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EXECUTIVE BOARD MEETING

SM/23/132
Correction 1

June 14, 2023

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Iceland—Staff Report for the 2023 Article IV Consultation**

Board Action:	The attached corrections to SM/23/132 (5/31/23) have been provided by the staff:
Mischaracterizations of the Views of the Authorities	**Page 15 (para. 28)**
Evident Ambiguity	**Pages 1, 8 (para. 13, line 6), 20 (para. 41, second bullet, line 4), 42 (para. 2, line 7)**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 2, 5, 8 (para. 13, line 11), 13, 14, 15 (para. 30, and footnote 13), 16, 20 (para. 41, second bullet, line 5), 27, 38, 42 (para. 2, line 4), 65, 68, 72 (Box 2, last paragraph), 73**
Typographical Errors	**Pages 21, 41, 58, 72 (Box 2, second bullet, and footnote 1)**
Questions:	Mr. Saxegaard, EUR (ext. 34846)

INTERNATIONAL MONETARY FUND

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, more 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, Minister of Culture and Business Affairs Lilja Alfreðsdóttir, Minister of Labor and Social Affairs Guðmundur Ingi and other representatives of the public and private sectors.

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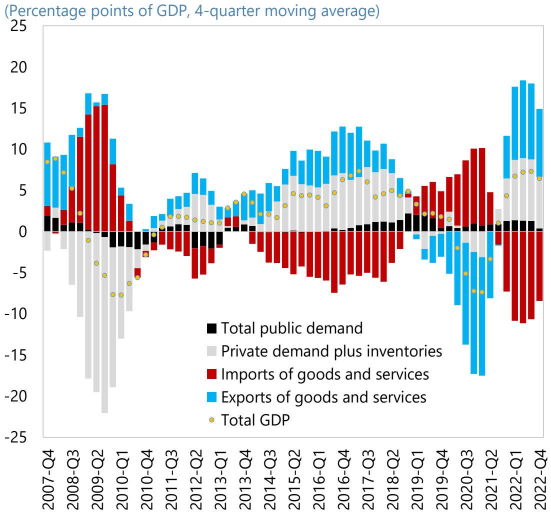
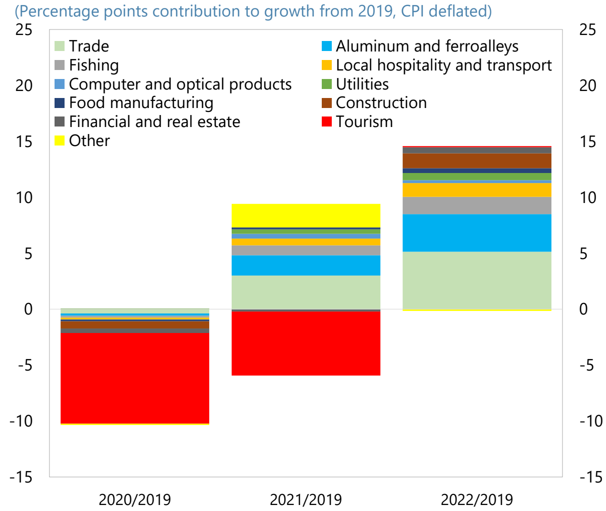
Contribution to Real GDP Growth
(Percentage points of GDP, 4-quarter moving average)



Source: Statistics Iceland

Sectoral Contributions to Real Turnover
(Percentage points contribution to growth from 2019, CPI deflated)



Source: Statistics Iceland

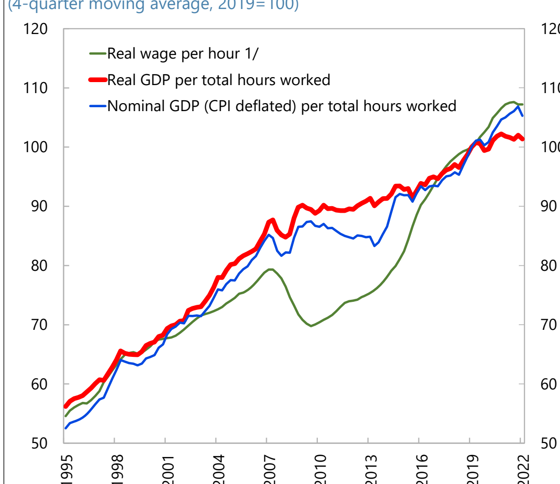
5. The recovery has been driven by domestic-oriented trade and traditional export sectors. Trade sectors generated significantly higher turnover in real terms (CPI-deflated) in 2022 than in 2019, but so did traditional export sectors that benefited from high international prices. While there were 15 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~~ scheduled to be paid in the middle of the year.

