INTERNATIONAL MONETARY FUND

IMF Country Report No. 25/141

ICELAND

June 2025

2025 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ICELAND

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 2025 Article IV consultation with Iceland, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 16, 2025 consideration of the staff report that concluded the Article IV consultation with Iceland.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 16, 2025, following discussions that ended on May 6, 2025, 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 May 28, 2025.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Iceland.

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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PRESS RELEASE

PR 25/212

IMF Executive Board Concludes 2025 Article IV Consultation with Iceland

FOR IMMEDIATE RELEASE

- Growth decelerated in 2024 but is expected to rise to 1.6 percent in 2025 and 2.2 percent in 2026, while inflation is projected to decline to the Central Bank of Iceland's 2.5 percent target in the second half of 2026. The direct impact of escalating global trade tensions is projected to be limited.

- The authorities' plans to turn the fiscal deficit in 2024 into a surplus by 2028 are appropriate given the need to rebuild buffers; details on the planned fiscal measures to achieve these targets have enhanced the credibility of the consolidation. Monetary policy is suitably tight given still elevated inflation, but the monetary stance should be reduced as inflation declines. Efforts to raise foreign exchange reserve coverage are welcome.

- Investments in physical and human capital, alongside continued efforts to promote innovation and reduce skills mismatches are needed to support medium-term growth. Taxation can play a supportive role in reducing housing market imbalances.

Washington, DC – June 24, 2025: The Executive Board of the International Monetary Fund (IMF) completed the Article IV Consultation for Iceland on June 16, 2025.[1] The authorities have consented to the publication of the Staff Report prepared for this consultation.[2]

The economy decelerated in 2024 to 0.5 percent due largely to weak exports from a disappointing fishing season and constraints on energy supply that curtailed aluminum production. Growth is expected to rebound to 1.6 percent in 2025 and 2.2 percent in 2026, driven by a recovery in exports, higher real wages, and continued monetary easing that more than offsets the impact of a moderately contractionary fiscal impulse. The impact of escalating global trade tensions is projected to be limited given that most goods exports are destined for Europe. Inflation is expected to gradually decline to the Central Bank of Iceland's 2.5 percent target in the second half of 2026. Medium-term prospects are favorable, with continued diversification of the economy toward higher value-added export-oriented sectors anticipated to bolster productivity growth and inflows of foreign labor expected to support a modest increase in employment growth.

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

[2] Under the IMF's Articles of Agreement, publication of documents that pertain to member countries is voluntary and requires the member consent. The staff report will be shortly published on the www.imf.org/iceland page.

Risks to growth are tilted to the downside while risks to inflation are broadly balanced. In particular, the impact of rising global trade tensions could be larger than anticipated if tariffs are extended to currently exempted items (e.g., pharmaceuticals) or if a reduction in travel to and from the US negatively affects tourism. Inflation could increase if trade tensions trigger supply disruptions or capital outflows, if a premature loosening of monetary policy further de-anchors inflation expectations, or as result of second-round effects from higher wage growth. Conversely, capital inflows could result in an appreciation of the exchange rate that would weaken competitiveness and put downward pressure on inflation.

Executive Board Assessment[3]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the prudent macroeconomic policies, which have helped to reduce imbalances. While noting that medium-term growth prospects are favorable, Directors observed that risks are tilted to the downside, notably from rising trade tensions. They emphasized the need to ensure macroeconomic stability and gradually rebuild fiscal buffers, while supporting stronger growth and reducing vulnerability to shocks.

Directors welcomed the ambitious fiscal targets and the improved transparency and credibility around the planned consolidation. They highlighted that increased infrastructure spending would help to close gaps in transport and energy and bolster growth prospects. Directors saw merit in implementing additional measures, if necessary, to achieve fiscal objectives. Noting the need to reduce procyclicality in fiscal policy, Directors supported the planned activation of revised fiscal rules in 2026. They also recommended measures to strengthen the Fiscal Council and increase the coverage and frequency of fiscal data.

Directors noted that price pressures remain elevated and agreed that tight monetary policy remained appropriate. They encouraged the Central Bank of Iceland (CBI) to gradually loosen the policy stance as inflation declines towards target and expectations become reanchored. Directors saw merit in transitioning to a more forecast-based inflation targeting framework as uncertainty declines. Noting the importance of increasing reserves to more prudent levels, Directors welcomed the CBI's decision to commence regular purchases of foreign exchange.

Directors welcomed that systemic risks in the financial sector are contained. They highlighted the need to remain vigilant to potential vulnerabilities in the housing market and the corporate sector, and to continue strengthening operational resilience. Directors saw scope to ease macroprudential policies should systemic risks recede as anticipated. While welcoming the progress on implementing FSAP recommendations, Directors urged further efforts to enhance pension fund governance, strengthen AML/CFT supervision of banks, and safeguard the independence and effectiveness of the CBI's supervisory activities.

Directors emphasized the importance of reforms to bolster productivity and diversify the economy, including by improving infrastructure and supporting innovation. Important measures include reducing skill mismatches, maximizing the efficiency of R&D incentives, and promoting AI while mitigating related risks. Directors welcomed plans to increase housing supply and improve housing affordability.

It is expected that the next Article IV consultation with Iceland will be held on the standard 12-month cycle.

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

Table 1. Iceland: Selected Economic Indicators, 2024–30							
	2024	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.	2030 Proj.
	(Percentage change unless otherwise indicated)						
National Accounts (constant prices)							
Gross domestic product	0.5	1.6	2.2	2.4	2.4	2.4	2.4
Total domestic demand	2.3	1.5	0.6	2.2	2.4	2.4	2.3
Private consumption	0.6	2.2	2.4	2.5	2.6	2.6	2.6
Public consumption	2.5	1.5	1.3	1.0	1.0	1.0	1.0
Gross fixed investment	7.5	4.1	-3.2	2.8	3.2	3.2	3.2
Net exports (contribution to growth)	-1.8	-0.3	1.6	0.3	0.1	0.0	0.2
Exports of goods and services	-1.2	3.3	3.0	3.3	3.1	3.0	3.2
Imports of goods and services	2.7	3.9	-0.7	2.7	2.9	2.9	2.9
Output gap (percent of potential output)	1.0	0.2	0.0	0.0	0.0	0.0	0.0
Selected Indicators							
Unemployment rate (percent of labor force)	3.4	3.9	4.0	4.0	4.0	4.0	4.0
Employment	4.1	0.4	0.9	1.1	1.1	1.1	1.1
Labor productivity	-3.3	1.2	1.3	1.3	1.3	1.3	1.3
Real wages	0.5	1.4	1.3	1.3	1.3	1.3	1.3
Nominal wages	6.4	4.9	4.4	3.8	3.8	3.9	3.8
Consumer price index (average)	5.9	3.5	3.0	2.5	2.5	2.5	2.5
Consumer price index (end period)	4.7	3.6	2.5	2.5	2.5	2.5	2.5
ISK/€ (average)	164	...	...	...	...	...	...
Money and Credit (end period)							
Credit to nonfinancial private sector	8.1	5.6	5.6	5.6	5.6	5.6	5.7
Central bank 7 day term deposit rate 1/	8.50	7.50	...	...	...	...	...
	(Percent of GDP unless otherwise indicated)						
General Government Finances 2/							
Revenue	42.8	43.2	42.4	42.4	42.4	42.5	42.6
Expenditure	46.3	44.5	43.2	42.9	42.8	42.7	42.7
Overall balance 3/	-3.5	-1.3	-0.7	-0.5	-0.3	-0.2	-0.1
Cyclically-adjusted primary balance	-1.5	0.7	0.9	1.2	1.4	1.6	1.7
Structural primary balance 4/	0.7	1.1	1.1	1.3	1.4	1.6	1.7
Gross debt	59.1	47.7	45.4	43.6	41.7	39.9	38.1
Balance of Payments							
Current account balance	-2.5	-2.6	-0.5	0.0	0.4	0.7	1.0
Gross external debt	67.0	65.4	61.6	58.5	55.4	52.4	49.5

Sources: Central Bank of Iceland; Ministry of Finance; Statistics Iceland; and IMF staff projections.
1/ For 2025, policy rate as of May.
2/ In April 2025, an agreement was reached on the settlement of remaining outstanding liabilities in the IL Fund (HFF).
3/ For 2024, the deficit now includes 1.2 percent of GDP in costs related to the purchase of houses in Grindavík that in the 2024 Article IV were classified below the line due to uncertainty about the correct statistical treatment.
4/ Cyclically-adjusted primary balance excluding one offs.

INTERNATIONAL MONETARY FUND

ICELAND

STAFF REPORT FOR THE 2025 ARTICLE IV CONSULTATION

May 28, 2025

KEY ISSUES

Context. Following a strong rebound after the pandemic, a successful tightening of fiscal and monetary policies has slowed domestic demand growth and reduced inflationary pressures. The challenges now are to fully return inflation to target while ensuring a soft landing for the economy; build resilience by gradually increasing fiscal buffers; and strengthen productivity and further diversify the economy to support medium-term growth and reduce Iceland's vulnerability to shocks.

Economic Developments and Outlook. The economy slowed sharply in 2024, mostly from weaker exports, but also reflecting tight macroeconomic policies. Growth is expected to recover in 2025 on the back of a pick-up in exports and continued monetary easing. Inflation is expected to return to target by the second half of 2026. Risks to growth, primarily from an increase in trade tensions, are tilted to the downside while risks to inflation are broadly balanced. The medium-term outlook is favorable.

Fiscal Policy. The authorities' fiscal consolidation targets are appropriate given the need to rebuild buffers; details on the planned fiscal measures to achieve these targets have enhanced the credibility of the consolidation. Increasing infrastructure spending would bolster growth prospects; scaling up private sector financing of infrastructure could complement these efforts, though care should be taken to contain fiscal risks. The activation of revised fiscal rules in 2026 will reduce procyclicality and increase the credibility of the fiscal consolidation, but the Fiscal Council needs strengthening.

Monetary Policy is suitably tight given still elevated inflation and inflation expectations. As inflation decreases, the policy rate should be reduced. A moderately tight policy stance remains appropriate until expectations become reanchored to the target. The Central Bank should transition to a more forecast-based inflation targeting environment as uncertainty declines. Efforts to raise foreign exchange reserve coverage are welcome.

Financial Policies. The banking sector is strong, but pockets of vulnerabilities remain, notably in the housing market. Macroprudential policies remain appropriate, though there may be scope for easing if systemic risks recede. Sustaining progress on FSAP implementation will require continued efforts and robust interagency coordination.

Structural Policies. Investments in physical and human capital and continued efforts to promote innovation and reduce skill mismatches are needed to sustain productivity growth. Taxation can play a supportive role in reducing housing market imbalances.

Approved By
Kristina Kostial (EUR) and Stefania Fabrizio (SPR)

The mission took place virtually April 7–11 and in Reykjavik during April 28–May 6, 2025. The team comprised Magnus Saxegaard (head), Thomas Gade, Amit Kara (all EUR), and Yurii Sholomytskyi (ICD). Kelly Gao and Eunmi Park (all EUR) supported the mission. Guðrún Ögmundsdóttir (OED) joined the discussions. The mission met with Prime Minister Kristrún Frostadóttir, CBI Governor Ásgeir Jónsson, Minister of Finance Daði Már Kristófersson, and other representatives of the public and private sectors.

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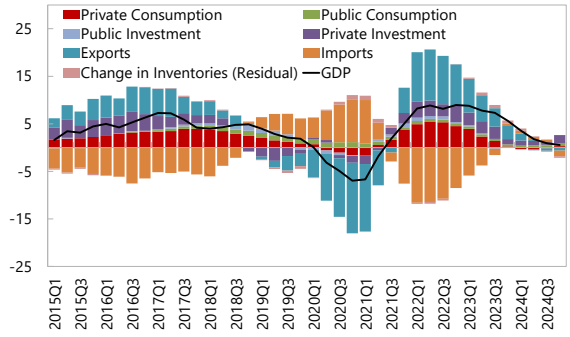
CONTEXT

1. Tight macroeconomic policies have successfully reduced imbalances accumulated after the pandemic. Thanks to continued fiscal consolidation and a tight monetary policy stance, domestic demand growth has decelerated and inflationary pressures have declined. Implementation of Fund policy advice has been good (Annex IV).

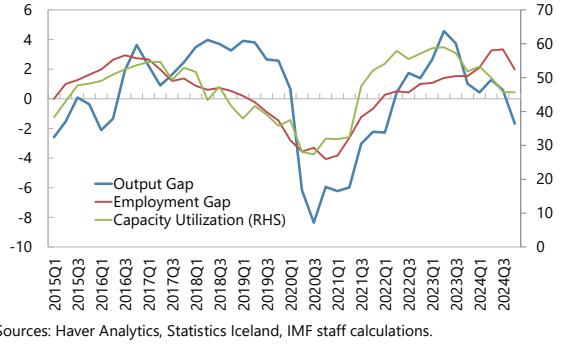
2. The challenge for the new government, which took office in December 2024, is to return inflation fully to target and build resilience. A tight macroeconomic policy stance remains appropriate in the near term. As inflationary pressures dissipate, a recalibration of the policy mix is warranted to ensure a soft landing while increasing fiscal buffers. Continued efforts are needed to strengthen productivity and further diversify the economy to support medium-term growth and reduce vulnerability to shocks.

RECENT ECONOMIC DEVELOPMENTS

3. The economy decelerated in 2024. It grew by 0.5 percent, down from 5.6 percent in 2023. The slowdown was largely due to weak services exports as well as a disappointing fishing season and constraints on energy supply that curtailed aluminum production. Private investment increased due to a pickup in residential construction and expansion of data centers, though leakages to imports were significant. Consumption growth remained subdued due to a rising savings rate and less immigration. The output gap is estimated to have narrowed sharply in 2024 while slack increased as evidenced by a decline in capacity utilization.



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

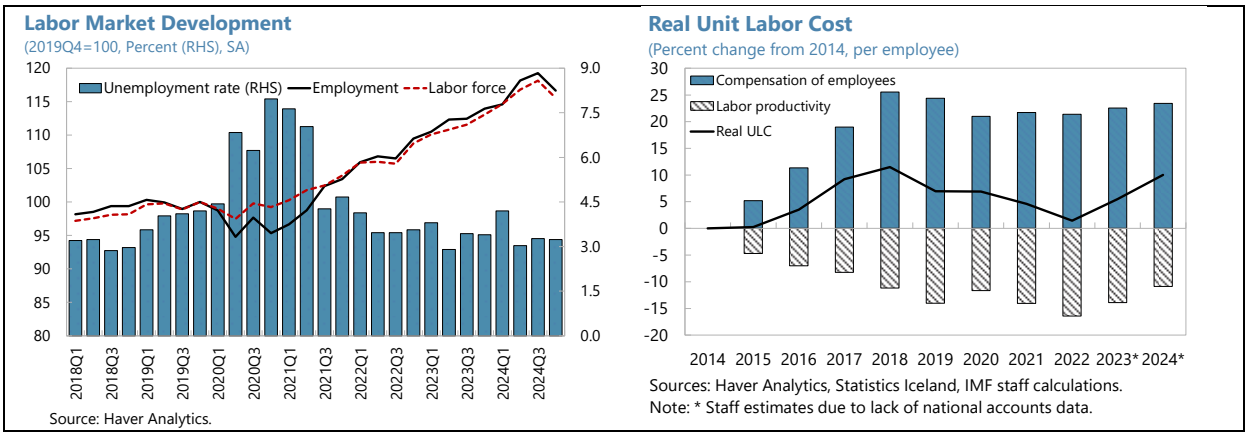


Sources: Haver Analytics, Statistics Iceland, IMF staff calculations.
Note: The employment gap is defined as the deviation of employment from its trend.

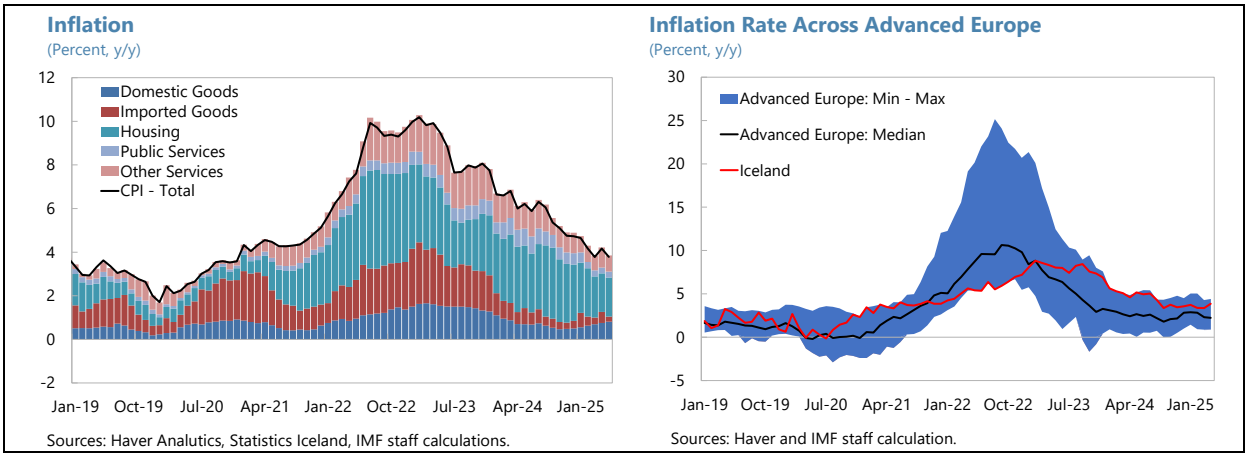
4. Pressures in the labor market have mostly subsided. The unemployment rate declined to 3.7 percent at end-2024 as a drop in employment was more than offset by a decline in the labor force from less immigration. Unemployment has increased slightly in recent months and is broadly in line with the estimated 4 percent neutral rate on a trend basis. Nominal wage growth eased to 6.6 percent in 2024 in line with declining inflation.[1] Real wage growth remains modest but outpaced

[1] Nominal wage growth increased in early 2025 due to base effects.

productivity growth in 2024, largely due to idiosyncratic factors that reduced output, while real unit labor costs (ULCs) have risen since the pandemic.



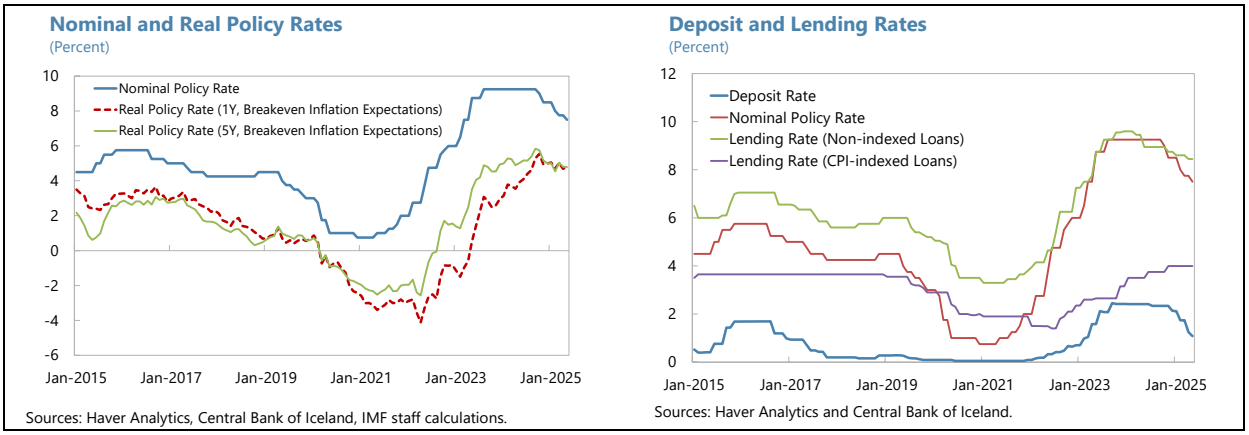
5. Inflation has declined but remains above the Central Bank of Iceland's (CBI's) 2.5 percent target. Inflation declined to 3.8 percent year-on-year in May and is now within the CBI's 1.0–4.0 percent notification band. Housing inflation has moderated but continues to be a key driver. Five-year break-even inflation expectations have declined somewhat but remain persistent and high at 3.4 percent as of May 2025.[2]



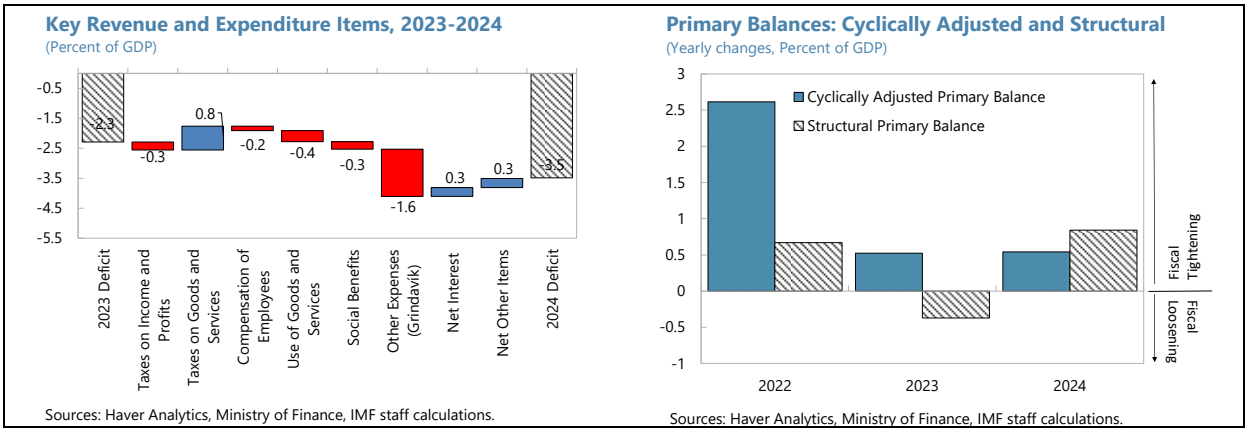
6. The monetary policy stance remains tight despite a reduction in the policy rate. The CBI raised the policy rate by 850 bps to 9.25 percent between May 2021 and August 2023. In October 2024, the CBI started reducing the policy rate to now 7.5 percent with the most recent 25 bps cut on May 21. The monetary stance remains tight with a real policy rate of around 4 percent, above estimates of the short-term neutral real rate (Box 1). Interest rates on non-indexed loans and bond yields have moved broadly in line with the policy rate. Meanwhile, the shift in recent years to CPI-indexed loans (whose debt service burden depends on the real interest rate and now accounts

[2] Inflation expectations have exceeded the inflation target for much of the past two decades, likely reflecting above-target headline inflation for much of the same period and several episodes of inflation spikes. For further discussion see IMF Selected Issues Paper No. 24/222.

for 55 percent of outstanding private sector debt) has cushioned the impact of high nominal interest rates on borrowers.



7. The fiscal deficit is on a downward trajectory, despite a temporary increase in 2024. After a large decline from 8.9 percent of GDP in 2020 to 2.3 percent in 2023, the deficit increased to 3.5 percent of GDP in 2024. This primarily reflects 1.2 percent of GDP in purchases of properties in the town of Grindavík and other spending related to the volcanic activity, along with a rise in social benefits linked to the 2023 wage bargaining round and an increase in the public wage bill.[3] Meanwhile, taxes on goods and services were positively impacted by stage one of the kilometer tax and the removal of the VAT exemption on electric cars. Without the Grindavík purchases, the cyclically adjusted primary deficit declined by 0.5 percentage points, implying a modest contractionary fiscal impulse.[4] Public debt remained broadly stable at just below 60 percent of GDP.

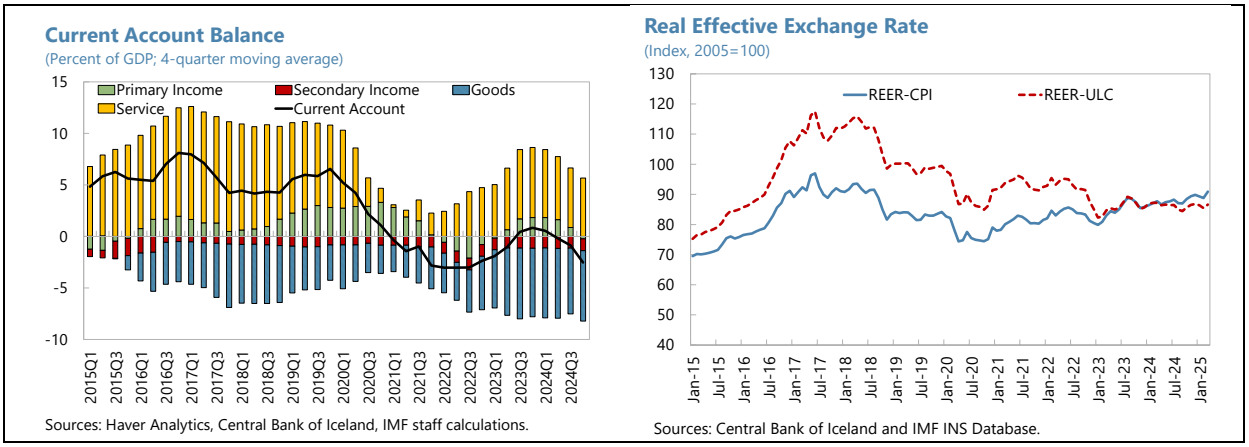


8. The current account turned negative in 2024. This deterioration reflects lower services exports, a disappointing fishing season, lower aluminum exports to the EU, and a surge in capital imports that more than offset an improvement in the terms of trade and an increase in exports of

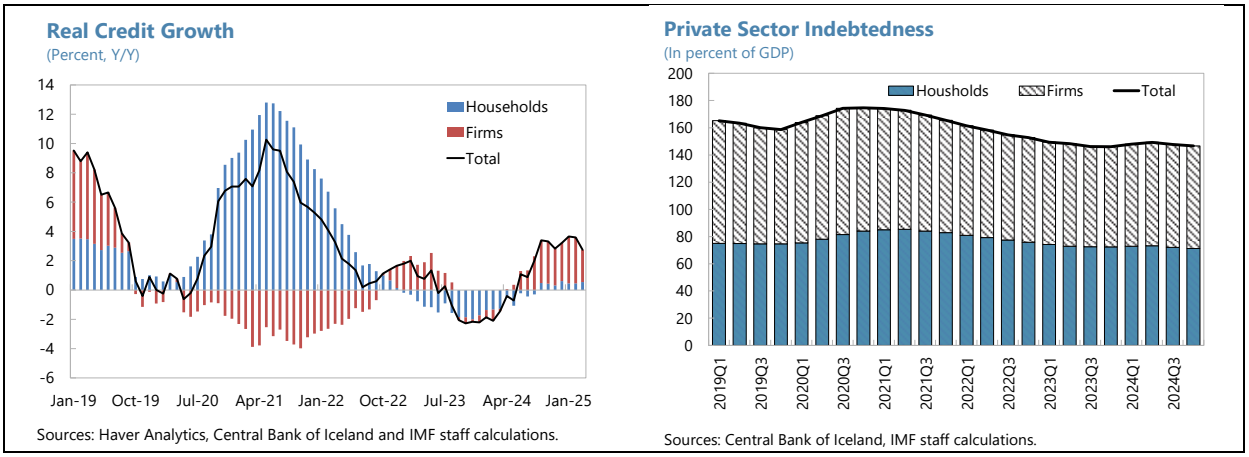
[3] In the wake of the volcanic activity the government and main lenders set up a Special Purpose Vehicle (SPV) to purchase properties in Grindavík, which had become uninhabitable. The government's contribution to this SPV has been reclassified from below-the-line to above-the-line since the 2024 Article IV, consistent with official data.

[4] Nearly 90 percent of displaced homeowners have used the proceeds to buy new houses. As a result, the impact on economic activity from these purchases is assessed to be negligible.

non-traditional sectors including pharmaceuticals and aquaculture. The primary income account weakened due to greater profit repatriation by foreign companies. Both the CPI- and ULC-based real effective exchange rate (REER) appreciated modestly in 2024. Iceland's external position is assessed to be moderately weaker than the level implied by fundamentals and desirable policies (Annex I).

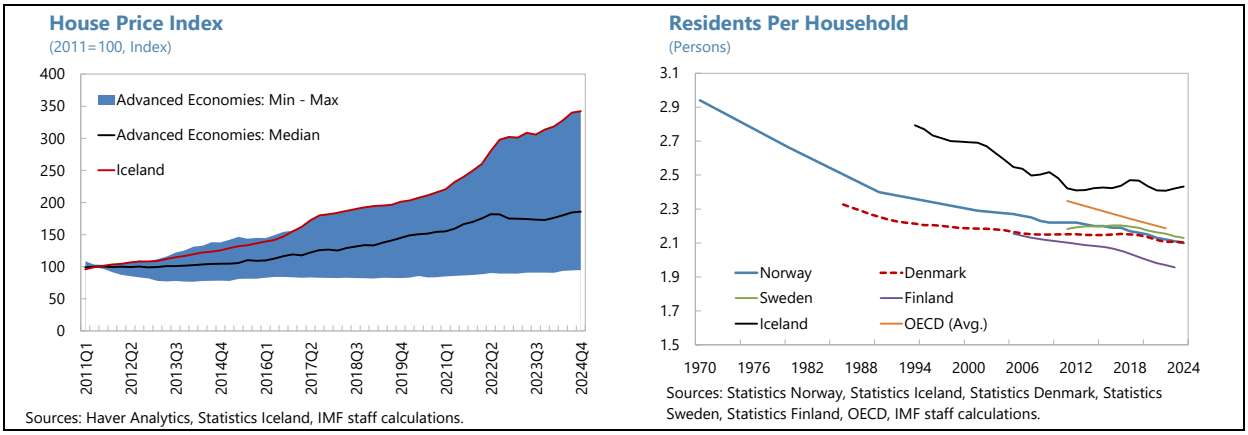


9. Credit growth is showing signs of recovery. After a downward trend since mid-2022, credit growth increased in 2024 due primarily to a pickup in lending to corporates, including construction and commercial real estate companies. Credit to households remained subdued as a pickup in mortgages due to falling interest rates was largely offset by a decline in other loans. The private sector debt-to-GDP ratio was broadly stable in 2024 and remains well-below its historical average.



10. Imbalances in the housing market have moderated, but house prices remain elevated. While house price growth has moderated, residential real estate prices remain high relative to standard metrics. Staff estimates of house price misalignment have declined to around 10 percent. Housing imbalances reflect a combination of demand and supply factors: Demand has been bolstered by increasing disposable incomes, rapid population growth, a rise in short-term rentals targeted at the tourism industry, and more recently the decline in interest rates and one-off factors related to the volcanic activity. There is also a structural increase in demand as the number of

residents per household gradually declines toward levels in other Nordic counties. Meanwhile, housing supply has failed to keep pace. Housing affordability remains a concern, especially for renters and low-income households.

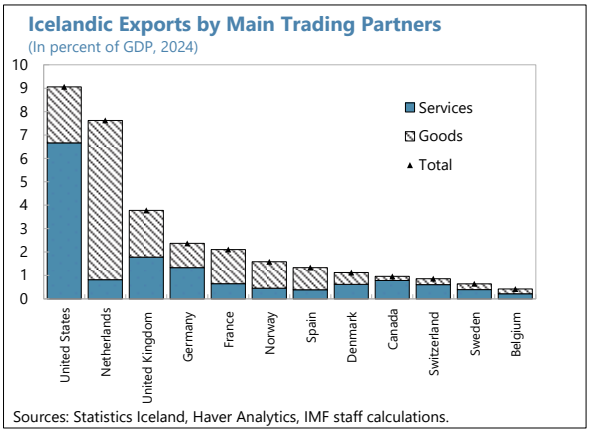


Sources: Haver Analytics, Statistics Iceland, IMF staff calculations.

Sources: Statistics Norway, Statistics Iceland, Statistics Denmark, Statistics Sweden, Statistics Finland, OECD, IMF staff calculations.

