

Inflation Dynamics and Key Drivers of Inflation

Amit Kara and Yurii Sholomytskyi

SIP/2026/082

IMF Selected Issues Papers are prepared by IMF staff as background documentation for periodic consultations with member countries. It is based on the information available at the time it was completed on July 10, 2026. This paper is also published separately as IMF Country Report No 26/209.

**2026
AUG**



IMF Selected Issues Paper
European Department

Inflation Dynamics and Key Drivers of Inflation, Iceland
Prepared by Amit Kara and Yurii Sholomytskyi

Authorized for distribution by Metodij Hadzi-Vaskov
August 2026

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ABSTRACT: Inflation in Iceland has remained persistently above target despite repeated tightening cycles, pointing to structural features that amplify and prolong price shocks. This paper uses a two-stage empirical framework (Pedroni, 2013) to identify the main drivers of Iceland's inflation dynamics and explain why inflation responds more strongly to shocks than in peer economies. A heterogeneous Panel SVAR for 45 countries shows that import price shocks dominate Iceland's CPI fluctuations, accounting for about three-quarters of forecast error variance at the eight-quarter horizon—nearly three times the panel median—while wage and domestic demand shocks play a smaller role. A second-stage cross-country regression links Iceland's stronger and more persistent pass-through to its structural characteristics, notably elevated inflation volatility and high union density. The results suggest that less firmly anchored inflation expectations and wage-setting institutions help transmit external price shocks into domestic inflation. Sustained disinflation and wage-setting practices more closely aligned with productivity developments would help reduce pass-through and strengthen the effectiveness of monetary policy.

RECOMMENDED CITATION: Kara, Amit and Yurii Sholomytskyi. 2026. "Inflation Dynamics and Key Drivers of Inflation." IMF Selected Issues Paper (SIP/2026/082). Washington, DC, International Monetary Fund.

JEL Classification Numbers:	E31, E52, F41, C33, J51
Keywords:	Inflation dynamics; import price pass-through; inflation persistence; inflation expectations; union density; monetary policy transmission; panel SVAR; small open economies; Iceland
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SELECTED ISSUES PAPERS

Inflation Dynamics and Key Drivers of Inflation

Iceland

Prepared by Amit Kara and Yurii Sholomytskyi¹

¹ The authors would like to thank Magnus Saxegaard, Metodij Hadzi-Vaskov, Thomas Gade, Harri Kemp, and seminar participants from the Icelandic authorities for helpful comments.



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SELECTED ISSUES

July 10, 2026

Approved By
European Department

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INFLATION DYNAMICS AND KEY DRIVERS OF INFLATION¹

A. Introduction

1. Conducting monetary policy in Iceland presents important challenges. Since the inflation target was adopted in 2001, inflation has averaged 4.9 percent — nearly double the target. Even restricting attention to the more stable post-crisis period (2011–25), inflation averaged 4.0 percent and exceeded the target in roughly two-thirds of the months over this period. The central bank's policy rate has averaged 5 percent since 2011 with a maximum of 9.25 percent and a minimum of 0.75 percent. Despite this, inflation has proved stubbornly difficult to bring back to target durably, pointing to structural drivers that monetary policy alone has struggled to offset.

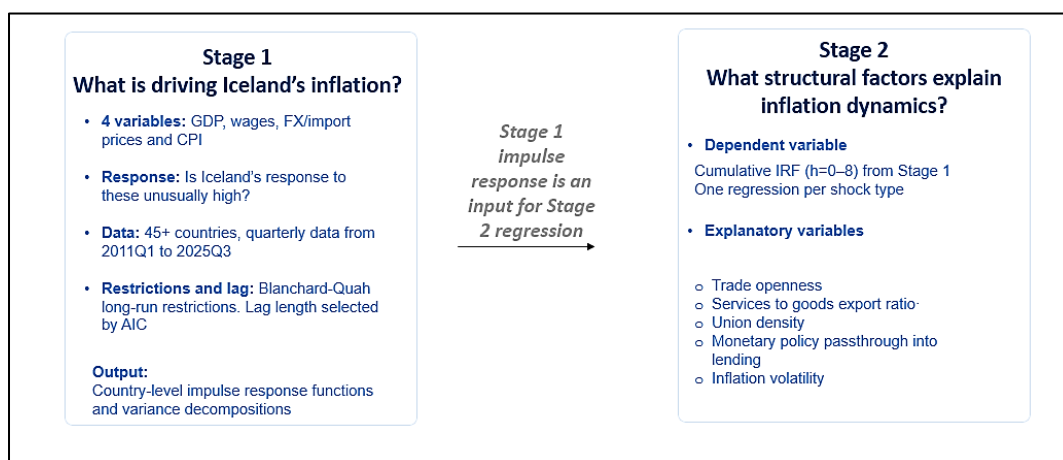
2. Iceland's inflation persistence reflects a combination of structural features. As a highly open, commodity-exporting economy with substantial services exports, Iceland is inherently exposed to large external price shocks. But exposure alone does not explain persistence: many small open economies face similarly large shocks without the same inflationary consequences. The literature points to labor market institutions, sectoral composition, and the strength of monetary transmission as important channels — and Iceland sits at an extreme high end of the spectrum on union density and near the low end of the distribution for policy-rate pass-through. Understanding which of these channels dominates, and by how much, is essential for assessing the appropriate policy response.

