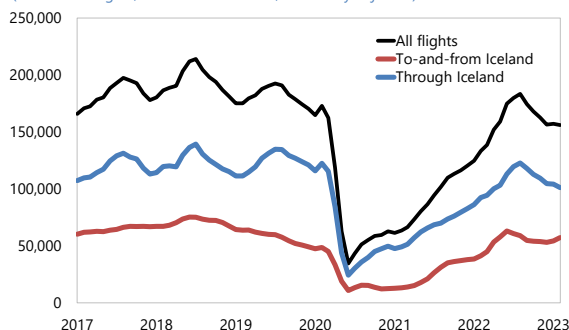
Sources: Statistics Iceland; Central Bank of Iceland.

Figure 2. Iceland: Tourism Developments

Flight arrivals have recovered strongly, especially those to and from Iceland...

Flight Arrivals in Reykjavik Control Area: 2017-2023 (Feb)

(Number of flights, 3-month annualized, seasonally adjusted)



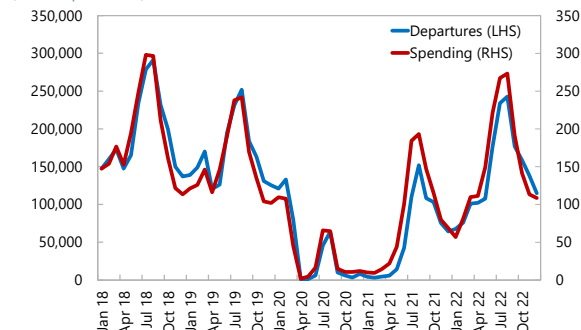
Source: ISAVIA.

... with tourist spending and flows reaching levels last seen before the pandemic.

Tourist Departures and Euro Spending in Iceland: 2018-2022

(Persons per month)

(Million euros)

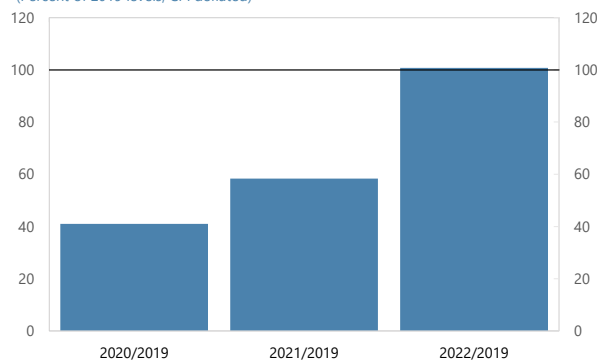


Sources: Haver Analytics, Inc., Statistics Iceland, Tourism Board, Icelandair.

The real value of turnover in the tourism sector has fully recovered ...

Real Turnover in Tourism: 2020-2022

(Percent of 2019 levels, CPI deflated)



Source: Statistics Iceland.

... as has employment in the tourism industry.

Employees in Tourism: 2019-2022

(Number of persons)

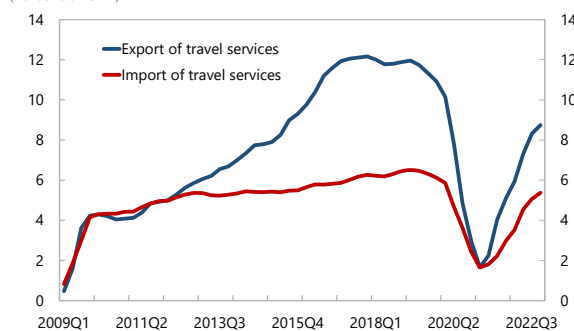


Sources: Haver Analytics, Inc. and Statistics Iceland.

The contribution of the travel balance to the current account balance increased in 2022...

Travel Balance: 2009-2022

(Percent of GDP)



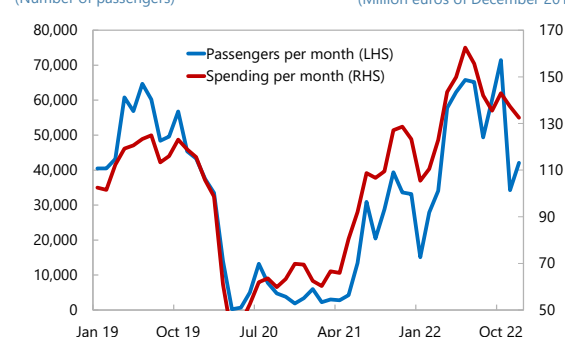
Sources: Haver Analytics, Inc. and Central Bank of Iceland.

... even when travel by Icelanders abroad reached new historic peaks.

Icelanders' Travel and Spending Abroad: 2019-2022

(Number of passengers)

(Million euros of December 2019)



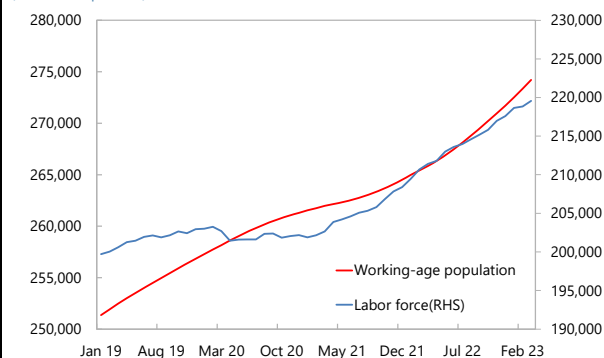
Source: Haver Analytics, Inc., Statistics Iceland, Tourism Board, Icelandair.

Figure 3. Iceland: Labor Market Developments

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

Working Population and Labor Force: 2019-2023

(Number of persons)

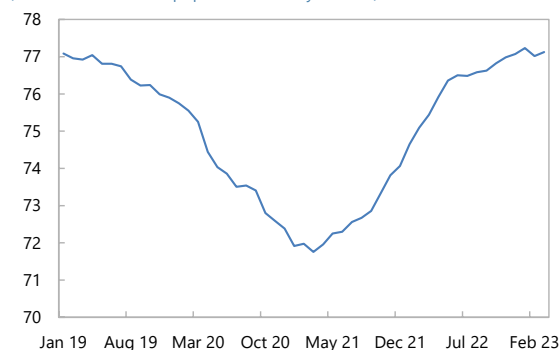


Sources: Haver Analytics, Inc. and Statistics Iceland.

...improving the employment rate.

Employment Rate: 2019-2023

(Percent of estimated population 16-74 years old)

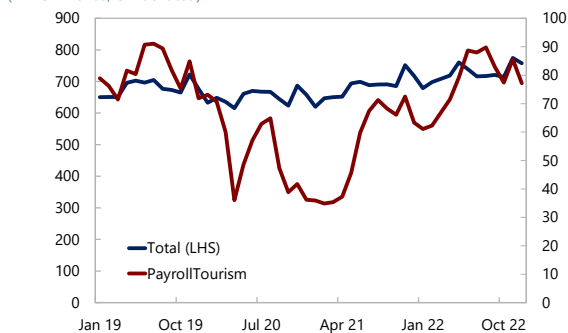


Sources: Haver Analytics, Inc. and Statistics Iceland.

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)



Sources: Haver Analytics, Inc. and Statistics Iceland.

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

Activity Rate: 2019-2023

(Percent of estimated population 16-74 years old)

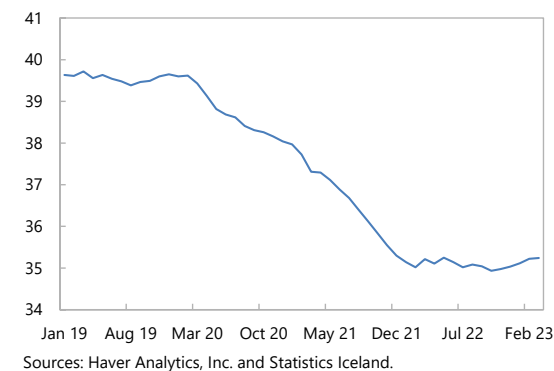


Sources: Haver Analytics, Inc. and Statistics Iceland.

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

Hours Worked per Week: 2019-2023

(Hours)

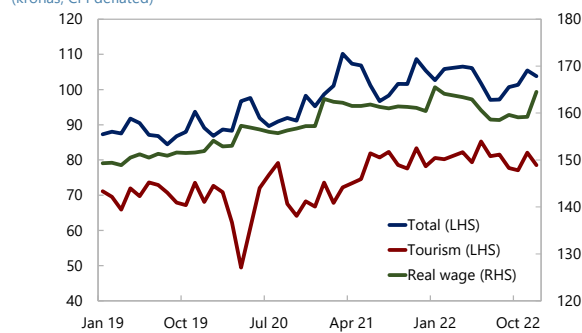


Sources: Haver Analytics, Inc. and Statistics Iceland.

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

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

(kronas, CPI deflated)



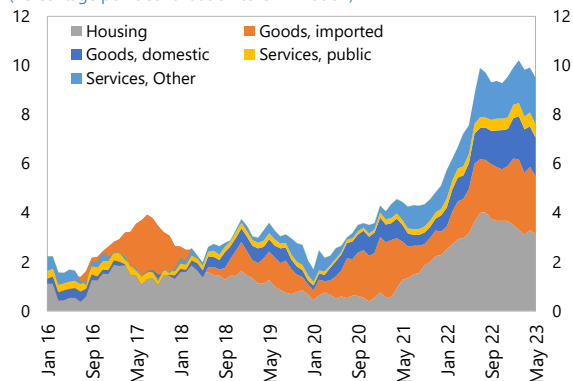
Sources: Haver Analytics, Inc. and Statistics Iceland.

Figure 4. Iceland: Inflation and Monetary Developments

Inflation reached double digits, initially driven by housing prices and later becoming more broad-based.

Consumer Price Inflation Components

(Percentage point contribution to CPI inflation)

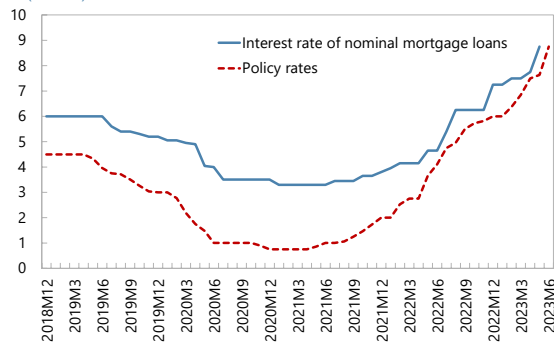


Sources: Haver Analytics, Inc. and Statistics Iceland.

Increases in the policy rate were transmitted to higher mortgage interest rates.

Interest Rate Transmission

(Percent)

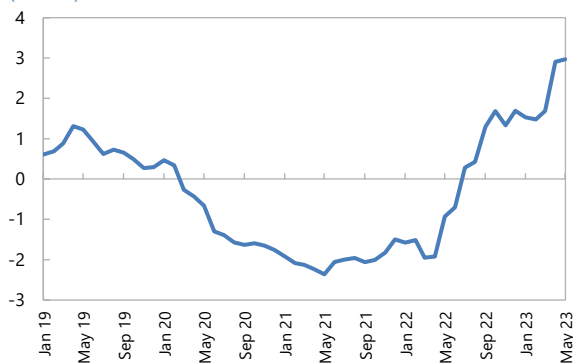


Source: CBI

Real policy rates turned positive.

Real Policy Rate ¹

(Percent)



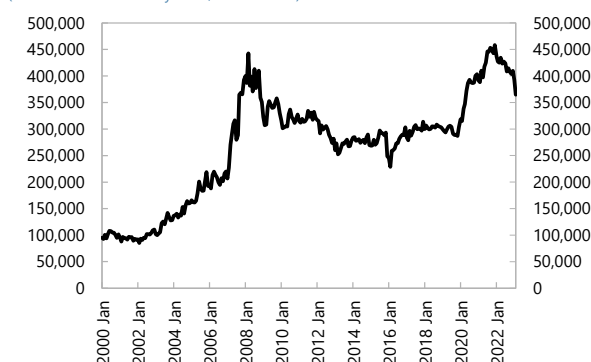
Sources: Haver Analytics, Inc. and IMF staff estimates.

1/ Computed from breakeven expectations estimated from real and nominal bonds maturing around 2030, monthly averages.

Real balances have declined but remain at historically high levels....

Real M1 Balances: 2000-2023

(Million krona of January 2008, CPI deflated)

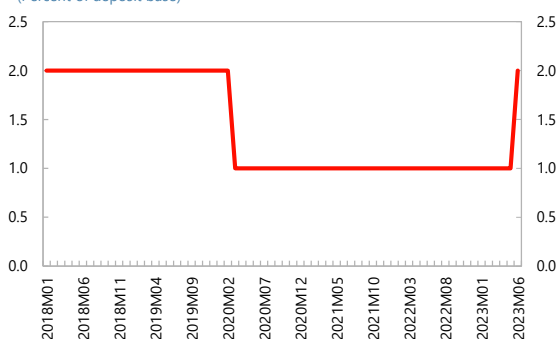


Source: Central Bank of Iceland

The reserve requirement has been increased back to pre-pandemic levels.

Total Reserve Requirements

(Percent of deposit base)

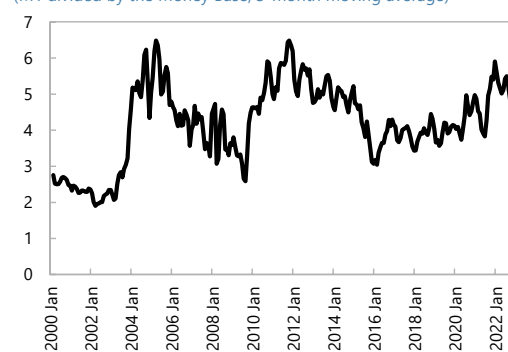


Source: Central Bank of Iceland.

The money multiplier increased during the pandemic and remains high.

M1 Money Multiplier: 2000-2023

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



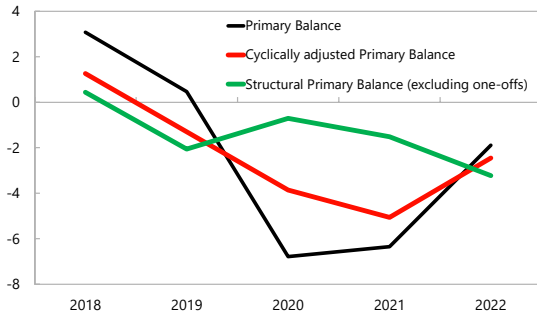
Source: Central Bank of Iceland

Figure 5. Iceland: Fiscal Developments and Issues

The fiscal position helped restrain demand growth, but the fiscal stance deteriorated in 2022.

Primary balances: 2018-2022

(Percent of GDP)

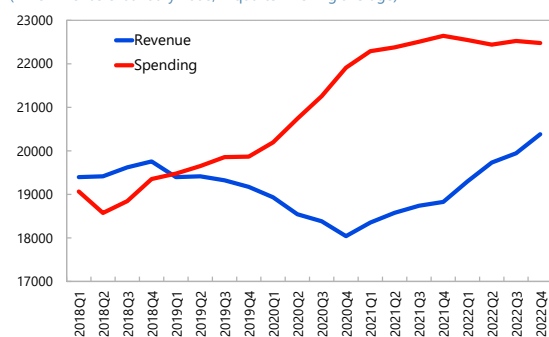


Source: Statistics Iceland.

While real revenues in 2022 increased with economic activity, real spending grew at a slower pace...

Real General Government Revenue and Spending

(Billion kronas of January 2008, 4-quarter moving average)

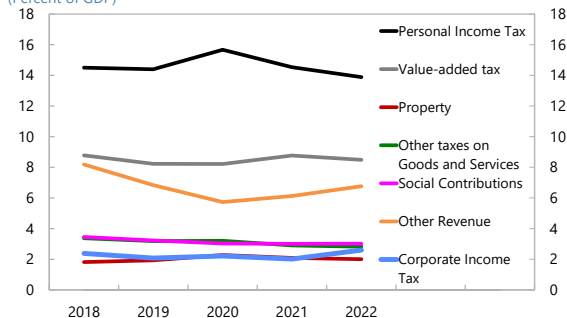


Source: Statistics Iceland.

On the revenue side, a decline in personal income taxes in 2022 was offset by extraordinary dividends from public entities (registered in other revenues).

General Government Revenue: 2018-2022

(Percent of GDP)

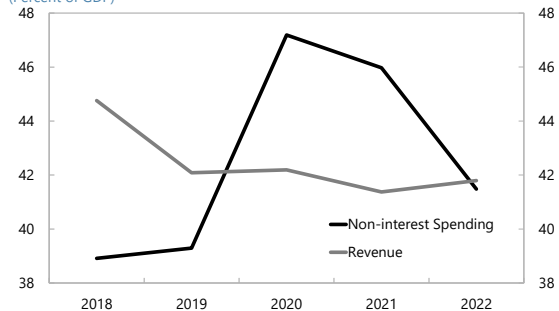


Source: Statistics Iceland.

The improvement in the primary balance was driven by a reduction in non-interest spending in percent of GDP.

General Government Revenue and Spending: 2018-2022

(Percent of GDP)

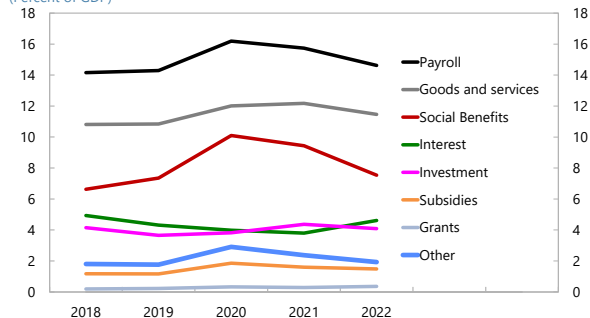


Source: Statistics Iceland.

... reflecting a decline in primary spending.

General Government Spending: 2018-2022

(Percent of GDP)

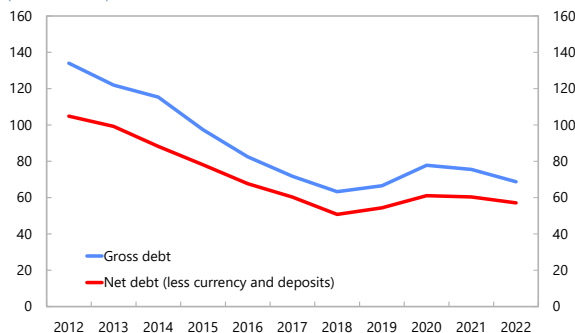


Source: Statistics Iceland.

Despite the fiscal deficit, the debt burden in 2022 declined on favorable debt dynamics, privatization, and use of deposits.

General Government Debt: 2012-2022

(Percent of GDP)



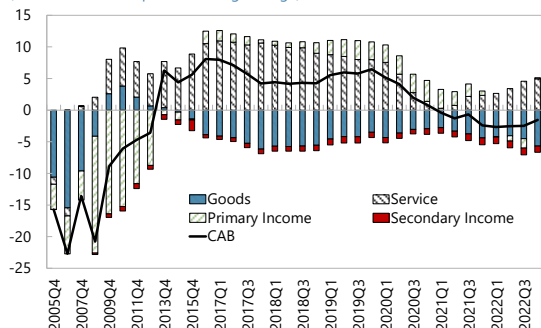
Source: Statistics Iceland.

Figure 6. Iceland: External Sector Developments

The current account deficit narrowed in 2022, with a stronger service trade balance.

Current Account Balance

(Percent of GDP; 4-quarter moving average)

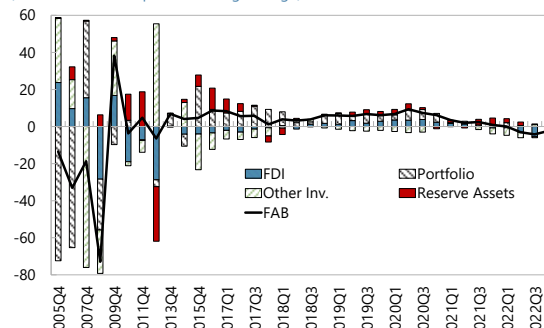


Source: Central Bank of Iceland.

FDI and portfolio flows were sizable compared to the previous year, while other flows declined.

Financial Account Balance

(Percent of GDP; 4-quarter moving average)

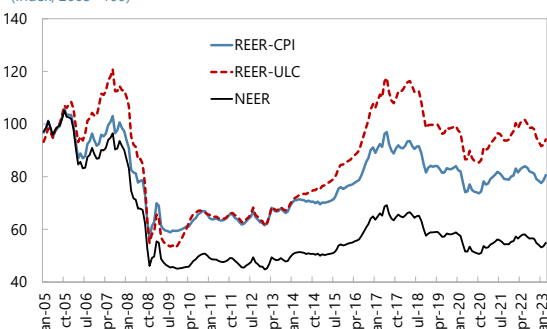


Source: Central Bank of Iceland.

The REER appreciated, on average, in 2022 compared to the previous year.

Real Effective Exchange Rate

(Index, 2005=100)

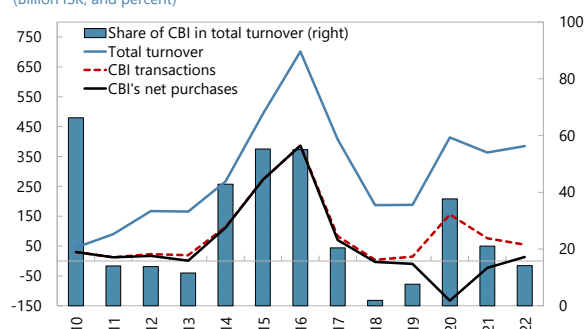


Sources: Central Bank of Iceland and IMF INS Database.

FX market turnover increased marginally, but the share of CBI transactions continued declining.

FX Market Turnover and Interventions

(Billion ISK, and percent)

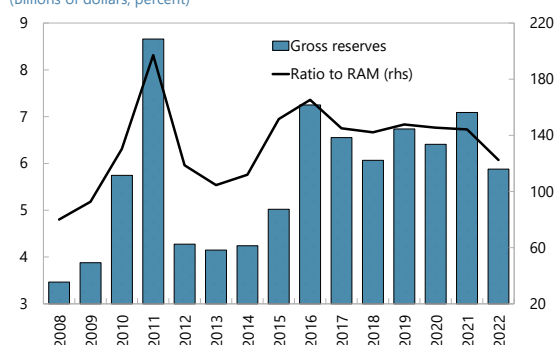


Source: Central Bank of Iceland.

The CBI maintains adequate reserves.

Gross Reserves

(Billions of dollars, percent)

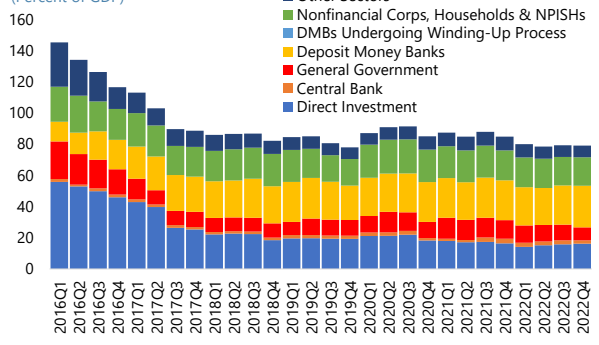


Sources: Central Bank of Iceland and IMF Staff Calculations.

The external debt has remained stable.