OUTLOOK AND RISKS

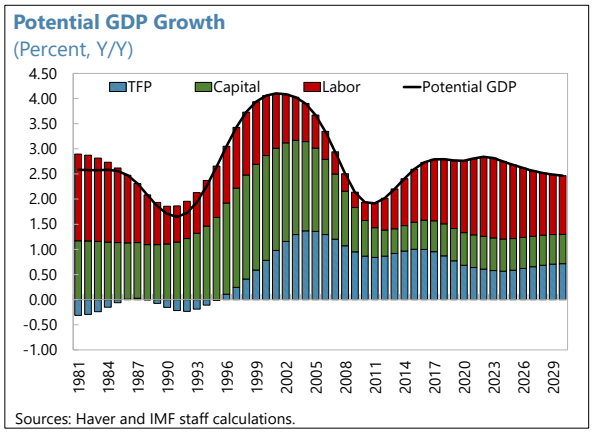
11. The economy is expected to strengthen, while inflation will continue moderating. Growth is projected to increase to 1.6 percent in 2025 and 2.2 percent in 2026, as rising real wages and a less restrictive monetary stance boost private consumption and investment, more than offsetting the impact of a moderately contractionary fiscal impulse. 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.[5] However, Iceland will be indirectly affected by lower growth in trading partners. Still, net exports are expected to drag on growth, with continued strong imports of capital goods and expectations of another disappointing fishing season more than offsetting a recovery in aluminum exports and a modest increase in tourism and exports of pharmaceuticals and aquaculture products. Inflation is projected to remain sticky due to elevated inflation expectations and a robust labor market, declining gradually to the CBI's 2.5 percent inflation target in 2026H2.



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

[5] The announced tariff on Icelandic goods exports to the US is 10 percent. Accounting for exemptions, the effective tariff is around 7.3 percent.

12. Medium-term growth prospects are favorable. Continued diversification of the economy toward higher value-added export-oriented sectors is anticipated to bolster productivity growth, while inflows of foreign labor would support a modest increase in employment. As a result, medium-term growth is expected to outpace that of many advanced economies, reaching 2.4 percent by the end of the projection period, while the current account is projected to gradually strengthen. Achieving this will require sustained efforts to foster innovation (see ¶32 and ¶33), combined with investment in infrastructure (see ¶18) and measures to boost housing supply (see ¶35).



13. Risks to growth are tilted to the downside while risks to inflation are broadly balanced (Annex II). The impact of escalating trade tensions could be larger than anticipated if tariffs are extended to currently exempted items (e.g., pharmaceuticals) and services exports (e.g., the movie industry) or if Iceland is affected by potential EU retaliatory tariffs. Also, the impact on tourism could be greater than expected if a reduction in travel to and from the U.S. negatively affects tourism. Inflation could increase if trade tensions trigger supply disruptions or capital outflows that weaken 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, including damage to undersea cables, could disrupt payment flows, with significant implications for economic activity and financial stability. A continuation of recent years' dry weather that triggers curtailments of energy supply or a further decline in fishing quotas could weaken exports. Second-round effects from higher wage growth could keep inflation elevated, while a premature loosening of monetary policy (e.g., due to uncertainty about the state of the economy) could further de-anchor inflation expectations and complicate the task of bringing inflation down to target. Upside risk to economic activity include lower-than-expected household savings that would bolster consumption, and a faster-than-anticipated expansion of activity in pharmaceutical and biotechnology sectors, and in aquaculture.

Authorities' Views

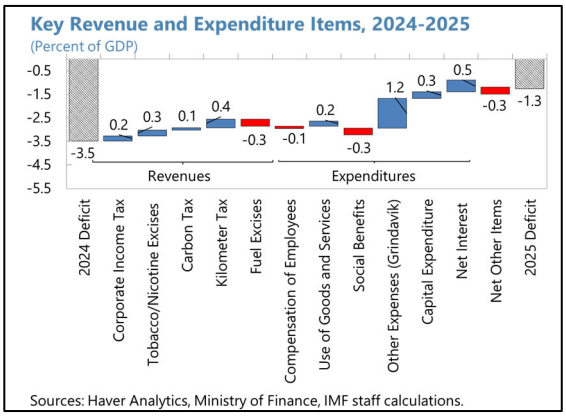
14. The authorities broadly agreed on the outlook and risks. They agreed that growth is likely to increase in the next two years as monetary policy becomes less restrictive, and that inflation was likely to decline. Like staff, they were concerned about the potential impact of rising global trade tensions. However, they argued that ongoing efforts to increase foreign currency reserves (see ¶25) would help the CBI mitigate the impact of any disruptive capital outflows. They also pointed to recent efforts (see ¶28) to improve the resilience of Iceland's payments infrastructure and believed the CBI's risk-based approach reduced the risk of a premature loosening of monetary policy (see ¶26). They concurred that the medium-term growth outlook was favorable.

POLICY DISCUSSIONS: SECURING A SOFT LANDING WHILE BUILDING RESILIENCE

Policy discussions focused on the appropriate policy mix to bring inflation to target while ensuring a soft economic landing for the economy, rebuilding buffers, safeguarding the resilience of the financial system, and implementing structural policies to boost productivity and diversify the economy.

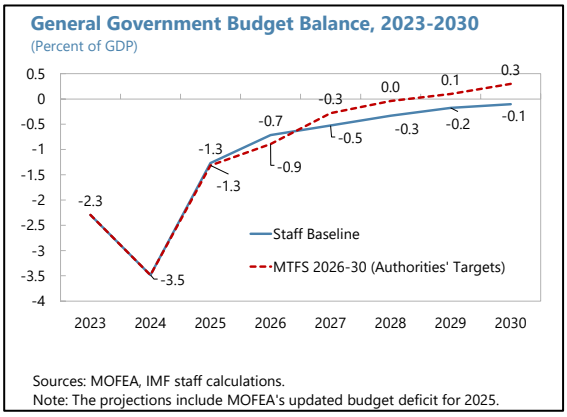
A. Fiscal Policy: Building Buffers to Bolster Resilience

15. Fiscal policy in 2025 is appropriately contractionary. The authorities' 2026–30 fiscal strategy (MTFS) projects a general government deficit of 1.3 percent of GDP this year, down from 3.5 percent in 2024. This projection aligns with staff's forecast. Part of the improvement is due to the expiry of one-off measures related to the volcanic activity, a decline in interest payments, and new revenue measures. The resulting 1.0 percentage point negative fiscal impulse (excluding the 2024 purchases of houses in Grindavík) is appropriately tight given elevated inflation expectations.



Sources: Haver Analytics, Ministry of Finance, IMF staff calculations.

16. The authorities' plans to gradually increase buffers are suitably ambitious. The MTFS envisages turning the fiscal deficit into a surplus of 0.3 percent of GDP by 2030 and a 3.5 percentage point reduction in the debt-to-GDP ratio. These targets are appropriately ambitious: Iceland does not face significant long-term spending pressures, and its overall risk of debt distress is low (Annex III). However, current debt levels exceed those of most other Nordic countries despite Iceland's economy being more shock prone. Staff's projections that only include measures presented to Parliament in a legislative proposal suggests the deficit will narrow to 0.1 percent of GDP by 2030; public debt is projected to decline to 38 percent due primarily to the settlement this year of the securities issued by the Housing Finance Fund (HFF) and sale of the government's remaining shares in Islandsbanki.[6,7]



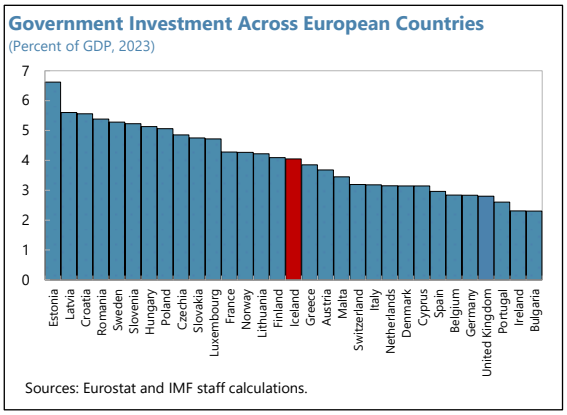
Sources: MOFEA, IMF staff calculations.
Note: The projections include MOFEA's updated budget deficit for 2025.

[6] In April 2025 a qualified majority of creditors approved an agreement for the early settlement of the HFF bonds. The agreement, which is subject to approval by Parliament, is expected to result in a reduction of government debt by at least 5 percentage points of GDP.

[7] The settlement of HFF securities are not included in the MTFS debt projections. Staff estimates that this transaction would reduce general government debt by 7.1 percentage points of GDP by 2030.

17. The MTFS is underpinned by substantial consolidation measures. Details in the MTFS about the planned measures to achieve the fiscal targets significantly increases the credibility of the consolidation. These measures include about 1.8 percent of GDP in expenditure reductions (e.g., streamlining operations and merging of institutions) to create space for new spending initiatives (e.g., in social security, health and transportation) and 1 percent of GDP in revenue measures (e.g., expanding kilometer-based taxation to all vehicles and increasing natural resource rent taxation on tourism and fisheries). Most of these measures have already been presented to Parliament and are included in staff's projections. Staff estimates that about 0.4 percent of GDP in additional measures may be needed over the next 5 years to meet the authorities' targets. The remaining measures outlined in the MTFS would cover this gap, but additional fiscal measures could be necessary (see ¶19) if the yield from planned revenue or expenditure measures fall short of expectations or if government investments is increased (see ¶18).

18. Increasing infrastructure spending would bolster Iceland's growth prospects. The government's intention to scale up investment in infrastructure is appropriate given infrastructure gaps in transport and energy and the need to boost productivity growth (see ¶33). However, while government investment as a share of GDP is broadly in line with that in other advanced European countries, the MTFS projects a medium-term decline compared to recent years. The authorities should, at a minimum, maintain the current level of government investment within the existing MTSF targets. As noted in the MTFS, identifying opportunities for Iceland's large 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, which are more burdensome than the OECD average, would help speed up infrastructure deployment.[8]



19. Should further measures be needed to achieve the MTFS targets or to increase infrastructure spending investment, the authorities could consider:

- *Increasing the preferential VAT rate and/or limiting the items that benefit from it*. Halving the gap between the VAT Revenue Ratio (VRR) in Iceland and the average in other Nordic countries (e.g., by reducing the number of items subject to reduced VAT) could raise nearly 0.5 percentage points of GDP in revenue.[9,10]

[8] For further details see OECD Infrastructure Toolkit.
[9] The VRR measures the amount of revenue that is theoretically possible give the statutory rate. For further details see OECD, "Consumption Tax Trends 2024: VAT/GST and Excise, Core Design Features and Trends".
[10] For a discussion of options to reform the VAT, see "Iceland: Modernizing the Icelandic VAT", IMF Country Report No. 14/291.

- *Increasing housing taxation*. Eliminating the capital gains exemption on housing or restricting it to primary residences and raising the property tax rate on vacant land would not only raise revenue but could also play a supportive role in curbing speculative demand and incentivizing supply in the housing market (see ¶35).

- *Streamlining R&D tax incentives*. To slow the growth in public R&D spending, the authorities could consider reassessing the 2020 increase in the ceiling on business R&D expenditures eligible for tax relief given that it is a significant driver of the increased cost of public R&D support, and primarily benefits medium and large firms where research suggests R&D support has less impact.[11,12]

- *Rationalizing government spending*. Structural primary expenditure has increased by about 5 percentage points of GDP over the past decade due to an expansion of the public wage bill and higher outlays on goods and services, subsidies, and social benefits. While the expenditure reductions envisaged in the MTFS are welcome, staff sees merit in carrying out a comprehensive review of government expenditure to identify possible efficiency gains.

20. Activation of revised fiscal rules in 2026 will reduce the procyclicality of fiscal policy and increase the credibility of the medium-term fiscal trajectory. The revised rules—which broadly align with staff's recommendations in the 2024 Article IV—include a net expenditure growth rule instead of the previous budget balance rule.[13] They preserve the 30 percent of GDP net debt ceiling, though the pace at which this ceiling is to be achieved will be more flexible than in the past. The combination of a net expenditure rule and flexible debt target will allow the authorities to factor in the state of the macroeconomy in their consolidation plans and reduce procyclicality.[14]

21. A more robust Fiscal Council would support the credibility and accountability of the fiscal rules.

- In addition to monitoring compliance with the rules, the Fiscal Council should also be tasked with evaluating the macroeconomic and fiscal projections underpinning the MTFS. As there are plans to task the Council also with monitoring productivity developments and making proposals for reforms, this will require a significant increase in its capacity and resources.

- To bolster transparency and enable the Council to monitor fiscal developments on an ongoing basis, there is a need to publish fiscal data corresponding to the coverage of the fiscal rules on a quarterly rather than annually basis as is currently the case, and ensure that these data are

[11] The cost of the R&D tax credit increased from just over 2 percent of corporate income tax revenue in 2012–16 to 16.3 percent in 2021.
[12] OECD, "The Impact of R&D Tax Incentives: Results from the OECD MICROBERD+ Project", OECD Science, Technology, and Industry Policy Papers No. 159, 2023.
[13] For further details see "Annex II: Reforming Iceland's Fiscal Rules", IMF Country Report No. 24/221.
[14] The revised rule state that if debt exceeds the target, the government must set clear and sufficiently ambitious objectives to ensure the debt target is reached within an acceptable time frame, taking into account the state of the economy and public finances.

independently verifiable.[15] Expanding the coverage of the budget and the fiscal rules to encompass the entirety of the central government would facilitate these efforts and also reduce incentives to shift spending and borrowing to parts of the government not covered by the rules.[16]

Authorities' Views

22. The authorities reaffirmed their commitment to a gradual buildup of fiscal buffers. They believe the measures outlined in the MTFS are likely sufficient to bring the fiscal deficit to a surplus by 2028 but acknowledged that additional measures could be necessary if planned measures fall short of expectations. They shared the view that there was a substantial infrastructure gap and are seeking ways to facilitate greater involvement of the Icelandic pension funds. They saw merit in staff's recommendation to increase the capacity of the Fiscal Council and to increase the coverage and frequency of budgetary data.

B. Monetary Policy: Calibrating the Pace of Monetary Easing

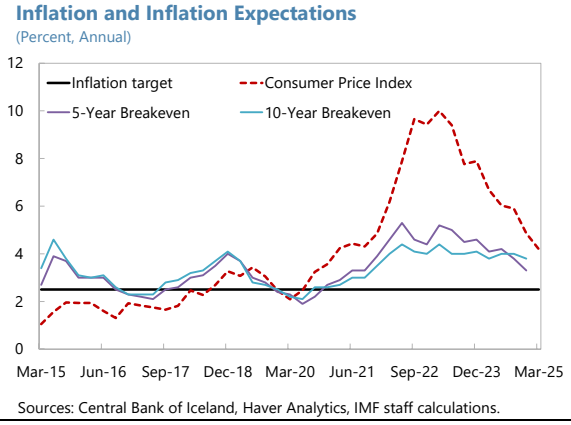
23. As inflation declines toward the target, the policy rate should be reduced. The current monetary stance is appropriately tight given still elevated inflation and inflation expectations, and is close to that predicted by a standard Taylor rule. The projected path for inflation, which entails reaching the 2.5 percent target in 2026H2, is assessed using a new quantitative model of the Icelandic economy to be consistent with approximately a 200 bps 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 2.5 percent target, appropriately balances the trade-offs between bringing inflation sustainably to target and the risk to the economy from an overly restrictive policy stance.[17,18] 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 toward its neutral level.

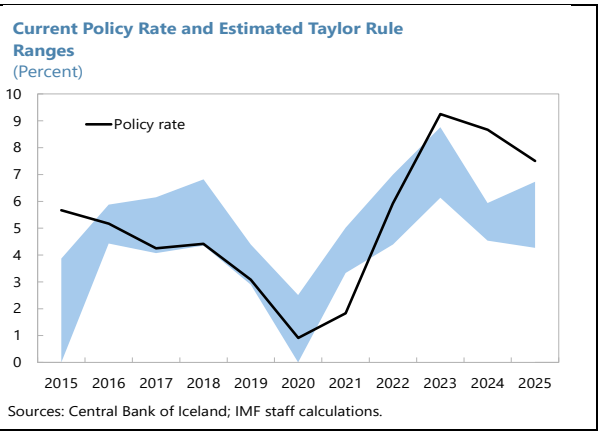
[15] Currently it is difficult for observers to verify the government spending deflator used to calculate net expenditure growth.

[16] Currently, the fiscal accounts are divided into three parts (A1, A2, and A3). Part A1 covers activities financed exclusively through tax revenues, statutory service revenues and contributions from the Treasury. Part A2 and A3 cover primarily activities of credit and investment funds, leasing and lending, as well as activities of majority state-owned companies. While the budget and fiscal rules cover part A1 only, quarterly statistical publications include data for the combined A sectors.

[17] Risk and liquidity premia imply that break-even inflation expectations measured using inflation-indexed bonds may exceed the inflation target while still being anchored. During 2017-19, when inflation in Iceland was broadly aligned with the 2.5 percent target, 5 and 10-year break-even inflation expectations averaged around 3 percent. For details see Pétursson, Þ. G. (2024), "Extracting inflation expectations and risk premia from the breakeven inflation rate in Iceland", Central Bank of Iceland Working Paper No. 97.

[18] In June 2024 Statistics Iceland change the methodology for measuring the house price component of inflation. Staff analysis suggests that the new methodology could result in lower but more volatile inflation moving forward. For further details see Selected Issues Paper: Assessing the Monetary Policy Implications of Changes in Owner-Occupied Housing Costs Measurement: Insights from IceQMod.



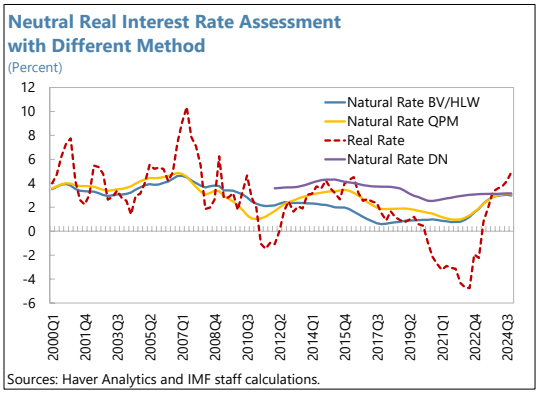


24. As uncertainty recedes, transitioning to a more forecast-based inflation targeting environment would increase predictability. The current elevated uncertainty suggests the pace of monetary easing should be gradual and guided more than usual by incoming data. However, given long lags in monetary policy transmission, the CBI should transition to a more forecast-based inflation targeting environment as uncertainty declines, to increase predictability and reduce financial market volatility. During this transition careful communication will be important to help anchor inflation expectations.

Box 1. Iceland: Assessing the Neutral Real Policy Rate

The real neutral interest rate r* is defined as the short-term interest rate that sustains output at its potential level and keeps inflation aligned with the target. Accordingly, the policy stance is considered tight when the real rate is above the neutral real rate (r > r*) and accommodative otherwise.

The short-term neutral real interest rate for Iceland is currently estimated to be around 2.7 percent. It is estimated using three different semi-structural models.[1] All models suggest that the neutral rate has declined over the past two decades but has increased after the pandemic as the economy rebounded. While there are significant differences pre-pandemic, the three models yield similar estimates of the level of the short-term neutral rate at present.



Structural and policy developments will determine how the neutral rate evolves. The neutral real rate is expected to decline gradually to 2.5 percent over the medium term, in line with staff's estimate of potential growth. An increase in productivity growth as the economy becomes more diversified and integration of AI gather pace will, together with robust population growth, boost potential growth and raise the neutral rate. The neutral rate could also rise if an increase in infrastructure investment raises potential growth. On the other hand, the natural rate could decline if trade policy uncertainty or geoeconomic fragmentation reduces Iceland's growth prospects, if an increase in uncertainty pushes up precautionary savings, or if the envisaged improvement in the current account results in an appreciation of the real exchange rate.

[1] The short-term neutral rate is estimated using: (i) a new Quarterly Projection Model (QPM) for Iceland; (ii) an open-economy extension of the semi-structural model of Holsten, Laubach and Williams (2017, 2023) developed by Bulíř and Vlček (2024); and (iii) a more flexible factor model developed Del Negro et al. (2017).

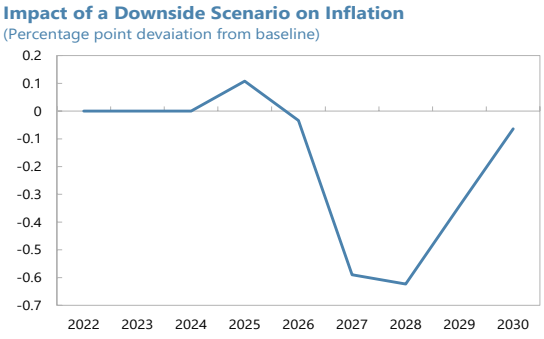
25. Given favorable market conditions, the CBI's decision to commence regular purchases of foreign exchange will strengthen its ability to stabilize the foreign exchange market during times of stress. At 117 percent of the Fund's Reserve Adequacy (ARA) metric at end-2024, reserves are within the 100–150 percent range considered adequate for precautionary purposes. Nonetheless, in April 2025 the CBI commenced regular purchases of €6 million (about 0.7 percent of reserves at end-2024) per week to 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 Fund's Reserve Adequacy (ARA) range.[19] This would enhance resilience and strengthen the CBI's ability to prevent disruptive movements in the exchange rate. 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 facilitate hedging of foreign currency risk.

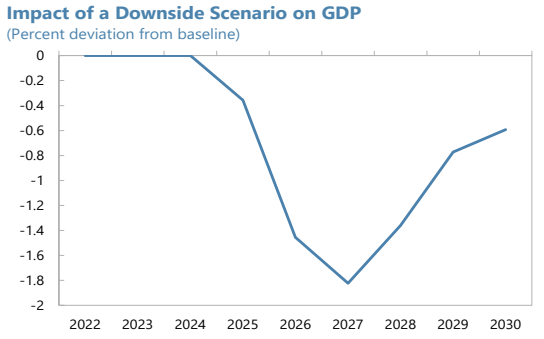
Box 2. Iceland: Policy Response in an Adverse Scenario

This box assesses the impact of an adverse scenario calibrated based on Scenario A in Box 1.1 of the April 2025 World Economic Outlook (WEO). The illustrative scenario includes four layers: (i) global divergence (e.g., weaker productivity growth in Europe and weaker domestic demand in China); (ii) a trade war (e.g., a ratcheting up of tariffs by the US and other countries); (iii) an increase in global uncertainty; and (iv) tighter financial conditions. The effect on the Icelandic economy is assessed by simulating the impact of the decline in growth in Iceland's trading partners.[1]

As a results of these shocks, annual real GDP growth in Iceland could be about 0.6 percentage points weaker on average in 2025–27 before gradually improving, while inflation could be about 0.2 percentage points lower than projected on average. This is broadly in line with estimates for the Euro Area.

Given the resilience of the domestic economy and labor market and the relatively large automatic stabilizers in Iceland, staff would advise against any discretionary fiscal stimulus to offset the impact of the shock.[2] Allowing automatic stabilizers to operate while maintaining the structural effort envisaged in the MTFS could lead to a temporary increase in the fiscal deficit of about 0.2 percentage points of GDP on average in 2025–27. The decline in inflation could also allow for a more rapid reduction in the policy rate.





[1] The impact is estimated using IceQMod. For details see Selected Issues Paper: Assessing the Monetary Policy Implications of Changes in Owner-Occupied Housing Cost Measurements: Insights from IceQMod.
[2] Automatic stabilizers in Iceland are large by relatively high and in line with those of other Nordic countries. For details see Kristjánson, A.S. (2024), "Automatic Stabilizers in Iceland", Nordic Economic Policy Review 2024.

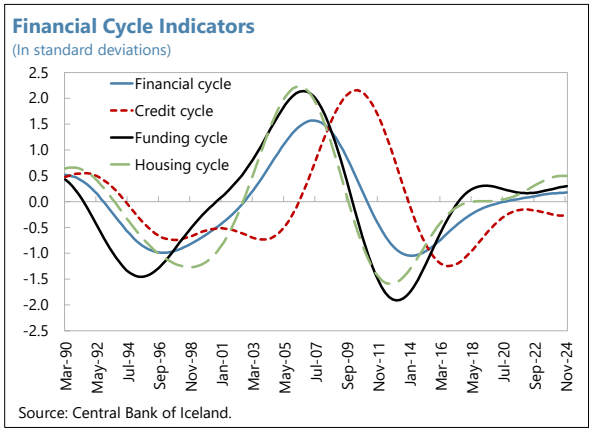
[19] As noted in the 2024 Article IV, the shallowness of Iceland's foreign exchange market implies that foreign exchange intervention could be warranted when the economy is faced with large non-fundamental shocks that trigger capital outflows. For details see IMF Selected Issues Paper no. 24/222.

Authorities' Views

26. The authorities reiterated their commitment to steer inflation and inflation expectations back to target. They expressed confidence that monetary policy was sufficiently tight to bring inflation back to target but argued that upside risks to inflation and the resilience of domestic demand reduced the urgency to ease the monetary policy stance in the near term. They agreed with staff that, to help anchor inflation expectations, a restrictive monetary policy could be necessary even after inflation reaches the target, and that a more forecast-based inflation targeting environment would be warranted as uncertainty declines. The authorities also agreed that an adequate level of foreign reverses was important to help the CBI prevent disruptive exchange rate movements and reiterated their plans to increase reserve coverage.

C. Maintaining a Robust Financial System

27. The banking sector remains resilient; systemic risks are contained and broadly unchanged from last year. Banks' capital ratios remain strong but declined slightly in 2024 as higher impairment charges, partly related to the increase in volcanic activity, reduced profitability. Non-performing loans (NPLs) rose modestly but remain low compared to their pre-pandemic averages. Liquidity buffers decreased slightly but remain ample. The foreign funding vulnerabilities identified in the 2023 FSAP continue to recede as interest rate spreads have declined and banks have refinanced foreign-currency bonds on more favorable terms. Risks in Iceland's large pension fund sector are broadly contained: inflows into the funds are well in excess of paid-out pension benefits while pension funds' lending practices are relatively conservative. The financial cycle remains on an upward trend, but its pace has decelerated owing mainly to the dynamics of residential real estate prices which have plateaued at a high level. The CBI's domestic systemic risk indicator, which is more sensitive to recent developments than the financial cycle, has increased slightly over the past year but remains below its long-term average.



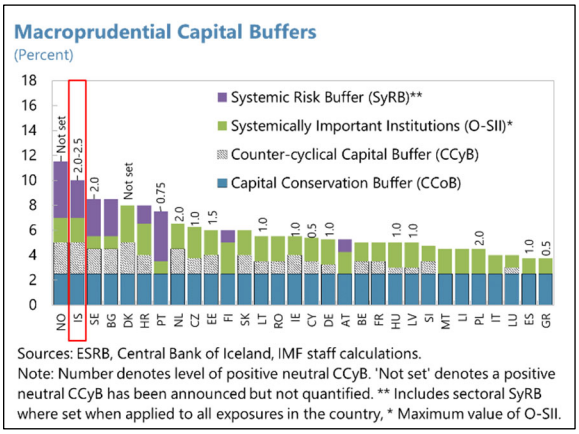
28. The residential real estate market, the hospitality sector, and operational security, remain potential vulnerabilities.

- *Residential real estate:* Although the quality of banks' mortgage portfolio remains high, an abrupt decline in residential house prices, especially if combined with higher-for-longer interest rates and an economic slowdown, could result in a deterioration in asset quality. This risk is mitigated by low loan-to-value (LTV) ratios, as well as the strong equity position of most borrowers and the increase in household savings and positive real wage growth in recent years.

- *Corporates:* Arrears on banks' corporate portfolio increased modestly in 2024 as the economy slowed but remain low overall. Risks are more elevated in the hospitality sector where the NPL ratio rose by 2.8 percentage points to 7.6 percent. This deterioration was due to a small number of large loans rather than a widespread increase in arrears in the sector. However, a decline in tourist arrivals could increase risks. NPLs in the construction sector increased by 2.5 percentage points to 3.7 percent in 2024Q4 but remain below their historical average. Risks in the commercial real estate sector are broadly contained.

- *Operational resilience:* Cyberattacks are an increasing threat and Iceland is vulnerable to disruptions to its cross-border payment infrastructure. The authorities are engaged in a multipronged effort to mitigate these risks, including strengthening the CBI's ability to ensure the resilience and efficiency of the domestic payment system, conducting cybersecurity exercises, establishing a cybersecurity testing framework, and making provisions for backup satellite connections in the event of disruptions to submarine cables.

29. 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. These requirements include a 2.5 percent countercyclical capital buffer (CCyB) which is at the top end of the recently announced 2.0–2.5 neutral range. While the current level of capital requirements is appropriate given still elevated risks in the housing market, there may be scope for easing if systemic risks recede. This should only be done once the impact of the Capital Requirements Regulation (CRR) III—expected to take effect by mid-2025—is clear.[20] If an easing is warranted this could be done by reducing the Systemic Risk Buffer (SyRB). Any easing of the CCyB should take care to safeguard the availability of capital that can be released if downside risks materialize. Borrower-based measures (BBMs) have contributed to contain household credit risk and should remain on hold for now. Plans to reduce the prevalence of CPI-indexed mortgage loans should be carefully timed given the beneficial impact indexation has had on the resilience of borrowers and financial stability.



Sources: ESRB, Central Bank of Iceland, IMF staff calculations.
Note: Number denotes level of positive neutral CCyB. 'Not set' denotes a positive neutral CCyB has been announced but not quantified. ** Includes sectoral SyRB where set when applied to all exposures in the country, * Maximum value of O-SII.

30. Sustaining the momentum in implementing FSAP recommendations will require continued efforts. 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 (see Annex V). Steps have also been taken

[20] CRR III introduces a new standardized approach to calculating lenders' capital requirements which will result in a reduction in capital charges on well-collateralized mortgages and operational risk.

to strengthen the supervision of pension funds, e.g., by performing regular on-site inspections for large pension funds and revising outsourcing guidelines. However, more progress is needed on legislative changes to improve pension fund governance, internal risk controls, and risk management. Proceeding with the pension fund reform agenda outlined in the FSAP in an incremental manner may facilitate progress moving forward. Further efforts 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 financial sector's operational risk management capacity.

Authorities' Views

31. The authorities concurred with staff's assessment that the financial system is resilient. They saw limited risk of a housing price correction and expressed confidence that, if house prices declined, household balance sheets would be sufficiently strong to prevent any adverse spillover to the financial sector. They agreed that global trade tensions posed challenges to the tourism sector but were confident that financial institutions had sufficient buffers to deal with a deterioration in asset quality. They shared staff's view that the current tight macroprudential stance is broadly appropriate, but some easing could be warranted if financial conditions continue to improve. The authorities noted the positive assessment of progress on implementing FSAP recommendations and looked forward to the recommendations of ongoing technical assistance from the Fund to enhance AML/CFT supervision of banks. They expressed hope that the diagnosis of the challenges facing the pension fund sector (the green paper) would be completed later this year and saw merit in staff's recommendation to adopt a more incremental approach moving forward. The authorities believed there was an opportunity to resume discussions on improving the legal protection of supervisors but saw limited scope to bridge differing opinions about the constitutionality of proposed changes to the funding framework for financial supervision.

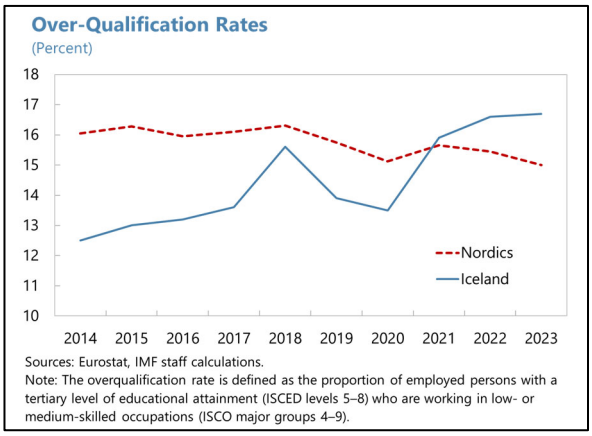
D. Structural Policies to Boost Productivity and Diversify the Economy

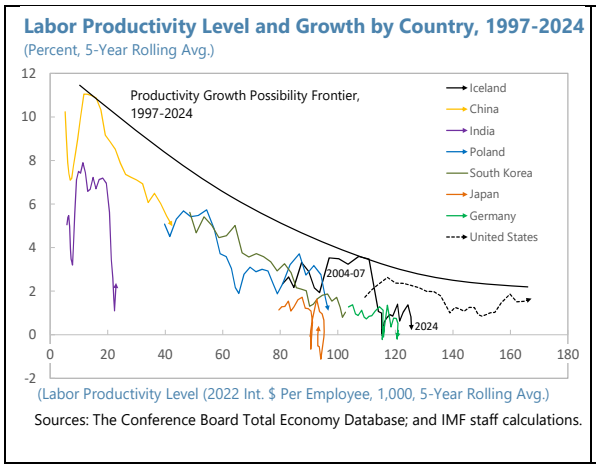
Enhancing Productivity and Innovation

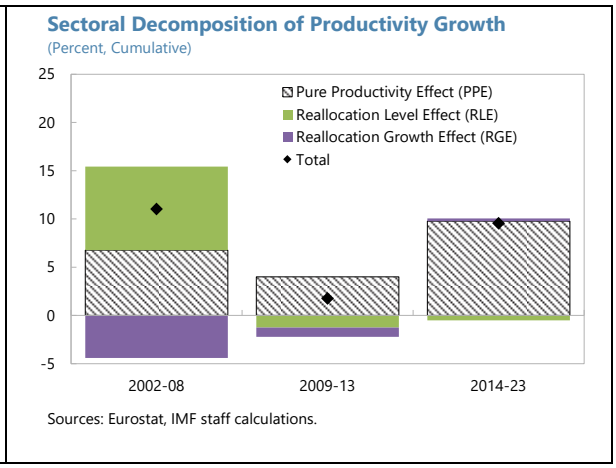
32. Investments in physical and human capital and continued efforts to promote innovation and improve allocative efficiency are needed to sustain productivity growth.