3. This paper identifies the sources of inflation in Iceland and the main structural factors that could help explain its persistence. The analysis aims to address two related questions. First, what is driving Iceland's inflation — import prices, wages, or domestic demand, and by how much? Second, how does Iceland respond to these shocks relative to peer economies? To answer these questions, we employ a two-stage empirical framework building on Pedroni (2013).

B. Methodology

4. We adopt a two-stage estimation framework. The first stage estimates a heterogeneous Panel SVAR following Pedroni (2013) to identify the structural drivers of Iceland's inflation and compare Iceland's response to these drivers relative to other countries. The second stage links the country-level impulse responses recovered from the first stage to observable structural characteristics in a cross-sectional regression, identifying the institutional and economic features that help explain cross-country differences in inflation dynamics.

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5. We impose the same long-run restrictions in a 4-variable VAR for 45 countries. The Panel SVAR is estimated on four variables: real GDP growth, nominal wage growth, CPI inflation, and import price growth. The Blanchard-Quah (1989) long-run restrictions impose economically motivated constraints on which shocks may have permanent effects. The VAR is estimated in the ordering [GDP, wages, import prices, CPI], reflecting the structural causal chain in a small open economy. GDP (productivity) shocks may permanently affect all variables; wage shocks may permanently affect import prices and the price level but not output; import price shocks may permanently affect the price level but not output or wages; and CPI shocks have no permanent effect on any other variable, consistent with the view that price level shifts are ultimately absorbed by the nominal exchange rate through purchasing power parity. This ordering is well suited to recovering the slow-building, institutionally mediated transmission from import prices and wages to consumer prices that is the central object of interest. Lag length in each country VAR is selected independently by the Akaike Information Criterion (AIC).

6. The Panel SVAR is estimated on four variables, and we use long-run identifying restrictions. In total, we run 45 country-level VARs with real GDP growth, nominal wage growth, import prices, and CPI inflation. We adopt Blanchard-Quah (1989) long-run restrictions as the identification strategy. The economic rationale is straightforward: the central object of interest — the long-run pass-through from import prices and wages to consumer prices — accumulates gradually over multiple quarters and is not well captured by contemporaneous impact restrictions. Blanchard-Quah restrictions instead operate directly on the long-run impact matrix, imposing economically motivated constraints on which shocks may have permanent effects. Lag length in each country's VAR is selected independently by the Akaike Information Criterion (AIC).

Table 1. Iceland: Blanchard-Quah Long-Run Restrictions

Long-run impact on →	GDP shock	Wage shock	Import price shock	CPI shock
GDP	✓	0	0	0
Wages	✓	✓	0	0
Import prices	✓	✓	✓	0
CPI	✓	✓	✓	✓

Note: ✓ denotes a permitted permanent effect; 0 denotes a restriction to zero in the long run.

7. The identifying restrictions impose a hierarchy across shocks where only real shocks move output permanently. GDP shocks are the only shocks permitted to have a permanent effect on all four variables. Wage shocks may permanently affect import prices and CPI but not GDP, reflecting the view that nominal wage innovations shift the cost base without altering productive capacity. Import price shocks may permanently affect CPI but not GDP or wages, consistent with the small open economy assumption that import prices are externally determined, and CPI shocks have no permanent effect on any other variable. These restrictions are imposed on the long-run moving average representation of the VAR rather than on contemporaneous relationships, making them well suited to recovering transmission mechanisms that accumulate over multiple quarters.

8. The first stage recovers country-specific responses net of global factors and generates the impulse response for all 45 countries separately. The Pedroni (2013) framework constructs a synthetic global entity from the panel to isolate idiosyncratic country-level shocks orthogonal to global factors. Country-level impulse response functions and forecast error variance decompositions are then recovered from the idiosyncratic component of each country's SVAR. These country-level estimates form the dependent variable in the second-stage cross-sectional regression, which relates the cumulative impulse response at an eight-quarter horizon to a set of structural characteristics: union density, trade openness, inflation volatility, the strength of monetary transmission through the lending channel, and inflation-targeting regime.