External Debt: 2016-22

(Percent of GDP)



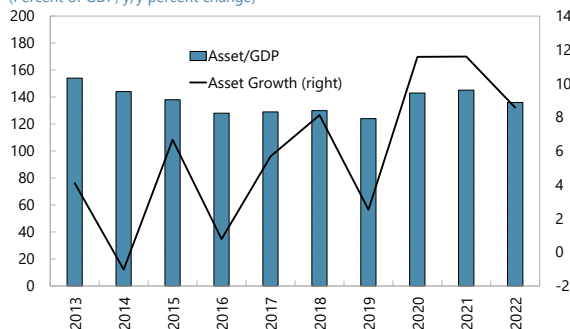
Sources: Haver Analytics, Inc, Central Bank of Iceland, and Statistics Iceland.

Figure 7. Iceland: Banking Sector Developments

Banks have started to reduce the growth rate of their balance sheets.

Banking System Asset

(Percent of GDP, y/y percent change)

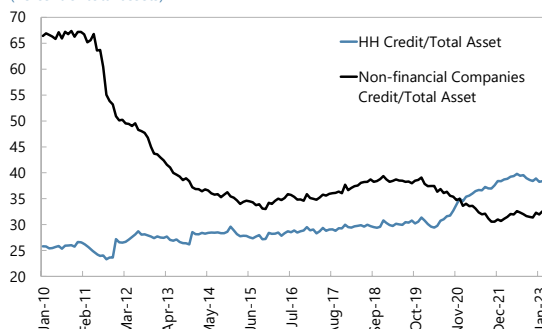


Source: Central Bank of Iceland.

In banks' balance sheets, households account for a larger share than firms.

Household and Non-Financial Corporate Credit

(Percent of total assets)

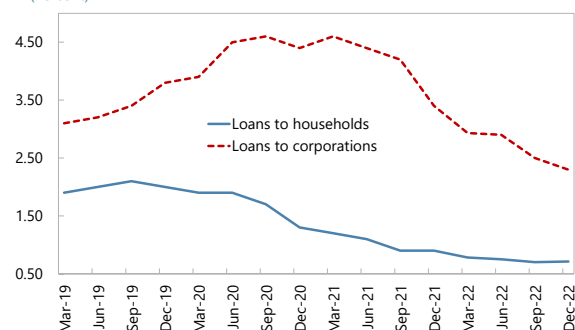


Source: Central Bank of Iceland.

Nonperforming loans have declined, improving asset quality.

Non-performing Loan Ratios

(Percent)

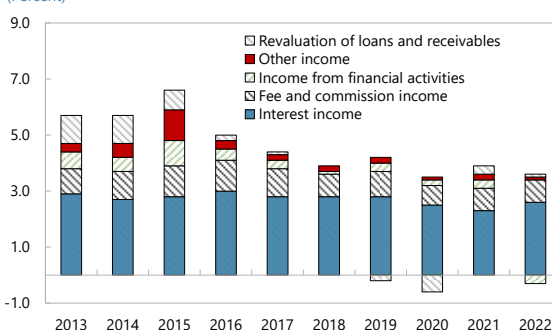


Source: Central Bank of Iceland.

Although profitability declined from high levels in 2021, banks operating income has remained stable.

Banks' Operating Income to Total Assets

(Percent)

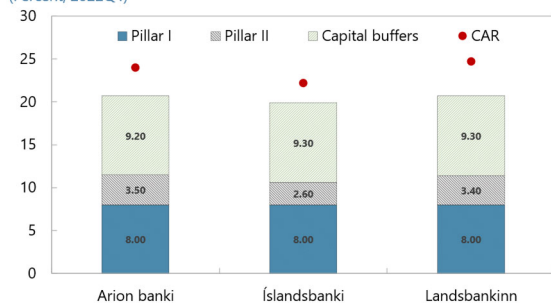


Source: Central Bank of Iceland.

Capital ratios of the three systemically important banks are well above regulatory minima...

Capital Requirements and Adequacy

(Percent, 2022Q4)



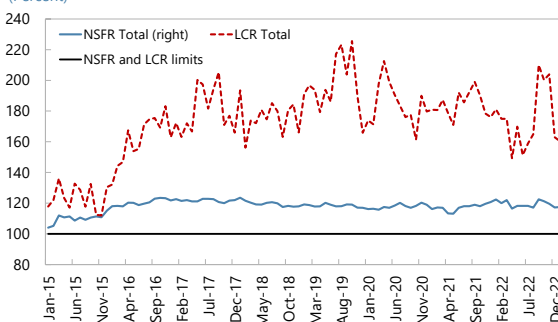
Sources: Central Bank of Iceland.

Note: Pillar II according to SREP 2022. Capital base as percent of risk-weighted assets, as of 2022Q4.

...and liquidity buffers are ample.

Liquidity Requirement

(Percent)



Sources: Central Bank of Iceland.

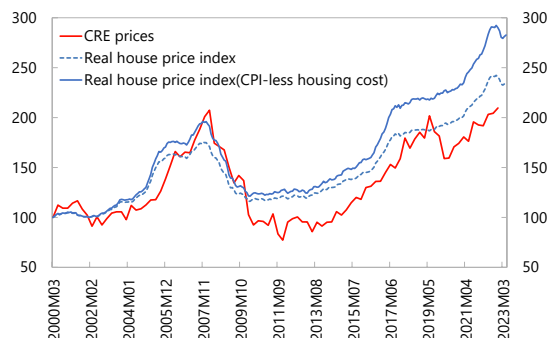
Notes: LCR limit is for all currencies combined.

Figure 8. Iceland: Housing Market Developments

Housing prices have started to decline in real terms...

Real Estate Indices

(Index, 2000M3=100)

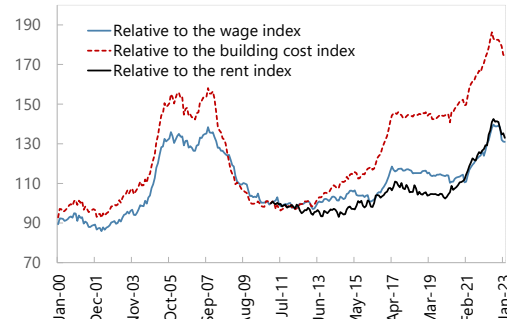


Sources: Statistics Iceland, Central Bank of Iceland and IMF staff calculations.

... although they remain high relative to fundamentals.

House Prices Relative to Fundamentals

(Index, January 2011 = 100)

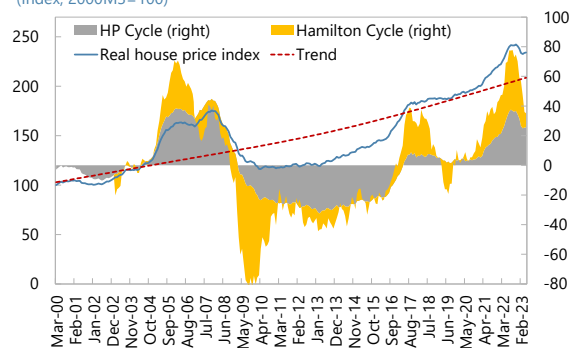


Sources: Statistics Iceland, Central Bank of Iceland, and IMF staff calculations.

The real house price cycle seems to have turned.

Real House Price: Trend and Cycle

(Index, 2000M3=100)

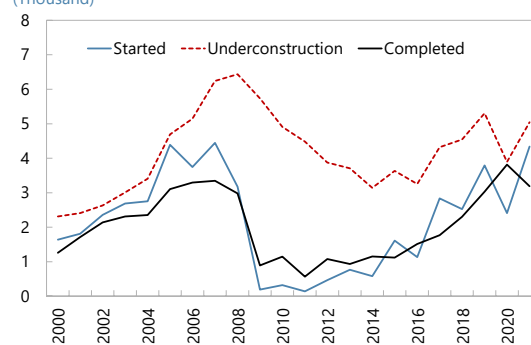


Sources: Statistics Iceland, Central Bank of Iceland, and IMF staff calculations. Note: Trend and cycle are constructed using Hodrick-Prescott (HP) and Hamilton filters.

Housing supply has continued recovering.

Construction of Residential Buildings

(Thousand)

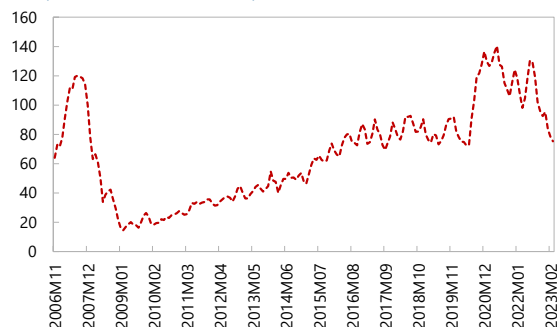


Sources: Federation of Icelandic Industries, Registers Iceland, Reykjavik Economics, Statistics Iceland, Central Bank of Iceland and IMF staff own calculations.

Real estate turnover has gradually declined from its highs during the pandemic.

Real Estate Turnover

(Index, December 2019 = 100)

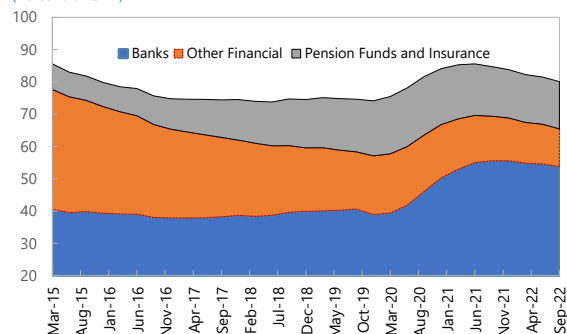


Sources: Registers Iceland and IMF staff calculations. Notes: Three-month moving average and deflated by the CPI.

Household indebtedness has returned to pre-pandemic levels, although with heavier bank involvement.

Household Loans by Source

(Percent of GDP)



Sources: Statistics Iceland, Central Bank of Iceland and IMF staff calculations

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

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(Percentage change unless otherwise indicated)												
National Accounts (constant prices)												
Gross domestic product	4.2	4.9	1.8	-7.2	4.3	6.4	3.2	1.9	2.1	2.1	2.1	2.2
Total domestic demand	7.6	4.5	0.5	-1.1	6.3	6.4	1.2	0.9	1.1	1.2	1.4	1.6
Private consumption	8.0	4.8	1.7	-3.4	7.0	8.6	1.8	0.9	1.1	1.2	1.5	1.7
Public consumption	2.9	4.7	3.9	5.1	2.4	1.6	0.8	1.0	1.0	1.0	1.0	1.0
Gross fixed investment	10.6	2.3	-4.1	-7.4	9.8	6.9	2.6	1.6	1.6	1.6	1.7	1.8
Net exports (contribution to growth)	-2.9	0.7	1.5	-6.1	-2.1	-0.2	1.6	1.0	1.0	0.9	0.7	0.7
Exports of goods and services	5.1	0.4	-5.5	-31.1	14.7	20.6	5.8	3.0	3.6	3.4	3.2	3.2
Imports of goods and services	11.8	-0.9	-9.1	-20.6	19.9	19.7	2.0	0.7	1.4	1.5	1.7	1.9
Output gap (percent of potential output)	1.5	3.6	3.5	-5.2	-2.5	0.9	1.5	0.9	0.6	0.3	0.1	0.0
Selected Indicators												
Gross domestic product (ISK bn.)	2,642	2,844	3,024	2,919	3,245	3,766	4,117	4,353	4,603	4,843	5,103	5,384
Gross domestic product (\$ bn.)	24.7	26.3	24.7	21.6	25.6	27.8	29.1	31.4	33.9	36.4	39.1	42.0
GDP per capita (\$ thousands)	73.1	75.4	69.1	59.2	69.3	74.0	75.2	81.6	87.1	92.4	98.3	104.5
Private consumption (percent of GDP)	50.1	50.3	50.2	52.0	52.0	52.2	52.8	52.7	52.3	51.6	50.9	50.3
Public consumption (percent of GDP)	23.7	24.1	24.6	28.1	27.6	25.9	24.6	24.3	24.4	24.8	25.1	25.4
Gross fixed investment (percent of GDP)	21.8	21.8	20.9	21.3	22.2	22.4	22.9	23.0	23.0	22.9	22.6	22.5
Gross national saving (percent of GDP)	26.0	26.4	27.2	22.3	20.0	21.1	21.5	21.7	22.3	22.8	23.3	23.7
Unemployment rate (percent of labor force)	3.3	3.1	3.9	6.4	6.0	3.8	3.3	3.6	3.7	3.8	3.9	4.0
Employment	1.0	1.8	0.9	-3.0	3.6	6.9	2.6	1.3	1.5	1.5	1.5	1.6
Labor productivity	3.8	2.6	1.6	-1.9	1.6	0.3	0.6	0.6	0.6	0.6	0.6	0.6
Real wages	7.2	3.7	1.8	3.4	3.7	0.0	0.6	0.6	0.6	0.6	0.6	0.6
Nominal wages	9.1	6.5	4.9	6.3	8.3	8.3	9.3	5.2	4.2	3.2	3.1	3.1
Consumer price index (average)	1.8	2.7	3.0	2.8	4.5	8.3	8.7	4.6	3.6	2.6	2.5	2.5
Consumer price index (end period)	1.9	3.7	2.0	3.6	5.1	9.6	7.4	4.0	3.0	2.5	2.5	2.5
Core CPI (average)	2.0	2.4	2.9	3.0	4.3	7.6	8.5	4.6	3.6	2.6	2.5	2.5
ISK/€ (average)	121	128	141	157	148	159	...	...	...	...	...	...
ISK/\$ (average)	107	108	123	135	127	135	...	...	...	...	...	...
Terms of trade (average)	1.5	-3.8	-0.8	-1.3	3.8	3.0	-2.9	-1.6	-1.1	-0.9	-0.1	-0.1
Money and Credit (end period)												
Base money (M0)	37.9	-1.7	-9.2	11.8	9.0	1.5	9.3	9.9	8.8	7.4	6.9	6.6
Broad money (M3)	5.0	7.0	6.6	7.4	10.9	8.9	10.8	8.3	7.6	6.5	6.3	6.2
Credit to nonfinancial private sector	9.2	11.9	2.9	10.5	10.5	11.2	9.3	5.7	5.2	5.2	5.4	5.5
Central bank 7 day term deposit rate 1/	4.25	4.50	3.00	0.75	2.00	6.00	8.75	...	...	...	...	...
(Percent of GDP unless otherwise indicated)												
General Government Finances 2/												
Revenue	45.4	44.8	42.1	42.2	41.4	41.8	42.8	42.8	42.4	42.0	41.4	41.3
Expenditure	44.4	43.8	43.6	51.2	49.8	46.1	45.5	45.7	45.0	43.6	43.3	43.3
Overall balance	1.0	0.9	-1.5	-9.0	-8.4	-4.3	-2.7	-2.9	-2.5	-1.7	-1.9	-1.9
Structural primary balance 3/	1.9	0.5	-2.0	-0.8	-1.5	-3.1	-1.4	-1.8	-1.2	0.0	0.0	0.2
Cyclically-adjusted primary balance	3.2	1.3	-1.3	-3.9	-5.1	-2.5	-0.8	-1.5	-0.9	0.1	0.1	0.2
Gross debt	71.7	63.2	66.6	77.8	75.6	68.7	65.1	61.2	60.0	58.2	56.5	55.2
Net debt	60.3	50.7	54.4	61.1	60.4	57.1	54.4	51.1	50.5	49.1	47.9	47.0
Balance of Payments												
Current account balance	4.2	4.3	6.5	1.0	-2.4	-1.5	-1.6	-1.3	-0.7	-0.1	0.6	1.2
of which: services balance	10.6	9.0	8.0	1.4	2.3	5.0	7.0	7.3	7.4	7.5	7.5	7.5
Capital and financial account (+ = outflow)	1.1	6.0	6.1	6.1	0.8	-2.4	-1.7	-1.5	-0.8	-0.2	0.5	1.1
of which: direct investment, net (+ = outflow)	-0.7	1.7	2.9	2.3	-0.7	-2.9	-0.8	-1.1	-1.0	-0.9	-0.9	-0.8
Gross external debt	90.3	73.3	78.4	90.4	82.8	75.2	75.2	69.3	64.1	59.6	55.4	51.5
Central bank reserves (\$ bn)	6.6	6.1	6.7	6.4	7.1	5.9	6.0	6.3	6.4	6.6	7.0	7.6

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

1/ For 2023, rate as of end-May.

2/ In 2020, the definition of the general government was expanded to include 24 new entities, of which the largest are the IL Fund and the Student Loan Fund.

3/ Cyclically-adjusted balance excluding one offs.

Table 2. Iceland: Money and Banking, 2017–22
(Billions of Kronur)

	2017	2018	2019	2020	2021	2022
Central Bank						
Net foreign assets	565	604	636	563	524	527
Assets	687	737	822	817	923	837
Liabilities	122	133	186	254	399	310
<i>of which:</i> central government foreign currency deposits	81	87	151	214	305	228
Net domestic assets	-417	-458	-505	-416	-363	-364
Central government, net	-23	-108	-82	-134	-46	-71
Assets	56	0	0	8	22	19
<i>of which:</i> recapitalization bond	0	0	0	0	0	0
Liabilities (current account)	79	108	82	142	68	90
Credit institutions (incl. nonbanks), net	-378	-302	-351	-137	-189	-183
Assets	6	6	6	8	8	6
Liabilities	384	308	357	145	197	189
<i>of which:</i> term deposits and CDs	303	231	299	145	196	189
Other items, net	-16	-48	-72	-144	-128	-110
ESI (asset management company)	9	5	3	2	1	1
Total Expenditure	22	58	82	151	134	115
Current Expenses	148	145	132	147	161	163
Currency issued	68	73	75	81	82	81
Deposit money banks' deposits at the central bank	80	72	57	66	79	82
Deposit Money Banks						
Net foreign assets	-277	-270	-302	-323	-397	-466
Assets	324	414	366	423	428	485
Liabilities	601	684	668	745	825	950
<i>of which:</i> bonds	504	577	569	634	710	748
Nonfinancial Assets	1,942	2,052	2,203	2,362	2,666	2,943
Central bank, net	379	293	328	208	279	278
Assets	379	294	330	213	282	280
Liabilities	0	1	2	5	2	2
Net Lending/Borrowing	91	59	63	262	235	250
<i>of which:</i> bonds	70	38	42	234	202	212
Financial Assets, Transactions	2,483	2,781	2,873	3,187	3,507	3,869
Nonfinancial	2,328	2,606	2,681	2,964	3,277	3,643
Corporations	1,302	1,464	1,492	1,483	1,462	1,649
Households	1,027	1,142	1,189	1,481	1,815	1,994
Financial	154	175	192	222	231	225
Other items, net	-1,011	-1,081	-1,062	-1,295	-1,356	-1,453
Liabilities, Transactions	1,665	1,782	1,901	2,039	2,268	2,478
Krona deposits	1,502	1,560	1,664	1,803	2,002	2,181
Foreign currency deposits	164	222	237	236	266	296
Consolidated Banking System						
Net foreign assets	289	334	335	241	126	61
Net domestic assets	1,437	1,513	1,633	1,872	2,216	2,489
General government, net	68	-49	-19	128	189	179
Gross Debt	2,483	2,781	2,873	3,187	3,507	3,869
Other items, net	-1,113	-1,219	-1,222	-1,442	-1,480	-1,558
Broad money	1,726	1,846	1,968	2,113	2,343	2,550
Net Debt	60	64	67	74	74	73

Sources: Central Bank of Iceland; and IMF staff projections.

Table 3. Iceland: Financial Soundness Indicators, 2019Q1–2022Q4 1/
(Percent)

	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2	2022Q3	2022Q4
Regulatory capital to risk-weighted assets 2/	22.4	22.6	22.9	24.2	24.5	24.8	24.5	24.9	24.3	24.9	24.7	25.4	23.1	23.3	22.8	23.7
Regulatory tier 1 capital to risk-weighted assets 2/	21.0	20.9	21.0	21.8	22.0	22.3	22.0	22.4	21.9	22.5	22.3	23.1	21.0	21.2	20.7	21.1
Net interest margin 2/	2.8	2.8	2.7	2.7	2.6	2.6	2.5	2.5	2.4	2.4	2.4	2.4	2.6	2.7	2.8	2.8
Return on assets 2/	1.4	1.4	1.3	1.2	-0.5	0.1	0.6	0.9	2.1	2.2	2.3	2.3	1.7	2.0	2.1	2.1
Return on equity 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	8.6	9.8	10.1	10.1
Net interest income to total income 2/ 3/	60.2	62.4	64.9	66.8	90.8	75.1	73.3	69.5	60.4	60.9	59.8	60.0	71.4	67.5	70.9	70.9
Noninterest expense to total income 2/ 3/	61.4	62.4	64.2	65.9	76.1	62.2	58.4	56.3	52.3	51.6	48.4	49.3	53.9	49.5	48.8	49.6
Liquid assets to total assets 2/ 4/	10.8	11.2	12.8	12.2	13.5	15.1	14.5	13.2	13.0	14.4	14.4	15.3	11.7	11.7	12.0	12.9
High-quality liquid assets to total assets	10.7	11.0	12.6	12.0	13.3	14.7	14.2	12.8	12.4	13.6	13.6	14.5	11.5	11.4	11.8	12.6
Net open foreign exchange position to capital 2/	0.0	0.7	1.0	2.1	-0.4	0.0	0.2	0.3	1.3	0.3	-0.4	-0.7	-0.7	0.6	0.2	0.5
Total nonperforming loans (NPLs), facility level 5/	2.2	2.2	2.7	2.6	3.6	3.3	3.3	2.9	2.8	2.6	2.4	2.1	1.8	1.8	1.5	1.5
Household NPLs, cross default basis 6/ 7/	2.0	2.2	2.3	2.1	2.2	2.7	2.4	2.9	2.8	2.5	2.2	1.8	1.6	1.3	1.3	1.4
Corporate NPLs, cross default basis 6/	5.9	4.6	4.7	4.8	6.2	8.5	9.1	18.0	17.8	17.6	16.7	14.2	13.2	10.1	9.4	7.9
Household and corporate NPLs, cross default basis 6/	4.2	3.5	3.6	3.6	4.6	6.0	6.1	10.9	10.5	10.0	9.3	7.8	7.2	5.5	5.2	4.6
Loan loss provisions to household loans in default	20.7	19.0	17.9	17.5	19.0	18.1	17.6	17.7	16.6	15.4	16.4	16.3	16.5	16.6	17.1	16.2
Loan loss provisions to corporate loans in default	32.5	35.7	33.3	31.5	34.1	33.6	34.2	34.1	33.1	28.1	28.4	27.9	28.7	26.6	27.3	24.8
Loan loss provisions to total loans in default	29.1	30.6	28.6	27.6	30.3	29.1	29.2	29.7	29.8	25.6	26.2	25.4	25.9	24.3	24.8	22.6

Sources: Central Bank of Iceland; IMF FSI database; and IMF staff calculations.

1/ Three largest deposit money banks unless otherwise indicated.

