



ICELAND

2024 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

July 2024

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2024 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis, following discussions that ended on May 22, 2024, with the officials of Iceland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 24, 2024.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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ICELAND

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION

June 24, 2024

KEY ISSUES

Economic Developments. Following an impressive recovery from the covid pandemic and commodity price shocks in recent years, a coordinated tightening of monetary and fiscal policies has successfully slowed domestic demand growth, strengthened the current account, and started to lower inflationary pressures. Recent volcanic activity has disrupted lives and livelihoods, but the macroeconomic impact is limited.

Fiscal Policy. The authorities' fiscal consolidation plans will help rebuild buffers needed to face future shocks, including from further volcanic activity. However, it will likely require additional measures. Reactivation of the fiscal rules in 2026 presents an opportunity to revisit their design to ensure fiscal policy is both sustainable *and* contributes to macroeconomic stability. Strengthening the Fiscal Council would enhance the credibility and accountability of the fiscal-rules framework.

Monetary and Exchange Rate Policies. The current monetary policy stance is sufficiently tight to reach the inflation target, and the central bank should proceed gradually with nominal loosening as inflation declines. An application of the Integrated Policy Framework suggests foreign exchange intervention could be warranted during a risk-off shock given shallow foreign exchange markets. The authorities should seek opportunities to build foreign exchange reserves to strengthen their ability to prevent disruptive exchange rate movements, and explore options to deepen the foreign currency derivatives market.

Financial Policies. The banking sector is well-capitalized, profitable, and liquid. The current tight macroprudential stance remains appropriate given accumulated risks in the housing market. Clarifying the neutral level of the countercyclical capital buffer would improve transparency. Supervisory efforts should focus on key vulnerabilities including from cyber-related operational risks and on strengthening the regulatory and supervisory framework. Sustaining the strong momentum in implementing FSAP recommendations will require continued efforts and robust interagency coordination.

Structural Policies. The recent collective wage bargaining agreement represents a big step forward in Icelandic labor relations. Iceland is well placed to deal with the physical risks from climate change, but further effort will be needed to achieve the envisaged reduction in greenhouse gas emissions. The authorities' efforts to diversify the economy are starting to yield results, but further reforms are needed to maximize the economic benefits of R&D incentives.

Approved By
Kristina Kostial (EUR)
and Peter Dohlman
(SPR)

The mission took place in Reykjavik during May 7–May 22, 2024. The team comprised Magnus Saxegaard (head), Thomas Gade, Fazurin Jamaludin, and Amit Kara (all EUR). Kelly Gao, Zhengting Yue, Petra Mitchell, and Marizelle Evio (all EUR) supported the mission. Guðrún Ögmundsdóttir (OED) joined the discussions. The mission met with Prime Minister Bjarni Benediktsson, CBI Governor Ásgeir Jónsson, Minister of Finance Sigurður Ingi Jóhannsson, Minister of Culture and Business Affairs Lilja Alfreðsdóttir and other representatives of the public and private sector.

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CONTEXT

1. The economy is cooling, narrowing domestic and external imbalances built-up during the post-pandemic period. A coordinated tightening of monetary and fiscal policies has successfully slowed domestic demand growth, reduced inflationary pressures, and strengthened the current account. Implementation of past Article IV recommendations has been good (Annex IV).

2. Iceland is experiencing an increase in volcanic activity on the Reykjanes peninsula. Earthquakes and volcanic eruptions are a regular occurrence in Iceland. However, volcanic eruptions on the Reykjanes peninsula are rare, with the last period of heightened seismic activity taking place between the years 950 and 1240. Volcanic activity in this area is also unusual because it is caused by fissures in the earth's crust that may or may not fill with magma, and not by an explosive volcanic eruption.¹ Fissure eruptions are typically (but not always) less violent and easier to protect against using barriers to divert the lava, and therefore tend to cause less damage to physical infrastructure. While the broader economic implications of the ongoing volcanic activity are limited, the area around the town of Grindavík has been declared unsafe, and the eruptions have absorbed the attention of policymakers (Box 1).

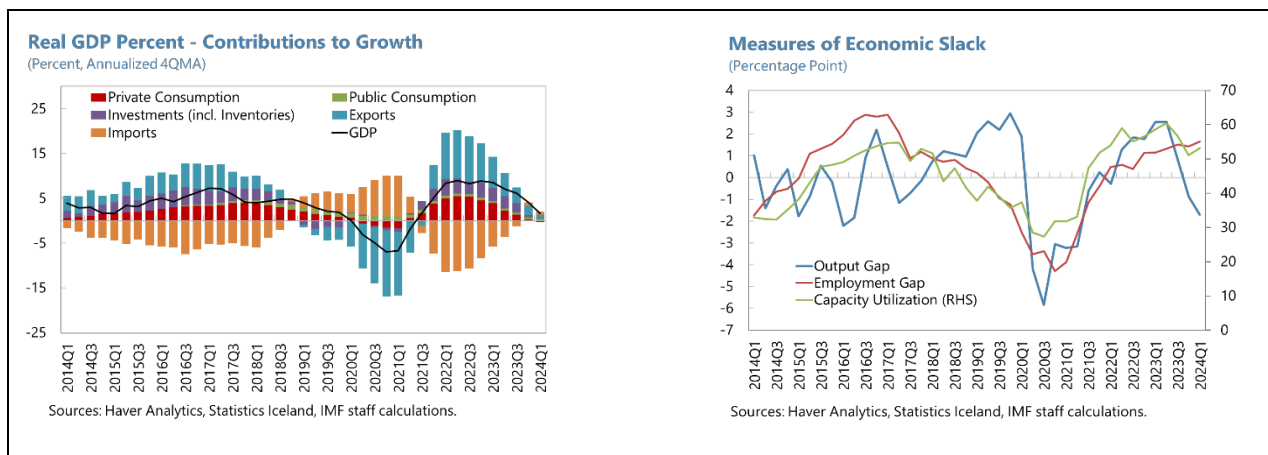
3. A change in the composition of the government is not expected to impact the direction of economic policy. Former Minister of Finance Bjarni Benediktsson has taken over as Prime Minister. He replaced Katrín Jakobsdóttir who stepped down on April 5 to run for President.² Former Minister of Infrastructure Sigurður Ingi Jóhannsson has taken over as Minister of Finance. Parliamentary elections will be held on or before September 27, 2025.

RECENT ECONOMIC DEVELOPMENTS

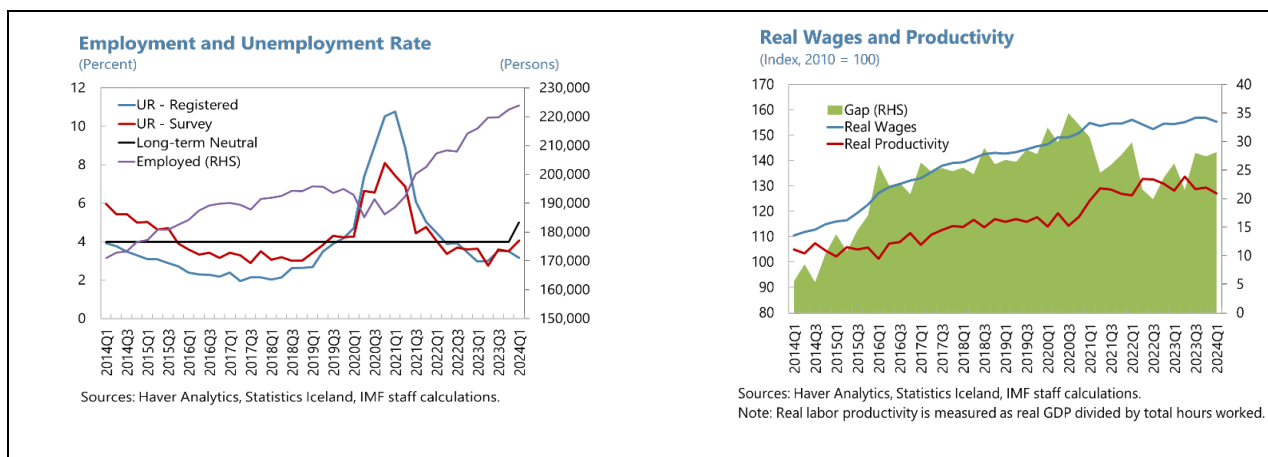
4. The economy grew by 4.1 percent in 2023 but has been decelerating considerably. The economy was operating significantly above capacity in 2022 and early 2023. Domestic demand slowed significantly through 2023 and in 2024Q1 as high inflation reduced real disposable income growth and weakened private consumption, while the increase in interest rates and the cost of capital incentivized household savings and reduced private investments. Imports were sharply lower because of the decline in domestic demand, more than offsetting slower export growth due to weaker external demand and low fish quotas. The output gap is now closing, and slack increasing as evidenced by lower employment and companies' declining capacity utilization.

¹ The only other part prone to fissure eruptions is Vestmannaeyjar (Westman Islands) off the South Coast. Vestmannaeyjar last experienced a volcanic eruption in 1973.

² Presidential elections were held on June 1. Businesswomen Halla Tómasdóttir won the election. The role is largely ceremonial, though the president has the power to not sign legislation, which Parliament can then either withdraw or submit to a referendum.

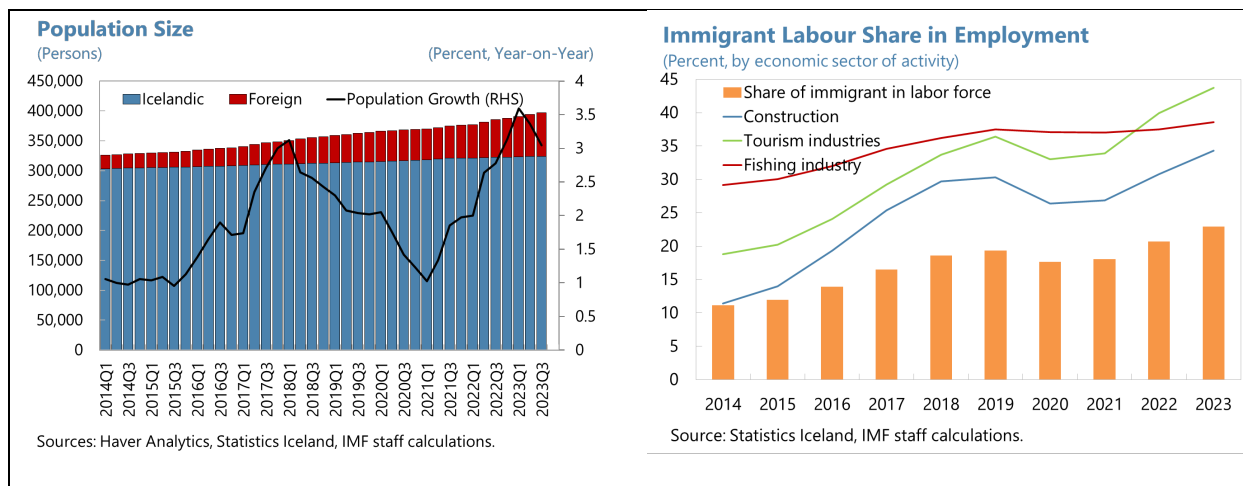


5. Labor market pressures have started to ease. The smoothed unemployment rate fell to 3.3 percent in mid-2023 following a surge in employment that more than offset an increase in the labor force boosted by immigration. Unemployment started to pick up in 2023H2, rising towards the estimated 4 percent neutral rate in early 2024. Nominal wage growth has been high in recent years but started to ease in late-2023 in line with declining inflation. Wage growth has outpaced productivity growth for much of the past decade, but since 2021 real wages have increased by only 1.4 percent compared to a 4.1 percent in hourly real labor productivity over the same period, supporting an increase in competitiveness. Hourly labor productivity is almost 10 percent higher than pre-covid notwithstanding a modest decline in late 2023.

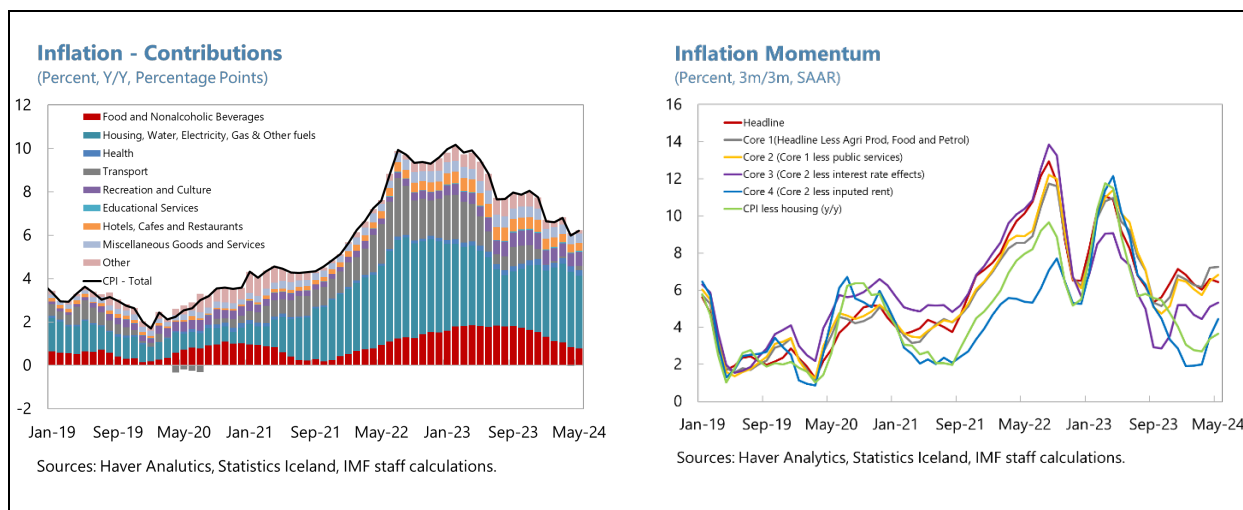


6. Continued strong immigration has eased constraints on the supply of labor. Immigration continued apace through 2023, contributing 2.6 percentage points to the 3.0 percent increase in the population in the four quarters through 2023Q3. The share of foreign labor in the labor force reached 22.9 percent in 2023, with the number of foreign workers particularly high in the construction, tourism, and fishing sectors.³

³ Statistics Iceland recently revised down the foreign share of the population due to an underestimation of the number of immigrants leaving the country.



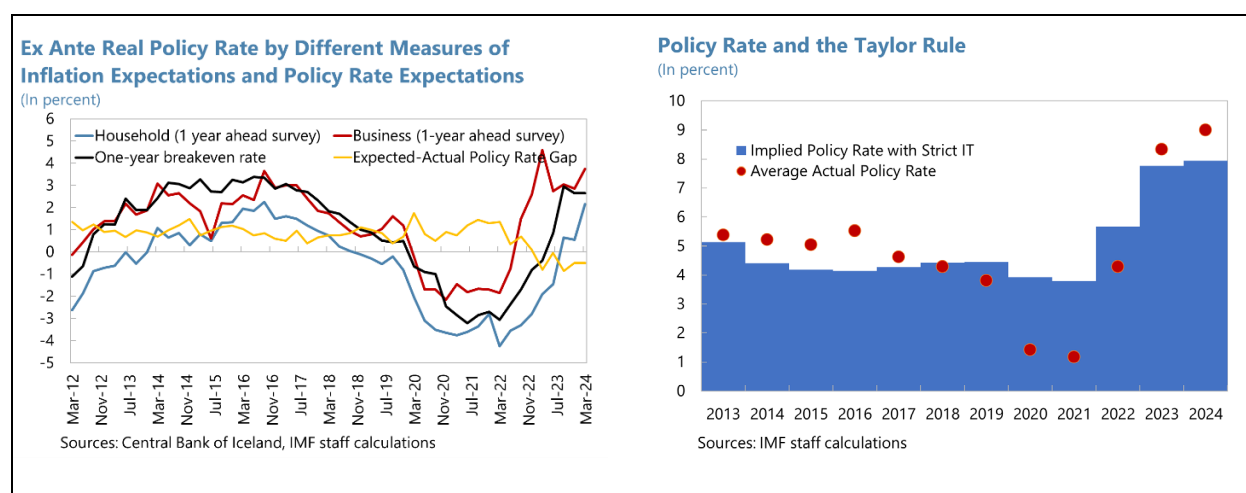
7. While still elevated on a year-on-year basis, measures of core inflation that exclude housing are inside the notification band on a momentum basis.⁴ Headline inflation has declined to 6.2 percent year-on-year in May (6.4 percent on momentum basis) from a peak of 10.2 percent in February 2023, and remains well-above the CBI’s 1-4 percent notification band and higher than in many European countries. Housing costs including interest costs are the main driver: inflation excluding housing was 4.2 percent year-on-year in May (3.7 percent on a momentum basis).⁵ A narrower measure of core inflation that also excludes agricultural products, fuel, and the cost of public services declined to 4.0 percent year-on-year in May (4.4 percent on a momentum basis). 10-year break-even inflation expectations rose in 2022 and early 2023 but have declined to 3.8 percent as of March 2024.



⁴ The CBI has an inflation target with a 2.5 percent headline inflation rate as the target. When inflation breaches the notification band of +/- 1.5 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.

⁵ The real interest rate contributed 1.6 percentage points to inflation in May on a year-on-year basis.

8. The CBI tightened monetary policy significantly in 2022-23 and has kept rates on hold thus far in 2024. It raised the policy rate to 9.25 percent in August 2023, an increase of 850 bps since April 2021. The real policy rate estimated from survey- and market-based indicators of breakeven inflation expectations became positive starting in September 2023 and is currently estimated to be around 2.2–3.8 percent, above recently-increased estimates of the neutral real rate.⁶ Meanwhile, the nominal policy rate is slightly above that predicted by a benchmark Taylor rule. Bank lending rates and bond yields have increased broadly in line with the policy rate. In April 2024, the CBI increased the reserve requirement from 2 to 3 percent to offset the rising cost of holding international reserves.



9. Fiscal policy was contractionary in 2023. The general government budget balance improved to a deficit of 2.0 percent of GDP from 4.0 percent in 2022 due to a combination of higher revenues and expenditure restraint. On a cyclically adjusted basis the deficit declined by 1.8 percentage points, implying a negative fiscal impulse to the economy.⁷

10. Ongoing asset-liability management operations will help reduce debt to levels that will provide further insurance against extreme events. At 65 percent of GDP, gross public debt is below pre-pandemic levels, on a downward path and resilient to shocks (Annex III).⁸ The privatization of Islandsbanki, which is expected to restart in 2024 and be completed in 2025, is expected to reduce gross debt by 2.1 percent of GDP. As part of the sales process the government has tabled draft legislation aimed at increasing transparency, including strengthened oversight by

⁶ The estimated range of the short-term ex ante real policy rate was calculated taking into account the nominal policy rate, two survey-based measures of inflation expectations (households and businesses) and one market-based rate (the one-year breakeven rate). The CBI's composite estimate puts the real rate at 3.3 percent in March 2024. The CBI estimates that the neutral real interest rate is currently between 1.5–2.3 percent, higher than previous estimates of 1.2–1.6 percent.

⁷ Based on a top-down estimate of the cyclically adjusted balance. Given the surge in corporate income taxes a bottom-up estimate would likely imply a more modest, albeit still negative, fiscal impulse.

⁸ Staff's definition of gross public debt includes general government credit institutions, of which the largest are the IL Fund and the Student Loan Fund.

Parliament and a commitment to publicize all bidder details. The willingness of the holders of the securities issued by the Housing Finance Fund (HFF) to engage in discussions to clarify the government’s obligations under the state guarantee are welcome and increase the likelihood of a negotiated settlement that does not undermine investor confidence.

Box 1. Iceland: Reykjanes Eruptions and the Policy Response

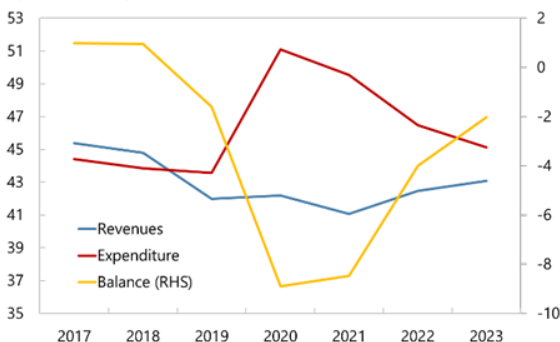
Due to ongoing volcanic activity on the Reykjanes peninsula, the town of Grindavík (1 percent of the population) was declared unsafe and evacuated in mid-November 2023. Commercial activities in the town were halted, though some have since resumed operations. The landing of fish at Grindavík port has been diverted to other towns. The nearby Svartsengi geothermal plant has been able to continue operating though lava damaged a pipe causing temporary hot water shortages in the area.

The government moved swiftly to protect infrastructure and support the needs of households and businesses. Significant efforts were devoted to construction of levees to divert the flow of lava. As a result, the damage to physical infrastructure has thus far been limited. In addition, the government provided temporary wage and housing support to displaced residents as well as operational and financial support for companies. Financial institutions cancelled interest payments on Grindavík residents’ mortgages while the CBI relaxed certain borrower-based measures on homeowners’ next home purchase. Finally, the government together with the main lenders have set up a Special Purpose Vehicle (SPV) to buy up residential property in the area.¹ The envelope for direct budgetary support related to the volcanic eruptions is currently ISK 26.7 billion (0.6 percent of GDP), most of which is financed from the general contingency fund. The maximum potential size of the SPV is estimated at ISK 75 billion (1.6 percent of GDP) of which ISK 36 billion would be provided by the government, while the rest is financed by banks and pension funds with mortgage lending in the area, and the Natural Catastrophe Insurance Fund.

¹ Most of the residential property in Grindavík is not damaged and hence does not qualify for insurance payments from the National Catastrophe Fund.

General Government Budget Balance

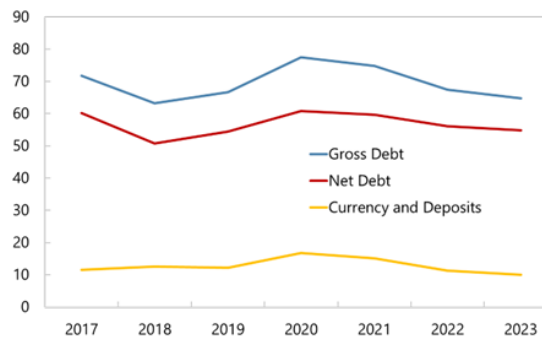
(Percent of GDP)



Sources: Haver Analytics, Statistics Iceland, IMF staff calculations.

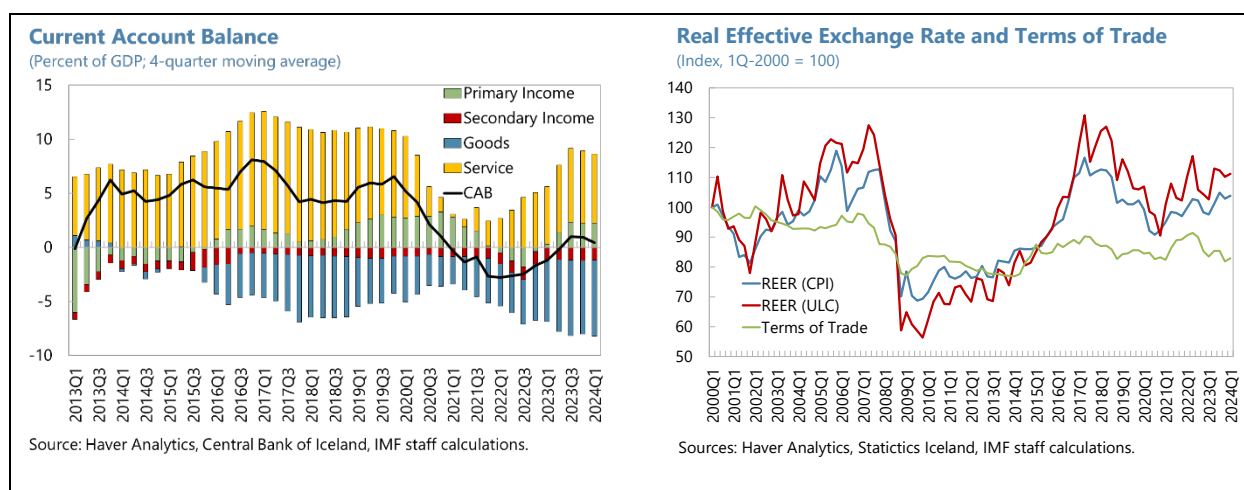
General Government Debt, 2017-2023

(Percent of GDP)



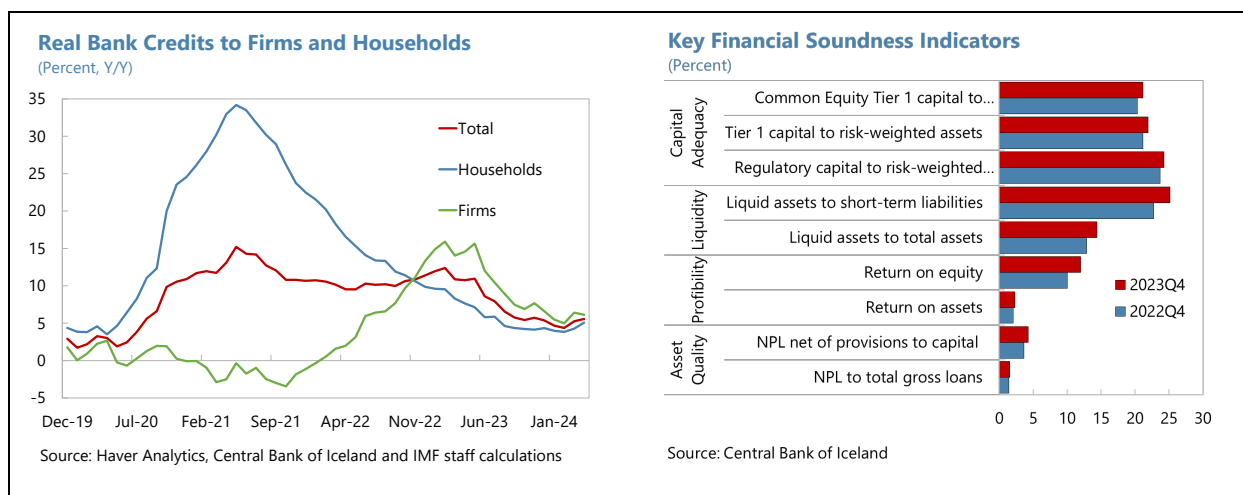
Sources: Statistics Iceland.

11. The current account turned positive in 2023 as strong tourism more than offset a deterioration in the terms of trade but worsened unexpectedly in 2024Q1. The current account balance in 2023 turned into a surplus of 1 percent of GDP due to a further increase in tourism receipts. However, the goods balance worsened as the impact of lower aluminum prices outweighed a sharp deceleration in imports volumes, while the primary income balance improved due to higher receipts of dividends and reinvested earnings, combined with lower profit repatriation by foreign companies.⁹ The financial account saw significant portfolio outflows in 2023, driven by the gradual build-up of foreign assets by pension funds. This was partly offset by FDI inflows associated with the sale of an Icelandic company to foreign investors and by inflows into the domestic bond market. The current account deterioration in 2024Q1 reflects some headwinds in the tourism industry, a disappointing capelin fishing season, and robust investment growth. The real effective exchange rate (REER) remained broadly stable in 2023 and 2024Q1 and staff assess Iceland's external position in 2023 as broadly in line with fundamentals and desirable policies (Annex I).



12. The banking system remains well-capitalized, liquid, and profitable. Capital ratios increased to 24 percent of risk-weighted assets in 2023, supported by an increase in profits as higher interest rates boosted banks' net interest margins. Liquidity buffers are ample, with a liquidity coverage ratio of 232 percent among domestic systemically important banks. Non-performing loans (NPLs) and NPLs net of provisions both rose through 2023 but remain low at around half their pre-pandemic averages. Higher interest rates led to a significant slowdown in bank credit growth in 2023, particularly pronounced for households. Pension funds' share of total financial sector assets has continued to increase with fund inflows far outstripping benefit payouts. While the share of pension funds' assets invested abroad remains well below the regulatory limit, its gradual increase has contributed to portfolio diversification and lower concentration risk.

⁹ Iceland experienced a positive terms of trade shock in 2022 due to rising aluminum prices, followed by a negative terms of trade shock in 2023 as aluminum prices normalized.