Labor Productivity and Real Wage per Hour 1/
(4-quarter moving average, 2019=100)

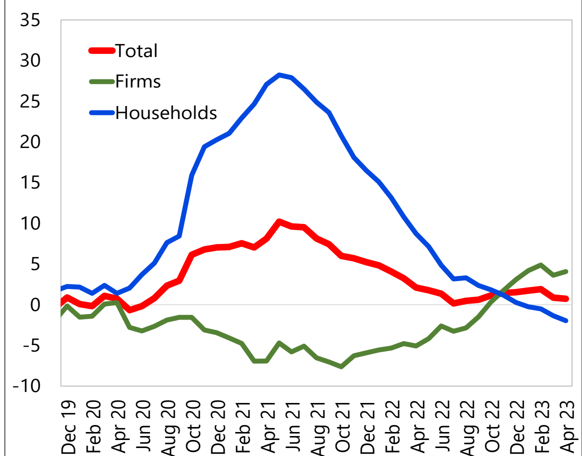


Source: Statistics Iceland.
1/ Labor survey data. National Accounts data differs from the aggregates computed from labor survey

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.

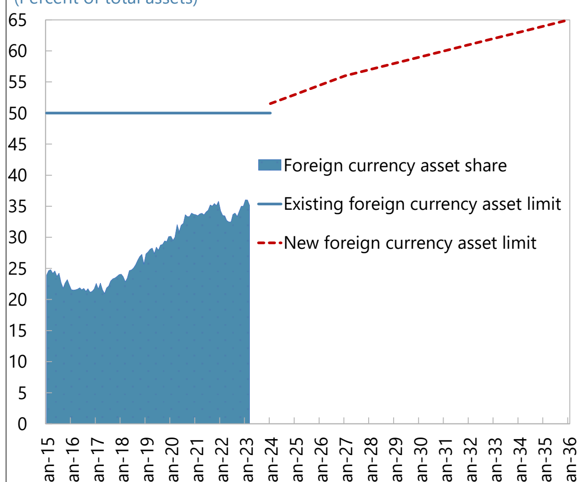
Real Bank Credit to Firms and Households
(Percent, y/y)



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

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, including 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 net FX purchases equivalent to ~~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

Pension Funds' Foreign Currency Assets
(Percent of total assets)



Source: Central Bank of Iceland.

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.

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.

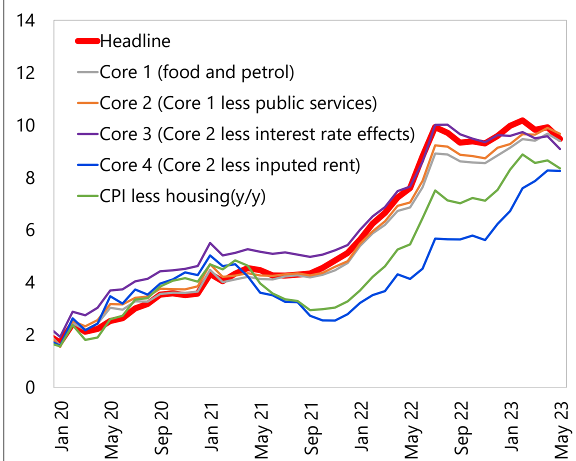
B. Monetary Policy: Tighter for Longer to Bring Inflation Back to Target

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~~presented a report to Parliament 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.

