Executive Summary

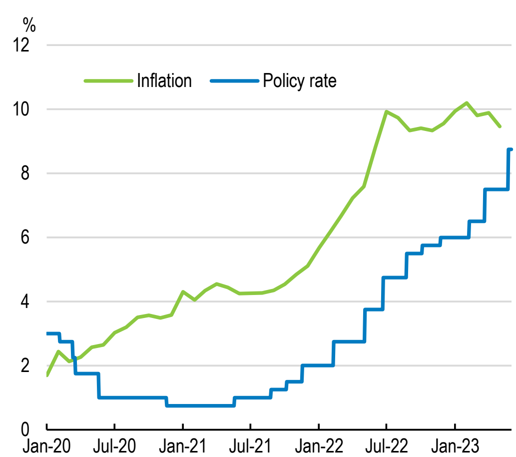
The economy remains strong, but inflation persists

The economy has expanded fast until recently, driven by a rapid recovery of foreign tourism and strong domestic demand. Growth is expected to slow gradually in the course of 2023 amidst tighter financial conditions.

Inflation remains persistent (Figure 1). It peaked in early 2023 at around 10% but has broadened, spreading to domestic services. Energy plays a small role for inflation since Iceland relies largely on domestic sources. Inflation expectations have become unanchored, even though the central bank has strengthened efforts to bring them back to target.

Figure 1. Inflation is persistent

Consumer price inflation and key policy interest rate



Note: Inflation refers to national headline consumer price inflation.
Source: Central Bank of Iceland; and OECD, Consumer Prices database.

StatLink https://stat.link/6aq0o7

Labour markets remain tight. The registered unemployment rate has hovered around 3.5% since mid-2022. Labour force participation is rising again after the pandemic-induced drop. However, imbalances, such as skills mismatch, the shortage of STEM and health care workers, or the simultaneous increase in unemployment and vacancies, are deepening. The decline in real wages may have come to a halt following the wage agreements of end-2022.

Growth is projected to slow (Table 1). Foreign tourism is likely to moderate as capacity limits become more apparent and economic conditions in the origin countries worsen. Tighter financial conditions will weigh on investment. Uncertainty surrounding the projections remains high.

Table 1. Growth is gradually slowing

(Annual growth, unless specified)	2021	2022	2023	2024
GDP at market prices	**4.3**	**6.4**	**4.4**	**2.6**
Private consumption	7.0	8.6	3.7	2.0
Gross fixed capital formation	9.8	6.9	- 5.5	3.1
Exports	14.7	20.6	5.0	3.8
Imports	19.9	19.7	- 1.8	2.4
Unemployment rate	6.0	3.7	3.9	4.3
Consumer price index	4.4	8.3	7.4	3.3
Current account (% of GDP)	- 2.8	- 1.8	- 0.8	- 0.2
Budget balance (% of GDP)	- 8.4	- 4.3	- 2.5	- 1.4
General government gross debt (% of GDP)[1]	77.2	78.4	78.6	78.6

1. Includes unfunded liabilities of government employee pension plans.
Source: OECD Economic Outlook No. 113 database.

Monetary and financial policies are being tightened

The central bank raised the key interest rate and tightened macro-prudential rules for financial institutions and households, notably in the face of higher risks coming from the housing market.

Interest rates are rising. In May 2023, the central bank raised the key policy rate to 8.75%, the 13th hike since tightening started in May 2021. Interest rates are now 8 percentage points higher than two years ago. The central bank had engaged in small-scale quantitative easing in 2020 but has since stopped buying treasury bonds (passive quantitative tightening).

The financial system looks stable overall. Corporate and household credit are expanding but debt levels remain modest. To address emerging risks, the central bank increased the counter-cyclical buffer from 0% to 2% in September 2022 and announced a further increase to 2.5% for March 2024. The capital adequacy ratios of the three systemically important banks are well above requirements. Íslandsbanki, the second-largest bank, has been partly privatised. Privatisation of the last tranche of 42% has been postponed to 2023-24.

Housing market risks remain elevated. House prices rose fast until mid-2022. The sharp increase in interest rates has cooled markets. Servicing mortgages has become more difficult, but household defaults remain low. To reduce debt service cost in the short term, households are increasingly turning to mortgages indexed to inflation. Housing supply is picking up.

Fiscal policy should be tightened more

Fiscal policy is contractionary, but costs related to ageing pose a risk to long-term debt sustainability.