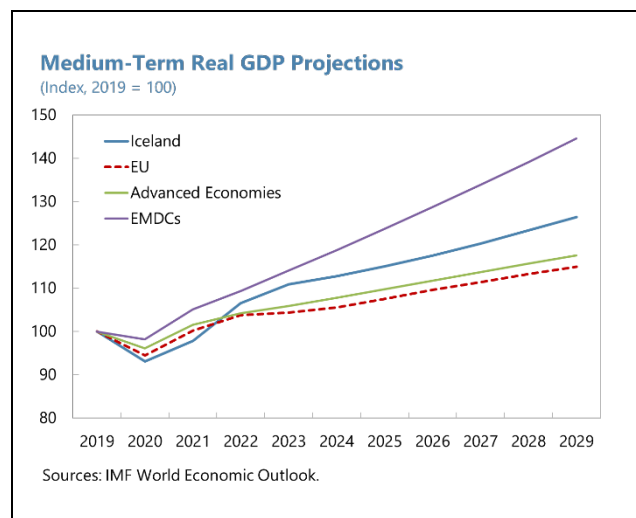
OUTLOOK AND RISKS

A. A Rapidly Cooling Economy with Persistent Inflation

13. The near-term outlook is shaped by continued tight macroeconomic policies, and a gradual recovery in external demand. The monetary policy stance is expected to remain broadly unchanged in 2024 before easing gradually in 2025, while the fiscal impulse is projected to be broadly neutral. The macroprudential policy stance is expected to remain broadly unchanged. Growth among Iceland's major trading partners is expected to increase modestly in 2024 and pick-up pace in 2025, supporting a gradual recovery in demand for Icelandic exports. The terms of trade are expected to improve in 2024 on a recovery in fish and aluminum prices, before deteriorating slightly in 2025.

14. Growth is expected to decline to 1.2 percent in 2024 on softening domestic demand before increasing to 2.4 percent in 2025 as the monetary policy stance is gradually eased. Tight macroeconomic policies and decelerating growth in tourism spending are expected to continue weighing down growth in 2024, contributing to a sharp narrowing of the output gap to 0.2 percent. Domestic demand would start expanding in 2025 driven by a gradual easing of the monetary policy stance and stronger private consumption and investment. A recovery in trading partner demand combined with a positive contribution from pharmaceuticals will provide support for exports in 2024 and 2025. Slower employment growth is expected to be matched by lower inflows into the labor force, resulting in unemployment stabilizing close to the 4 percent neutral rate. Inflation is expected to decline to 4.8 percent by end-2024 and 2.8 percent by end-2025. The main drivers are subdued domestic demand as an increase in the savings rate more than offsets the impact of rising real wages, a modest increase in import prices, and slowing house price growth.

15. Medium-term growth prospects remain favorable. Efforts to diversify the economy towards innovation-based sectors are expected to support productivity growth and increase the resilience of the economy to shocks, while immigrant labor inflows—although more modest than in recent years—will facilitate continued employment growth. The recently concluded multi-year wage agreement will strengthen the link between wage and productivity growth and support external competitiveness. Growth in Iceland is expected to outpace that in other advanced economies (on average) with potential growth averaging 2¼ percent through the projection period.



16. Risks to the outlook are broadly balanced (Annex II). Downside risks to growth and inflation include a sharper-than-anticipated contraction in domestic demand and inflation undershoot due to a larger-than-expected impact from the current tight monetary stance, and a further increase in volcanic activity that causes widespread economic damage and requires significant government support. Upside risks to inflation include tight labor markets that could lead to higher-than-expected wage growth, and a premature loosening of monetary policy in advanced economies that could keep imported inflation high. Upward pressure on inflation could also come from unanticipated spending in the run-up to the 2025 parliamentary elections that would delay fiscal consolidation. External downside risks include an abrupt global slowdown that would reduce demand for Icelandic exports and the price of commodities including aluminum. Meanwhile, cyberattacks on critical infrastructure could disrupt domestic and cross-border payment systems, with significant implications for economic activity and financial stability. Upside risk to economic activity include a faster-than-expected recovery in private consumption fueled by increasing confidence and accumulated savings, and higher tourism receipts. Also, a larger-than-anticipated impact of recent breakthroughs in the pharmaceutical and biotechnology sectors, a greater contribution from knowledge-based firms, and commercialization of climate capture and storage technologies could boost growth.

Authorities' Views

17. The authorities broadly agreed with staff's views on the outlook and risks. They agreed that tight macroeconomic policies would continue to weigh on the economy in 2024, and that inflation was likely to continue to decline. The authorities agreed that risks to the outlook were broadly balanced with upside risks to tourism arrivals offsetting the risk of a faster-than-anticipated cooling of domestic demand. They concurred with staff's assessment that the medium-term growth outlook was broadly favorable and likely to be supported by continued strong immigration, innovation and productivity growth.

MACROECONOMIC POLICIES: SECURING A SOFT LANDING

Policy discussions focused on policies to achieve a soft landing, bring inflation to target, build buffers, strengthen the financial system in line with FSAP recommendations, and structural policies to further diversify the economy and accelerate the green transition.

A. Fiscal Policy: Additional Measures Needed to Build Buffers

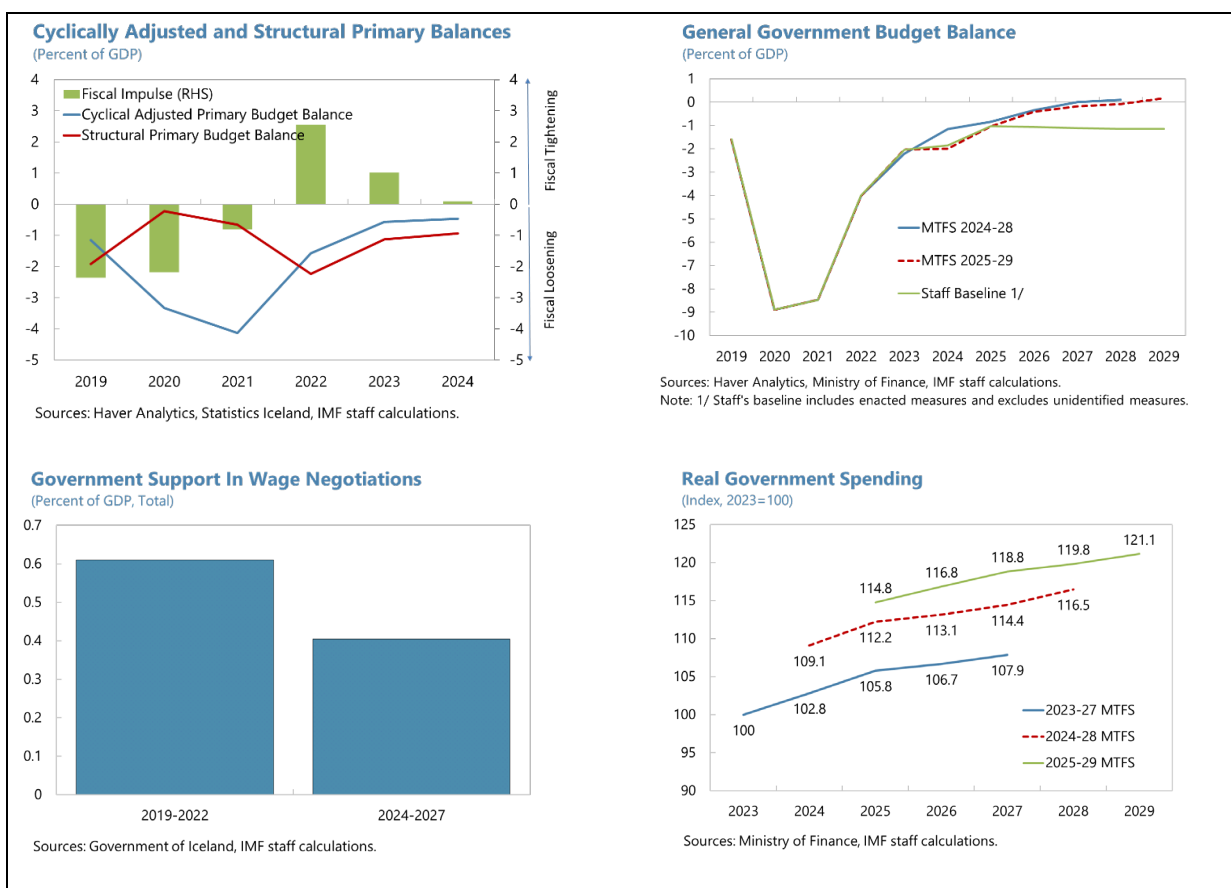
18. Fiscal policy in 2023 was appropriately contractionary, helping to reduce imbalances and start the process of building buffers. The 2023 outturn was broadly in line with the authorities' 2024–28 medium-term fiscal strategy (MTFS) and staff's policy advice in the 2023 Article IV consultation (Annex IV), with some unavoidable spending toward year-end related to the volcanic eruptions.

19. The authorities plan to reduce the fiscal deficit over the next years.

- The original 2024 budget targeted a fiscal deficit of 1.1 percent of GDP. However, the 2025–29 MTFS, which is broadly consistent with staff's projections, suggests a higher general government deficit of 1.8 percent of GDP, reflecting additional temporary expenditure related to the volcanic eruptions, and a structural increase in social spending associated with the recently concluded wage bargaining round.
- Beyond 2024, the MTFS targets a gradual narrowing of the deficit and a fiscal surplus by 2029, consistent with Iceland's fiscal rules that are set to be reactivated in 2026.¹⁰ The envisaged cumulative 2.0 percentage point reduction in the deficit would be achieved by a combination of revenue and expenditure measures, some of which have already been identified (e.g. user-based car taxes, a 15 percent minimum tax on multinational corporations, and increased aquacultural duties) and a further 0.5 percent of GDP that will be identified later.¹¹ However, the projected real value of the expenditure envelope remains higher than in the 2023–27 MTFS, due partly to not all pandemic-related spending being reversed as well as a reclassification of the support for electric vehicles from the revenue to expenditure side of the budget. Staff's baseline forecasts, which incorporate somewhat more conservative revenue forecasts and tax buoyancy assumptions, and only include already-identified measures, suggest the fiscal deficit will narrow by 0.7 percentage points through 2029.

¹⁰ The authorities have reversed their decision to bring forward the reintroduction of the fiscal rule from 2025 to 2026 to allow for more time to reassess of the design of these rules, as the volcanic eruptions have absorbed the attention of policymakers.

¹¹ The user-based car tax is projected to gradually reach a yield of 0.6 percent of GDP in additional revenues per year, starting from 2025.



20. The authorities' fiscal targets for 2024 and beyond are broadly appropriate, though the envisaged medium-term consolidation is likely to require additional measures.

- The broadly neutral fiscal impulse this year is appropriate given the narrowing of economic imbalances. Spending associated with the increase in volcanic activity needs to be accommodated, while the fiscal package associated with the recently concluded wage agreement is less costly than the previous wage bargaining round and partly reflects the lack of cost-of-living adjustments to social benefits. Any revenues above those projected in the budget should be saved to aid the medium-term consolidation effort.
- Beyond 2024, the authorities' ambitious targets are consistent with a gradual increase in fiscal space to face future shocks and commensurate with the magnitude of risks facing the Icelandic economy, including from further volcanic activity. Staff estimates that this will likely require a cumulative 1.3 percent of GDP in fiscal measures over the next 5 years some of which are included in the 2025-29 MTFS projections, but not yet enacted or identified. To achieve that, the authorities could also consider (i) reducing the number of items subject to reduced VAT rates; (ii) streamlining tax expenditures and incentives; (iii) increasing the taxation of realized capital gains on second homes and investment properties; and (iv) reversing the increase in the

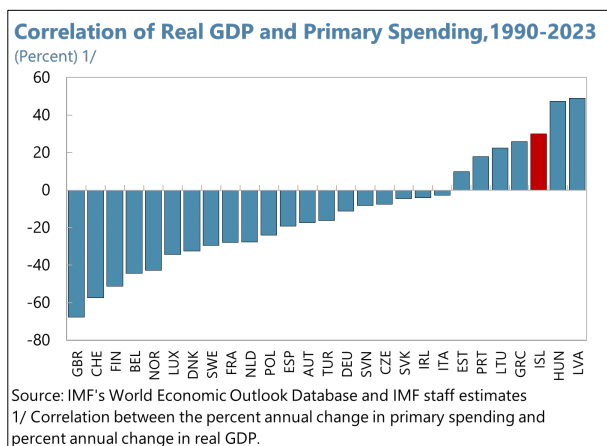
government’s real spending envelope relative to the 2023–27 MTFS.¹² Ceteris paribus, this additional consolidation could lower GDP by 0.4–1.0 percent by the end of the projection period—around 0.1 percent annually—relative to the baseline, though the resulting decline in public debt (to 40 percent of GDP by 2029) would make Iceland well placed to deal with extreme adverse shocks.

	2024	2025	2026	2027	2028	2029
Staff’s Baseline Projection	-1.9	-1.0	-1.1	-1.1	-1.1	-1.1
MTFS (2025-29)	-1.8	-0.9	-0.6	-0.3	-0.1	0.1
Staff’s Recommended Path	-1.9	-0.8	-0.4	-0.1	0.1	0.2
Needed Measures (Cumulative)		0.2	0.7	1.1	1.2	1.3

Sources: Statistics Iceland, Ministry of Finance, MTFS 2025-2029, IMF staff calculations.
Note: Staff’s baseline projection includes enacted measures and excludes unidentified measures.

21. Reactivation of the fiscal rules in 2026 presents an opportunity to revisit their design to ensure fiscal policy is both sustainable and contributes to macroeconomic stability.

- The current fiscal rules require the overall fiscal balance to be positive on average over a 5-year period and sets a 30 percent of GDP cap on net debt.¹³ Both the overall balance rule and the debt rule are effective at ensuring the sustainability of public finances. However, while the overall balance rule allows for deficits during a downturn, it is less effective at ensuring fiscal surpluses during an upturn. Rather, the rule creates an incentive to use cyclically-high revenues to finance new structural spending or reduce taxes, thereby contributing to pro-cyclical fiscal policy that amplifies economic cycles and complicates macroeconomic management. The resilience of the fiscal framework has also been undermined by prolonged periods of suspension resulting in part from excessive constraints on government spending during severe downturns.



¹² According to the OECD, Iceland’s VAT Revenue Ratio (VRR) in 2020—a standard measure of the efficiency of the VAT system—was significantly below the OECD average, suggesting there is considerable revenue potential from VAT base broadening.

¹³ The fiscal rules were suspended in 2019 following the bankruptcy of Wow Air. The suspension was extended in 2020 by five years because of the Covid-19 pandemic and extended by another one year in 2024. The rules are set to be reinstated in 2026.

- To reduce the procyclicality of fiscal policy, staff recommends replacing the existing overall balance rule with a limit on government spending (net of unemployment benefits and interest payments). This could be accompanied by a provision that allows for new spending initiatives if these are fully funded by permanent revenue measures. To provide flexibility to deal with extreme events, the fiscal rules should include well-defined and time-limited escape clauses that specify the correction mechanism once the rule is re-instated. Staff also recommends maintaining a limit on net debt to provide a long-term anchor for fiscal policy, but to replace the existing correction mechanism with (additional) restrictions on spending that (unlike debt) is directly under the control of the government. These restrictions should be carefully calibrated to ensure consistency between the new expenditure rule and the debt rule. Finally, consideration should be given to expanding the coverage of the fiscal rules to better capture the totality of the fiscal risks confronting the sovereign and to reduce the incentive to shift spending and borrowing to parts of the public sector not covered by the fiscal rules.¹⁴

22. Strengthening fiscal institutions would support the credibility and accountability of the fiscal rules framework. In particular, the Fiscal Council should be empowered and given the resources to evaluate the macroeconomic and fiscal projections underpinning the MTFs, including the cost and revenue implications of new fiscal measures, and to assess implementation of escape clauses and correction mechanisms.¹⁵ To improve the ability of the Fiscal Council to monitor compliance, the authorities should also start publishing data on fiscal aggregates corresponding to the coverage of the fiscal rules on a quarterly basis, rather than annually as is currently the case.

Authorities' Views

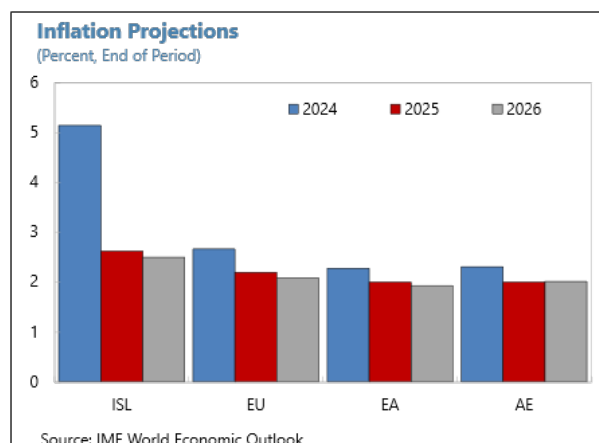
23. The authorities reiterated their commitment to a gradual build-up of fiscal buffers. They noted that reaching the MTFs fiscal targets would require implementing the fiscal measures envisaged in the MTFs, and acknowledged that additional measures could be needed in the event of a revenue shortfall. The authorities agreed on the merits of replacing the overall balance rule with an expenditure rule when the fiscal rules are reinstated in 2026. They also saw merits in staff's proposal to expand the role of the Fiscal Council, as well as the suggestion to expand the coverage of the fiscal rules.

¹⁴ The current fiscal rules relate to a subset of general government referred to as A1. A1 includes activities by the state and municipal governments that are financed by tax revenues, statutory service revenues and contributions. A2 includes state-controlled credit and investment funds and other activities that fund most of their operations through sales of products and services, rent, and credit activities. A3 refers to public enterprises that perform most of their functions in the field of public services.

¹⁵ Empowering the Fiscal Council to assess baseline revenue forecasts and revenue measures is particularly important under an expenditure rule to avoid over-optimistic revenue forecasts that can lead to rising deficits and increasing indebtedness.

B. Monetary Policy: Calibrating Policy to Bring Inflation Back to Target

24. Despite persistently elevated housing costs, headline inflation is expected to reach the 2.5 percent target in the first half of 2026. While price pressures are proving more persistent than in other advanced economies, headline inflation is expected to reach the 2.5 target in 2026H1 on a year-on-year basis and by the end of 2025 on a momentum (3m/3m) basis, within the two-year monetary policy horizon. Measures of core inflation that exclude housing and interest costs are expected to reach the target sooner.¹⁶



25. With the monetary policy stance sufficiently tight to reach the target within the monetary policy horizon, the CBI should proceed with nominal loosening as inflation declines.

- With headline inflation and inflation expectations still elevated relative to the target, the current monetary policy stance—as measured by the ex-ante real policy rate—remains appropriately tight in the near term. As inflation and inflation expectations decline, there is scope to lower the nominal policy rate to avoid a further increase in the ex-ante real policy rate that is not justified by the inflation outlook and could weaken an already cooling economy. The fact that the full effect of the current tightening cycle is likely yet to be seen—monetary policy lags are estimated to be between 12 and 18 months—underscores the need for caution against overtightening.¹⁷ Incremental cuts in the policy rate as inflation declines would give policymakers time to adjust to changes in the inflation outlook and assess the effects of their actions, while reducing the risk of financial market volatility.
- Staff recommends a gradual easing of the monetary policy stance towards the estimated neutral real rate once headline inflation and inflation expectations falls inside the 1–4 percent notification band and there is clear evidence that inflation will return to target.¹⁸ Keeping the real policy rate elevated for longer would increase the risk of an inflation undershoot, in the context of significant lags in the monetary transmission mechanism. Loosening the monetary stance sooner could lead to a resurgence of inflation that could require additional tightening later. Given high uncertainty, the CBI should stand ready to reassess the monetary policy stance if shocks materialize.

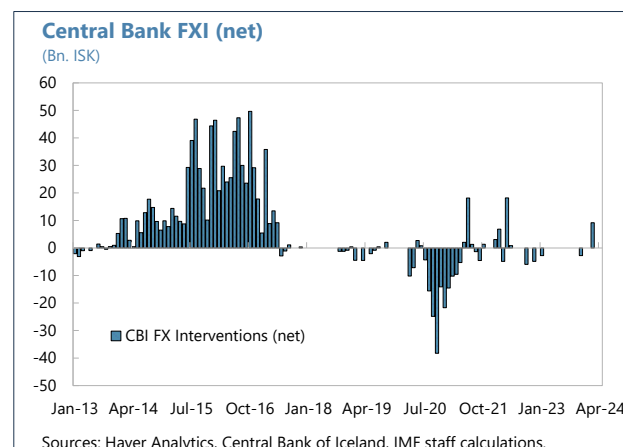
¹⁶ The methodological change to the measurement of the housing component of inflation in June 2024 is likely to reduce its volatility. It is not clear whether this will have an impact on when headline inflation will reach the target.

¹⁷ [Central Bank of Iceland's Monetary Bulletin 2001/4.](#)

¹⁸ Headline inflation is projected to fall within the 1–4 percent notification band by early 2025 on a year-on-year basis.

26. An application of the Integrated Policy Framework (IPF) to Iceland suggests some benefits of foreign exchange intervention at times of stress, in line with the overall strategy pursued by the CBI.

The CBI in recent years has intervened sparingly in the foreign exchange market, selling foreign exchange in early 2023 and purchasing more recently. Iceland is the first advanced economy pilot under the IPF.¹⁹ Foreign exchange intervention could be warranted because the shallowness of foreign exchange markets creates a risk that large and sudden movements in capital flows lead to disruptive exchange rate movements, especially in times of global stress. The pilot study shows that when faced with fundamental external or



domestic shocks (e.g., a global slowdown, or monetary policy miscalibration at home or abroad), the authorities should rely on standard macroeconomic tools including monetary policy, and let the exchange rate adjust freely. However, when faced with large non-fundamental shocks that trigger sudden capital outflows (e.g. a risk-off shock), foreign exchange intervention can reduce the burden on monetary policy and help cushion the impact of the shock.²⁰ While reserves in Iceland are adequate for precautionary purposes, the authorities should consider options to opportunistically build reserves to strengthen their ability to use foreign exchange intervention in line with IPF guidelines to prevent disruptive movements in the exchange rate. They should also explore options to gradually deepen the foreign currency derivatives market, including by reassessing the limits on commercial banks' derivative transactions, to encourage greater participation of foreign investors in the domestic bond market and facilitate hedging of foreign currency risk.

Authorities' Views

27. The authorities reiterated their commitment to steering inflation and inflation expectations back to target. They agreed that it is increasingly likely that the current monetary policy stance is sufficiently tight to bring inflation back to target, but expressed concern that inflation expectations remain unanchored. They cautioned that the upward revision to growth in 2023 may require monetary policy to remain tight for longer than previously anticipated, and pointed to uncertainty about the impact on inflation of the recently-concluded wage agreement and associated increase in government spending. They saw merit in staff's recommendation to deepen the foreign exchange derivatives market but emphasized the importance of proceeding cautiously

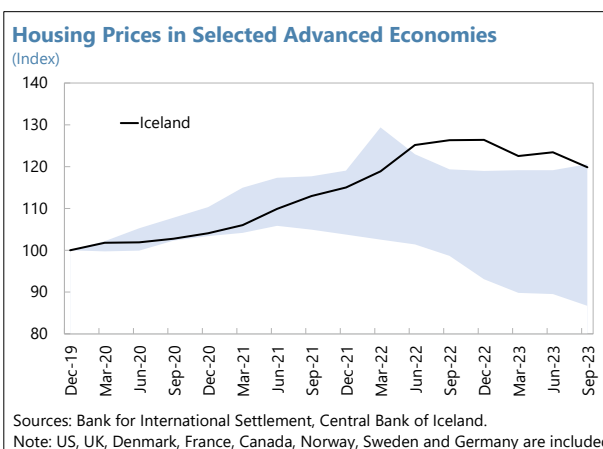
¹⁹ See Selected Issues Paper: Integrated Policy Framework–Iceland Pilot Study

²⁰ IPF guidance on when foreign exchange intervention *could* be useful complements existing Fund policies, including provisions under the Integrated Surveillance Decision (ISD), which note that "A member *should* intervene in the exchange market if necessary to counter disorderly market conditions, which may be characterized inter alia by disruptive short-term movements in the exchange rate" (see [IMF Integrated Surveillance Decision](#) for further details).

to avoid increasing financial stability risks. The authorities agreed that an adequate level of foreign reserve was important to ensure the CBI is able to prevent disruptive exchange rate movements.

C. Maintaining a Robust Financial System

28. Although prices remain elevated and housing affordability remains a concern, risk posed by house price imbalances have receded. While house prices remain high relative to standard metrics, real house prices have stabilized and estimates of house price misalignment have receded, with recent nominal price increases largely driven by structural and one-off factors (Figure 8). Still, the correction in housing prices relative to fundamentals has been modest compared to past peaks and to comparator countries.



29. Despite pressures from higher interest rates, systemic risks are broadly contained and have declined slightly from last year. Borrowers' ability to shift seamlessly from non-indexed to indexed loans—which carry a lower debt service burden in the near term—has cushioned the impact of higher interest rates on loans extended by banks and pension funds.²¹ As a result, the deterioration in households' and corporates' debt repayment capacity has been limited, with overall NPL ratios below pre-pandemic levels and loan impairment increasing only marginally in 2023.²² Financial institutions are also well provisioned against future losses. Meanwhile, bank funding vulnerabilities identified in the 2023 FSAP appear to have receded given outsized foreign currency liquidity buffers, a decline in the cost of foreign funding driven by lower spreads on foreign currency denominated loans, and pension funds' stated intention to maintain their share of investments in the domestic market.^{23,24} While the housing market continues to push the CBI's estimate of the financial cycle upwards, the credit cycle has been moderating, with the credit gap remaining in negative territory amid slowing credit growth and a decline in private sector indebtedness. The CBI's domestic systemic risk indicator, which is more sensitive to recent developments than the financial

²¹ Indexed loans are anchored to the CPI and the impact of indexation is added to the principal and not reflected in debt service payments immediately. Given the impact on principal, the reference interest rates on indexed loans are lower than those on non-indexed loans. The initial debt service burden on an indexed loan is thus lighter. A non-indexed loan exposes borrowers to greater interest rate risk while an indexed loan raises equity risk.

²² The share of stage 2 loans increased by 0.6 percentage points in 2023, due partly to loans affected by the recent volcanic activity being moved from stage 1 to stage 2. The share of loans moved to Stage 3 increased by 0.2 percentage points.

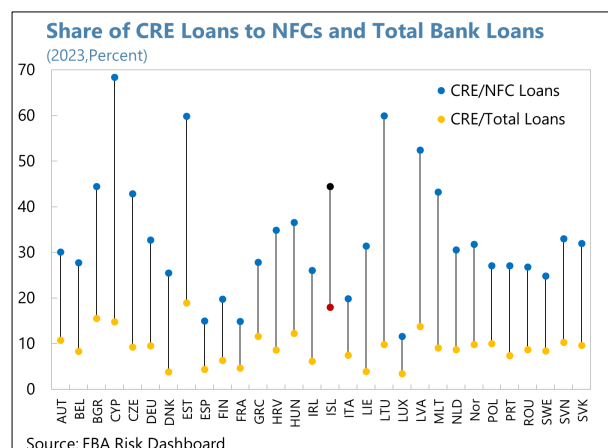
²³ Foreign funding, mainly from unsecured debt securities and nonresident deposits, accounts for about 25 percent of total bank funding. Pension funds are an important source of funding for banks, mostly through holdings of shares, direct deposits, or covered bonds.

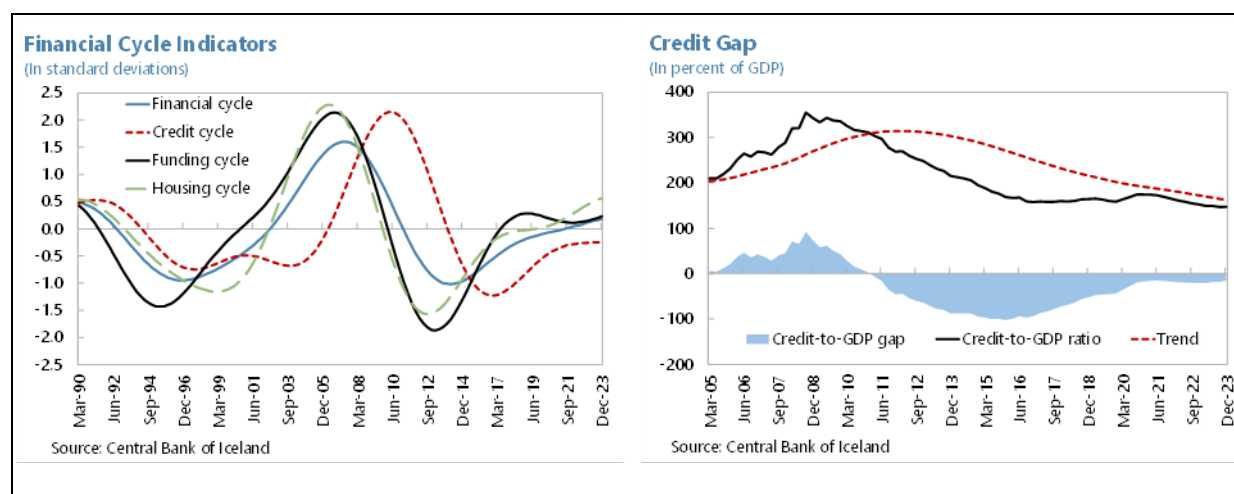
²⁴ A lack of liquidity makes it difficult for pension funds to quickly reduce their exposure to the domestic market.

cycle, further suggests systemic risks are declining, though risks are still evident in the housing market. The CBI's estimate of Growth at Risk remains moderate with a 10 percent probability of an economic contraction over the next 24 months.