2/ Data for 2019Q1 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, 2017–28 1/
(Percent of GDP)

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total Revenue	45.4	44.8	42.1	42.2	41.4	41.8	42.8	42.8	42.4	42.0	41.4	41.3
Taxes	33.7	33.0	31.9	33.3	32.1	31.9	33.2	33.2	33.4	33.3	32.9	32.9
Taxes on income and profits	18.3	18.0	17.5	18.6	17.5	17.8	17.6	17.7	17.6	17.6	17.4	17.6
Personal income tax	14.2	14.5	14.4	15.7	14.5	13.9	14.0	14.2	14.2	14.1	14.0	14.1
Corporate income tax	3.0	2.4	2.1	2.2	2.0	2.6	2.5	2.5	2.5	2.5	2.4	2.4
Capital gains tax and rental income	1.1	1.1	1.1	0.7	1.0	1.3	1.0	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	1.9	1.8	1.9	2.3	2.1	2.0	2.5	2.4	2.3	2.3	2.2	2.2
Taxes on goods and services	12.5	12.1	11.4	11.4	11.7	11.3	12.3	12.3	12.6	12.7	12.5	12.4
Value added tax	9.0	8.8	8.2	8.2	8.8	8.5	8.6	8.7	9.0	9.2	9.0	8.9
Other taxes on goods and services	3.4	3.4	3.2	3.2	2.9	2.8	3.6	3.6	3.6	3.5	3.5	3.5
Taxes on international trade	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Other taxes	0.6	0.6	0.6	0.7	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social contributions	3.4	3.5	3.2	3.0	3.0	3.0	3.1	3.1	3.1	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	8.1	8.2	6.8	5.7	6.1	6.8	6.3	6.4	5.8	5.4	5.3	5.3
Property income	4.3	4.3	3.6	2.7	2.9	4.0	3.3	3.3	2.7	2.4	2.3	2.3
of which: interest income	2.7	2.8	2.3	1.8	1.7	2.2	1.7	1.8	1.3	1.0	1.0	0.9
Total Expenditure	44.4	43.8	43.6	51.2	49.8	46.1	45.5	45.7	45.0	43.6	43.3	43.3
Current Expenses	43.4	41.8	42.1	49.8	47.8	44.3	43.7	44.0	43.2	41.8	41.5	41.5
Compensation of employees	14.1	14.2	14.3	16.2	15.7	14.6	14.8	14.6	14.5	14.4	14.3	14.3
Use of goods and services	10.6	10.8	10.8	12.0	12.2	11.5	11.3	11.9	11.7	11.2	11.1	11.1
Consumption of fixed capital	2.1	2.1	2.2	2.5	2.4	2.3	2.2	2.1	2.1	2.0	2.0	2.0
Interest	5.7	4.9	4.3	4.0	3.8	4.6	4.4	3.7	3.3	3.0	3.0	3.0
Subsidies	1.2	1.2	1.2	1.8	1.6	1.5	1.7	1.8	1.7	1.5	1.5	1.5
Grants	0.2	0.2	0.2	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	6.5	6.6	7.4	10.1	9.4	7.5	7.3	7.7	8.0	7.9	7.8	7.8
Other expense	3.1	1.8	1.8	2.9	2.4	1.9	1.7	1.9	1.6	1.5	1.5	1.5
Nonfinancial Assets	1.0	2.1	1.5	1.4	2.0	1.8	1.8	1.7	1.7	1.8	1.8	1.8
Nonfinancial assets, acquisition	3.1	4.1	3.7	3.8	4.4	4.1	4.0	3.8	3.8	3.8	3.8	3.8
Consumption of fixed capital (-)	-2.1	-2.1	-2.2	-2.5	-2.4	-2.3	-2.1	-2.1	-2.1	-2.0	-2.0	-2.0
Net Lending/Borrowing	1.0	0.9	-1.5	-9.0	-8.4	-4.3	-2.7	-2.9	-2.5	-1.7	-1.9	-1.9
Financial Assets, Transactions	-6.7	-1.2	-1.3	0.9	-3.2	2.0	-2.8	-4.4	-1.4	-1.3	-1.2	-1.1
Currency and deposits	-5.6	-0.3	0.4	4.2	0.3	-1.2	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	1.3	1.3	-2.4	0.3	0.1	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Loans	-4.9	-3.0	0.1	-3.1	-1.4	1.7	0.1	0.1	0.1	0.1	0.1	0.1
Shares and other equities	-5.6	-1.1	-0.3	0.0	-1.7	0.9	-3.0	-4.5	-1.5	-1.4	-1.3	-1.3
Other accounts receivable	8.0	1.9	1.0	-0.5	-0.4	1.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, Transactions	-7.7	-2.1	0.3	9.9	5.2	6.3	2.2	-0.3	2.1	1.2	1.4	1.6
Securities other than shares	-4.8	-2.9	-3.5	6.3	2.0	3.7	2.2	-0.2	2.1	1.6	1.5	1.6
Loans	-3.2	-0.4	3.3	2.4	3.0	1.7	0.0	-0.2	0.0	-0.4	-0.2	0.0
Krona denominated	0.2	-0.7	1.1	0.3	-0.1	-0.8	0.0	0.0	0.0	0.0	0.0	0.0
Foreign currency denominated	-3.4	0.3	2.2	2.2	3.1	2.6	0.0	-0.2	0.0	-0.4	-0.2	0.0
Insurance technical reserves	0.2	0.2	0.3	0.2	0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.0
Other accounts payable	0.1	1.1	0.3	0.9	0.2	0.8	0.0	0.0	0.0	0.0	0.0	0.0
Gross Debt	71.7	63.2	66.6	77.8	75.6	68.7	65.1	61.2	60.0	58.2	56.5	55.2
Krona denominated	67.2	58.8	60.3	69.3	64.9	60.2	57.3	54.0	53.2	52.2	51.0	49.9
Foreign currency denominated	4.5	4.5	6.3	8.5	10.6	8.5	7.8	7.2	6.8	6.0	5.5	5.2
Net Debt 2/	60.3	50.7	54.4	61.1	60.4	57.1	54.4	51.1	50.5	49.1	47.9	47.0
Memorandum Items:												
Primary revenue	42.7	42.0	39.8	40.4	39.6	39.6	41.1	41.1	41.1	40.9	40.4	40.4
Primary expenditure	38.7	38.9	39.3	47.2	46.0	41.5	41.1	42.0	41.6	40.7	40.3	40.3
Primary balance	3.9	3.1	0.5	-6.8	-6.3	-1.9	0.0	-1.0	-0.5	0.3	0.2	0.2
Structural balance 3/	-1.2	-1.7	-4.1	-2.9	-3.6	-5.6	-4.3	-3.8	-3.4	-2.1	-2.2	-3.3
Structural primary balance 3/	1.9	0.5	-2.0	-0.8	-1.5	-3.1	-1.4	-1.8	-1.2	0.0	0.0	0.2
Gross domestic product (ISK bn)	2,642	2,844	3,024	2,919	3,245	3,766	4,117	4,353	4,603	4,843	5	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

2/ Gross debt less currency and deposits.

3/ Cyclically-adjusted balance excluding one offs.

Table 5. Iceland: General Government Financial Balance Sheet, 2017–28
(Percent of GDP)

	2017	2018	2019	2020	2021	2022 Prel.	2023 Proj.	2024 Proj.	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.
Financial assets	83.7	78.9	74.7	82.5	75.0	64.8	56.5	49.0	44.9	41.4	38.1	35.0
Currency and deposits	11.5	12.5	12.2	16.7	15.2	11.7	10.7	10.1	9.5	9.1	8.6	8.1
Other assets	95.2	89.3	86.7	65.7	59.8	53.1	45.8	38.9	35.4	32.3	29.5	26.8
Securities other than shares	5.8	6.7	4.3	4.8	4.4	3.4	3.1	2.9	2.8	2.6	2.5	2.4
Loans	29.1	24.0	23.2	20.9	17.2	14.7	13.6	12.9	12.4	11.9	11.4	11.0
Shares and other equities	27.8	27.5	27.8	32.3	31.9	28.5	23.1	17.3	14.8	12.7	10.7	8.9
Other accounts receivable 1/	32.5	31.0	31.4	7.8	6.3	6.6	6.0	5.7	5.4	5.1	4.9	4.6
Liabilities	105.0	95.6	99.1	114.4	110.5	101.1	94.7	89.2	86.5	83.4	80.6	77.9
Gross debt	71.7	63.2	66.6	77.8	75.6	68.7	65.1	61.2	60.0	58.2	56.5	55.2
Securities other than shares	54.6	47.8	48.5	56.5	52.8	49.2	47.2	44.5	44.2	43.6	42.9	42.2
Loans	17.1	15.4	18.1	21.3	22.8	19.5	17.9	16.7	15.8	14.6	13.7	12.9
Krona denominated	12.5	10.9	11.7	12.5	11.7	10.7	9.7	9.2	8.7	8.3	7.9	7.5
Foreign currency denominated	4.6	4.5	6.4	8.8	11.0	8.9	8.1	7.5	7.1	6.3	5.8	5.5
Other liabilities	33.2	32.3	32.5	36.6	34.9	32.4	29.6	28.0	26.5	25.2	24.0	22.8
Insurance technical reserves	26.9	26.2	27.2	29.3	27.9	25.1	22.9	21.7	20.5	19.5	18.6	17.7
Other accounts payable	6.3	6.1	5.3	7.3	7.1	7.3	6.7	6.3	6.0	5.7	5.4	5.1
Net financial worth 1/	-21.3	-16.6	-24.4	-31.9	-35.5	-36.3	-38.2	-40.3	-41.6	-42.0	-42.4	-42.9
Memorandum item:												
Net debt 2/	60.3	50.7	54.4	61.1	60.4	57.1	54.4	51.1	50.5	49.1	47.9	47.0

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, 2017–28

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(Billions of dollars)												
Current account	1.0	1.1	1.6	0.2	-0.6	-0.4	-0.5	-0.4	-0.2	0.0	0.2	0.5
Trade balance	1.1	0.9	1.1	-0.3	-0.5	-0.2	-0.1	0.0	0.1	0.3	0.5	0.7
Balance on goods	-1.5	-1.5	-0.9	-0.6	-1.1	-1.6	-2.2	-2.3	-2.4	-2.5	-2.4	-2.4
Merchandise exports f.o.b.	5.0	5.7	5.3	4.7	6.0	7.4	7.3	7.6	7.9	8.2	8.7	9.2
Merchandise imports f.o.b.	6.5	7.2	6.2	5.3	7.2	9.0	9.5	9.9	10.3	10.7	11.1	11.6
Balance on services	2.6	2.4	2.0	0.3	0.6	1.4	2.0	2.3	2.5	2.7	3.0	3.2
Exports of services, total	6.3	6.4	5.4	2.5	3.5	5.5	6.4	6.8	7.2	7.5	7.9	8.3
Imports of services, total	3.7	4.0	3.5	2.2	2.9	4.1	4.3	4.5	4.6	4.8	5.0	5.1
Primary income balance	0.1	0.4	0.7	0.7	0.2	0.0	0.0	0.0	0.1	0.2	0.2	0.3
Receipts	0.8	0.9	0.9	0.7	0.7	0.8	0.8	0.9	0.9	1.0	1.0	1.0
of which: dividends and reinvested earnings	0.4	0.6	0.6	0.5	0.6	0.6	0.6	0.6	0.7	0.7	0.7	0.7
of which: interest receipts	0.3	0.2	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Expenditures	0.7	0.5	0.2	0.0	0.6	0.8	0.8	0.9	0.9	0.8	0.8	0.7
of which: dividends and reinvested earnings	0.0	-0.2	-0.4	-0.5	0.2	0.3	0.1	0.1	0.1	0.1	0.1	0.1
of which: interest payments	0.6	0.5	0.5	0.4	0.3	0.3	0.6	0.7	0.7	0.7	0.6	0.6
Secondary income balance	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.4	-0.4	-0.4	-0.5	-0.5	-0.5
Capital and financial account (+ = outflow)	0.3	1.6	1.5	1.3	0.2	-0.7	-0.5	-0.5	-0.3	-0.1	0.2	0.4
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)	0.3	1.6	1.5	1.3	0.2	-0.6	-0.5	-0.4	-0.2	0.0	0.2	0.5
Direct investment (+ = outflow)	-0.2	0.5	0.7	0.5	-0.2	-0.8	-0.2	-0.4	-0.4	-0.3	-0.3	-0.3
Portfolio investment ("+" = outflow)	2.3	1.3	0.7	1.0	0.0	0.5	-0.7	-0.6	-0.2	-0.1	0.0	0.1
Assets (+ = outflow)	1.0	1.2	1.1	0.7	1.4	0.9	0.6	0.6	0.6	0.6	0.6	0.6
Liabilities (+ = inflow)	-1.3	-0.1	0.4	-0.3	1.4	0.4	1.2	1.2	0.8	0.7	0.6	0.5
of which: net borrowing (+ = inflow)	-1.7	-0.3	-0.3	-0.3	1.5	0.3	1.1	1.1	0.7	0.6	0.5	0.4
Other investment (+ = outflow)	-1.1	-0.2	-0.5	-0.1	-0.8	0.0	0.2	0.1	0.2	0.1	0.0	0.1
Assets (+ = outflow)	-0.8	0.2	-1.0	0.2	0.0	0.5	0.3	0.0	0.0	0.0	0.0	0.0
Liabilities (+ = inflow)	0.3	0.4	-0.4	0.2	0.8	0.5	0.0	-0.1	-0.1	0.0	0.0	-0.1
of which: net outflows related to bank estates' compositions	0.0	-0.3	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserve assets (+ = increase/outflow)	-0.8	0.0	0.6	-0.2	1.1	-0.5	0.1	0.3	0.1	0.2	0.4	0.6
Net errors and omissions (+ = inflow)	-0.7	0.5	-0.1	1.2	0.9	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
(Percent of GDP)												
Current account	4.2	4.3	6.5	0.9	-2.4	-1.5	-1.6	-1.3	-0.7	-0.1	0.6	1.2
Trade balance	4.5	3.5	4.5	-1.6	-2.0	-0.7	-0.4	-0.1	0.4	0.8	1.3	1.8
Balance on goods	-6.1	-5.5	-3.5	-2.9	-4.4	-5.7	-7.4	-7.4	-7.1	-6.8	-6.2	-5.8
Merchandise exports f.o.b.	20.2	21.8	21.6	21.7	23.7	26.7	25.2	24.1	23.3	22.7	22.3	21.9
Merchandise imports f.o.b.	26.3	27.3	25.1	24.6	28.0	32.4	32.6	31.5	30.4	29.4	28.5	27.6
Balance on services	10.6	9.0	8.0	1.4	2.3	5.0	7.0	7.3	7.4	7.5	7.5	7.5
Exports of services, total	25.6	24.3	22.1	11.5	13.7	19.6	21.9	21.5	21.1	20.7	20.2	19.8
Imports of services, total	14.9	15.3	14.1	10.2	11.4	14.6	14.9	14.2	13.7	13.2	12.7	12.2
Primary income balance	0.5	1.7	2.8	3.3	0.7	0.2	0.1	0.1	0.2	0.5	0.6	0.7
Receipts	3.2	3.4	3.5	3.4	2.9	2.9	2.9	2.8	2.8	2.7	2.6	2.4
of which: interest receipts	1.1	0.6	0.6	0.3	0.2	0.4	0.4	0.4	0.4	0.4	0.4	0.3
Expenditures	2.7	1.7	0.7	0.1	2.2	2.8	2.8	2.7	2.5	2.3	2.0	1.7
of which: interest payments	2.3	1.9	1.8	1.8	1.1	1.2	2.2	2.2	2.0	1.8	1.6	1.4
Secondary income balance	-0.8	-0.9	-0.8	-0.9	-1.1	-1.0	-1.2	-1.3	-1.3	-1.3	-1.3	-1.3
Capital and financial account (+ = outflow)	1.1	6.0	6.1	6.1	0.8	-2.4	-1.7	-1.5	-0.8	-0.2	0.5	1.1
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)	1.2	6.1	6.1	6.1	0.9	-2.3	-1.6	-1.4	-0.7	-0.1	0.6	1.1
Direct investment (+ = outflow)	-0.7	1.7	2.9	2.3	-0.7	-2.9	-0.8	-1.1	-1.0	-0.9	-0.9	-0.8
Portfolio investment ("+" = outflow)	9.2	4.8	3.0	4.8	0.1	1.9	-2.2	-2.1	-0.7	-0.3	0.0	0.1
Assets (+ = outflow)	4.0	4.4	4.5	3.2	5.6	3.3	1.9	1.8	1.6	1.5	1.4	1.3
Liabilities (+ = inflow)	-5.2	-0.4	1.5	-1.6	5.5	1.3	4.1	3.8	2.4	1.8	1.5	1.2
of which: net borrowing (+ = inflow)	-6.9	-1.0	-1.2	-1.4	5.9	1.1	3.9	3.6	2.2	1.6	1.3	1.0
Other investment (+ = outflow)	-4.4	-0.7	-2.1	-0.2	-3.2	0.1	0.8	0.4	0.5	0.2	0.1	0.2
Assets (+ = outflow)	-3.3	0.9	-3.9	0.9	-0.1	1.8	0.9	0.1	0.1	0.1	0.1	0.1
Liabilities (+ = inflow)	1.2	1.7	-1.8	1.2	3.1	1.7	0.1	-0.3	-0.4	-0.1	0.0	-0.1
Change in reserve assets (+ = increase/outflow)	-3.3	0.2	2.3	-1.0	4.5	-1.8	0.3	1.1	0.2	0.6	1.1	1.3
Net errors and omissions (+ = inflow)	-3.0	1.9	-0.3	5.3	3.4	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
Central bank reserves (\$ bn)	6.6	6.1	6.7	6.4	7.1	5.9	6.0	6.3	6.4	6.6	7.0	7.6
(Percent of GDP)	26.5	23.1	27.3	29.7	27.7	21.1	20.4	20.0	18.7	18.1	17.9	18.0
Memorandum item:												
Gross domestic product (\$ bn)	24.7	26.3	24.7	21.6	25.6	27.8	29.1	31.4	33.9	36.4	39.1	42.0

Sources: Central Bank of Iceland; and IMF staff projections.

Table 7. Iceland: International Investment Position, 2012–22
(Percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Assets	278.2	276.4	250.6	213.0	157.1	115.5	119.4	128.6	153.9	158.6	133.3
Direct investment	95.4	109.4	99.4	91.2	63.7	25.8	26.3	26.6	29.7	26.2	22.3
Portfolio investment	59.0	62.5	63.9	40.1	37.4	43.7	46.1	58.0	76.1	86.6	71.3
Equity and investment fund shares	34.8	34.6	36.8	35.3	34.9	40.1	40.5	52.1	69.8	79.8	65.4
Debt securities	24.2	27.9	27.1	4.8	2.5	3.5	5.6	6.0	6.3	6.8	5.9
Financial derivatives	0.1	0.2	0.6	0.5	0.3	0.5	0.4	0.4	0.6	0.2	0.4
Other investment	94.4	79.6	61.3	53.0	23.3	19.5	20.7	16.4	19.6	17.2	17.1
Reserve assets	29.3	24.7	25.4	28.3	32.5	26.0	25.9	27.2	28.0	28.4	22.2
Liabilities	724.4	661.2	623.4	218.1	155.2	113.5	110.2	108.6	119.5	119.2	109.2
Direct investment	81.9	97.0	96.4	92.4	80.7	45.0	40.6	39.0	39.6	38.1	37.5
Portfolio investment	324.2	285.9	289.1	41.8	49.0	42.9	42.6	44.5	50.5	50.3	42.4
Equity and investment fund shares	3.2	3.5	3.6	4.0	3.6	4.8	5.7	10.6	12.8	12.2	7.9
Debt securities	320.9	282.5	285.5	37.8	45.4	38.0	36.9	33.9	37.7	38.1	34.5
Financial derivatives	0.1	0.3	0.8	0.6	0.4	0.4	0.2	0.1	0.2	0.5	0.8
Other investment	318.3	278.0	237.1	83.3	25.2	25.2	26.7	24.9	29.2	30.4	28.5
Net international investment position	-446.2	-384.8	-372.9	-5.1	1.9	2.0	9.3	20.0	34.4	39.4	24.2

Sources: Central Bank of Iceland; 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 2022 was weaker than the level implied by fundamentals and desirable policies. The current account balance recorded a 1.5 percent deficit in 2022 due to a weaker-than-expected trade and primary income balance, despite a strong improvement in the service trade compared to 2021. The assessment reflects an adjustment to the current account for the transitory impact from the pandemic, due mainly to the tourism balance, but it is subject to large uncertainty with regards to the treatment of the use of intellectual property in external trade statistics. A positive net international investment position and its trajectory, and adequate foreign exchange reserve buffers supports external sustainability and mitigates potential adverse risks due to the cyclical position of the economy.

Potential Policy Responses: Faster-than-envisaged fiscal consolidation and a tighter stance on monetary policy would support improvements in the current account balance in the near term. Structural reforms to diversify exports and encourage firm digitalization and innovation will be critical to maintaining external competitiveness and ensure a recovery in the current account. The flexible foreign exchange rate should act as the main shock absorber, with interventions limited to disorderly market conditions and under special scenarios identified in the Fund's integrated policy framework (IPF), such as when frictions in the foreign exchange markets give rise to destabilizing premia.

Foreign Assets and Liabilities: Position and Trajectory

Background. The net international investment position (NIIP) declined to 24.2 percent of GDP in 2022 from 39.4 percent in 2021. In addition to a negative impact from the current account, the NIIP weakened due to valuations and negative returns on investments abroad. Gross assets amounted to 133.3 percent of GDP in 2022 and gross liabilities stood at 109.8 percent of GDP, mostly from portfolio investments in debt securities (about 35 percent) and FDI (about 37.5 percent). Among debt securities, more than half were Eurobonds issued abroad by banks and about 25 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.

2022 (percent of GDP)	NIIP: 24.2	Gross Assets: 133.3	Debt Assets: 30.3	Gross Liabilities: 109.2	Debt Liabilities: 77.0
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Current Account

Background. The current account (CA) balance in 2022 remained in deficit, at 1.5 percent of GDP, compared to an average surplus of 5.5 percent of GDP in the five years preceding the pandemic. The negative CA was largely driven by a deficit in the trade balance driven by strong import demand, and a weaker primary income balance. 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 underperform in 2023, but it improves gradually over the medium term.

Assessment. The EBA-lite cyclically adjusted CA balance stood at -2.2 percent of GDP in 2022. Incorporating the transitory impact of the pandemic (primarily on the tourism balance) increases the adjusted CA balance to -1.4 percent of GDP. The EBA-lite CA regression estimates a norm of 1.6 percent of GDP, implying a staff-assessed CA gap of -3.0 percent. The assessment is subject to large uncertainty surrounding the treatment of the use of intellectual property in the statistics on external trade in services (about 1.3 percent of GDP for 2022), which are currently excluded from CA statistics pending a methodological review by Statistics Iceland. Contribution from the relative fiscal policy gap (smaller than the world average) is offset by other policies leaving most of the gap unexplained by model residuals.