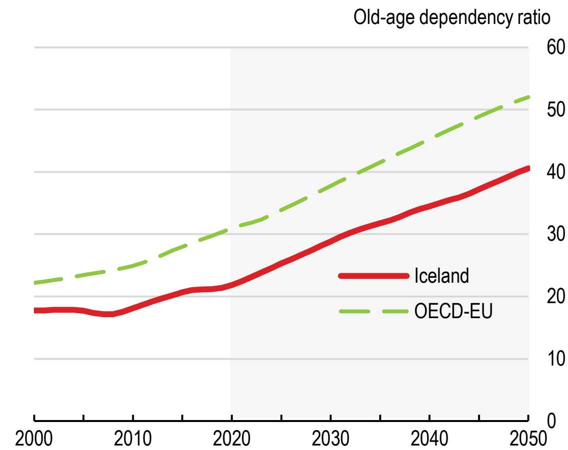
The general government fiscal balance recovered from around -9% in 2020 to around -4.5% in 2022, and the fiscal stance has become contractionary. Public debt as measured by the OECD rose from around 61% of GDP in 2019 to around 78% in 2022, while contingent liabilities continue to decline. The government projects the debt ratio to decline from 2023 and the budget to return to balance in 2027.

Government spending has been pro-cyclical most of the time since the turn of the millennium. However, the fiscal framework adopted in 2015 has improved the budget process. Adding a spending rule could help reduce procyclicality further.

Ageing costs are rising. Iceland's population is getting older and growing more slowly (Figure 2). The government projects health and long-term care spending to rise by more than 3% of GDP by 2050, although from a lower level than in almost any other OECD country. Reforms to the retirement age and others, such as reducing tax expenditures, would slow the build-up of debt.

Marginal tax rates for low-and middle-income earners are high, reducing their incentives to work. High marginal tax rates could also discourage second earners, often women, from taking up work or working longer hours, partly driving the large gap in working hours between men and women.

Figure 2. Iceland is ageing, but less than other OECD countries



Note: The old age dependency ratio is the number of individuals aged 65 and more to the population aged between 15 and 64.
Source: United Nations, Department of Economic and Social Affairs, Population Division, World Population Prospects 2022.
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Improving the business climate

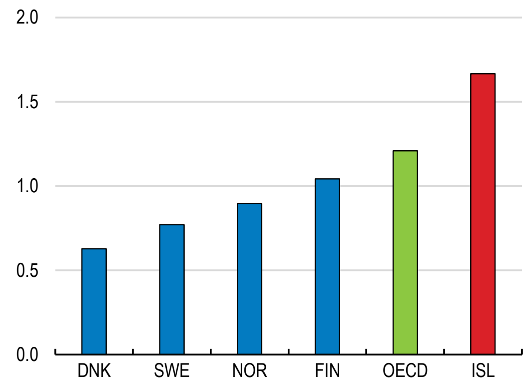
Labour productivity has been trending up by around 1% yearly, close to the OECD average, but has recently slowed. Structural reforms could reinvigorate productivity growth and help with the fight against inflation.

Despite progress, further improvements in the business climate are called for. Over the past two years reforms opened the tourism sector to more competition. Similar measures were implemented in the construction sector, and licensing requirements have been eased or removed for some professions. Even so, barriers to entry for domestic and foreign companies remain high (Figure 3). The licensing and permit system for professional services is extensive, and reform meets with resistance from vested interests. Access for companies domiciled outside the European Economic Area is more restricted than in other OECD countries.

The electricity market could be more open. Productivity increases in the power sector have been close to the OECD average. This mostly state- and municipally-owned sector has been following EU minimum regulatory requirements since 2003 and reforms to create a transparent and fully operational wholesale market are underway.

Figure 3. Entry barriers have long been high

Barriers to domestic and foreign entry, 2018



Note: A higher indicator value means more stringent regulation. Reforms since 2018 have not been taken into account.
Source: OECD, Product Market Regulation database.
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Iceland's insolvency framework is cumbersome. Firms face more barriers to restructuring or exit than in most other OECD countries. Temporary simplifications introduced during the pandemic should become permanent.

Making the most of immigration

Immigration has increased rapidly since the late 1990s, with the share of foreign citizens soaring to around 18% of the population by mid-2023, transforming the economy and bringing benefits and challenges. A comprehensive approach is needed to make the most of immigration.

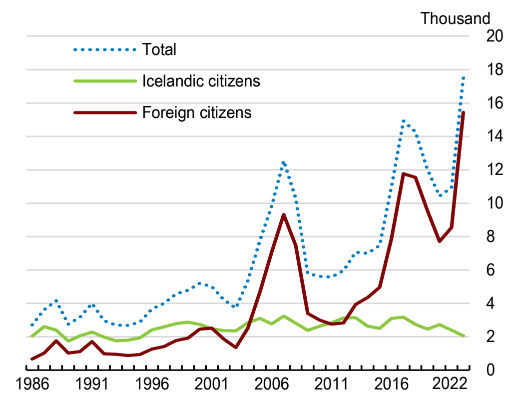
Immigration has visible impacts on the economy. Increasing immigration yields large demographic gains to Iceland, helping to contain the pressures of an ageing population (Figure 4). There are also important labour market benefits arising from increasing migration inflows in the form of enhanced flexibility, knowledge transfer and support to fast-growing sectors.