30. Households and corporates remain resilient, though bank's high exposure to commercial real estate (CRE) is a source of vulnerability.

- *Households*: Although rising interest rates have translated into an increased debt service burden, household indebtedness has contracted in real terms for over a year and arrears on loans remain close to historical lows. An increase in household savings in 2023 and positive real wage growth should help sustain households' debt service capacity.
- *Non-financial corporations (NFCs)*. NFCs' profitability and ability to meet short-term liquidity needs have recovered since 2021 and are above pre-pandemic levels. Lending to NFCs picked up in the last quarter of 2023 although corporate debt as a percent of total assets remains at the lowest level in a decade. Meanwhile, NFCs' arrears remain contained, with NPLs rising only marginally in 2023. NFCs' reliance on foreign currency and indexed loans—which together make around two-thirds of outstanding corporate loans—has muted the sensitivity of corporate borrowing to domestic interest rates, although NFCs remain vulnerable to the risk of a reassessment of the inflation outlook in advanced economies that could keep foreign interest rates high for long.
- *Commercial Real Estate (CRE)*. CRE prices remain elevated due in part to limited supply—resulting from the slow pace of construction since the global financial crisis—and robust demand. Banks are heavily exposed to the CRE sector, and CRE companies' debt to the banking system continues to increase. However, risks to the banking system are mitigated by low loan-to-value ratios and high risk weights on CRE-backed loans, as well as CRE firms' reduced short-term refinancing needs given a recent lengthening of debt maturities.





31. Supervisory efforts should focus on key areas of vulnerabilities and strengthening the regulatory and supervisory framework. The impact of a slowing economy and still-high interest rates on asset quality requires close monitoring and the housing market remains a potential source of vulnerabilities.²⁵ Maintaining banks' strong liquidity buffers would help ensure resilience, including against foreign currency funding risks and a reassessment of the inflation outlook in advanced economies. Given growing cybersecurity threats, efforts should continue to strengthen the CBI's and the financial industry's operational risk management capacity, in line with FSAP recommendations, including by implementing the EU's Digital Operational Resilience Act (DORA). Meanwhile, supervisors should prepare for the timely implementation of the EU's CRR III regulation that aims to better capture operational risks.²⁶ The CBI should also continue monitoring progress in banks' adoption of the strengthened NPL framework, which aims to facilitate timely identification of credit risks and the assessment of loan impairments, including by improving the recording of NPLs and forbore loans, in line with European Banking Authority guidelines.

32. The currently tight macroprudential stance remains appropriate, but clarifying the neutral level of the countercyclical capital buffer would improve transparency.

- The tightening of borrower-based macroprudential measures in recent years has been effective at containing risks in the residential real estate market. Following the increase to 2.5 percent that came into effect in March 2024, the counter-cyclical capital buffer (CCyB) in Iceland is at the top of the range among European countries, effectively locking in banks' excess capital buffers and bolstering financial sector resilience. The current macroprudential stance remains appropriate given accumulated risks in the housing market, but regulators should stand ready to release the CCyB if downside macro-financial risks materialize.

²⁵ [Follow-Up Report on Vulnerabilities in the Residential Real Estate Sectors of the EEA Countries](#), European Systemic Risk Board, February 2024.

²⁶ CRR III amends the European Banking Authority's Capital Requirements Regulation (EU) no. 575/2013 and introduces a new standardized approach to calculating lenders' capital requirements relating to operational risk.

- Given the lack of excessive credit growth, the CBI should clarify its policy with regard to the neutral level of the CCyB. Iceland's susceptibility to shocks unrelated to vulnerabilities arising from excessive credit growth (e.g. natural disasters and volatile capital flows) argues for a positive neutral rate for the CCyB to provide some insurance against hard-to-predict periods of stress.²⁷ Furthermore, a positive CCyB during normal times would give policy makers time to collect evidence of a build-up in vulnerabilities and allow a more gradual increase in buffers if higher levels are warranted.²⁸

33. Maintaining the strong momentum in implementing FSAP recommendations will require further efforts and robust interagency coordination. The authorities have made significant progress on high-priority FSAP recommendations, including enhancing the CBI's oversight capacity and systemic risk analysis, strengthening macroprudential, liquidity, and crisis management, and bolstering cybersecurity threat preparedness (Annex V). Draft legislation has been tabled in Parliament to strengthen the CBI's ability to ensure the resilience and efficiency of the domestic payment system, while a crisis management handbook has been approved. Meanwhile, the CBI has established a working group to determine the steps needed to operationalize an Emergency Liquidity Assistance (ELA) framework. Work has also progressed on a cybersecurity strategy for the financial sector, which is expected to be completed later this year. However, more progress is needed on reforms to safeguard the independence and effectiveness of the CBI's supervisory activities, including through a streamlined and independent budgetary process for banking supervision, and improved legal protection of supervisors. Further efforts are also needed to improve the governance, internal controls, and risk management of pension funds. Meanwhile, the authorities should continue their efforts to strengthen processes for mitigating money laundering/ terrorism financing risks, including increasing data collection and analysis, enhancing anti-money laundering/countering the financing of terrorism (AML/CFT) supervision of banks, and improving access to beneficial ownership information. Finally, to better understand and estimate the impact of financial integrity events, the authorities should build on ongoing efforts to include such events in bank stress tests.

Authorities' Views

34. The authorities broadly concurred with staff's assessment of the resilience of the financial system. They agreed that households and corporates balance sheets remain resilient despite the increase in interest rates, and that financial institutions have sufficient buffers to deal with a potential deterioration in asset quality. They concurred with staff's assessment that much of the recent increase in house prices was due to structural factors. As a result, they saw limited risk of a housing price correction and instead pointed to the risk that house prices could start increasing when the CBI started loosening monetary policy. They agreed that a positive neutral CCyB makes

²⁷ The large impact of the global financial crisis on Iceland has increased uncertainty about estimating the long-term credit-to-GDP trend and the credit gap, suggesting a positive level for the CCyB would be prudent even when the credit gap is assessed to be closed.

²⁸ The additional time a positive neutral CCyB affords policymakers is particularly valuable given that buffer decisions are typically subject to long phase-in periods.

sense for Iceland, given the difficulty of forecasting turning points in market conditions. The authorities appreciated the positive assessment of progress on implementation of FSAP recommendation and took note of staff's call for further progress on recommendations related to the funding framework for financial supervision and the legal protection of supervisors. The Ministry of Finance and Economic Affairs emphasized that any alteration of the funding arrangements would need to meet constitutional requirements and respect the fiscal authority of the Parliament. The authorities confirmed that continuing to strengthen the AML/CFT regime is a priority and look forward to Fund technical assistance to support ongoing efforts in this area.

D. Structural Reforms are Starting to Bear Fruits

35. The recently concluded collective wage bargaining agreement represents a big step forward in Icelandic labor relations.

- The four-year agreement provides certainty and stability and recognizes the importance of wage bargaining in creating the conditions for macroeconomic stability. Indeed, the 4 percent average increase in wages is broadly in line with targeted inflation and expected productivity growth and should help reduce inflation and preserve external competitiveness.²⁹ Also, the move away from nominal wage increases that are independent of the wage level should allow the negotiated wage settlement to better anchor wage increases across the salary scale and reduce wage drift.
- As during previous bargaining rounds, a commitment by the government to increase social spending was necessary to secure agreement between the parties. While the current framework provides the government with a useful lever to encourage responsible wage agreements, over time it would be desirable to reduce the role of the state to clearly separate fiscal policy and wage bargaining and to preserve the integrity of the budgetary process.

36. Further efforts will be needed to achieve Iceland's ambitious climate targets.

- Iceland's greenhouse gas (GHG) emissions increased by about 4 percent in 2023 compared with 2022, primarily due to higher emissions from aviation.³⁰ Iceland GHG emissions per capita remain high compared to the EU, largely due to significant emissions from energy-intensive industries.³¹ Iceland is an advantageous location for these types of industries given an abundant

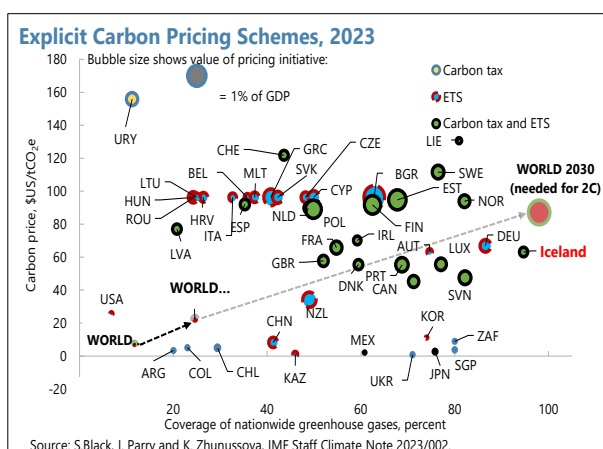
²⁹ Consistent with staff's advice in the 2023 Article IV consultation, the new agreement includes a redesigned bonus anchored to the level of labor productivity at the start of the agreement, which should help prevent real wage increases during periods when labor productivity is declining.

³⁰ Based on Statistics Iceland's data on emissions, which considers emissions of Icelandic entities regardless of where the emissions occur. These differ 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 are reported separately).

³¹ Aviation to and from Iceland is another major source of GHG emissions.

supply of renewable energy that allows aluminum and ferrous alloys to be produced with significantly lower GHG emissions than in other countries.³²

- Iceland is committed to reduce net GHG emissions by at least 55 percent by 2030 compared to 1990 levels, to be achieved jointly with the European Union and Norway, and has a goal of carbon neutrality by 2040. Iceland is currently engaged in discussions with the European Union to confirm a new national target for reducing emissions in sectors not covered by the EU's Emissions Trading System (ETS) scheme that is consistent with the 55 percent goal. The recently released *Climate Action Plan* suggests this could require a reduction in GHG emissions from non-ETS sectors of around 41 percent by 2030 relative to 2005 levels.
- Iceland is broadly on track to achieve its previous national emission reduction target of reducing emissions by 29 percent by 2030 relative to 2005 levels, with a projected shortfall of 4 percent based on existing policies.^{33,34} The updated *Climate Action Plan* outlines ambitious sector-specific mitigation measures to support the new 41 percent emissions reduction target.³⁵ In that context, the authorities should consider raising the economy-wide net effective carbon rate, including by raising carbon taxes in sectors with relatively low levels of taxes on emissions, incentivizing the capture of CO₂ emissions, and scaling up investments in alternative sources of renewable energy including hydropower, wind power, and green hydrogen.³⁶ Broadening the carbon tax base and raising the effective energy tax rate would also help make up for lost revenue from taxes on fossil fuel consumption. In addition, continued support for environmental R&D and investment in green technologies would help climate mitigation efforts and support economic diversification.



³² Almost 90 percent of Iceland's energy needs are sourced from renewables (geothermal, hydro, wind and solar) and almost all the electricity generation is from renewable sources.

³³ The existing emissions reduction target is consistent with the EU's previous emissions reduction target of 40 percent by 2030 compared to 1990 levels.

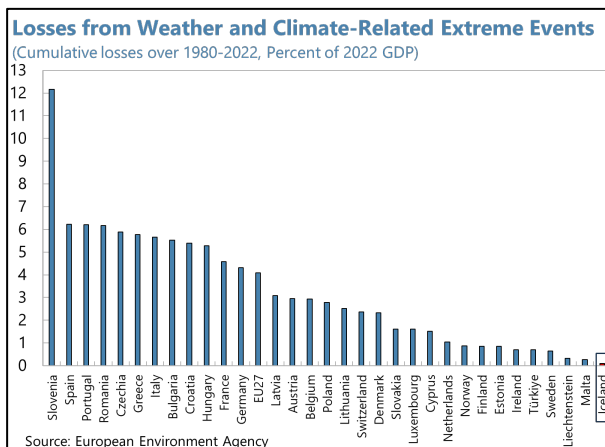
³⁴ Further details on Iceland's progress towards meeting the 29 percent target can be found in the EFTA Surveillance Authority's [Climate Progress Report 2023](#).

³⁵ Further details on the updated *Climate Action Plan* can be found on the website www.co2.is.

³⁶ There is scope to raise carbon taxes on emissions from the use of diesel in the agriculture and fisheries sector, and to broaden the coverage of carbon taxes to electricity production which, in the case of Iceland, includes emissions from the production of geothermal energy. For further details see "On the Road to Carbon Neutrality, Fishing for Energy Exchange and Carbon Absorption", IMF Country Report No. 22/194.

37. Iceland is well placed to deal with the physical risks from climate change.

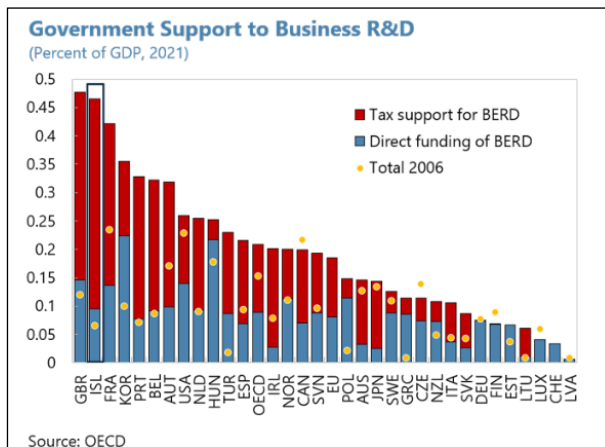
- Iceland has a relatively low exposure to the physical effects of climate change and has a high level of preparedness for natural disasters, as evidenced by low historical losses from climate-related events and a “very low risk” score on the EU’s INFORM Climate Change Risk Index. Looking ahead, Iceland maintains its “very low risk” score even under a pessimistic scenario where the global surface temperature rises by 4°C.³⁷



- Despite Iceland’s relatively favorable position with respect to physical risks the economy will need to adapt to climate change. Investment will be required, for example, in the power sector to harness new sources of hydropower resulting from glacial melt, and in alternative sources of renewable energy including wind power and green hydrogen. The fishing sector will need support to adapt to depleting fish stocks resulting from ocean acidification, which is expected to be particularly pronounced in the waters around Iceland.

38. The authorities’ efforts to diversify the economy are starting to yield results, but reforms are needed to maximize the economic benefits of R&D incentives and improve the business environment.

- Iceland has significantly increased R&D spending in recent years and currently provides some of the most attractive R&D incentives in the OECD.³⁸ These incentives are starting to bear fruit: Since the R&D tax incentives were introduced in 2010, the value-added of high-tech sectors has increased by about 170 percent, while employment has increased by 40 percent. This is consistent with recent IMF research that points to the growth impact of R&D



³⁷ The pessimistic scenario is based on the high-emission Representative Concentration Pathway 8.5 and Shared Socioeconomic Pathway 3 which describe a fragmented world scenario with regional rivalries and high challenges to adaptation and mitigation.

³⁸ According to the OECD, the R&D tax incentives have led to a boost in investment spending, as well as improvements in sales, employment, and wages. For details see the 2023 OECD Economic Survey for Iceland.

grants.³⁹ R&D incentives have also encouraged the growth of innovative firms within traditional sectors, including fishing.

- At the same time, the sharp increase in R&D spending has raised concerns about its efficiency and budgetary impact. Moving forward, the criteria for expenditures that are eligible for the R&D tax credit should be further clarified and measures to prevent misuse strengthened in order to keep costs under control and maximize the economic impact of R&D incentives. The share of traditional export industries (aluminum, fishing, tourism) in the economy has remained broadly unchanged, underscoring the importance of further efforts to support diversification. Efforts to improve educational outcomes while streamlining professional licensing requirements for foreign nationals would help alleviate the shortage of high-skilled workers and help foster innovation. Meanwhile, further improving physical infrastructure would facilitate access to domestic and international markets and support supply chain efficiency. In that context, Iceland's large pension funds are well-placed to scale up their involvement in infrastructure financing.

Authorities' Views

39. The authorities broadly agreed with staff's recommendation on structural policies.

They agreed with staff's positive assessment of the recently concluded collective wage agreement and took note of staff's call to reduce the role of the state in the wage bargaining process. On climate policies, the authorities underscored their strong commitment to take the measures needed to achieve the new more stringent emission reduction target consistent with the EU's Fit for 55 and took note of staff's call for higher carbon rates in sectors with relatively low taxes on emissions. The authorities agreed that policies to support economic diversification were starting to bear fruit. At the same time, they agreed that the cost of the R&D credit scheme had increased dramatically and that there was a need to further clarify eligibility criteria and enhance oversight to prevent misuse. They also recognized the importance of raising educational standards and introducing a simplified professional licensing process for foreign nationals to address ongoing and future shortages in high-skilled workers. Finally, they agreed that there was scope for pensions funds to play a greater role in funding infrastructure investment in Iceland.

STAFF APPRAISAL

40. A coordinated tightening of macroeconomic policies has successfully narrowed domestic and external imbalances built up during the post-pandemic period. The economy was operating above capacity in 2022 and early 2023, but decelerated significantly since mid-2023 and the output gap is now closing. The ongoing volcanic activity on the Reykjanes peninsula has disrupted lives and livelihoods, but its broader economic implications are expected to be limited.

³⁹ The Fiscal Monitor finds that a 0.5 percent of GDP increase in fundamental research, R&D grants for innovative start-up and tax breaks to encourage applied innovation in firms, will raise GDP for the average advanced country by 2 percent. For details see "Chapter 2: A Fresh Perspective on Innovation", IMF Fiscal Monitor, April 2024.

41. Appropriately tight macroeconomic policies are expected to dampen economic growth in the near term, while medium-term growth prospects are favorable. Growth is expected to decline in 2024 before increasing in 2025 on the back of a gradual easing of the monetary policy stance. Inflation is projected to reach the 2.5 percent inflation target in first half of 2026. Medium-term growth prospects remain favorable, driven by an expansion of innovation-based sectors and migrant labor inflows. Risks to the outlook are broadly balanced.

42. The authorities' fiscal targets are broadly appropriate, though additional measures are required to achieve the planned medium-term consolidation. The broadly neutral fiscal impulse this year is warranted given the narrowing of economic imbalances and spending associated with the volcanic activity. The envisaged medium-term fiscal consolidation is consistent with a gradual increase in fiscal space to prepare for future shocks, but will require additional measures over the next five years, which could include reducing the number of items subject to reduced VAT rates, streamlining tax expenditures and incentives, and increasing the taxation of realized capital gains on second homes and investment properties, as well as further spending measures. Public debt is on a downward path and resilient to shocks.

43. Reactivation of the fiscal rules in 2026 presents an opportunity to revisit their design to ensure fiscal policy is both sustainable *and* contributes to macroeconomic stability. To reduce procyclicality and bolster the sustainability of fiscal policy, the authorities should consider replacing the current overall balance rule with a limit on government spending. Increasing the resources of the Fiscal Council and strengthening its mandate would help support the support the credibility of the fiscal rules.

44. The CBI should lower the policy rate as inflation declines. The monetary policy stance remains appropriately tight given still elevated inflation and inflation expectations. It should be eased toward the estimated neutral real rate once headline inflation and inflation expectations fall inside the 1–4 percent notification band and there is clear evidence that inflation will return to target.

45. An application of the IMF's Integrated Policy Framework to Iceland suggests some benefits of foreign exchange interventions during times of stress. Iceland's shallow foreign exchange markets create a risk of disruptive exchange movements during times of stress. In these circumstances, foreign exchange intervention can reduce the burden on monetary policy and help cushion the impact of the shock. The CBI should seek opportunities to increase reserves to strengthen its ability to prevent disruptive exchange rate movements. The authorities should also explore options to deepen the foreign currency derivatives market in a manner consistent with continued foreign exchange market stability.

46. Systemic risks in the financial sector have declined slightly from last year and are broadly contained. Financial institutions remain resilient, while risks posed by housing price imbalances have receded. The currently tight macroprudential stance is appropriate, but clarifying the neutral level of the countercyclical capital buffer would improve transparency. Supervisory efforts should focus on monitoring the impact of the slowing economy and still-high interest rates,

while improving operational risk management and monitoring banks' implementation of the strengthened NPL framework.

47. Maintaining the strong momentum in FSAP implementation will require robust interagency coordination. The authorities have made significant progress on high-priority recommendations. More progress is now needed on reforms to safeguard the independence and maintain the effectiveness of the CBI's supervisory activities, and to improve the governance, internal controls, and risk management of pension funds. The authorities should also continue efforts to mitigate money laundering/terrorism financing risks.

48. Structural policies should focus on gradually reducing state involvement in collective wage bargaining, accelerating the green transition, and further diversifying the economy. The recently concluded collective wage bargaining agreement represents a big step forward in Icelandic labor relations. Over time, it would be desirable to reduce the role of the state in collective wage bargaining to preserve the integrity of the budgetary process. Achieving Iceland's ambitious climate agenda will require additional policy effort. In that context, the authorities should consider raising carbon taxes in sectors with relatively low levels of taxes on emissions. Efforts to diversify the economy are yielding results, but further reforms are needed to maximize the economic benefits of R&D incentives.

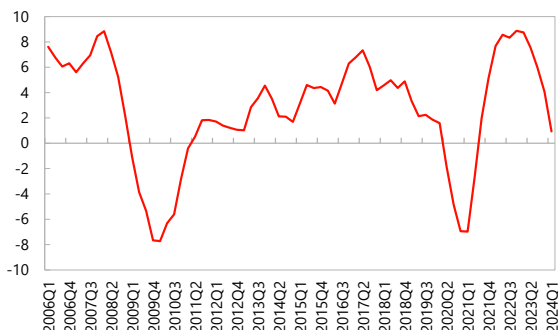
49. It is proposed that the next Article IV consultation with Iceland take place on the standard 12-month cycle.

Figure 1. Iceland: Key Macroeconomic Developments

Growth eased significantly towards the end of 2023 and contracted in early 2024.

GDP Growth

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

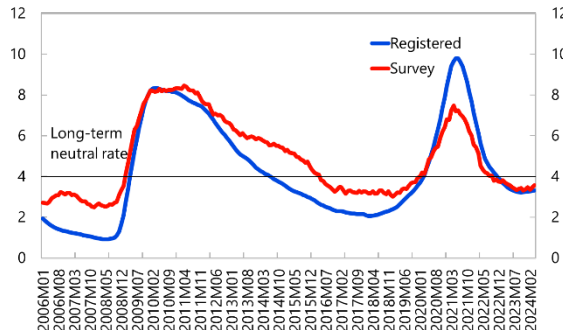


Source: Statistics Iceland.

The unemployment rate bottomed-out in 2023.

Unemployment Rate

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

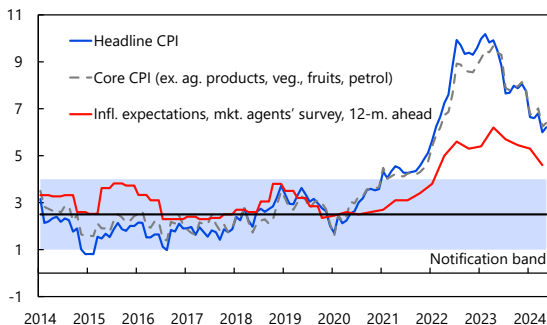


Sources: Statistics Iceland; Directorate of Labor.

Inflation has declined from its February 2023 peak but remains elevated on a year-on-year basis.

Inflation and Inflation Expectations

(Percentage change y/y)

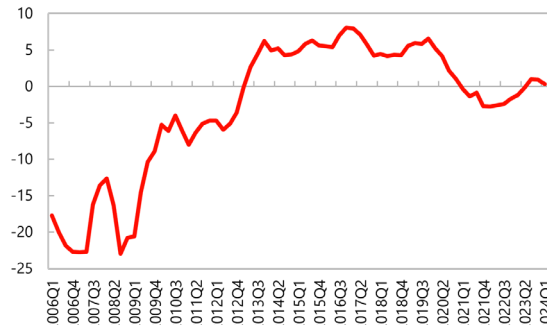


Source: Statistics Iceland.

The current account improved in 2023, but deteriorated in 2024Q1.

Current Account Balance

(Percent of GDP; 4-quarter moving average)

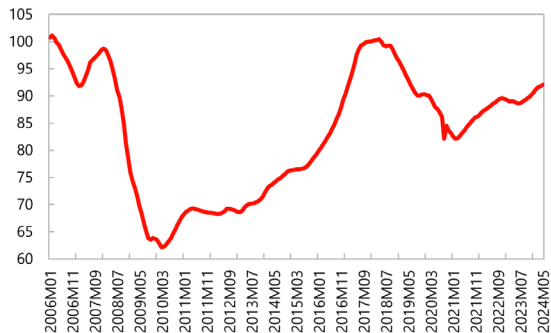


Sources: Statistics Iceland; Central Bank of Iceland.

The Real Effective Exchange Rate was broadly stable during 2023.

Real Exchange Rate

(Index, 12-month moving average)

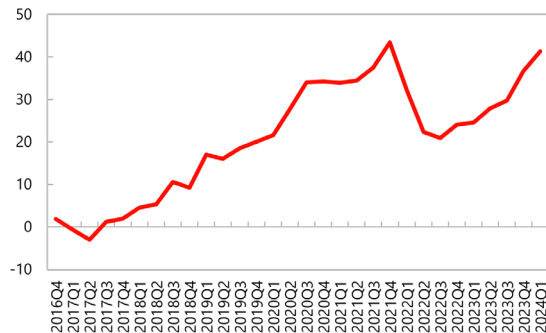


Source: Central Bank of Iceland.

The improvement in the NIIP is in line with improvements in the current account.

Net International Investment Position

(Percent of GDP; 4-quarter moving average)



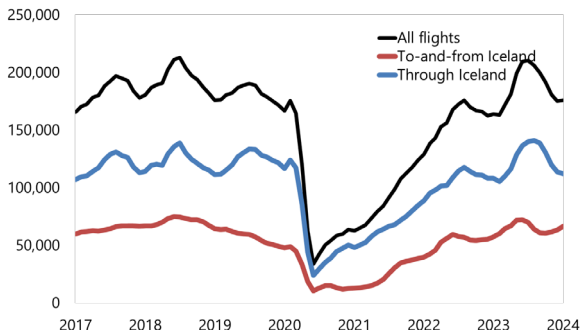
Sources: Statistics Iceland; Central Bank of Iceland.

Figure 2. Iceland: Tourism Developments

Flight arrivals have declined somewhat, mainly due to less transit traffic...

Flight Arrivals in Reykjavik Control Area: 2017-2024 (Jan)

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



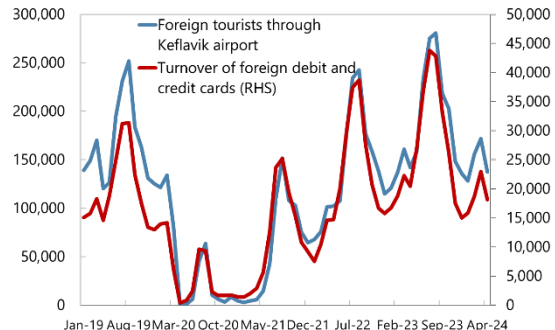
Source: ISAVIA.

... but tourism flows have eased into 2024.

Foreign Tourists and Consumption in Iceland: 2019-2024

(Persons per month)

(Million kronas)

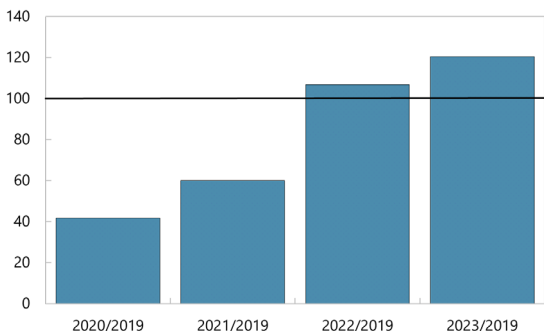


Source: Haver Analytics, Inc., Statistics Iceland, Tourism Board, ISAVIA.

Real turnover in the tourism sector increased somewhat in 2023.