- Productivity growth is expected to be an important driver of potential growth over the medium term (see ¶12). While the level of labor productivity is high, productivity growth has slowed since the global financial crisis as a result of lower TFP growth and declining capital intensity; it is currently below the productivity growth frontier (see Annex VII). Staff analysis suggests the decline in labor productivity growth is the result of labor no longer moving to high productivity sectors (likely because of the financial sector shrinking to more sustainable levels and the expansion of the hospitality 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.

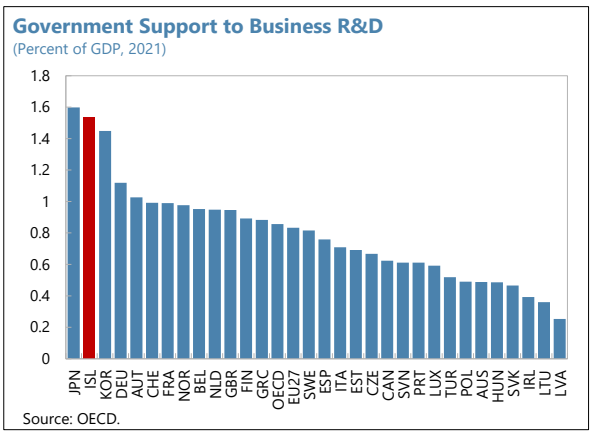
- Increasing productivity is a priority for the authorities. The focus should be on improving infrastructure (see ¶18) to facilitate access to domestic and international markets. Also, sustained efforts to promote innovation, including strengthening the system of R&D incentives (see ¶33), would support the creation of more high-growth firms. Working with stakeholders in the labor market to strengthen incentives for pursuing higher education in fields where there is a shortage of skills and streamlining professional licensing requirements for foreign nationals would help address skills mismatches and improve allocative efficiency by facilitating the movement of workers to more high-productivity firms and sectors.







33. 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 make Iceland one of the most attractive jurisdictions in the OECD for investing in R&D despite relatively high corporate taxes.[21] As a result, the value-added of high-tech sectors is increasing rapidly and fast-growing innovative firms are emerging in traditional sectors, including marine products. However, the sharp increase in public R&D spending has raised concerns about the budgetary impact and efficiency of the R&D tax support scheme. Plans to revise the R&D



[21] ECD Corporate Tax Statistics, 2023.O

legislation provide an opportunity to clarify eligibility criteria and thus stimulate R&D by increasing the predictability of the scheme. Also, as noted in ¶19 there may be merit in reassessing the 2020 increase in the ceilings on eligible business R&D expenditures given it is a driver of rising budgetary costs. Finally, the authorities could consider making business R&D expenses deductible against payroll taxes rather than corporate income taxes given evidence that payroll tax offsets have a greater impact on firms' R&D expenditure.[22] Since payroll taxes are payable by both profitable and unprofitable firms, this could also reduce administrative costs by avoiding the need for refunds to loss-making companies.

34. Increased integration of Artificial Intelligence (AI) could bolster productivity growth. A robust digital infrastructure, high levels of human capital, and a strong legal framework suggest Iceland is well placed to benefit from AI. Staff analysis suggests the proportion of jobs that are well positioned to take advantage of productivity gains from AI is higher than in other advanced economies (see Annex VIII). Conversely, the share of jobs at risk of displacement from AI is smaller than in other advanced economies, 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 across sectors, while providing support to the most vulnerable.

Reducing Imbalances in the Housing Market

35. Further efforts are needed to develop a housing strategy that meets the needs of Iceland's growing population. The government's intention to tighten control over short-term rentals will help mitigate the impact of the tourism industry on housing demand and improve housing affordability, especially for renters. Meanwhile, plans to make state land available for the construction of new homes, and simplify building and planning regulations, will help increase housing supply. Targeted homeowner assistance programs can complement these efforts, though such programs would need to be designed in a way that minimizes macroeconomic risks. Housing taxation can play a supportive role in reducing housing market imbalances. For example, staff analyses (Annex IX) suggest that increasing capital gains taxation on secondary homes and investment properties could help curb speculative demand. In addition, raising the tax rate on vacant lots in urban areas could help incentivize supply.

Authorities' Views

36. The authorities broadly agreed with staff's recommendation on structural policies. They concurred that investments in physical and human capital, along with efforts to promote innovation and improve allocative efficiency, were essential for sustaining Iceland's medium-term growth prospects. They viewed the ongoing review of the legislation governing R&D incentives as an opportunity to increase efficiency and contain costs and took note of staff's recommendations.

[22] The greater impact of payroll taxes could be because they are payable more frequently than other corporate taxes, allowing for quicker tax relief. For details see OECD, "The Impact of R&D Tax Incentives: Results from the OECD MICROBERD+ Project", OECD Science, Technology, and Industry Policy Papers No. 159, 2023.

The authorities see significant scope for AI to increase productivity growth and believe that the tight labor market would help mitigate the impact of AI-related job displacements. They emphasized their commitment to improve housing supply and increase affordability. The authorities agreed that any housing support programs would need to be carefully designed to minimize risks to the economy and saw merit in exploring tax policy changes to reduce housing market distortions and incentivize supply.

STAFF APPRAISAL

37. The outlook for the Icelandic economy is broadly positive. For 2025, growth is expected to strengthen to 1.6 percent supported by higher real wages, continued monetary easing, and a recovery in exports. The direct impact of escalating global trade tensions is projected to be limited, though Iceland will be indirectly affected by lower growth in trading partners. Inflation is projected to decline to the CBI's 2.5 percent inflation target in the second half of 2026. Medium-term growth prospects are favorable, driven by the expansion of higher value-added export-oriented sectors. Risks to growth, notably from a larger-than-expected impact of rising trade tensions, are tilted to the downside while risks to inflation are broadly balanced.

38. The authorities' fiscal targets are appropriately ambitious. Given still elevated inflation and the fact that Iceland's public debt is higher than that of most Nordic countries despite the economy being more shock prone, the authorities plan to turn fiscal deficits into a small surplus by 2028, while creating space for new spending initiatives. The MTFS detailing fiscal measures to achieve these targets significantly increases the credibility of the envisaged consolidation.

39. Increasing infrastructure spending would bolster Iceland's growth prospects. At a minimum, the authorities should seek to maintain the current level of government investment over the medium-term. Identifying opportunities for Iceland's pension funds to scale up their financing of infrastructure could complement these efforts, though the authorities should be mindful of fiscal risks.

40. There is scope for further savings should additional measures be needed to achieve the MTFS targets or increase infrastructure spending. Options include reducing reliance on preferential VAT rates and increasing housing taxation as well as streamlining R&D support and rationalizing government spending.

41. Activation of the revised fiscal rules in 2026 is welcome, but the Fiscal Council needs strengthening. The net expenditure rule will allow factoring in the state of the economy in consolidation plans and reduce procyclicality. An expanded role for the Fiscal Council would bolster the credibility of the fiscal rules; this will require a significant increase in the capacity and resources of the Council. To improve transparency and enable monitoring of fiscal developments on an ongoing basis, the coverage and frequency of budgetary data should be increased.

42. The policy rate should be reduced as inflation declines towards the CBI's target. Staff envisages approximately a 200 bps reduction in the policy rate over the next 4–5 quarters, entailing

a gradual easing of the monetary policy stance until inflation expectations are reanchored. Risks including persistent wage increases above productivity growth may justify a more gradual easing of the policy rate. While elevated uncertainty warrants a greater-than-usual reliance on incoming data, the CBI should switch to a more forecast-based inflation targeting framework as uncertainty declines.

43. The CBI's decision to commence regular purchases of foreign exchange will strengthen its ability to stabilize the foreign exchange market during times of stress. Given the uncertain external environment and the shock-prone nature of the economy, it is prudent to maintain reserves well above the lower end of the 100–150 percent of the Fund's ARA range. The authorities should also explore options to deepen the foreign currency derivatives market.

44. Systemic risks in the financial sector are contained and the macroprudential stance is broadly appropriate. Pockets of vulnerabilities, notably in the housing market, require continued vigilance, though conservative loan-to-value ratios and the strong equity position of most borrowers are a mitigating factor. If systemic risks recede as anticipated, there may be scope for some easing of the macroprudential stance. This should be done in a way that safeguards the availability of releasable capital under the CCyB.

45. Significant progress has been made in implementing FSAP recommendations, though more is needed. Remaining priorities include legislative changes to enhance pension fund governance, strengthen AML/CFT supervision of banks, safeguard the independence and effectiveness of the CBI's supervisory activities, and strengthen legal protection for supervisors.

46. Structural policies should focus on boosting productivity and further diversifying the economy. The authorities should prioritize improving infrastructure, continuing to support innovation, strengthening incentives for pursuing higher education, and streamlining licensing requirements for foreign nationals. Reforms are also needed to maximize the efficiency of R&D incentives. Iceland is well placed to benefit from AI but needs to mitigate possible disruptions to the labor market.

47. Housing policies need further adjustment. The government's plans to increase housing supply and improve affordability is welcome; housing assistance programs can help but need to be carefully designed to minimize risks. Housing taxation, for example an increase in capital gains taxation on secondary homes, can help in reducing housing market imbalances.

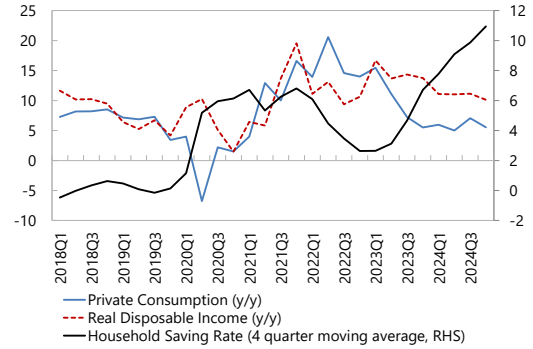
48. It is proposed that the next Article IV consultation with Iceland take place on the standard 12-month cycle.

Figure 1. Iceland: Real Sector Developments

Consumer spending remains subdued due in part to modest real income growth and a high savings rate.

Private Consumption, Income and Savings

(Percent)

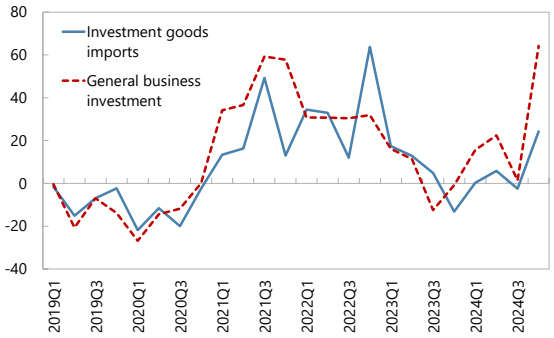


Source: Statistics Iceland.

Rebound in investment spending reflects imports of IT equipment for data centers.

Investment Goods Imports and Investment

(Percent, y/y)

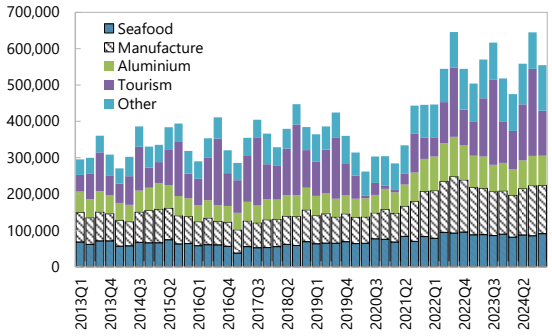


Sources: Statistics Iceland, Central Bank of Iceland.

Aluminum exports have moderated because of slower demand from the EU and energy constraints in 2024.

Goods and Service Exports

(M. ISK)

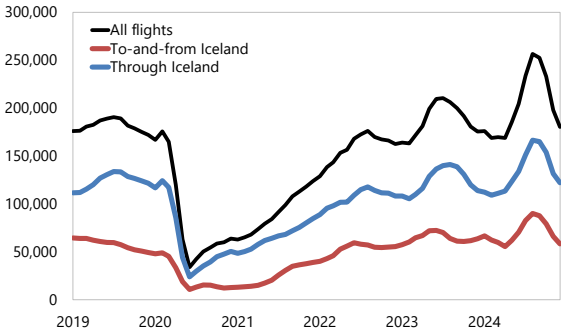


Source: Statistics Iceland.

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

Flight Arrivals in Reykjavik Control Area, 2019-2024

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

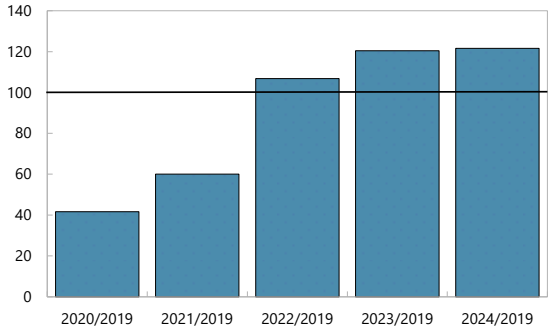


Source: ISAVIA.

Real turnover in the tourism sector increased modestly in 2024.

Real Turnover in Tourism, 2020-2024

(Percent of 2019 level, CPI deflated)

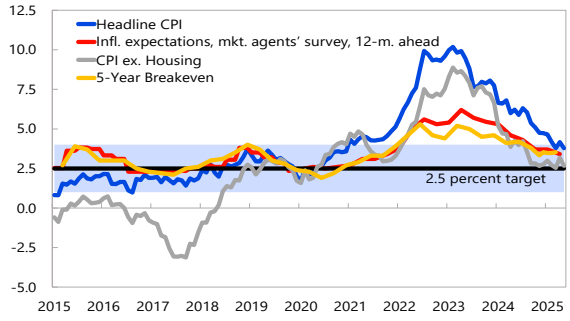


Sources: Statistics of Iceland and IMF staff calculation.

Inflation (ex-housing) and inflation expectations (5y BE) are within the Central Bank of Iceland's notification band

Inflation and Inflation Expectations

(Percentage change, y/y)



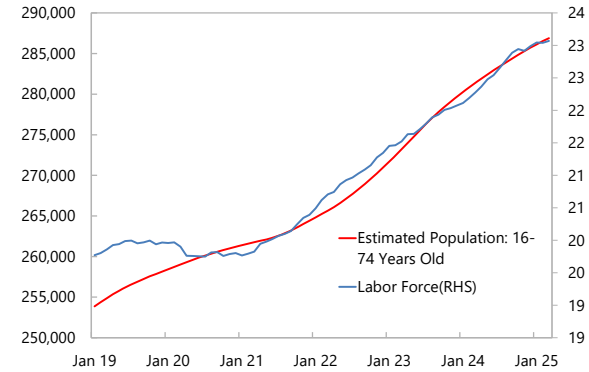
Source: Statistics Iceland, Central Bank of Iceland.

Figure 2. 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, 2019-2025

(Number of persons)

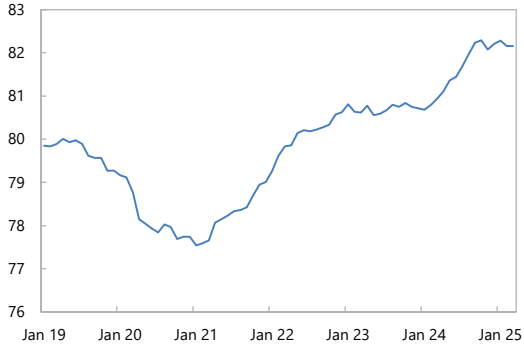


Sources: Haver Analytics, Inc. and Statistics Iceland.

The activity rate has recovered from pandemic-era lows but started to decline towards the end of 2024.

Activity Rate, 2019-2025

(Percent of estimated population, 16-74 years old)

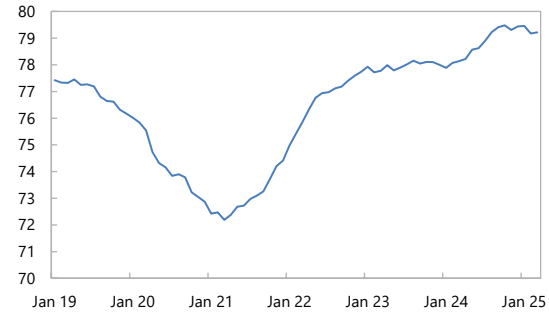


Sources: Haver Analytics, Inc. and Statistics Iceland.

The employment rate may have reached a cyclical peak.

Employment Rate, 2019-2025

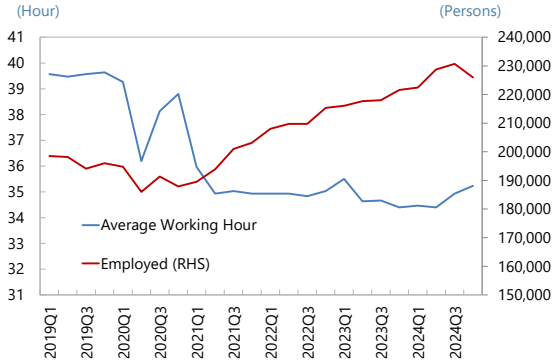
(Percent of estimated population, 16-74 years old)



Sources: Haver Analytics, Inc. and Statistics Iceland.

Average hours worked per week have declined since the onset of the pandemic.

Weekly Hours Worked and Employment

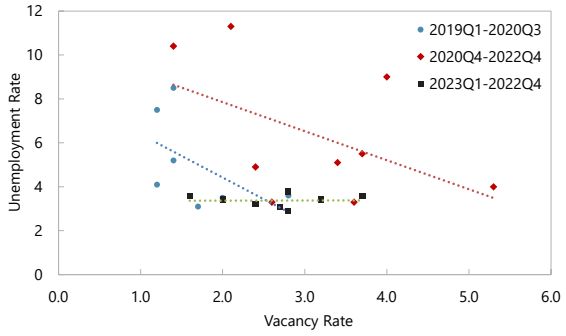


Sources: Haver Analytics, Statistics Iceland, IMF staff calculations.

The Beveridge curve has flattened since the onset of Covid, as immigration flows are linked to the business cycle.

Beveridge Curve

(Percent)

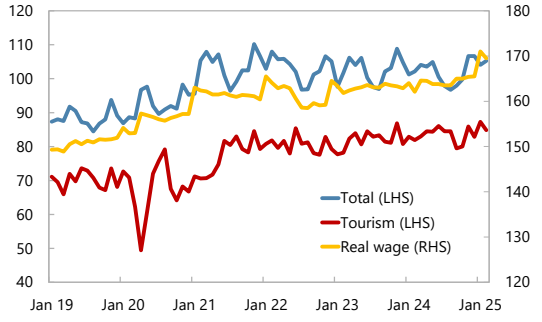


Sources: Haver Analytics, Statistics Iceland, IMF staff calculations.

Real wages have remained broadly constant despite the high inflation.

Payroll per Employee per Hour and Real Wage, 2019-2025

(Kronas, CPI deflated)



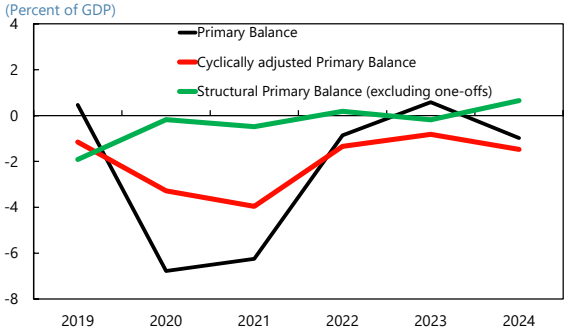
Sources: Haver Analytics, Inc. and Statistics Iceland.

Figure 3. Iceland: Fiscal Developments and Issues

The fiscal position was impacted by one-off expenditures in 2024 related to volcanic activity...

Primary Balances, 2019-2024

(Percent of GDP)

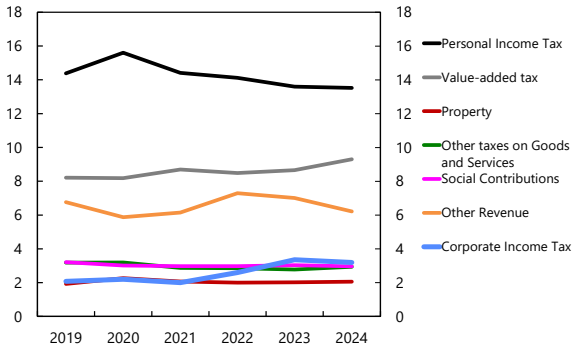


Source: Statistics Iceland.

The revenue composition was broadly unchanged through 2024.

General Government Revenue, 2019-2024

(Percent of GDP)

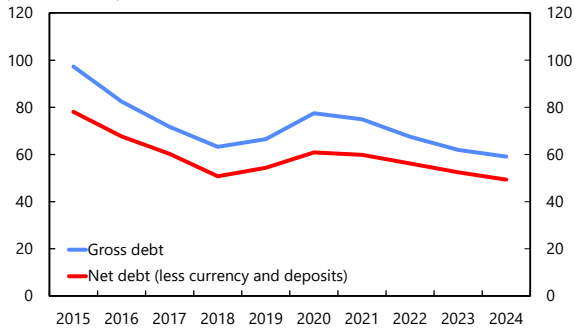


Source: Statistics Iceland.

While the debt level continued a modest downward trend...

General Government Debt, 2015-2024

(Percent of GDP)

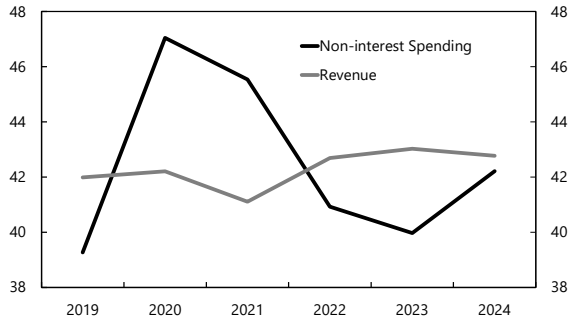


Source: Statistics Iceland.

...which resulted in an increase in non-interest spending.

General Government Revenue and Spending, 2019-2024

(Percent of GDP)

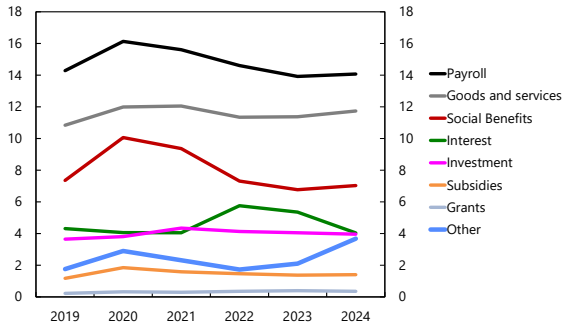


Source: Statistics Iceland.

The increase in spending manifested itself primarily in higher investments (purchase of properties in Grindavík) and other spending.

General Government Spending, 2019-2024

(Percent of GDP)

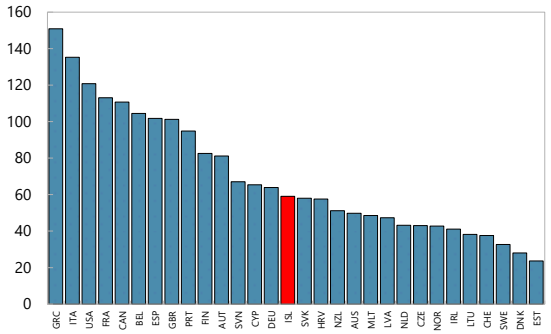


Source: Statistics Iceland.

... now at debt levels below the average of advanced economies, but higher than e.g., the other Nordics.

General Government Debt

(Percent of GDP)

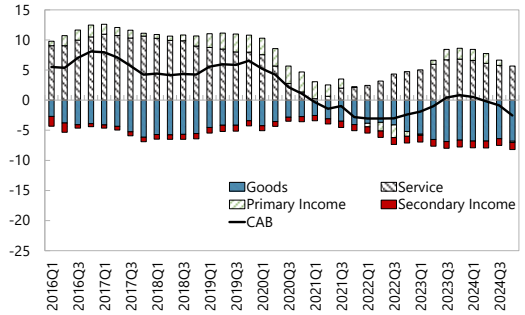


Source: World Economic Outlook.

Figure 4. Iceland: External Sector Developments

The current account deteriorated in 2024 due to a weakening trade balance and primary income account.

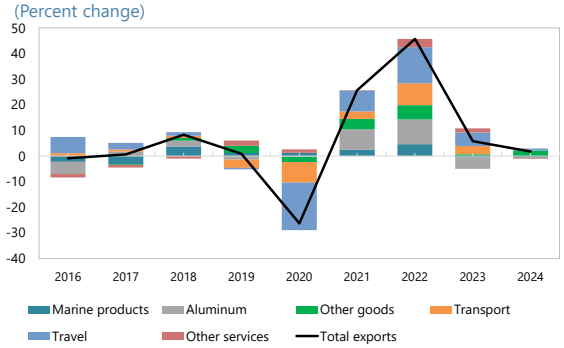
Current Account Balance
(Percent of GDP; 4-quarter moving average)



Source: Central Bank of Iceland.

Increased exports of pharmaceutical products partly offset weakness in aluminum, fisheries, and tourism.

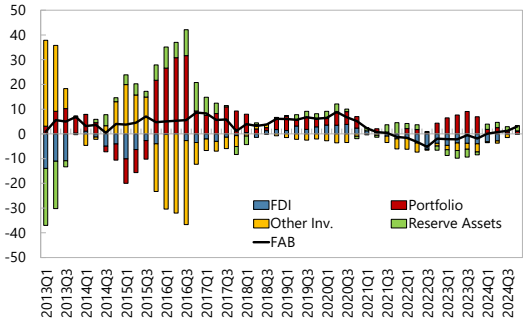
Nominal Exports (FOB) and Contributions of Subcomponents
(Percent change)



Sources: Statice and IMF staff calculations.

FDI moderated, but portfolio flows continued to grow.

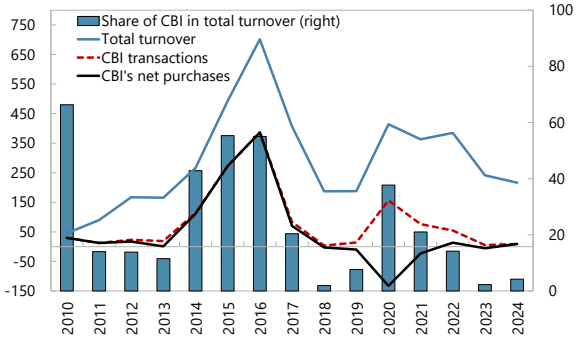
Financial Account Balance
(Percent of GDP; 4-quarter moving average)



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

FX interbank market turnover declined slightly in 2024 as did the share of CBI interventions.

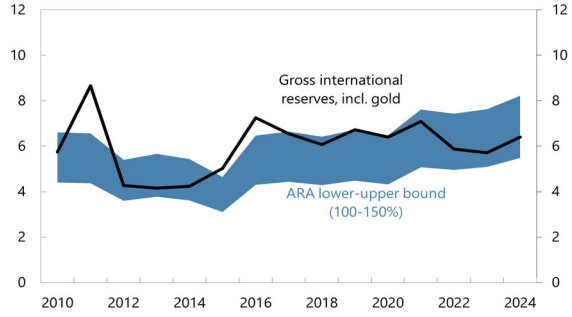
FX Market Turnover and Interventions
(Billion ISK, and percent)



Source: Central Bank of Iceland.

Reserves increased in 2024 and remain adequate for precautionary purposes.

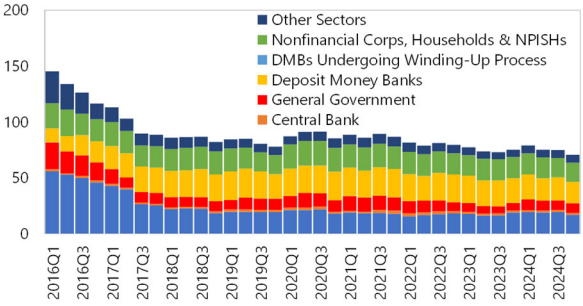
Reserves Adequacy Level
(Billion USD)



Sources: Central Bank of Iceland and IMF staff calculations.

External debt has remained stable.

External Debt, 2016-24
(Percent of GDP)



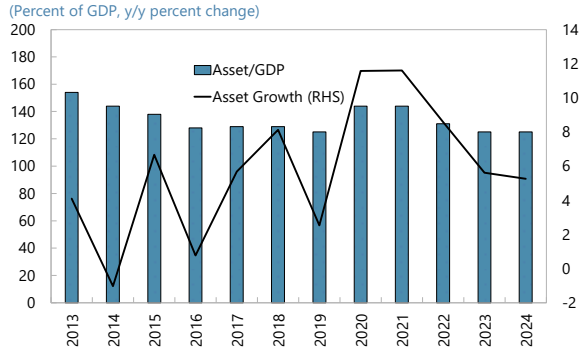
Sources: Haver Analytics, Central Bank of Iceland, and Statistics Iceland.

Figure 5. Iceland: Banking Sector Developments

The growth rate of banks' balance sheets moderated in 2024 with the ratio of assets broadly stable.

Banking System Assets

(Percent of GDP, y/y percent change)

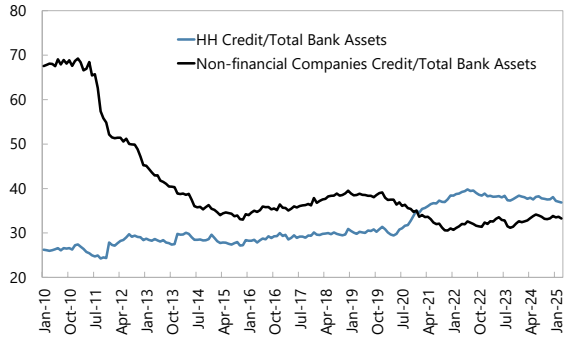


Source: Central Bank of Iceland.

Banks' exposure to households and non-financial corporates remain broadly unchanged.

Exposure to Households and Non-Financial Corporations

(Percent of total banking sector assets)

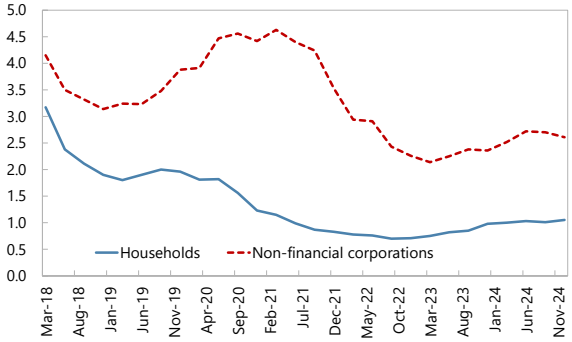


Source: Central Bank of Iceland.

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

Non-Performing Loan Ratios

(Percent)

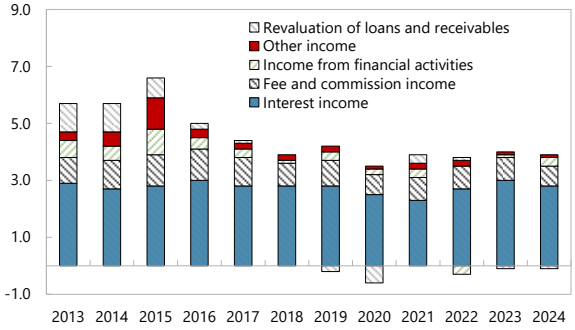


Source: Central Bank of Iceland.