However, important challenges regarding the integration of immigrants need to be addressed. Effective language training and efficient skills recognition are essential for helping immigrants to meet their potential. At the same time, immigrants' skills should be strengthened, including through more job opportunities in the public sector by developing a specific strategy to this end, as well as through re-skilling.

A better integration of immigrants requires further efforts in the areas of education and housing. Solid foundational and vocational skills are key to stronger education outcomes of immigrant students, with increased teacher preparedness for diverse classrooms a prerequisite. Moreover, the supply of social and affordable housing needs to be expanded, as planned.

Figure 4. Immigration has risen fast

Immigration flows



Note: Immigrating Icelandic and foreign citizens who obtain a residence permit or a work permit for over three months.
Source: Statistics Iceland.
StatLink https://stat.link/smnqax

Decarbonising the economy

Iceland has committed to reduce carbon emissions from their 1990 level by 55% by 2030, by joint agreement with the European Union and Norway. It should do so in a sustainable and cost-efficient manner.

Iceland's per capita carbon emissions exceed the OECD average but are declining. Industry makes up an outsized share because of the oil-powered fishing fleet and three large aluminium smelters. Agriculture is also emitting carbon above the OECD average.

Climate policies need to be strengthened further. Costs and benefits of individual emission reduction measures listed in the climate action plan have been more thoroughly assessed. Reduction targets could be set in partnership with individual sectors. Regulatory procedures for wind energy are being developed. Carbon pricing should be broadened and a path for further rises laid out.

Main findings	Key recommendations
Monetary and fiscal policies	
Inflation has far exceeded the target for more than two years.	Tighten monetary policy further if needed to re-anchor expectations and to bring inflation back to target in due time.
The fiscal stance has turned contractionary.	Continue to tighten fiscal policy and reinstate the fiscal rule by 2026 at the latest.
Iceland's natural capital generates rents for tourism that can be tapped.	Remove tax exemptions in the tourism sector, notably the reduced VAT rate.
Policies to improve the business climate	
Labour market imbalances, in particular skills mismatch, are high.	Invest in education and skills that are high in demand such as STEM and health care, and foster gender balance across professions and economic sectors.
The power wholesale market is not fully operational. Some contracts between power producers and customers are opaque.	Set up a transparent electricity wholesale market coordinated by an independent operator.
Decarbonising the economy	
Albeit falling, carbon emissions remain above the OECD average.	Extend carbon taxation to all greenhouse gases and to all areas not covered by the EU emission trading scheme. Map out a gradual increase in the carbon tax so that tax levels in the non-ETS sectors converge to those in the ETS sectors.
Abatement costs of various climate actions have been thoroughly assessed. They vary strongly across actions.	Based on cost-benefit analysis, prioritise climate actions that carry a low cost per tonne of reduced carbon emissions. End actions with high cost.
Addressing the challenges and unleashing the benefits of immigration	
There is scope to attract more highly skilled immigrants in view of specialist shortages in frontier sectors, notably ICT.	Proceed with the timely implementation of the new provisions for the issuance of work permits for foreign experts. Ensure a swift adoption of the draft bill envisaging an extension of the duration of residence and work permits for foreign experts.
The unemployment rate and overqualification are higher for immigrant workers than for natives, largely reflecting relatively poor command of Icelandic, with room to define more clearly the role and responsibilities of stakeholders in the provision of language training for adult immigrants.	Make language training for adult immigrants part of a comprehensive approach to immigrant integration, combining it with vocational training, and by involving all partners. Increase the accessibility and flexibility of the language training courses. Ensure coherence of teaching quality standards and introduce student evaluation in language training of adult immigrants to help them improve their learning outcomes.
Refugee inflows have increased rapidly in recent years.	Ensure a successful integration of refugees, notably through supporting the rapid acquisition of language skills.
The skills recognition system is complex and information on recognition requirements and processes difficult to access, discouraging third-country immigrants from applying.	Ensure clear eligibility rules and well-coordinated procedures for the recognition of foreign qualifications. Ease access to the skills recognition system by establishing a one-stop shop that offers multiple services to immigrants.
Immigrant students underperform their native counterparts by a wide margin in reading literacy and have higher upper secondary drop-out rates.	Implement the Education Policy 2030 measures for students with a diverse linguistic background within the envisaged timeline.
Immigrants face high housing costs, and the stock of social and affordable housing does not appear to be sufficient to match the needs of an increasing immigrant population.	Better target housing allowances at low-income households and ensure appropriate investment in social and affordable housing based upon a rigorous assessment of pending demand.

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