Real Turnover in Tourism: 2020-2023

(Percent of 2019 level, CPI deflated)

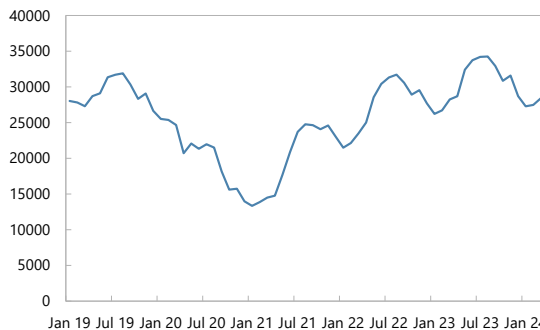


Source: Statistics of Iceland and IMF staff calculation.

... resulting in rising employment in the tourism sector.

Employees in Tourism: 2019-2024

(Number of persons)

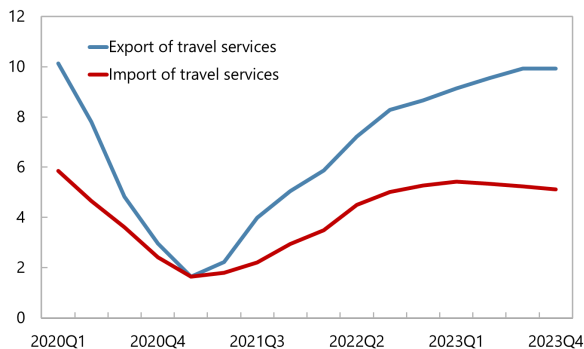


Sources: Haver Analytics, Inc. and Statistics Iceland.

The contribution of the travel balance to the current account balance increased further in 2023...

Travel Balance: 2020-2023

(Percent of GDP)



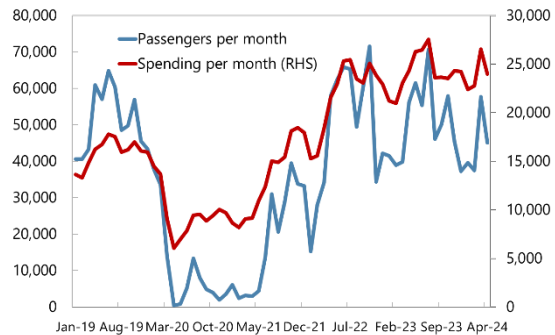
Sources: Haver Analytics, Inc. and Central Bank of Iceland.

...while Icelanders' travels abroad have moderated in line with lower domestic demand.

Icelanders' Travel and Spending Abroad: 2019-2024

(Number of passengers)

(Million kronas)



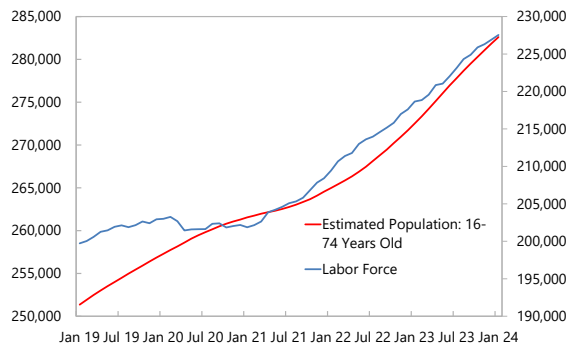
Source: Haver Analytics, Inc. and Statistics Iceland.

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: 2019-2024

(Number of persons)

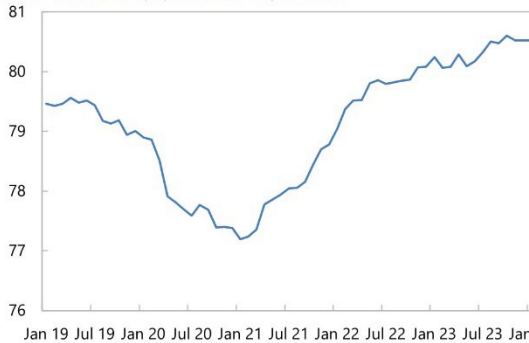


Sources: Haver Analytics, Inc. and Statistics Iceland.

The activity rate has recovered from pandemic-era lows, but may have peaked for now.

Activity Rate: 2019-2024

(Percent of estimated population 16-74 years old)

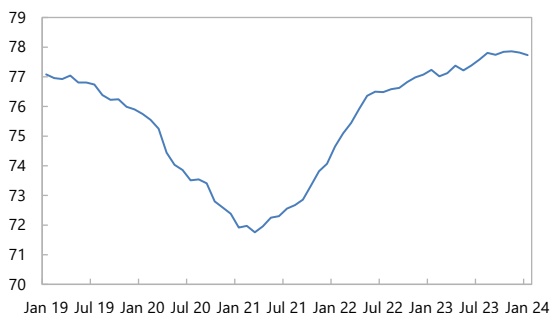


Sources: Haver Analytics, Inc. and Statistics Iceland.

The employment rate may have reached a cyclical peak.

Employment Rate: 2019-2024

(Percent of estimated population 16-74 years old)

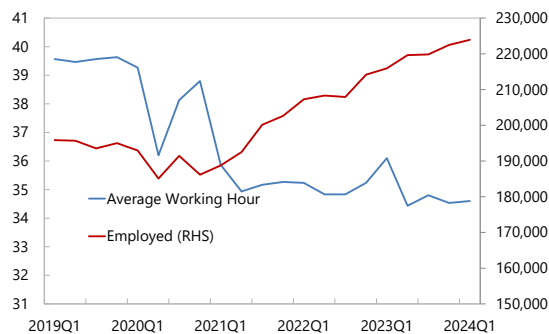


Sources: Haver Analytics, Inc. and Statistics Iceland.

Average hours worked per week have been on a declining trend since the Covid-19 pandemic.

Weekly Hours Worked and Employment

(Hour) (Persons)

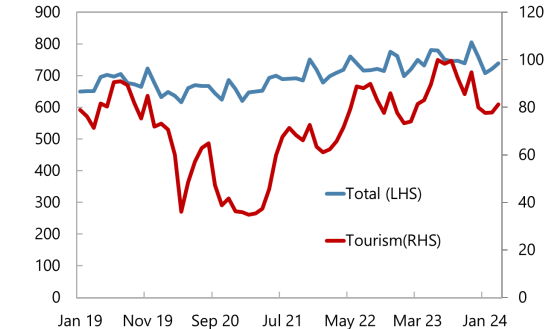


Sources: Haver Analytics, Statistics Iceland, IMF staff calculations.

The overall payroll has remained broadly stable.

Payroll: 2019-2024

(Million kronas, CPI deflated)

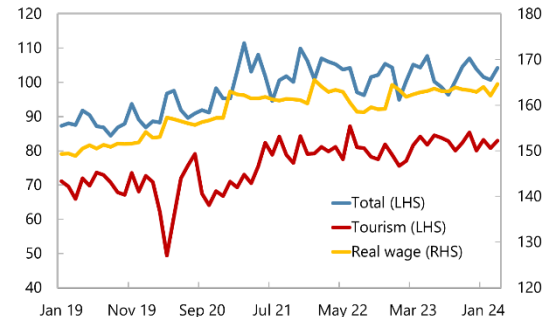


Sources: Haver Analytics, Inc. and Statistics Iceland.

Real wages have remained broadly constant despite the high inflation.

Payroll per Employee per Hour and Real Wage: 2019-2024

(kronas, CPI deflated)

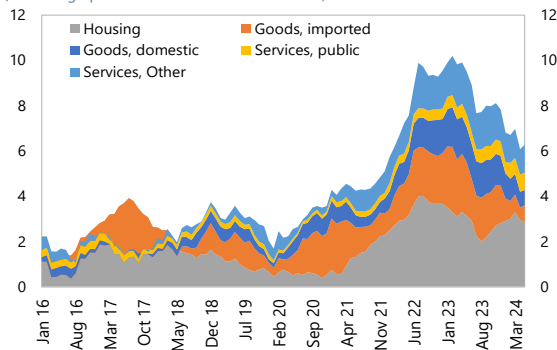


Sources: Haver Analytics, Inc. and Statistics Iceland.

Figure 4. Iceland: Inflation and Monetary Developments

Inflation is declining but remains high due to persistent housing costs.

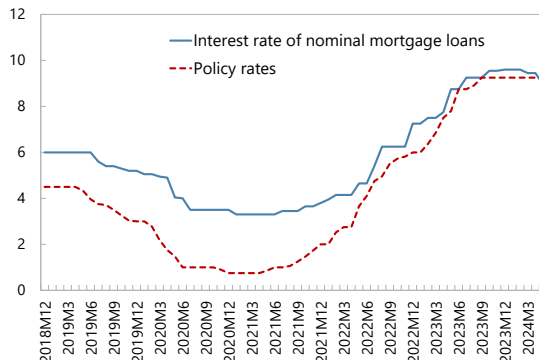
Consumer Price Inflation Components
(Percentage point contribution to CPI inflation)



Sources: Haver Analytics, Inc. and Statistics Iceland.

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

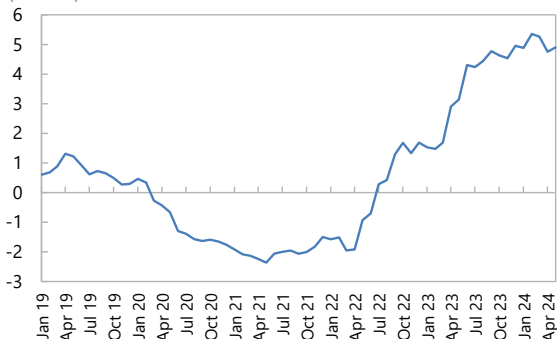
Interest Rate Transmission
(Percent)



Source: Central Bank of Iceland.

The real policy rate has become increasingly positive.

Real Policy Rate ¹
(Percent)

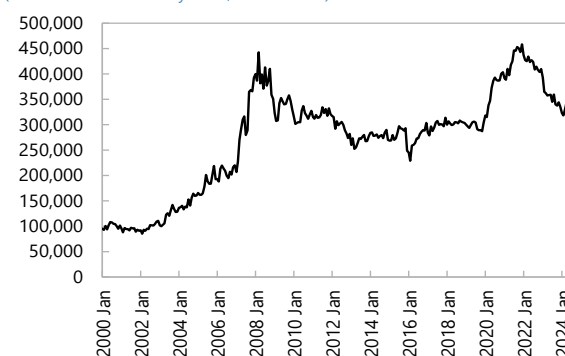


Sources: Haver Analytics, Inc. and IMF staff estimates.

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

Real M1 balances have declined but remain close to historical highs.

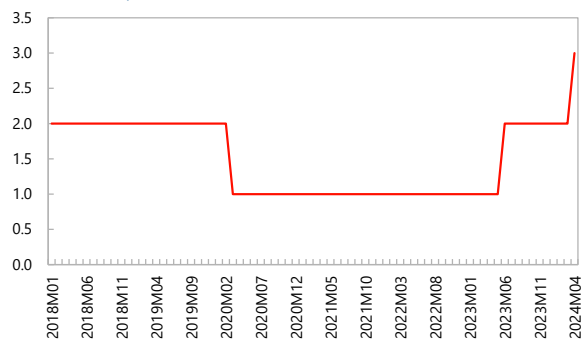
Real M1 Balances: 2000-2024
(Million krona of January 2008, CPI deflated)



Source: Central Bank of Iceland

The reserve requirement has been increased and is now above the pre-pandemic level.

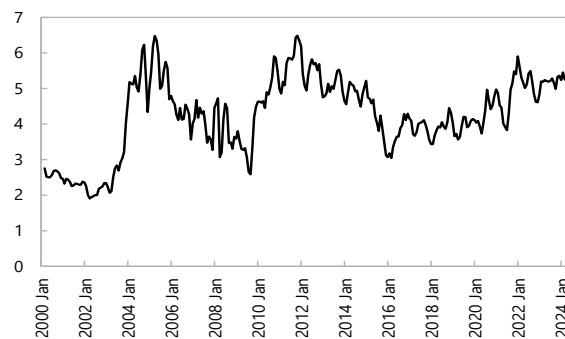
Total Reserve Requirements
(Percent of deposit base)



Source: Central Bank of Iceland.

The money multiplier increased during the pandemic and remains high.

M1 Money Multiplier: 2000-2024
(M1 divided by the Money Base, 3-month moving average)

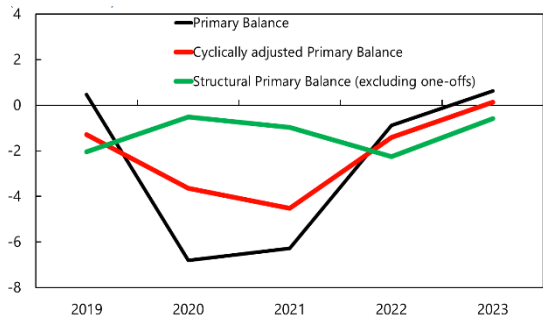


Source: Central Bank of Iceland

Figure 5. Iceland: Fiscal Developments and Issues

The improved fiscal position helped narrow domestic and external imbalances...

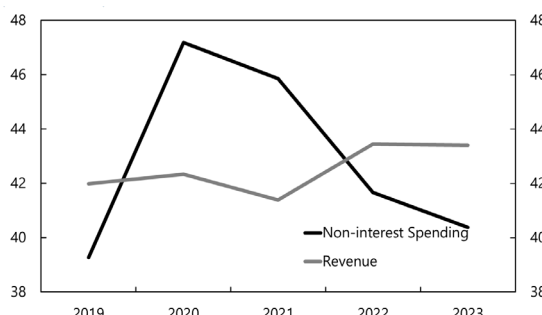
Primary Balances: 2019–2023
(Percent of GDP)



Source: Statistics Iceland.

...mainly through a reduction in non-interest spending in percent of GDP.

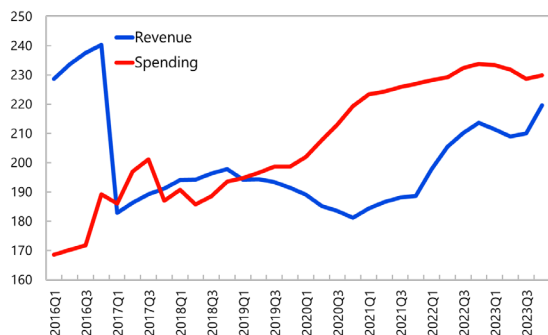
General Government Revenue and Spending: 2019–2023
(Percent of GDP)



Source: Statistics Iceland.

There was a slight uptick in spending towards end-2023 due to volcanic activity, supported by stronger revenues.

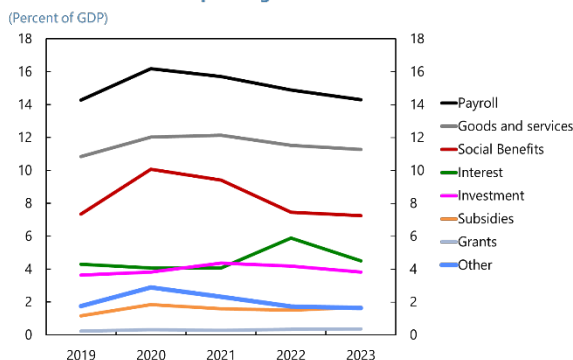
Real General Government Revenue and Spending
(Billion kronas of January 2008, 4-quarter moving average)



Source: Statistics Iceland.

And expenditure compression across most components.

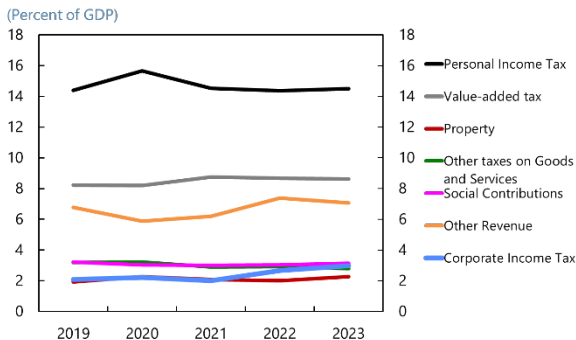
General Government Spending: 2019-2023



Source: Statistics Iceland.

On the revenue side, corporate income tax increased and other revenues (dividends and interest) remained strong.

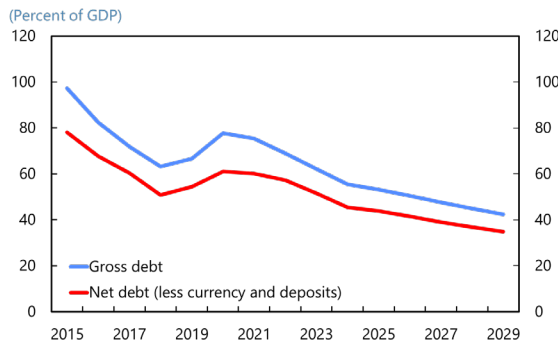
General Government Revenue: 2019-2023



Source: Statistics Iceland.

The debt burden continued to decline in 2023 on favorable debt dynamics, privatization, and use of government deposits.

General Government Debt: 2015-2029



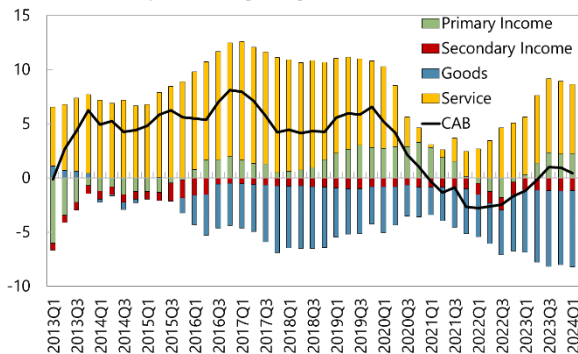
Source: Statistics Iceland.

Figure 6. Iceland: External Sector Developments

The current account improved in 2023 on strong services exports but deteriorated in 2024Q1.

Current Account Balance

(Percent of GDP; 4-quarter moving average)

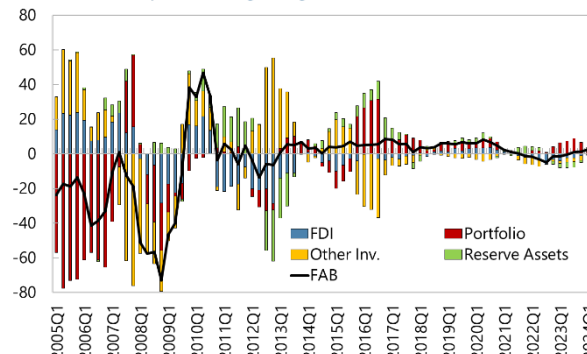


Source: Haver Analytics, Central Bank of Iceland, IMF staff calculations.

FDI and portfolio flows continued to grow.

Financial Account Balance

(Percent of GDP; 4-quarter moving average)

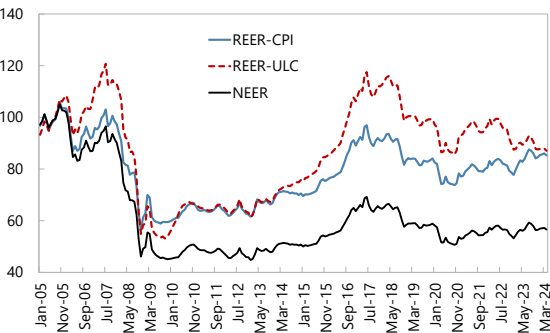


Source: Haver Analytics, Central Bank of Iceland, IMF staff calculations.

The REER remained broadly stable through 2023.

Real Effective Exchange Rate

(Index, 2005=100)

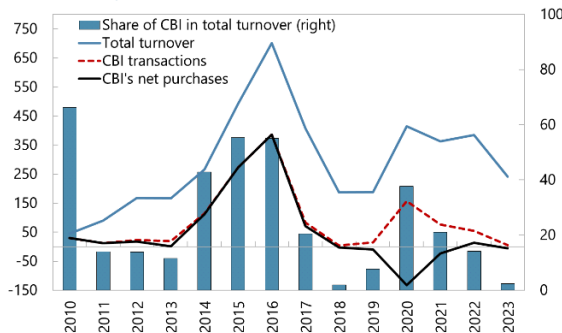


Sources: Central Bank of Iceland and IMF INS Database.

FX interbank market turnover declined in 2023 as did the share of CBI interventions.

FX Market Turnover and Interventions

(Billion ISK, and percent)

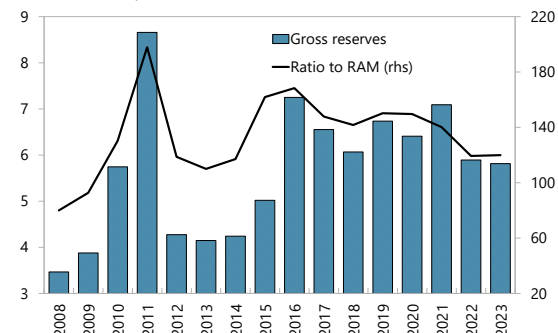


Source: Central Bank of Iceland.

Reserves declined but remain adequate for precautionary purposes.

Gross Reserves

(Billions of dollars, percent)

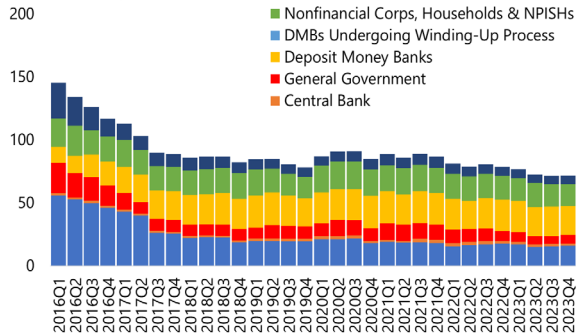


Sources: Central Bank of Iceland and IMF Staff Calculations.

External debt has remained stable.

External Debt: 2016-23

(Percent of GDP)



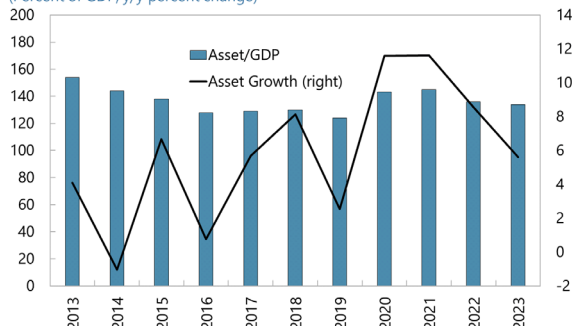
Sources: Haver Analytics, Inc, Central Bank of Iceland, and Statistics Iceland.

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)

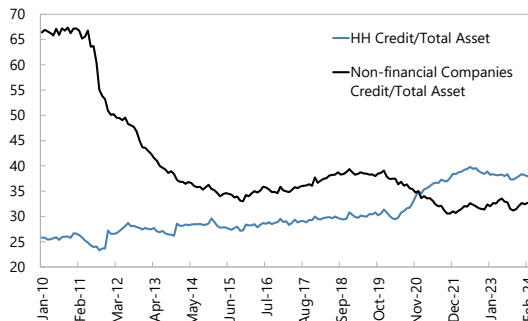


Source: Central Bank of Iceland.

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

Household and Non-Financial Corporate Credit

(Percent of total assets)

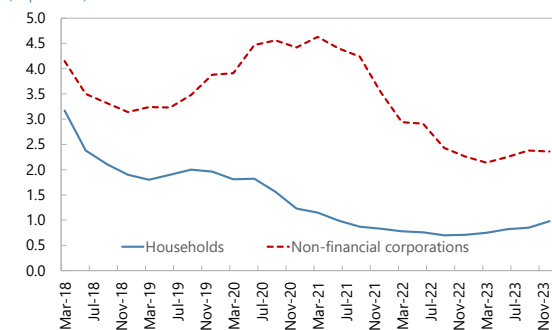


Source: Central Bank of Iceland.

Nonperforming loans have increased marginally but remained low compared to pre-pandemic levels.

Non-Performing Loan Ratio

(In percent)

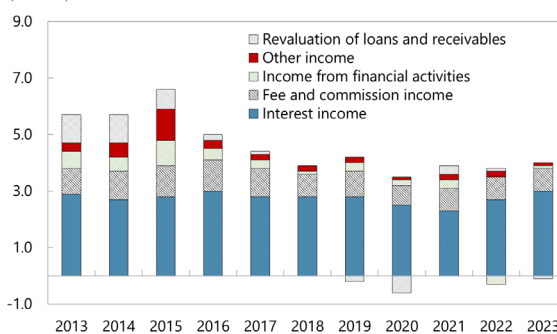


Sources: Central Bank of Iceland

Higher interest income has increased bank profitability.

Banks' Operating Income to Total Assets

(Percent)

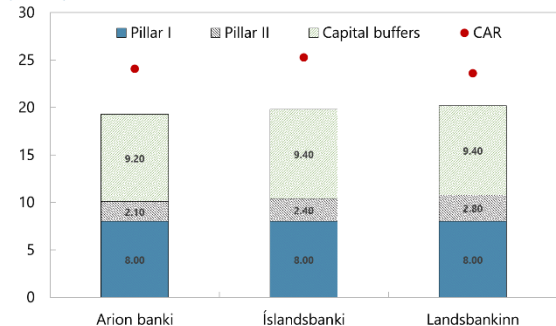


Source: Central Bank of Iceland

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

Capital Requirements and Adequacy

(Percent)

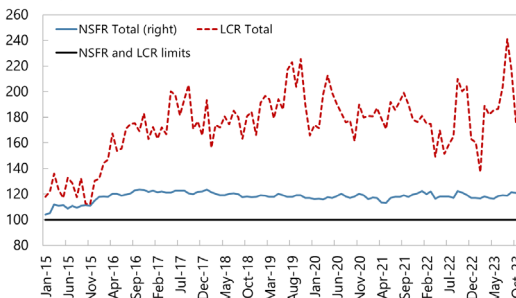


Sources: Central Bank of Iceland.

...and liquidity buffers remain ample.

Liquidity Requirement

(Percent)



Sources: Central Bank of Iceland.

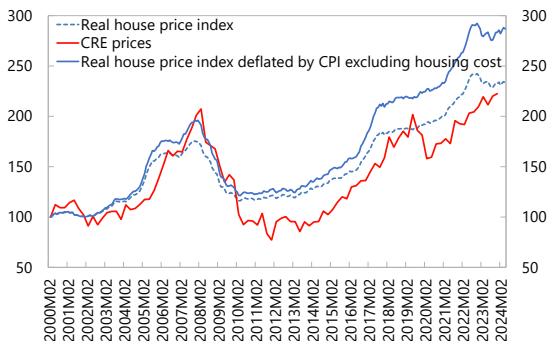
Notes: LCR limit is for all currencies combined.

Figure 8. Iceland: Housing Market Developments

The acceleration in housing prices has slowed ...

Real Estate Indices

(Index, 2000M3=100)

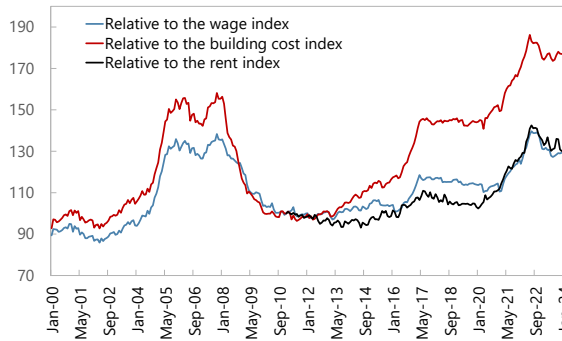


Sources: Statistics Iceland, CBI and IMF staff calculations.

... and this has been reflected in valuations relative to fundamentals...

House Prices Relative to Fundamentals

(Index, January 2011 = 100)

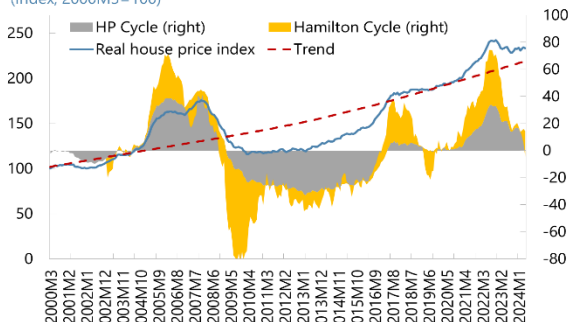


Sources: Statistics Iceland, CBI and IMF staff calculations.

...as well as a turn in the housing cycle...