Iceland: EBA-lite Model Results, 2022		
	CA model 1/ (in percent of GDP)	REER model 1/ (in percent of GDP)
CA-Actual	-1.5	
Cyclical contributions (from model) (-)	0.7	
COVID-19 adjusters (-) 2/	-0.8	
Additional temporary/statistical factors (-)	0.0	
Natural disasters and conflicts (-)	-0.1	
Adjusted CA	-1.4	
CA Norm (from model) 3/	1.6	
Adjustments to the norm (-)	0.0	
Adjusted CA Norm	1.6	
CA Gap	-3.0	0.4
o/w Relative policy gap	1.8	
Elasticity	-0.3	
REER Gap (in percent)	9.7	-1.2
1/ Based on the EBA-lite 3.0 methodology.		
2/ Additional cyclical adjustment to account for the temporary impact of the pandemic on tourism (0.8 percent of GDP). 90 percent of the shock to tourism is assumed temporary.		
3/ Cyclically adjusted, including multilateral consistency adjustments.		

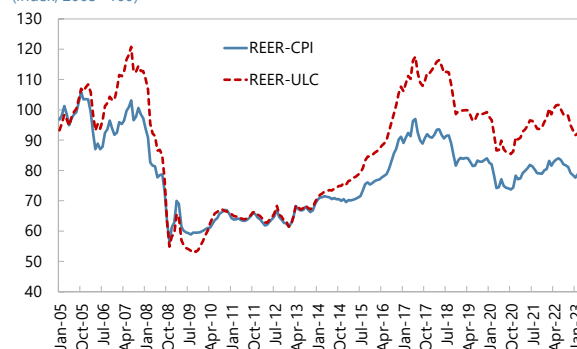
Real Exchange Rate

Background. The average REER based on the consumer price (unit labor costs) appreciated by 2.8 (2.3) between 2022 and 2021, consistent with the movement in the terms of trade. Compared to the previous five-year average, Iceland's REER (CPI based) was 2.7 percent lower in 2022. Unit labor cost continued increasing in 2022, and were about 7 percent higher than in 2021. In the first quarter of 2023 the average CPI-based REER depreciated by a 3.5 percent compared to 2022.

Assessment. The IMF staff CA gap implies a 9.7 percent real overvaluation (applying an estimated elasticity of 0.31). The EBA-lite REER model suggests an undervaluation of 1.2 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 for staff's assessment.

Real Effective Exchange Rate

(Index, 2005=100)



Sources: Central Bank of Iceland and IMF INS Database

Capital and Financial Accounts: Flows and Policy Measures

Background. Gross capital inflows remained large (about 6.5 percent of GDP in 2022 after record-high inflows of 9.16 percent of GDP in 2021), marking a significant departure from a persistent reduction in financial account liabilities since the GFC. The increase in liabilities were mainly due to direct investment (about 3.5 percent of GDP). Gross outflows amount to 5.6 percent of GDP, driven mostly by portfolio investment. The net inflows, in turn, were about 1 percent of GDP. The discrepancy between the financial account and the CA balance, resulting in net error and omission, declined in 2022, after large levels in the preceding two years. With the exchange rate act of 2021, the remaining capital flow management measures (CFM) introduced in 2008 were removed, and no new CFMs were introduced in 2022.

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.

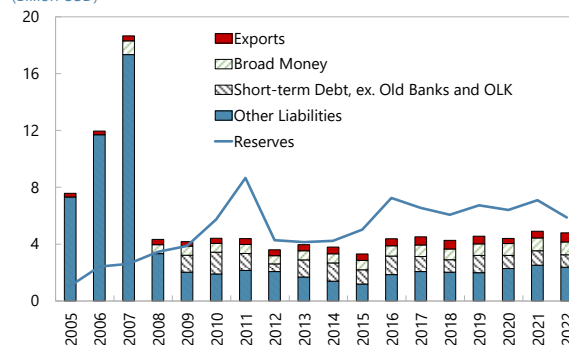
FX Intervention and Reserves Level

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 14.2 percent in 2022 (down from 21 percent in 2021). Interventions were two-sided with net purchases of about 0.4 percent of GDP in 2022. Foreign exchange reserves decreased by US\$1.2 billion, to a total of US\$5.9 billion dollars by the end-2022, due also to valuation changes and treasury bond repayments. The level of foreign exchange reserves was equivalent to 22 percent of GDP and about 5 months of prospective goods and services imports.

Assessment. At 123 percent of the Fund's ARA metric, the end-2022 level of reserves remains adequate for precautionary purposes.

RAM Decomposition

(Billion USD)



Sources: Central Bank of Iceland and IMF staff calculations.

Annex II. Risk Assessment Matrix

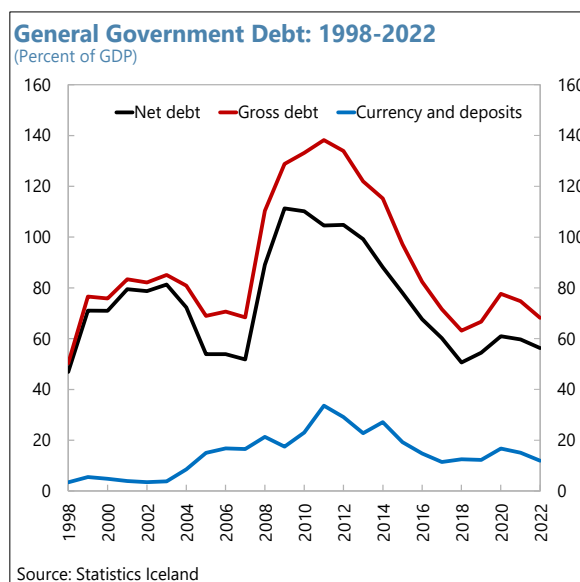
Risks	Relative Likelihood	Impact if Realized	Policy Response
Global Risks			
Conjunctural Risks			
Systemic financial instability. Sharp swings in real interest rates, risk premia, and assets repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing markets dislocations and adverse cross-border spillovers.	Medium	Medium - A sharp tightening of financial conditions in trading partners increases risk aversion and funding costs for Icelandic banks, and undermines confidence. - Decline in supply of credit and increase in borrowing costs for non-financial corporates and households depresses domestic demand.	- Provide liquidity support to banks, if needed. - Allow automatic stabilizers to operate. - Adjust monetary policy as needed. - Allow exchange rate to adjust while intervening to prevent disorderly market conditions.
Intensification of regional conflict(s). Escalation regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, FDI and financial flows.	High	High - Lower growth in trading partners reduces demand for Icelandic exports. - Lower tourism income. - Supply chain disruptions trigger a further increase in inflation and inflation expectations.	- Stand ready with targeted fiscal and financial support measures, if needed. - Adjust monetary policy to steer inflation and inflation expectations back to target.
Abrupt global slowdown or recession. Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and downward pressures on some commodity prices.	Medium (U.S.) / High (Europe)	High - Reduced demand for Icelandic exports and tourism flows. - Lower commodity prices reduce export earnings and worsens the current account deficit.	- Allow automatic stabilizers to operate. - Allow exchange rate to adjust while intervening to prevent disorderly market conditions.
Monetary policy miscalibration. Amid high economic uncertainty and volatility, major central banks slow monetary policy tightening or pivot to loosen monetary policy stance prematurely, de-anchoring inflation expectations and triggering a wage-price spiral in tight labor markets.	Medium	Medium - Import prices will rise, feeding into domestic inflation. - Further de-anchoring of inflation expectations.	- Allow exchange rate to adjust while intervening to prevent disorderly market conditions. - Tighten further monetary policy to steer inflation and inflation expectations back to target.

Risks	Relative Likelihood	Impact if Realized	Policy Response
Structural Risks			
Cyberthreats. Cyberattacks on critical domestic and/or international physical or digital infrastructure (including digital currency and crypto ecosystems) trigger financial and economic instability.	Medium	Medium Disruption of cross-border payments and financial flows.	- Stand ready to provide support to critical infrastructure or institutions. - If effects are widespread, consider fiscal and liquidity support.
Extreme climate events. Extreme climate events cause more severe than expected damage to infrastructure (especially in smaller vulnerable economies) and loss of human lives and livelihoods, amplifying supply chain disruptions and inflationary pressures, causing water and food shortages, and reducing growth.	Medium	Medium Iceland events destroy, infrastructure, wealth and hamper economic activity.	- Support affected sectors and rebuild damaged infrastructure reallocating fiscal spending as needed. - Allow exchange rate to adjust while intervening to prevent disorderly market conditions.
Iceland-Specific Risks			
A sudden correction in the domestic real estate market.	Medium	Medium - Lower house prices would reduce household wealth and could lower consumption. - A drop in real estate prices would result in higher impairment charges for banks, caused by defaults or delayed loan repayments by highly leveraged households.	Stand ready to loosen macroprudential tools as needed, including by allowing banks to use available capital buffers.
Increasing labor market tensions.	Medium	Medium - Higher real wage growth pushes up firms' costs and increases inflation. - Further de-anchoring of inflation expectations. - Disruption to economic activity	- Adjust monetary policy to steer inflation and inflation expectations back to target. - Consider reforms that reduce tensions in the labor market, including improvements to the conflict-resolution mechanisms in the collective bargaining framework.
The EU's FIT for 55 package provisions for international aviation, without adequate adaptations, could significantly increase the cost of flights to Iceland.	Medium	Medium - Higher costs of international travel to Iceland and lower flight availability from international carriers. - Reduction in number of tourists and redeployment of tourism workers. - Lower migration.	- Temporary support to affected industries and workers to cushion the shock and facilitate the reallocation of capital and labor. - Accelerate efforts to promote Iceland as a unique destination, including by expanding the range of unique experiences offered to tourists and by targeting high-value tourists that are less price sensitive.

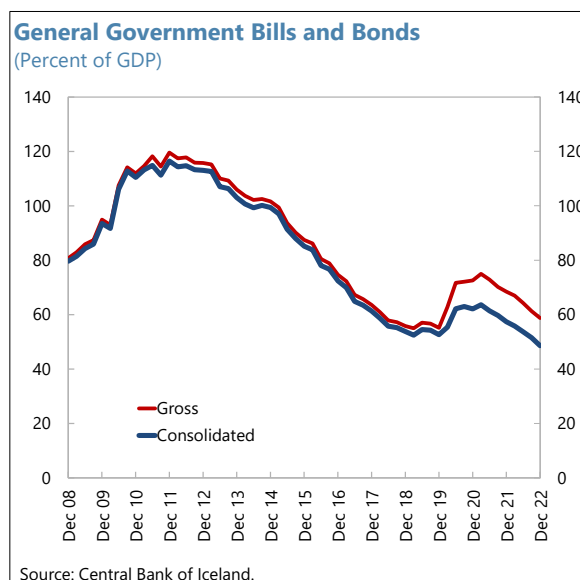
Annex III. Public Sector Debt Sustainability Analysis

Iceland's public debt is assessed to be sustainable with high probability, as vulnerabilities remain manageable with the envisaged medium-term fiscal outlook.¹ The relatively low maturity of public debt is a vulnerability, while Iceland's large institutional investor sector managing a mandatory pension saving scheme and the low foreign holding of domestic currency debt are a source of strength.

1. Iceland's public debt remains manageable. Gross general government debt amounted to 68 percent of GDP by end 2022, with net debt close to 57 percent of GDP after netting out liquid currency and deposits. Gross debt fell by about 7 percent of GDP on account of (i) favorable debt dynamics (nominal GDP growth being higher than the implicit nominal interest rate) and (ii) the partial sale of shares of state-owned bank Islandsbanki. Government deposits declined by about 4 percent of GDP, mainly to pay off maturing bonds issued abroad and to help fund the deficit. The reduction in government FX deposits also reduced international reserves, as foreign currency Treasury deposits are held in the central bank and form part of international reserves.



2. Iceland enjoys favorable market access abroad and domestically. Although no new international bonds were issued in 2022, rating agencies have maintained Iceland's triple A rating. Holders of krona-denominated securities issued by the general government are mainly domestic, while that issued abroad is more diversified. A large institutional investor base includes pension funds, which hold about 40 percent of public debt issued domestically. Domestic banks hold about 25 percent and foreign investors about 5 percent of domestic debt.

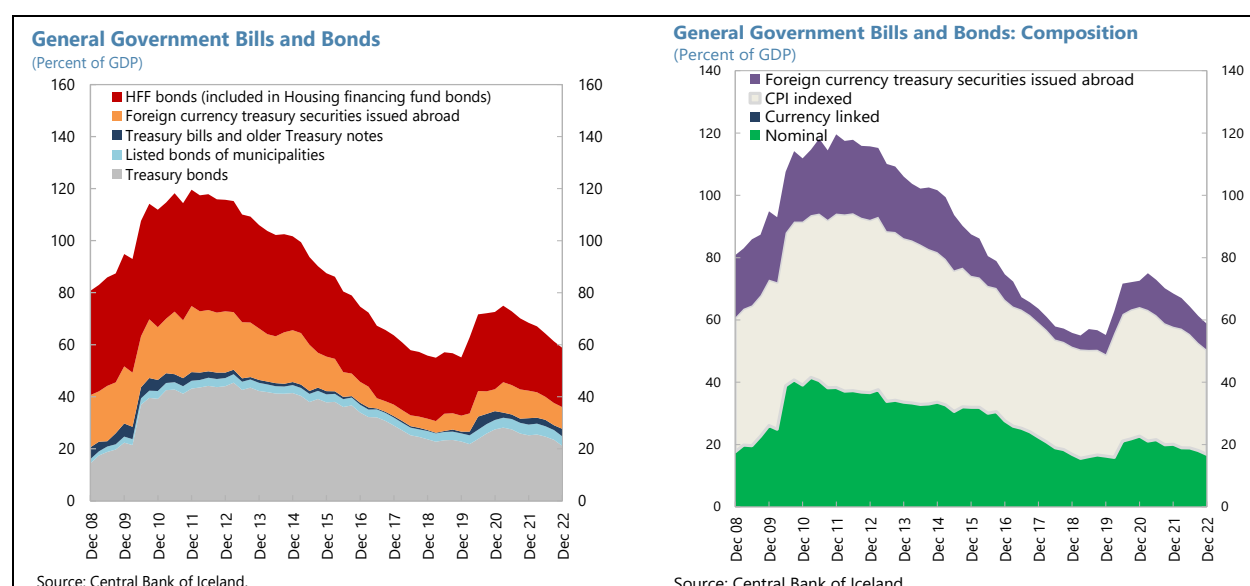


3. Holdings of government debt by government credit funds imply that consolidated general government debt is lower than the debt issued by individual agencies.

¹ 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.

The main issuers of general government securities are the Treasury, Municipalities, and government credit funds, of which the IL Fund, formerly the Housing Financing Fund (HFF) is the largest. Nevertheless, general government debt is smaller than the sum of the obligations of individual issuers, after consolidation, because the HFF and other government credit funds that are considered part of the general government hold about 10 percent of GDP in assets issued by the Treasury and Municipalities.² For instance, the level of general government securities, net of government credit funds holding of debt from the Treasury and Municipalities, reached about 50 percent of GDP in 2022, out of the total consolidated general government debt of 68 percent of GDP.

4. The net government debt bears little currency risk but some liquidity and interest rate risk. Although about 15 percent of the debt is denominated in foreign currency, most of FX debt is hedged with foreign currency deposits of the Treasury at the CBI. About 60 percent of the debt is denominated in kronur and indexed to the CPI, while the remainder is unindexed nominal krona debt. The treasury securities have a low residual maturity of about 5 years, with foreign currency securities having a low maturity of 3.6 years and indexed securities an average maturity of 7 years. The low maturity exposes the government to fluctuations in interest rates and funding risk.



5. The DSA is based on staff's baseline fiscal projections. These are in line with the 2023 budget and 2024–29 medium-term fiscal policy strategy. 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.

² Other HFF assets include the remainder of the mortgage portfolio, which has declined to about 4 percent of GDP by end 2022.

Annex III. Figure 1. Iceland: Public Debt Sustainability Analysis (DSA)—Risk of Sovereign Stress

Horizon	Mechanical Signal	Final Assessment	Comments
Overall	...	Low	The overall risk of sovereign stress is low, reflecting a relatively low level of vulnerability in the near-term and moderate levels of vulnerability in the medium- and long-term horizons.
Near-term 1/	Low	n.a.	Not applicable
Medium-term	Moderate	Moderate	Medium-term risks are assessed as moderate against a mechanical high signal on gross financing needs given that these financing needs include amortization of bonds from the former HFF, which has significant assets to service the debt including into the extended period. The high financing needs also reflect the relatively low average maturity of domestic and foreign bonds, with a peak in amortization in 2028. The depth of the domestic investor pool and the practice of the treasury to hold foreign currency deposits in the central bank for almost the amount of outstanding foreign currency bonds issued abroad provides comfort. The reactivation of fiscal rules under the baseline will help lower the sovereign stress risks in the medium term.
Fanchart	Low	...	
GFN	High	...	
Stress test	...	...	
Long-term	...	Low	Long-term risks are low over the extended period, but will tend to deteriorate going forward with aging-related expenditures on health and social security.
Sustainability assessment 2/	Not required for surveillance countries	Sustainable with high probability	Debt is assessed as sustainable with high probability. Public debt of the general government is expected to fall over the extended period, conditional on the reactivation of the fiscal rules and related implementation of fiscal adjustment measures consistent with the medium-term fiscal strategy and that are assessed as feasible in spite of not yet being legislated.
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Commentary: Iceland is at a low overall risk of sovereign stress and debt is sustainable. Most indicators have started to normalize as the recovery from the COVID-19 shock has proceeded. Medium-term liquidity risks as analyzed by the GFN Financeability Module are moderate. Over the longer run, Iceland should start with reforms to tackle risks arising from population aging in the long term.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

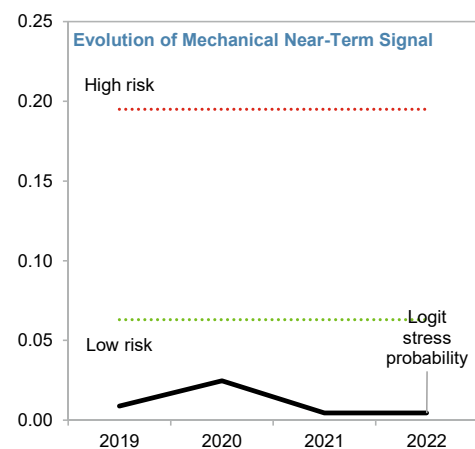
2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Annex III. Figure 2. Iceland: Public Debt Sustainability Analysis (DSA)—Near-Term Risk Analysis

Year of data	2019	2020	2021	2022
To predict stress in $[t+1, t+2]$	2020-21	2021-22	2022-23	2023-24
Logit stress probability (LSP)	0.009	0.025	0.005	0.004
Change in LSP	0.000	0.016	-0.020	0.000
due to:				
Institutional quality	0.000	-0.001	-0.001	0.000
Stress history	0.000	0.000	0.000	0.000
Cyclical position	-0.002	0.000	0.002	0.000
Debt burden & buffers	0.005	0.005	-0.006	-0.001
Global conditions	-0.003	0.011	-0.012	0.001

Prob. of missed crisis, 2023-2024 (if stress not predicted): 0.0 pct.

Prob. of false alarm, 2023-2024 (if stress predicted): 94.9 pct.

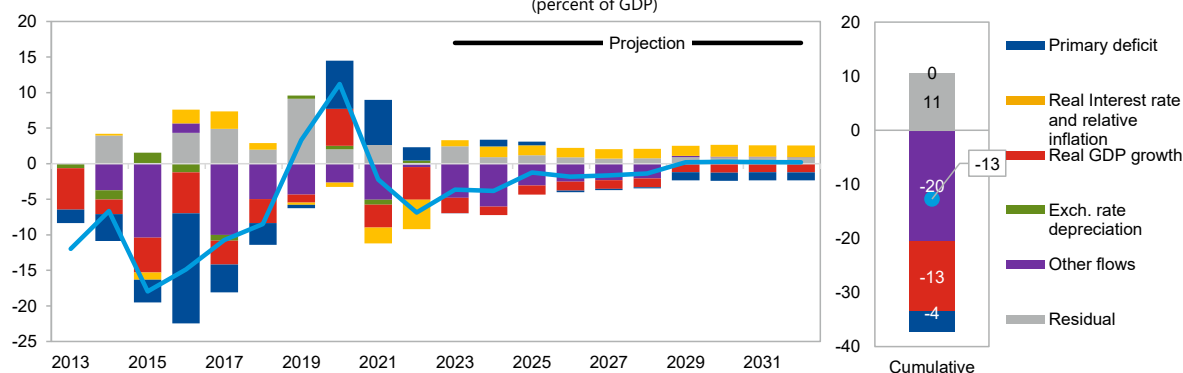


Staff commentary: Iceland's risk of near-term stress is low. The improvement largely reflects the normalization in global conditions from the COVID-19 shock as well as an improvement in debt indicators as the domestic recovery has gained steam.

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

	Actual	Medium-term projection							Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	
Public debt	68.7	65.1	61.2	60.0	58.2	56.5	55.2	55.3	55.6	55.8	56.0	
Change in public debt	-6.8	-3.6	-3.8	-1.2	-1.8	-1.7	-1.4	0.2	0.3	0.2	0.2	
Contribution of identified flows	-6.7	-6.1	-4.8	-2.4	-2.7	-2.4	-2.2	-0.7	-0.6	-0.7	-0.7	
Primary deficit	1.9	0.0	1.0	0.5	-0.3	-0.2	-0.2	-1.2	-1.2	-1.2	-1.2	
Noninterest revenues	39.6	41.1	41.1	41.1	40.9	40.4	40.4	40.9	40.9	40.9	40.9	
Noninterest expenditures	41.5	41.1	42.0	41.6	40.7	40.3	40.3	39.8	39.8	39.8	39.8	
Automatic debt dynamics	-8.2	-1.3	0.3	0.1	0.1	0.1	0.1	0.2	0.4	0.4	0.4	
Real interest rate and relative inflation	-4.1	0.8	1.5	1.4	1.3	1.3	1.3	1.4	1.7	1.6	1.6	
Real interest rate	-4.3	0.7	1.4	1.3	1.2	1.3	1.3	1.4	1.6	1.6	1.6	
Relative inflation	0.2	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	
Real growth rate	-4.6	-2.1	-1.2	-1.3	-1.2	-1.2	-1.2	-1.2	-1.3	-1.2	-1.2	
Real exchange rate	0.4	...	...	...	...	...	...	...	...	...	...	
Other identified flows	-0.4	-4.8	-6.0	-3.1	-2.5	-2.3	-2.1	0.2	0.1	0.1	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other transactions	-0.4	-4.8	-6.0	-3.1	-2.5	-2.3	-2.1	0.2	0.1	0.1	0.0	
Contribution of residual	-0.1	2.5	0.9	1.2	0.9	0.7	0.8	0.9	0.9	0.9	0.9	
Gross financing needs	9.5	8.8	8.4	7.0	7.9	5.9	10.4	5.9	7.2	6.8	6.7	
of which: debt service	9.8	10.4	9.2	7.9	9.2	7.0	11.5	8.0	9.3	8.9	8.8	
Local currency	5.6	5.7	3.7	3.7	1.4	1.5	4.4	2.4	2.7	2.8	2.2	
Foreign currency	2.4	0.0	1.7	0.4	2.0	1.4	2.6	0.6	0.8	1.0	1.0	
Memo:												
Real GDP growth (percent)	6.4	3.2	1.9	2.1	2.1	2.1	2.2	2.2	2.3	2.2	2.2	
Inflation (GDP deflator; percent)	9.0	5.9	3.8	3.5	3.0	3.2	3.2	2.9	2.7	2.7	2.6	
Nominal GDP growth (percent)	16.1	9.3	5.7	5.7	5.2	5.4	5.5	5.2	5.0	4.9	4.9	
Effective interest rate (percent)	2.4	7.0	6.0	5.8	5.2	5.5	5.6	5.6	5.8	5.7	5.6	

Contribution to Change in Public Debt
(percent of GDP)

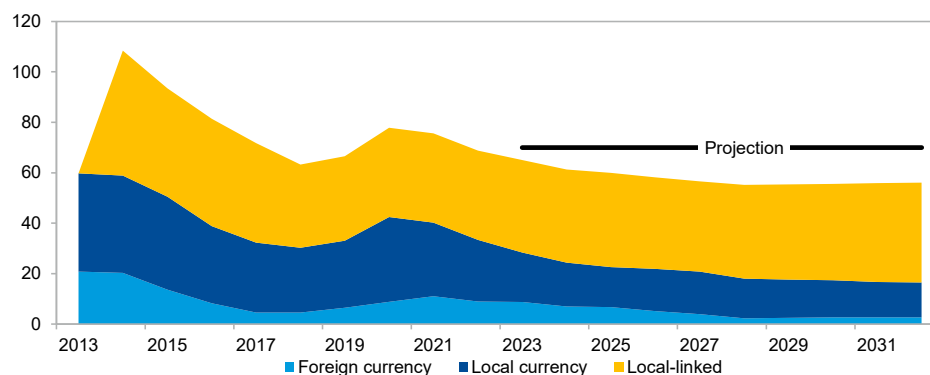


Staff commentary: Public debt will continue falling over the extended projection period as HFF liabilities are repaid using its remaining assets and fiscal rules are followed.