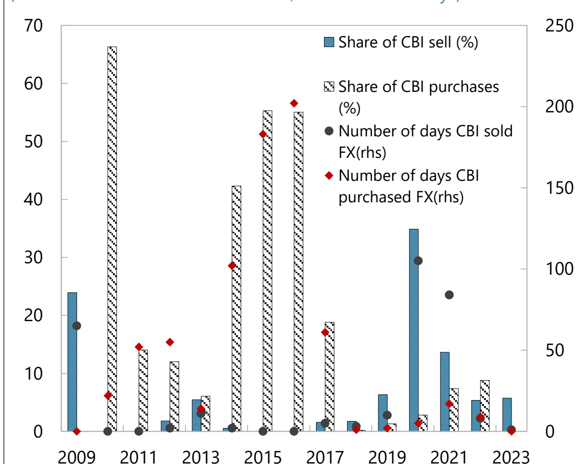
Consumer Price Inflation: 2020-2023
(Year on year)



Sources: Haver Analytics, Inc. and Statistics Iceland.

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~~ 98 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

Foreign Exchange Market Interventions
(Percent of total FX market turnover, and number of days)



Source: Central Bank of Icleand

[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

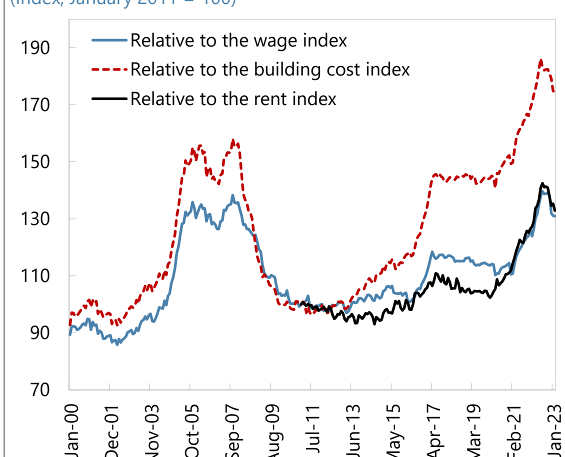
28. The authorities reiterated their commitment to steering inflation back to target. They agreed that inflation has become more broad-based and persistent, and that lowering inflation is proving more challenging than initially envisaged. At the same time, the CBI is firmly committed to its inflation-targeting framework and stands ready to raise interest rates further if necessary 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 VI~~II~~) 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

House Prices Relative to Fundamentals
(Index, January 2011 = 100)



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

[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 for indexed mortgages 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~~ issued covered bonds in foreign currency to broaden their investor base ~~bonds to meet rollover needs of cross-border foreign currency bonds~~.

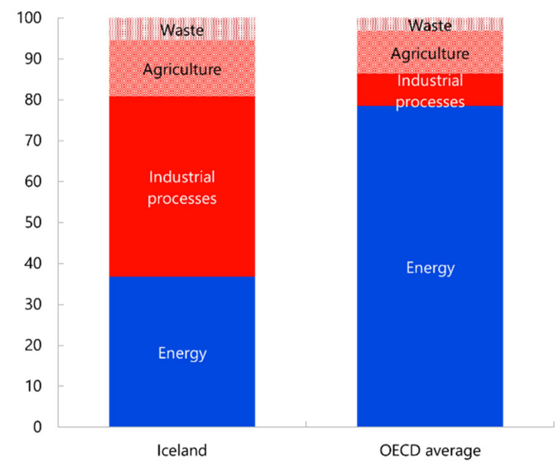
[19] The FSAP sensitivity analysis simulates a parallel 2 percentage point increase in the yield curve (together with a corresponding impact on the risk premium of banks' cost of funding) on top of an adverse scenario that already includes an increase in interest rates of around 4 percentage points.

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]

Sources of Greenhouse Gas Emissions, 2020
(Percent)



Note: Excludes land use, land-use change, forestry, and international aviation.
Source: OECD

- 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~~is producing green hydrogen, and is at the forefront of electric vehicle adoption. However, with emission~~s~~ cuts 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 CO_2 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 ("*hagvaxtarauki*"), 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.