Broadly stable bank profitability.

Banks' Operating Income to Total Assets

(Percent)

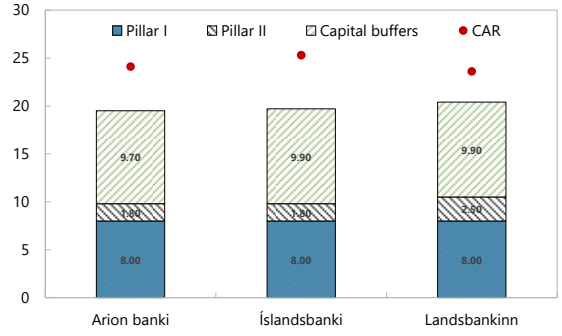


Source: Central Bank of Iceland

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

Capital Requirements and Adequecy

(Percent)

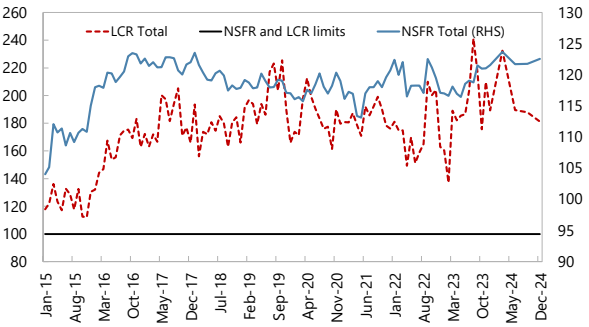


Source: Central Bank of Iceland.

...and liquidity buffers remain ample.

Liquidity Requirement

(Percent)



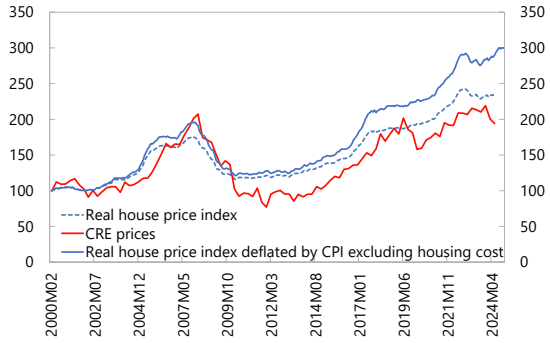
Source: Central Bank of Iceland.
Note: LCR limit is for all currencies combined.

Figure 6. Iceland: Housing Market Developments

The increase in real house prices moderated in 2024, while CRE-prices declined moderately…

Real Estate Indices

(Index, 2000M3=100)

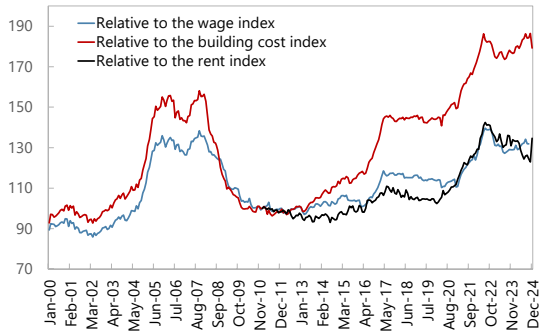


Sources: Statistics Iceland, CBI and IMF staff calculations.

…but housing prices remain elevated across most metrices…

House Prices Relative to Fundamentals

(Index, January 2011 = 100)

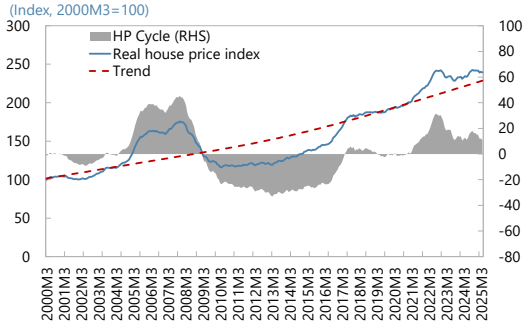


Sources: Statistics Iceland, CBI and IMF staff calculations.

…also reflected in an elevated housing cycle…

Real House Price: Trend and Cycle

(Index, 2000M3=100)

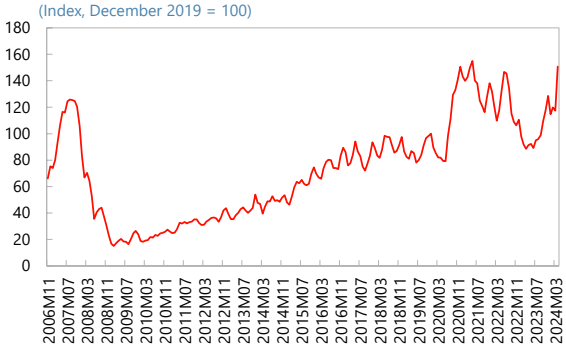


Sources: Statistics Iceland, Central Bank of Iceland, and IMF staff calculations.
Note: Trend and cycle are constructed using Hodrick-Prescott (HP) filters.

…while real estate turnover has picked-up recently.

Real Estate Turnover

(Index, December 2019 = 100)

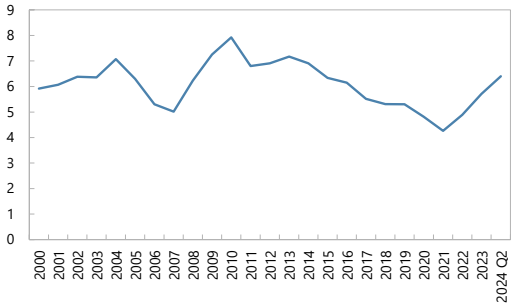


Sources: Registers Iceland and IMF staff calculations.
Notes: Three-month moving average and deflated by the CPI.

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

Household Interest Payment to Disposable Income

(Percent)

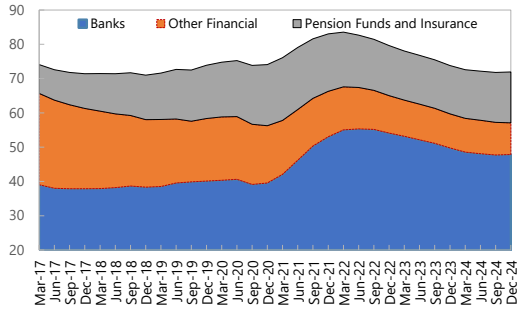


Source: Central Bank of Iceland

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, 2020–2030

	2020	2021	2022	2023	2024	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.	2030 Proj.
	(Percentage change unless otherwise indicated)										
National Accounts (constant prices)											
Gross domestic product	-6.9	5.0	9.0	5.6	0.5	1.6	2.2	2.4	2.4	2.4	2.4
Total domestic demand	-1.0	7.2	8.4	2.3	2.3	1.5	0.6	2.2	2.4	2.4	2.3
Private consumption	-3.1	6.9	8.3	0.5	0.6	2.2	2.4	2.5	2.6	2.6	2.6
Public consumption	5.2	2.3	2.3	1.8	2.5	1.5	1.3	1.0	1.0	1.0	1.0
Gross fixed investment	-7.4	14.3	16.1	4.3	7.5	4.1	-3.2	2.8	3.2	3.2	3.2
Net exports (contribution to growth)	-6.0	-2.2	0.2	3.2	-1.8	-0.3	1.6	0.3	0.1	0.0	0.2
Exports of goods and services	-30.7	14.8	22.1	6.3	-1.2	3.3	3.0	3.3	3.1	3.0	3.2
Imports of goods and services	-20.6	20.5	20.1	-1.0	2.7	3.9	-0.7	2.7	2.9	2.9	2.9
Output gap (percent of potential output)	-6.0	-4.1	0.9	2.7	1.0	0.2	0.0	0.0	0.0	0.0	0.0
Selected Indicators											
Gross domestic product (ISK bn.)	2,929	3,273	3,882	4,339	4,616	4,876	5,172	5,440	5,747	6,068	6,413
Gross domestic product ($ Mn.)	21,630	25,770	28,696	31,452	33,463	35,003	37,907	40,674	43,815	47,154	50,816
GDP per capita ($ thousands)	61.1	71.9	78.6	83.8	87.2	89.5	94.8	99.7	105.2	111.0	117.2
Private consumption (percent of GDP)	52.0	51.6	50.3	49.3	49.1	49.1	48.9	48.8	48.6	48.4	48.2
Public consumption (percent of GDP)	28.1	27.4	25.7	25.0	25.5	25.6	25.4	25.2	24.9	24.6	24.3
Gross fixed investment (percent of GDP)	21.2	22.9	24.3	24.8	26.4	26.9	25.6	25.8	25.8	25.9	25.9
Gross national saving (percent of GDP)	22.4	20.2	22.1	26.3	24.0	24.4	25.1	25.8	26.2	26.5	27.0
Unemployment rate (percent of labor force)	6.3	5.8	3.6	3.4	3.4	3.9	4.0	4.0	4.0	4.0	4.0
Employment	-3.2	3.4	7.0	3.6	4.1	0.4	0.9	1.1	1.1	1.1	1.1
Labor productivity	-1.3	3.9	1.8	1.3	-3.3	1.2	1.3	1.3	1.3	1.3	1.3
Real wages	3.4	3.7	0.0	0.9	0.5	1.4	1.3	1.3	1.3	1.3	1.3
Nominal wages	6.3	8.3	8.3	9.8	6.4	4.9	4.4	3.8	3.8	3.9	3.8
Consumer price index (average)	2.8	4.5	8.3	8.7	5.9	3.5	3.0	2.5	2.5	2.5	2.5
Consumer price index (end period)	3.6	5.1	9.6	7.8	4.7	3.6	2.5	2.5	2.5	2.5	2.5
Core CPI (average)	3.0	4.3	7.6	8.6	6.1	3.5	3.1	2.5	2.5	2.5	
ISK/€ (average)	157	148	159	163	164	...	...	...	...	...	...
ISK/$ (average)	135	127	135	138	138	...	...	...	...	...	...
Terms of trade (average)	-1.5	3.9	2.5	-5.6	0.9	-0.7	0.5	-0.1	1.0	1.0	1.0
Money and Credit (end period)											
Base money (M0)	11.8	9.0	1.5	-21.5	16.7	11.5	10.6	9.9	9.8	9.2	8.9
Broad money (M3)	7.4	10.9	8.9	8.3	11.7	9.3	8.3	6.8	6.8	6.5	6.3
Credit to nonfinancial private sector	10.5	10.5	11.3	5.2	8.1	5.6	5.6	5.6	5.6	5.6	5.7
Central bank 7 day term deposit rate 1/	0.75	2.00	6.00	9.25	8.50	7.50	...	...	...	...	...
	(Percent of GDP unless otherwise indicated)										
General Government Finances 2/											
Revenue	42.2	41.1	42.7	43.0	42.8	43.2	42.4	42.4	42.4	42.5	42.6
Expenditure	51.1	49.6	46.7	45.3	46.3	44.5	43.2	42.9	42.8	42.7	42.7
Overall balance 3/	-8.9	-8.5	-4.0	-2.3	-3.5	-1.3	-0.7	-0.5	-0.3	-0.2	-0.1
Cyclically-adjusted primary balance	-3.3	-4.0	-1.3	-0.8	-1.5	0.7	0.9	1.2	1.4	1.6	1.7
Structural primary balance 4/	-0.2	-0.5	0.2	-0.2	0.7	1.1	1.1	1.3	1.4	1.6	1.7
Gross debt	77.5	74.9	67.5	62.0	59.1	47.7	45.4	43.6	41.7	39.9	38.1
Net debt	60.9	59.8	56.2	52.5	49.3	40.0	38.1	36.6	35.1	33.7	32.2
Balance of Payments											
Current account balance	1.0	-2.8	-2.4	0.8	-2.5	-2.6	-0.5	0.0	0.4	0.7	1.0
of which: services balance	1.4	2.1	4.7	6.8	5.7	6.1	6.6	6.8	6.9	7.0	7.1
Capital and financial account (+ = outflow)	5.1	-1.3	-2.0	-2.0	3.0	-2.7	-0.7	-0.1	0.2	0.5	0.9
of which: direct investment, net (+ = outflow)	2.3	-2.0	-3.8	-4.0	-0.2	-1.7	-1.9	-1.9	-1.8	-1.6	-1.5
Gross external debt	90.8	84.8	75.6	75.1	67.0	65.4	61.6	58.5	55.4	52.4	49.5
Central bank reserves ($ Mn.)	6,408	7,091	5,879	5,720	6,397	6,607	6,627	6,902	6,973	7,280	7,533

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

1/ For 2025, policy rate as of May.

2/ In 2020, the definition of the general government was expanded to include 24 new entities, of which the largest are the IL Fund and the Student Loan Fund. In April 2025, an agreement was reached on the settlement of remaining outstanding liabilities in the IL Fund (HFF).

3/ Costs related to the purchase of houses in Grindavík (1.2 percent of GDP) that in the 2024 Article IV were classified below the line are now classified above the line due to uncertainty about the future value of these properties.

4/ Cyclically-adjusted primary balance excluding one offs.

Table 2. Iceland: Money and Banking, 2020–2030

(Billions of kronur unless otherwise indicated)

	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Central Bank											
Net foreign assets	563	524	527	515	548	572	559	581	575	600	617
Assets	817	923	837	790	886	837	824	846	841	866	882
Liabilities	254	399	310	276	339	266	266	266	266	266	266
of which: central government foreign currency deposits	214	305	228	197	260	187	187	187	187	187	187
Net domestic assets	-416	-363	-364	-387	-398	-405	-375	-379	-353	-358	-353
Central government, net	-134	-46	-72	-68	-61	-61	-61	-61	-61	-61	-61
Assets	8	22	19	22	23	23	23	23	23	23	23
of which: recapitalization bond	0	0	0	0	0	0	0	0	0	0	0
Liabilities (current account)	142	68	90	90	84	84	84	84	84	84	84
Credit institutions (incl. nonbanks), net	-137	-189	-183	-228	-258	-344	-313	-317	-292	-296	-292
Assets	8	8	6	1	0	0	0	0	0	0	0
Liabilities	145	197	189	229	258	344	314	317	292	296	292
of which: term deposits and CDs	145	196	189	229	258	282	269	291	286	310	327
Other items, net	-144	-128	-109	-91	-79	-122	-112	-102	-92	-81	-70
ESI (asset management company)	2	1	2	0	0	0	0	0	0	0	0
Total Expenditure	151	134	116	101	90	82	73	63	54	44	33
Current Expenses	147	161	163	128	149	166	184	202	222	242	264
Currency issued	81	82	81	76	71	101	113	127	141	157	173
Deposit money banks' deposits at the central bank	66	79	82	52	78	66	71	76	81	86	91
Deposit Money Banks											
Net foreign assets	-323	-397	-462	-376	-439	-442	-451	-459	-468	-475	-483
Assets	423	428	489	604	492	489	480	472	464	456	448
Liabilities	745	825	952	981	931	931	931	931	931	931	931
of which: bonds	634	710	748	773	743	743	743	743	743	743	743
Nonfinancial Assets	2,362	2,666	2,940	3,071	3,461	3,720	3,995	4,239	4,499	4,761	5,034
Central bank, net	208	279	278	289	343	354	347	373	373	403	425
Assets	213	282	280	290	344	355	348	374	374	404	426
Liabilities	5	2	2	1	1	1	1	1	1	1	1
Net Lending/Borrowing	262	235	250	266	344	294	297	299	303	306	309
of which: bonds	234	202	212	215	286	236	239	241	245	248	251
Financial Assets, Transactions	3,187	3,507	3,870	4,036	4,389	4,637	4,893	5,164	5,453	5,754	6,078
Nonfinancial	2,964	3,277	3,648	3,840	4,152	4,386	4,630	4,888	5,164	5,452	5,762
Corporations	1,483	1,462	1,655	1,761	1,953	2,063	2,177	2,299	2,429	2,564	2,710
Households	1,481	1,815	1,993	2,078	2,199	2,323	2,452	2,589	2,735	2,888	3,052
Financial	222	231	221	197	238	251	264	276	289	302	316
Other items, net	-1,295	-1,356	-1,457	-1,520	-1,616	-1,564	-1,541	-1,598	-1,630	-1,702	-1,778
Liabilities, Transactions	2,039	2,268	2,478	2,695	3,022	3,279	3,545	3,780	4,031	4,286	4,551
Krona deposits	1,803	2,002	2,181	2,387	2,721	2,952	3,192	3,403	3,630	3,859	4,098
Foreign currency deposits	236	266	296	308	301	326	353	376	401	427	453
Consolidated Banking System											
Net foreign assets	241	126	65	139	109	130	108	121	108	125	133
Net domestic assets	1,872	2,216	2,486	2,624	2,977	3,242	3,542	3,777	4,057	4,310	4,582
General government, net	128	189	179	199	283	232	235	238	241	245	247
Gross Debt	3,187	3,507	3,870	4,036	4,389	4,637	4,893	5,164	5,453	5,754	6,078
Other items, net	-1,442	-1,480	-1,563	-1,611	-1,696	-1,627	-1,587	-1,625	-1,637	-1,689	-1,743
Broad money	2,113	2,343	2,550	2,763	3,085	3,372	3,650	3,898	4,165	4,435	4,716
Net Debt	74	74	73	68	63	93	106	119	134	149	165

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

Table 3. Iceland: Financial Soundness Indicators, 2015–2024[1]

(Percent)

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Regulatory capital to risk-weighted assets	27.1	28.3	25.9	23.0	23.0	24.7	24.8	23.2	24.1	23.6
Regulatory tier 1 capital to risk-weighted assets	25.9	27.7	25.4	22.2	21.2	22.2	22.5	21.0	21.5	21.0
Net interest margin	2.8	3.0	2.9	2.9	2.8	2.5	2.4	2.7	3.0	2.9
Return on assets	3.8	2.3	2.1	1.8	1.3	0.3	2.2	2.0	2.3	2.1
Return on equity	19.0	11.1	11.0	10.0	8.2	1.7	11.8	9.7	11.9	10.8
Net interest income to total income 2/	40.0	50.4	52.4	56.3	63.6	77.2	60.3	70.2	68.9	68.2
Noninterest expense to total income 2/	46.3	59.7	62.2	67.3	63.5	63.2	50.4	50.5	44.9	46.3
Liquid assets to total assets 3/	26.2	24.1	23.9	21.3	19.4	14.1	14.3	12.1	14.4	13.5
High-quality liquid assets to total assets	18.3	18.3	15.4	11.7	11.6	13.8	13.5	11.8	14.2	13.6
Net open foreign exchange position to capital	8.9	2.2	0.6	0.7	1.0	0.0	0.1	0.2	0.6	0.6
Total nonperforming loans (NPLs), facility level 4/	2.0	1.9	2.1	2.5	2.4	3.3	2.5	1.7	1.5	1.9
Household NPLs, cross default basis 5/	8.2	5.3	3.6	2.4	2.2	2.6	2.3	1.4	2.2	2.3
Corporate NPLs, cross default basis 5/	7.2	7.0	6.6	6.9	5.0	10.5	16.6	10.2	5.1	4.5
Household and corporate NPLs, cross default basis 5/	6.9	6.1	5.2	4.9	3.7	6.9	9.4	5.6	3.6	3.4
Loan loss provisions to household loans in default	45.0	42.6	34.2	24.2	18.8	18.1	16.2	16.6	13.9	14.2
Loan loss provisions to corporate loans in default	45.4	51.6	43.5	38.1	33.3	34.0	29.4	26.9	25.1	23.5
Total Expenditure	47.4	48.7	41.3	33.5	29.0	29.6	26.8	24.4	21.5	19.5

Sources: Central Bank of Iceland; IMF FSI database; and IMF staff calculations.
1/ Three largest deposit money banks unless otherwise indicated.
2/ Total income is total gross income.
3/ Liquid assets comprise cash and balances with the central bank, claims on credit institutions, and bonds and debt instruments.
4/ Over 90 days in default. From 2017 EBA definition for non-performing loans is used, i.e. facility level, over 90 days in default or unlikely to pay.
5/ Over 90 days in default or deemed unlikely to be paid.

Table 4. Iceland: General Government Operations, 2020–2030[1]

(Percent of GDP)

	2020	2021	2022	2023	2024	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.	2030 Proj.
Total Revenue	**42.2**	**41.1**	**42.7**	**43.0**	**42.8**	**43.2**	**42.4**	**42.4**	**42.4**	**42.5**	**42.6**
Taxes	**33.2**	**31.9**	**32.3**	**32.9**	**33.4**	**34.0**	**33.5**	**33.6**	**33.7**	**33.7**	**33.8**
Taxes on income and profits	18.5	17.4	18.2	18.6	18.4	18.6	18.3	18.3	18.3	18.2	18.2
Personal income tax	15.6	14.4	14.1	13.6	13.5	13.6	13.5	13.5	13.5	13.4	13.4
Corporate income tax	2.2	2.0	2.6	3.4	3.2	3.4	3.2	3.2	3.2	3.2	3.2
Capital gains tax and rental income	0.7	1.0	1.5	1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6
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	2.3	2.1	2.0	2.0	2.1	2.1	2.0	2.0	2.0	2.0	2.0
Taxes on goods and services	11.4	11.6	11.3	11.4	12.2	12.5	12.5	12.6	12.6	12.7	12.7
Value added tax	8.2	8.7	8.5	8.7	9.3	9.4	9.3	9.4	9.4	9.4	9.4
Other taxes on goods and services	3.2	2.9	2.9	2.8	2.9	3.1	3.1	3.2	3.2	3.3	3.3
Taxes on international trade	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other taxes	0.7	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Social contributions	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**	**3.1**	**3.0**	**3.1**	**3.2**	**3.2**	**3.2**
Grants	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Other revenues	**5.9**	**6.2**	**7.3**	**7.0**	**6.2**	**6.0**	**5.7**	**5.6**	**5.5**	**5.5**	**5.5**
Property income	2.9	3.0	4.4	4.0	3.3	3.0	2.7	2.6	2.5	2.4	2.4
of which: interest income	1.9	1.8	2.6	2.5	1.5	1.6	1.2	1.0	0.9	0.8	0.8
Total Expenditure	**51.1**	**49.6**	**46.7**	**45.3**	**46.3**	**44.5**	**43.2**	**42.9**	**42.8**	**42.7**	**42.7**
Current Expenses	**49.7**	**47.6**	**44.8**	**43.5**	**44.5**	**43.1**	**41.4**	**41.2**	**41.1**	**41.0**	**41.0**
Compensation of employees	16.1	15.6	14.6	13.9	14.1	14.2	14.2	14.1	14.1	14.1	14.1
Use of goods and services	12.0	12.1	11.3	11.4	11.7	11.5	11.2	11.0	11.0	10.9	10.9
Consumption of fixed capital	2.4	2.4	2.2	2.3	2.2	2.3	2.2	2.2	2.2	2.2	2.2
Interest	4.1	4.0	5.8	5.4	4.0	3.65	2.76	2.67	2.57	2.57	2.57
Subsidies	1.8	1.6	1.5	1.4	1.4	1.4	1.2	1.2	1.2	1.2	1.2
Grants	0.3	0.3	0.3	0.4	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Social benefits	10.1	9.4	7.3	6.8	7.0	7.3	7.3	7.3	7.3	7.3	7.3
Other expense	2.9	2.3	1.7	2.1	3.7	2.4	2.2	2.2	2.2	2.2	2.2
Nonfinancial Assets	**1.4**	**2.0**	**1.9**	**1.8**	**1.7**	**1.4**	**1.7**	**1.7**	**1.7**	**1.7**	**1.7**
Nonfinancial assets, acquisition	3.8	4.3	4.1	4.1	4.0	3.7	3.9	3.9	3.9	3.9	3.9
Consumption of fixed capital (-)	-2.4	-2.4	-2.2	-2.3	-2.2	-2.3	-2.2	-2.2	-2.2	-2.2	-2.2
Net Lending/Borrowing 2/	**-8.9**	**-8.5**	**-4.0**	**-2.3**	**-3.5**	**-1.3**	**-0.7**	**-0.5**	**-0.3**	**-0.2**	**-0.1**
Financial Assets, Transactions	**1.0**	**-2.6**	**1.7**	**1.3**	**2.3**	**-4.2**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Currency and deposits	4.2	0.3	-1.4	-0.5	0.9	-1.5	0.0	0.0	0.0	0.0	0.0
Securities other than shares	0.3	0.1	-0.4	-0.3	-0.5	0.0	0.0	0.0	0.0	0.0	0.0
Loans	-3.1	-1.4	0.6	-2.3	2.1	0.1	0.1	0.1	0.1	0.1	0.1
Shares and other equities	0.0	-1.7	3.0	-1.3	-2.1	-2.8	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	-0.4	0.2	-0.1	5.7	2.0	0.0	0.0	0.0	0.0	0.0	0.0
Liabilities, Transactions	**9.9**	**5.9**	**5.7**	**3.6**	**5.8**	**-3.0**	**0.8**	**0.6**	**0.4**	**0.3**	**0.2**
Securities other than shares	6.3	1.9	3.6	1.7	-0.7	-13.3	1.2	0.8	0.4	0.3	0.2
Loans	2.5	3.7	0.7	0.7	1.5	10.3	-0.4	-0.3	0.1	0.0	0.0
Krona denominated	0.4	0.6	2.7	1.6	-0.1	10.3	0.0	0.0	0.0	0.0	0.0
Foreign currency denominated	2.1	3.1	-2.0	-0.9	1.6	0.0	-0.4	-0.3	0.1	0.0	0.0
Insurance technical reserves	0.2	0.1	0.4	0.7	0.6	0.0	0.0	0.1	0.0	0.0	0.0
Other accounts payable	0.9	0.2	0.9	0.5	4.4	0.0	0.0	0.0	0.0	0.0	0.0
Gross Debt	**77.5**	**74.9**	**67.5**	**62.0**	**59.1**	**47.7**	**45.4**	**43.6**	**41.7**	**39.9**	**38.1**
Krona denominated	69.0	64.4	60.7	56.8	52.6	41.6	40.0	38.8	37.1	35.6	34.0
Foreign currency denominated	8.5	10.6	6.9	5.2	6.5	6.1	5.4	4.8	4.6	4.3	4.1
Net Debt 3/	**60.9**	**59.8**	**56.2**	**52.5**	**49.3**	**40.0**	**38.1**	**36.6**	**35.1**	**33.7**	**32.2**
Memorandum Items:											
Primary revenue	40.3	39.3	40.1	40.5	41.2	41.6	41.3	41.4	41.6	41.7	41.8
Primary expenditure	47.0	45.5	40.9	40.0	42.2	40.8	40.4	40.3	40.2	40.1	40.1
Primary balance	-6.8	-6.2	-0.9	0.6	-1.0	0.8	0.9	1.2	1.4	1.6	1.7
Structural balance 4/	-2.3	-2.7	-2.9	-3.1	-1.9	-1.0	-0.5	-0.4	-0.3	-0.2	-0.1
Structural primary balance 4/	-0.2	-0.5	0.2	-0.2	0.7	1.1	1.1	1.3	1.4	1.6	1.7
Gross domestic product (ISK bn)	2,929	3,273	3,882	4,339	4,616	4,876	5,172	5,440	5,747	6,068	6,413

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

1/ In 2020, the definition of the general government was expanded to include 24 new entities, of which the largest are the IL Fund and the Student loan Fund. In April 2025, an agreement was reached on the settlement of remaining outstanding liabilities in the IL Fund (HFF).

2/ Costs related to the purchase of houses in Grindavík(1.2 percent of GDP) that in the 2024 Article IV were classified below the line are now classified above the line due to uncertainty about the future value of these properties.

3/ Gross debt less currency and deposits.

4/ Cyclically-adjusted balance excluding one offs.