Annex III. Figure 4. Iceland: Public Debt Sustainability Analysis (DSA)—Public Debt Structure Indicators

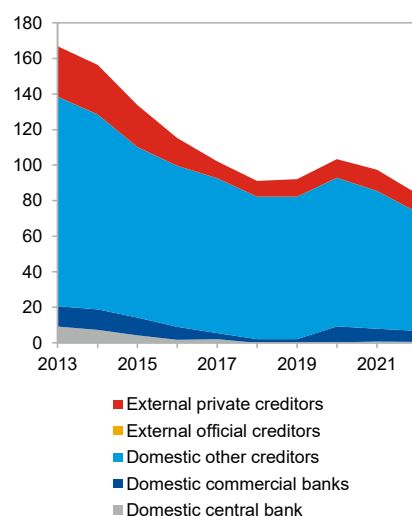
Iceland: Public Debt Structure Indicators

Debt by Currency (percent of GDP)



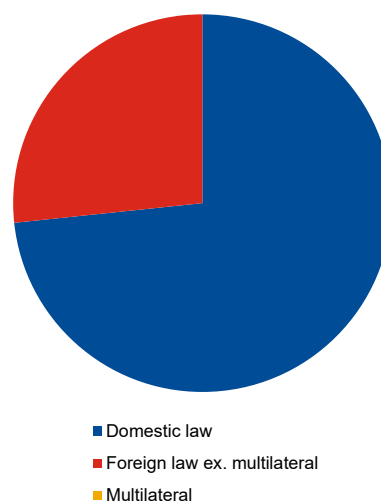
Note: The perimeter shown is general government.

Public Debt by Holder (percent of GDP)



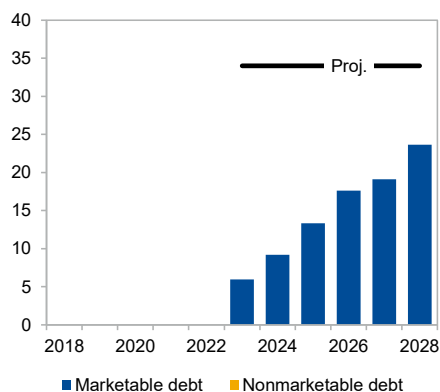
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2022 (percent)



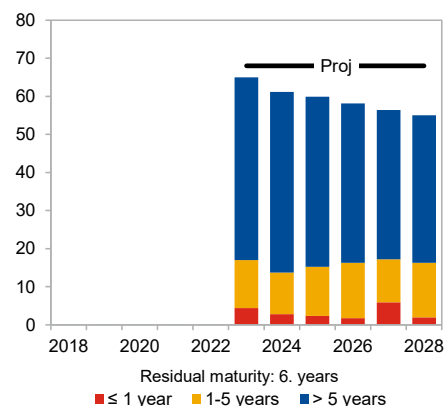
Note: The perimeter shown is general government.

Debt by Instruments (percent of GDP)



Note: The perimeter shown is general government.

Public Debt by Maturity (percent of GDP)



Note: The perimeter shown is general government.

Annex III. Figure 5. Iceland: Public Debt Sustainability Analysis (DSA)—Debt Coverage and Disclosures

					Comments
1. Debt coverage in the DSA: 1/					
	CG	GG	NFPS	CPS	Other
1a. If central government, are non-central government entities insignificant?					n.a.
2. Subsectors included in the chosen coverage in (1) above:					
Subsectors captured in the baseline					Inclusion
CPS NFPS GG: expected CG	1	Budgetary central government			Yes
	2	Extra budgetary funds (EBFs)			Yes
	3	Social security funds (SSFs)			Yes
	4	State governments			Yes
	5	Local governments			Yes
	6	Public nonfinancial corporations			no
	7	Central bank			no
	8	Other public financial corporations			no
3. Instrument coverage:					
	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/
4. Accounting principles:					
Basis of recording		Valuation of debt stock			
Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/	
5. Debt consolidation across sectors:					
	Consolidated		Non-consolidated		

General government debt includes legacy debt from the former Housing Financing Fund, which are excluded from the definition of debt subject to fiscal rules but considered part of the central administration following a statistical reclassification in [2019].

Color code: ■ chosen coverage ■ Missing from recommended coverage ■ Not applicable

Reporting on Intra-Government Debt Holdings									
Holder		Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp
Issuer									
CPS NFPS GG: expected CG	1	Budget. central govt							
	2	Extra-budget. funds							
	3	Social security funds							
	4	State govt.							
	5	Local govt.							
	6	Nonfin pub. corp.							
	7	Central bank							
	8	Oth. pub. fin. corp							
Total		0	0	0	0	0	0	0	0

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.

2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.

3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.

4/ Includes accrual recording, commitment basis, due for payment, etc.

5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).

6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.

7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Annex IV. Fiscal and Monetary Policy and Private Saving Rate: GIMF Simulations¹

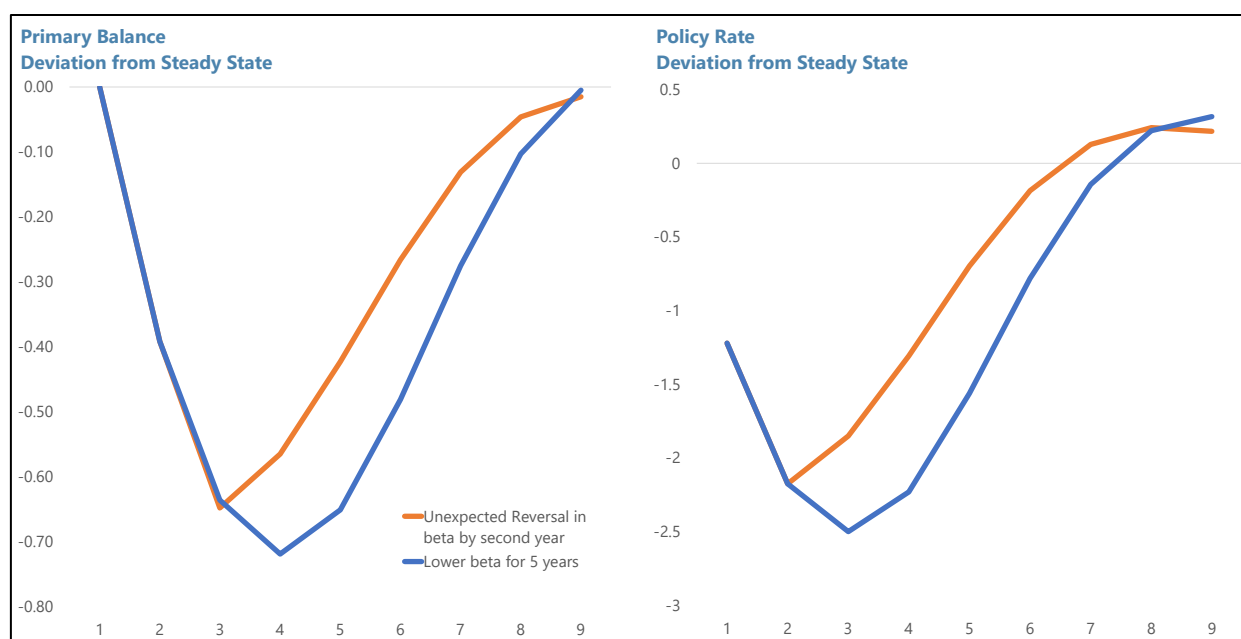
Model simulations using the IMF's Global Integrated Monetary and Fiscal Model (GIMF) suggest that a reduction in primary balances together with a relaxation of the monetary policy stance was an appropriate countercyclical policy response to increases in the private saving rate, such as that which took place around the world during the pandemic. At the same time, the duration of fiscal and monetary stimulus depends on how long the private saving rate around the world remains elevated. The simulations suggest that a faster than expected return of the private saving rate to its steady state level—such as that which has occurred in Iceland—warrants a faster fiscal consolidation path and a tighter monetary policy stance.

- 1. Private and public saving rates played a crucial role in macroeconomic outcomes during the pandemic.** The pandemic disrupted economic activity around the world, with policy makers responding to the resulting recession with an array of macroeconomic policy measures. Macroeconomic outcomes included a large increase in the private saving rate accompanied by a sharp deterioration in the public saving rates, as fiscal balances deteriorated, and public debt increased. Following the successful rollout of vaccination campaigns around the world and the associated reopening of economies, domestic demand recovered, and the private saving rates fell quickly back to pre-crisis levels. At the same time, the speed of medium-term fiscal consolidation varies across countries, with most envisaging several years before returning to pre-pandemic levels.
- 2. Model simulations suggest that fiscal and monetary support was a warranted countercyclical measure to exogenous changes in the private saving rate.** It implies that in response to an increase in private saving, a deterioration in primary fiscal balances and lower policy rates was a useful tool to cushion the downturn in the economy. It also suggests that a faster than expected return of the private saving rate to its equilibrium level warrants a faster than envisaged fiscal consolidation.
- 3. The simulations are done using a version of the GIMF model calibrated to Iceland.**
 - GIMF is a dynamic general equilibrium model widely used in IMF's flagship publications, in which consumers react to incentives created by policy decisions. The model is useful for considering the interaction between the evolution of private saving and fiscal support. Monetary and fiscal policies have macroeconomic effects because the model includes nominal and real rigidities and several features that imply that Ricardian equivalence does not hold. The latter includes myopic consumers with limited lifetimes, declining life-cycle-labor income, some

¹ Written by Jorge Ivan Canales-Kriljenko (EUR).

consumers that lack access to financial markets, and distortionary taxes.^{2,3,4} The model calibration is the same used in the selected issues paper for the 2021 Article IV Consultation on Iceland.⁵

- A change in the private savings rate is modelled by varying the intertemporal discount variable in the consumers' utility functions, the beta. A decrease in the beta discounts future consumption at a lower rate, tending to increase the share of future relative to current consumption. In other words, it tends to increase the saving rate. The simulations assume that the beta increases in the three area blocks. It suggests that the highest economic impact on economic activity in Iceland comes from the increase in the beta in its trading partners, rather than from its own intertemporal discount variable.
- The simulations suggest that a reassessment of intertemporal preferences after the pandemic would have warranted a faster fiscal consolidation and a removal of monetary policy stimulus.



² Anderson, Derek, Benjamin Hunt, Mika Kortelainen, Michael Kumhof, Douglas Laxton, Dirk Muir, Susanna Mursula, and Stephen Snudden, 2013, "Getting to Know GIMF: The Simulation Properties of the Global Integrated Monetary and Fiscal Model", IMF Working Paper No. 13/55.

³ Kumhof, M. and D. Laxton, 2009, "Simple, Implementable Fiscal Policy Rules", IMF Working Paper No. 09/76.

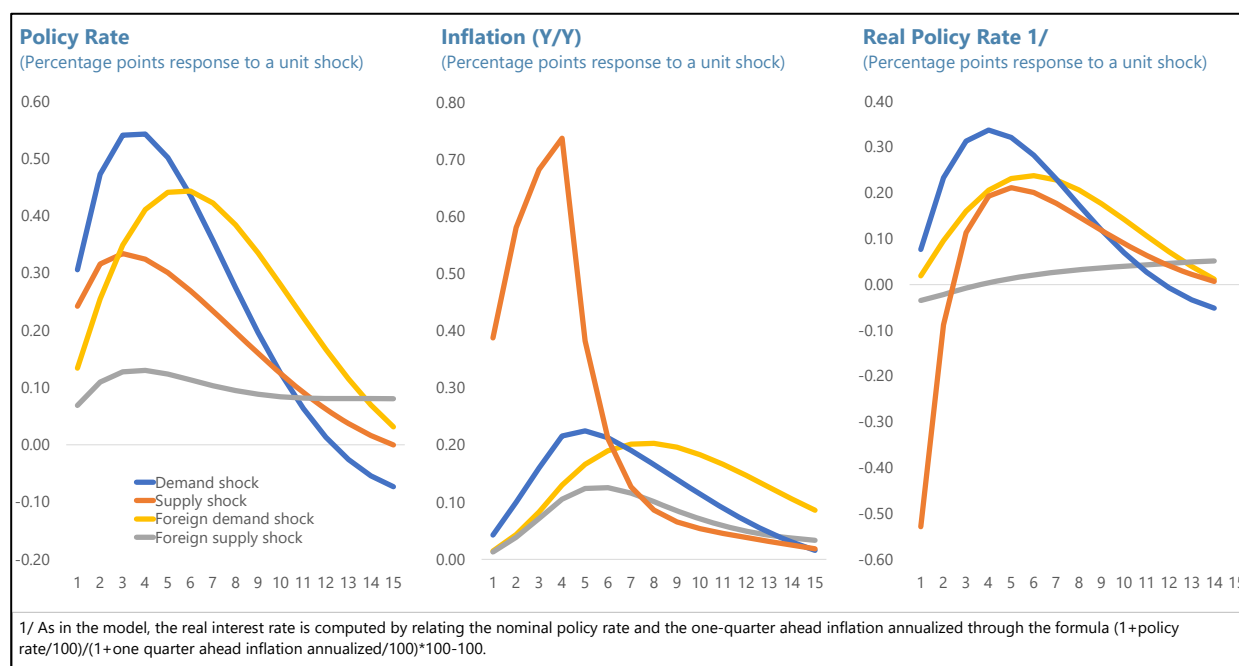
⁴ Kumhof, M., D. Laxton, D. Muir and S. Mursula, 2010, "The Global Integrated Monetary Fiscal Model (GIMF) - Theoretical Structure", IMF Working Paper No. 10/34.

⁵ The model structure is described in Kumhof and others (2010) with a three-economic area block, adapted to the economies of Iceland, the Euro area, and the rest of the world. The model parameters used here yield the main macroeconomic ratios in Iceland.

Annex V. Monetary Policy Tightening: Guidance from Monetary Policy Models (A GPM Analysis)¹

1. Monetary policy decisions within an inflation targeting framework need to take into account the interaction between economic activity, inflation, and policy interest rates. To discuss the policy tradeoffs involved, this section uses a model akin to the IMF's global projection model (GPM)^{2,3} adapted to Iceland. The model has forward-looking equations for the determinants of inflation, the evolution of the output gap (Phillips curve), and a policy reaction function for Iceland. It also takes as given the evolution of inflation and economic activity in Iceland's trading partners, as these variables affect both the evolution of inflation and economic activity in Iceland. Model parameters are estimated using Bayesian methods, which optimize the likelihood that the data is consistent with the model and priors about the distributions of the estimated parameters.

2. The key insight from the impulse responses of the estimated model is that the appropriate policy response depends on the type of inflationary shock. The policy rate response needs to be stronger when the source of inflationary pressure originates in strong demand, whether domestic or foreign. In such cases, the policy rate needs to rise significantly more than the corresponding rise in consumer prices to bring inflation under control. The response to supply shocks can be milder to the extent of initially delivering negative real rates but policy rates need to remain elevated for longer to contain second round effects with positive real rates later on.



¹ Written by Jorge Ivan Canales-Kriljenko (EUR).

² Honjo Keiko and Benjamin Hunt, 2006, "Stabilizing Inflation in Iceland", IMF Working Paper No. 06/262.

³ Carabenciov, Ioan and others, 2013, "GPM6 - The Global Projection Model with 6 Regions", IMF Working Paper No. 13/87.

Box 1. Key Model Equations

Phillips curve

$$DLA_CPI_t = a1 * DLA_CPI_{t-1} + (1-a1) * DLA_CPI_{t+1} + a2 * L_GDP_GAP_t + a3 * DLA_Z_t + RES_DLA_CPI_t$$

Aggregate demand equation

$$L_GDP_GAP_t = b1 * L_GDP_GAP_{t-1} + (1-b1) * L_GDP_GAP_{t+1} - b2 * (RR_GAP_t) + b3 * (L_Z_GAP_t) + b4 * L_GDP_RW_GAP_t + RES_L_GDP_GAP_t$$

Unconditional Interest rate parity

$$RR_t - RR_RW_t = 4 * (LZ_E_t - LZ_t) + RR_BAR_t - RR_RW_BAR_t + RES_RR_DIFF_t$$

Policy reaction function

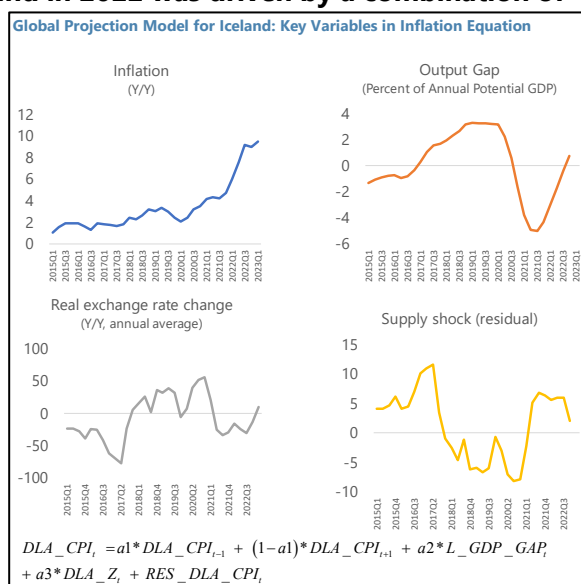
$$RS_t = g1 * RS_{t-1} + (1-g1) * \left(RR_BAR_t + D4L_CPI_{t+4} + g2 * (D4L_CPI_{t+4} - D4L_CPI_TAR_{t+4}) + g3 * L_GDP_GAP_t \right) + RES_RS_t$$

where:

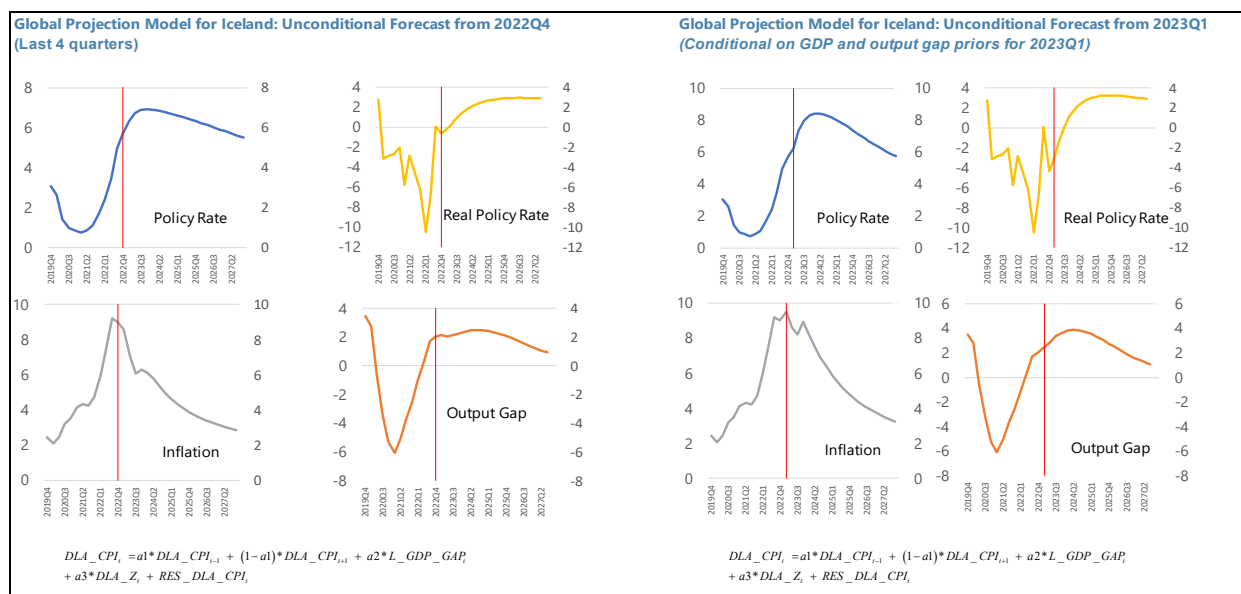
DLA_CPI	Quarterly CPI inflation, annualized.
L_GDP_GAP	Output gap
DLA_Z	Quarterly real exchange rate depreciation
RR_GAP	Real policy interest rate gap, deviation from neutral rate
L_Z_GAP	Real exchange rate gap, deviation from equilibrium REER.
$L_GDP_RW_GAP$	Output gap in trading partners
RR	Real policy interest rate
LZ_E	Expected real exchange rate
L_Z	Real exchange rate
RR_BAR	Neutral real policy interest rate
RS	Nominal policy interest rate
$D4L_CPI$	Annual inflation (4-quarters)
$D4L_CPI_TAR$	Inflation target

Key Parameter Estimates					
Equation	Parameter	Variable	Distribution	Prior	Estimate
Inflation	a1	DLA_CPI{-1}	gamma	0.44	0.31
Inflation	a2	DLA_CPI{+1}	beta	0.43	0.04
Inflation	a3	L_GDP_GAP	gamma	0.10	0.01
Aggregate demand	b1	L_GDP_GAP{-1}	gamma	0.92	0.97
Aggregate demand	b2	-(RR_GAP)	normal	0.40	0.23
Aggregate demand	b3	(L_Z_GAP)	gamma	0.50	0.02
Aggregate demand	b4	L_GDP_RW_GAP	beta	0.25	0.25
Reaction Fn.	g1	RS{-1}	gamma	0.40	0.64
Reaction Fn.	g2	D4L_CPI{+4} - D4L_CPI_TAR{+4}	gamma	0.60	0.63
Reaction Fn.	g3	L_GDP_GAP	gamma	0.38	0.47
Exchange Rate expectations	phi	L_Z{+1}	beta	0.50	0.50

3. The model suggests that inflation in Iceland in 2022 was driven by a combination of factors. Economic activity recovered quickly following the pandemic, opening up a positive output gap. Currency movements reversed in the middle of the year from an appreciation that contained inflationary pressure to a depreciation that put upward pressure on prices. The model, suggests, however, that the most important driver was a cost-push, supply-side increase in consumer prices. These observations result from taking as given the evolution of GDP, consumer prices, and policy rates in Iceland and trading partners, and backing from the model the residuals that would make the model and observations consistent with each other.