Real House Price: Trend and Cycle

(Index, 2000M3=100)

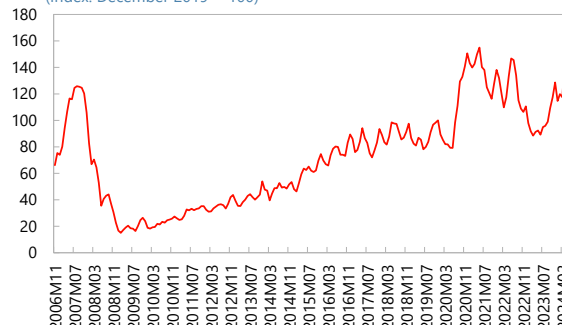


Sources: Statistics Iceland, Central Bank of Iceland, and IMF staff calculations. Note: Trend and cycle are constructed using Hodrick-Prescott (HP) and Hamilton filters.

though real estate turnover has picked up recently

Real Estate Turnover

(Index, December 2019 = 100)

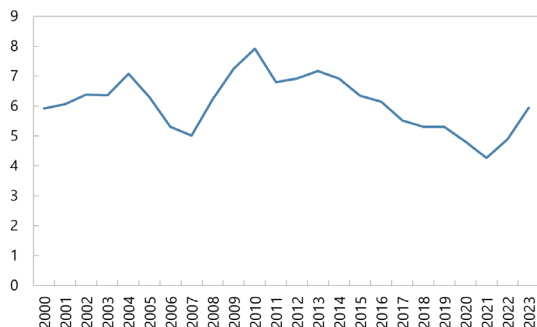


Sources: Registers Iceland and IMF staff calculations. Notes: Three-month moving average and deflated by the CPI.

Higher interest rates have increased the debt service burden emanating from households' mortgage loans.

Household Interest Payment to Disposable Income

(Percent)

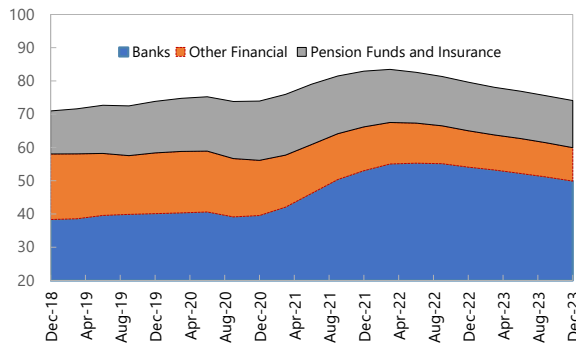


Source: Central Bank of Iceland

Tighter financial conditions have supported the gradual normalization of post-pandemic lending to households.

Household Loans by Source

(Percent of GDP)



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

Table 1. Iceland: Selected Economic Indicators, 2019–29

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Percentage change unless otherwise indicated)										
National Accounts (constant prices)											
Gross domestic product	1.9	-6.9	5.1	8.9	4.1	1.2	2.4	2.2	2.3	2.4	2.4
Total domestic demand	0.5	-1.0	7.1	8.2	1.2	0.4	1.7	1.8	2.1	2.2	2.2
Private consumption	1.7	-3.1	6.9	8.3	0.5	0.8	1.6	2.0	2.3	2.5	2.5
Public consumption	3.9	5.2	2.3	2.3	2.2	1.6	1.5	1.0	1.0	1.0	1.0
Gross fixed investment	-4.1	-7.4	14.1	15.1	-0.6	0.9	3.2	2.8	3.2	3.1	3.0
Net exports (contribution to growth)	1.6	-6.0	-2.1	0.4	2.8	0.5	0.8	0.4	0.3	0.3	0.3
Exports of goods and services	-5.3	-30.7	14.6	22.3	4.8	2.0	3.8	3.2	3.2	3.2	3.2
Imports of goods and services	-9.1	-20.6	19.9	20.0	-1.4	1.0	2.2	2.4	2.7	2.7	2.7
Output gap (percent of potential output)	3.2	-6.0	-3.7	1.6	2.3	0.2	-0.3	-0.2	-0.1	0.0	0.0
Selected Indicators											
Gross domestic product (ISK bn.)	3,026	2,929	3,276	3,883	4,279	4,560	4,827	5,087	5,375	5,678	5,998
Gross domestic product (\$ Mn.)	24,681	21,630	25,798	28,702	31,020	32,971	35,491	38,168	41,125	44,304	47,729
GDP per capita (\$ thousands)	70.6	61.1	72.0	78.7	82.7	83.7	88.6	93.7	99.4	105.3	111.7
Private consumption (percent of GDP)	50.2	52.0	51.5	50.3	50.0	50.0	49.6	49.2	48.8	48.6	48.3
Public consumption (percent of GDP)	24.6	28.1	27.4	25.6	25.7	25.4	25.5	25.9	26.2	26.5	26.8
Gross fixed investment (percent of GDP)	20.9	21.2	22.8	24.0	23.7	23.5	23.9	23.8	24.0	24.0	24.0
Gross national saving (percent of GDP)	27.2	22.4	20.2	22.6	25.3	24.7	25.2	25.4	25.5	25.5	25.5
Unemployment rate (percent of labor force)	3.9	6.4	6.0	3.8	3.4	3.9	4.1	4.1	4.1	4.0	4.0
Employment	0.9	-3.0	3.6	6.9	4.7	0.6	1.8	1.6	1.7	1.8	1.8
Labor productivity	1.0	-2.4	1.5	-0.2	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Real wages	1.8	3.4	3.7	0.0	0.9	0.6	0.6	0.6	0.6	0.6	0.6
Nominal wages	4.9	6.3	8.3	8.3	9.8	6.6	3.9	3.1	3.1	3.1	3.1
Consumer price index (average)	3.0	2.8	4.5	8.3	8.7	6.0	3.3	2.5	2.5	2.5	2.5
Consumer price index (end period)	2.0	3.6	5.1	9.6	7.8	5.1	2.6	2.5	2.5	2.5	2.5
Core CPI (average)	2.9	3.0	4.3	7.6	8.6	6.1	3.4	2.5	2.5	2.5	2.5
ISK/€ (average)	141	157	148	159	163	...	...	...	...	...	...
ISK/\$ (average)	123	135	127	135	138	...	...	...	...	...	...
Terms of trade (average)	-0.8	-1.5	3.9	2.5	-5.7	1.0	-1.3	-0.4	-0.5	-0.5	-0.5
Money and Credit (end period)											
Base money (M0)	-9.2	11.8	9.0	1.5	-21.5	13.3	11.9	10.7	10.4	9.9	9.4
Broad money (M3)	6.6	7.4	10.9	8.9	8.3	10.6	8.8	7.6	7.3	6.8	6.5
Credit to nonfinancial private sector	2.9	10.5	10.5	11.3	5.2	4.1	5.8	5.4	5.7	5.6	5.6
Central bank 7 day term deposit rate 1/	3.00	0.75	2.00	6.00	9.25	9.25	...	...	...	...	...
	(Percent of GDP unless otherwise indicated)										
General Government Finances 2/											
Revenue	42.0	42.2	41.1	42.5	43.1	43.1	42.3	41.6	41.4	41.4	41.4
Expenditure	43.6	51.1	49.5	46.5	45.1	45.0	43.3	42.6	42.5	42.5	42.5
Overall balance	-1.6	-8.9	-8.5	-4.0	-2.0	-1.9	-1.0	-1.1	-1.1	-1.1	-1.1
Cyclically-adjusted balance	-3.3	-5.3	-6.3	-4.9	-3.3	-2.1	-0.9	-1.0	-1.0	-1.1	-1.1
Structural primary balance 3/	-1.9	-0.2	-0.7	-2.4	-1.4	-1.0	-0.3	-0.1	0.0	0.2	0.3
Gross debt	66.5	77.5	74.8	67.4	64.8	59.6	54.4	51.7	48.9	46.2	43.8
Net debt	54.4	60.9	59.8	56.0	54.8	50.2	45.6	43.4	41.0	38.7	36.7
Balance of Payments											
Current account balance	6.5	1.0	-2.7	-1.7	0.9	0.9	1.2	1.5	1.5	1.5	1.5
of which: services balance	8.0	1.4	2.3	5.1	6.7	6.7	6.8	6.8	6.7	6.6	6.5
Capital and financial account (+ = outflow)	6.1	4.9	-1.1	-1.5	1.3	0.7	1.0	1.3	1.3	1.3	1.3
of which: direct investment, net (+ = outflow)	2.8	2.3	-2.0	-3.4	-0.9	-0.3	-0.9	-0.9	-0.8	-0.8	-0.6
Gross external debt	78.3	90.2	84.4	74.7	71.6	65.9	61.2	56.9	52.9	49.2	45.7
Central bank reserves (\$ Mn.)	6,736	6,408	7,091	5,879	5,720	5,584	5,351	5,385	5,500	5,648	5,653

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

1/ For 2024, rate as of end-April.

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

3/ Cyclically-adjusted primary balance excluding one offs.

Table 2. Iceland: Money and Banking, 2019–23

(Billions of krónur, unless otherwise indicated)

	2019	2020	2021	2022	2023
Central Bank					
Net foreign assets	636	563	524	527	515
Assets	822	817	923	837	790
Liabilities	186	254	399	310	276
<i>of which:</i> central government foreign currency deposits	151	214	305	228	197
Net domestic assets	-505	-416	-363	-364	-387
Central government, net	-82	-134	-46	-72	-68
Assets	0	8	22	19	22
<i>of which:</i> recapitalization bond	0	0	0	0	0
Liabilities (current account)	82	142	68	90	90
Credit institutions (incl. nonbanks), net	-351	-137	-189	-183	-228
Assets	6	8	8	6	1
Liabilities	357	145	197	189	229
<i>of which:</i> term deposits and CDs	299	145	196	189	229
Other items, net	-72	-144	-128	-109	-91
ESI (asset management company)	3	2	1	2	0
Total Expenditure	82	151	134	116	110
Current Expenses	132	147	161	163	128
Currency issued	75	81	82	81	76
Deposit money banks' deposits at the central bank	57	66	79	82	52
Deposit Money Banks					
Net foreign assets	-302	-323	-397	-462	-379
Assets	366	423	428	489	595
Liabilities	668	745	825	952	975
<i>of which:</i> bonds	569	634	710	748	767
Nonfinancial Assets	2,203	2,362	2,666	2,940	3,074
Central bank, net	328	208	279	278	289
Assets	330	213	282	280	290
Liabilities	2	5	2	2	1
Net Lending/Borrowing	63	262	235	250	266
<i>of which:</i> bonds	42	234	202	212	215
Financial Assets, Transactions	2,873	3,187	3,507	3,870	4,036
Nonfinancial	2,681	2,964	3,277	3,648	3,840
Corporations	1,492	1,483	1,462	1,655	1,761
Households	1,189	1,481	1,815	1,993	2,078
Financial	192	222	231	221	197
Other items, net	-1,062	-1,295	-1,356	-1,457	-1,518
Liabilities, Transactions	1,901	2,039	2,268	2,478	2,694
Krona deposits	1,664	1,803	2,002	2,181	2,386
Foreign currency deposits	237	236	266	296	308
Consolidated Banking System					
Net foreign assets	335	241	126	65	136
Net domestic assets	1,633	1,872	2,216	2,486	2,626
General government, net	-19	128	189	179	199
Gross Debt	2,873	3,187	3,507	3,870	4,036
Other items, net	-1,222	-1,442	-1,480	-1,563	-1,608
Broad money	1,968	2,113	2,343	2,550	2,762
Net Debt	67	74	74	73	68

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

Table 3. Iceland: Financial Soundness Indicators, 2019Q1–2023Q4 1/
(Percent)

	2019Q1	2019Q2	2019Q3	2019Q4	2020Q1	2020Q2	2020Q3	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4	2022Q1	2022Q2	2022Q3	2022Q4	2023Q1	2023Q2	2023Q3	2023Q4
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	24.8	25.4	23.2	23.3	22.9	23.7	24.0	24.2	24.0	24.3
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	22.4	23.1	21.0	21.2	20.8	21.1	21.1	21.4	21.5	21.9
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	3.0	3.0	3.0	3.0
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	2.2	2.3	2.3	2.3
Return on equity 2/	8.7	8.7	8.3	7.2	-3.4	0.6	3.7	5.9	11.3	11.7	12.5	12.4	8.6	9.8	10.1	10.1	12.0	11.8	11.7	12.0
Net interest income to total income 2/ 3/	60.2	62.4	64.9	66.8	90.8	75.1	73.3	69.5	63.6	64.2	63.4	64.2	71.4	67.5	70.9	70.9	65.7	69.7	71.1	69.1
Noninterest expense to total income 2/ 3/	61.4	62.4	64.2	65.9	76.1	62.2	58.4	56.3	47.9	46.8	43.8	45.0	53.9	49.5	48.8	49.6	45.2	45.5	44.4	44.6
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	13.0	13.6	14.8	14.4
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	12.8	13.3	14.5	14.2
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	-0.3	0.1	0.8	1.8
Total nonperforming loans (NPLs), facility level 5/	2.2	2.2	2.5	2.6	2.5	3.3	3.2	2.9	2.9	2.6	2.4	2.1	1.8	1.8	1.5	1.4	1.4	1.5	1.5	1.6
Household NPLs, facility level 5/	1.8	1.9	2.0	2.0	1.8	1.8	1.6	1.2	1.2	1.0	0.9	0.8	0.8	0.8	0.7	0.7	0.8	0.8	0.9	1.0
Non-financial corporate NPLs, facility level 5/	3.2	3.2	3.5	3.9	3.9	4.5	4.6	4.4	4.6	4.4	4.2	3.5	2.9	2.9	2.4	2.3	2.1	2.3	2.4	2.4
Household NPLs, cross default basis 6/	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	1.7	2.1	2.3	2.5
Non-financial 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	6.2	5.2	4.7	4.2
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	3.9	3.7	3.5	3.3
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	16.2	15.8	16.0	13.9
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	22.1	20.8	22.6	25.1
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	20.5	19.4	20.7	21.6

Sources: CBI; IMF FSI database; and IMF staff calculations.

1/ Three largest deposit money banks unless otherwise indicated.

2/ Data for 2017Q1 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.

Table 4. Iceland: General Government Operations, 2019–29 1/
(Percent of GDP)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Total Revenue	42.0	42.2	41.1	42.5	43.1	43.1	42.3	41.6	41.4	41.4	41.4
Taxes	31.9	33.2	31.8	32.2	32.9	32.9	32.8	32.5	32.6	32.6	32.6
Taxes on income and profits	17.5	18.5	17.4	18.1	18.7	18.2	18.3	18.1	18.2	18.2	18.2
Personal income tax	14.4	15.6	14.4	14.0	13.9	13.8	13.8	13.8	13.8	13.8	13.8
Corporate income tax	2.1	2.2	2.0	2.6	3.4	3.1	3.2	3.0	3.1	3.1	3.1
Capital gains tax and rental income	1.1	0.7	1.0	1.5	1.4	1.3	1.3	1.3	1.3	1.3	1.3
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
Taxes on property	1.9	2.3	2.1	2.0	2.0	2.0	1.9	1.9	1.9	1.9	1.9
Taxes on goods and services	11.4	11.4	11.6	11.3	11.5	11.6	11.6	11.6	11.6	11.6	11.6
Value added tax	8.2	8.2	8.7	8.5	8.6	8.5	8.5	8.3	8.3	8.3	8.2
Other taxes on goods and services	3.2	3.2	2.9	2.9	2.8	3.1	3.2	3.2	3.3	3.3	3.3
Taxes on international trade	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other taxes	0.6	0.7	0.4	0.4	0.4	0.6	0.6	0.6	0.6	0.6	0.6
Social contributions	3.2	3.0	3.0	3.0	3.0	3.0	3.0	2.9	2.9	3.0	3.2
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other revenues	6.8	5.9	6.1	7.2	7.1	7.1	6.4	6.0	5.8	5.6	5.5
Property income	3.5	2.9	3.0	4.4	4.1	4.0	3.4	3.0	2.8	2.6	2.5
<i>of which: interest income</i>	2.3	1.9	1.8	2.6	2.6	2.6	2.1	1.6	1.5	1.3	1.2
Total Expenditure	43.6	51.1	49.5	46.5	45.1	45.0	43.3	42.6	42.5	42.5	42.5
Current Expenses	42.1	49.7	47.5	44.6	43.5	43.7	41.9	41.2	41.0	41.0	41.0
Compensation of employees	14.3	16.1	15.6	14.6	14.4	14.3	14.1	14.0	14.0	14.0	14.0
Use of goods and services	10.8	12.0	12.0	11.3	11.5	11.4	11.1	11.1	11.1	11.1	11.1
Consumption of fixed capital	2.2	2.4	2.4	2.2	2.3	2.2	2.1	2.0	2.0	2.0	2.0
Interest	4.3	4.1	4.0	5.8	5.0	4.1	3.1	2.5	2.6	2.6	2.6
Subsidies	1.2	1.8	1.6	1.5	1.4	1.4	1.5	1.2	1.2	1.2	1.2
Grants	0.2	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	7.3	10.1	9.4	7.3	6.9	7.5	7.4	7.7	7.7	7.7	7.7
Other expense	1.8	2.9	2.3	1.7	1.8	2.5	2.2	2.2	2.1	2.1	2.1
Nonfinancial Assets	1.5	1.4	2.0	1.9	1.6	1.3	1.4	1.4	1.5	1.5	1.5
Nonfinancial assets, acquisition	3.7	3.8	4.3	4.1	3.9	3.4	3.5	3.4	3.5	3.5	3.5
Consumption of fixed capital (-)	-2.2	-2.4	-2.4	-2.2	-2.3	-2.2	-2.1	-2.0	-2.0	-2.0	-2.0
Net Lending/Borrowing	-1.6	-8.9	-8.5	-4.0	-2.0	-1.9	-1.0	-1.1	-1.1	-1.1	-1.1
Financial Assets, Transactions	-1.3	1.0	-2.6	1.6	2.5	-1.7	-2.5	-1.2	-1.1	-1.1	-1.0
Currency and deposits	0.4	4.2	0.3	-1.4	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Securities other than shares	-2.4	0.3	0.1	-0.4	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.1	-3.1	-1.4	0.6	3.2	0.1	0.1	0.1	0.1	0.1	0.1
Shares and other equities	0.1	0.0	-1.7	3.0	0.1	-1.9	-2.6	-1.3	-1.2	-1.2	-1.2
Other accounts receivable	0.5	-0.4	0.2	-0.1	-0.7	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, Transactions	0.3	9.9	5.9	5.6	4.5	1.6	-1.5	-0.1	0.0	0.1	0.1
Securities other than shares	-3.5	6.3	1.9	3.6	2.4	-0.6	-1.5	0.3	0.1	0.1	0.1
Loans	3.3	2.5	3.7	0.6	1.2	2.2	0.0	-0.4	-0.2	0.0	0.0
Krona denominated	1.1	0.4	0.6	2.6	2.4	1.4	0.0	0.0	0.0	0.0	0.0
Foreign currency denominated	2.2	2.1	3.1	-2.0	-1.1	0.8	0.0	-0.4	-0.2	0.0	0.0
Insurance technical reserves	0.3	0.2	0.1	0.4	0.5	0.0	0.0	0.0	0.1	0.0	0.0
Other accounts payable	0.2	0.9	0.2	1.1	0.3	0.0	0.0	0.0	0.0	0.0	0.0
Gross Debt	66.5	77.5	74.8	67.4	64.8	59.6	54.4	51.7	48.9	46.2	43.8
Krona denominated	60.3	69.0	64.3	60.5	59.7	54.0	49.1	47.2	44.8	42.3	40.1
Foreign currency denominated	6.3	8.5	10.5	6.9	5.1	5.6	5.3	4.6	4.1	3.9	3.7
Net Debt 2/	54.4	60.9	59.8	56.0	54.8	50.2	45.6	43.4	41.0	38.7	36.7
Memorandum Items:											
Primary revenue	39.7	40.3	39.3	39.9	40.5	40.5	40.2	40.0	39.9	40.1	40.2
Primary expenditure	39.3	47.0	45.5	40.7	40.1	40.9	40.2	40.1	39.9	39.9	39.9
Primary balance	0.5	-6.8	-6.2	-0.9	0.4	-0.4	0.0	-0.1	0.0	0.2	0.3
Structural balance 3/	-3.9	-2.3	-2.9	-5.5	-3.8	-2.5	-1.3	-1.0	-1.1	-1.1	-1.1
Structural primary balance 3/	-1.9	-0.2	-0.7	-2.4	-1.4	-1.0	-0.3	-0.1	0.0	0.2	0.3
Gross domestic product (ISK bn)	3,026	2,929	3,276	3,883	4,279	4,560	4,827	5,087	5,375	5,678	5,998

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

2/ Gross debt less currency and deposits.

3/ Cyclically-adjusted balance excluding one offs.

Table 5. Iceland: General Government Financial Balance Sheet, 2019–29

(Percent of GDP)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Financial assets	74.7	82.2	74.3	64.4	65.0	59.3	53.6	49.6	45.9	42.3	39.0
Currency and deposits	12.2	16.7	15.1	11.3	10.0	9.3	8.8	8.4	7.9	7.5	7.1
Other assets	86.7	65.5	59.2	53.0	55.1	49.9	44.7	41.3	38.0	34.9	32.0
Securities other than shares	4.3	4.7	4.3	3.3	3.1	2.9	2.8	2.6	2.5	2.4	2.2
Loans	23.2	20.8	17.1	15.1	16.9	16.0	15.2	14.6	13.9	13.3	12.7
Shares and other equities	27.8	32.2	31.6	28.2	28.5	24.9	21.0	18.6	16.4	14.3	12.4
Other accounts receivable 1/	31.4	7.7	6.2	6.5	6.5	6.1	5.8	5.5	5.2	4.9	4.7
Liabilities	99.0	114.0	109.4	99.7	95.9	88.8	82.0	77.9	73.9	69.8	66.1
Gross debt	66.5	77.5	74.8	67.4	64.8	59.6	54.4	51.7	48.9	46.2	43.8
Securities other than shares	48.5	56.3	52.3	47.7	45.7	42.0	38.4	36.5	34.5	32.6	30.9
Loans	18.1	21.2	22.5	19.7	19.1	17.5	16.0	15.2	14.4	13.6	12.9
Krona denominated	11.7	12.4	11.6	12.5	13.7	11.7	10.5	10.4	10.0	9.5	9.0
Foreign currency denominated	6.4	8.8	10.9	7.2	5.4	5.9	5.5	4.8	4.4	4.1	3.9
Other liabilities	32.5	36.4	34.6	32.3	31.2	29.2	27.6	26.2	24.9	23.6	22.4
Insurance technical reserves	27.2	29.1	27.6	25.5	24.7	23.2	21.9	20.8	19.8	18.7	17.7
Other accounts payable	5.3	7.3	7.0	6.8	6.5	6.1	5.7	5.4	5.2	4.9	4.6
Net financial worth 1/	-24.4	-31.8	-35.1	-35.3	-30.9	-29.5	-28.5	-28.3	-28.0	-27.5	-27.1
Memorandum item:											
Net debt 2/	54.4	60.9	59.8	56.0	54.8	50.2	45.6	43.4	41.0	38.7	36.7

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, 2019–29

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
						Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
	(Millions of dollars)										
Current account	1,616	228	-692	-482	294	297	420	567	628	667	704
Trade balance	1,127	-293	-461	-47	-16	263	317	395	416	426	445
Balance on goods	-846	-590	-1,059	-1,499	-2,106	-1,961	-2,092	-2,185	-2,325	-2,480	-2,639
Merchandise exports f.o.b.	5,347	4,720	6,105	7,524	6,845	7,451	7,844	8,189	8,515	8,856	9,212
Merchandise imports f.o.b.	6,193	5,310	7,165	9,023	8,952	9,411	9,937	10,374	10,840	11,336	11,851
Balance on services	1,973	297	598	1,452	2,090	2,223	2,409	2,580	2,741	2,906	3,084
Exports of services, total	5,442	2,485	3,506	5,616	6,608	6,890	7,279	7,661	8,057	8,473	8,911
Imports of services, total	3,469	2,188	2,907	4,163	4,517	4,667	4,870	5,081	5,316	5,567	5,827
Primary income balance	693	706	35	-113	684	450	523	595	658	711	753
Receipts	869	725	761	748	1,146	963	914	893	891	908	926
<i>of which:</i> dividends and reinvested earnings	598	528	575	518	726	549	517	514	520	536	552
<i>of which:</i> interest receipts	143	73	46	93	282	271	260	248	246	253	261
Expenditures	176	19	725	861	462	513	391	298	232	197	173
<i>of which:</i> dividends and reinvested earnings	-373	-453	368	418	-376	-188	-194	-200	-207	-213	-220
<i>of which:</i> interest payments	450	391	282	359	722	581	470	394	336	305	284
Secondary income balance	-204	-185	-266	-322	-374	-416	-419	-423	-446	-470	-494
Capital and financial account (+ = outflow)	1,501	1,055	-279	-423	409	231	349	491	546	579	609
Capital account balance (+ = inflow)	-14	-17	-19	-25	-31	-33	-35	-38	-41	-44	-48
Financial account (+ = outflow)	1,515	1,071	-260	-397	440	264	385	529	587	623	656
Direct investment (+ = outflow)	703	500	-517	-964	-285	-98	-309	-327	-348	-371	-302
Portfolio investment ("+" = outflow)	747	1,007	20	1,233	2,108	822	1,090	1,097	1,080	1,046	1,273
Assets (+ = outflow)	1,108	696	1,431	1,002	1,986	1,886	1,786	1,686	1,686	1,686	1,686
Liabilities (+ = inflow)	361	-311	1,411	-231	-122	1,063	695	588	605	640	413
<i>of which:</i> net borrowing (+ = inflow)	-306	-283	1,495	-290	-56	1,144	732	578	544	524	238
Other investment (+ = outflow)	-511	-273	-991	-272	-899	-248	-119	-248	-254	-195	-313
Assets (+ = outflow)	-950	-61	-31	612	-99	-352	-364	-375	-387	-399	-411
Liabilities (+ = inflow)	-439	212	960	884	800	-105	-245	-127	-133	-204	-98
<i>of which:</i> net outflows related to bank estates' compositions	33	26	4	76	2	18	1	12	12	12	12
Change in reserve assets (+ = increase/outflow)	555	-205	1,143	-495	-367	-137	-232	33	115	149	5
Net errors and omissions (+ = inflow)	-87	860	451	110	177	0	0	0	0	0	0
	(Percent of GDP)										
Current account	6.5	1.1	-2.7	-1.7	0.9	0.9	1.2	1.5	1.5	1.5	1.5
Trade balance	4.6	-1.4	-1.8	-0.2	-0.1	0.8	0.9	1.0	1.0	1.0	0.9
Balance on goods	-3.4	-2.7	-4.1	-5.2	-6.8	-5.9	-5.9	-5.7	-5.7	-5.6	-5.5
Merchandise exports f.o.b.	21.7	21.8	23.7	26.2	22.1	22.6	22.1	21.5	20.7	20.0	19.3
Merchandise imports f.o.b.	25.1	24.5	27.8	31.4	28.9	28.5	28.0	27.2	26.4	25.6	24.8
Balance on services	8.0	1.4	2.3	5.1	6.7	6.7	6.8	6.8	6.7	6.6	6.5
Exports of services, total	22.0	11.5	13.6	19.6	21.3	20.9	20.5	20.1	19.6	19.1	18.7
Imports of services, total	14.1	10.1	11.3	14.5	14.6	14.2	13.7	13.3	12.9	12.6	12.2
Primary income balance	2.8	3.3	0.1	-0.4	2.2	1.4	1.5	1.6	1.6	1.6	1.6
Receipts	3.5	3.4	2.9	2.6	3.7	2.9	2.6	2.3	2.2	2.1	1.9
<i>of which:</i> interest receipts	0.6	0.3	0.2	0.3	0.9	0.8	0.7	0.6	0.6	0.6	0.5
Expenditures	0.7	0.1	2.8	3.0	1.5	1.6	1.1	0.8	0.6	0.4	0.4
<i>of which:</i> interest payments	1.8	1.8	1.1	1.3	2.3	1.8	1.3	1.0	0.8	0.7	0.6
Secondary income balance	-0.8	-0.9	-1.0	-1.1	-1.2	-1.3	-1.2	-1.1	-1.1	-1.1	-1.0
Capital and financial account (+ = outflow)	6.1	4.9	-1.1	-1.5	1.3	0.7	1.0	1.3	1.3	1.3	1.3
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
Financial account (+ = outflow)	6.1	5.0	-1.0	-1.4	1.4	0.8	1.1	1.4	1.4	1.4	1.4
Direct investment (+ = outflow)	2.8	2.3	-2.0	-3.4	-0.9	-0.3	-0.9	-0.9	-0.8	-0.8	-0.6
Portfolio investment ("+" = outflow)	3.0	4.7	0.1	4.3	6.8	2.5	3.1	2.9	2.6	2.4	2.7
Assets (+ = outflow)	4.5	3.2	5.5	3.5	6.4	5.7	5.0	4.4	4.1	3.8	3.5
Liabilities (+ = inflow)	1.5	-1.4	5.5	-0.8	-0.4	3.2	2.0	1.5	1.5	1.4	0.9
<i>of which:</i> net borrowing (+ = inflow)	-1.2	-1.3	5.8	-1.0	-0.2	3.5	2.1	1.5	1.3	1.2	0.5
Other investment (+ = outflow)	-2.1	-1.3	-3.8	-0.9	-2.9	-0.8	-0.3	-0.6	-0.6	-0.4	-0.7
Assets (+ = outflow)	-3.8	-0.3	-0.1	2.1	-0.3	-1.1	-1.0	-1.0	-0.9	-0.9	-0.9
Liabilities (+ = inflow)	-1.8	1.0	3.7	3.1	2.6	-0.3	-0.7	-0.3	-0.3	-0.5	-0.2
Change in reserve assets (+ = increase/outflow)	2.2	-0.9	4.4	-1.7	-1.2	-0.4	-0.7	0.1	0.3	0.3	0.0
Net errors and omissions (+ = inflow)	-0.4	4.0	1.8	0.4	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Central bank reserves (\$ mn)	6,736	6,408	7,091	5,879	5,720	5,584	5,351	5,385	5,500	5,648	5,653
(Percent of GDP)	27.3	29.6	27.5	20.5	18.4	16.9	15.1	14.1	13.4	12.7	11.8
Memorandum item:											
Gross domestic product (\$ mn)	24,681	21,630	25,798	28,702	31,020	32,971	35,491	38,168	41,125	44,304	47,729
Sources: Central Bank of Iceland; and IMF staff projections.											