Table 5. Iceland: General Government Financial Balance Sheet, 2020–2030

(Percent of GDP)

	2020	2021	2022	2023	2024	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.	2030 Proj.
Financial assets	**82.2**	**74.4**	**64.4**	**58.2**	**56.6**	**49.4**	**46.7**	**44.5**	**42.2**	**40.1**	**38.1**
Currency and deposits	16.7	15.1	11.3	9.5	9.8	7.7	7.3	6.9	6.6	6.2	5.9
Other assets	65.5	59.3	53.0	48.7	46.9	41.6	39.4	37.5	35.6	33.9	32.2
Securities other than shares	4.7	4.3	3.3	2.7	2.0	1.9	1.8	1.7	1.6	1.5	1.4
Loans	20.8	17.1	15.1	10.9	12.3	11.8	11.2	10.8	10.4	9.9	9.5
Shares and other equities	32.2	31.6	28.3	25.7	22.1	18.1	17.0	16.2	15.3	14.5	13.7
Other accounts receivable 1/	7.7	6.2	6.5	9.4	10.4	9.9	9.3	8.9	8.4	7.9	7.5
Liabilities	**114.0**	**109.6**	**99.8**	**94.0**	**94.1**	**80.9**	**76.7**	**73.4**	**70.0**	**66.7**	**63.5**
Gross debt	77.5	74.9	67.5	62.0	59.1	47.7	45.4	43.6	41.7	39.9	38.1
Securities other than shares	56.3	52.4	47.7	44.4	41.0	33.1	31.5	30.3	29.0	27.7	26.5
Loans	21.2	22.6	19.8	17.6	18.1	14.6	13.9	13.3	12.7	12.2	11.7
Krona denominated	12.4	11.6	12.6	12.1	11.2	8.1	8.2	8.2	7.9	7.6	7.3
Foreign currency denominated	8.8	10.9	7.2	5.6	6.8	6.5	5.7	5.1	4.9	4.6	4.4
Other liabilities	36.4	34.6	32.3	32.0	35.1	33.2	31.3	29.9	28.3	26.8	25.3
Insurance technical reserves	29.1	27.6	25.5	24.9	24.1	22.8	21.5	20.6	19.5	18.5	17.5
Other accounts payable	7.3	7.0	6.8	7.1	10.9	10.4	9.8	9.3	8.8	8.3	7.9
Net financial worth 1/	**-31.8**	**-35.2**	**-35.4**	**-35.8**	**-37.5**	**-31.5**	**-30.0**	**-29.0**	**-27.8**	**-26.6**	**-25.4**
Memorandum item:											
Net debt 2/	60.9	59.8	56.2	52.5	49.3	40.0	38.1	36.6	35.1	33.7	32.2

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, 2020–2030

	2020	2021	2022	2023	2024	2025 Proj.	2026 Proj.	2027 Proj.	2028 Proj.	2029 Proj.	2030 Proj.
					(Millions of dollars)						
Current account	**237**	**-726**	**-682**	**264**	**-847**	**-903**	**-196**	**20**	**164**	**310**	**528**
Trade balance	-293	-502	-132	48	-383	-598	21	89	296	504	784
Balance on goods	-590	-1,045	-1,492	-2,090	-2,280	-2,720	-2,477	-2,679	-2,729	-2,782	-2,836
Merchandise exports f.o.b.	4,720	6,120	7,531	6,858	7,018	7,360	7,664	7,933	8,448	8,994	9,570
Merchandise imports f.o.b.	5,310	7,165	9,023	8,948	9,297	10,080	10,141	10,612	11,178	11,775	12,406
Balance on services	297	543	1,360	2,138	1,897	2,123	2,498	2,768	3,025	3,286	3,620
Exports of services, total	2,485	3,506	5,615	6,805	6,899	7,386	7,874	8,391	8,921	9,468	10,104
Imports of services, total	2,188	2,963	4,255	4,667	5,002	5,263	5,375	5,623	5,895	6,183	6,484
Primary income balance	715	40	-227	576	-77	80	179	348	308	269	230
Receipts	728	762	724	1,161	1,244	1,265	1,293	1,321	1,321	1,323	1,327
of which: dividends and reinvested earnings	528	575	497	735	786	804	827	851	866	881	897
of which: interest receipts	75	46	90	276	298	293	288	283	268	252	236
Expenditures	13	722	951	586	1,321	1,185	1,114	973	1,013	1,054	1,097
of which: dividends and reinvested earnings	-460	368	506	-262	241	203	163	122	139	156	184
of which: interest payments	391	279	361	731	913	827	798	695	705	715	715
Secondary income balance	-185	-265	-323	-360	-387	-386	-396	-418	-440	-463	-487
Capital and financial account (+ = outflow)	**1,110**	**-343**	**-579**	**-619**	**988**	**-961**	**-259**	**-47**	**92**	**232**	**444**
Capital account balance (+ = inflow)	-17	-19	-25	-31	-28	-29	-31	-34	-36	-39	-42
Financial account (+ = outflow)	1,127	-324	-554	-588	1,016	-932	-228	-14	128	271	486
Direct investment (+ = outflow)	500	-517	-1,094	-1,262	-70	-600	-705	-770	-800	-739	-742
Portfolio investment ("+" = outflow)	1,007	20	1,249	2,182	369	-625	194	126	479	409	687
Assets (+ = outflow)	696	1,431	1,005	2,044	1,282	332	1,032	1,052	1,072	1,092	1,112
Liabilities (+ = inflow)	-311	1,411	-244	-138	913	957	839	926	593	683	425
of which: net borrowing (+ = inflow)	-283	1,495	-290	-72	602	532	278	444	124	178	-119
Other investment (+ = outflow)	-218	-1,055	-315	-1,024	38	87	248	318	342	258	252
Assets (+ = outflow)	131	-64	573	-160	117	-178	-137	-144	-152	-140	-147
Liabilities (+ = inflow)	349	991	888	864	79	-264	-385	-462	-494	-398	-399
of which: net outflows related to bank estates' composition	26	4	76	2	17	1	12	12	12	12	0
Change in reserve assets (+ = increase/outflow)	-205	1,143	-495	-367	713	210	19	276	71	307	253
Net errors and omissions (+ = inflow)	**906**	**422**	**153**	**-821**	**1,890**	**0**	**0**	**0**	**0**	**0**	**0**
					(Percent of GDP)						
Current account	**1.1**	**-2.8**	**-2.4**	**0.8**	**-2.5**	**-2.6**	**-0.5**	**0.0**	**0.4**	**0.7**	**1.0**
Trade balance	-1.4	-1.9	-0.5	0.2	-1.1	-1.7	0.1	0.2	0.7	1.1	1.5
Balance on goods	-2.7	-4.1	-5.2	-6.6	-6.8	-7.8	-6.5	-6.6	-6.2	-5.9	-5.6
Merchandise exports f.o.b.	21.8	23.7	26.2	21.8	21.0	21.0	20.2	19.5	19.3	19.1	18.8
Merchandise imports f.o.b.	24.5	27.8	31.4	28.5	27.8	28.8	26.8	26.1	25.5	25.0	24.4
Balance on services	1.4	2.1	4.7	6.8	5.7	6.1	6.6	6.8	6.9	7.0	7.1
Exports of services, total	11.5	13.6	19.6	21.6	20.6	21.1	20.8	20.6	20.4	20.1	19.9
Imports of services, total	10.1	11.5	14.8	14.8	14.9	15.0	14.2	13.8	13.5	13.1	12.8
Primary income balance	3.3	0.2	-0.8	1.8	-0.2	0.2	0.5	0.9	0.7	0.6	0.5
Receipts	3.4	3.0	2.5	3.7	3.7	3.6	3.4	3.2	3.0	2.8	2.6
of which: interest receipts	0.3	0.2	0.3	0.9	0.9	0.8	0.8	0.7	0.6	0.5	0.5
Expenditures	0.1	2.8	3.3	1.9	3.9	3.4	2.9	2.4	2.3	2.2	2.2
of which: interest payments	1.8	1.1	1.3	2.3	2.7	2.4	2.1	1.7	1.6	1.5	1.4
Secondary income balance	-0.9	-1.0	-1.1	-1.1	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0
Capital and financial account (+ = outflow)	**5.1**	**-1.3**	**-2.0**	**-2.0**	**3.0**	**-2.7**	**-0.7**	**-0.1**	**0.2**	**0.5**	**0.9**
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)	5.2	-1.3	-1.9	-1.9	3.0	-2.7	-0.6	0.0	0.3	0.6	1.0
Direct investment (+ = outflow)	2.3	-2.0	-3.8	-4.0	-0.2	-1.7	-1.9	-1.9	-1.8	-1.6	-1.5
Portfolio investment ("+" = outflow)	4.7	0.1	4.4	6.9	1.1	-1.8	0.5	0.3	1.1	0.9	1.4
Assets (+ = outflow)	3.2	5.6	3.5	6.5	3.8	0.9	2.7	2.6	2.4	2.3	2.2
Liabilities (+ = inflow)	-1.4	5.5	-0.8	-0.4	2.7	2.7	2.2	2.3	1.4	1.4	0.8
of which: net borrowing (+ = inflow)	-1.3	5.8	-1.0	-0.2	1.8	1.5	0.7	1.1	0.3	0.4	-0.2
Other investment (+ = outflow)	-1.0	-4.1	-1.1	-3.3	0.1	0.2	0.7	0.8	0.8	0.5	0.5
Assets (+ = outflow)	0.6	-0.2	2.0	-0.5	0.3	-0.5	-0.4	-0.4	-0.3	-0.3	-0.3
Liabilities (+ = inflow)	1.6	3.8	3.1	2.7	0.2	-0.8	-1.0	-1.1	-1.1	-0.8	-0.8
Change in reserve assets (+ = increase/outflow)	-0.9	4.4	-1.7	-1.2	2.1	0.6	0.1	0.7	0.2	0.7	0.5
Net errors and omissions (+ = inflow)	4.2	1.6	0.5	-2.6	5.6	0.0	0.0	0.0	0.0	0.0	0.0
Central bank reserves ($ mn)	**6,408**	**7,091**	**5,879**	**5,720**	**6,397**	**6,607**	**6,627**	**6,902**	**6,973**	**7,280**	**7,533**
(Percent of GDP)	29.6	27.5	20.5	18.2	19.1	18.9	17.5	17.0	15.9	15.4	14.8
(Percent of reserve adequacy metric)	148.3	139.7	118.6	112.4	116.8	115.5	118.3	118.8	119.4	120.1	120.8
Memorandum item:											
Gross domestic product ($ mn)	21,630	25,770	28,696	31,452	33,463	35,003	37,907	40,674	43,815	47,154	50,816

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

Table 7. Iceland: International Investment Position, 2013–2024

(Percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Assets	**276.4**	**250.6**	**213.0**	**157.1**	**115.5**	**119.4**	**128.5**	**153.9**	**170.2**	**133.8**	**134.3**	**141.9**
Direct investment	109.4	99.4	91.2	63.7	25.8	26.3	26.6	29.6	32.9	23.9	23.3	23.5
Portfolio investment	62.5	63.9	40.1	37.4	43.7	46.1	58.0	75.9	91.5	70.4	77.1	84.7
Equity and investment fund shares	34.6	36.8	35.3	34.9	40.1	40.5	52.0	69.6	84.7	64.6	68.9	79.8
Debt securities	27.9	27.1	4.8	2.5	3.5	5.6	6.0	6.3	6.8	5.8	8.3	5.0
Financial derivatives	0.2	0.6	0.5	0.3	0.5	0.4	0.4	0.6	0.2	0.4	0.4	0.4
Other investment	79.6	61.3	53.0	23.3	19.5	20.7	16.4	20.0	17.4	17.4	15.4	14.1
Reserve assets	24.7	25.4	28.3	32.5	26.0	25.9	27.2	27.9	28.2	21.6	18.2	19.2
Liabilities	**661.2**	**623.4**	**218.1**	**155.2**	**113.5**	**110.2**	**108.5**	**119.7**	**126.6**	**110.3**	**101.0**	**99.3**
Direct investment	97.0	96.4	92.4	80.7	45.0	40.6	39.0	39.5	45.0	40.7	38.9	38.2
Portfolio investment	285.9	289.1	41.8	49.0	42.9	42.6	44.5	50.4	49.8	38.8	32.9	33.5
Equity and investment fund shares	3.5	3.6	4.0	3.6	4.8	5.7	10.6	12.8	12.1	7.5	5.6	7.1
Debt securities	282.5	285.5	37.8	45.4	38.0	36.9	33.9	37.6	37.7	31.3	27.4	26.4
Financial derivatives	0.3	0.8	0.6	0.4	0.4	0.2	0.1	0.2	0.5	0.8	0.3	0.2
Other investment	278.0	237.1	83.3	25.2	25.2	26.7	24.8	29.7	31.2	30.0	28.9	27.4
Net international investment position	**-384.8**	**-372.9**	**-5.1**	**1.9**	**2.0**	**9.3**	**20.0**	**34.2**	**43.6**	**23.4**	**33.4**	**42.5**

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 2024 was moderately weaker than the level implied by fundamentals and desirable policies. The current account balance deteriorated to a deficit of 2.5 percent of GDP in 2024 from a surplus of 0.7 percent of GDP in 2023. The deterioration was primarily driven by a worsening of the goods trade balance, alongside a worsening of the primary income balance. A positive net international investment position and adequate foreign exchange reserve buffers support external sustainability and mitigate potential adverse risks.*

Potential Policy Responses: *The current account is expected to remain broadly unchanged in 2025 and improve gradually over the medium-term supported by moderately tight macroeconomic policies. The CBI's decision to commence regular purchases of foreign exchange will help improve reserve coverage and strengthen its ability to stabilize the foreign market during times of stress. Sustained efforts to foster innovation are needed to facilitate the diversification of the economy toward higher value-added export-oriented sectors. The flexible exchange rate should act as the main shock absorber.*

Foreign Assets and Liabilities: Position and Trajectory

Background. The net international investment position (NIIP) expanded to 42.5 percent of GDP in 2024, up from 33.4 percent in 2023. The improvement was driven by portfolio investments by pension funds, which contributed to a 6 percentage points increase in Iceland's gross assets to 141.9 percent of GDP. Meanwhile, gross liabilities stood at 99.3 percent of GDP. The majority of gross liabilities reflect portfolio investments in debt securities (about 26.4 percent of GDP) and FDI (about 38.2 percent of GDP).

Assessment. The NIIP is forecasted to remain at its current levels over the medium term, consistent with a recovery in the current account balance. However, fluctuations in valuation effects create uncertainties around the projections and pose a potential downside risk.

2024 (Percent of GDP)	NIIP: 42.5	Gross Assets: 141.9	Debt Assets: 28.5	Gross Liab.: 99.3	Debt Liab.: 64.6

Current Account

Background. The current account (CA) deteriorated in 2024, reaching a deficit of 2.5 percent of GDP from a surplus of 0.8 percent of GDP in 2023. The worsening is explained by a disappointing fishing season, lower aluminum exports to the EU, and a surge in imports of investment goods, as well as a weakening of the primary income account owing to greater profit repatriation by foreign companies. Volcanic activity is also estimated to have weakened the current account, resulting in a smaller increase in tourist arrivals than would otherwise have been the case. The CA balance is projected to remain broadly unchanged in 2025.

Assessment. The EBA-lite adjusted CA balance stood at -1.3 percent of GDP in 2024 after accounting for an adjustor to capture the impact of volcanic activity. The EBA-lite CA regression estimates a norm of -0.2 percent of GDP, implying a staff–assessed CA gap of -1.1 percent. There is a moderate positive contribution from policy gaps, mostly due to the fiscal policy gap being smaller than the world average.

Iceland: Model Estimates for 2024

(In percent of GDP)

	CA model 1/	REER model
	(in percent of GDP)	
CA-Actual	**-2.5**	
Cyclical contributions (from model) (-)	0.1	
Natural disasters and conflicts (-)	-1.3	
Adjusted CA	**-1.3**	
CA Norm (from model) 2/	**-0.2**	
Adjustments to the norm (+)	0.0	
Adjusted CA Norm	**-0.2**	
CA Gap	**-1.1**	**-1.7**
o/w Relative policy gap	1.8	
Elasticity	-0.3	
REER Gap (in percent)	**3.8**	**5.8**

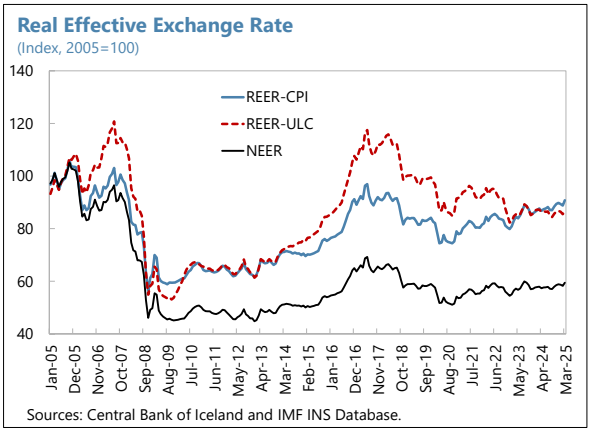
1/ Based on the EBA-lite 3.0 methodology

2/ Cyclically adjusted, including multilateral consistency adjustments.

Real Exchange Rate

Background. The CPI-based real effective exchange rate (REER) appreciated by about 3 percent in 2024 due to the high inflation in Iceland, the ULC-based REER appreciated by 0.5 percent.

Assessment. Both the CA and the REER approach suggest the real exchange rate is moderately overvalued. While the CA gap implies a 3.8 percent real overvaluation (applying an estimated elasticity of -0.3), the EBA-lite REER model suggests an overvaluation of 5.8 percent.



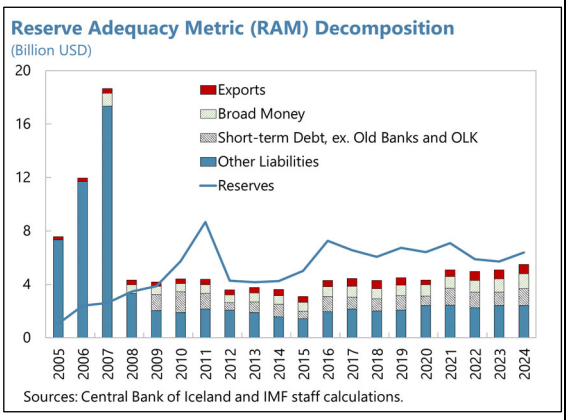
Capital and Financial Accounts: Flows and Policy Measures

Background. Gross capital inflows in 2024 decreased to around 4.4 percent of GDP, down from 7.4 percent of GDP in 2023. This decline can be attributed to a reduction in direct investment, which accounted for about 1.6 percent of GDP. Gross outflows amounted to about 5.5 percent of GDP, which is lower than 2023 figures, with portfolio investment as the main contributor. The discrepancy between the financial account and the current account balance, leading to net errors and omissions, rose significantly in 2024 to approximately 5.7 percent of GDP. 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 in 2024 was low and amounted to 4.2 percent compared to 2.3 percent in 2023. Total interventions amounted to about 0.3 percent of GDP. Foreign exchange reserves increased by about by $700 million, to a total of US$6.42 billion dollars by end-2024. The level of foreign exchange reserves is equivalent to 19.2 percent of GDP and about 5 months of prospective goods and services imports. In April 2025, the CBI commenced regular purchases of €6 million (about 0.7 percent of reserves at end-2024) per week to offset a projected decline in reserve coverage over the next two years.



Assessment. At 117 percent of the Fund's ARA metric, the end 2024 level of reserves remains adequate for precautionary purposes. The decision to commence regular purchases of foreign exchange will enhance resilience and strengthen the CBI's ability to prevent disruptive movements in the exchange rate.

Annex II. Risk Assessment Matrix[1]

Risks	Relative Likelihood	Impact if Realized	Policy Response
Global Risks			
Conjunctural Risks			
Trade policy and investment shocks. Higher trade barriers or sanctions reduce external trade, disrupt FDI and supply chains, and trigger tighter financial conditions, and higher inflation.	**High**	**Medium** • Lower growth in trading partners reduces demand for Icelandic exports. The impact would be larger if tariffs are extended to pharmaceutical products or if Iceland is affected by potential EU retaliation. • A reduction in the number of tourists travelling to and from the US negatively impacts tourism. • Supply chain disruptions or capital outflows weaken the exchange rate and put upward pressure on inflation and inflation expectations; conversely capital inflows could put upward pressure on the change rate and weaken competitiveness.	• Adjust monetary policy to steer inflation and inflation expectations back to target. • Allow automatic stabilizers to operate and provide targeted support to vulnerable households as needed. • Allow exchange rate to adjust; if accompanied by a risk-off shock, consider the use of FXI to prevent disorderly market conditions and ease the burden on monetary policy.
Regional conflict. Intensification of conflicts (e.g., in the Middle East, Ukraine, Sahel, and East Africa) or terrorism disrupt trade in energy and food, tourism, supply chains, remittances, FDI and financial flows, payment systems, and increase refugee flows.	**Medium**	**Medium** • Lower growth in trading partners reduces demand for Icelandic exports and tourism income. • Supply chain disruptions trigger a further increase in inflation and inflation expectations. • Risk of drying-up of liquidity in the FX market.	• Adjust monetary policy to steer inflation and inflation expectations back to target. • Allow automatic stabilizers to operate and provide targeted support to vulnerable households as needed. • Allow exchange rate to adjust; if accompanied by a risk-off shock, consider the use of FXI to prevent disorderly market conditions and 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			
Deepening geoeconomic fragmentation. Persistent conflicts, inward-oriented policies, protectionism, weaker international cooperation, labor mobility curbs, and fracturing technological and payments systems lead to higher input costs, hinder green transition, and lower trade and potential growth.	**High**	**Medium** • Lower trading partner growth and trade barriers reduce demand for Icelandic exports and decreases confidence. • Supply bottlenecks result in higher input costs, increasing the cost of Iceland's imports.	• Allow exchange rate to adjust while intervening to prevent disorderly market conditions. • Adjust monetary policy to steer inflation and inflation expectations back to target. • Allow automatic stabilizers to operate.
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.	**High**	**High** • Damage to undersea cables disrupts connectivity. • Disruption of cross-border payments and financial flows.	• Stand ready to provide support to critical infrastructure or institutions. • Provide liquidity support to banks, if needed.
Climate change. Extreme climate events driven by rising temperatures cause loss of human lives, severe damage to infrastructure, supply disruptions, lower growth, and financial instability.	**Medium**	**Medium** • Damage to infrastructure and wealth weakens economic activity.	• 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			
Increasing labor market tightness.	**Medium**	**Medium** • Higher real wage growth pushes up firms' costs, increases inflation, and weakens competitiveness.	• Adjust monetary policy to steer inflation and inflation expectations back to target. • Accelerate structural reforms to increase productivity.
Premature loosening of monetary policy. Uncertainty about the state of the economy and the outlook for inflation could result in premature easing.	**Medium**	**Medium** • Increase in inflation and inflation expectations, damaging central bank credibility.	• Adjust monetary policy to steer inflation and inflation expectations back to target.
Continuation of recent years' dry weather.	**Medium**	**Medium** • Reduced water levels in hydropower reservoirs results in a curtailment of energy supply to aluminum smelters, lowering exports.	• Invest in an expansion of energy supply. • Diversify the economy to reduce reliance on energy-intensive industries.
Further decline in fish quotas	**Medium**	**Medium** • A further decline in the sustainable level of fish stocks would result in lower fishing quotas and weaken exports.	• Diversify the economy to reduce reliance on the traditional fishing industry.

Annex III. Sovereign Risk and Debt Sustainability Assessment

Annex III. Table 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. The re-introduction of fiscal rules in 2026 will help ensure 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	Low	
GFN	Low	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 settlement of outstanding HFF liabilities and the sale of Islndsbanki will substantially lower debt in 2025. The reintroduction of the revised 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 adoption of the measures-specified in the MTFS 2026-30. Long-term spending pressures are mitigated by favorable demographics due to migration inflows.

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 1. Iceland: Debt Coverage and Disclosures

							Comments
1. Debt coverage in the DSA: 1/			CG	GG	NFPS	CPS	Other	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. A settlement was reached on outstanding HFF liabilities in 2025.
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	
CPS	NFPS	GG: expected	CG	2	Extra budgetary funds (EBFs)		Yes	
CPS	NFPS	GG: expected	CG	3	Social security funds (SSFs)		Yes	
CPS	NFPS	GG: expected	CG	4	State governments		Yes	
CPS	NFPS	GG: expected	CG	5	Local governments		Yes	
CPS	NFPS	GG: expected	CG	6	Public nonfinancial corporations		no	
CPS	NFPS	GG: expected	CG	7	Central bank		no	
CPS	NFPS	GG: expected	CG	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

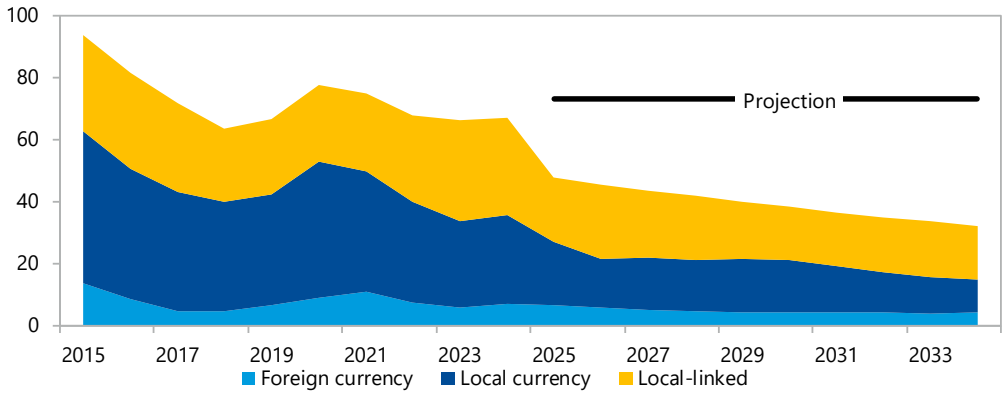
					Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
					Issuer									
CPS	NFPS	GG: expected	CG	1	Budget. central govt									0
CPS	NFPS	GG: expected	CG	2	Extra-budget. funds									0
CPS	NFPS	GG: expected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

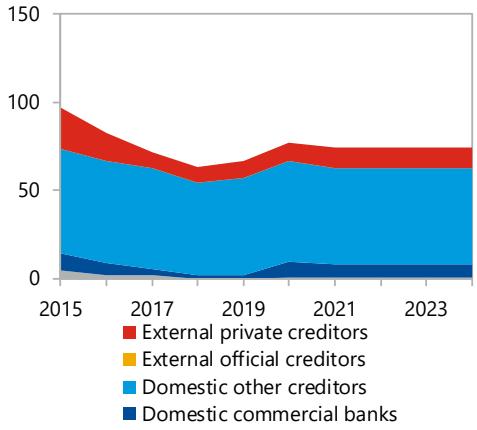
Annex III. Figure 2. Iceland: Public Debt Structure Indicators

Debt by Currency (Percent of GDP)



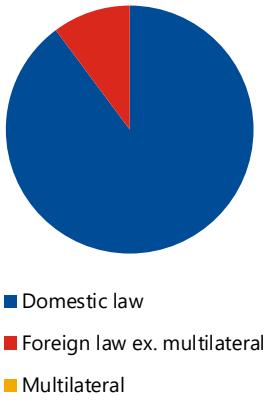
Note: The perimeter shown is general government.

Public Debt by Holder (Percent of GDP)



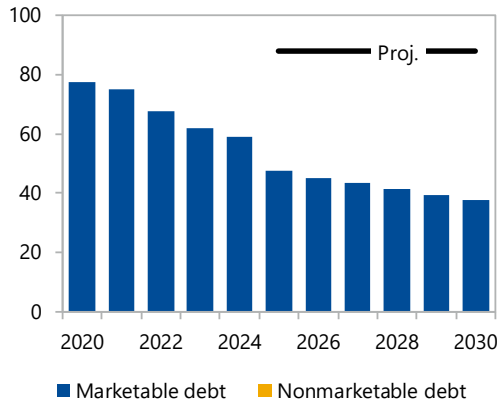
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2024 (percent)



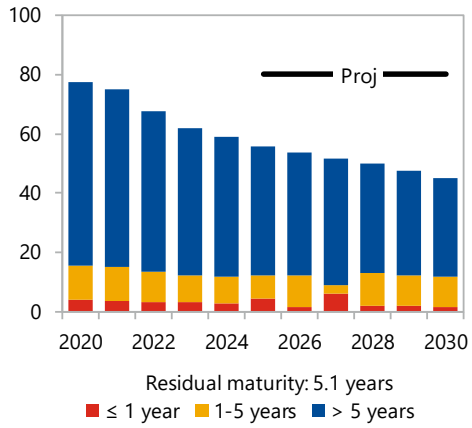
Note: The perimeter shown is general government.

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.

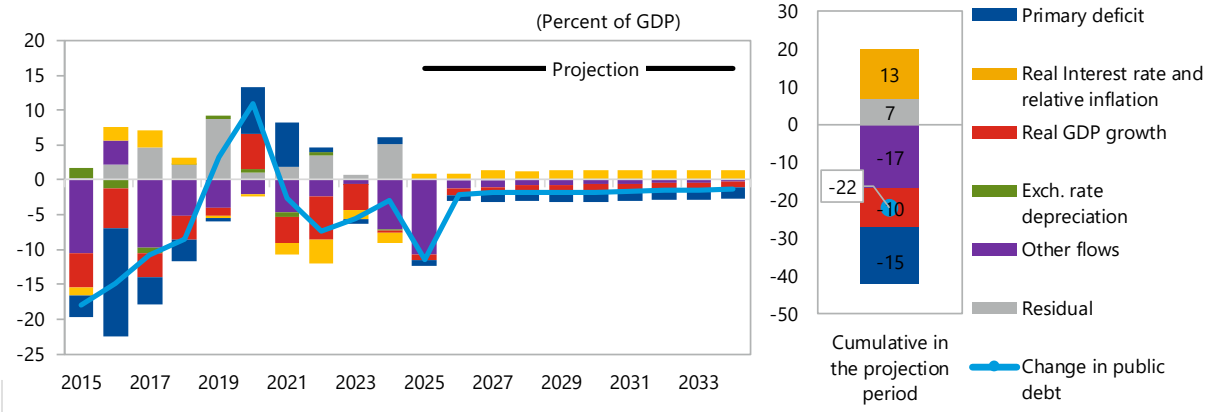
Commentary: Public debt is largely in domestic currency with a significant share linked to CPI. Iceland has a large institutional investor base, including pension funds. Most debt has a residual matury slightly shorter than six years.

Annex III. Table 2. Iceland: Baseline Scenario

(Percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034
Public debt	59.1	47.6	45.4	43.6	41.7	39.9	38.1	36.4	34.9	33.4	32.0
Change in public debt	-2.9	-11.5	-2.2	-1.9	-1.9	-1.8	-1.8	-1.6	-1.5	-1.5	-1.4
Contribution of identified flows	-8.1	-11.5	-2.0	-1.8	-1.9	-1.9	-1.8	-1.7	-1.6	-1.5	-1.5
Primary deficit	1.0	-0.8	-0.8	-1.1	-1.3	-1.5	-1.6	-1.6	-1.6	-1.6	-1.6
Noninterest revenues	41.2	41.6	41.2	41.3	41.5	41.7	41.7	41.7	41.7	41.7	41.7
Noninterest expenditures	42.2	40.9	40.4	40.2	40.2	40.1	40.1	40.1	40.1	40.1	40.1
Automatic debt dynamics	-2.1	-0.1	-0.1	0.3	0.2	0.3	0.4	0.4	0.4	0.4	0.4
Real interest rate and relative inflation	-1.6	0.8	0.9	1.3	1.2	1.3	1.4	1.3	1.3	1.3	1.2
Real interest rate	-1.8	0.7	0.8	1.3	1.2	1.3	1.3	1.3	1.3	1.2	1.2
Relative inflation	0.2	0.1	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.0
Real growth rate	-0.3	-0.9	-1.0	-1.1	-1.0	-1.0	-1.0	-0.9	-0.9	-0.8	-0.8
Real exchange rate	-0.2	...	...	...	...	...	...	...	...	...	...
Other identified flows	-7.0	-10.7	-1.1	-1.0	-0.8	-0.7	-0.6	-0.5	-0.5	-0.4	-0.3
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	-1.5	-1.6	-1.2	-1.0	-0.9	-0.8	-0.8	-0.6	-0.5	-0.5	-0.4
Other transactions	-5.5	-9.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Contribution of residual	5.2	0.0	-0.1	0.0	0.0	0.1	0.0	0.1	0.1	0.0	0.1
Gross financing needs	8.9	8.7	3.4	2.7	6.6	3.4	3.9	3.6	2.3	3.9	2.0
of which: debt service	9.4	11.1	5.4	4.8	8.7	5.7	6.3	5.8	4.4	5.9	4.0
Local currency	6.3	3.3	0.2	1.2	4.4	3.1	3.7	3.3	1.9	1.8	1.8
Foreign currency	1.3	0.0	1.4	1.0	1.9	0.1	0.1	0.8	0.6	1.5	0.1
Memo:											
Real GDP growth (percent)	0.5	1.6	2.2	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Inflation (GDP deflator; percent)	5.9	4.3	3.5	2.7	3.2	3.1	3.2	3.1	3.0	2.9	2.8
Nominal GDP growth (percent)	6.4	5.9	5.8	5.2	5.7	5.6	5.7	5.6	5.5	5.4	5.3
Effective interest rate (percent)	2.8	5.5	5.2	5.7	6.0	6.3	6.7	6.7	6.6	6.6	6.6

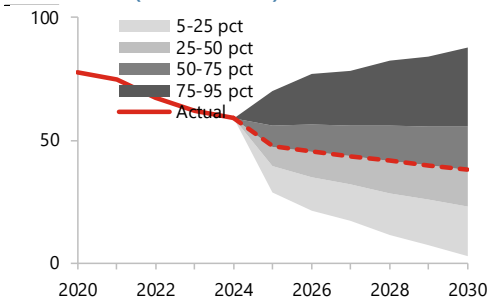
Contribution to Change in Public Debt



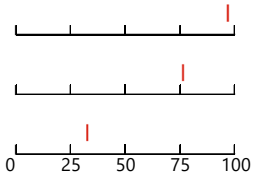
Commentary: Public debt is projected to gradually decline, supported by the reinstated fiscal rule from 2026. A settlement was reached in 2025 between the government and 18 pensions funds on outstanding liabilities in HFF, leading to an estimated 7.1 percentage points of GDP decline in the debt ratio in 2025, in addition to a 1.9 percentage points of GDP reduction in the debt ratio due to the privatization of Islandsbanki (both recorded under 'other transactions').

