CONCLUDING STATEMENT

Iceland: Staff Concluding Statement of the 2025 Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC: An International Monetary Fund mission, led by Magnus Saxegaard and comprising Thomas Gade, Amit Kara, and Yurii Sholomytskyi, conducted discussions for the 2024 Article IV consultation with Iceland virtually during April 7-11, 2025, and in Reykjavik, Iceland, during April 28 to May 5, 2025. At the conclusion of the visit, the mission issued the following statement:

A successful tightening of macroeconomic policies has slowed the economy and reduced imbalances accumulated after the pandemic. The challenges now are to fully return inflation back to target while ensuring a soft landing for the economy; to build resilience by gradually increasing fiscal buffers; and to strengthen productivity and further diversify the economy to support medium-term growth and reduce Iceland's vulnerability to shocks.

The economy slowed sharply in 2024, but growth is expected to pick up in 2025 and medium-term prospects remain favorable. Growth slowed to 0.5 percent in 2024 (from 5.6 percent in 2023) due largely to idiosyncratic factors (e.g., a disappointing fishing season and constraints on energy supply) that reduced exports, as well as subdued consumption growth. Growth is expected to rise to 1.8 percent in 2025 and 2.4 percent in 2026 supported by a recovery in exports, higher real wages, and continued monetary easing. The direct impact of escalating global trade tensions is projected to be limited given that most goods exports are destined for Europe; this projection assumes that the pharmaceutical sector, which is more reliant on the US market, remains exempt from tariffs. However, Iceland will be indirectly affected by lower growth in its trading partners. Inflation is projected to remain sticky due to elevated inflation expectations and still high wage growth, declining gradually to the Central Bank of Iceland's (CBI's) 2.5 percent inflation target in the second half of 2026. The medium-term growth outlook is positive, with the expansion of higher value-added export-oriented sectors expected to boost productivity growth, and migrant labor inflows facilitating a modest increase in employment.

Risks to growth are tilted to the downside while risks to inflation are broadly balanced. The impact of rising trade tensions could be larger than projected if US tariffs are extended to pharmaceuticals products, or if Iceland is affected by potential EU retaliation. Also, a reduction in the number of tourists travelling to and from the US could negatively impact tourism. Inflation could rise if trade tensions trigger supply chain disruptions or capital flight weakens the exchange rate. Conversely, capital inflows could put upward pressure on the exchange rate and weaken competitiveness. On the domestic side, attacks on physical or digital infrastructure could disrupt payment flows and thus economic activity and financial stability. A continuation of recent years' dry weather could curtail energy supply and weaken exports. Second-round effects from higher wage growth could keep inflation elevated, while a premature loosening of monetary policy could further de-anchor inflation expectations. Upside risk include a reduction in household savings that would bolster consumption, and a faster-than-anticipated expansion of activity in pharmaceuticals and aquaculture.

Fiscal Policy: Building Buffers to Bolster Resilience

The authorities' fiscal targets are suitably ambitious. The Medium-Term Fiscal Strategy (MTFS) projects a general government deficit this year of 1.3 percent of GDP, close to staff's projection of 1.2 percent of GDP and down from 3.5 percent of GDP in 2024. The resulting 0.6 percentage point contractionary fiscal impulse is appropriate given still elevated inflation. The authorities' medium-term fiscal targets, which entail turning the fiscal deficit into a surplus by 2028, are suitably ambitious considering that Iceland's public indebtedness is higher than that of most Nordic countries despite the economy being more shock prone.

The consolidation measures in the MTFS will help the authorities achieve their fiscal targets. Staff welcomes that this year's MTFS identifies all fiscal measures planned by the authorities to achieve their medium-term fiscal targets; this significantly increases the credibility of the consolidation. Measures appropriately include a combination of expenditure reductions (e.g., streamlining operations and merging of institutions) and revenue measures (e.g., expanding kilometer-based taxation to all vehicles and increasing natural resource rent taxation on tourism and fisheries). Staff projections that only include measures that have been presented to Parliament in a legislative proposal, indicate that about 0.5 percent of GDP in additional measures will be needed over the next five years to meet the authorities' targets. The measures outlined in the MTFS would cover this gap, but additional fiscal effort could be necessary if spending increases more than anticipated or if the yield from revenue measures falls short of expectations (see below).

Increasing infrastructure spending while safeguarding fiscal sustainability would bolster Iceland's growth prospects. The government's intention to scale up public investment is welcome given infrastructure gaps in transport and energy. However, the MTFS projects a medium-term decline in government investment as a share of GDP compared to recent years. Staff recommends to, at a minimum, maintain the current level of government investment within the MTFS deficit targets. As noted in the MTFS, identifying opportunities for Iceland's pension funds to scale up their financing of infrastructure in a manner consistent with their fiduciary duties could help complement these efforts, though care should be taken to contain any increase in fiscal risks. Partnering with multilateral investment banks or international infrastructure funds could provide useful expertise with private financing of infrastructure projects. Streamlining permitting and licensing procedures would help speed up infrastructure deployment.