Table 7. Iceland: International Investment Position, 2012–23
(Percent of GDP)

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Assets	278.2	276.4	250.6	213.0	157.1	115.5	119.4	128.5	153.3	164.0	133.2	134.8
Direct investment	95.4	109.4	99.4	91.2	63.7	25.8	26.3	26.6	29.6	32.9	23.9	22.9
Portfolio investment	59.0	62.5	63.9	40.1	37.4	43.7	46.1	58.0	75.9	85.8	70.4	77.9
Equity and investment fund shares	34.8	34.6	36.8	35.3	34.9	40.1	40.5	52.0	69.6	79.1	64.6	69.6
Debt securities	24.2	27.9	27.1	4.8	2.5	3.5	5.6	6.0	6.3	6.7	5.8	8.3
Financial derivatives	0.1	0.2	0.6	0.5	0.3	0.5	0.4	0.4	0.6	0.2	0.4	0.4
Other investment	94.4	79.6	61.3	53.0	23.3	19.5	20.7	16.4	19.5	17.0	16.9	15.1
Reserve assets	29.3	24.7	25.4	28.3	32.5	26.0	25.9	27.2	27.9	28.2	21.6	18.5
Liabilities	724.4	661.2	623.4	218.1	155.2	113.5	110.2	108.5	119.1	126.2	109.2	98.1
Direct investment	81.9	97.0	96.4	92.4	80.7	45.0	40.6	39.0	39.5	45.0	39.7	34.8
Portfolio investment	324.2	285.9	289.1	41.8	49.0	42.9	42.6	44.5	50.4	49.8	38.9	33.5
Equity and investment fund shares	3.2	3.5	3.6	4.0	3.6	4.8	5.7	10.6	12.8	12.1	7.6	5.7
Debt securities	320.9	282.5	285.5	37.8	45.4	38.0	36.9	33.9	37.6	37.7	31.3	27.9
Financial derivatives	0.1	0.3	0.8	0.6	0.4	0.4	0.2	0.1	0.2	0.5	0.8	0.4
Other investment	318.3	278.0	237.1	83.3	25.2	25.2	26.7	24.8	29.1	30.9	29.7	29.4
Net international investment position	-446.2	-384.8	-372.9	-5.1	1.9	2.0	9.3	20.0	34.2	37.8	24.0	36.7

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 2023 was broadly in line with the level implied by fundamentals and desirable policies. The current account balance recorded a 1 percent surplus in 2023, from a 1.7 percent deficit in 2022, aided by a stronger primary income balance, and a further improvement in the service trade compared to 2022. 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: The envisaged fiscal trajectory and a tight stance on monetary policy would support the current account balance to remain in line with the fundamentals. Structural reforms to diversify exports and encourage firm digitalization and innovation will be critical in maintaining external competitiveness and ensuring a stable current account balance. The flexible exchange rate should act as the main shock absorber, with interventions limited to disorderly market conditions and under the 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) expanded to 36.7 percent of GDP in 2023, up from 24.0 percent in 2022. This improvement was driven by surpluses in the current account, as well as valuation and exchange rate changes. In 2023, gross assets amounted to 134.8 percent of GDP while gross liabilities stood at 98.1 percent of GDP. The majority of gross liabilities were attributed to portfolio investments in debt securities (about 28 percent of GDP) and FDI (about 34.8 percent of GDP).

Assessment. The NIIP is forecasted to maintain its current levels over the medium term, aligning with a gradual improvement in the current account balance. However, large fluctuations in valuation effects create uncertainties around the projections and pose a potential downside risk.

2023 (Percent of GDP)	NIIP: 36.7	Gross Assets: 134.8	Debt Assets: 30.6	Gross Liab.: 98.1	Debt Liab.: 71.2
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Current Account

Background. The current account (CA) balance turned positive in 2023, reaching 1.0 percent of GDP, following two consecutive years of deficits (2.7 percent of GDP in 2021 and 1.7 percent of GDP in 2022). The improvement in the CA was largely driven by a stronger services balance, supported by tourism income, and primary income balance, which improved due to higher receipts of dividends and reinvested earnings, combined with lower repatriation of profits by foreign companies. However, the goods balance worsened as a deteriorating terms-of-trade more than offset a sharp deceleration in imports. The CA balance is projected to continue improving gradually over the medium term.

Assessment. The EBA-lite cyclically adjusted CA balance stood at 1.2 percent of GDP in 2023. The EBA-lite CA regression estimates a norm of 1.3 percent of GDP, implying a staff-assessed CA gap of -0.1 percent. There is a large contribution from policy gaps, mostly due to the relative fiscal policy gap (smaller than the world average), which are offset by unexplained model residuals.

Iceland: Model Estimates for 2023 (in percent of GDP)

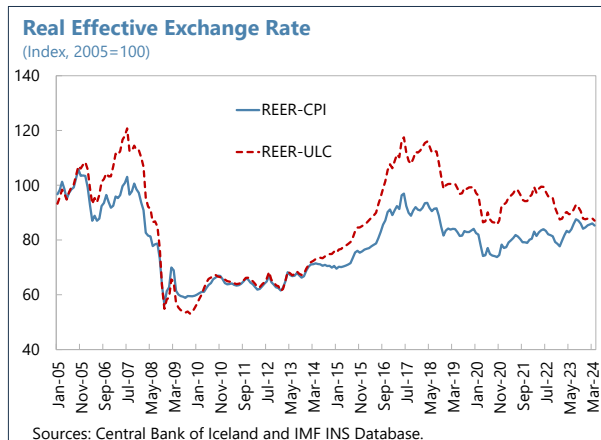
	CA model 1/	REER model
	(in percent of GDP)	
CA-Actual	1.0	
Cyclical contributions (from model) (-)	-0.2	
Natural disasters and conflicts (-)	0.0	
Adjusted CA	1.2	
CA Norm (from model) 2/	1.3	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	1.3	
CA Gap	-0.1	-5.1
o/w Relative policy gap	2.8	
Elasticity	-0.3	
REER Gap (in percent)	0.4	17.1

1/ Based on the EBA-lite 3.0 methodology
2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The average REER based on consumer prices appreciated by 2.3 between 2023 and 2022, consistent with the movement in the terms of trade. Compared to the previous five-year average, Iceland's REER (CPI based) was 1.9 percent higher in 2022. Unit labor cost-based REER, however, declined in 2023, about 7 percent lower than in 2022. In the first two months of 2024 the average CPI-based REER appreciated further by a 2.3 percent compared to 2023.

Assessment. The CA gap implies a 0.4 percent real overvaluation (applying an estimated elasticity of 0.3). The EBA-lite REER model suggests an overvaluation of 17 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 the basis for staff's assessment.



Capital and Financial Accounts: Flows and Policy Measures

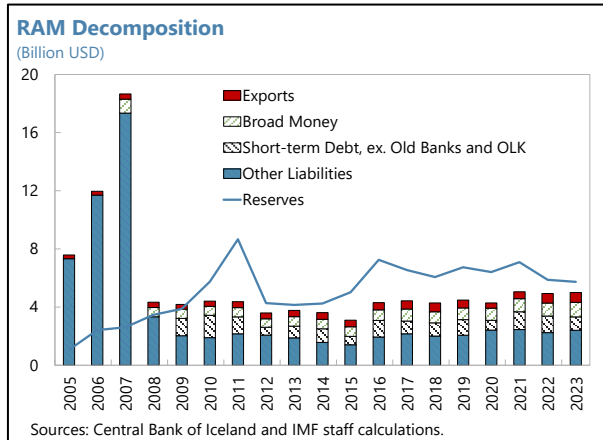
Background. Gross capital inflows declined (about 3.1 percent of GDP) in 2023 after record-high inflows in 2021 and 2022 (about 11.0 and 6.3 percent of GDP, respectively), making a significant departure from a persistent reduction in financial account liabilities since the GFC. The increase in liabilities was mainly due to direct investment (about 1.8 percent of GDP). Gross outflows amounted to 7.3 percent of GDP, driven mostly by portfolio investment; net inflows were about 4.2 percent of GDP. The discrepancy between the financial account and the CA balance, resulting in net error and omission, increased further in 2023 (though still lower than the 2020-2021 average). 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 since then.

Assessment. Capital inflows to Iceland remain dependent on global market conditions. But 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 turnover was 2.3 percent in 2023 - the lowest since 2018 and down from 14 percent in 2022. Total interventions (net sales) were about 0.1 percent of GDP in 2023, down from 0.3 percent in 2022. Foreign exchange reserves decreased by US\$80 million, to a total of US\$5.8 billion dollars by the end-2023, due also to treasury bond buybacks maturing in June 2024. The level of foreign exchange reserves was equivalent to 19 percent of GDP and about 5 months of prospective goods and services imports.

Assessment. At 115 percent of the Fund's ARA metric, the end 2023 level of reserves remains adequate for precautionary purposes.



Annex II. Risk Assessment Matrix¹

Risks	Relative Likelihood	Impact if Realized	Policy Response
Global Risks			
Conjunctural Risks			
Systemic financial instability. High interest rates and risk premia and asset repricing amid economic slowdowns and political uncertainty (e.g., from elections) trigger market dislocations, with cross-border spillovers and an adverse macro-financial feedback loop affecting weak banks and NBFIs.	Medium	Medium <ul style="list-style-type: none"> • Tighter financial conditions increase risk aversion and trigger capital outflows. • A decline in supply of credit and increase in borrowing costs for non-financial corporates and households depresses domestic demand. • Risk of drying-up of liquidity in the FX market. 	<ul style="list-style-type: none"> • Allow exchange rate to adjust while intervening to prevent disorderly market conditions. • Adjust monetary policy as needed. • Provide liquidity support to banks, if needed. • Allow automatic stabilizers to operate. • If accompanied by a risk-off shock, consider the use of FXI to ease the burden on monetary policy.
Intensification of regional conflict. Escalation or spread of the conflict in Gaza and Israel, Russia's war in Ukraine, and/or other regional conflicts or terrorism disrupt trade (e.g., energy, food, tourism, supply chains), remittances, FDI and financial flows, payment systems, and increase refugee flows.	High	Medium <ul style="list-style-type: none"> • 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. • Risk of drying-up of liquidity in the FX market. 	<ul style="list-style-type: none"> • Allow exchange rate to adjust while intervening to prevent disorderly market conditions. • Adjust monetary policy to steer inflation and inflation expectations back to target. • Stand ready with targeted fiscal and financial support measures, if needed. • If accompanied by a risk-off shock, consider the use of FXI to ease the burden on monetary policy.
Abrupt global slowdown or recession. Global and idiosyncratic risk factors cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation triggering sudden stops in EMDEs.	Medium	High <ul style="list-style-type: none"> • Reduced demand for Icelandic exports and tourism flows. • Lower commodity prices reduce export earnings. • Risk of drying-up of liquidity in the FX market. 	<ul style="list-style-type: none"> • Allow exchange rate to adjust while intervening to prevent disorderly market conditions. • Allow automatic stabilizers to operate. • If accompanied by a risk-off shock, consider the use of FXI to ease the burden on monetary policy.

¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

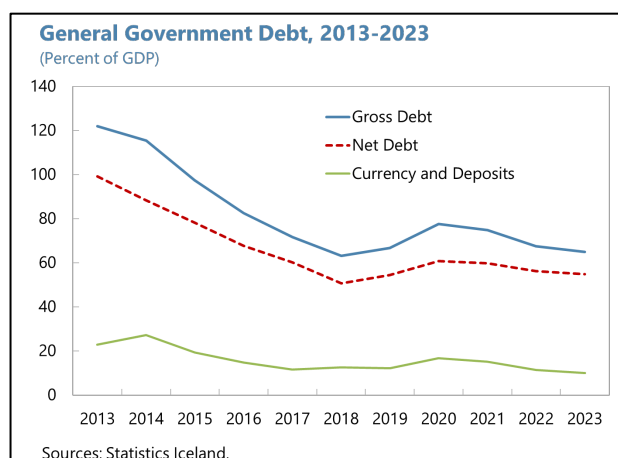
Risks	Relative Likelihood	Impact if Realized	Policy Response
Structural Risks			
<p>Monetary policy miscalibration. Amid high economic uncertainty, major central banks loosen policy stance prematurely, hindering disinflation, or keep it tight for longer than warranted, causing abrupt adjustments in financial markets and weakening the credibility of central banks.</p>	Medium	<p style="text-align: center;">Medium</p> <p>Premature loosening:</p> <ul style="list-style-type: none"> • Import prices will rise, feeding into domestic inflation. • Further de-anchoring of inflation expectations. <p>Tight for longer:</p> <ul style="list-style-type: none"> • Sharp slowdown in external demand. • Lower import prices. • Higher risk premium. 	<p>Premature loosening:</p> <ul style="list-style-type: none"> • Allow exchange rate to adjust while intervening to prevent disorderly market conditions. • Tighten monetary policy to steer inflation and inflation expectations back to target. <p>Tight for longer:</p> <ul style="list-style-type: none"> • Allow exchange rate to adjust while intervening to prevent disorderly market conditions. • Loosen monetary policy to steer inflation and inflation expectations back to target.
<p>Cyberthreats. Cyberattacks on physical or digital infrastructure and service providers (including digital currency and crypto assets) or misuse of AI technologies trigger financial and economic instability.</p>	Medium	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Disruption of cross-border payments and financial flows. 	<ul style="list-style-type: none"> • Stand ready to provide support to critical infrastructure or institutions. • If effects are widespread, consider fiscal and liquidity support.
<p>Extreme climate events. Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.</p>	Medium	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Damage to infrastructure and wealth weakens economic activity. 	<ul style="list-style-type: none"> • Stand ready to provide targeted fiscal support to affected sectors. • Allow exchange rate to adjust while intervening to prevent disorderly market conditions.
Iceland-Specific Risks			
<p>Increased volcanic activity.</p>	Medium	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Damage to infrastructure and wealth weakens economic activity. • Lower tourism inflows. 	<ul style="list-style-type: none"> • Stand ready to provide targeted fiscal support to sectors impacted by volcanic activity. • Adjust monetary policy to the lower demand, depending on how the shock manifests itself in terms of overall demand, the labor market and inflation expectations.
<p>Increasing labor market tightness/premature loosening of domestic monetary policy</p>	Medium	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Higher real wage growth pushes up firms' costs and increases inflation. • Further de-anchoring of inflation expectations. • Disruption to economic activity. 	<ul style="list-style-type: none"> • Adjust monetary policy to steer inflation and inflation expectations back to target.
<p>Tight for longer domestic monetary policy</p>	Medium	<p style="text-align: center;">Medium</p> <ul style="list-style-type: none"> • Faster cooling of the economy than expected, lower domestic demand, and rising economic slack. • Inflation undershoots the target for a sustained period of time, damaging central bank credibility. 	<ul style="list-style-type: none"> • Adjust monetary policy to steer inflation and inflation expectations back to target.

Annex III. Sovereign Risk and Debt Sustainability Assessment

Iceland's public debt is projected on a downward path through the projection horizon as vulnerabilities remain manageable with the envisaged medium-term fiscal outlook¹. Public debt bears little currency risk but some liquidity and interest rate risks, while Iceland's large institutional investor sector managing a mandatory pension saving scheme is a source of strength. Reintroduction of the fiscal rules in 2026 helps to ensure debt-sustainability in the medium-term, while reforms to tackle risks from long-term demographic pressures on health spending, should advance.

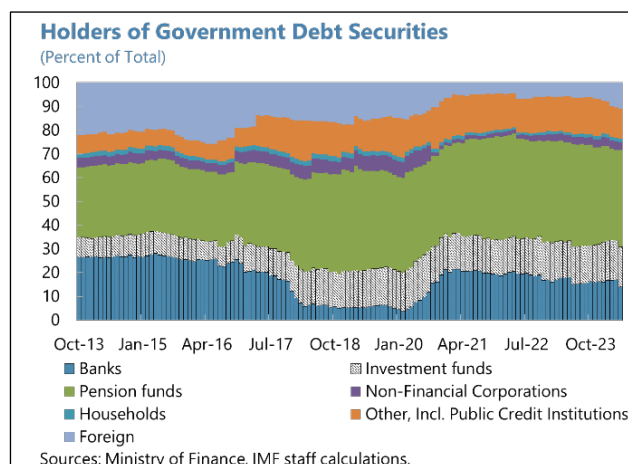
1. Public debt is on a downward trajectory and remains manageable.

General government gross debt amounted to 64.8 percent of GDP by end-2023. Net debt was 54.8 percent after excluding liquid currency and deposits of the government. Government deposits declined by about 1.3 percent of GDP during 2023, including FX deposits due to early repayment of a foreign currency denominated bond maturing in 2024. The repayment also reduced foreign reserves, as foreign currency treasury deposits are held in the central bank and are part of international reserves. This development was partially reversed in March 2024, with the issuance of a green bond (see below).



2. Iceland continues to enjoy favorable market access abroad and domestically.

No new international bonds were issued in 2023, but the Treasury issued an inaugural green bond in March 2024 in the amount of €750 million. A large institutional investor base includes pension funds, which hold about 40 percent of public debt issued domestically. Domestic banks hold about 15 percent and foreign investors about 10 percent of domestic debt. Iceland's credit rating improved slightly in 2023 with one agency raising its rating to A+, while others maintained their A rating.



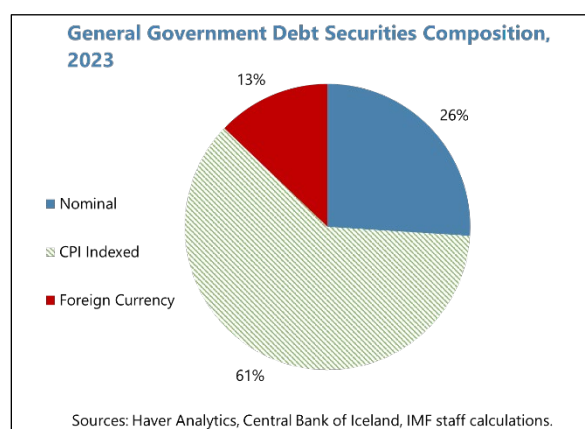
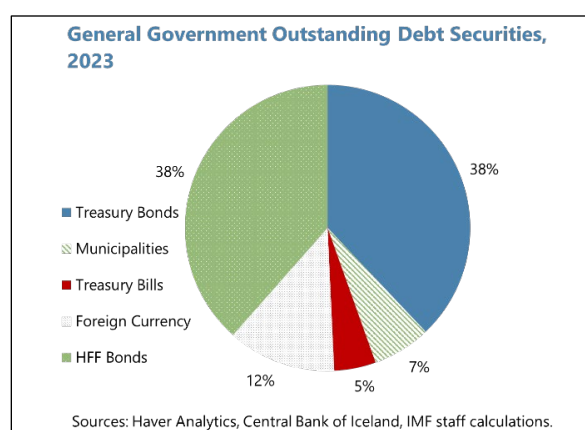
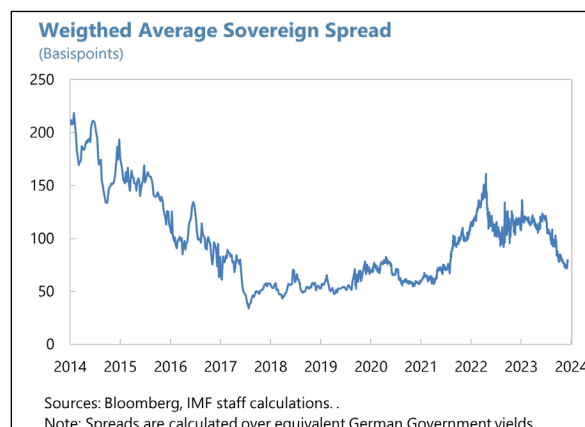
¹ Staff's baseline projections assume the government spending projections in government's MTFs 2025–29 adjusted for inflation differences, planned but unidentified adjustment, and staff's macroeconomic framework. Staff has more conservative assumptions on revenue projections, including on tax buoyancy, through the projection period.

Sovereign spreads declined through 2023 and early 2024 to 80 bps over equivalent German issuance. Meanwhile, yields on domestic treasury notes increased modestly to around 7 percent by end-2023 in part due to ongoing monetary tightening.

3. Government guaranteed HFF bonds are a significant part of general government outstanding debt securities. General government outstanding issuance consists mainly of Treasury Bonds (38 percent of total), government guaranteed bonds of the HFF (38 percent of total) and foreign currency- denominated debt issuance abroad (12 percent of total), while municipal issuance is only a small part of general government issuance (7 percent of total). The government initiated voluntary swap auctions for holders of outstanding HFF bonds during 2023, and in February 2024, the government, and representatives of 18 pension funds, which together hold the largest share of HFF bonds, announced that they would start negotiations on an early settlement of the HFF's bonds.

4. Net government debt bears little currency risk but some liquidity and interest rate risks. Although about 13 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 local currency and indexed to the CPI, while the remainder is unindexed nominal local currency debt. The treasury securities have a short residual maturity of about 5.5 years, with foreign currency securities having a short maturity of 5 years and indexed securities an average maturity of 6.3 years. The short maturity exposes the government to some interest rates and funding risk.

5. Long-term pension and health spending pressures are contained but require long-term planning and adherence to the fiscal rules. The SRDSA points to adverse demographic developments in Iceland in the decades ahead. The Public Finance Act in Iceland states that the Minister of Finance and Economic Affairs should, every three years, submit to parliament a report that provides an assessment of the spending impact of demographic variables for the coming



decades. This supports an informed debate of the need to adjust to demographic change. Iceland has a well-developed and large pillar II and III pension system, and future unfunded pension liabilities under pillar I are financed as accrual interest in the budget. According to the latest report from 2021, health expenditures will increase significantly over the next 30 years, adding 3 percent of GDP of additional health spending needs annually by 2050, due to aging, according to the authorities' long-term projections. A mitigating circumstance has been the large inflow of mainly young immigrants over the last decade, many of which have settled in Iceland, resulting in more favorable demographic projections. Nevertheless, adherence to the fiscal rule and reforms to contain long-term spending pressures, or broadening the tax base, will be needed.

6. The SRDSA is based on staff's baseline fiscal projections. These are in line with the 2024 budget and 2025–29 medium-term fiscal policy strategy. The SRDSA suggests a debt-stabilizing primary balance (excluding other identified flows) of 0.2 percent of GDP, which is expected to be reached by the end of the projection period. This is consistent with the authorities' fiscal objective of stabilizing public sector debt by the end of the forecast horizon.

Annex III. Figure 1. Iceland: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	...	Low	The overall risk of sovereign stress is low on a continued recovery and improved debt indicators. Delays in fiscal consolidation in the run-up to the 2025 elections is an upside risk to debt. The re-introduction of fiscal rules in 2026 will help ensuring medium-term debt sustainability.
Near term 1/			
Medium term	Low	Low	Medium-term risks are assessed as low. In the baseline interest rate risks are low, but can increase in an adverse high interest rate scenario. The wide fan chart is the result of the 2008 crisis, and thus the size of historical shocks to debt. The reintroduction of the fiscal rules in 2026 will help ensuring medium-term debt sustainability.
Fanchart	Moderate	...	
GFN	Low	...	
Stress test		...	
Long term	...	Low	Long-term risks are low given the advanced pension system. Age related spending on health and social security will increase in the long-term. The fiscal rules, and the prudent long-term planning perspective of Icelandic policy making, will help ensuring debt sustainability.
Sustainability assessment 2/	Not required for surveillance countries	Not required for surveillance countries	
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Commentary: Iceland is at a low overall risk of sovereign stress and debt is projected on a downward path in the baseline. Debt indicators have improved, and medium-term liquidity needs are low. The reintroduction of the fiscal rules in 2026 will help ensuring medium-term debt sustainability. Over the longer run, the narrowing of the deficit projected by the authorities will need further measures and specification of planned but unspecified measures, but it does not jeopardize sustainability. Reforms to tackle health spending pressures from long-term population aging should advance.

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.

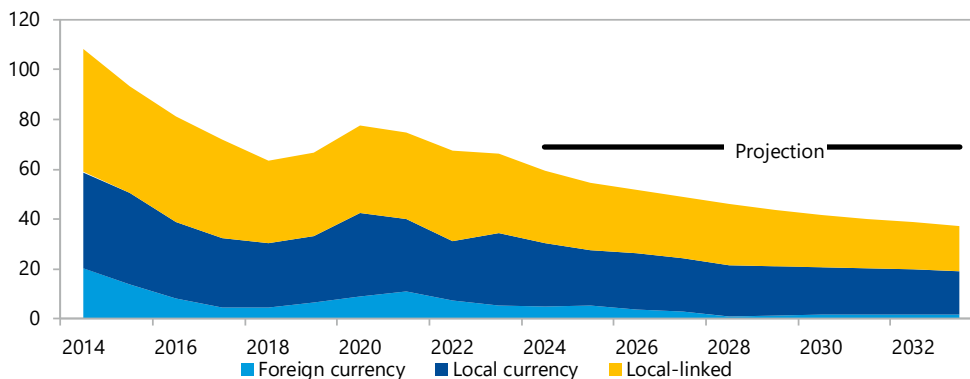
1/ The near-term assessment is not applicable in cases where there is a disbursing IMF arrangement. In surveillance-only cases or in cases with precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement.

Annex III. Figure 2. Iceland: Debt Coverage and Disclosures

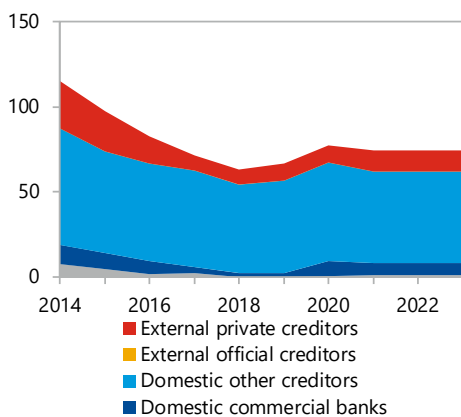
										Comments						
1. Debt coverage in the DSA: 1/					CG	GG	NFPS	CPS	Other							
1a. If central government, are non-central government entities insignificant?										n.a.						
2. Subsectors included in the chosen coverage in (1) above:																
Subsectors captured in the baseline										Inclusion						
CPS	NFPS	GG: expected	CG	1	Budgetary central government					Yes	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.					
				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									
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	Total			
CPS	NFPS	GG: expected	CG	Issuer												
				1	Budget. central govt										0	
				2	Extra-budget. funds											0
				3	Social security funds											0
				4	State govt.											0
				5	Local govt.											0
				6	Nonfin pub. corp.											0
				7	Central bank											0
8	Oth. pub. fin. corp											0				
Total					0	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. Comment: Debt coverage is general government debt in line with the publication of general government debt from Statistics Iceland. Pension liabilities and the guaranteed HFF bonds are included in the SRDSF. The government's recent purchase of homes in Grindavik is included in debt.																

Annex III. Figure 3. Iceland: Public Debt Structure Indicators
Debt by Currency (Percent of GDP)



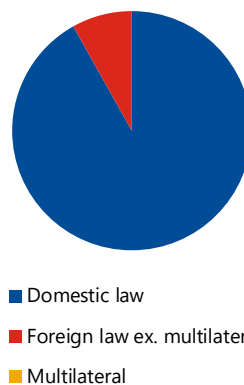
Note: The perimeter shown is general government.