9. The second stage links these country-specific responses to structural features that may explain cross-country differences in pass-through. The country-level impulse responses recovered from Stage 1 are used as the dependent variable in a second-stage regression. For each country, we extract the cumulative impulse response of CPI to an import price shock at the eight-quarter horizon and regress it on variables that capture the structural characteristics of each economy. The objective is to identify which structural features explain why some countries — and Iceland in particular — transmit import price shocks more strongly and persistently into consumer prices than others.

C. Data

10. The dataset provides a consistent post-crisis panel for estimating inflation dynamics across countries. The panel comprises 45 advanced and emerging market economies over the past

decade and a half. The sample window (2011Q1-2025Q3) covers the post-Global Financial Crisis period and thereby avoids the structural break associated with Iceland's financial crisis. The four core VAR variables — real GDP growth, nominal wage growth, CPI inflation, and changes in import prices — are drawn from standard national sources and expressed as annualized quarterly log-differences. Seasonal adjustment is applied to all variables prior to estimation using STL decomposition with a seasonal window of four quarters. The full country list is provided in Annex I.

11. The second stage regressors include a selection of structural variables available for all 45 countries in the panel. Trade openness is measured as the sum of exports and imports as a share of GDP. The service-to-goods export ratio captures the sectoral composition of each country's export base. Union density, measuring formal trade union membership as a share of employees, is drawn from the ILO and OECD ICTWSS databases. The strength of monetary transmission is captured by the sum of the pass-through coefficients in a regression of policy rate changes into bank lending rates. Inflation volatility is measured as the annualized standard deviation of quarterly CPI inflation over the sample period. Iceland sits at the extreme upper end on union density and close to the lower end on the strength of the bank lending channel.

D. Results

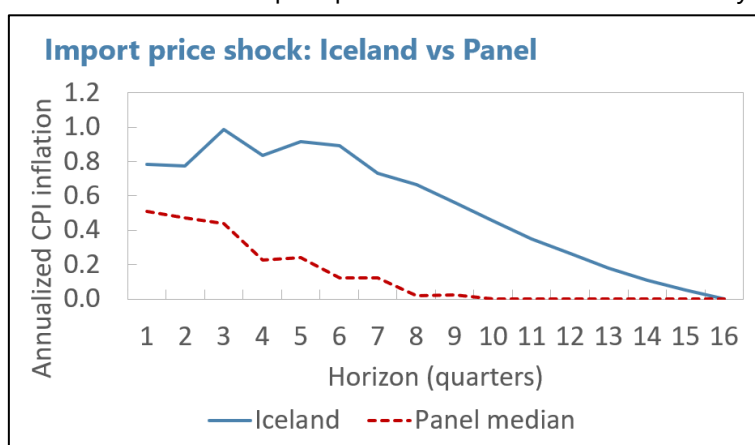
12. Import price shocks are the dominant driver of Iceland's CPI variance. The import price shock in Iceland accounts for 75 percent of forecast error variance at the eight-quarter horizon — nearly three times the panel median of 26 percent for the overall sample. By contrast, wage and demand shocks play a comparatively smaller role in Iceland relative to peers. For instance, wage shocks account for 11 percent of Iceland's CPI inflation variance against a panel median of 33 percent, while GDP shocks account for just 3 percent compared with a panel median of 20 percent. Iceland's inflation is thus predominantly an external price phenomenon, with domestic wage and demand dynamics playing a secondary role that is the reverse of the typical cross-country pattern.

Table 2. Iceland: CPI Forecast Error Variance Decomposition at h = 8 Quarters

	Iceland	Panel Median
Import Price	75%	26%
Own-CPI	11%	13%
Wages	11%	33%
Supply (GDP)	3%	20%

13. Iceland's impulse response to import price shocks is larger and more persistent relative to other countries. A one-standard-deviation import price shock raises Iceland's CPI by

close to 1 percentage point at its peak in the third quarter, a response that is large relative to the panel distribution. It is also more persistent - while the panel median response dissipates relatively quickly, Iceland's response takes considerably longer to unwind. This combination of a larger peak effect and a slower dissipation is consistent with import price



shocks becoming embedded in the domestic price level through successive rounds of adjustments, rather than passing through at once and fading soon afterwards.