Additional fiscal effort could be required if planned measures fall short of expectations, or to scale up government investment. In such a scenario, the authorities could consider: (i) increasing the preferential VAT rate and/or limiting the items that benefit from it; (ii) increasing housing taxation (see below); (iii) streamlining R&D incentives including by reassessing the 2020 increase in the ceiling on eligible business R&D expenditure (see below); and (iv) carrying out a comprehensive review of public expenditure to identify potential savings.

Activation of revised fiscal rules in 2026 is welcome; however, their credibility would be enhanced by strengthening the Fiscal Council.

- The revised fiscal framework—which broadly aligns with staff's recommendations in the 2024 Article IV—includes a net expenditure growth rule instead of the previous budget balance rule. It preserves the 30 percent of GDP net debt ceiling though the speed at which this is to be achieved will be more flexible than in the past. The revised framework will allow the authorities to factor in the state of the economy in their consolidation plans and reduce procyclicality.

- The Fiscal Council, which will be responsible for monitoring compliance with the fiscal rules, should be tasked with evaluating the macroeconomic and fiscal projections underpinning the MTFS. The intention is also that the Council will be responsible for monitoring productivity developments and for making proposals for reforms. This would require a significant increase in the capacity and resources of the Fiscal Council.

- To bolster transparency and enable the Fiscal Council to monitor fiscal developments and compliance with the fiscal rules on an ongoing basis, the authorities should start publishing fiscal data corresponding to the coverage of the fiscal rules on a quarterly rather than annual basis as is currently the case, and ensure that these data are independently verifiable. Expanding the coverage of the budget and the fiscal rules to encompass the entirety of the central government would facilitate these efforts. This would also reduce incentives to shift spending and borrowing to parts of the government not covered by the fiscal rules.

Monetary Policy: Calibrating the Pace of Monetary Easing

As inflation declines toward the target, the policy rate should be reduced. The current monetary stance is appropriately tight given still elevated inflation and inflation expectations. Staff's inflation forecast, which envisions reaching the 2.5 percent target in the second half of 2026, is in the IMF's view consistent with a 250 basis points reduction in the policy rate over the next 4–5 quarters. This policy trajectory, which maintains a tight policy stance (but progressively less so) until inflation expectations become reanchored to the inflation target, would balance the trade-offs between bringing inflation sustainably to target and the risk to the economy from an overly restrictive policy stance. Persistent wage increases above productivity growth or a rise in imported inflation would warrant a more gradual easing of the monetary policy stance, while indications that inflation is likely to undershoot the target on a sustained basis would call for a more rapid reduction in the policy rate. The current elevated uncertainty suggests the pace of monetary easing should be guided more than usual by incoming data. As uncertainty declines the CBI should transition to a more forecast-based inflation targeting environment to increase predictability and reduce financial market volatility.

The CBI's decision to commence regular purchases of foreign exchange is opportune given current favorable market conditions and will strengthen its ability to stabilize the

foreign exchange market during times of stress. The purchase program, which will be revised as conditions warrant, will help offset a projected decline in reserve coverage over the next two years. Staff agree that, given the current uncertain external environment and the shock prone nature of the economy, it is prudent to maintain a level of reserves well above the lower end of the 100-150 percent of the Fund's Reserve Adequacy (ARA) range. As noted in the 2024 Article IV consultation, the authorities should also explore options to gradually deepen the foreign currency derivatives market when conditions allow, to encourage greater participation of foreign investors in the domestic bond market and to facilitate hedging of foreign currency risk.

Financial Sector: Maintaining a Robust Financial System

The banking system remains resilient and systemic risks are contained, but pockets of vulnerabilities remain that require continued vigilance. Financial institutions are well capitalized and have ample liquidity buffers, while non-performing loans remain low compared to their pre-pandemic average. The financial cycle has decelerated but remains somewhat elevated, while the CBI's domestic systemic risk indicator has increased slightly although it is below its long-term average. These indicators suggest risks are primarily concentrated in the housing market. An abrupt fall in house prices combined with higher-for-longer interest rates and an economic slowdown could result in a deterioration in asset quality. Risks are partially mitigated by conservative loan-to-value ratios and the strong equity position of most borrowers. Corporate credit risk has increased modestly, including in the hospitality sector, and could rise further if rising trading tensions trigger a decline in tourist arrivals. Meanwhile, cybersecurity threats are an increasing concern, and staff welcomes the authorities' efforts to enhance operational security and enhance the resilience of the domestic payment system.