Public Debt by Holder (Percent of GDP)



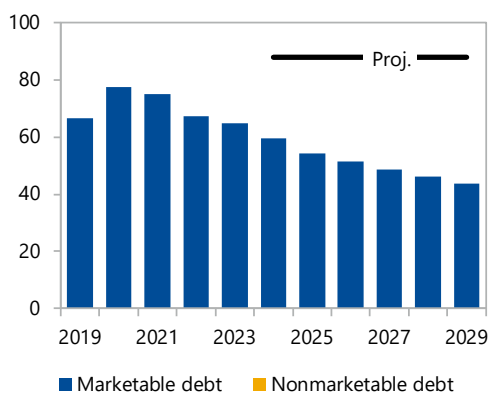
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2023 (percent)



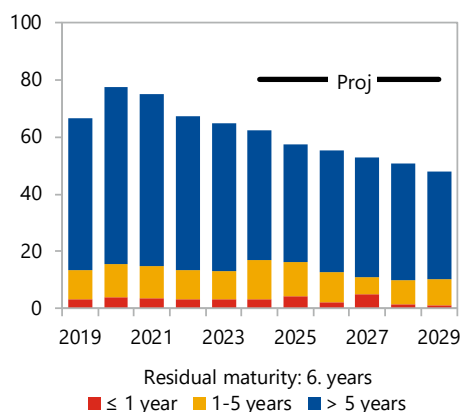
Note: The perimeter shown is general government.

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.

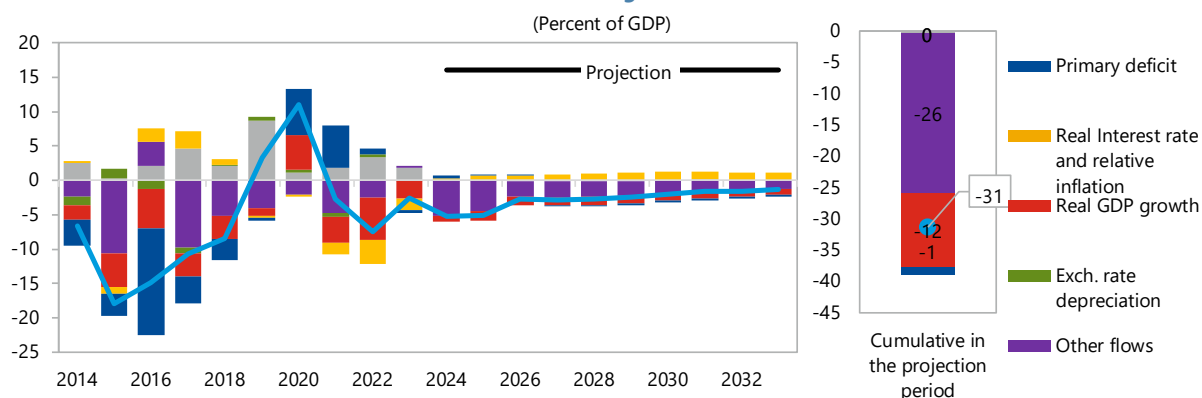
Commentary: Public debt is largely in domestic currency with a significant share linked to CPI. Iceland has a large institutional investor base, including pension funds. Most debt have a residual maturity slightly shorter than six years.

Annex III. Figure 4. Iceland: Baseline Scenario

(Percent of GDP unless indicated otherwise)

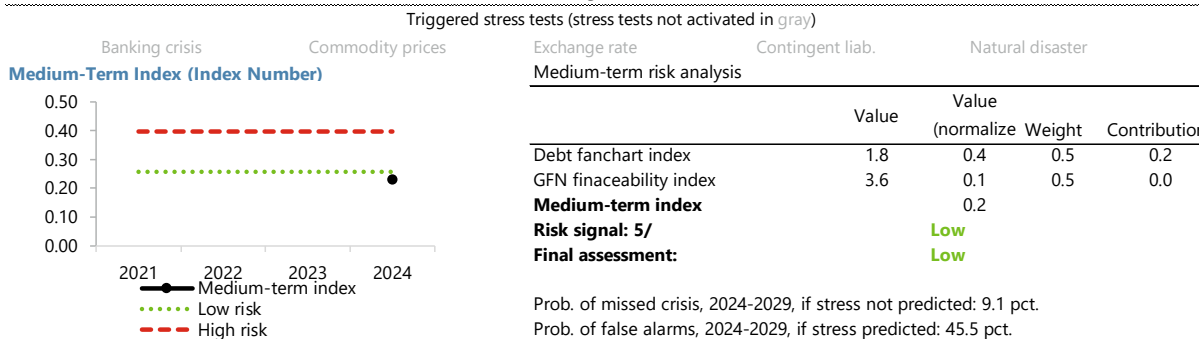
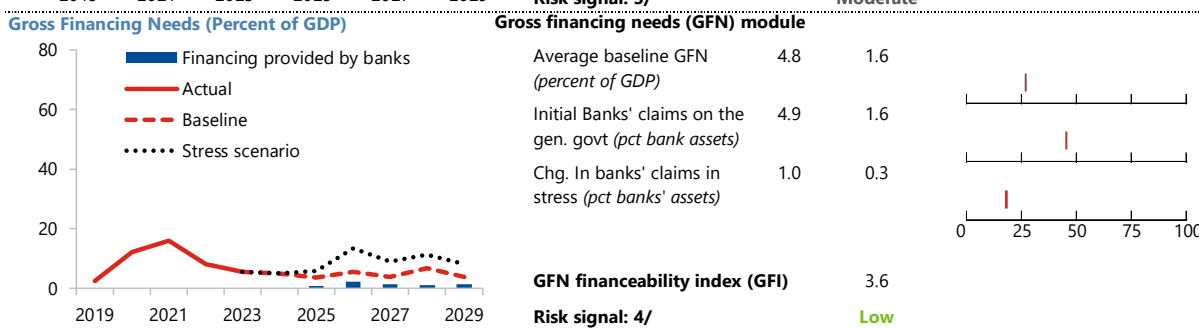
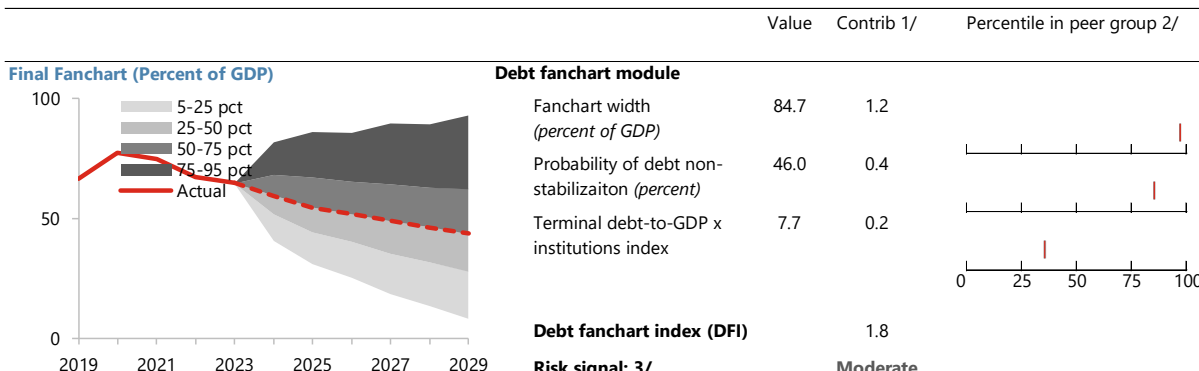
	Actual	Medium-term projection						Extended projection			
	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033
Public debt	64.8	59.6	54.4	51.7	48.9	46.2	43.8	41.8	40.2	38.6	37.4
Change in public debt	-2.6	-5.2	-5.1	-2.7	-2.8	-2.7	-2.4	-2.0	-1.6	-1.5	-1.3
Contribution of identified flows	-4.4	-5.2	-5.1	-2.6	-2.7	-2.5	-2.3	-2.0	-1.8	-1.5	-1.3
Primary deficit	-0.4	0.4	0.0	0.1	0.0	-0.1	-0.3	-0.3	-0.3	-0.3	-0.3
Noninterest revenues	40.5	40.5	40.2	40.0	39.9	40.1	40.2	40.2	40.2	40.2	40.2
Noninterest expenditures	40.1	40.9	40.2	40.1	39.9	39.9	39.9	39.9	39.9	39.9	39.9
Automatic debt dynamics	-4.4	-0.5	-0.6	-0.4	-0.3	-0.1	0.0	0.1	0.1	0.1	0.2
Real interest rate and relative inflation	-1.7	0.3	0.8	0.7	0.9	1.0	1.1	1.2	1.1	1.1	1.1
Real interest rate	-1.9	0.1	0.7	0.7	0.8	1.0	1.1	1.1	1.1	1.1	1.1
Relative inflation	0.1	0.2	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-2.6	-0.8	-1.4	-1.2	-1.2	-1.2	-1.1	-1.1	-1.0	-1.0	-0.9
Real exchange rate	0.0	...	...	...	...	...	...	...	...	...	...
Other identified flows	0.4	-5.2	-4.5	-2.3	-2.4	-2.3	-2.1	-1.9	-1.6	-1.4	-1.2
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	-2.6	-2.6	-2.1	-1.6	-1.4	-1.3	-1.1	-1.0	-0.8	-0.7	-0.6
Other transactions	3.0	-2.6	-2.4	-0.7	-1.0	-1.0	-0.9	-0.9	-0.8	-0.7	-0.6
Contribution of residual	1.8	0.0	0.0	-0.1	-0.1	-0.2	-0.1	0.1	0.1	0.0	0.0
Gross financing needs	5.6	5.0	3.7	5.7	3.7	6.9	3.8	3.7	4.1	4.0	4.7
of which: debt service	8.6	7.2	5.7	7.1	5.2	8.3	5.2	5.0	5.3	5.0	5.6
Local currency	5.7	2.9	3.2	1.4	1.9	3.6	2.4	2.5	2.7	2.4	2.9
Foreign currency	1.1	0.7	0.0	1.7	1.4	2.6	0.6	0.7	0.9	0.9	1.0
Memo:											
Real GDP growth (percent)	4.1	1.2	2.4	2.2	2.3	2.4	2.4	2.5	2.5	2.5	2.5
Inflation (GDP deflator; percent)	5.9	5.3	3.4	3.2	3.3	3.2	3.1	3.0	2.9	2.8	2.7
Nominal GDP growth (percent)	10.2	6.6	5.8	5.4	5.7	5.6	5.6	5.5	5.4	5.3	5.2
Effective interest rate (percent)	2.9	5.5	4.6	4.4	4.9	5.3	5.7	5.8	5.7	5.7	5.7

Contribution to Change in Public Debt



Commentary: Public debt will continue falling over the extended projection period as HFF liabilities are repaid and the government divest other public holdings using its remaining assets, also reflected in significant other transactions, and the reinstated fiscal rules are followed.

Annex III. Figure 5. Iceland: Medium-Term Risk Assessment

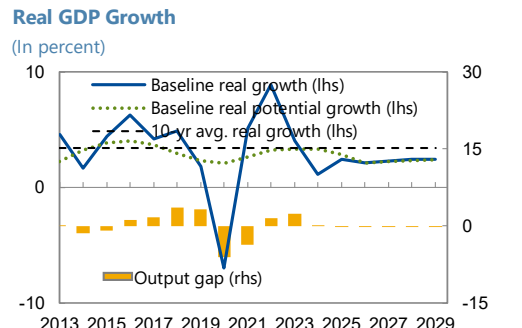
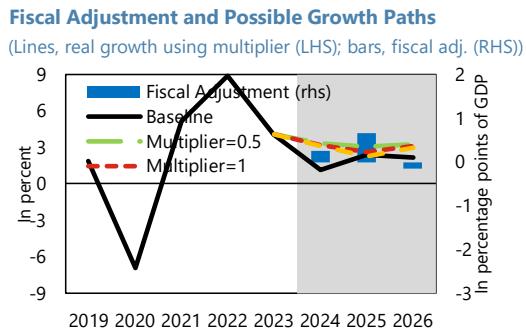
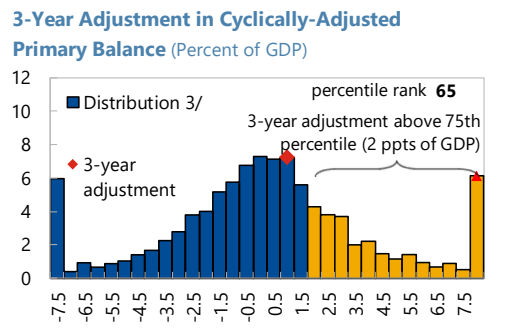
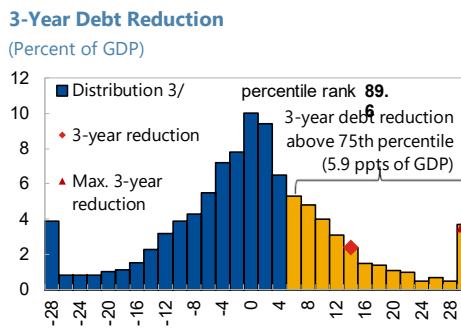
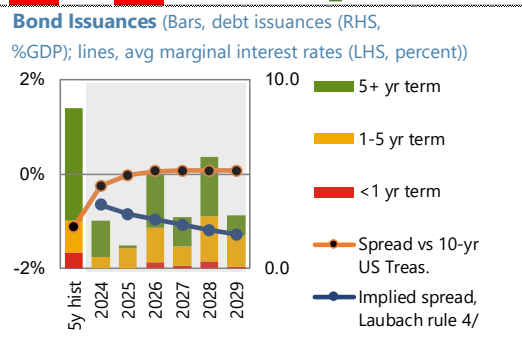
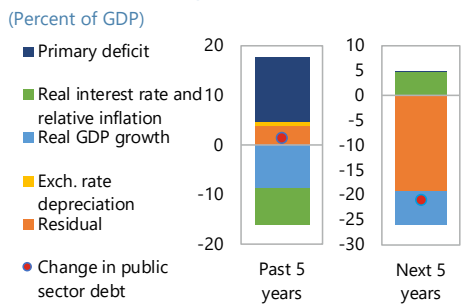
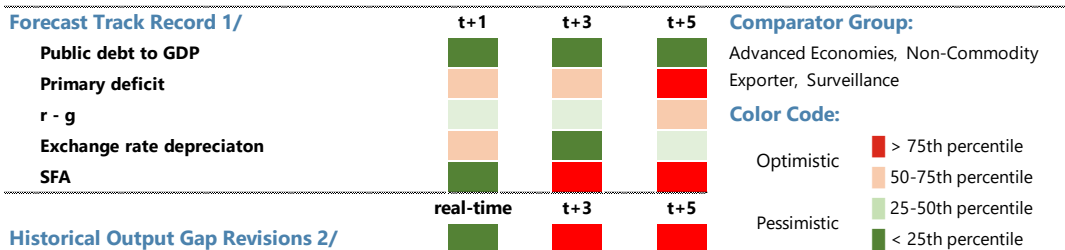


Commentary: The wide fan chart is impacted by the 2008 crisis and the historical shock to debt. The reintroduction of fiscal rules in 2026 should underpin the baseline, but does not impact the fanchart calculated on the basis of historical shocks.

Source: IMF staff estimates and projections.

1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.
 2/ The comparison group is advanced economies, non-commodity exporter, surveillance.
 3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, it is moderate risk.
 4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, it is moderate risk.
 5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, it is moderate risk.

Annex III. Figure 6. Iceland: Realism of Baseline Assumptions



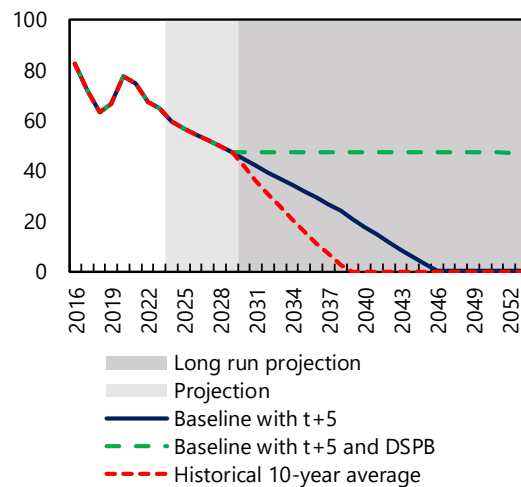
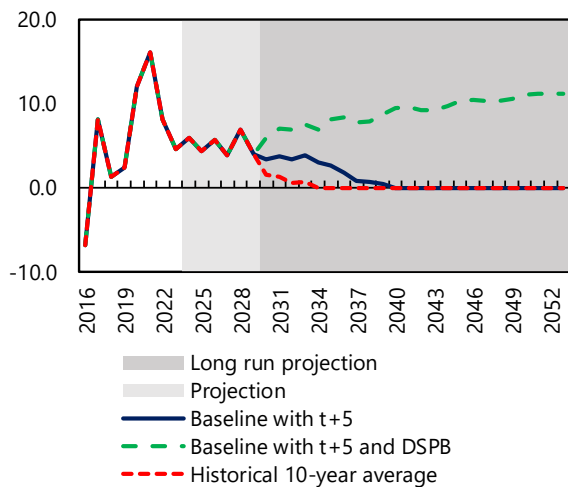
Commentary: The realism assessment reveal potential optimism bias on the primary deficit and stock-flow adjustments at the t+5 horizon. These can potentially be explained by the inclusion of HFF liabilities in general government debt in 2019. The average issuance over the last 5 years is impacted by the pandemic period, with deficits close to the 2008 crisis.

Source : IMF Staff.

1/ Projections made in the October and April WEO vintage.
 2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates
 3/ Data cover annual observations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.
 4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

Annex III. Figure 7. Iceland: Long-Term Risk Assessment—Large Amortization

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio	Green
	Amortization-to-GDP ratio	Green
	Amortization	Green
Medium-term extrapolation with debt stabilizing primary balance	GFN-to-GDP ratio	Green
	Amortization-to-GDP ratio	Green
	Amortization	Red
Historical average assumptions	GFN-to-GDP ratio	Green
	Amortization-to-GDP ratio	Green
	Amortization	Green
Overall Risk Indication		Green



Commentary: The large amortization module indicates overall low funding/roll-over risks in the long-term, on staff's baseline assumptions. The risk indication is somewhat higher, but manageable, using an assumption of the debt-stabilizing primary balance in the projections.

Annex IV. Previous Article IV Recommendations

Annex IV. Table 1. Iceland: Implementation of Article IV Recommendations	
Key Recommendations	Implementation Status
Fiscal Policy	
Accelerating Medium-Term Fiscal Consolidation to Speed Up Disinflation and Rebuild Buffers.	
<ul style="list-style-type: none"> It would be desirable to frontload the overall fiscal consolidation in the MTF5, to bring the deficit close to zero by 2025. Reversing the 3-6 percent increase in the real spending envelope in the MTF5. Reducing the number of items subject to reduced VAT rates. Reviewing existing tax expenditures to explore the scope for efficiency gains and improvements in targeting. 	<ul style="list-style-type: none"> Progress. The fiscal outcome in 2023 was better than projected by staff, due in part to cyclical developments. While the envisaged pace of fiscal consolidation is somewhat more gradual than recommended in the 2023 Article IV, this is appropriate given the narrowing of imbalances and a more favorable debt outlook. Limited progress. While the 2025-29 MTF5 envisaged a reduction in government expenditure relative to the size of the economy, the projected real expenditure envelope in the 2025-29 MTF5 remains 6-8 percent above that in the 2023-27 MTF5. This partly reflects the shift in support for electric vehicles from the revenue side to the expenditure side of the budget, starting in 2024. Limited progress. The authorities are working on reducing the VAT gap. However, there is limited change in the number of items subject to a lower VAT rate. Some progress. The authorities are reviewing R&D tax expenditures with a view to increase efficiency and prevent misuse.
Reinstating the Fiscal Rules to Underpin Long-Term Sustainability	
<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> Delayed. The decision to reinstate the fiscal rules in 2025, one year earlier than envisaged, has been reversed to allow time for a reconsideration of their design.
Privatization Process and Government Obligations in HFF	
<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> Some progress. The privatization of Islandsbanki is expected to restart in 2024 and be completed in 2025. The government has introduced legislation, with stricter rules governing the sale and greater oversight by Parliament. Some progress. The government has proposed a draft bill on winding down insolvent public entities, currently discussed in parliament. Further, the Minister of Finance and Economic Affairs and representatives of the pension funds, which together hold the largest share of bonds in HFF, have started negotiations on a settlement.

Key Recommendations	Implementation Status
Monetary Policy	
<ul style="list-style-type: none"> 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. 	<ul style="list-style-type: none"> Progress. The CBI tightened the policy rate further in 2023 and has maintained a tight monetary policy stance thus far. Inflation is gradually declining and is expected to reach the target within the monetary policy horizon.
Structural Policies	
Diversifying and Tourism	
<ul style="list-style-type: none"> Ease 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. 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. 	<ul style="list-style-type: none"> Some progress. The authorities are making efforts in diversifying the economy, including R&D incentives in the traditional exporting sectors, e.g., fisheries, that allow these sectors to innovate and move traditional exports further up the value chain. There has been limited progress on measures to ease the regulatory burden. Progress. The government adopted in the 2024 budget a new alternative airport tax, reestablished the hotel accommodation tax (following its abolishment during the pandemic) with the rate raised and the base broadened. The government is also considering user-based fees or limits at popular tourist attractions to prevent potential overcrowding.
Climate	
<ul style="list-style-type: none"> With emission 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. 	<ul style="list-style-type: none"> Progress. The authorities published an updated Climate Action Plan in June 2024 that includes sector-specific mitigation measures. The authorities will use taxes and subsidies across a broader range of sectors, including the fishing sector, to incentivize the capture of CO₂ emissions, encourage the transition from diesel and petrol to electricity, and scale up investments in renewable energy including hydropower, wind power, and green hydrogen.
Labor Market	
<ul style="list-style-type: none"> 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. Mechanisms to resolve protracted impasses in negotiations should be strengthened, including by ensuring that the state mediator is able to bring negotiating parties together and make proposals to resolve disagreements. 	<ul style="list-style-type: none"> Progress. The 2024 wage negotiations agreed on a productivity bonus relative to the start of the agreement, aiming at better aligning the real wage with real productivity developments. Some progress. While there have been no formal changes to the role of the state mediator, the role is assessed to have been strengthened in practice.

Annex V. Update on the Implementation of FSAP Recommendations

Recommendations	Horizon ¹	Status
<i>Cross-Cutting</i>		
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.	NT	The CBI has increased its resources as well as reorganized and improved its operations. The Banking Supervision Division and the Insurance and Pension Division have been merged into a single Microprudential Supervision Division to optimize resources and strengthen supervision. Post-merger, there are now two positions tasked with analyzing market risk and IRRBB. Resources dedicated to monitoring operational risks, including ICT and cybersecurity risks, have been more than doubled. The CBI has also increased resources for the implementation of a TIBER-IS framework for testing cyber security among participants critical to the financial system. A cross-divisional team has been set up to focus on financial climate risks (including stress testing) and other environmental issues, accompanied by an increase of resources (2 FTEs). Considerations are underway to increase the resources for the RA to 3 FTEs later in 2024.
<i>Regulation and Supervision: Banking and Pension Funds</i>		
Develop and implement a streamlined and independent budgetary process for supervision.	NT	Given the classification of supervisory fees as a form of tax—changes affecting which would require legislative changes—close consultation and collaboration between the CBI and the MoFEA are underway to identify viable options for streamlining and reforming this process whilst ensuring adherence to the constitution.
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.	NT	The CBI has proposed draft amendments to the Central Bank Act to enhance the legal protection of supervisors following the merger of the CBI and the FSA has been drafted by the CBI. Further consultations are in the pipeline among the PMO, MoFEA, and the CBI on the best next steps on the recommendation, given the potential need to take a more comprehensive approach that goes beyond financial supervisors. The CBI and the MoFEA are in consultations to consider options to broaden the definition of related party transactions and the CBI's supervisory oversight over banks' external auditors.

Recommendations	Horizon ¹	Status
Regulation and Supervision: Banking and Pension Funds		
Remove MoFEA staff from CBI's FMEN (independence) and implement internal delegation of powers framework (accountability).	NT	<p>The MoFEA staff member that sat on the CBI's FMEN was replaced by an external member in January 2024. With the statutory amendments to the Central Bank Act in June 2023, the delegation of powers within the CBI was strengthened and the FMEN's decision-making prerogative has been clarified including on administrative fines and per diem fines, referral of alleged violations to the police, revocation of operating licenses for severe or repeated violations and the dismissal of board members and managing directors for conduct constituting a violation. The CBI now makes all other decisions.</p> <p>The CBI is finalizing a framework for internal delegation of powers which consists of rules of signature for the whole Bank and delegation of power from the Governor to the Deputy Governor for Financial Supervision and formal procedures within the supervision divisions (Conduct Supervision and Microprudential Supervision) regarding signature authorizations. Other working procedures describing the delegation of power from the Governor to other departments within the Bank on certain issues such as foreign exchange interventions are already in place or being further developed.</p>
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.	NT	Several aspects of the risk management practices are already evaluated each year as a part of SREP including the adequacy of banks' risk management resources, risk appetite, the roles and responsibility of board and employees etc. Climate risks are also incorporated into the SREP process each year. The SREP process with respect to these risk factors often involves on-site visits. The Microprudential Supervision Division is revising the on-site inspection program, in line with FSAP recommendations.
Issue application regulations or supervisory guidance to banks for appropriate and proportionate implementation of EU rules (ensure compliance with Basel standards) and EBA guidelines.	MT	The CBI has been in contact with banking supervisory authorities in other Nordic countries to learn from other countries' experiences on how the Bank can close the gap between the EU rules and Basel standards.

Recommendations	Horizon ¹	Status
<i>Regulation and Supervision: Banking and Pension Funds</i>		
Align rules on governance, internal controls, risk management with IORP II or Solvency II, and enact more stringent rules for outsourcing.	NT	The CBI has reevaluated the guidelines on outsourcing to enact more stringent rules on outsourcing. A working group spearheaded by MoFEA is drafting a “green paper”, which will conduct a diagnosis on the current situation and challenges facing the pension system, which is expected to be completed in 2024 and to be followed by a “white paper” that will identify policy options, expected to be completed in 2025. The white paper is expected to provide the basis for legislative amendments.
Perform regular on-site inspections for large pension funds and re-establish institutionalized supervisory dialogue.	I	<p>The Financial Supervisory Committee is expected to approve the CBI’s revised risk-based supervisory framework for pension funds—including the minimum frequency of on-site inspections—by end-June 2024. On-site inspections for larger pension funds (impact category 1 and 2) will be conducted at least every five years. The CBI will perform on-site inspections on smaller pension funds (categorized in impact categories 3 and 4) based on the results of the risk assessment.</p> <p>The CBI has formalized meetings with the four largest pension funds (covering around 60 percent of total pension fund assets) annually. The meetings are attended by Deputy Governors for Financial Stability and Financial Supervision, Directors of the Macroprudential Supervision and Financial Stability, and directors and senior staff members of pension funds. Meetings with the Icelandic Pension Fund Association will be held twice a year to discuss supervisory priorities and other relevant topics.</p>
Define infringements and sanctions in the Pension Fund Act.	NT	A working group spearheaded by MoFEA is drafting a “green paper”, which will conduct a diagnosis on the current situation and challenges facing the pension system, which is expected to be completed in 2024 to be followed by a “white paper” that will identify policy options, expected to be completed in 2025. The white paper is expected to provide the basis for legislative amendments.

Recommendations	Horizon ¹	Status
Systemic Risk Analysis		
Develop approaches to monitor funding risks from nonbank financial institutions (including pension funds) and foreign investors.	NT	The CBI has continued developing ways to monitor funding risks from nonbank financial institutions, for example, by gathering better information on ownership of covered bonds issued by commercial banks and using information about deposits from nonbank financial institutions and foreign investors in liquidity stress tests.
Differentiate inflation indexed and non-indexed lending and funding instruments in the analysis of inflation impact on banks' credit, interest rate, and market risks.	MT	In the short term, the PD and LGD models are supplemented with new sensitivity analysis that reflect the different risks associated with indexed/non-indexed loans more accurately. On a more permanent basis, the next revision of the credit risk models will include PD and LGD models estimated on a borrower level (compared to the current aggregate basis). That will allow greater differentiation between the risk involved with indexed and non-indexed loans. The data requirements for the revised models may however push the implementation back as far as 2027.
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.	NT	The CBI has added various scenarios for individual currencies with runoff and haircut rates of different severity to the liquidity stress tests and results are included in monthly reports and presentations to the Financial Stability Committee. LCRs for all significant currencies are monitored at least on a monthly basis. Outlier banks are addressed through pillar 2 (SREP/ILAAP) and other supervisory actions. The CBI has regulatory limits for euros and already calculates the euro HQLA/FX net outflows with a minimum ratio of 100 percent.
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.	NT	The CBI closely monitors changes in the pension funds' investments, whether caused by the external or internal environment. This includes asset composition, risk profile, arrears, etc. Current monitoring covers the impact of developments in interest rates and inflation on pension funds' investment behavior and Pillar III cash flows.
Perform data quality checks for pension funds' supervisory reporting data, require pension funds to submit corrections and expand automated validation rules.	NT	The CBI has expanded the automated validation rules for pension funds' annual reports and list of assets. Data quality checks have been expanded in Power BI and a dashboard showing warnings and reporting errors has been developed. The next step is to implement the changes in the ExMon monitoring tool and determine which alerts can result in an automated rejection of the report. The pension funds are required to submit corrections if the reports are found to be faulty in material ways.