Annex III. Figure 3. Iceland: Medium-Term Risk Assessment

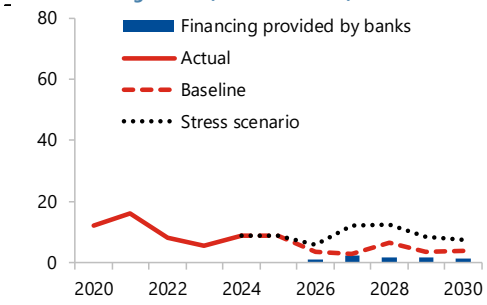
Final Fanchart (Percent of GDP)



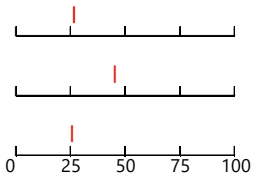
Debt fanchart module	Value	Contrib 1/	Percentile in peer group 2/
Fanchart width *(percent of GDP)*	84.9	1.2	
Probability of debt non-stabilizaiton *(percent)*	25.6	0.2	
Terminal debt-to-GDP x institutions index	6.7	0.1	
Debt fanchart index (DFI)		1.6	
Risk signal: 3/		Moderate	



Gross Financing Needs (Percent of GDP)



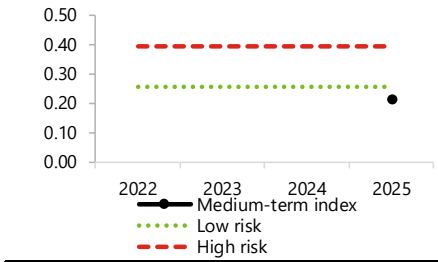
Gross financing needs (GFN) module			
Average baseline GFN *(percent of GDP)*	4.8	1.6	
Initial Banks' claims on the gen. govt *(pct bank assets)*	4.9	1.6	
Chg. In banks' claims in stress *(pct banks' assets)*	1.5	0.5	
GFN financeability index (GFI)		3.7	
Risk signal: 4/		Low	



Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-Term Index (Index Number)



Medium-term risk analysis

	Value	(normalized)	Weight	Contribution
Debt fanchart index	1.6	0.4	0.5	0.2
GFN finaceability index	3.7	0.1	0.5	0.0
Medium-term index		0.2		
Risk signal: 5/		Low		
Final assessment:		Low		

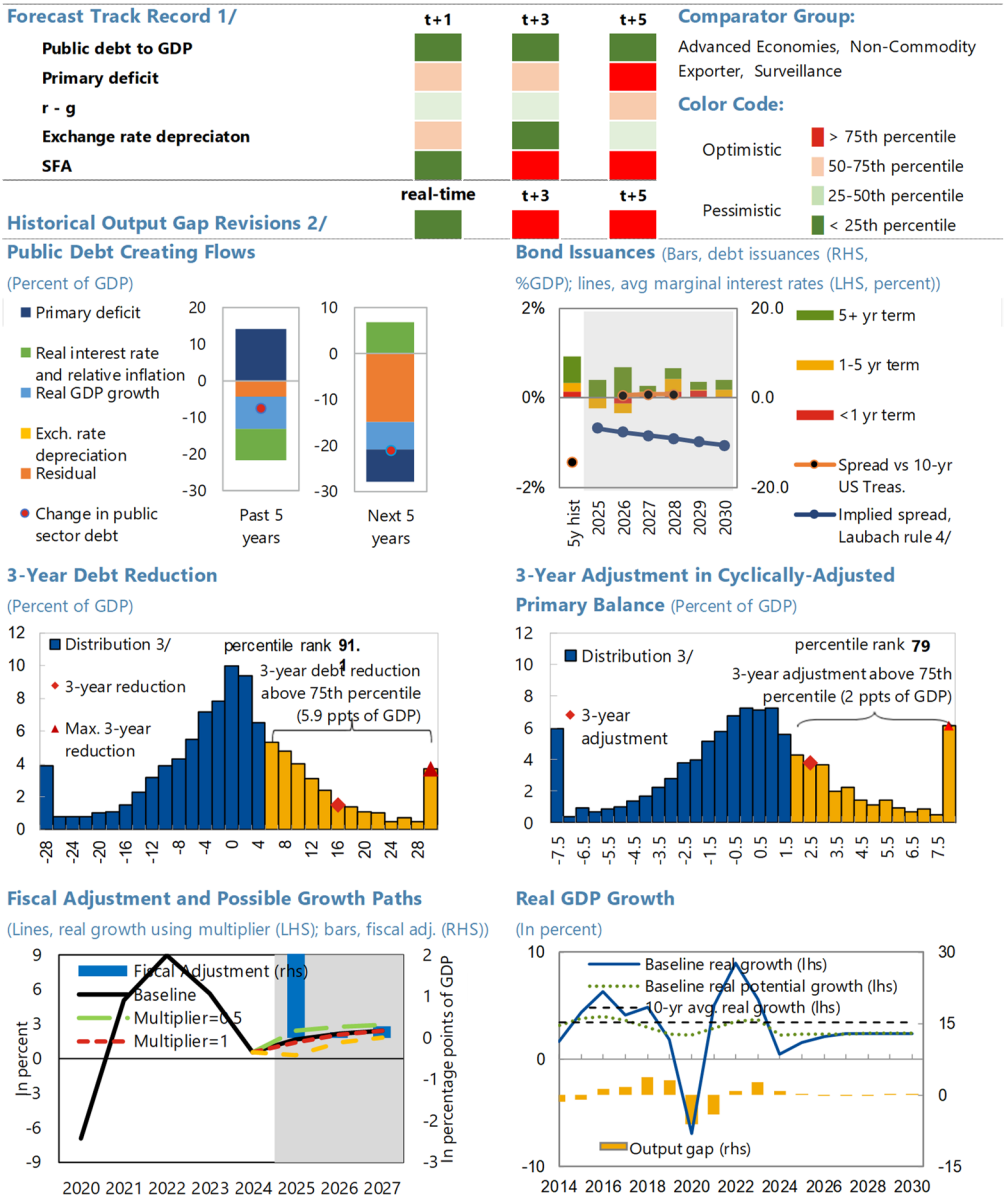
Prob. of missed crisis, 2025-2030, if stress not predicted: 9.1 pct.
Prob. of false alarms, 2025-2030, if stress predicted: 50.0 pct.

Commentary: The wide fan chart is impacted by the 2008 crisis and the historical shock to debt. Debt declines in 2025 due to the settlement of ourstanding HFF liabilities and the sale of Islandsbanki. 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 4. Iceland: Realism of Baseline Assumptions



Commentary: The fiscal adjustment in 2025 is impacted by the government's purchase of properties in Grindavik in 2024, an estimated 1.2 percent of GDP. The realism assessment reveal potential optimism bias on the primary deficit and stock-flow adjustments at the t+5 horizon. The reduction in the primary deficit is supported by credible measures in the MTFS 2026-30 and the reintroduction of the amended fiscal rule from 2026. Historical stock-flow adjustments are impacted by HFF liabilities since 2019. A settlement was reached in 2025 on outstanding liabilities and the government taking over the assets in HFF. 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 obervations 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.

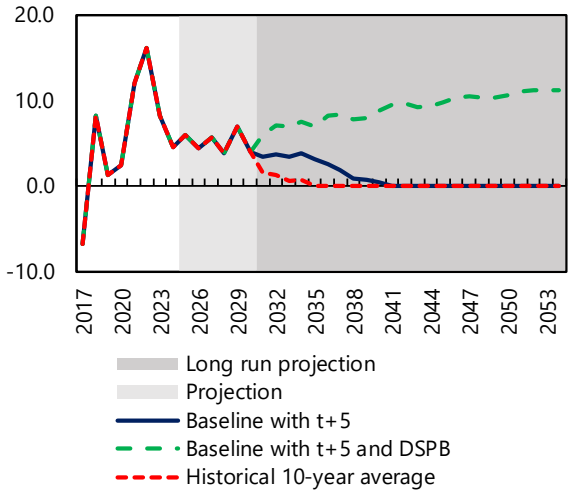
Annex III. Figure 5. Iceland: Triggered Modules

Large amortizations | Pensions | **Health** | Climate change: Adaptation | Climate change: Mitigation | Natural Resources

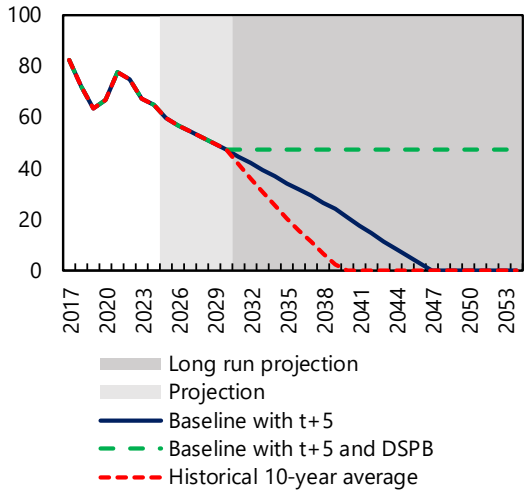
Long-Term Risk Assessment: Large Amortization

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

GFN-to-GDP Ratio

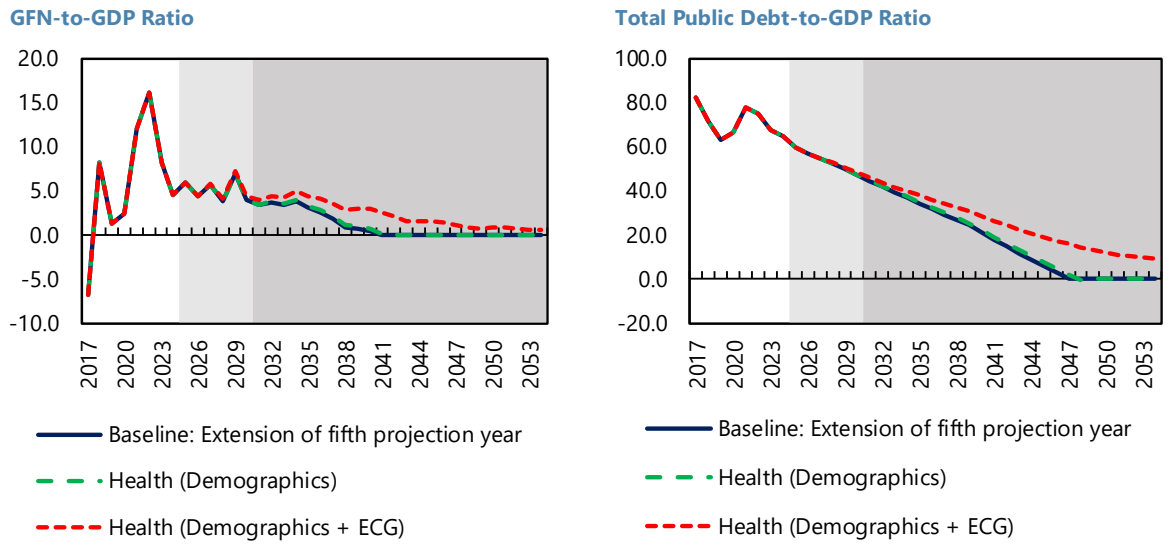


Total Public Debt-to-GDP Ratio



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 managable, using an assumption of the debt-stabilizing primary balance in the projections.

Annex III. Figure 6. Iceland: Demographics-Health



Commentary: Demographic projections for Iceland suggest a lower trajectory of debt consolidation in some scenarios. Favorable demographics due to migration inflows are a mitigating factor.

Annex IV. Previous Article IV Recommendations

Key Recommendations	Implementation Status
Fiscal Policy	
Gradual Fiscal Consolidation to Create Fiscal Space	
• Reverse the increase in the government's real spending envelope relative to the 2023–27 MTFS.	• One of the main objectives in the 2026–30 Medium-Term Fiscal Strategy is to reduce the government's expenditure level relative to GDP.
• Reduce the number of items subject to reduced VAT rates.	• The authorities are working on reducing the VAT gap. There has been limited change in the number of items subject to a lower VAT rate.
• Streamline tax expenditures and incentives	• The new government intends to enhance tax compliance, close loopholes, and narrow tax exemptions. An example of the measures announced for 2026 is the plan to abolish personal income tax bracket sharing between couples and to end the ability to use unused personal tax credits to reduce the capital income tax.
• Increase the taxation of realized capital gains on second homes and investment properties	• No measures have been outlined to increase taxation on second homes.
Reinstate the Fiscal Rules to Underpin Long-Term Sustainability and Strengthen the Fiscal Council	
• Replace the existing overall balance rule with a limit on government spending (net of unemployment benefits and interest payments), while maintaining a limit on net debt to provide a long-term anchor for fiscal policy.	• A revised fiscal rule is set to be introduced in 2026. It includes a net expenditure growth rule instead of the previous budget balance rule. The revised rule preserves the 30 percent of GDP net debt ceiling, though the pace at which this ceiling is to be achieved will be more flexible than in the past.
• Expand 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.	• The authorities are considering a review of the coverage of the budget and fiscal rules. Risks to debt are mitigated by the fact that borrowing by entities outside the scope of the current fiscal rules is mainly via on-lending from the central government.
• Empower the Fiscal Council with evaluating 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.	• As part of the amendments to the fiscal rule, the Fiscal Council has been tasked with assessing the revenue implications of new fiscal measures.
Privatization Process and Government Obligations in HFF	
• The planned privatization of Islandsbanki should be completed in a manner that respects the importance of high-quality bank ownership	• The planned sale is expected to take place through a public offering in the first half of 2025, giving individuals priority over legal entities. Legislation enacted last year governing the sale of the state's remaining shares

Key Recommendations	Implementation Status
	ensures that the offering process will be conducted with objectivity, efficiency, equality, and transparency.
Monetary Policy	
• Gradually ease the monetary policy stance 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	• Inflation is gradually declining and is expected to reach the target in 2026H2. The CBI has lowered the policy rate by 150 bps since October 2024.
Macroprudential Policy	
• The CBI should clarify its policy regarding the neutral level of the CCyB.	• The Financial Stability Committee of the CBI clarified that the CCyB would generally range between 2-2.5 percent of the domestic risk base.
Foreign Exchange Reserves and FX Derivatives Market	
• Opportunistically build reserves to strengthen their ability to use foreign exchange intervention to prevent disruptive movements in the exchange rate.	• The CBI has announced a program of regular foreign currency purchases in the interbank foreign exchange market. More specifically, the CBI intends to purchase 6 million euros per week in the market. The first purchase took place on April 15, 2025. The CBI will review the purchase programme as circumstances warrant. The main objectives of the currency purchase program is to increase the share of reserves financed in Icelandic krónur and to meet the Treasury's need for currency. The CBI will continue its policy of intervening in the foreign exchange market as it deems necessary to mitigate short-term exchange rate volatility.
• Gradually deepen the foreign currency derivatives market, including by reassessing the limits on commercial banks' derivative transactions	• From the Minutes of the Financial Stability Committee meeting in June 2024: The Committee discussed the opinion of the IMF mission that visited Iceland in May 2024. The IMF noted that the shallowness of the domestic foreign exchange market gave rise to the risk of excessive exchange rate volatility during shocks, and it proposed that consideration be given to imposing restrictions on the commercial banks' derivatives trading in order to deepen the market. In April 2022, the FSN approved the Rules on Derivatives Transactions, no. 412/2022, which limited the total scope of financial institutions' derivatives trading so that the net forward FX position vis-à-vis any given counterparty may not exceed 10% of the capital base and the total forward FX position (the sum of the forward position vis-à-vis all counterparties combined) may not exceed 50 percent of the capital base. The Committee discussed the importance of using macroprudential tools to limit position-taking involving the Icelandic krónur. The experience of increased freedom in the derivatives market had been positive, however. The current scope was used mainly to serve customers in the import and

Key Recommendations	Implementation Status
	export sectors with forward foreign currency contracts. A wider interest rate differential with abroad could affect position-taking in high yielding currencies. Under current conditions, the FSN considered it appropriate to exercise caution in amending rules on derivatives trading, and it was of the opinion that the rules should not be amended at the present time.
Structural Policies	
Diversification	
• The criteria for expenditures that are eligible for the R&D tax credit should be further clarified and measures to prevent misuse strengthened to keep costs under control and maximize the economic impact of R&D incentives.	• The government has decided to undertake a comprehensive review of the legislation on research and development (R&D) to ensure that R&D tax incentives are as effective as possible and are directed toward projects that align with the objectives of the support system. The aim is also to strengthen oversight and enhance cooperation between the institutions involved, as well as to establish clearer rules to prevent misuse.
Climate	
• Raise 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.	• The carbon rate was increased by 59 percent on January 1, 2025 and there are plans to increase it further. As a part of the legislation on new kilometer charge the carbon tax will increased by approximately 25 percent. It will then have doubled from the 2024 value to approximately 70 EUR per ton CO_2. • The authorities published an updated Climate Action Plan in June 2024 that includes sector-specific mitigation measures. They 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	
• Over time, reduce the role of the state in collective wage bargaining to preserve the integrity of the budgetary process.	• The next collective bargaining round will take place in 2027.

Annex V. Update on the Implementation of FSAP Recommendations

Recommendations	Horizon[1]	Status
Cross-Cutting		
Increase resources at the CBI for oversight of market risk, interest rate risk in the banking book (IRRBB), financial climate risks, and operational risks (ICT risk and cybersecurity); and for the RA.	NT	The CBI has enhanced its operations and resources. It merged the Banking Supervision and Insurance & Pension Divisions into a single Microprudential Supervision Division to optimize resources and strengthen supervision. Two positions are now dedicated to analyzing market risk and IRRBB. Operational risk monitoring resources, including ICT and cybersecurity, have more than doubled to 6 FTEs. Additionally, the CBI has increased resources for implementing the TIBER-IS framework for cybersecurity testing among critical financial system participants. A new cross-divisional team has been established to address financial climate risks and environmental issues, adding 2 FTEs.
Regulation and Supervision: Banking and Pension Funds		
Develop and implement a streamlined and independent budgetary process for supervision.	NT	Supervisory fees are classified as a tax. Therefore, the MoFEA believes that allowing CBI to directly collect supervisory fees would be unconstitutional. The CBI is working on finding options to the budgetary process to discuss with the MoFEA.
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 previously proposed amendments to the Central Bank Act to enhance supervisors' legal protection post-merger with the FSA, but the PMO has not advanced this. Further consultations among the PMO, MoFEA, and CBI are planned to determine next steps, potentially requiring a broader approach beyond financial supervisors. A letter to the ministries on this issue is in progress.
Remove MoFEA staff from CBI's FMEN (independence) and implement internal delegation of powers framework (accountability).	NT	In January 2024, an external member replaced the MoFEA staff member on the CBI's FMEN. The June 2023 amendments to the Central Bank Act strengthened the delegation of powers within the CBI and clarified the FMEN's decision-making authority, including administrative fines, police referrals for violations, revocation of operating licenses for serious or repeated offenses, and dismissal of board members for misconduct. The CBI now handles all other decisions.

Recommendations	Horizon[1]	Status
		The CBI is finalizing an internal delegation framework that includes signature rules for the entire Bank and delegation from the Governor to the Deputy Governor for Financial Supervision, along with formal procedures for signature authorizations in the supervision divisions. Additional procedures for delegating power to other departments, such as foreign exchange interventions, are being developed or are already in place.
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	Each year, several aspects of risk management practices are evaluated as part of the SREP, including banks' risk management resources, risk appetite, and the roles of boards and employees. Climate risks are also included in the SREP process, which often involves on-site visits. The Microprudential Supervision Division has updated the on-site inspection program to conduct exams for category 1 and 2 entities on a 1–5 year cycle based on risk level. For category 3 and 4 entities, on-site inspections are performed as needed, following a risk-based approach.
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 contacted banking supervisory authorities in other Nordic countries to learn how to close the gap between EU rules and Basel standards. Following this consultation, no further action is foreseen.
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 revised outsourcing guidelines to establish stricter rules. A MoFEA-led working group is drafting a "green paper" to diagnose the current challenges facing the pension system. The green paper is expected to be published in 2025, followed by a white paper compiling of legislative amendments.
Perform regular on-site inspections for large pension funds and re-establish institutionalized supervisory dialogue.	I	On-site inspections for larger pension funds (categories 1 and 2) will occur at least every five years. Inspections for smaller pension funds (categories 3 and 4) will be based on risk assessment results. The CBI has established annual meetings with the four largest pension funds. These meetings include Deputy Governors for Financial Stability and Financial Supervision, along with directors and senior staff from the pension funds. Additionally, biannual meetings with the Icelandic Pension Fund Association will focus on supervisory priorities and relevant topics.

Recommendations	Horizon[1]	Status
Define infringements and sanctions in the Pension Fund Act.	NT	A MoFEA-led working group is drafting a "green paper" to diagnose the current challenges in the pension system to be published in 2025, followed by a white paper compiling legislative amendments.
Systemic Risk Analysis		
Develop approaches to monitor funding risks from nonbank financial institutions (including pension funds) and foreign investors.	NT	The CBI is enhancing its monitoring of funding risks from nonbank financial institutions by improving data collection on ownership of covered bonds from commercial banks and incorporating deposits from nonbank institutions and foreign investors into 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 being updated with new sensitivity analyses to better reflect the risks of indexed versus non-indexed loans. In the long term, the next revision of credit risk models will estimate PD and LGD on a borrower level, allowing for better differentiation between these loan types. However, the data requirements for these revised models may delay implementation until 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 incorporated various scenarios for individual currencies, with different runoff and haircut rates, into liquidity stress tests. Results are included in monthly reports to the Financial Stability Committee. LCRs for all significant currencies are monitored at least monthly. Outlier banks are addressed through pillar 2 (SREP/ILAAP) and other supervisory measures. The CBI also has regulatory limits for euros and calculates the euro HQLA/FX net outflows, maintaining 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 pension funds' investments, influenced by both external and internal factors, including asset composition, risk profile, and arrears. Current monitoring focuses on the effects of interest rate and inflation developments on 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 enhanced automated validation rules for pension funds' annual reports and asset lists. These rules now include SQL data quality checks, and a dashboard for warnings and reporting errors has been developed. Data quality checks are integrated into the ExMon monitoring tool, with alerts that can lead to automated report rejections. Pension funds must submit corrections if their reports contain significant errors.

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	Efforts are ongoing to introduce an account-to-account (A2A) domestic retail solution to enhance the resilience and efficiency of the domestic payment system. The CBI, in collaboration with the PMO and MoFEA, has drafted a bill that grants the CBI authority to issue rules for improving domestic payments, which Parliament adopted on June 22, 2024. In November 2024, the CBI invited proposals for a centralized domestic infrastructure for payment requests, with eight parties participating. The CBI has updated its crisis cash distribution playbook and formed a working group within the Payments Council to assess commercial responses to significant disruptions in the debit and credit card systems.
Produce a financial sector specific cybersecurity strategy, clearly setting out the roles and responsibilities of each party.	I	A working group within the CBI, in collaboration with SURF, is developing a crisis coordination plan for the financial sector. This plan extends the business continuity plans (BCP) of financial institutions and the CBI, clearly outlining roles and responsibilities for safeguarding the operational security of financial market infrastructure and stability while addressing technical issues separately. The plan will involve the Financial Stability Council, EU-SCICF, and CERT-IS, which reports to the Department of Civil Protection and Emergency Management of the National Police. Plans are in place to launch a dedicated incident center to enhance communication, streamline interactions, and mitigate risks within the system. The MoFEA and CBI are also coordinating efforts to create a cybersecurity strategy for the financial sector.
Macroprudential Policies		
Further enhance transparency and accountability by developing a heatmap and regularly publishing reports on risk analysis.	I	The Financial Stability Committee updates a non-published heat map quarterly to visually present risks. The CBI has traditionally used this heat map to illustrate key risk factors for financial stability. The Financial Stability Report is currently under review, incorporating best practices from financial stability reports of other Nordic countries.
Further strengthen the analytical capacity by strengthening the analysis of tail risks, spillovers, systemic risks and calibration of macroprudential tools.	NT	The CBI conducts regular monitoring through monthly and quarterly internal analyses and publishes a detailed assessment in the Financial Stability Report twice a year. The Financial Stability Committee meets quarterly, receiving comprehensive presentations and memos from the CBI that assess the financial cycle and systemic risk accumulation using various financial indicators. The Committee focuses on growth-at-risk and the distribution of LTV and DSTI measurements to monitor tail risks and makes quarterly decisions regarding the application of macroprudential tools.

Recommendations	Horizon[1]	Status
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 quarterly and is prepared to take macroprudential actions if risks continue. The CBI also tracks developments in European CRE macroprudential measures, particularly from the ESRB, and is ready to implement them if necessary. With access to essential data on residential real estate transactions and leases from the Housing and Construction Authority, the CBI is developing a model to assess cyclical risks by creating quality-adjusted indexes of residential real estate and rental prices.
Close data gaps related to non-financial private sectors (households, non-financial corporates).	I	The CBI and MoFEA are collaborating to gain access to tax reports from households and non-financial corporates to address data gaps. The CBI aims to match income information from tax reports with debt data from the credit registry. Non-financial corporate tax reports will also enhance data quality regarding domestic entities' foreign debt. Additionally, the CBI has intensified data collection on the CRE market by regularly purchasing data on available square meters for sale and rent, as well as tracking CRE rental price trends. The CBI also gathers detailed information on CRE under construction from the Housing and Construction Authority and monitors the quarterly and annual results of publicly listed CRE companies.
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, titled Contingency Plan for Liquidity or Equity Shortfall at Credit Institutions, has been approved and operationalized. The RA is shifting towards testing and simulation, having participated in an internal simulation exercise in 2023 and completed its first exercise with three DSIBs in spring 2024. This exercise assessed the banks' ability to produce reliable and accurate data under pressure. In fall 2024, the RA will focus on a Nordic-Baltic simulation exercise addressing the winding up or resolution of a failed bank. The Risk Management Department of the CBI is designing and conducting these simulations. Specific tests for the four largest banks are planned for 2025, along with a multi-annual testing plan for presentation to the banks. Additionally, the Risk Management Department is planning an internal test in fall 2025, which will cover the failure and resolution of banking institutions.

Recommendations	Horizon[1]	Status
Establish a coordination body on resolution issues between the MoFEA and the CBI (RA).	I	Discussions are ongoing to formalize information sharing between the CBI and MoFEA on resolution issues, considering either a written MoU for a formal coordination body or a sub-group under the Financial Stability Council. This will be finalized with an MoU signing in 2025. Coordination and information sharing will occur in the new subgroup, with biannual meetings involving representatives from the Icelandic RA and the Ministry of Finance and Economic Affairs.
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	Efforts are underway to explore potential legislative amendments needed for implementing this recommendation. The MoFEA oversees the project, with preparatory work supported by the CBI.
Develop a repo market and operationalize the ELA, including the assessment of collateral eligibility.	NT	The CBI has made efforts to develop an efficient money market, but challenges persist due to its small size and lack of liquidity. Banks have been hesitant to commit to two-way pricing for suggested tenors (one week to three months). While the CBI has revisited this issue multiple times, establishing a repo market requires significant commitment from banks, particularly the three D-SIBs. Additionally, the comfortable liquidity positions of individual banks diminish their need for an active cash market.
		The CBI has established an ELA working group to ensure the operational effectiveness of ELA from both practical and legal perspectives, including assessing collateral eligibility. The group has collaborated with the FSA, which manages debt portfolio data, and has accessed the POWER BI Dashboard for this information. They emphasize the need to classify assets based on transferability, which relevant financial institutions will be required to do. Currently, the CBI is assessing the overall ELA collateral eligibility of Icelandic financial counterparties. Financial institutions must report their obligations, including loan portfolios, to the CBI's Register of Obligations. Efforts are underway to utilize this Register for evaluating potential ELA collateral, thereby enhancing transparency and risk assessment. Furthermore, in line with Norwegian and Swedish law, the CBI is considering legislative measures to gain exclusive authority for the registration, mobilization, and monitoring of loan portfolios pledged as collateral by local financial institutions.
Operationalize the application of all the resolution tools (not just bail-in).	NT	Resolution plans for Iceland's three D-SIBs are increasingly focused on developing transfer strategies (non bail-in), aligning with EEA developments. The current priority is to finalize bail-in playbooks, with Master playbooks (including transfer strategies) expected

Recommendations	Horizon[1]	Status
		to be completed by 2025, in accordance with EBA Guidelines 2022/01 and the amended testing guidelines. The RA is now concentrating on the operationalization of transfer strategies following progress in bail-in strategy implementation. The first resolution plan utilizing a transfer tool as the preferred strategy has been approved. This drafting process allowed for a detailed examination of transfer strategies, including establishing a transfer perimeter and preparing for operational transfers. The RA has referenced both EBA GL 2022/01 and EBA GL 2022/11 (Transferability guidelines). Initial tests with the bank are scheduled for 2025, and the RA is also drafting a multiannual testing plan.
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	The CBI is continuously refining its risk assessment methodology, focusing on improving data collection and analysis. While some amendments were made in the past year, the methodology for assessing both sectoral risk and individual supervised entities is currently being enhanced with IMF technical assistance. Thematic on-site inspections have been conducted over the last two years and are ongoing, with efforts to better integrate this supervisory tool into work procedures. Additionally, initiatives to improve the detection of unlicensed virtual asset service providers are underway, expected to be completed by 2025.
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 is utilizing inputs from registered entities to address discrepancies in Business Registry certificates. This data supports monitoring and supervisory actions that correct the beneficial ownership registry. Efforts are enhanced through regular communication with registered companies. A steering group, including participation from the CBI and other agencies, serves as a forum for coordination and improvement of AML/CFT measures.

Annex VI. Data Issues

Annex VI. 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	B	A	B		
Granularity 3/	B		A	A	B		
			A		B		
Consistency			A	A		A	
Frequency and Timeliness	A	A	B	B	A		

Note: When the questionnaire does not include a question on a specific dimension of data quality for a sector, the corresponding cell is blank.
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.
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 IMF *Review of the Framework for Data Adequacy Assessment for Surveillance*, January 2024, Appendix I).
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.

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.

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; Production-based GDP or gross value added by industry are available only on an annual basis and only in nominal terms. Statistics Iceland is in the intial phase of developing quarterly GDP data using the production approach. Currently, there are no plans to compile GDP data using the income approach. At the same time, Statistics Iceland plans to start compiling annual data using a more micro-based approach, potentially allowing for more detailed statistics. Statistics Iceland has 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. Data on Services Exports are often significantly revised given collection lags. 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.

Changes since the last Article IV consultation. The authorities have formed a high-level working group that will look at ways to strengthen the infrastructure for data collection, building on experiences in other countries, and assess the resource needs of Statistics Iceland. Statistics Iceland is reviewing the methodology used for seasonally adjusting national accounts data.

Corrective actions and capacity development priorities. None beyond the issues raised above. No capacity development priorities.

Use of data and/or estimates different from official statistics in the Article IV consultation. None.

Other data gaps. None identified.

Annex VI. Table 2. Iceland: Data Standards Initiative

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 VI. Table 3. Iceland: Table of Common Indicator Required for Surveillance

(As of May 14, 2025)

	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	Mar. 2025	Apr. 2025	D and M	D and M	D	D	...	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr. 2025	May. 2025	M	M	M	M	1W	NLT 7D
Reserve/Base Money	Apr. 2025	May. 2025	M	M	M	M	2W	NLT 1W
Broad Money	Mar. 2025	Apr. 2025	M	M	M	M	1M	1M
Central Bank Balance Sheet	Apr. 2025	May. 2025	M	M	M	M	2W	NLT 1W
Consolidated Balance Sheet of the Banking System	Mar. 2025	Apr. 2025	M	M	M	M	1M	1M
Interest Rates[2]	Apr. 2025	May. 2025	D	D	D	D	...	D
Consumer Price Index	Apr. 2025	May. 2025	M	M	M	M	1M	NLT 2W
Revenue, Expenditure, Balance and Composition of Financing[3]–General Government[4]	Q4, 2024	Mar. 2025	Q	Q	A	Q	2Q	1Q
Revenue, Expenditure, Balance and Composition of Financing[3]–Central Government	Q4, 2024	Mar. 2025	Q	Q	M	Q	1M	1Q
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar. 2025	May. 2025	M	M	Q	Q	1Q	1Q
External Current Account Balance	Q4, 2024	Mar. 2025	Q	Q	Q	Q	1Q	NLT 10W
Exports and Imports of Goods and Services	Q4, 2024	Mar. 2025	Q	Q	M	M	8W	NLT 5W
GDP/GNP	Q4, 2024	Mar. 2025	Q	Q	Q	Q	1Q	75D
Gross External Debt	Q4, 2024	Mar. 2025	Q	Q	Q	Q	1Q	NLT 10W
International Investment Position	Q4, 2024	Mar. 2025	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/).

Annex VII. Decomposing Labor Productivity Developments in Iceland[1]

Increasing productivity growth is a priority for the new government. Our analysis shows that raising productivity growth is essential to support growth rate over the medium-term. Historically, productivity growth has been driven by efficiency factors, such as technological progress, process efficiency, and a better educated workforce. However, the incentive for labor to move to highly productive activities could be strengthened and there may be scope to strengthen the conditions for high-growth enterprises.

Macro Perspective—Essential to Strengthen Overall Productivity Growth

1. The slowdown in productivity since the global financial crisis is driven by lower total factor productivity and capital intensity. We apply standard growth accounting using a Cobb-Douglas production function to identify the drivers of the slowdown in labor productivity growth.[2] Our analysis shows that Total Factor Productivity (TFP) growth has been an important driver of output growth historically. However, as TFP has slowed in recent years, labor input has become an increasingly important driver for potential output (see Figure 1). This also means that labor productivity growth is declining while capital deepening has slowed.