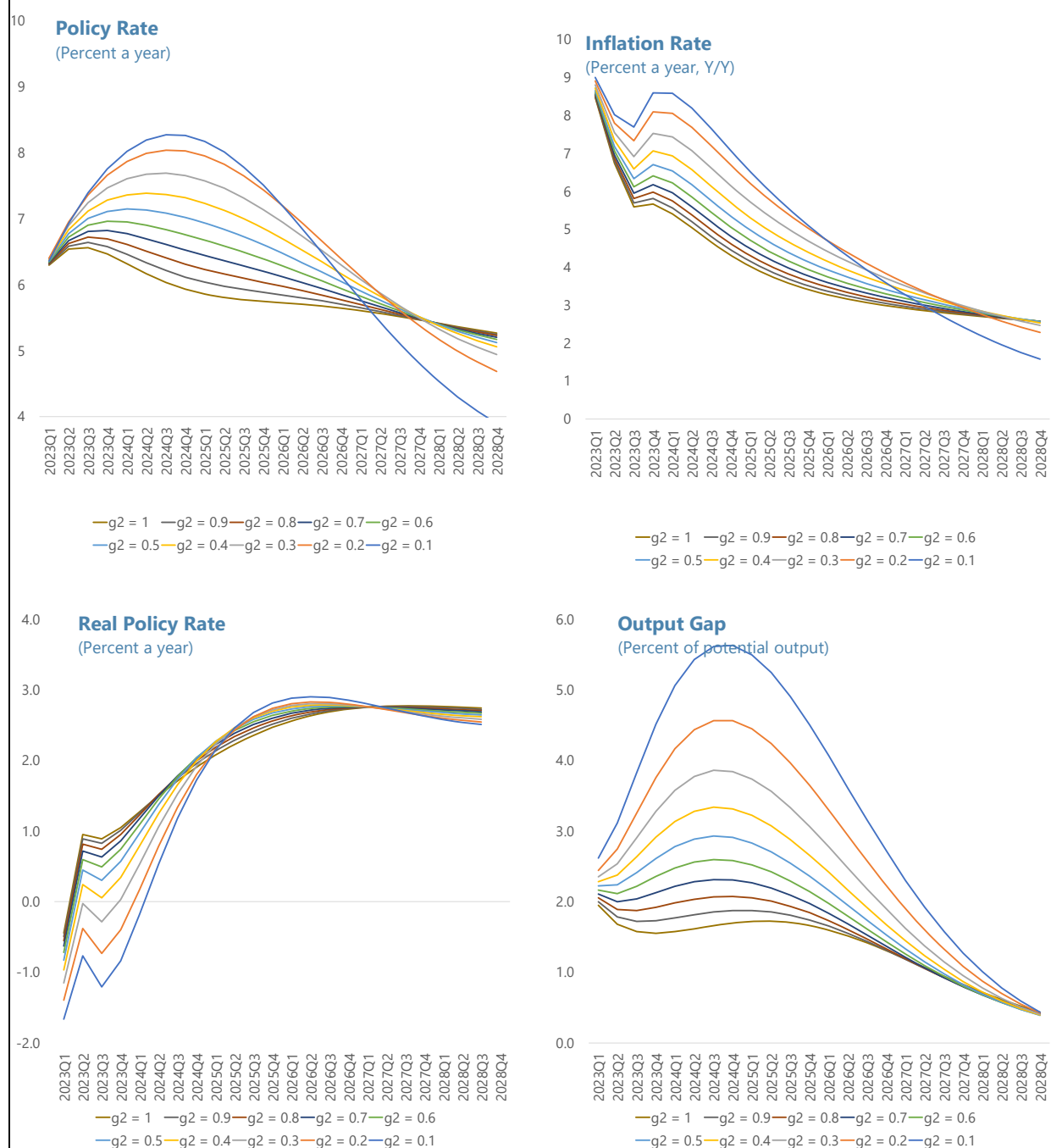


4. Unconditional forecasts using the model suggest that additional policy rate increases are warranted over the next few quarters to steer inflation and inflation expectations back to target. The central bank was one of the first in advanced economies to raise the policy rate in response to rising inflation. The tightening cycle accelerated in the second half of 2022 when inflation in Iceland and abroad picked up following the start of the war in Ukraine. Unconditional forecasts, which assumes no new shocks during the forecast horizon, using data through end 2022 suggest that additional hikes were warranted at the time, which indeed took place during Q1. Using high frequency indicators to proxy a figure for 2023Q1 GDP and complete the information required for an unconditional forecast starting in Q2 suggests that additional tightening of about one percentage point would be needed in the next few quarters.



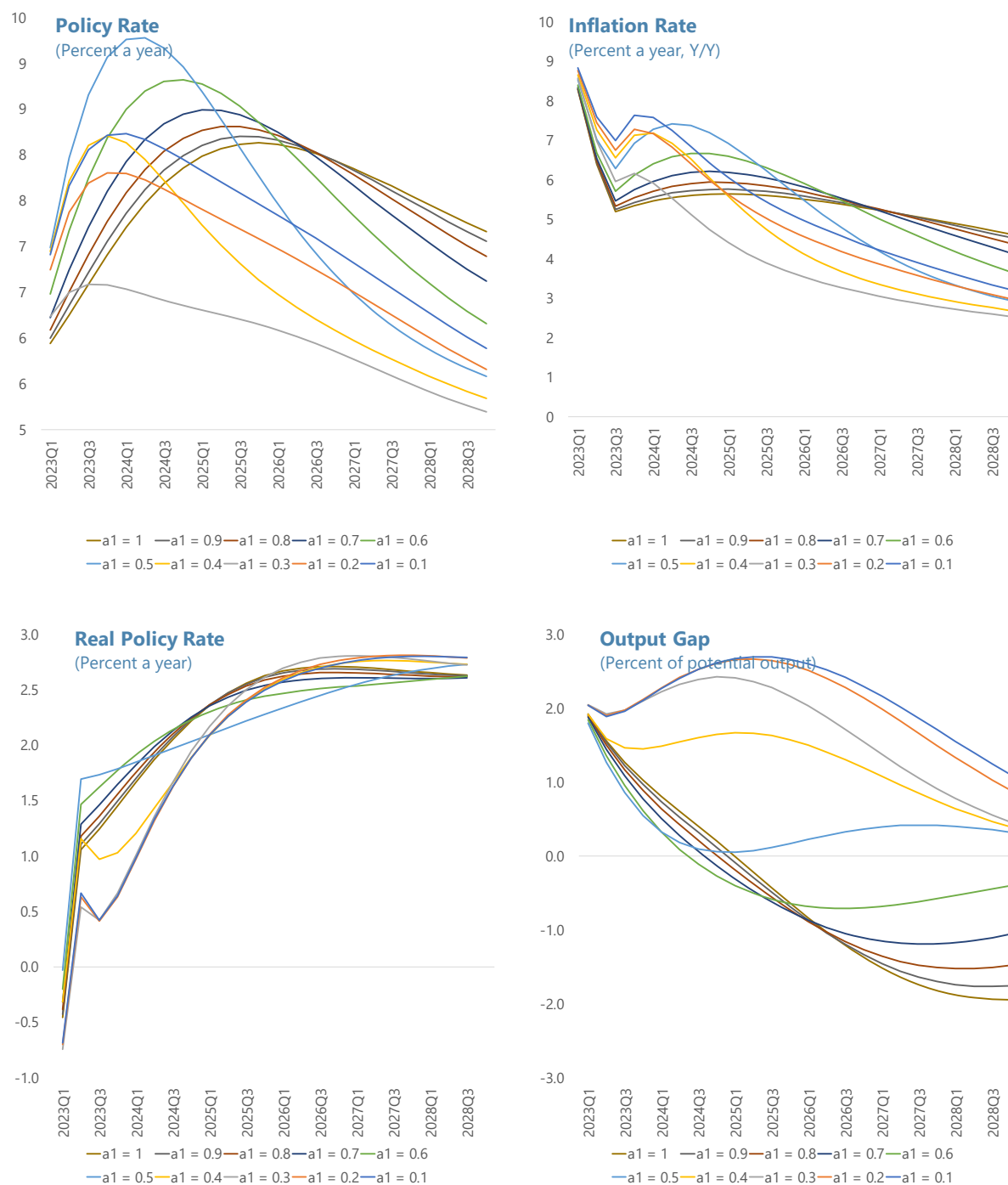
5. Sensitivity analysis highlights the importance of a strong policy reaction to keep inflationary pressures contained. Higher weights on the deviation of inflation from target would result in inflation peaking sooner and the required additional tightening being lower. Alternatively, a policy rule with a low weight on inflation is likely to result in significantly higher inflation levels that could even spiral out of control. The key message from the model is that stronger real interest responses to increases in inflation early on tend to reduce the need for higher policy rates in the future because the inflationary process would be contained earlier. The inflation dynamics are significantly less sensitive to the assumed weight on the output gap. Sensitivity analysis also shows that the degree of persistence of the inflation process can affect the strength of the policy reaction, but the relationship is nonlinear.

6. The model assumes policy reactions need to be gradual, in part to factor in the uncertain economic environment. The model simulations in GPM-type models incorporate this consideration by including an autoregressive component in the policy reaction function. The autoregressive component implies that policy rates adjust gradually over time, for example, to allow financial institutions to adjust to the new policy environment and to factor in uncertainty about the future outlook for inflation. At the same time, movements in the policy rate need to be sufficiently large to stabilize inflation expectations without getting into extremely high levels of inflation.

Annex V. Figure 1. Iceland: Sensitivity to Weigh of Inflation in Policy Reaction Function

Source: IMF staff model simulations

Annex V. Figure 2. Iceland: Sensitivity to Inflation Persistence



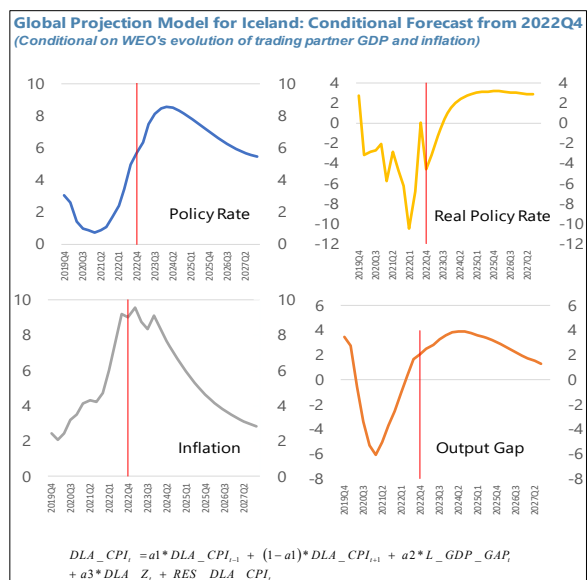
Source: IMF staff model simulations

7. Conditioning on the evolution of the external environment does not materially change the need for further policy tightening.

The IMF's April 2023 World Economic Outlook envisages a deceleration in inflation and a reduction in the positive output gap in trading partners. Ceteris paribus, this provides some help with the disinflationary process in Iceland and reduces somewhat the need for further increases in the policy rate, though the overall impact is small.

8. The results of the model simulations can be summarized as follows:

- A strong systematic reaction to deviations of inflation from target is crucial to keep inflation contained in an inflation targeting framework.
- The pace of adjustment needs to factor in the balance of risks and uncertainty about the path of inflation: Slow policy rate reactions to increases in inflation could result in unnecessarily high inflation and interest rates. Very fast policy reactions could create problems in the financial sector if financial institutions do not have enough time to adjust to changes in the monetary policy stance.
- Some of the increase in inflation observed in the second half of 2022 can be attributed to temporary factors that will fade and facilitate the reduction in inflation. Nevertheless, policy rate hikes will be still required through mid-2023 to steer inflation back to target. Conditioning the model inflation forecast on the expected evolution of economic activity and inflation in trading partners is consistent with this view. As a word of caution, model simulations assumes that expectations are formed according to the model and that, in the long run they, are fully anchored at the target. If inflation expectations get anchored away from the target, or completely unanchored, policy interest rates would likely need to be significantly higher to steer not only inflation, but also inflation expectations back to target.

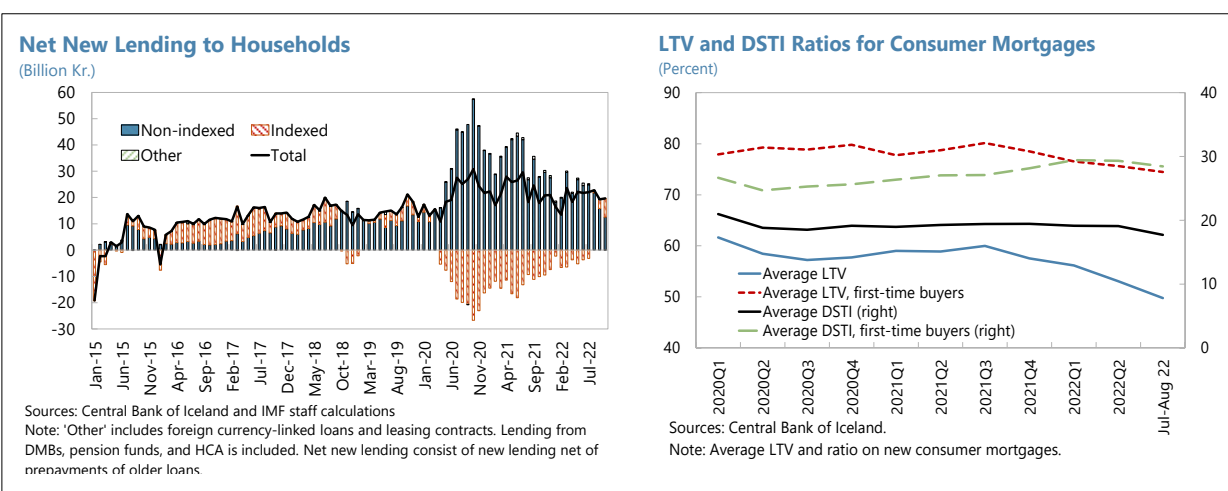


Annex VI. Macroprudential Measures

1. Macroprudential measures have been tightened to mitigate financial stability risks emanating mainly from rising house prices and increasing household indebtedness.

- The CBI lowered the loan-to-value ratio (LTV) for mortgages from 85 percent to 80 percent (keeping it at 90 percent for first-time buyers) in June 2021 and lowered the maximum LTV for first-time buyers from 90 percent to 85 percent in June 2022.
- A 35 percent (40 percent for first-time buyers) debt service to income (DSTI) ratio was introduced in September 2021 (effective December 2021). The rule was amended in June 2022 by including a minimum reference interest rate of 3 percent for CPI-indexed loans and 5.5 percent for non-indexed loans.¹ In addition, the maximum loan period for the calculation of debt service was set at 25 years for indexed loans (initially 30 years) and 40 years for non-indexed loans.
- To ensure have sufficient capital to tackle a potential decline in the quality of the mortgage portfolio, the countercyclical capital buffer (CCyB) was increased to its pre-pandemic level of two percent in September 2021 (effective September 2022) and to 2.5 percent in March 2023 (effective March 2024).

2. The tightening of macroprudential measures, supported by the increase in interest rates, helped mitigate systemic risk and improve resilience. The issuance of new mortgages has decelerated in recent months contributing to a moderation in overall credit growth. The composition of net new loans has also shifted with the share of indexed loans increasing in recent months after falling during the pandemic. A more stringent macroprudential stance has also contributed to a higher homeowners' equity ratio and improved new borrowers' debt service capacity.



¹ Principal payments on indexed loans are linked to the inflation and change when prices rise or fall. By end-2022, the share of indexed and non-indexed loans in total household loan stock was 47 and 53 percent, respectively.

Annex VII. The “GDP Bonus” Clause in Icelandic Wage Agreements: Pros, Cons, and Suggestions for Improvements¹

A contingent wage adjustment mechanism (known as the bonus payment — “hagvaxtarauki”) was introduced as part of the 2019–2022 collective wage bargaining agreements. It included several positive aspects but contributed to inflationary pressures. Nevertheless, it could be usefully redesigned to better align wages, inflation expectations, and productivity, while facilitating multiyear agreements that reduce the costs of annual renegotiation.

1. The 2019–22 collective wage bargaining agreements included a bonus increase in base wages, contingent on the evolution of GDP per capita.² The contingent payment facilitated an agreement in 2019 with lower increases in sectoral minimum wages than was demanded by unions. Mechanically, it consisted of a bonus with five thresholds depending on GDP per capita growth (as a proxy for the increase in labor productivity), on top of the negotiated increase in wages. If GDP per capita growth was below the minimum threshold (one percent) there would be no bonus. Operationally, the bonus was calculated based on the preliminary real GDP per capita estimate of the National Statistical Agency, released in March. The bonus was typically payable starting in May, though in late 2022, it was frontloaded with the temporary extension of the 2019–2022 agreement.

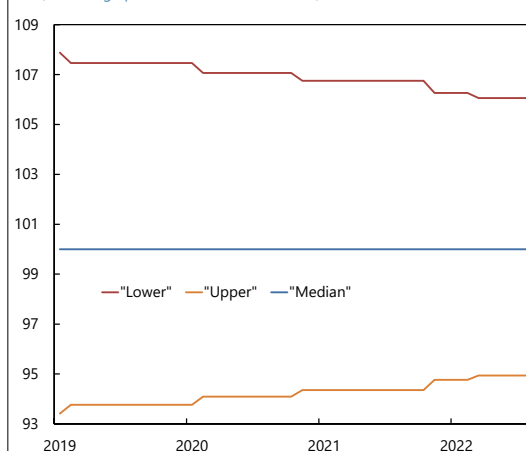
Bonus Table in 2019–22 CIE-SGS Labor Agreement

Per capita GDP (Percent, Y/Y)	Wage bonus (ISK per month)
1.0 - 1.50	3,000
1.51 - 2.00	5,500
2.01 - 2.50	8,000
2.51-3.0	10,500
>3.0	13,000

Source: 2019–2022 labor agreement between the confederation of Icelandic enterprises and the federation of general and special workers.

2. The nominal wage increases during the three years of the agreement were independent of the wage level, with the objective of reducing inequality. Prior to 2019, unions had argued that income equality was being eroded over time because of low wage increases for low-income individuals. The 2019–22 wage agreement addressed these concerns by implicitly awarding higher percentage wage increases and higher bonuses to lower income workers, resulting in a narrowing of wage differentials and lower income inequality.

Dispersion in Wage Tables: 2019–22
(Percentage point deviation from median)

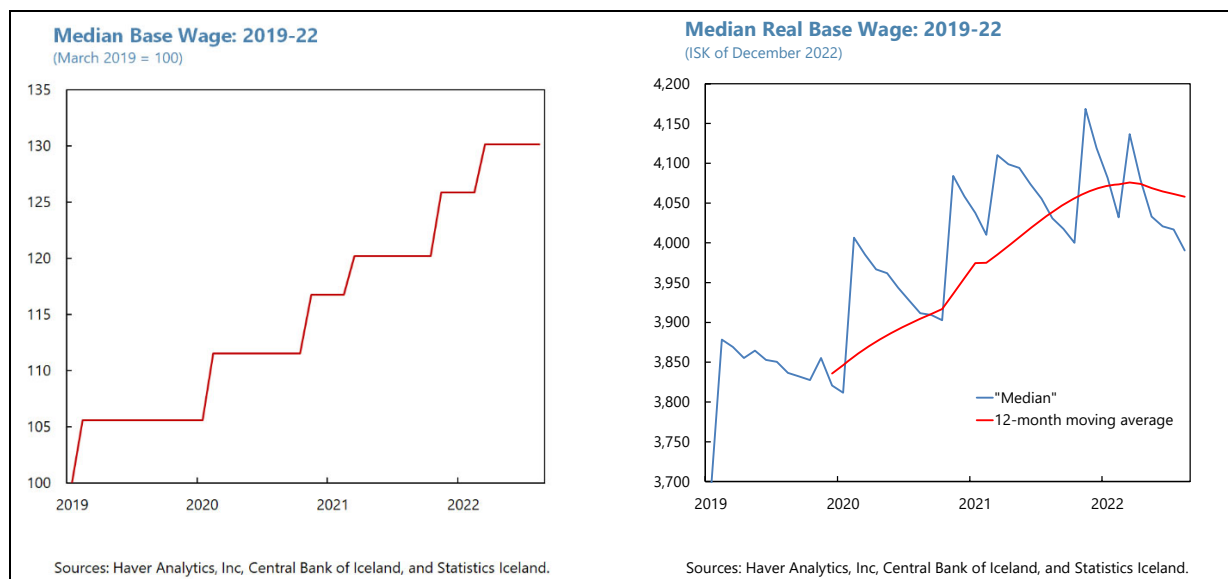


Sources: Haver Analytics, Inc, Central Bank of Iceland, and Statistics Iceland.

¹ Written by Jorge Ivan Canales Kriljenko and Yen Mooi (both EUR).

² Collective agreements cover about 90 percent of the workforce. For this box, we describe the labor agreement of the largest union in Iceland, which has about 75 thousand members, about 35 percent of the work force.

3. The resulting growth in negotiated wages ended up being higher than the level consistent with productivity growth and stable inflation. Over the three years covered by the agreement median minimum wages increased by a cumulative 30 percent in nominal terms through November 2022. The cumulative increase incorporates both the increase in nominal base wages agreed at the start of the agreement (22 percentage points) plus the bonus payments that were awarded in May 2021 and 2022 (8 percentage points). As a result, median real wages in November 2022 were 5 percent higher than in March 2019, before the agreement took effect. This is despite GDP per capita declining by 2.3 percent over the three-year period.



4. The high wage awards contributed to the rapid recovery from the pandemic but also to the build-up of imbalances in the economy. The agreement supported the purchasing power of low-income workers during the pandemic and contributed to high savings rates that boosted domestic demand during the recovery period. At the same time, these agreements contributed to some of the economic imbalances the economy is currently facing, including an overheating economy, rising inflation, and current account deficits.

5. The flaws in the existing arrangement stem largely from the fact that the contingent wage adjustment mechanism (the “bonus”) does not directly take into account the evolution of the level of labor productivity in the economy.

- First, the bonus payments in the 2019–22 agreement resulted in increases in real wages even though the proxy for labor productivity (GDP per capita) declined over the period. This was possible because of the lack of a clearly defined reference level for labor productivity at the start of the agreement. In particular, the pandemic resulted in a sharp drop in GDP per capita in 2019 relative to its level at the start of the agreement in 2018. While real GDP per capita increased in 2020–22, it had yet to fully return to its 2018 levels. Nevertheless, workers received a bonus payment when GDP per capita started to recover, even if it was lower than when the agreement was signed.

- Second, real GDP per capita is not a good indicator of labor productivity. By using real GDP per capita as an indicator, the bonus does not accurately capture the actual work effort during the year, including changes in labor force participation or hours worked. For instance, in an environment where labor force participation was increasing, using real GDP per capita as an indicator would typically result in real wage increases in excess of the improvement in labor productivity.