Recommendations	Horizon ¹	Status
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.	I/NT	Work is underway to introduce an account-to-account (A2A) domestic retail solution to increase resilience and efficiency of the domestic payment system in 2024. The CBI, in cooperation with the PMO and MoFEA, has drafted a bill granting the CBI authority to issue rules aimed at increasing resilience and efficiency in domestic payments. The bill has been adopted by Parliament. The CBI has also updated its playbook for cash distribution in a crisis situation and also established a working group in the Payments Council to investigate how commercial businesses might react to a significant disruption to the debit and credit card system. The conclusions of the working group were presented to the Payment Council and subsequently communicated to relevant agencies.
Produce a financial sector specific cybersecurity strategy, clearly setting out the roles and responsibilities of each party.	I	A working group within the CBI along with SURF is working on a coordination plan for the financial sector that can be activated in a crisis. The coordination plan is designed to be an extension of business continuity plans (BCP) of financial institutions and the CBI itself, when acting as a bank. The focus of the plan is to clearly set out the roles and responsibilities of each party in safeguarding the operational security of financial market infrastructure and financial stability while technical issues are being handled on a second action path. The plan will involve the Financial Stability Council, and the coming EU-SCICF; and the CERT-IS at the Electronic Communications Office, which reports to the Department of Civil Protection and Emergency Management of the National Commissioner of the Icelandic Police. The MoFEA and the CBI have met to coordinate work on developing a financial sector specific cybersecurity strategy and work is ongoing.
Macprudential Policies		
Further enhance transparency and accountability by developing a heatmap and regularly publishing reports on risk analysis.	I	The Financial Stability Committee uses a heat map, which is updated on a quarterly basis for a graphic presentation of risks. That heat map is not published. The CBI has historically used a heatmap for a visual representation for the development of keys risk factors for financial stability. The Financial Stability Report is currently under review by the CBI, taking into account best practices in the current set up of financial stability reports issued by other Nordic countries.

Recommendations	Horizon ¹	Status
Macroprudential Policies		
Further strengthen the analytical capacity by strengthening the analysis of tail risks, spillovers, systemic risks and calibration of macroprudential tools.	NT	The CBI monitors the situation on a regular basis, e.g. through monthly and quarterly internal analyses. The CBI also publishes a detailed assessment twice a year in the Financial Stability Report. The Financial Stability Committee meets quarterly and regularly receives detailed presentations and memos from the CBI, which include an assessment of the financial cycle and accumulation of systemic risk based on a broad base of financial indicators. The Financial Stability Committee closely looks at growth-at-risk and the distribution of LTV and DSTI measurements, among other things, to monitor tail risks and makes decision on a quarterly basis on the application of macroprudential tools.
Continue closely monitoring cyclical risks in the real estate market and corporates, and take further macroprudential measures if risks persist.	I	The Financial Stability Committee monitors the RRE and CRE markets on a quarterly basis and is ready to take further actions and use macroprudential measures if risks persist. Furthermore, the CBI closely monitors the ongoing developments of CRE macroprudential measures in Europe, especially from the ESRB, and stands ready to implement them, if needed. The CBI has access to all essential data on residential real estate transactions and leases in Iceland from the Housing and Construction Authority and is using the data to develop a model to assess cyclical risks, including by creating indexes of residential real estate and rental prices, which will be quality-adjusted.
Close data gaps related to non-financial private sectors (households, non-financial corporates).	I	The CBI and MoFEA are working closely to obtain access to tax reports both from households and non-financial corporates to help close data gaps. The CBI hopes to be able to match information on income from tax reports and debt from the credit registry. Tax reports from non-financial corporates will be used, among others, to increase data quality and information about foreign debt of domestic entities. The CBI has also increased data collection on the CRE market, including through regular purchase of data on available square meters of CRE for sale and rent as well as information on the development of CRE rental prices. The CBI further collects detailed information on CRE under construction from the Housing and Construction Authority and monitors the annual and quarterly results of the CRE companies listed on the stock market.

Recommendations	Horizon ¹	Status
Liquidity and Crisis Management		
Approve the crisis management handbook and test it in a simulation exercise, widening its scope to the resolution stage.	I	The crisis management handbook, namely the <i>Contingency plan for liquidity or equity shortfall at credit institutions</i> , has been approved and operationalized. The RA is moving more into testing and simulation. In 2023 RA was part of an internal simulation exercise (management exercise) and in spring 2024 has completed the first exercise with the three DSIBs. The exercise tested the ability of the three banks to produce reliable and accurate data under time pressure. In the fall of 2024, the RA will be focusing on a Nordic-Baltic simulation exercise that is expected to consider the winding up or resolution of a failed bank. The Risk Management Department of the CBI has been designing and running the simulation exercise.
Establish a coordination body on resolution issues between the MoFEA and the CBI (RA).	I	There is an active discussion on how to formalize information sharing and dialogue between the CBI and MoFEA on resolution issues. The two possibilities under review are either a written MoU between the two institutions on a formal coordination body or establishing a sub-group under the Financial Stability Council.
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.	NT	Work is underway to consider possible legislative amendments that might be needed to implement this recommendation.
Develop a repo market and operationalize the ELA, including the assessment of collateral eligibility.	NT	The CBI has made several efforts to develop an efficient money market although this has so far proved challenging due to the small size of the market and the need for more liquidity. Banks have been reluctant to commit to two-way pricing for any suggested tenors (from one week to three months). The issue has been revisited by the CBI several times, but the development of a repo market is subject to attaining a critical level of commitment by the banks (at least the three D-SIBs). The comfortable liquidity position of individual banks also reduces their need for an active cash market.

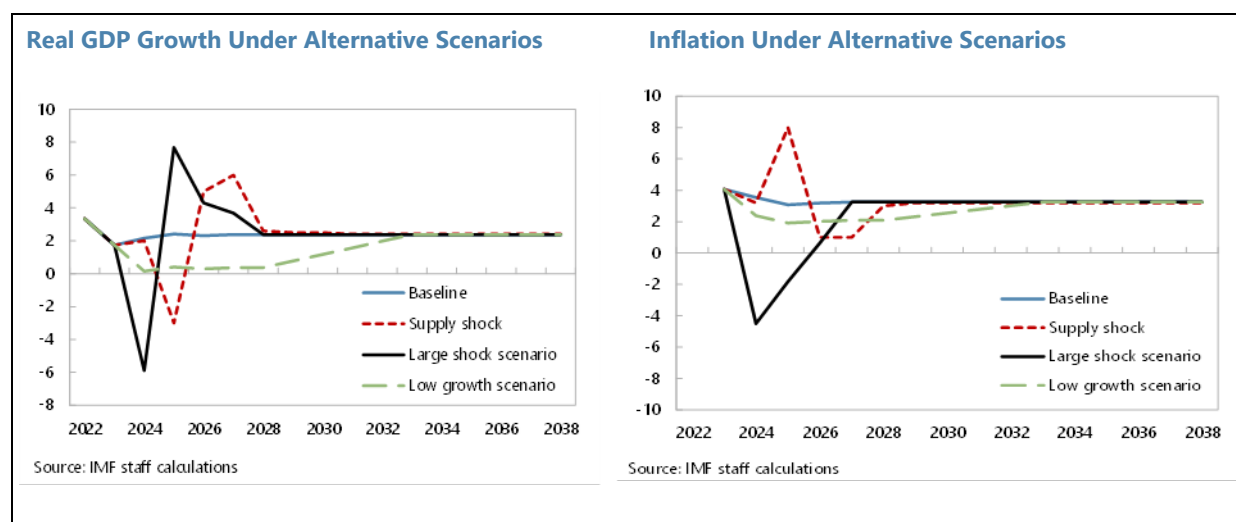
Recommendations	Horizon ¹	Status
Liquidity and Crisis Management		
		The CBI has set up a special ELA working group to oversee the management of the necessary steps to make ELA as operational as possible, both from a practical and a legal perspective. One of the assignments of the working group is to assess the collateral eligibility for ELA. The ELA working group has been in contact with the FSA part of the CBI that manages and collects data on the debt portfolio of the entire banking system and has gained access to the POWER BI Dashboard for the debt portfolio. The working group has highlighted the necessity of classifying the assets in relation to transferability. Relevant financial institutions will be required to do so.
Operationalize the application of all the resolution tools (not just bail-in).	NT	Resolution plans for the three D-SIBs in Iceland are increasingly focused on elaborating variant resolution strategies, collectively referred to as transfer strategies (non bail-in). This is in line with developments in the EEA. Currently the focus on work with banks is to finalize bail-in playbooks with Master playbooks (including transfer strategies) set for completion in 2025. This is in line with the EBA Guidelines 2022/01, as amended by the EBA testing guidelines. The RA has shifted focus towards operationalization of transfer strategies, as progress has been made regarding operationalization of bail-in strategies.
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.	NT	Work has started on developing a methodology for assessing sectoral risk. The procedure and work descriptions were published in May. Work on a methodology for risk assessment of supervised entities has been completed. Thematic on-site inspections have been conducted in the last two years but has not been included in any documented procedures. Work in other areas has either been completed or expected to be completed in 2024.
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.	NT	The Business Registry continues to leverage inputs from registered and reporting entities and actions include following up on discrepancies discovered in the preparation of Business Registry certificates. Data are further leveraged to conduct monitoring and supervisory actions that lead to corrections in the

Recommendations	Horizon ¹	Status
AML/CFT		
		beneficial ownership registry. These efforts are supplemented by maintaining strong and regular communication with registered companies. A steering group, which involves participation from other agencies—including the CBI—provides an additional forum for coordination and input for continued improvement of AML/CFT measures.
¹ I = Immediate; NT = near term; MT = medium term; CBI = Central Bank of Iceland; MoFEA = Ministry of Finance and Economic Affairs; PMO = Prime Minister's Office; MoCBA = Ministry of Culture and Business Affairs; RA = Resolution Authority		

Annex VI. Reforming Iceland's Fiscal Rules

1. Iceland has a sound fiscal framework that aims to ensure fiscal sustainability and economic stability, but current fiscal rules focus on sustainability over stability. Iceland's fiscal framework has two core objectives—sustainability and economic stability—that are based on laws enshrined in the 2015 Act on Public Finances. Despite the emphasis of stability as a core objective under the law, Iceland's fiscal rules, as they currently stand, lean more towards ensuring fiscal sustainability than economic stability. For example, the rules concerning the overall budget balance and debt rules are all tailored to achieve a gradual reduction in the level of public debt over the medium term.¹ By contrast, the overall budget balance rule has a tendency to magnify the business cycle because revenues are cyclical and the government can, under the rule, increase public spending lockstep during an upturn, which intensifies the cycle. Conversely, during a downturn, there is a need to curb spending to comply with the rule, again deepening the downturn. A fiscal rule that contributes to economic stability would instead restrain government spending when economy-wide aggregate demand is elevated and boost spending when aggregate demand is weak.

2. We assess the cyclical properties of the budget balance rule with a spending rule using a forward-looking scenarios analysis exercise based on IMF (2009).² We compare the cyclical properties of a budget balance rule with a expenditure rule in which nominal government spending grows in line with potential GDP adjusted for the inflation target. We explore the properties of these two rules under three distinct scenarios—a large negative GDP growth shock scenario, a low GDP growth scenario and a supply shock scenario. Under the large negative growth shock scenario,

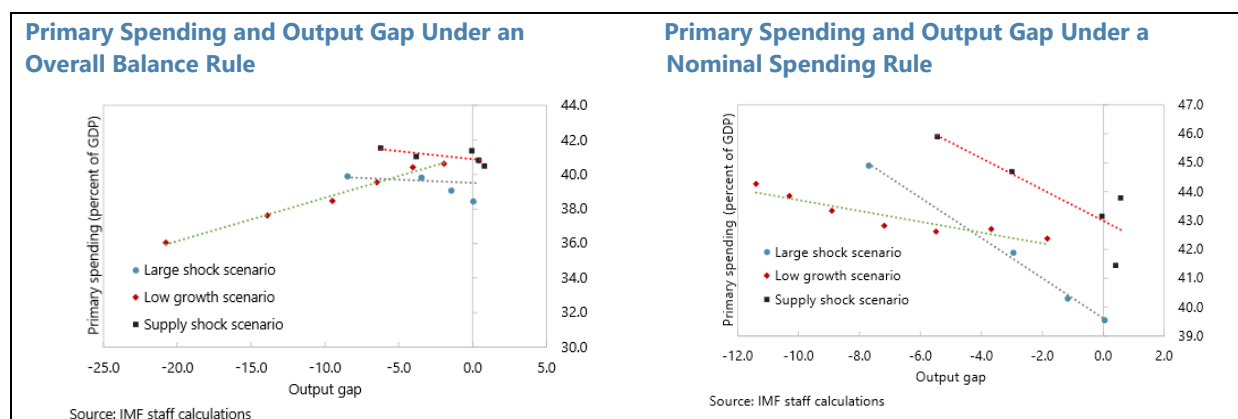


¹ The current fiscal rules require the overall fiscal balance to be above -2.5 percent of GDP and positive on average over a 5-year period. It also sets a cap on net debt of 30 percent of GDP and requires any excess to be reduced on average by 5 percent per year.

² International Monetary Fund (IMF). 2009. "Fiscal Rules—Anchoring Expectations for Sustainable Public Finances" available at <https://www.imf.org/external/np/pp/eng/2009/121609.pdf>

GDP growth and the GDP deflator fall immediately in year one by 2 standard deviations (based on the 10-year historical data). The economy recovers swiftly with no lasting damage to the level of GDP. Under the low GDP growth scenario, GDP growth and the deflator are persistently lower by a relatively small 0.5 standard deviation, and in the supply shock scenario, GDP and inflation move in opposite directions.

3. Switching from a budget balance rule to an expenditure rule would encourage a fiscal policy that contributes to economic stability. The behavior of fiscal policy across the cycle is illustrated by the correlation between primary balance and the output gap.³ For the low growth scenario, the positive correlation when fiscal policy follows a budget balance rule signals a procyclical relationship. Fiscal policy is broadly neutral under a budget balance rule in the large negative shock scenario and the supply shock scenario. By contrast, a negative correlation is observed for all three shocks when fiscal policy follows a nominal spending rule, suggesting fiscal policy is countercyclical.



4. A nominal spending rule is countercyclical under a demand shock, but during a supply shock its cyclical properties depend on the relative sizes of the price and output shocks. A spending rule based on a nominal anchor—e.g. a target growth rate for primary government spending—is effective in countercyclical demand management during demand shocks when output and prices move in the same direction. Consider the equation below:

$$Spending = \varphi GDP^{Pot} \times Prices^{Pot}$$

$$\frac{Spending}{GDP^R \times Prices} = \frac{\varphi}{\frac{GDP^R \times Prices}{GDP^{Pot} \times Prices^{Pot}}}$$

$$\frac{Spending}{Nominal\ GDP} = \frac{\varphi}{(1 + gap)(1 + price\ gap)}$$

³ Primary spending adjusts in the model to comply with the assumed fiscal rules. Government revenues respond mechanically to the economic cycle based on pre-defined revenue elasticities.

Where *Spending* is government spending, GDP^{Pot} is potential GDP, GDP^R is real GDP and *gap* is output gap. $Prices^{Pot}$ is the price level consistent with the inflation target and *prices* is the current price level. Under a favorable demand shock scenario, when prices rise and aggregate demand is high, government spending as a share of nominal GDP must fall. Conversely, when prices and output fall in an adverse demand shock scenario, government spending as a share of GDP must increase, and that in turn will boost economic activity. The countercyclical properties of a nominal spending rule are, however, more nuanced under a supply shock scenario where prices and output move in opposite directions. The share of government spending will depend on the relative size of the output gap and the price gap.

5. A real spending rule is countercyclical under demand and supply shock scenarios. A spending rule based on a real anchor such as potential GDP remains countercyclical under demand and supply shocks because the rule is unaffected by price shocks. Consider the equation:

$$\frac{Spending_t}{P_t} = \varphi * GDP_t^{Pot}$$

$$\frac{\frac{Spending_t}{P_t}}{GDP_t^R} = \frac{\varphi * GDP_t^{Pot}}{GDP_t^R} = \frac{\varphi}{\frac{GDP_t^R}{GDP_t^{Pot}}} = \frac{\varphi}{(1 + gap)}$$

This implies that government spending as a share of GDP falls when the output gap is positive and rises when the output gap is negative. A real spending rule remains countercyclical in relation to output during a supply shock. However, due to the inverse relationship between prices and output in a supply shock scenario, the change in government spending will amplify the initial price shock. A spending rule based on a real anchor—e.g. a target growth rate for real primary government spending—has weaker countercyclical properties than a spending rule based on a nominal anchor when the economy is hit by demand shocks, but still contributes to economic stability by allowing the government to run budget deficits during a downturn and requiring budget surpluses during an upturn.

6. International experience points to a mix of real and nominal spending targets. Several countries have adopted a spending rule in their fiscal framework, with the Netherlands and Finland choosing a real spending rule and Denmark and Sweden choosing a nominal spending rule. One common theme across all these four countries is that the spending rule is defined on a version of spending that excludes interest payments on government debt. Denmark, Netherlands, and Sweden also exclude cyclical forms of spending in their definition of the spending target. The coverage also varies. Denmark stipulates separate legally binding spending limits for different levels of government, whereas Finland and Sweden have established nominal limits or spending ceilings for the central government, and Netherlands sets a limit on non-cyclical components of General government spending.

Annex VI. Table 1. Iceland: Expenditure Rules in Select Countries

Country	Coverage	Exclusion	Real or Nominal
Denmark	Separate ceilings for central government, regions, and municipalities	Interest on government debt, unemployment benefits, employment measures, some investment	Nominal, but adjustments to changes in prices and wages are possible
Finland	Central government	Interest on government debt, cyclical expenditure, financial investments	Real – ceiling for $t+1$ adjusted to updated price and wages
The Netherlands	General government	Interest on government debt, cyclical component elements of social unemployment benefits	Real – indexed to price and wage inflation
Sweden	Central government budget and old-age pension	Interest on government debt	Nominal

Annex VII. Data Issues

Annex VII. Table 1. Iceland: Data Adequacy Assessment for Surveillance

Data Adequacy Assessment Rating 1/							
A							
Questionnaire Results 2/							
Assessment	National Accounts	Prices	Government Finance Statistics	External Sector Statistics	Monetary and Financial Statistics	Inter-sectoral Consistency	Median Rating
	A	A	A	A	B	A	A
Detailed Questionnaire Results							
Data Quality Characteristics							
Coverage	A	A	A	A	B		
Granularity 3/	B		A	A	B		
			B		B		
Consistency			A	A			A
Frequency and Timeliness	A	A	B	A	A		
<p>Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.</p> <p>1/ The overall data adequacy assessment is based on staff's assessment of the adequacy of the country's data for conducting analysis and formulating policy advice, and takes into consideration country-specific characteristics.</p> <p>2/ The overall questionnaire assessment and the assessments for individual sectors reported in the heatmap are based on a standardized questionnaire and scoring system (see <i>IMF Review of the Framework for Data Adequacy Assessment for Surveillance</i>, January 2024, Appendix I).</p> <p>3/ The top cell for "Granularity" of Government Finance Statistics shows staff's assessment of the granularity of the reported government operations data, while the bottom cell shows that of public debt statistics. The top cell for "Granularity" of Monetary and Financial Statistics shows staff's assessment of the granularity of the reported Monetary and Financial Statistics data, while the bottom cell shows that of the Financial Soundness indicators.</p>							
A	The data provided to the Fund is adequate for surveillance.						
B	The data provided to the Fund has some shortcomings but is broadly adequate for surveillance.						
C	The data provided to the Fund has some shortcomings that somewhat hamper surveillance.						
D	The data provided to the Fund has serious shortcomings that significantly hamper surveillance.						
<p>Rationale for staff assessment. Data provision to the Fund is adequate for surveillance purposes. Expenditure-based GDP data are available by component on a quarterly basis. Nonetheless, there is still scope for improvement for Income Accounts by sector that are not sufficiently detailed and available only on an annual basis with a significant lag; Production-based GDP or gross value added by industry that are available only on an annual basis and only in nominal terms, with a considerable lag. For the time being, the substantial amount of intellectual property receipts that was included in the national accounts and balance of payment statistics until 2022 has been taken out. There is scope to improve cooperation and data sharing between Statistics Iceland and other institutions involved in data production including the CBI and the Ministry of Finance, in order to strengthen the analysis of economic developments and to ensure methodological consistency of compiled data with international standards. The authorities could consider publishing general government asset and liabilities statistics on a quarterly frequency and general government expenditure and revenue statistics on a monthly frequency. The 2023 FSAP found remaining data gaps in the monetary and financial sector data, notably in the CRE sector, micro household and NFC balance sheet data, and climate risks.</p>							
<p>Changes since the last Article IV consultation. Statistics Iceland plans to compile and publish quarterly GDP for income and production approach. Statistics Iceland has started internal work with the aim of publishing data by end 2026. The annual approach will be changed to a more micro-based approach, with the possibility to compile more detailed statistics, likely to be completed in 2025. Also, Statistics Iceland completed an internal review on the treatment of intellectual property rights in the national accounts and balance of payments statistics, raised in the 2023 Staff Report, and concluded that the specific entries of intellectual property rights should not be included in the statistics. The authorities are working on closing data gaps identified in the 2023 FSAP.</p>							
<p>Corrective actions and capacity development priorities. None beyond the issues raised above. No capacity development priorities.</p>							
<p>Use of data and/or estimates different from official statistics in the Article IV consultation. None.</p>							
<p>Other data gaps. None identified.</p>							

Annex VII. Table 2. Iceland: Data Standards Initiatives

Iceland subscribes to the Special Data Dissemination Standard (SDDS) since June 1996 and publishes the data on its National Summary Data Page. The latest SDDS Annual Observance Report is available on the Dissemination Standards Bulletin Board (<https://dsbb.imf.org/>).

Annex VII. Table 3. Iceland: Table of Common Indicators Required for Surveillance

(As of June 06, 2024)

	Data Provision to the Fund				Publication under the Data Standards Initiatives through the National Summary Data Page			
	Date of Latest Observation	Date Received	Frequency of Data ⁶	Frequency of Reporting ⁶	Expected Frequency ^{6,7}	Iceland ⁸	Expected Timeliness ^{6,7}	Iceland ⁸
Exchange Rates	May, 2024	Jun, 2024	D and M	D and M	D	D	...	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	May, 2024	Jun, 2024	M	M	M	M	1W	NLT 7D
Reserve/Base Money	May, 2024	Jun, 2024	M	M	M	M	2W	NLT 1W
Broad Money	Apr, 2024	May, 2024	M	M	M	M	1M	1M
Central Bank Balance Sheet	May, 2024	Jun, 2024	M	M	M	M	2W	NLT 1W
Consolidated Balance Sheet of the Banking System	Apr, 2024	May, 2024	M	M	M	M	1M	1M
Interest Rates ²	May, 2024	Jun, 2024	D	D	D	D	...	D
Consumer Price Index	May, 2024	Jun, 2024	M	M	M	M	1M	NLT 2W
Revenue, Expenditure, Balance and Composition of Financing ³ —General Government ⁴	Q1, 2024	Jun, 2024	Q	Q	A	Q	2Q	1Q
Revenue, Expenditure, Balance and Composition of Financing ³ —Central Government	Q1, 2024	Jun, 2024	Q	Q	M	Q	1M	1Q
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Mar, 2024	Jun, 2024	M	M	Q	Q	1Q	1Q
External Current Account Balance	Q1, 2024	Jun, 2024	Q	Q	Q	Q	1Q	NLT 10W
Exports and Imports of Goods and Services	Q1, 2024	Jun, 2024	Q	Q	M	M	8W	NLT 5W
GDP/GNP	Q1, 2024	Jun, 2024	Q	Q	Q	Q	1Q	75D
Gross External Debt	Q1, 2024	Jun, 2024	Q	Q	Q	Q	1Q	NLT 10W
International Investment Position	Q1, 2024	Jun, 2024	Q	Q	Q	Q	1Q	NLT 10W

¹ Includes reserve assets pledged or otherwise encumbered, as well as net derivative positions.

² Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³ Foreign, domestic bank, and domestic nonbank financing.

⁴ The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵ Including currency and maturity composition.

⁶ Frequency and timeliness: ("D") daily; ("W") weekly or with a lag of no more than one week after the reference date; ("M") monthly or with lag of no more than one month after the reference date; ("Q") quarterly or with lag of no more than one quarter after the reference date; ("A") annual; ("SA") semiannual; ("I") irregular; ("NA") not available or not applicable; and ("NLT") not later than.

⁷ Encouraged frequency of data and timeliness of reporting under the e-GDDS and required frequency of data and timeliness of reporting under the SDDS and SDDS Plus. Any flexibility options or transition plans used under the SDDS or SDDS Plus are not reflected. For those countries that do not participate in the IMF Data Standards Initiatives, the required frequency and timeliness under the SDDS are shown for New Zealand, and the encouraged frequency and timeliness under the e-GDDS are shown for Eritrea, Nauru, South Sudan, and Turkmenistan.

⁸ Based on the information from the Summary of Observance for SDDS and SDDS Plus participants, and the Summary of Dissemination Practices for e-GDDS participants, available from the IMF Dissemination Standards Bulletin Board (<https://dsbb.imf.org/>).



ICELAND

STAFF REPORT FOR THE 2024 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

June 24, 2024

Prepared By

The European Department
(in consultation with other departments)

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FUND RELATIONS	2
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FUND RELATIONS

(As of May 31, 2024)

Membership Status: Joined December 27, 1945

General Resources Account:	SDR Million	Percent of Quota
Quota	321.80	100.00
Fund holdings of currency	252.00	78.31
Reserve tranche position	69.80	21.69

SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	420.62	100.00
Holdings	426.20	101.33

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	Nov. 19, 2008	Aug. 31, 2011	1,400.00	1,400.00
Stand-By	Mar. 22, 1962	Mar. 21, 1963	1.63	0.00
Stand-By	Feb. 16, 1961	Dec. 31, 1961	1.63	0.00

Projected Payments to the Fund¹

(SDR million; based on existing use of resources and present holdings of SDRs):

	2024	2025	2026	2027	2028
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.00	0.00	0.00	0.00
Total	0.00	0.00	0.00	0.00	0.00

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative (MDRI): Not applicable

Implementation of Catastrophe Containment and Relief (CCR): Not applicable

¹ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangements:

The *de jure* exchange rate arrangement is free floating, and the *de facto* exchange rate arrangement under the IMF classification system is floating. The CBI publishes daily data on its foreign exchange intervention with a lag.

Iceland has accepted the obligations under Article VIII, Sections 2(a), 3, and 4 of the IMF's Articles of Agreement and maintains an exchange system free of multiple currency practices and restrictions on payments and transfers for current international transactions, with the exception of restrictions imposed for security reasons, which have been notified to the Fund in accordance with the Executive Board Decision No. 144-(52/51).

Last Article IV Consultation:

Discussions for the 2023 Article IV Consultation were held during April 25–May 09, 2023. The staff report (IMF Country Report No. 22/193) was considered by the Executive Board on May 30, 2023. Article IV consultations with Iceland are currently held on a 12-month cycle.

Technical Assistance:

Department	Purpose	Date
MCM	Capital account liberalization	March 2010
MCM	Reserves building and liquidity management	June 2010
MCM	Public debt management	July 2010
FAD	Fiscal framework issues	August 2010
MCM	Capital controls liberalization	November 2010
MCM	Converging to EU regulations-credit bureaus	January 2011
MCM	Liquidity management	March 2011
FAD	Tax policy	March 2011
STA	External Sector Statistics	April 2011
FAD	Organic Budget Law	October 2011
FAD	Follow up on Organic Budget Law	May 2012
MCM	Capital account liberalization	March 2013
FAD	IPSAS in Iceland: Towards Enhanced Fiscal Transparency	December 2013
FAD	VAT reform	February 2014
MCM	Capital controls liberalization	May 2014
MCM	Banking supervision	February 2015
MCM	Banking supervision	March 2015
MCM	Stress testing	April 2015
FAD	Workshop on Distributional Effects of Tax Reforms and Expenditure Measures	April 2015
MCM	Banking supervision	September 2015
MCM	Banking supervision	March 2016
FAD	Organic Budget Law implementation	April 2016