The current macroprudential stance is broadly appropriate, though there may be scope for some easing if financial conditions improve as anticipated. Overall capital requirements on Icelandic banks are relatively high compared to other European countries, bolstering banks' resilience in a shock prone economy. While these requirements are broadly appropriate given still elevated risks in the housing market, there may be scope for some easing if systemic risks recede. It would be prudent to defer such a decision until the impact of the Capital Requirements Regulation (CRR) III—expected to take effect by mid-2025—is clear. Any easing of the macroprudential stance should take care to safeguard the availability of releasable capital under the countercyclical capital buffer (CCyB). Borrower-based measures (BBMs) have contributed to contain household credit risk and should remain on hold for now. The government's plans to reduce the prevalence of CPI-indexed mortgage loans should be carefully timed given the beneficial impact indexation has had on borrower resilience and financial stability.

Sustaining the momentum in implementing Financial Sector Assessment Program (FSAP) recommendations will require continued efforts. Staff welcomes the significant progress achieved in implementing the recommendations from the 2023 FSAP. Since the 2024 Article IV, progress has been made on operationalizing an Emergency Liquidity Assistance (ELA) framework, while efforts are ongoing with technical assistance from the Fund to enhance AML/CFT supervision of banks. Steps have been taken to strengthen the supervision of pension funds, but more progress is needed on legislative changes to enhance pension fund governance, internal risk controls, and risk management. Focusing on incremental changes rather than comprehensive reforms may facilitate progress moving forward. Further steps are also needed to safeguard the independence and effectiveness of the CBI's supervisory activities, including through a streamlined and independent budgetary process for financial supervision and improved legal protection for supervisors. Lastly, efforts should continue to strengthen the CBI's and the financial sector's operational risk management capacity.

Structural Policies to Boost Productivity and Diversify the Economy

Investments in physical and human capital, along with continued efforts to promote innovation and improve allocative efficiency are needed to sustain productivity growth.

- While the level of labor productivity is high, productivity growth has slowed since the global financial crisis due to lower total factor productivity (TFP) growth and decreasing capital intensity. Staff analysis suggests this is largely the result of a lower share of jobs in high productivity sectors (likely due to the financial sector shrinking to more sustainable levels and the expansion of the tourism sector) rather than a decline in within-sector productivity growth. Meanwhile, the share of fast-growing firms that can drive economy-wide productivity gains is below the EU average.

- The authorities' ambition to increase productivity growth is welcome. To achieve this they should: (i) focus on improving infrastructure to facilitate firms' access to domestic and international markets; (ii) continue their efforts to promote innovation and the creation of more high-growth businesses; (iii) work with stakeholders in the labor market to strengthen incentives for pursuing higher education in fields where there is a shortage of skills; and (iv) streamline professional licensing requirements for foreign nationals.

Incentives to promote innovation and diversification of the economy are bearing fruit, but there is scope to improve the efficiency of R&D support schemes. Generous tax incentives have made Iceland one of the most attractive jurisdictions in the OECD for R&D investment and contributed to the emergence of several fast-growing innovative firms. However, the sharp increase in public R&D spending has raised concerns about budgetary costs and efficiency. Plans to revise the R&D legislation provide an opportunity to clarify eligibility criteria and thus increase the predictability of the scheme. Also, as noted previously, there may be merit in reassessing the 2020 increase in the ceilings on eligible business R&D expenditures given that it primarily benefits medium and large firms where research suggests R&D support has less impact. Allowing businesses to deduct R&D expenses from payroll taxes could bolster the impact of the scheme given evidence that payroll tax offsets have a greater impact on firms' R&D tax expenditure. This would also reduce administrative costs by eliminating the need for refunds to loss-making companies.

Integration of Artificial Intelligence (AI) could bolster productivity growth. Iceland's strong digital infrastructure, relatively high levels of human capital, and robust legal framework suggest that it is well placed to benefit from AI. Staff analysis indicates that the proportion of jobs that are well positioned to take advantage of productivity gains from AI is higher than in other advanced economies. Conversely, the share of jobs at risk of displacement from AI is smaller, though still significant. To mitigate potential disruptions to the labor market the authorities should provide opportunities for re-skilling and scale up active labor market policies to facilitate the movement of workers between sectors and provide support to the most vulnerable.

Further efforts are needed to develop a housing strategy that meets the needs of Iceland's growing population. The government's plans to tighten control over short-term rentals and increase the supply of housing could help improve housing affordability. Targeted homeowner assistance programs can play a complementary role, though such programs would need to be designed in a way that minimizes fiscal risks and risks to macroeconomic and financial stability. Housing taxation can also play a supportive role in reducing housing market imbalances. For instance, increasing capital gains taxation on secondary homes and investment properties and raising the tax rate on vacant lots in urban areas could not only raise revenue but also play a supportive role in curbing speculative demand and incentivizing supply.

The IMF team would like to thank the authorities and other interlocutors for their generous hospitality and constructive dialogue.