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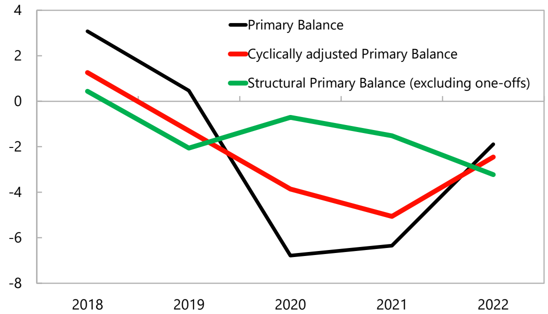
[26] Emissions from flights transiting through Iceland are typically lower than other flights between Europe and the US given that the shorter distance between Iceland and Europe/US allows for the use of smaller and more efficient aircraft. Thus, if EU's FIT for 55 reduces the comparative advantage of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

Figure 5. Iceland: Fiscal Developments and Issues

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

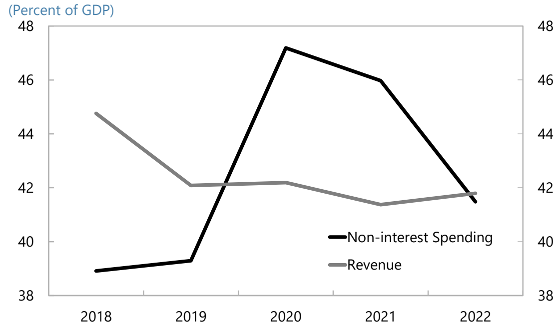
Primary balances: 2018-2022
(Percent of GDP)



Source: Statistics Iceland.

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

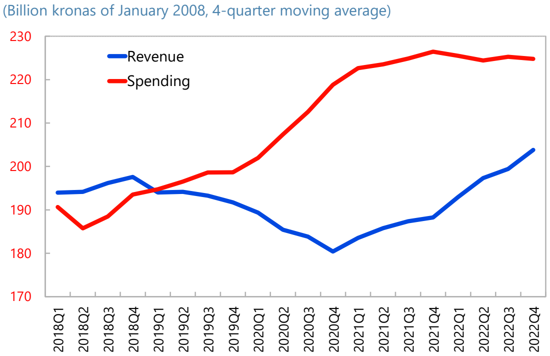
General Government Revenue and Spending: 2018-2022
(Percent of GDP)



Source: Statistics Iceland.

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

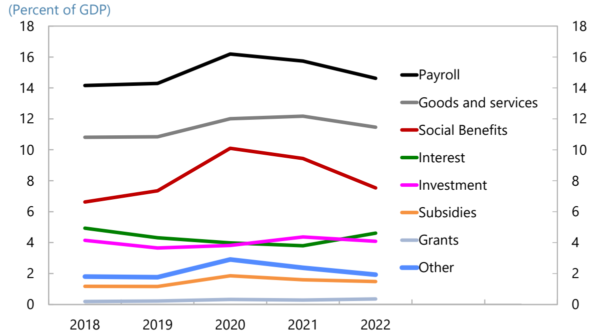
Real General Government Revenue and Spending
(Billion kronas of January 2008, 4-quarter moving average)



Source: Statitics Iceland.

… reflecting a decline in primary spending.

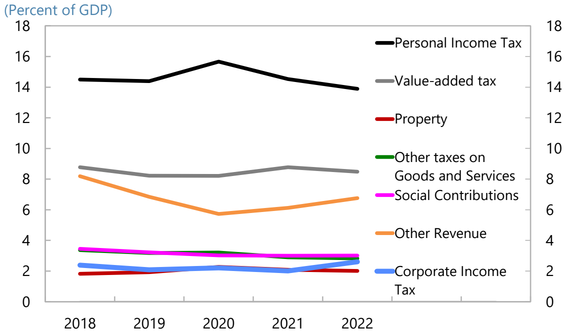
General Government Spending: 2018-2022
(Percent of GDP)



Source: Statitics 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).