6. The upcoming centralized wage negotiations provide an opportunity to redesign the contingent wage adjustment mechanism (bonus payment) to better align it with productivity and the inflation forecast. An improved agreement would have the following key elements:

- A 3-year agreement is reached, which reduces incurring frequent contracting costs that tend to disrupt economic activity.
- Despite the significant uncertainty about inflation, nominal wage awards are aligned with inflation expectations and real productivity growth, reducing the possibility of wage-price spirals or highly persistent inflation.
- The arrangement would balance a forward-looking component and a backward-looking adjustment mechanism that compensates for productivity breakthroughs and allows real wages to decline when productivity falters.
- It would protect workers by ruling out a decline in nominal wages even if the economy falters and labor productivity declines.
- It would allow social objectives about equity to be achieved and allow companies to incorporate stable labor costs in their assessment of profitable investment opportunities.

If such an agreement could be reached, monetary policy would have an easier job reducing inflation, and thus protecting the purchasing value of worker's remuneration. The probability of conflict in the labor market would decline because the contingent part of the arrangement would automatically self-correct deviations from the wage agreement reached due to (i) technological innovation, (ii) inflation surprises coming from abroad or domestic disruptions, (iii) measurement errors that arise from using preliminary data, and (iv) terms of trade surprises, among others. While this does not avoid negotiation for the distribution of the pie, it would help reduce the need for frequent negotiations.

7. Building upon the 2019-2022 agreement, such a wage agreement could be within reach by adjusting the existing setup. In this section we provide a concrete example of a possible wage agreement that would achieve these goals.

- First, the negotiating partners would agree on the level of base wages at the start of the agreement taking into account the evolution of real wages and labor productivity since the last agreement.

- Second, the arrangement would establish a state-contingent method to adjust wages over the duration of the arrangement. This would include a forward-looking mechanism to adjust base wages, and a backward-looking self-correcting mechanism through a bonus adjustment.
- Third, base wages would be adjusted annually reflecting forward-looking independent forecasts of inflation and long-term expected productivity growth, which could reflect readily available information that is already used for other purposes in the Icelandic context. For instance, for inflation expectations, the agreement could use the National Statistics Office forecast that is reflected in the preparation of the budget.³ For long-term productivity, the arrangement could use the measure already incorporated in Iceland's legal system and used for calculations of personal income taxes (Income Tax Act, Article 66.5)
- Fourth, a state-contingent and backward-looking bonus will adjust base wages based on the ex-post evolution of economy-wide labor productivity, relative to the reference year. The bonus payment would be related to the evolution of the ratio of the level of real GDP per hour and real base wages per hour (the 'ratio'), as a proxy for labor productivity in the economy.⁴ To factor in terms of trade gains/losses and changes in the number of hours worked, the concept of real GDP per hour should be nominal GDP deflated by the consumer price level, divided by the average number of hours worked stipulated in the labor agreement. A bonus adjustment would be made if and only if the change in the ratio of labor productivity to wages between the concluded year and the reference year were positive. The percent increase would be equal to the growth rate in the ratio relative to the base year.
- Fifth, this percent increase would apply to either the median of the job categories (if a redistributive compression is desirable) or to each job category. It would need to be adjusted to changes in the work hours stipulated in the agreement, as the increase is per hour worked.

8. This proposed arrangement would better link the evolution of real wages with productivity. It would allow real wages to fall when the economy suffers a negative productivity shock and to increase when the economy is facing a positive shock. It also balances the forward-looking component in the medium-term productivity estimate with a backward-looking assessment of gains in productivity over the earlier year. The self-correcting mechanism would address inflation surprises as well as lower real wages than warranted given productivity improvements in the economy. It would also self-equilibrate for any difference between long-term expected and actual productivity gains in the economy. There may be other reforms consistent with price stability and keeping wages aligned with productivity, but the suggested solution should be relatively straightforward to implement given the bonus payment system already in place.

³ Ideally, the wage increases should be aligned with the inflation forecast, with the self-equilibrating mechanism in the bonus formula taking care of deviations from the inflation target ex post. Nevertheless, during periods of high inflation lower ex-post adjustments due to unwarranted reduction in real wages are better to avoid unnecessary tension in the labor market.

⁴ Although Statistics Iceland normally does not report GDP per hour worked in its preliminary estimates, the information is available and could be easily reported.

Annex VIII. FSAP Recommendations

The 2023 update to the Iceland FSAP concludes that the Icelandic financial system is fairly solid, well regulated, and supervised, albeit with some vulnerabilities that justify the high capital and liquidity buffers in international comparisons. The recommendations focus on areas in which more power and resources are needed to support the supervisory function and on areas where a better delineation and distribution of responsibilities might be warranted.

1. The key recommendations from the in-depth assessment of the financial system can be organized as those intended to (i) further strengthen the regulation and supervision of banks and pension funds, (ii) expand and improve the early detection of systemic risk, including from and cyberattacks, (iii) improve the monitoring and implementation of macroprudential policies (iv) improve the ability of the central bank to handle liquidity and solvency crises, and (v) consolidate the efforts to strengthen the financial system's integrity, for instance, in the handling of the risks of money laundering and terrorism financing.
2. Worth highlighting among these recommendations are the need for better governance in the systemically important pension fund system, the importance of providing legal protection to supervisors in the exercise of their functions, the benefits of a better and clearer delineation and distribution of supervisory and regulatory responsibilities, the urgency in strengthening cybersecurity, and of being operationally ready to handle potential crises.

Recommendations	Authorities	Timeline ¹
Cross-cutting		
Increase resources at the CBI for oversight of market risk, interest rate risk in the banking book (IRRBB), financial climate risks, and operational risks (ICT risk and cybersecurity); and for the RA.	CBI	NT
Regulation and Supervision: Banking and Pension Funds		
Develop and implement a streamlined and independent budgetary process for supervision.	MoFEA, CBI	NT
Update legislation to: a) ensure protection of supervisors; b) broaden the definition of related-party transactions, and c) broaden CBI's supervisory oversight over bank's external auditors.	MoFEA, CBI	NT
Remove MoFEA staff from CBI's FMEN (independence) and implement internal delegation of powers framework (accountability).	MoFEA, CBI	NT
Implement a comprehensive on-site inspection program for banks' risk management practices across all material risk domains incorporating an improved risk-based supervisory plan and ensure integration of climate-risks into supervisory processes.	CBI	NT
Issue application regulations or supervisory guidance to banks for appropriate and proportionate implementation of EU rules (ensure compliance with Basel standards) and EBA guidelines.	MoFEA, CBI	MT
Align rules on governance, internal controls, risk management with IORP II or Solvency II, and enact more stringent rules for outsourcing.	MoFEA, CBI (FSA)	NT
Perform regular on-site inspections for large pension funds and re-establish institutionalized supervisory dialogue.	CBI (FSA)	I

Recommendations	Authorities	Timeline ¹
Define infringements and sanctions in the Pension Fund Act.	MoFEA	NT
Systemic Risk Analysis		
Develop approaches to monitor funding risks from nonbank financial institutions (including pension funds) and foreign investors.	CBI	NT
Differentiate inflation indexed and non-indexed lending and funding instruments in the analysis of inflation impact on banks' credit, interest rate, and market risks.	MoFEA, CBI	MT
Continue conducting liquidity stress tests with various runoff and haircut rates, enhance monitoring of LCR by currencies, and address outlier banks through Pillar 2 and supervisory actions.	CBI	NT
Closely monitor the impact of higher inflation and interest rates on banks' solvency condition and pension funds' investment behavior, counterparty default risk, and (particularly for smaller pension funds) Pillar III cash flows.	CBI (FSA)	NT
Perform data quality checks for pension funds' supervisory reporting data, require pension funds to submit corrections and expand automated validation rules.	CBI (FSA)	NT
Cybersecurity Supervision and Oversight		
Investigate alternative domestic retail payment solutions in the event of a significant disruption to the credit and debit card system and refine playbooks to test how cash will be distributed and used in a crisis situation.	CBI	I/NT
Produce a financial sector specific cybersecurity strategy, clearly setting out the roles and responsibilities of each party.	CBI, MoFEA	I
Macroprudential Policies		
Further enhance transparency and accountability by developing a heatmap and regularly publishing reports on risk analysis.	CBI	I
Further strengthen the analytical capacity by strengthening the analysis of tail risks, spillovers, systemic risks and calibration of macroprudential tools.	CBI	NT
Continue closely monitoring cyclical risks in the real estate market and corporates, and take further macroprudential measures if risks persist.	CBI	I
Close data gaps related to non-financial private sectors (households, non-financial corporates).	CBI	I
Liquidity and Crisis Management		
Approve the crisis management handbook and test it in a simulation exercise, widening its scope to the resolution stage.	CBI(RA)	I
Establish a coordination body on resolution issues between the MoFEA and the CBI (RA).	MoFEA, CBI (RA)	I
Adopt a seven-day deadline for the Icelandic Depositors' and Investors' Guarantee Fund (TVF)'s disbursements and grant TVF access to adequate external funding sources.	CBI (RA)	NT
Develop a repo market and operationalize the ELA, including the assessment of collateral eligibility.	CBI	NT
Operationalize the application of all the resolution tools (not just bail-in).	CBI (RA)	NT
AML/CFT		
Improve collection and analysis of data; refine the risk assessment methodology; enhance AML/CFT supervision of banks; and continue to detect unlicensed virtual asset service providers.	CBI	NT
Continue to improve bank's access to and maintenance of adequate, accurate and up-to-date information on the beneficial ownership and control of legal persons.	CBI, MoCBA	NT
¹ I = Immediate (within 1 year); NT = Near Term (1–3 years); MT = Medium Term (3–5 years).		

Annex IX. Tourism in Iceland – Building Sustainably to Fly Higher¹

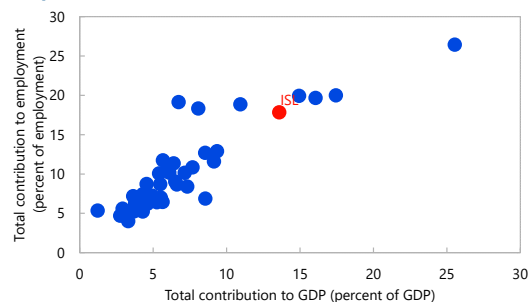
A. Developments in the Tourism Sector

1. Iceland’s tourism sector has rapidly taken off since the Eyjafjallajökull volcanic eruptions in 2010, establishing tourism as a major sector in the economy. Concerted efforts by the authorities, supported by a well-executed social media outreach and marketing campaign, and improved connectedness had all contributed to the sector’s success. Tourist arrivals increased fivefold, peaking in 2018, and the sector doubled its value added in 2010–18. The boom had also spurred growth in construction, retail trade, entertainment, and other economic sectors, contributing to real GDP growth averaging at almost 4 percent and a current account surplus averaging at 5½ percent of GDP in the 7 years prior to the pandemic.

2. Iceland’s attractiveness as a tourist destination is driven by non-cost competitiveness factors. In the World Economic Forum (WEF) Travel and Tourism Development Index, Iceland maintains a consistent strong standing (23 in 2021, 22 in 2019). Rather than push factors, such as economic growth in visitors’ countries of origin, or cost competitiveness, tourists to Iceland are drawn by non-cost factors.² The country’s safety and security, prioritization of travel and tourism, and tourist services rank favorably in the WEF sub-indices.

3. The industry is a major source of export revenues and contributes significantly to GDP and employment. The World Travel and Tourism Council (WTTC) estimates that the tourism sector in Iceland contributed 13.6 percent to total GDP in 2021 (2019: 21.4 percent), including through indirect spillovers to other sectors. In terms of employment, WTTC estimates show a contribution of 17.8 percent to total employment in 2021 (2019: 22.3 percent), double the global and European averages of 9 percent. Based on Statistics Iceland figures, the tourism sector’s direct contribution to GDP is 6.1 percent and 12.5 percent of employment in 2022. BOP numbers for 2022 show that travel and tourism constitute almost a third of goods and services exports, and three quarters of service exports.

Contribution of Tourism to GDP and Employment in Europe, 2021



Note: Tourism contribution to GDP is calculated by the WTTC. According to WTTC/Oxford Economics methodology, tourism contribution to GDP is the sum of direct and indirect contribution of travel and tourism. Direct contribution reflects total spending on travel and tourism by residents and non-residents for business and leisure purposes as well as government spending directly linked to visitors less domestic and imported purchases made by the different tourism sectors. Indirect contribution includes GDP supported by travel and tourism investment spending, government spending which helps travel and tourism activity, and domestic (non-imported) supply chain purchases of goods and services by the sectors dealing directly with tourists.

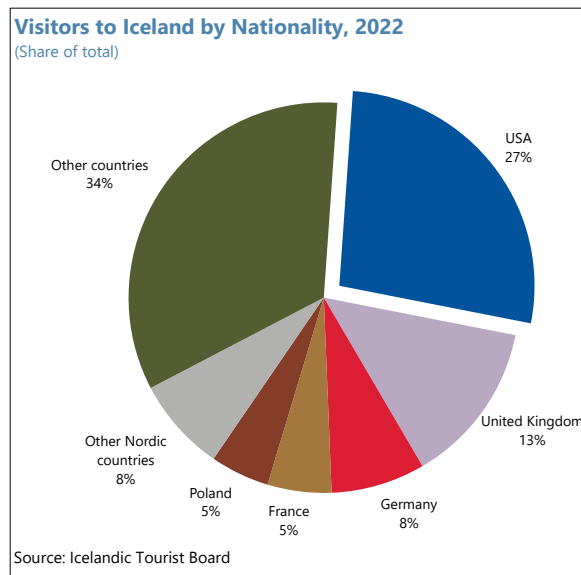
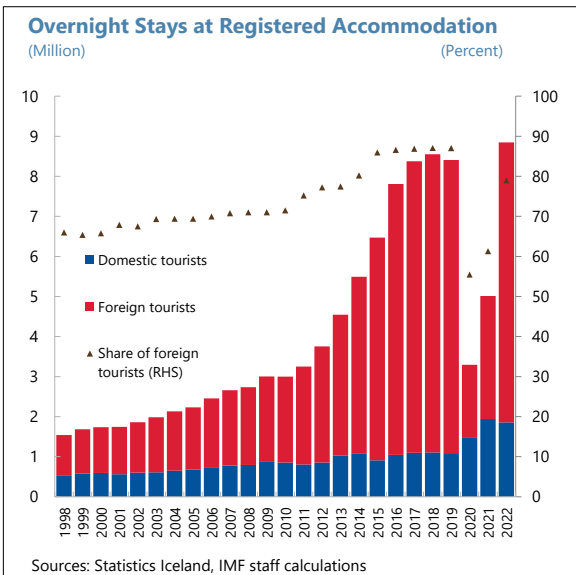
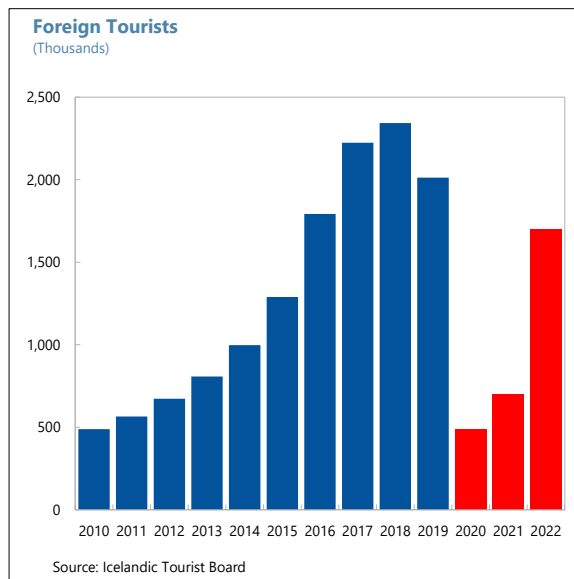
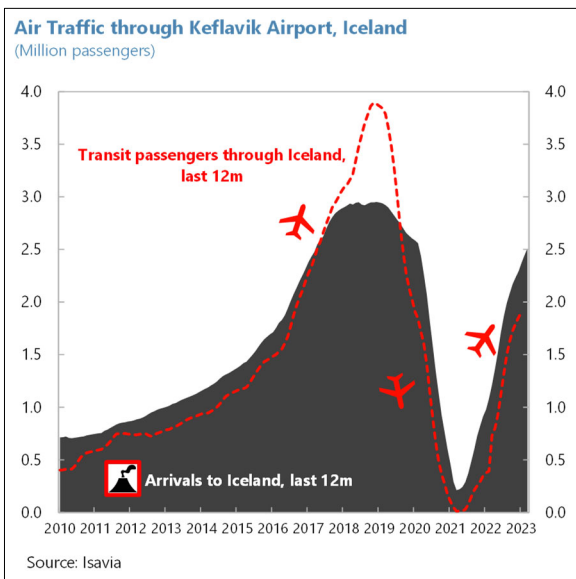
Sources: World Travel and Tourism Council (WTTC) and IMF staff calculations.

4. The COVID-19 pandemic caused a severe disruption to the industry and the economy. Passenger arrivals, hotel stays, and foreign credit card spending dropped by almost 80 percent. Tourism turnover plummeted by 60 percent, leading to a 31 percent reduction in exports of goods

¹ Written by Yen Mooi with assistance from Kelly Gao (both EUR).

² See “Iceland’s Tourism Eruption”, IMF Country Paper No. 17/164.

and services in 2020. The collapse in tourism led to a contraction in real growth by 6.6 percent and unemployment rose to 6.4 percent in 2020. The tourism sector contributed to more than 90 percent of the decline in employers and employees. Government support, including salary subsidies, has helped the industry remain resilient. Since the pandemic, there has also been some consolidation in the industry with the closure of smaller establishments.



5. The sector has rebounded since 2021, and turnover is back at pre-pandemic levels.

In 2022, Iceland received nearly 1.7 million foreign tourists, which is 85 percent of 2019 levels. Nevertheless, turnover was already back at pre-pandemic levels, suggesting higher spending per tourist than previously. On average, stays are also longer compared to pre-pandemic periods (2022: 7.4 nights; 2019: 6.6; 2018: 6.3), attributable to changes in travel patterns after the pandemic. The largest proportion of inbound visitors are from the United States (27 percent), followed by the U.K.,

Germany, and France, with leisure reasons being the primary reason for visiting, and the country's nature significantly being the top draw.³ Domestic tourism has also increased – constituting about 20 percent of total tourists in 2022, up from 13 percent in 2019. This has supported the occupancy numbers in registered accommodation, partially compensating for the fall in international tourist numbers during the pandemic.

6. The tourism labor force has been supported by immigration. Employment in the tourism sector has increased with the growth of the industry. The sector employs almost 29,000 people, a large proportion supplied by the immigrant labor force. Immigrant employees constitute 40 percent of total employment in tourism in 2022, a share that has more than doubled since 2010.



B. Tourism Policies

7. The authorities' Tourism Policy Framework 2020–30 was published in 2019 and emphasizes sustainable development as the overarching policy objective for the sector. It appropriately focuses on profitability and value creation, an enhanced quality of life for locals, a unique visitor experience, and environmental conservation.

- With the pandemic over, work has restarted on an action plan for the Tourism Policy Framework that aims to balance tourism growth with its social and environmental impact. Working groups comprised of government and industry stakeholders will work on defining concrete actions for the action plan, targeted for completion in late-2023.
- The authorities are also developing the Tourism Balance Axis to measure the impact of tourism on Iceland's economy, infrastructure, public services, and society, and whether the tourism carrying capacity of these factors have been reached.
- Other policy initiatives include the development of the Varða/Sites of Merit program, which was launched in 2021 to highlight exemplary holistic destination management at popular tourist sites – Þingvellir National Park was the first destination to be awarded in June 2022.

³ Icelandic Tourist Board visitor surveys

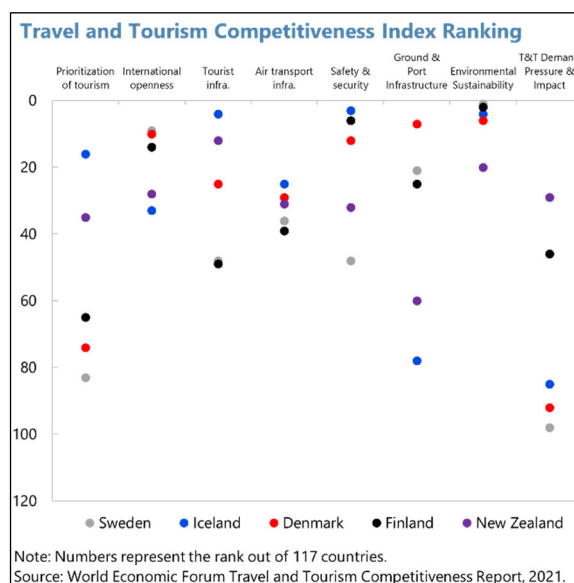
- Destination management plans (DMPs) have assisted regions in identifying their geographical attributes and key target markets, and led to better collaboration with local government planning authorities, e.g., on traffic management, construction planning, and tourism education.

8. To improve competitiveness and efficiency, the authorities have also implemented several recommendations from the OECD Competition Assessment review of 2020. These include a rationalization of costs imposed on the restaurant sector and the removal of overly prescriptive standards for accommodations and hotels.

C. Challenges

9. The tourism boom in Iceland has undoubtedly contributed significantly to the economy, but the surge of tourist arrivals has also imposed several negative externalities. This includes pressure on the local housing market, as the supply of accommodation has been unable to keep up with the surge of visitors, and strains on public services from the growing number of users. Particularly in certain popular sites during busy seasons, the environment has also come under pressure, and facilities can get overcrowded.

10. The tourism model needs to be reexamined in light of current and future challenges, including from impacts of global emissions reduction efforts on the aviation industry. Prior to the pandemic, the collapse of low-cost carrier WOW air in March 2019 and the global grounding of Boeing 737 Max hampered Icelandair's capacity to boost supply, and had already called into question the tourism-led growth model. Looking ahead, global efforts to reduce emissions from international travel through the EU's Fit for 55 scheme, if implemented without adequate adaptations, could adversely impact the cost and availability of flights to Iceland. This could limit the strength of the hub-and-spoke model, which contributed greatly to the growth of Iceland's tourism sector. The sector thus needs to increase its resilience to these and other potential shocks in the future.

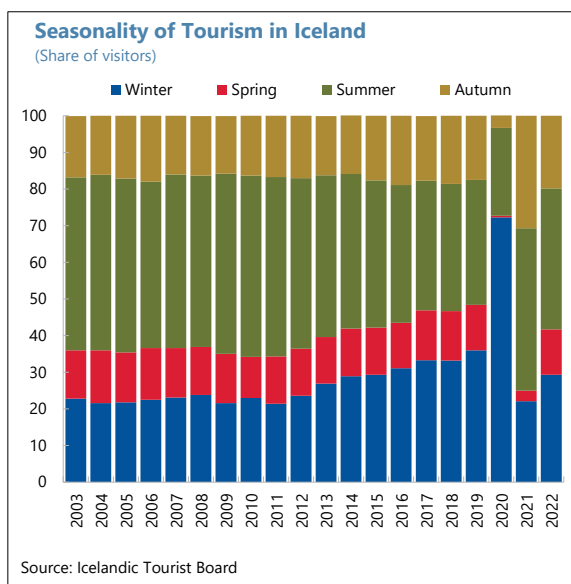


11. Iceland consistently underperforms in ground and port infrastructure in the WEF rankings. Infrastructure limitations mean tourism is concentrated around the south and west of the island. For example, capacity at Keflavik airport has not grown in tandem with the increased traffic, and road accessibility in certain parts of the country can be challenging in periods of inclement weather. There is also a lack of connectivity with regional airports, such as Akureyri in the north and Egilsstadir in the eastern part of the country.