14. Inflation volatility and labor market characteristics seem to be the main factors explaining Iceland's relatively high import price pass-through. Inflation volatility is the most robust predictor of import price pass-through, entering with a positive and highly significant coefficient: countries with more volatile inflation history transmit import price shocks more strongly and persistently into consumer prices. This is consistent with the role of inflation expectations: economies with a history of volatile inflation are more likely to have less firmly anchored expectations, making each new shock more persistent. Einarsson and Pétursson (2026) find that Iceland's trend inflation continues to be more volatile than in other advanced economies, largely reflecting less firmly anchored inflation expectations and, more recently, the interaction of weakly anchored expectations and large global supply shocks. Union density also enters positively and significantly, indicating that higher-union-density economies tend to exhibit larger cumulative CPI responses to import price shocks. Trade openness and the strength of monetary transmission through the lending channel do not enter significantly, suggesting that the pass-through mechanism operates through the inflation expectations and wage-setting channel rather than through goods market competition or the interest rate channel.²

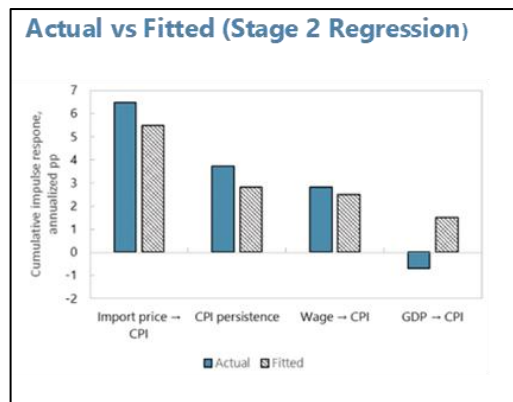
² While the cumulative impulse response is, by construction, partly a function of each economy's inflation volatility—since structural responses are scaled by the underlying shock standard deviation—this dependence enters as a common scaling factor rather than as a structural channel; because our institutional regressors are themselves largely orthogonal to inflation volatility (jointly explaining under 5 percent of its cross-country variation), the scale sensitivity affects the amplitude of the dependent variable but not the estimated significance of the structural coefficients.

Table 3. Iceland: Structural Determinants of Inflation Dynamics:
Cross Country Regression Results
 (Dependent variable: Cumulative IRF h=0-8 quarters)

	Import price → CPI	CPI persistence	Wage → CPI	GDP → CPI
Constant	-2.4***	+1.0	-0.1	+2.8
Lending channel (θ)	-0.3	-1.0	-0.0	-4.0*
Union density	+0.0**	+0.0	-0.0	+0.0
Trade openness	-0.2	+0.2	-0.2	-0.5
UD × Openness	+0.0	+0.0	+0.1	+0.2*
Inflation volatility	+1.9***	+0.6**	+1.7***	-0.1
R²	0.68	0.27	0.56	0.18
Adj R²	0.64	0.16	0.50	0.06

*** p<0.01, ** p<0.05, * p<0.10. HC3 robust Ses, 2011Q1–2025Q3

15. Iceland's position in the cross-sectional regression is well explained by its structural characteristics. Above-average inflation volatility and economies with high union density tend to show stronger pass-through. The second-stage regression fits Iceland's estimated impulse response closely, indicating that Iceland is not a true outlier once its institutional and historical features are accounted for.



E. Conclusions

16. This paper set out to address two questions: what is driving Iceland's inflation, and what factors help explain Iceland's relatively stronger inflation response to shocks. The Panel SVAR results establish that import price shocks are the dominant driver of Iceland's CPI, accounting for 75 percent of forecast error variance at the eight-quarter horizon — nearly three times the cross-country sample median. The second-stage cross-sectional regression shows that this excess sensitivity reflects Iceland's structural characteristics, such as its history of elevated inflation volatility and high union density.

17. Inflation volatility reflects the degree to which inflation expectations are anchored. In general, economies with a history of volatile inflation also have less firmly anchored expectations, and less anchored expectations make each new import price shock more persistent and more difficult to contain, thereby creating a self-reinforcing dynamic. Conversely, achieving a sustained

period of low and stable inflation could help reduce pass-through by firmly anchoring expectations — a virtuous cycle in which disinflation begets disinflation.

18. The significant association between union density and import price pass-through points to a second structural channel. High union density tends to be associated with stronger pass-through of external price shocks, likely embedding import price increases into the domestic cost base through successive bargaining rounds. Structural measures that strengthen the link between wage settlements and productivity — rather than realized inflation — would help moderate these second-round effects and reduce the degree to which external shocks become entrenched in domestic prices.

19. Two limitations of the analysis merit acknowledgment. First, Iceland's extensive system of CPI-indexed financial contracts and wage agreements is likely an additional channel that operates independently of union density and warrants further analysis. Second, the results could be assessed for sensitivity to a broader set of VAR variables in Stage 1 and structural characteristics in Stage 2, as well as alternative methods such as local projections. Both limitations point to productive directions for further research.

Annex I. Country List

The panel comprises the following 45 advanced and emerging market economies:

Advanced Economies: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Japan, Korea, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, United Kingdom, United States.

Emerging Market Economies: Brazil, Bulgaria, Chile, China, Colombia, Croatia, Hungary, India, Indonesia, Latvia, Lithuania, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, Slovak Republic, Slovenia, South Africa, Thailand, Turkey, Ukraine.

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