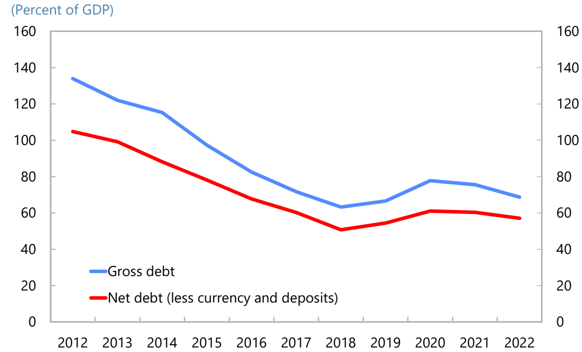
General Government Revenue: 2018-2022
(Percent of GDP)



Source: Statistics Iceland.

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.

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

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/	**REER model** 1/
	(in percent of GDP)	
CA-Actual	**-1.5**	
Cyclical contributions (from model) (-)	0.7	
COVID-19 adjustors (-) 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.

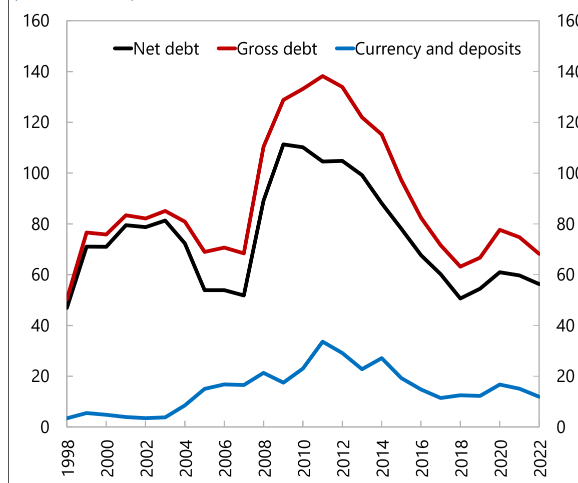
Risks	Relative Likelihood	Impact if Realized	Policy Response
Structural Risks			
Cyberthreats. Cyberattacks on critical domestic and/or international physical or digital infrastructure (including digital currency and crypto ecosystems) trigger financial and economic instability.	Medium	Medium • Disruption 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.

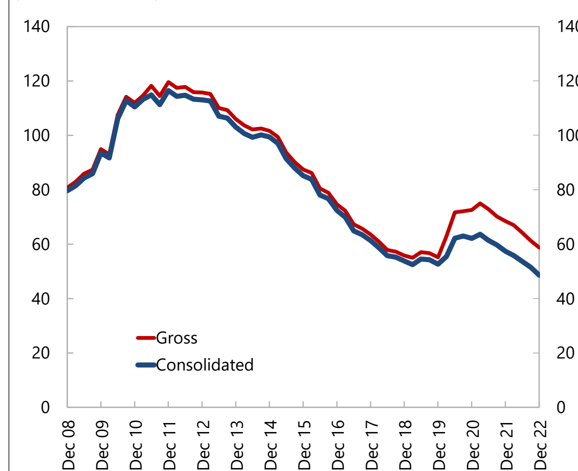
General Government Debt: 1998-2022
(Percent of GDP)



Source: Statistics Iceland

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~~ single A rating. Holders of krona-denominated securities issued by the general government are mainly domestic, while that issued abroad is ~~more diversified~~held by non-residents. 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.

General Government Bills and Bonds
(Percent of GDP)



Source: Central Bank of Iceland.

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.

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.

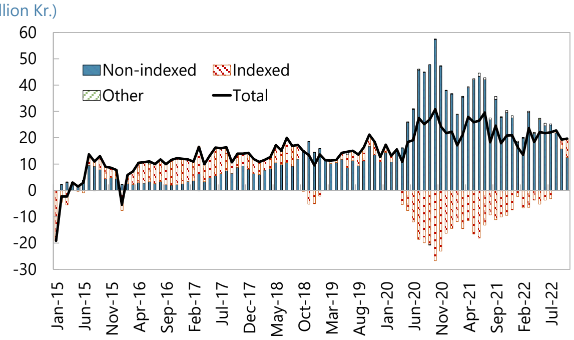
- The CBI lowered the loan-to-value ratio (LTV) for mortgages from 85 percent to 80 percent (keeping it at 90 percent for first-time buyers) in June 2021 and lowered the maximum LTV for first-time buyers from 90 percent to 85 percent in June 2022.