D. Policy Recommendations

12. To strengthen the social and environmental sustainability of tourism, the authorities should further explore new avenues for growing the industry without increasing the already-high number of tourists. The focus in the Tourism Policy Framework is appropriately on maximizing the contribution of the tourism sector in a sustainable manner that protects the natural resources on which tourism depends, and limits the negative spillovers (see Box 1 for examples of sustainable tourism practices in other countries). This means not pursuing volume growth strategies, but rather focusing on increasing value (or yield) through other mechanisms.⁴ Measures could include:

- **Targeting high value, instead of volume.** Tourism marketing has been focusing more on attracting high-value tourist segments, and in recent years has included participation in luxury travel shows and a greater emphasis on the “Meetings, Incentives, Conferences and Exhibitions” (MICE) sector. The authorities could consider including a broader definition of “high value” to target not only tourists with higher budgetary resources and greater willingness to spend, but also encompass tourists who are environmentally aware, keen to engage with local communities, and seeking a low carbon footprint.^{5,6} Specific target markets taking into account the emissions and expenditures of tourist origins could also be considered (see Box 1).
- **Encouraging longer stays,** which would allow the same contribution to value added with fewer tourists, hence a lower carbon footprint. Longer-stay visitors are also more likely to travel more widely, helping disperse both the positive and negative spillovers of tourism to different regions of Iceland.
- **Further developing the range of unique experiences offered to tourists.** This could encourage a positive feedback cycle: it would also be easier to sell more activities to longer-stay tourists, and providing a larger range of activities can also induce tourists to stay longer. Activities could include specialized tours, cultural visits, and nature excursions. Iceland is well-positioned to take advantage of the growing trends in adventure tourism and wellness travel, given its unique landscape and



⁴ Oklevik et al (2019). “Overtourism, optimisation, and destination performance indicators: a case study of activities in Fjord Norway”, *Journal of Sustainable Tourism*.

⁵ Gossling, S., Ring, A., Dwyer, L., Andersson, A.-C., & Hall, C. M. (2016). “Optimizing or maximising? A challenge to sustainable tourism”, *Journal of Sustainable Tourism*.

⁶ New Zealand has focused on targeting high-value segments (2019 New Zealand-Aotearoa Government Tourism Strategy). Discussions are afoot in the industry on the broadening the definition of “high value” beyond economic factors.

natural endowments. While some efforts are already being made in this direction, there is ample potential for these segments to grow further. Increasing the range of experiences on offer across different times of year could also help to reduce the seasonality of the sector.

- **Increasing accessibility to more remote regions.** Improved accessibility will allow a diversification of tourism to other regions and communities in the country, beyond the south and western regions. This includes infrastructure improvements, e.g., enhancing the capacity of Keflavik airport and ensuring road accessibility particularly in periods of inclement weather, and improving connectivity to regional airports.

13. To manage the negative externalities on natural resources, the authorities could also consider implementing price-based measures (e.g., departure taxes, charges on cruise ships, and entrance fees to national parks) and revisit the need for a reduced VAT rate in the tourism sector (see Box 2 for further details). Several measures are being analyzed as part of the review of the overall framework for tourism taxation, which was a commitment made in the 2021 Agreement on the Platform for the Coalition Government. The accommodation tax will also be reinstated from 2024.

E. Conclusion

14. The development of a new action plan gives Iceland an opportunity to have a fresh look at the tourism model, and enact necessary and important structural change to build a stronger and more resilient tourism sector for the future.

Box 1. Sustainable Tourism Practices in Other Countries

The United Nations World Tourism Organization (UNWTO) and UN Environment Program (UNEP) defines sustainable tourism as one that “takes full account of current and future economic, social and environmental impacts, addressing the needs of visitors, the industry, the environment, and host communities.”¹ Some examples of practices from other countries are provided below:

The environment

- Strategic choices on market development can be informed using a methodology to link tourist expenditures and emissions based on various tourist markets (Norway)
- Encouraging the use of sustainable transport modes (including expanding electric vehicle charging stations) (Norway)
- A new regulatory framework for more sustainable fishing tourism was implemented (Norway)

Local communities (hosts)

- Community-based tourism initiatives that are run by local communities (Sweden, Bhutan).

Tourists (visitors)

- Enhancing digital and information services (such as through a national online platform, mobile apps, augmented reality tools) (Norway)

The industry

- Certification schemes to ensure that tourism businesses meet environmental and social standards (Costa Rica, Sweden, Norway)
- Courses on sustainable tourism development and management (Norway)
- The Better Work Plan (New Zealand) focuses on supporting the tourism workforce and confronting the systemic challenges they face. It includes:
 - Establishing fit-for-purpose education and training (e.g., through partnerships between industry bodies and the Services Workforce Development Council)
 - Showcasing fulfilling and diverse career pathways through public campaigns
 - Establishing a Tourism and Hospitality Accord to identify businesses that meet quality employment standards and practices
 - Exploring options for clearer long-term immigration settings.

¹ UNEP and UNWTO, (2005) “Tourism More Sustainable—A Guide for Policy Makers”

Box 2. Taxation of Tourism in Iceland¹

This box considers how modifications to the tax system could support the government's tourism sector strategy, in particular a reassessment of the need for a reduced VAT rate currently applied to a number of tourism services. It does not consider the appropriateness of the standard VAT rate, which would require a wider analysis of the performance and impact of the VAT across the economy.

Taxing Tourism

Tourism is based on a country's natural or man-made resources that generate economic rents. The appropriate tax policy to share these rents between the private sector and the government depends critically on the nature of the resources and facilities offered by a particular country:

- **Location-Specific Rents:** The ability to extract rents from tourists will depend on the substitutability of the service offered by a particular country. A high price elasticity of demand e.g., for sandy beach destinations in the same coastal region, would imply lower prices, as well as potentially lower taxes.² For resources that are more unique, demand will be more inelastic, giving rise to 'location specific' rents, which can be taxed more heavily. In this scenario, a lower tax rate aimed at boosting activity may result in an overall revenue loss.
- **Incidence of Taxation:** One argument often made in favor of taxing the tourism sector the social welfare loss from raising taxes on foreigners is lower than taxing nationals, making them a politically attractive (non-voting) tax base.² However, the incidence of taxes on the sector (tourists vs. domestic service providers) will depend on the relative elasticities of supply and demand.
- **'Over-tourism':** Also of relevance is the ability of a countries' tourism sector to increase the supply of tourism services in response to higher demand. In the case of countries lowering taxes or subsidizing the sector in order to incentivize consumption, the limited carrying capacity of the accommodation sector or even the country's attractions may result in issues of saturation and overcrowding, with associated environmental and social impacts.

A number of characteristics of the Icelandic tourism sector are relevant for tax policy:

- **Price Inelastic Demand:** Despite relatively high price levels, Iceland has seen growing tourist numbers. Icelandic Tourism Board surveys suggest that non-price factors tend to weigh more heavily on visitors' choice of Iceland as a tourism destination. Industry experts see Iceland as being a unique 'bucket list' destination, competing with other such destinations offering unique nature experiences such as Ecuador, Costa Rica, Norway, and New Zealand. Survey data also suggests that those visiting are from higher-than-average income groups in their home countries.
- **Supply-Constrained Sector:** With close to 100 percent hotel occupancy rates in peak seasons, tourism in Iceland appears to be a more supply-constrained than demand-constrained market in particular in the southern and western regions.

VAT on Tourism in Iceland

VAT is a significant source of tax revenue in Iceland, generating 8.8 percent of GDP in 2021. The standard rate of VAT is 24 percent. A reduced VAT rate (of 11 percent) on services associated with the tourism sector

¹ Written by Alpa Shah (FAD)

² Ebrill, Liam, Michael Keen, Jean-Paul Bodin and Victoria Summers, 2001, *The Modern VAT*, International Monetary Fund, Washington DC

Box 2. Taxation of Tourism in Iceland (continued)

was introduced after the 2008–11 crisis to boost demand.³ With the sector's rapid growth in the last decade, there is a case for reconsidering whether this reduced VAT rate is still warranted:

- **Revenue Generation:** In 2021, total turnover generated by the tourist industry was 405 billion ISK (11 percent of GDP). Given the significance of this tax base, the revenue forgone due to the discounted VAT rate is sizeable and has implications for Iceland's broader fiscal strategy.
- **Efficiency:** Firms operating in the sector may not be able to fully offset VAT paid on their inputs at the standard rate against the services sold at a reduced rate. This may be particularly detrimental to small and medium enterprises (SMEs), and is of relevance where the government is trying to incentivize new supply and development of tourist facilities in the more remote areas of the country.
- **Equity:** A key reason for reduced rates on certain basic goods and necessities is the promotion of equity, as lower income households spend a greater share of their income on these items. Tourism services used exclusively for leisure (e.g., tours) should arguably be taxed at the standard rate.
- **Compliance and Administration:** Multiple VAT rates complicate administration and compliance, and create opportunities for abuse, especially given the wide gap between the standard and the reduced rate. The variation opens opportunities for misclassification for tax purposes (e.g., rental of a snowmobile represented as a snowmobile tour), including in cases where service providers (e.g., tour operators or hotels) bundle inputs upon which multiple rates apply.^{4,5}

Given the wide gap between the 11 percent reduced rate and 24 percent standard rate, the authorities could consider a gradual phased approach to increasing the rate, over 3 to 4 years. This would allow time for adjustment and to observe the reaction of supply and demand in different service categories, as well as to manage the risk of adding excessive upward pressure on prices.

VAT on Tourism: International Practice

Across Europe, most countries apply some form of reduced rate to hotel accommodation and restaurants. Of the Nordic countries, Norway applies a reduced rate to hotel accommodation, passenger transport and certain cultural activities but not to restaurants. Sweden provides a reduced rate for hotel and restaurant services, but not for transportation or cultural events. Seven EU countries offer a reduced rate on passenger transportation.

Where reduced rates are offered for hotel accommodation, restaurants, passenger transportation or cultural activities, the average VAT rate discount across 29 European countries is 12.5 percent, ranging widely from 9 percent to as high as 20 percent.^{6,7}

³ This includes hotel accommodation, restaurants, travel agent services and guided tours.

⁴ "Iceland: Modernizing the Icelandic VAT", IMF Country Report No. 14/291.

⁵ While hotel accommodation is taxed at the reduced rate of 11 percent, other guest services (e.g., personal care and wellness, telecommunication, and laundry services) usually provided by hotels are taxed at the standard rate.

⁶ Sample includes 27 EU countries, Norway and the United Kingdom.

⁷ Across Europe, countries have standard VAT rates ranging from 17 percent to 27 percent. For EU countries, the regulated minimum standard VAT rate is 15 percent.

Box 2: Taxation of tourism in Iceland (concluded)

Few countries offer reduced VAT rates for tour operators. For tour operators in the EU, member countries apply the simplified Tour Operators Margin Scheme, which treats all pan-EU transactions as a single supply in their home country, applying VAT on the margin between the cost and sales price, without any deductions for input VAT. A selection of other countries which are considered to be high-value tourist destinations do not offer a wide range of reduced rates or exemptions for services typically consumed by tourists. In fact, the Maldives goes in the opposite direction, with a higher rate for tourism services.

Country	Tax	Rate	Notes
Costa Rica	VAT	13	No reduced rates for tourism services
Ecuador	VAT	12	Zero rate on passenger transportation
Egypt	VAT	14	No reduced rates for tourism services
Maldives	GST	16	Standard rate is 8 percent, 16 percent for supply of tourist goods and services
New Zealand	GST	15	No reduced rates for tourism services
Norway	VAT	25	Reduced rate (12 percent) for hotel, passenger transportation and cultural
Seychelles	VAT	15	No reduced rates for tourism services
South Africa	VAT	15	transportation

Tourism Excises

Some destinations have also introduced corrective taxes to ensure that the negative externalities of tourist visits are reflected in prices. In many cases, the revenue from such taxes is then used to preserve the tourist resource. For example, the Maldives charges tourists an additional 'green tax' of US\$3–6 per day, New Zealand charges an International Visitor Conservation and Tourism Levy of NZ\$35 (US\$22), charged when paying visa fees. Costa Rica charges a US\$15 Tourism Arrival Tax, and Ecuador charges a tax of US\$20 for tourists visiting the Galapagos Islands. At the extreme, Bhutan charges a daily US\$200 visa fee for visiting tourists. In the region, Norway is considering introducing a tourist levy in 2024.

In general, it is advisable to limit the use of specific fees to very unique tourism sites or activities, and to otherwise apply a more general approach, e.g., departure fees included in the cost of air tickets, visa fees, hotel charges or entrance fees to ecologically sensitive areas. This approach strikes a balance between extracting the maximum rent from highly inelastic consumer demand, while ensuring that there is a low-cost way to administer the taxes.



Appendix I. Draft Press Release

IMF Executive Board Concludes 2023 Article IV Consultation with Iceland

FOR IMMEDIATE RELEASE

Washington, DC – [June 14, 2023]: The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation¹ with Iceland. This also included a discussion of the findings of the Financial Sector Assessment Program (FSAP) exercise for Iceland.²

The Icelandic economy has shown remarkable resilience and rebounded quickly from the multiple shocks in recent years. Real GDP grew by 6.4 percent in 2022, the fastest since 2007, on the back of a strong rebound in tourism and domestic demand, and higher incomes from an improvement in the terms of trade. The economy is currently operating well above potential which, together with high import and house prices, has pushed inflation significantly above target, and contributed to external imbalances. The Central Bank of Iceland has raised the policy rate by 800 basis points between April 2021 and May 2023, and tightened macroprudential measures. Fiscal policy was contractionary in 2022, though not enough to sufficiently slow domestic demand, and the underlying fiscal stance deteriorated.

While growth is expected to moderate to 3.2 percent in 2023 and 1.9 percent in 2024 on headwinds from abroad and tight macroeconomic policies, the medium-term outlook is favorable. In the near term, policy tightening coupled with headwinds from the deteriorating terms of trade will dampen domestic demand and reduce imbalances, though private consumption growth is likely to remain robust on a further drawdown of household savings and strong employment growth supported by continued immigration. Merchandise exports are projected to moderate on slower trading partner growth, though tourism is expected to continue growing. Over the medium term, exports will be the main growth driver, while continued policy tightening brings domestic demand to sustainable levels. Inflation is forecast to decline modestly to around 7 percent by end-2023 on tighter macroeconomic policies, and approach target by end-2025. The current account is projected to gradually strengthen on lower import prices and tighter policies, and to revert to a surplus over the medium term. The outlook is subject to significant downside risks including more persistent inflation, tensions around

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

² Under the FSAP, the IMF assesses the stability of the financial system, and not that of individual institutions. The FSAP assists in identifying key sources of systemic risk and suggests policies to help enhance resilience to shocks and contagion. In member countries with financial sectors deemed by the IMF to be systemically important, it is a mandatory part of Article IV surveillance, and supposed to take place every five years.

the upcoming wage negotiations, and tighter global financial conditions. Potential upside risks stem from breakthroughs in the pharmaceutical industry and other non-traditional industries, and commercialization of climate mitigation technologies.

Iceland's robust financial system has weathered the impact of the covid pandemic, owing to substantially improved macro-financial frameworks since the global financial crisis. As outlined in the Financial System Stability Assessment it is exiting the pandemic with a resilient and a highly capitalized banking sector. Banks have high profitability, and liquidity positions exceeding regulatory minima, but there remain areas of vulnerabilities. The sector is highly exposed to mortgages and commercial real estate and could come under pressure if downside risks materialize. Foreign funding from unsecured debt securities and nonresident deposits accounts for about a quarter of total funding and is mainly used to finance foreign-currency denominated corporate loans. Given continued tightening of global financial conditions, banks may have to roll over upcoming maturing foreign-currency bonds at higher spreads. Pension funds are an important source of funding for banks, mostly through holdings of shares, direct deposits or covered bonds. Banks could face funding pressures if pension funds were to re-direct their investments from domestic to foreign markets.

Executive Board Assessment³

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³ At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Iceland: Selected Economic Indicators, 2017–28

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
						Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
(Percentage change unless otherwise indicated)												
National Accounts (constant prices)												
Gross domestic product	4.2	4.9	1.8	-7.2	4.3	6.4	3.2	1.9	2.1	2.1	2.1	2.2
Total domestic demand	7.6	4.5	0.5	-1.1	6.3	6.4	1.2	0.9	1.1	1.2	1.4	1.6
Private consumption	8.0	4.8	1.7	-3.4	7.0	8.6	1.8	0.9	1.1	1.2	1.5	1.7
Public consumption	2.9	4.7	3.9	5.1	2.4	1.6	0.8	1.0	1.0	1.0	1.0	1.0
Gross fixed investment	10.6	2.3	-4.1	-7.4	9.8	6.9	2.6	1.6	1.6	1.6	1.7	1.8
Net exports (contribution to growth)	-2.9	0.7	1.5	-6.1	-2.1	-0.2	1.6	1.0	1.0	0.9	0.7	0.7
Exports of goods and services	5.1	0.4	-5.5	-31.1	14.7	20.6	5.8	3.0	3.6	3.4	3.2	3.2
Imports of goods and services	11.8	-0.9	-9.1	-20.6	19.9	19.7	2.0	0.7	1.4	1.5	1.7	1.9
Output gap (percent of potential output)	1.5	3.6	3.5	-5.2	-2.5	0.9	1.5	0.9	0.6	0.3	0.1	0.0
Selected Indicators												
Gross domestic product (ISK bn.)	2,642	2,844	3,024	2,919	3,245	3,766	4,117	4,353	4,603	4,843	5,103	5,384
Gross domestic product (\$ bn.)	24.7	26.3	24.7	21.6	25.6	27.8	29.1	31.4	33.9	36.4	39.1	42.0
GDP per capita (\$ thousands)	73.1	75.4	69.1	59.2	69.3	74.0	75.2	81.6	87.1	92.4	98.3	104.5
Private consumption (percent of GDP)	50.1	50.3	50.2	52.0	52.0	52.2	52.8	52.7	52.3	51.6	50.9	50.3
Public consumption (percent of GDP)	23.7	24.1	24.6	28.1	27.6	25.9	24.6	24.3	24.4	24.8	25.1	25.4
Gross fixed investment (percent of GDP)	21.8	21.8	20.9	21.3	22.2	22.4	22.9	23.0	23.0	22.9	22.6	22.5
Gross national saving (percent of GDP)	26.0	26.4	27.2	22.3	20.0	21.1	21.5	21.7	22.3	22.8	23.3	23.7
Unemployment rate (percent of labor force)	3.3	3.1	3.9	6.4	6.0	3.8	3.3	3.6	3.7	3.8	3.9	4.0
Employment	1.0	1.8	0.9	-3.0	3.6	6.9	2.6	1.3	1.5	1.5	1.5	1.6
Labor productivity	3.8	2.6	1.6	-1.9	1.6	0.3	0.6	0.6	0.6	0.6	0.6	0.6
Real wages	7.2	3.7	1.8	3.4	3.7	0.0	0.6	0.6	0.6	0.6	0.6	0.6
Nominal wages	9.1	6.5	4.9	6.3	8.3	8.3	9.3	5.2	4.2	3.2	3.1	3.1
Consumer price index (average)	1.8	2.7	3.0	2.8	4.5	8.3	8.7	4.6	3.6	2.6	2.5	2.5
Consumer price index (end period)	1.9	3.7	2.0	3.6	5.1	9.6	7.4	4.0	3.0	2.5	2.5	2.5
Core CPI (average)	2.0	2.4	2.9	3.0	4.3	7.6	8.5	4.6	3.6	2.6	2.5	2.5
ISK/€ (average)	121	128	141	157	148	159	...	...	...	...	...	...
ISK/\$ (average)	107	108	123	135	127	135	...	...	...	...	...	...
Terms of trade (average)	1.5	-3.8	-0.8	-1.3	3.8	3.0	-2.9	-1.6	-1.1	-0.9	-0.1	-0.1
Money and Credit (end period)												
Base money (M0)	37.9	-1.7	-9.2	11.8	9.0	1.5	9.3	9.9	8.8	7.4	6.9	6.6
Broad money (M3)	5.0	7.0	6.6	7.4	10.9	8.9	10.8	8.3	7.6	6.5	6.3	6.2
Credit to nonfinancial private sector	9.2	11.9	2.9	10.5	10.5	11.2	9.3	5.7	5.2	5.2	5.4	5.5
Central bank 7 day term deposit rate 1/	4.25	4.50	3.00	0.75	2.00	6.00	8.75	...	...	...	...	...
(Percent of GDP unless otherwise indicated)												
General Government Finances 2/												
Revenue	45.4	44.8	42.1	42.2	41.4	41.8	42.8	42.8	42.4	42.0	41.4	41.3
Expenditure	44.4	43.8	43.6	51.2	49.8	46.1	45.5	45.7	45.0	43.6	43.3	43.3
Overall balance	1.0	0.9	-1.5	-9.0	-8.4	-4.3	-2.7	-2.9	-2.5	-1.7	-1.9	-1.9
Structural primary balance 3/	1.9	0.5	-2.0	-0.8	-1.5	-3.1	-1.4	-1.8	-1.2	0.0	0.0	0.2
Cyclically-adjusted primary balance	3.2	1.3	-1.3	-3.9	-5.1	-2.5	-0.8	-1.5	-0.9	0.1	0.1	0.2
Gross debt	71.7	63.2	66.6	77.8	75.6	68.7	65.1	61.2	60.0	58.2	56.5	55.2
Net debt	60.3	50.7	54.4	61.1	60.4	57.1	54.4	51.1	50.5	49.1	47.9	47.0
Balance of Payments												
Current account balance	4.2	4.3	6.5	1.0	-2.4	-1.5	-1.6	-1.3	-0.7	-0.1	0.6	1.2
of which: services balance	10.6	9.0	8.0	1.4	2.3	5.0	7.0	7.3	7.4	7.5	7.5	7.5
Capital and financial account (+ = outflow)	1.1	6.0	6.1	6.1	0.8	-2.4	-1.7	-1.5	-0.8	-0.2	0.5	1.1
of which: direct investment, net (+ = outflow)	-0.7	1.7	2.9	2.3	-0.7	-2.9	-0.8	-1.1	-1.0	-0.9	-0.9	-0.8
Gross external debt	90.3	73.3	78.4	90.4	82.8	75.2	75.2	69.3	64.1	59.6	55.4	51.5
Central bank reserves (\$ bn)	6.6	6.1	6.7	6.4	7.1	5.9	6.0	6.3	6.4	6.6	7.0	7.6

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

1/ For 2023, rate as of end-May.

2/ In 2020, the definition of the general government was expanded to include 24 new entities, of which the largest are the IL Fund and the Student Loan Fund.

3/ Cyclically-adjusted balance excluding one offs.