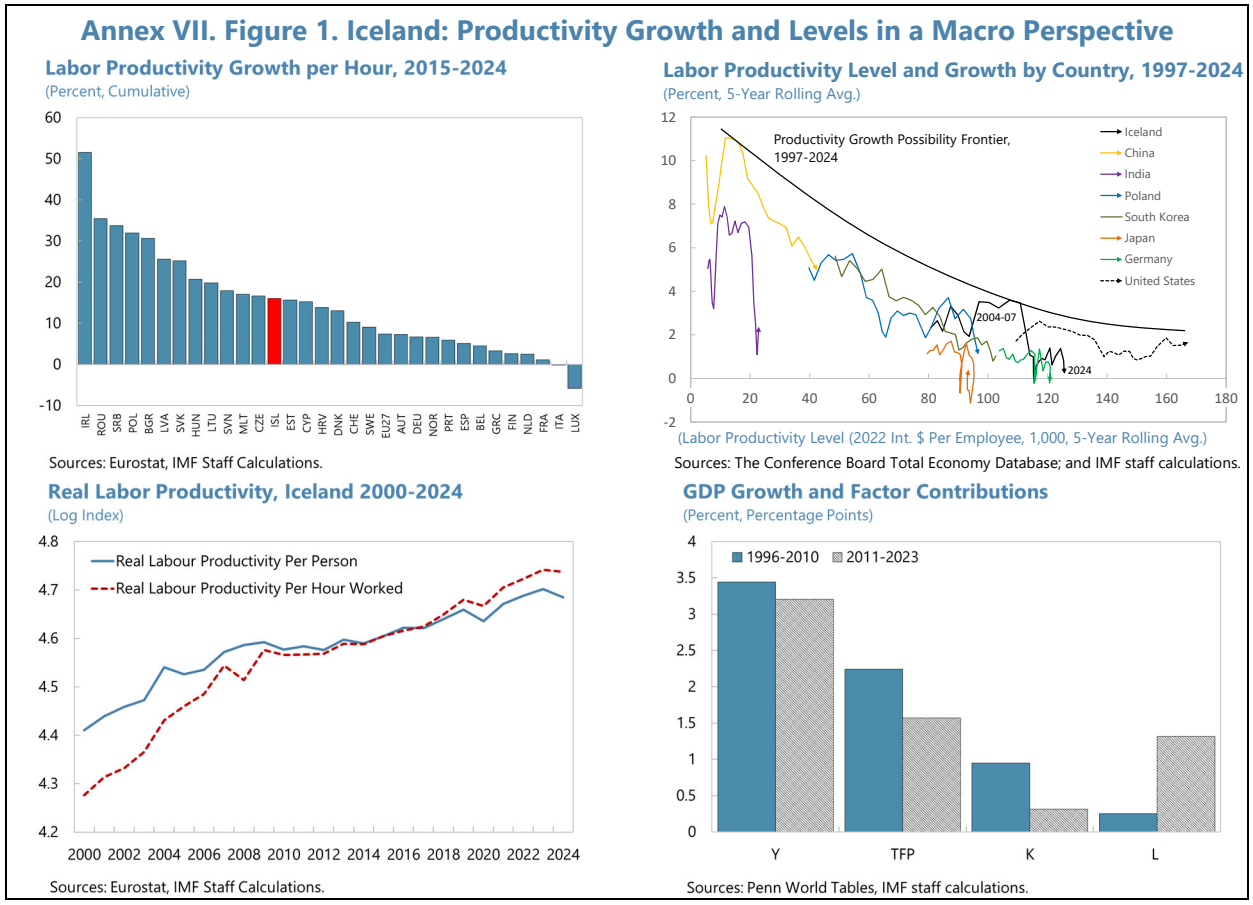
2. Iceland has scope to move closer to the productivity growth frontier. The labor productivity level in Iceland is high and among the top 15 percentile of countries globally. Staff analysis of productivity growth relative to the productivity level (in purchasing power parity per capita terms) shows that Iceland historically has been close to what can be perceived as the global productivity growth frontier, broadly comparable with other open advanced economies. However, labor productivity sharply declined after the financial crisis in 2008. Identifying ways to help stem this decline and (partially) reverse the decline in productivity would help support growth over the medium term.

Sectoral Perspective—Strengthen Incentive for Labor to move into High Productivity Activities

3. There are large sectoral differences in productivity levels and their contribution to growth. Labor productivity growth has been led by the financial sector, fisheries and aquaculture, and Information and Communications Technologies (ICT), all experiencing high productivity growth rates of close to 50 percent over the last decade (see Figure 2). These sectors also have a higher productivity level than other sectors. Other important sectors such as trade, transport, accommodation and food services, and manufacturing have had lower productivity growth, yet still contributed significantly to overall productivity growth because of their size.

[1] Prepared by Thomas Gade (EUR) with input from Amit Kara and Kelly Gao (both EUR).

[2] See also Central bank of Iceland, Monetary Bulletin, May 2021, Box 3.



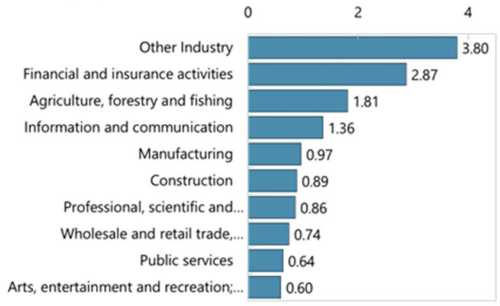
4. Productivity growth is driven by efficiency gains and technological progress. The *generalized exactly additive decomposition methodology* (see Box 1) gives a granular view of each sectors contribution to overall productivity growth. We decompose developments into three components: a Pure Productivity Effect (PPE), a Reallocation Level Effect (RLE), and a Reallocation Growth Effect (RLG). The PPE has been the dominant effect during the last decade, reflecting pure productivity improvements within sectors as a result of efficiency factors such as technological progress, improved internal processes, or training and upskilling of the workforce (see Figure 3). This is especially the case for the fisheries and aquaculture sector, food and beverage products, wholesale and retail trade, and finance and insurance (see Table 1). Meanwhile, the real estate sector and transport sector experienced notable negative efficiency effects.

5. Labor has moved towards sectors with a lower relative productivity level. Further decomposing the Reallocation Level Effect (RLE) into a relative prices effect (RLPE) and relative labor share effect (RLPE), we can determine the effect of a shift in relative prices and shifts in relative labor shares on productivity growth (see Table 2). The overall RLE has had only a modest contribution on productivity growth over the last decade. However, there are large differences between sectors. Construction, real estate, administrative support services, public services and to a lesser extent accommodation and food services have seen large contributions from RLE, which in most cases are

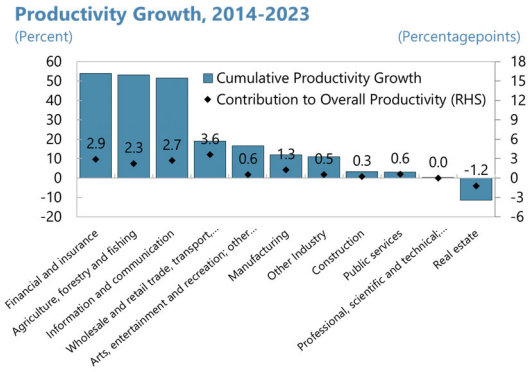
driven by an increased labor share.[3] Except real estate activities, these are all sectors with a low level of productivity relative to other sectors. Meanwhile, labor has shifted out of fishing and aquaculture, food products, and finance and insurance activities, which are all sectors with a high productivity level.

6. Relative prices can play a role for some sectors. The development in relative prices can increase the specific sectors share in total value added, while holding pure productivity growth and shifts in labor shares constant. The overall relative price effect during the last decade has been negative driven particularly by negative developments in relative prices for fishing and aquaculture, food products, finance and insurance services, and for basic pharmaceutical products. Meanwhile, the public sector has experienced a positive relative price effect.

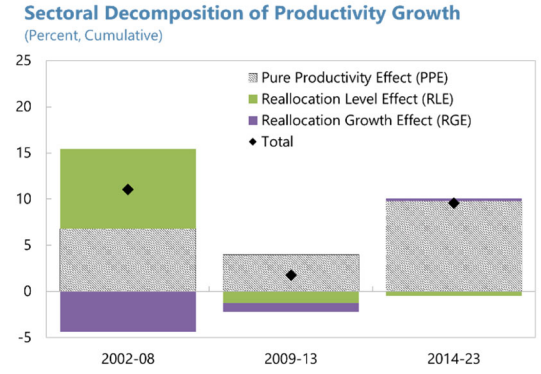
Annex VII. Figure 2. Iceland: Sectoral Decomposition of Labor Productivity Growth



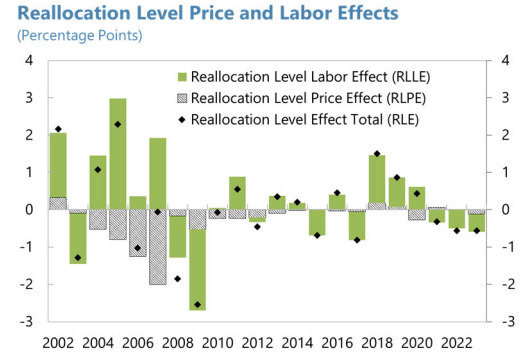
Sources: Eurostat, IMF staff calculations.
Note: Chart excludes real estate activities, which is 13.2.



Sources: Eurostat, IMF staff calculations.



Sources: Eurostat, IMF staff calculations.



Sources: Eurostat, IMF staff calculations.
Note: The difference to total is due to an exempted minor covariance term.

[3] Iceland has a relatively large public sector with a measured low productivity level. However, measuring output and productivity statistically can be challenging in the public sector given the difficulty with defining outputs, and measurements are therefore typically input based. This can lead to underestimation of productivity in the public sector, which has expanded in Iceland in recent years.

Annex VII. Box 1. Iceland: A Sectoral Decomposition Methodology

We use the *generalized exactly additive decomposition (GEAD)* by Tang and Wang (2004) to estimate sectoral contributions to aggregate labor productivity growth. According to the methodology, aggregate labor productivity growth can be decomposed into three terms: (i) within-sector productivity ("pure productivity effect"); (ii) resource reallocation growth ("reallocation level effect"); and (iii) a covariance term ("reallocation growth effect") as follows:

$$G_t = \sum \frac{Y_{i,t-1}}{Y_{t-1}} G_{i,t} + \frac{Z_{i,t-1}}{z_{t-1}} (p_{i,t} l_{i,t} - p_{i,t-1} l_{i,t-1}) + \frac{Z_{i,t-1}}{z_{t-1}} (p_{i,t} l_{i,t} - p_{i,t-1} l_{i,t-1}) G_{i,t} \quad (1)$$

Where $\frac{Y_{i,t-1}}{Y_{t-1}}$ denotes the nominal gross value added of sector i relative to total gross value added, G_t aggregate labor productivity growth, $G_{i,t}$ labor productivity growth in sector i (pure productivity effect), $l_{i,t}$ its employment share, and p_i its price level relative to the overall economy. The relative importance of each component differs across countries, industries and over time.

The first term represents pure productivity effect (PPE), capturing sectoral efficiency gains as firms within a sector become more efficient at producing output for a given level of input. This can reflect technological progress, improved internal processes, or training and upskilling of the workforce. Isolating pure productivity growth allows capturing the effect of productivity changes while abstracting from non-efficiency factors (i.e., changes in the relative size of a sector). A positive term implies a pure productivity effect from efficiency gains.

The second term is the clean reallocation level effect (RLE), holding constant productivity growth. It involves structural changes within the economy, resulting from the movement of labor towards productive sectors or shifts in the industry composition due to the entry and exit of firms, scaled by each sector's productivity level (Z_i) relative to the aggregate (Z). The scaling implies an overall increase in aggregate labor productivity by favoring the above-average productivity sector. A positive term implies favorable developments in relative prices or labor moving to a specific sector. The higher the relative productivity level of the sector, the higher the effect. A negative term in aggregate means that labor or prices moves to sectors with a relatively lower productivity level.

The third term captures the dynamic reallocation growth effect (RGE), represented by the covariance term between real productivity growth and the reallocation effect. This accounts for the economic impact of Baumol's cost disease, wherein resources shift to sectors with negative labor productivity growth (a declining productivity level). This effect is typically very small.

The GEAD can be further extended to provide additional details on the reallocation level effect in terms of isolating the effects of prices and labor. Equation (1) can be further detailed into a relative price effect and the labor effect through the following terms:[1]

$$G_t = \sum \frac{Y_{i,t-1}}{Y_{t-1}} G_{i,t} + \frac{Y_{i,t-1}}{Y_{t-1}} \left(\frac{p_{i,t}}{p_{i,t-1}} - 1 \right) + \frac{Y_{i,t-1}}{Y_{t-1}} \left(\frac{l_{i,t}}{l_{i,t-1}} - 1 \right) + \frac{Y_{i,t-1}}{Y_{t-1}} \left(\frac{p_{i,t}}{p_{i,t-1}} - 1 \right) \left(\frac{l_{i,t}}{l_{i,t-1}} - 1 \right)$$

$$+ \frac{Y_{i,t-1}}{Y_{t-1}} \left(\frac{p_{i,t}}{p_{i,t-1}} - 1 \right) G_{i,t} + \frac{Y_{i,t-1}}{Y_{t-1}} \left(\frac{l_{i,t}}{l_{i,t-1}} - 1 \right) G_{i,t} + \frac{Y_{i,t-1}}{Y_{t-1}} \left(\frac{p_{i,t}}{p_{i,t-1}} - 1 \right) \left(\frac{l_{i,t}}{l_{i,t-1}} - 1 \right) G_{i,t} \quad (2)$$

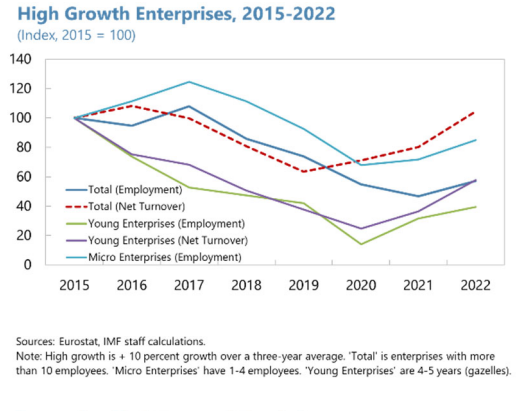
The second and third term in equation (2) capture *reallocation level price effects* (RLPE) and *reallocation level labor effects* (RLLE) respectfully. The last four terms represent typically minor interaction terms.

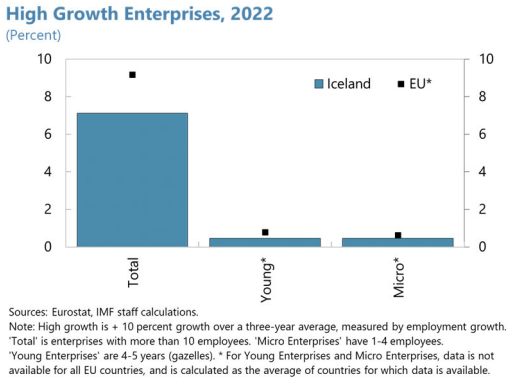
[1] *See Montebello & Darmanin (2021) for a full derivation.*

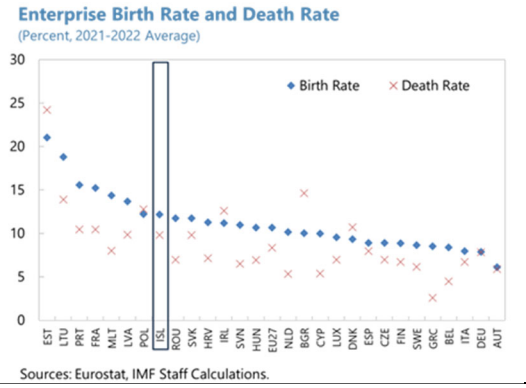
Micro Perspective – Scope to Encourage More High-Growth Enterprises

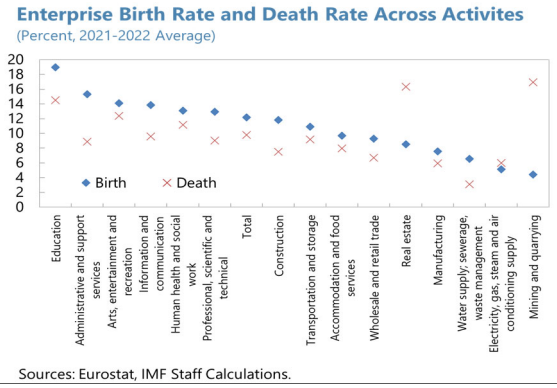
7. Iceland has relatively few high-growth enterprises. A dynamic business environment fosters high-growth enterprises and is typically associated with a higher economy-wide productivity growth rate.[4] The share of high-growth enterprises declined in the five-year period leading up to the pandemic, but has partially recovered. However, the share of high-growth enterprises (measured by employment growth) remains below the EU27 average for the economy as a whole, while more in line for young and micro enterprises (see Figure 3).[5] This may indicate that there is further scope to encourage high-growth enterprises that can help drive economy-wide productivity growth expand their activities. Addressing structural impediments including skill shortages and infrastructure gaps that can impact the potential to scale-up could help.

Annex VII. Figure 3. Iceland: Business Demographics









8. Enterprise birth and death rates suggest few restrictions to entry and exit. Enterprise birth and death rates are higher than the European average, and higher than in other Nordic countries. Enterprise birth rates across various activities overall indicate good business dynamics for entry and exit. However, the birth rate and death rate is lower e.g., in retail and wholesale activities as well as in manufacturing, possibly indicating some restrictions to entry and exit in those areas of activity (see Figure 3). [6]

[4] See e.g., J. Du and Y. Temouri, "High growth firms and productivity: Evidence from the United Kingdom", Small Business Economics, Vol. 44, No. 1, 2015.

[5] Iceland is more in line with the EU-27 average when growth is measured by net turnover rather than by employment growth. However, comparable cross-country data is limited.

[6] Data for Iceland may be impacted by few firms in the sample, especially when disaggregating across activities.

Annex VII. Table 1. Iceland: Detailed Sectoral Decomposition of Labor Productivity Growth

(Cumulative percent and percentage points contribution)

	2002-2008				2009-2013				2014-2023			
	Total	**PPE**	**RLE**	**RGE**	**Total**	**PPE**	**RLE**	**RGE**	**Total**	**PPE**	**RLE**	**RGE**
Total - all NACE activities	**11.0**	**6.8**	**8.7**	**-4.4**	**1.8**	**4.0**	**-1.3**	**-1.0**	**9.5**	**9.8**	**-0.5**	**0.3**
Crop and animal production, hunting and related service activities	**0.1**	0.8	-0.6	-0.1	**0.1**	0.0	0.1	0.0	**-0.3**	0.1	-0.4	0.0
Forestry and logging	**0.0**	0.0	0.0	0.0	**0.0**	0.0	0.0	0.0	**0.0**	0.0	0.0	0.0
Fishing and aquaculture	**-2.5**	0.8	-3.2	-0.1	**1.1**	-0.5	2.1	-0.4	**-1.5**	2.5	-3.6	-0.3
Mining and quarrying	**0.0**	0.0	0.0	0.0	**0.0**	-0.1	0.0	0.0	**0.0**	0.1	0.1	-0.1
Manufacturing												
Food products; beverages and tobacco products	**-2.1**	0.9	-3.0	0.0	**1.6**	0.9	0.7	0.0	**-1.1**	1.4	-2.4	-0.1
Textiles, wearing apparel, leather and related products	**-0.2**	0.1	-0.3	0.0	**0.1**	0.0	0.1	0.0	**0.0**	0.0	-0.1	0.0
Wood, paper, printing and reproduction	**-0.1**	0.0	-0.1	0.0	**-0.1**	0.2	-0.2	0.0	**-0.2**	0.0	-0.2	0.0
Chemicals and chemical products	**-0.1**	0.0	-0.2	0.0	**0.0**	0.1	-0.1	0.0	**0.0**	-0.1	0.2	-0.1
Basic pharmaceutical products and pharmaceutical preparations	**0.2**	-0.3	0.6	-0.1	**-0.2**	0.0	-0.2	0.0	**-1.1**	-0.4	-1.6	0.9
Rubber and plastic products and other non-metallic mineral products	**0.0**	-0.2	0.2	0.0	**-0.5**	0.0	-0.4	0.0	**0.2**	0.0	0.3	0.0
Basic metals and fabricated metal products, except machinery and equipment	**1.3**	0.8	0.4	0.0	**-0.6**	0.4	-0.8	-0.1	**0.5**	-0.1	0.5	0.1
Computer, electronic and optical products	**0.0**	0.0	0.0	0.0	**0.0**	0.0	0.0	0.0	**0.2**	-0.1	0.4	-0.1
Electrical equipment	**0.0**	0.0	0.0	-0.1	**0.1**	0.0	0.1	0.0	**-0.1**	0.0	-0.1	0.0
Machinery and equipment n.e.c.	**0.0**	-0.1	0.1	0.0	**0.2**	0.1	0.1	0.0	**0.1**	0.0	0.0	0.0
Motor vehicles, trailers, semi-trailers and of other transport equipment	**-0.1**	0.3	0.0	-0.4	**0.0**	0.0	0.0	-0.1	**0.0**	0.0	0.0	0.0
Furniture; jewellery, musical instruments, toys; repair and install. of mach. and equip.	**-0.2**	-0.7	0.5	-0.1	**0.3**	0.2	0.1	0.0	**0.0**	0.7	-0.5	-0.2
Electricity, gas, steam and air conditioning supply	**0.8**	0.9	-0.2	0.0	**0.8**	0.8	0.1	-0.1	**-0.1**	0.4	-0.4	-0.1
Water supply; sewerage, waste management and remediation activities	**0.3**	-0.1	0.4	0.0	**0.2**	0.1	0.2	0.0	**-0.2**	0.1	-0.2	0.0
Construction	**1.3**	-3.3	4.9	-0.4	**-3.8**	-0.2	-3.8	0.2	**4.0**	0.0	4.0	0.0
Wholesale and retail trade; repair of motor vehicles and motorcycles	**-0.3**	0.1	-0.4	0.0	**0.1**	0.2	-0.1	0.1	**1.6**	2.6	-0.9	0.0
Transportation and storage	**-0.5**	0.0	-0.5	0.0	**1.3**	0.8	0.5	0.0	**0.6**	-0.5	0.7	0.4
Accommodation and food service activities	**0.2**	0.4	-0.1	-0.1	**0.8**	0.0	0.8	0.0	**1.9**	0.2	1.0	0.6
Information and communication	**-1.0**	0.9	-1.7	-0.2	**0.8**	0.4	0.3	0.0	**1.2**	2.1	-0.7	-0.2
Financial and insurance activities	**4.8**	9.0	-3.8	-0.4	**-2.1**	0.6	-2.9	0.2	**-1.1**	2.8	-3.7	-0.2
Real estate activities	**4.4**	-2.4	9.0	-2.1	**1.0**	2.0	-0.3	-0.7	**-0.5**	-2.4	2.3	-0.4
Professional, scientific and technical activities	**0.6**	0.4	0.2	-0.1	**0.0**	-0.1	0.1	0.0	**0.4**	-0.2	0.6	0.0
Administrative and support service activities	**0.6**	0.0	0.6	-0.1	**0.4**	0.0	0.4	0.0	**2.1**	-0.1	1.9	0.3
Public administration, defence, education, human health and social work activities	**3.2**	-1.8	5.1	-0.2	**0.0**	-1.7	1.7	-0.1	**2.2**	0.2	2.0	0.0
Arts, entertainment and recreation; other services	**0.7**	0.1	0.6	0.0	**0.2**	-0.1	0.3	0.0	**0.7**	0.4	0.4	0.0

Source: Eurostat, IMF staff calculations.

Annex VII. Table 2. Iceland: Breakdown of Detailed Reallocation Level Effect in Prices and Labor

(Cumulative percentage points)

	2002-2008			2009-2013			2014-2023		
	RLE (Total)	RLPE (Price)	RLLE (Labor)	RLE (Total)	RLPE (Price)	RLLE (Labor)	RLE (Total)	RLPE (Price)	RLLE (Labor)
Total - all NACE activities	**8.7**	**1.3**	**7.4**	**-1.3**	**-0.3**	**-1.2**	**-0.5**	**-1.2**	**0.1**
Crop and animal production, hunting and related service activities	**-0.6**	-0.1	-0.5	**0.1**	0.0	0.1	**-0.4**	0.0	-0.3
Forestry and logging	**0.0**	0.0	0.0	**0.0**	0.0	0.0	**0.0**	0.0	0.0
Fishing and aquaculture	**-3.2**	-1.3	-2.0	**2.1**	1.4	0.5	**-3.6**	-1.8	-2.0
Mining and quarrying	**0.0**	0.0	0.0	**0.0**	0.0	0.0	**0.1**	0.0	0.1
Manufacturing									
Food products; beverages and tobacco products	**-3.0**	-1.7	-1.3	**0.7**	-0.2	0.9	**-2.4**	-0.9	-1.5
Textiles, wearing apparel, leather and related products	**-0.3**	-0.1	-0.2	**0.1**	0.0	0.0	**-0.1**	0.0	-0.1
Wood, paper, printing and reproduction	**-0.1**	0.0	-0.1	**-0.2**	-0.2	-0.1	**-0.2**	0.1	-0.3
Chemicals and chemical products	**-0.2**	0.0	-0.2	**-0.1**	0.0	0.0	**0.2**	0.1	0.1
Basic pharmaceutical products and pharmaceutical preparations	**0.6**	0.2	0.4	**-0.2**	-0.3	0.2	**-1.6**	-1.3	-0.2
Rubber and plastic products and other non-metallic mineral products	**0.2**	0.0	0.2	**-0.4**	0.0	-0.5	**0.3**	0.2	0.1
Basic metals and fabricated metal products, except machinery and equipment	**0.4**	0.2	0.2	**-0.8**	-1.0	0.1	**0.5**	0.9	-0.3
Computer, electronic and optical products	**0.0**	0.0	-0.1	**0.0**	0.0	0.0	**0.4**	0.1	0.3
Electrical equipment	**0.0**	0.0	0.0	**0.1**	0.0	0.1	**-0.1**	-0.1	0.0
Machinery and equipment n.e.c.	**0.1**	0.0	0.1	**0.1**	-0.1	0.2	**0.0**	0.0	0.0
Motor vehicles, trailers, semi-trailers and of other transport equipment	**0.0**	0.0	0.1	**0.0**	0.0	0.0	**0.0**	0.0	0.0
Furniture; jewellery, musical instruments, toys; repair and install. of mach. and equip.	**0.5**	0.3	0.2	**0.1**	-0.1	0.2	**-0.5**	-0.3	-0.2
Electricity, gas, steam and air conditioning supply	**-0.2**	-0.3	0.2	**0.1**	0.6	-0.5	**-0.4**	-0.4	0.0
Water supply; sewerage, waste management and remediation activities	**0.4**	0.2	0.2	**0.2**	0.0	0.2	**-0.2**	-0.2	0.0
Construction	**4.9**	-0.1	5.3	**-3.8**	-0.5	-3.7	**4.0**	0.8	3.1
Wholesale and retail trade; repair of motor vehicles and motorcycles	**-0.4**	-0.7	0.3	**-0.1**	0.3	-0.4	**-0.9**	-0.2	-0.7
Transportation and storage	**-0.5**	-0.2	-0.2	**0.5**	0.2	0.3	**0.7**	0.3	0.4
Accommodation and food service activities	**-0.1**	-0.2	0.1	**0.8**	0.1	0.7	**1.0**	0.2	0.6
Information and communication	**-1.7**	-1.0	-0.7	**0.3**	0.2	0.1	**-0.7**	-0.4	-0.3
Financial and insurance activities	**-3.8**	-4.9	1.5	**-2.9**	-1.4	-1.5	**-3.7**	-1.0	-2.7
Real estate activities	**9.0**	5.0	3.6	**-0.3**	-0.2	0.0	**2.3**	-0.2	2.4
Professional, scientific and technical activities	**0.2**	0.0	0.2	**0.1**	0.1	0.0	**0.6**	0.7	0.0
Administrative and support service activities	**0.6**	0.1	0.5	**0.4**	0.0	0.4	**1.9**	0.4	1.5
Public administration, defence, education, human health and social work activities	**5.1**	5.5	-0.5	**1.7**	0.5	1.3	**2.0**	2.2	-0.1
Arts, entertainment and recreation; other services	**0.6**	0.4	0.1	**0.3**	0.1	0.2	**0.4**	0.1	0.2

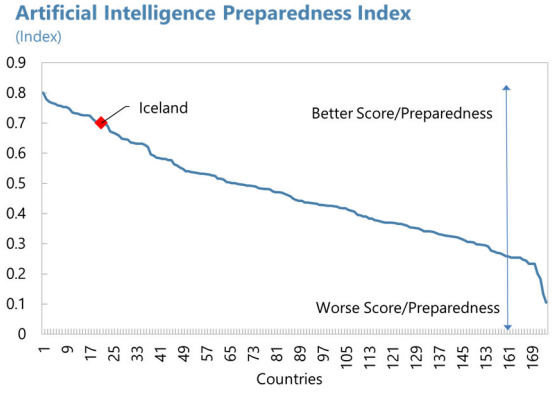
Source: Eurostat, IMF staff calculations.

Annex VIII. The Impact of Artificial Intelligence (AI) on the Labor Market in Iceland[1]

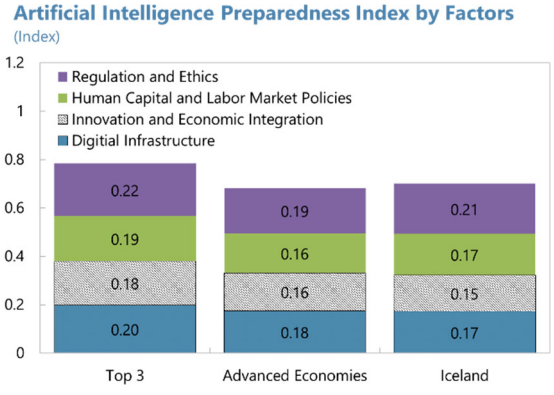
Icelandic companies are increasingly using AI, and a further roll-out in the public sector is on the new government's agenda. Iceland is among the top performers in digitalization and is well-prepared to benefit from the roll-out of AI. Using labor market micro data our study suggests that Iceland is less vulnerable to job displacement from AI than other advanced economies. However, one out of five persons in the labor force is vulnerable to job displacement from AI. While the tight labor market is a mitigating factor, continued reskilling and upskilling of the labor force is needed.

1. Artificial Intelligence (AI) and Generative AI models have evolved significantly in recent years. AI models have progressed from earlier machine learning models to now performing cognitive functions, processing vast amounts of data, recognizing patterns, and making decisions. Today, AI systems routinely exceed human performance on standard benchmarks.[2] As AI models continue to develop and their use expands, they have the potential to reshape the job landscape across a broad range of skills and sectors. While there are likely productivity gains in this process, it may also lead to job displacement during the transition.

Annex VIII. Figure 1. Iceland: Artificial Intelligence Preparedness Index (AIPI)



Sources: Cazzaniga and others (2024), IMF staff calculations.



Sources: Cazzaniga and others (2024), IMF staff calculations.

2. Iceland is among the top performers in digitalization and is well-prepared to benefit from AI. The IMF's Artificial Intelligence Preparedness Index (AIPI) indicates that Iceland is positioned well to roll out AI effectively and capitalize on potential benefits. Iceland's AI preparedness aligns broadly with the performance of the top 20 percent of countries across a range of indicators (see Figure 1).[3] Lowering the gap to the top 3 performers would require additional

[1] Prepared by Thomas Gade (EUR).

[2] See "The AI Index 2024 Annual Report," AI Index Steering Committee, Institute for Human-Centered AI, Stanford University, Stanford, CA, April 2024.

[3] The IMF's AIPI (Cazzaniga and others, 2024) assesses the level of AI preparedness as of 2023 across 174 countries, based on a rich set of macro-structural indicators that cover the countries' digital infrastructure, human capital and labor market policies, innovation and economic integration, and regulation and ethics.

investments in digital infrastructure, continued reforms to strengthen innovation and economic integration as well as strengthening human capital and labor market policies.[4]

3. Icelandic companies are increasingly using AI. The economy has traditionally been centered around fisheries, manufacturing, retail services and public services, with tourism and transport activities gaining in size over the last decade, and the development and production of pharmaceutical and aquaculture products gaining prominence more recently. AI is increasingly being used across sectors, including traditional sectors, but especially in the high growth sectors such as e.g. quality control in the pharmaceutical sector and in the marine product and services sector, as well as in energy, healthcare, and finance.

4. The new government is supporting further efficiency and innovation by using AI. The Icelandic authorities developed their first official AI strategy in 2021, which focused on the foundations for the use of AI, such as ethical concerns and security challenges. The most recent government strategy from 2024–26 centered around wide-spread use of AI, AI to strengthen competitiveness, use in the education system, in health care and for an improved public service.[5] The new government is continuing its support for efficiency and innovation through the use of AI and plans to formulate a clear legal framework for AI. Impact on the labor market—Less vulnerable to job displacement than the average Advanced Economy, but pockets of vulnerability exist.