- 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 to 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).

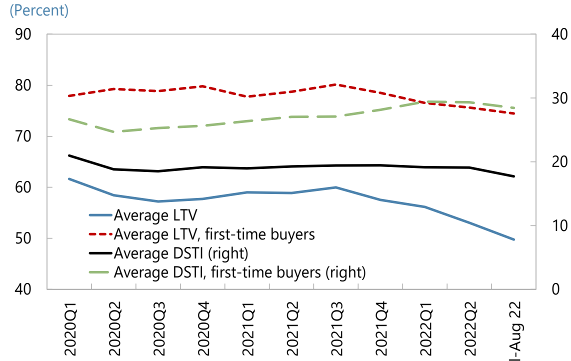
2. The tightening of macroprudential measures, supported by the increase in interest rates, helped mitigate systemic risk and improve resilience. The issuance of new mortgages has decelerated in recent months contributing to a moderation in overall credit growth. The composition of net new loans has 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.

Net New Lending to Households
(Billion Kr.)



Sources: Central Bank of Iceland and IMF staff calculations
Note: 'Other' includes foreign currency-linked loans and leasing contracts. Lending from DMBs, pension funds, and HCA is included. Net new lending consist of new lending net of prepayments of older loans.

LTV and DSTI Ratios for Consumer Mortgages
(Percent)



Sources: Central Bank of Iceland.
Note: Average LTV and ratio on new consumer mortgages.

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[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 IX. Tourism in Iceland – Building Sustainably to Fly Higher[1]

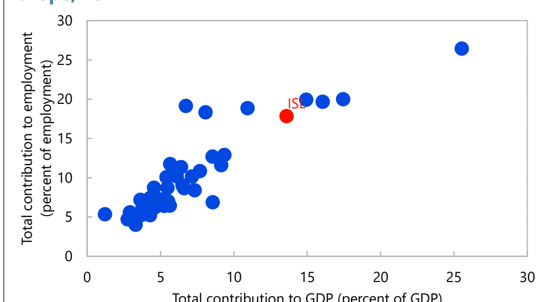
A. Developments in the Tourism Sector

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 almost quadrupled ~~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 its share of employment 12.5 percent ~~of employment~~ in 2022. BOP numbers for 2022 show that travel ~~and tourism~~ constitutes ~~almost a third~~about 20 percent of goods and services exports, and ~~three quarters~~around 45 percent 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-redisents 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.

- 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.

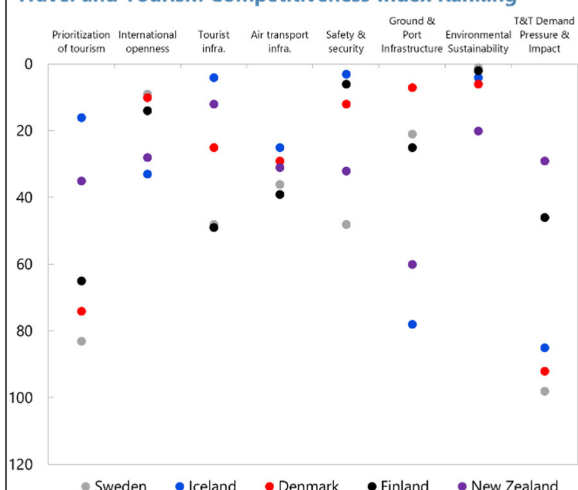
8. To improve competitiveness and efficiency, the authorities have also implemented ~~several~~ many of the recommendations from the OECD Competition Assessment review of 2020. These include a rationalization of costs imposed on the restaurant sector and the removal of overly prescriptive standards for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

Travel and Tourism Competitiveness Index Ranking



Note: Numbers represent the rank out of 117 countries.
Source: World Economic Forum Travel and Tourism Competitiveness Report, 2021.

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.

Box 2. Taxation of Tourism in Iceland[1]

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 is that 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~~ 6 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 broaden the VAT base, improve the neutrality and efficiency of the VAT, and raise fiscal revenue~~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~~ 403 billion ISK (~~11~~ 12.4 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, but with a delay. 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]

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[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.