5. Measuring exposure and complementarity to AI. We use the measure of exposure to AI developed by Felten et. al. (2021), further extended by Pizzinelli et. al. (2023) with a measure of complementarity, to determine whether AI may complement or replace jobs (see Box 1).[6] The result is a matrix of high exposure or low exposure, and high complementarity or low complementarity. We apply these measures to Icelandic micro data from the 2023 Labor Force Survey, using approximately 7,500 observations. This allows us to assess exposure and complementarity across 114 occupations, 20 economic activities, 10 age groups, gender, 3 educational attainment groups, income deciles, and immigrant or non-immigrant status.[7]

[4] The IMD World Digital Ranking reports a similarly high level of digital competitiveness. The report suggests that improvements are needed in the areas of Knowledge (PISA scores, International Experience, Foreign Highly Skilled Personnel, Graduates in Science, and spillovers from public research to R&D driven productivity) and Future Readiness (PPPs in the technology area and the government's cyber security capacity).

[5] See Ministry of Higher Education, Science and Innovation, (Previously Ministry of Higher Education, Industry, and Innovation), Government Action Plan 2024–26.

[6] These measures are constructed based on US occupational data on skill requirements etc. The specific characteristics of the Icelandic economy and required skills to perform a certain occupation may be different. However, as both are advanced economies, we apply these measures as proxy measures for Iceland.

[7] When disaggregating the data into subgroups and joint subgroups, the number of observations within each group and especially joint subgroups declines significantly, which increases the statistical uncertainty of the results.

Annex VIII. Box 1. Iceland: Measuring Exposure and Complimentary to AI

Measuring Exposure

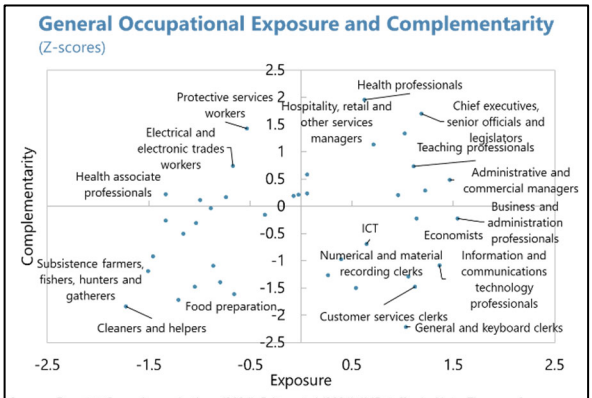
Felten et. al. (2021) develops a measure of occupational exposure to AI, linking common and general applications of AI (e.g., abstract strategy games, real-time video games, image recognition, image generation, reading comprehension, language modelling, translation and speech recognition) to workplace skills and occupations, using US occupational characteristics from the O*NET database. The index is essentially a measure of the overlap between AI and human skills, which is then weighted by the degree of importance and complexity of such skills in each job. High exposure occupations are typically service-related (see figure below).

Measuring Complimentary

Pizzinelli and others (2023) develop an index of complementarity, drawing also on the O*NET database, but from 'work contexts' and 'skills', adding an element of physical and social context. The authors argue that some societies may be less likely to allow unsupervised use of AI in some cases. For instance, the criticality of decisions and the gravity of the consequences of errors may motivate societies to require humans, although highly exposed to AI, to make final decisions or take actions. These include e.g. health professionals, judges, and certain types of technical experts and operators (see figure below).

Bringing exposure and complimentary together conceptually

The measures of exposure and complementarity can conceptually be thought of as a matrix with four quadrants: 'High Exposure and High Complementarity' (HEHC), 'High Exposure and Low Complementarity' (HELC), 'Low Exposure and High Complementarity' (LEHC), and 'Low Exposure and Low Complementarity' (LELC), using the medians across all exposure and complementarity values as thresholds. The measure of High Exposure and Low Complementarity (lower right quadrant in the figure) can be interpreted as occupations which are at higher risk of job displacement.



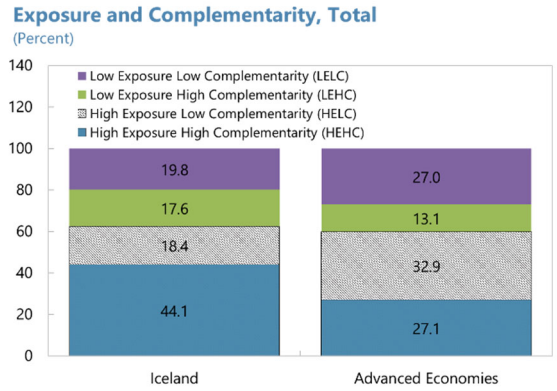
Sources: Eurostat, Cazzaniga and others (2024), Felten et al (2021), IMF staff calc. Note: The use of z-scores deviate slightly from the measures, although the median and means are broadly similar.

6. Iceland is less vulnerable to job displacement than other advanced economies.

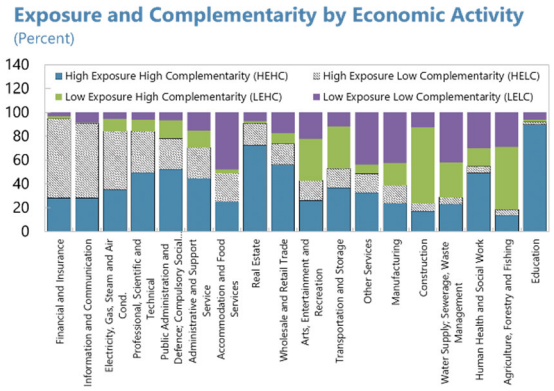
The overall exposure of employment in Iceland is broadly in line with the average advanced economy of around 60 percent of employment.[8] However, the share of high complementarity occupations is much higher in Iceland due to a significant share of the population working in the retail sector, education and health services, which are among the activities that typically have a high share of complementarity due to the need for human interaction. Meanwhile, about one out of five persons are vulnerable to job displacement, mainly in finance and insurance, ICT, professional, scientific and technical, public administration, administrative support services and accommodation services. This suggest there is a continued need to reskill and upskill Icelandic workers.

[8] This result is broadly in line with 2024 study by the Ministry of Higher Education, Industry and Innovation and Statistics Iceland, published in the authorities' 2024 Report on AI.

Annex VIII. Figure 2. Iceland: Overall Exposure and Complementarity



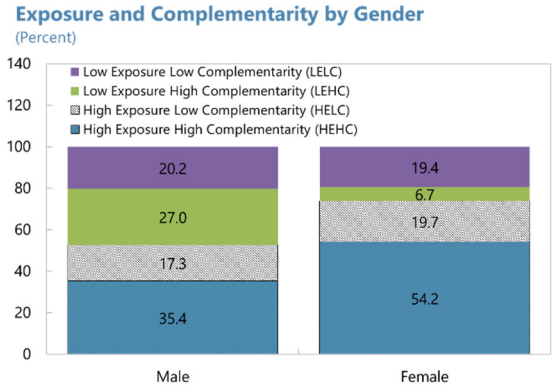
Sources: Eurostat, IMF staff calculations.



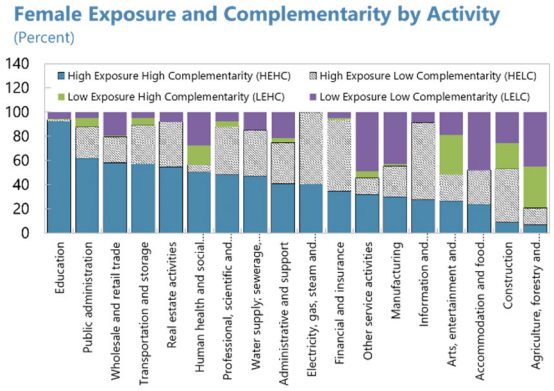
Sources: Eurostat, IMF staff calculations.

7. Women are more exposed to AI than men but have more high complementarity jobs. Almost three out of four women in the labor market are exposed to AI compared to about half of the men. However, most of the women who are exposed to AI work in high complementarity sectors including in the educational sector as teaching professionals, the health and social sector as personal care workers or in the retail sector as sales workers. Meanwhile, about the same share of women and men are vulnerable to job displacement, about 40,000 workers in total.

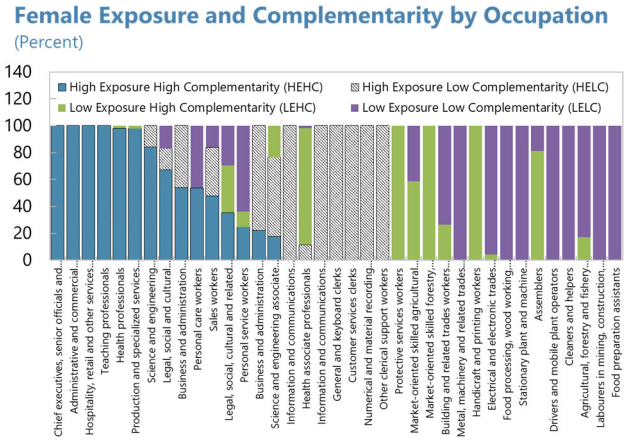
Annex VIII. Figure 3. Iceland: Gender Differences



Sources: Eurostat, IMF staff calculations.



Sources: Eurostat, IMF staff calculations.

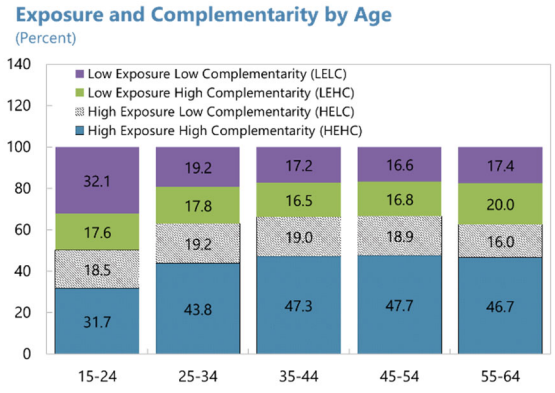


Sources: Eurostat, IMF staff calculations.

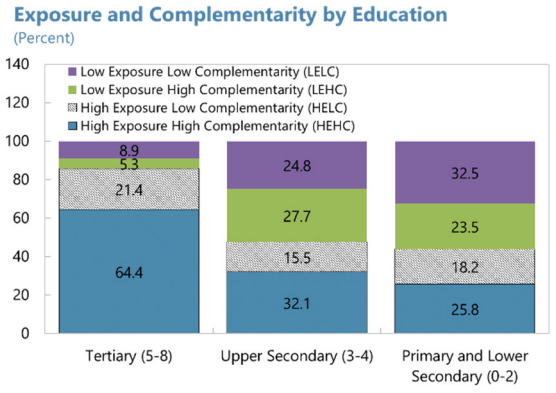
8. Vulnerability to job displacement is evenly distributed across ages and incomes. The overall share of exposure to AI varies across incomes, age, education, and income, mainly due to a higher share of complementarity in the job function among those with a tertiary education and higher incomes. Meanwhile, the share of those that are vulnerable to job displacement is both smaller and more evenly distributed across ages, education and incomes.

9. Immigrants are less exposed to job displacement than non-immigrants. More than 40 percent of immigrants occupy jobs with a low exposure and low complementarity to AI, which is about 5 percent of the labor force.[9] This is because immigrants typically occupy labor intensive jobs in the agricultural, fishing, construction, and the accommodation and food service industry. Meanwhile, only 10 percent are vulnerable to AI-driven job displacement and may decide to relocate if so.

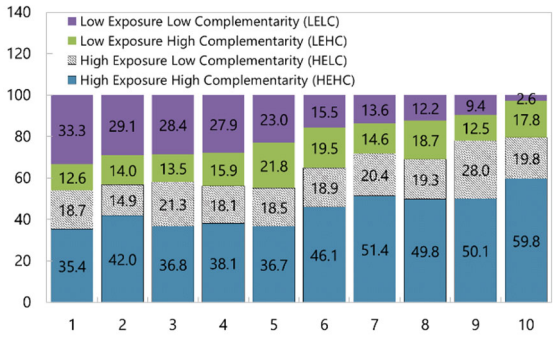
Annex VIII. Figure 4. Iceland: Other Differences in Exposure and Complementarity



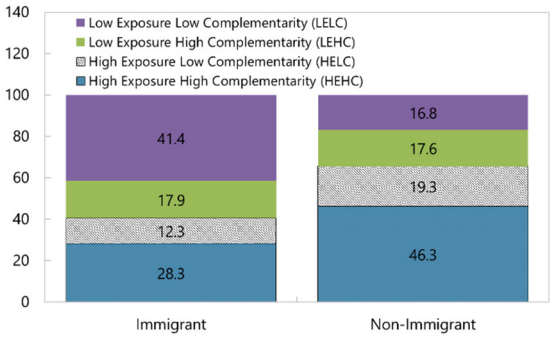
Sources: Eurostat, IMF staff calculations.



Souces: Eurostat, IMF staff calculations.



Sources: Eurostat, IMF staff calculations.



Sources: Eurostat, IMF staff calculations.

[9] This study may underestimate the number of immigrants in the labor force as the cleaned LFS data for use in this study suggest that 12.5 percent of the labor force are immigrants.

Annex IX. Taxation of Housing in Iceland[1]

The primary objective of tax policy is to mobilize sufficient revenue efficiently and equitably—not to target housing prices. In the long run, housing prices are driven by supply and demand, influenced more by factors such as zoning, land use regulations, and the cost of capital than by tax policy. We recommend that tax policy remain focused on its core mission of revenue mobilization, treating any short-run effects on housing demand and supply as incidental.

1. There are mainly four taxes levied on housing in Iceland. These include capital gains taxes, property taxes, income taxes on rental properties, and stamp duty.[2] In the following sections, we provide an overview of these four housing-related taxes, assess them from efficiency and equity perspectives, and offer recommendations for reform.

Capital Gains Tax

2. Exemptions reduce the effective tax rate on capital gains from housing. Capital gains from residential property are taxable in the year of the sale, with a standard rate of 22 percent. However, the law provides significant exemptions. First, for those who have owned the property for more than two years, if the total volume of residential property owned by the seller(s) does not exceed 600 m^3 for a single person (or 1200 m^3 for couples) on the date of sale, the sale is completely exempt from capital gains tax. This is a large exemption given the average size of a house, and the exemption therefore typically extends beyond the primary residence. Second, even if the property has been owned for less than two years, or if the total size of the properties owned by the seller(s) exceeds the aforementioned limits, the seller may request a deferral of the capital gains tax for up to two years. If the seller purchases a new property or begins construction on a property within this two-year window in Iceland or the European Union, the capital gains tax will be deducted from the value of the new property, establishing the basis for future capital gains tax.

3. Reducing the scope of the exemption from capital gains taxation could reduce speculative demand for housing. The capital gains tax exemptions encourage investment in housing as a speculative asset and distorts investment in other asset classes. Elimination of this exemption or at least restricting the exemption to the primary residence is likely to have two main effects. First, the required pre-tax return has to increase. For a given future price path of housing, this implies the current price must decline to increase the pre-tax return. The lower demand for housing has the potential to enhance affordability for those purchasing homes for residential purposes. Second, for a given economic return, the current law incentivizes investment in housing rather than other sectors of the economy, creating tax induced inefficiency. Therefore, reducing the scope of the exemption would enhance economic efficiency. International experience indicates that a complete elimination of the exemption may not be practical. Accordingly, we recommend either

[1] Prepared by Andualem Mengistu (FAD).

[2] Real property is not subject to VAT at first sale. In addition, VAT paid on labor costs in property construction is refunded at a rate of 35 percent. For further details see "Iceland: Modernizing the Icelandic VAT", IMF Country Report No. 14/291.

limiting the exemption to primary residences while taxing secondary homes and investment properties.

Property Tax

4. Property taxes are governed by the Act on Municipal Revenue Sources. The main features of the law are as follows: (i) a tax rate of up to 0.5 percent of the property's value applies to the following types of properties: apartments and residential houses, including land rights; hereditary lands in rural areas; landed properties; outbuildings and structures on farms related to agriculture; all benefits and summer cottages; as well as land rights; and (ii) a tax rate of 1.32 percent is applied to all other real estate, such as industrial, office, and commercial buildings; fish farming facilities; medical institutions; schools; dormitories; kindergartens; gymnasiums; and libraries. Municipalities are permitted to increase the above rates by up to 25 percent, resulting in rates of 0.625 percent and 1.65 percent, respectively.[3] Municipalities routinely levy lower tax rates. For instance, the property tax on residential property in Reykjavik is 0.18 percent of the value of the property.[4] But the tax rate on commercial properties is at the higher end (1.6 percent of the value of the property).

5. A reform to property taxation could help and incentivize housing supply. Property taxation in Iceland generates significant revenue, well above the EU average. However, this revenue primarily reflects the relatively high tax rate applied to commercial properties. While a revenue-neutral policy that lowers the rate on commercial properties while increasing the rate on residential properties could be beneficial, a related—and potentially more effective—policy would be to increase the property tax rate on vacant lots in urban areas. A higher tax on idle plots raises the financial cost of holding undeveloped land, thereby incentivizing owners to either develop the land or sell it to those who will. This can lower land costs, increase housing supply, and contribute to a reduction in housing prices.

Stamp Duty

6. A stamp duty is levied on the transfer of property, requiring the purchaser to pay a registration fee of 2,700 ISK ($19.37) and a stamp duty of 0.8 percent of the property's value if the buyer is an individual, or 1.6 percent if the buyer is a legal entity. Exemptions apply for first-time residential property buyers, reducing the stamp duty to 0.4 percent, and for forced sales by a mortgagee, where the stamp duty is 0.4 percent for individuals and 0.8 percent for legal entities.

7. One significant drawback of stamp duties (and transaction taxes in general) is that they are payable upon the sale of a property. This discourages property owners from selling, leading to distortions in the real estate market. The distortive effect becomes more pronounced as

[3] The law exempts churches and places of worship of the Icelandic National Church and other religious associations, museum buildings (provided they are not operated for profit), and the residences of foreign states.

[4] 63.5 percent of Iceland's population resides in Reykjavik and its surrounding municipalities. Source of the tax rate information is: Property rates | Reykjavik

the stamp duty rate increases. However, due to the relatively low rate in Iceland, coupled with exemptions and reductions, stamp duties may have a limited impact on the market.

Rental Income Taxation[5]

8. Rental income is considered income from business income, but with important exemptions. Rental income earned by individuals from leasing any type of property, including residential real estate, is generally considered income from business activities.[6] After deducting eligible operational expenses, this income is subject to the same progressive income tax rates as wages and salaries. However, there are two important exemptions. First, if the income arises from the rental of residential properties covered by the Rent Act and no more than two distinct residential units are leased, the income is not classified as business income. In such cases, a flat tax rate of 22 percent applies, but 50 percent of the income is exempt, resulting in an effective tax rate of 11 percent. Second, income from short-term rentals of the taxpayer's primary residence and, at most, one additional personally used property—commonly referred to as home accommodation (e.g., via Airbnb or Vrbo)—is also not treated as business income. To qualify, the rental period must not exceed 30 consecutive days or 90 days per calendar year, and total rental income must remain below ISK 2 million. In this case, a flat tax rate of 22 percent applies to the gross income, with no deductions allowed. Additionally, taxpayers may deduct rental payments made on their primary residence against rental income earned from temporarily leasing out their own home. Moreover, if the gross income from short-term rentals remains below ISK 2 million, the activity is exempt from VAT.

9. Harmonizing the tax treatment of various rental incomes would help enhance the neutrality, equity, and efficiency in the taxation of real estate income. The taxation of short-term rentals on a gross basis effectively aligns its treatment with that of rental income earned by businesses. Thus, the primary challenge appears to be one of tax administration rather than policy design, as there are indications that taxpayers may underreport or conceal such income with relative ease.[7] The significantly lower tax rate applied to long-term rentals under the Rent Act creates notable opportunities for tax arbitrage, e.g., property owners may exploit this differential by ostensibly renting properties long-term while informally engaging in short-term rentals. While the preferential tax treatment for long-term rentals under the Rent Act may be warranted as a measure to support housing affordability, it remains unclear why this category of rental income should be taxed more favorably than that of rental income of businesses. The current framework disadvantages professional rental operations, subjecting them to higher tax rates and more stringent regulatory requirements. To mitigate these distortions, it is recommended to standardize the taxation of rental income across property types and ownership arrangements, thereby enhancing neutrality, equity, and efficiency in the taxation of real estate income.

[5] For further details see Airbnb - Tax Guide 2024 - Iceland - REDLINE.docx

[6] Rental income earned by corporations is included in taxable corporate income and subject to the standard corporate income tax rate of 20 percent. In addition, dividends distributed from after-tax profits are subject to dividend taxation.

[7] For further details see the Bill amending the Act on Restaurants, Guesthouses, and Entertainment No. 85/2007.

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INTERNATIONAL MONETARY FUND

ICELAND

STAFF REPORT FOR THE 2025 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

May 27, 2025

Prepared By

The European Department
(in consultation with other departments)

CONTENTS

FUND RELATIONS _____ 2

FUND RELATIONS

(As of April 30, 2025)

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	428.14	101.79

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 Fund[1]
(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 2024 Article IV Consultation were held during May 7–May 22, 2024. The staff report (IMF Country Report No. 24/221 available at available at https://www.imf.org/iceland) was considered by the Executive Board on July 15, 2024. Article IV consultations with Iceland are currently held on a 12-month cycle.

Financial Sector Assessment Program (FSAP) Participation and ROSC:

The Financial System Stability Assessment (FSSA) for the last financial stability assessment was discussed by the Board on June 23, 2023. The FSSA and accompanying Reports on the Observation of Standards and Codes (ROSCs) are available at https://www.imf.org/iceland.

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	Distributional Effects of Tax Reforms and Expenditures	April 2015
MCM	Banking supervision	September 2015
MCM	Banking supervision	March 2016
FAD	Organic Budget Law implementation	April 2016
LEG	AML/CFT Risk-Based Supervision	2025–27

Statement by the Staff Representative on Iceland
June 16, 2025

This statement provides information that has become available since the staff report was issued to the Board on May 30, 2025. The thrust of the staff appraisal remains unchanged.

Revised national accounts data point to a sharper slowdown in 2024 and stronger momentum so far this year.[1] Real GDP growth for 2024 was revised down from 0.5 percent to -0.7 percent, largely due to substantial volume revisions to net exports in 2023 and 2024. Real GDP growth in 2025Q1 surprised to the upside, growing by 2.6 percent year-on-year. Stronger-than-expected exports, particularly services, was one of the main drivers. As anticipated in the staff report, private consumption and investment are picking up in line with the increase in real wages and a less restrictive monetary policy stance. Also, private investment was stronger-than-anticipated due partly to continued strong investment in data centers, though leakages to imports were significant.

The current account was also affected by the revisions. For 2024, the current account deficit was revised up by 0.2 percentage point of GDP. This reflected a sharp deterioration of the primary income balance, which was partly offset by an improved trade balance as net exports in nominal terms were revised upwards. The deficit remained elevated in 2025Q1, driven by imports of capital goods for data centers while the primary income balance improved due to lower profit repatriation by foreign companies.

Staff's policy advice remains as set out in the staff report. While the 2024 revision will have carryover effects into this year, it is more than outweighed by the stronger-than-expected performance in 2025Q1. Taken together, this suggests there are modest upside risk to staff's 2025 growth forecast. As these revisions mostly reflect movements in external trade, the impact on domestic demand and inflation is expected to be relatively small. Indeed, inflation declined to 3.8 percent year-on-year in May, indicating that the disinflation process continues apace. As a result, staff's assessment of fiscal and monetary policies is unchanged. The revisions also do not alter staff's assessment that Iceland's external position in 2024 was moderately weaker than the level implied by fundamentals and desirable policies.

[1] Statistics Iceland released on May 30th major revisions to national accounts data including from methodological changes for the period 1995-2024. In parallel, the Central Bank of Iceland released revised balance of payment figures for the same period.

Statement by Mr. Vasiliauskas, Executive Director for Iceland
and Ms. Ogmundsdottir, Advisor to the Executive Director
Executive Board Meeting
June 16, 2025

On behalf of our Icelandic authorities, we thank the mission team for the constructive discussions during the Article IV mission and a useful and well-balanced Article IV report and Selected Issues Paper. Our authorities broadly agree with the conclusions and recommendations of the staff reports.

Recent macroeconomic developments and outlook

Iceland successfully weathered the external shocks of recent years, and the large output loss of 2020 was fully recovered by 2023. The current account has been broadly balanced with a rising investment level supported by a strong national saving position. The positive net international investment position has continued to strengthen, led by growing foreign assets of pension funds, while external liabilities are at their lowest since the turn of the millennium.

The financial sector remains strong and resilient, and private sector debt has been contained at low levels in a historical and regional context. Treasury debt as a share of GDP is on a downward path and is close to the European median. Unemployment has been low, income levels have risen, and the króna exchange rate has remained broadly stable. This is testament to institutional improvements in recent years, sizable buffers and carefully designed macroeconomic and macroprudential policies aimed at building resilience and preserving economic and financial stability.

The strong post-pandemic rebound has led to increased capacity pressures and rising inflation. However, as the staff report highlights, a tight monetary and fiscal policy stance has succeeded in easing demand pressures in the economy, with inflation gradually declining.

The Central Bank of Iceland's latest macroeconomic forecast assumes a rebound in GDP growth this year, with a return to its trend growth rate by next year. Inflation is expected to fall below 3 percent in the latter half of next year and reach the 2.5 percent target in early 2027, slightly later than staff's projection of inflation reaching the target in the latter half of 2026.

The economic outlook remains highly uncertain, however, amid rising global geopolitical and trade tensions. The Icelandic economy will mainly be impacted indirectly through slowing global activity but is well placed to meet the challenges that these may pose.

Fiscal policy

The authorities are taking targeted steps to eliminate the budget deficit and reduce the debt ratio, thereby rebuilding fiscal buffers, contributing to reducing inflation, and facilitating a decline in interest rates. The fiscal outlook for 2025 has improved. The Government aims to achieve an overall surplus in 2028, for the first time since 2018. Moody's upgraded Iceland's credit rating to A1 from A2 in 2024. The main reasons for the upgrade were a declining debt ratio and an improved fiscal position, with a smaller budget deficit.

In 2026, revised fiscal rules will come into effect. A stability rule (net expenditure rule) will be implemented to support economic stability. The debt rule will be preserved to ensure sustainability, while the balanced budget and debt reduction rules will be discontinued. The rule limits expenditure growth to a maximum of 2 percent, which is lower than the long-term potential GDP growth rate and reduces procyclicality. Amid

continued global uncertainty, there is increased urgency to strengthen fiscal buffers. To ensure the Treasury can shoulder burdens in the event of future shocks, fiscal policy must remain prudent.

The Government has successfully completed the full privatization of Íslandsbanki by divesting its remaining shares in the bank. Initially, the plan was to sell the remaining shares in two separate offerings. However, due to strong demand in the public offering, with the participation of roughly 10 percent of the adult population in Iceland, all remaining shares were sold.

The wind-down of the Government-backed Housing Financing Fund (HFF) is coming to an orderly conclusion. The debt ratio (according to the Maastricht criteria) will decline by 5 percent of GDP as a result. In relation to the settlement, the Treasury has issued new Government bonds totaling ISK 540 billion, or 11.7 percent of GDP. This issuance serves to settle both the Treasury's previous borrowings from the HFF and its liability for the fund's outstanding obligations.

Monetary Policy

In May 2021, the Central Bank's Monetary Policy Committee (MPC) started unwinding the monetary support to offset the large contraction following the global pandemic. The policy rate reached 9.25 percent in August 2023 in an effort to contain the sharp increase in inflation following the post-pandemic recovery and the inflationary impact of Russia's war against Ukraine. Inflation gradually eased from its 10.2 percent peak in February 2023 to 3.8 percent in May this year. The policy rate has therefore gradually been lowered to its current level of 7.5 percent.

Monetary policy remains tight, reflecting the broad-based nature of inflation as can be seen from the fact that underlying inflation remains close to 4 percent and that medium-term inflation expectations have been stuck above 3 percent for a significant period.

At its May meeting, the MPC reiterated that it viewed a real policy rate of roughly 4 percent as a sufficiently tight monetary stance to ensure that inflation will return to target within an acceptable time frame. The committee, however, noted that given the remaining inflation pressures, any further easing would depend on inflation moving markedly closer to the Bank's inflation target and cautioned that a premature loosening of the monetary policy stance could reignite inflationary pressures and undermine the progress of re-anchoring inflation expectations.

Our authorities share staff's assessment that a tight monetary policy stance is needed to ensure that inflation returns to target, and inflation expectations become securely re-anchored. They also agree that the risks to the inflation outlook are broadly balanced.

Financial sector

The Icelandic financial system relies largely on bank-intermediation and a large and nearly fully funded pension fund system. The system has remained resilient, and the systemically important banks have maintained strong capital and liquidity ratios. Our authorities consider it of utmost importance to continue to safeguard financial system resilience.

Borrower-based measures (BBMs) have been used actively by the Central Bank in the current cycle. They have played an important role in safeguarding the resilience of household balance sheets. The housing market has shown clear signs of cooling lately, reflected in slower house price growth, reduced turnover, and declining new mortgage lending.

The Financial Stability Committee of the Central Bank has determined a positive neutral rate for the counter-cyclical capital buffer. Our authorities believe that strong and partially releasable capital buffers are important to safeguard financial stability, not least in the current environment of heightened global uncertainty. The impact of CRR III on capital levels will be assessed over the coming months and may lead to a reassessment of the current buffer requirements.

In April, the Central Bank initiated a program of regular foreign currency purchases in the interbank foreign exchange market. The main objective is to increase foreign exchange reserves, which are instrumental in maintaining economic and financial stability. At the end of 2024 reserves amounted to 118 percent of the IMF's reserve adequacy metric (RAM).

Recent volatility in international financial markets has had limited impact on financial markets in Iceland. Access to international capital markets has been ample at favorable terms for both the Government and the Icelandic banks. The Icelandic króna has remained broadly stable and the economy has not experienced capital outflows as frequently seen in previous risk off episodes.

Operational risk remains a central challenge to financial market participants and infrastructure in the current environment. Our authorities place great emphasis on ensuring that important infrastructure for the financial system is secure and effective, and that emergency plans are in place to address operational shocks, should they occur. The Central Bank is catalyzing projects to increase resilience in the payment system in line with the FSAP recommendations.

The Icelandic authorities have made a determined effort to implement the 2023 FSAP recommendations to enhance the resilience of the financial sector. Considerable steps have been taken to strengthen and bolster efficiency and synergy in banking supervision, including a reorganization of the supervision departments of the Central Bank, and enhanced internal governance. Additionally, resources for monitoring market risk and operational risk, including ICT and cybersecurity, have been increased. Monitoring of LCR by currencies was enhanced by adding various scenarios for individual currencies to the liquidity stress tests.

Changes to the Central Bank Act have widened the CBI's role and responsibility in macroprudential policy as well as in financial supervision through a merger with the Financial Supervision Authority. Thus, the Central Bank is now the sole institution responsible for price stability, financial stability and financial supervision and regulation. This arrangement has worked well. It has supported consistent policy decisions and implementation, and ensured transparency, sharing of decision-making power, and accountability.

Structural policies

Our authorities concur that sustained investments in both physical and human capital, along with efforts to promote innovation and improve allocative efficiency, are essential for sustaining Iceland's medium-term growth prospects. The Fund's recommendations are consistent with several initiatives already underway, such as the ongoing review of the legislation governing R&D incentives. This review aims to improve efficiency of measures and contain costs. In addition, the Government is in the final stages of preparing a new comprehensive Policy on Science, Technological Development, and Innovation covering the period through 2035. The policy is scheduled to be launched and submitted to Parliament in June 2025.

Furthermore, boosting productivity, value creation, and regional balance is a key policy priority of the Government. This will be achieved by a focus on a healthy labor market, creation of high-quality jobs, ensuring social protection, and preparing workers for the green and digital transitions.

Our authorities recognize the significant potential of AI to contribute to productivity growth. They share staff's view that Iceland's tight labor market may help mitigate the impact of job displacements associated with AI adoption. At the same time, they remain firmly committed to ensuring that public policy in this area is grounded in the principles of just and inclusive labor market transitions.

Our authorities agree that any housing support programs will need to be carefully designed to minimize risks to the economy. Additionally, our authorities see merit in exploring tax policy reforms aimed at reducing housing market distortions and incentivizing new supply.

To conclude

Our authorities highly value the Fund's vital role in the surveillance of the economy and financial sector and staff's dedication and quality engagement. They will carefully consider staff's recommendations.