

# Iceland: Staff Concluding Statement of the 2026 Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC: An International Monetary Fund mission, led by Metodij Hadzi-Vaskov and comprising Thomas Gade, Amit Kara, and Harri Kemp, held discussions for the 2026 Article IV consultation with Iceland virtually during May 26–29 and in Reykjavik during June 2–11, 2026. The mission met with Prime Minister Kristrún Frostadóttir, Central Bank Governor Ásgeir Jónsson, Minister of Finance Daði Már Kristófersson, and other representatives of the public and private sectors. At the conclusion of the visit, the mission issued the following statement:

The authorities have appropriately tightened macroeconomic policies in response to domestic demand pressures. Notwithstanding, wage growth, inflation, and inflation expectations remain elevated, while high global uncertainties due to the war in the Middle East have tilted risks to growth to the downside and inflation risks to the upside. The policy priorities are thus to lower inflation sustainably to target and increase resilience to shocks by further building fiscal buffers and advancing structural reforms.

Economic activity moderated in the past years, while inflationary pressures remained elevated. Growth slowed markedly since mid-2023 amid tight macroeconomic policies, weaker labor inflows, and idiosyncratic shocks. After a contraction in 2024, the economy expanded modestly in 2025, supported by consumption and investment. Meanwhile, exports remained weak while imports were boosted by data center investments, resulting in a widening of the current account deficit. Inflation remained well above the Central Bank of Iceland's 2.5 percent target, reflecting persistent wage and housing cost pressures and persistently elevated inflation expectations. While the labor market has cooled, wage growth continues to outpace productivity, adding to inflationary pressures and questions about competitiveness. The external position is assessed to be moderately weaker than warranted by fundamentals.

The economy is projected to recover, led by a rebound in net trade, while inflation is expected to increase due to the Middle East war. Growth is projected to recover gradually with GDP expanding by 1.8 and 2.1 percent in 2026 and 2027, respectively. Economic activity is supported by a rebound in exports and easing financial conditions, while average inflation is expected to remain elevated at 5.2 percent in 2026 and 3.2 percent in 2027, before declining toward target by early-2028. Medium-term growth is supported by productivity gains from continued diversification toward new export-oriented sectors, including aquaculture, biotech, renewable energy, and digital infrastructure, contingent on sustained efforts to boost business dynamism, reduce

skills shortages, and foster innovation.

Risks to growth are tilted to the downside and inflation risks to the upside. Key risks include an escalation of global geopolitical tensions, stronger-than-expected wage growth, and disruptions to key export sectors. The principal downside risk is a more intense or prolonged war in the Middle East. Further increases in energy prices, combined with a tightening in financial conditions and lower growth in main trading partners—as assumed in the April 2026 WEO severe scenario—could result in an important weakening of the macroeconomic outlook. Under this scenario, GDP growth would be 0.6 and 0.5 percentage points lower, and inflation would be 0.8 and 1.7 percentage points higher in 2026 and 2027, respectively. The relatively lower fuel import dependency and favorable energy mix would dampen the economic impact on Iceland compared to many other advanced economies.

#### Fiscal Policy: Building Buffers and Bolstering Resilience

The fiscal stance in 2026 is appropriately contractionary and supports the disinflation effort. The planned consolidation reflects a combination of revenue measures and expenditure restraint, overall leading to a modestly negative fiscal impulse in 2026. The main revenue measures include the introduction of a kilometer-based vehicle tax and the full-year effect of fisheries-related levies, while expenditure restraint is achieved through public sector streamlining and consolidation. This is appropriate given elevated inflation and the need to rebuild fiscal buffers. At the same time, temporary measures to mitigate the impact of higher energy prices, including the reduction in the VAT rate on fuel, should remain time-bound and be phased out as planned, as they weaken price signals and are not well targeted. Should energy prices remain elevated for longer, any additional support should be well targeted to vulnerable households and offset elsewhere in the budget to preserve the fiscal consolidation path and meet the deficit targets.

The medium-term fiscal targets are appropriately ambitious and should be fully implemented. The Medium-Term Fiscal Strategy envisages achieving a balanced budget by 2027 and a surplus thereafter, placing public debt on a firm downward trajectory. These targets are well calibrated given the still-elevated level of public debt relative to Nordic peers and the economy's exposure to shocks. While planned revenue measures remain important as part of the consolidation process, expenditure restraint is expected to continue—including through a downsizing of the public sector wage bill. Staff projections, which only include legislated actions, suggest that the planned measures, if implemented, are broadly sufficient to meet the deficit targets. Longer-term spending pressures are expected to rise due to rising health costs and needed investments in infrastructure, but remain moderate compared to many advanced economies.

Balancing consolidation with growth-enhancing investment remains a key challenge. Scaling up public investment—particularly in energy and transport infrastructure—is essential to close maintenance gaps, alleviate bottlenecks, support diversification, and raise potential growth. The authorities' plans to establish a state-owned infrastructure company and expand the use of public-private partnerships could help mobilize additional investment. It will be important to ensure that the associated fiscal risks—including contingent liabilities and off-balance-sheet exposures—are carefully contained, transparently recorded, and subject to regular monitoring.

Should additional measures be needed to meet the MTF5 targets, mitigate long-term spending pressures, or scale up infrastructure investment, the authorities could consider:

**Revenue raising measures:** Raising the preferential VAT rate and/or narrowing the range of eligible goods and services—could generate additional revenues estimated at close to 0.5 percent of GDP. Housing taxation could also be increased, including by restricting the capital gains exemption on housing and raising the property tax rate on vacant land. In addition, there is scope to streamline tax expenditures, including by reassessing the 2020 increase in the ceiling on business R&D; expenditures eligible for tax relief.

**Rationalizing government spending:** Staff analysis suggests scope for rationalization and reallocation, including by improving education outcomes for a given level of spending, reviewing spending on recreational services, and containing growth in the public sector wage bill. Such reforms could help support medium-term growth while strengthening fiscal sustainability.

Should revenue raising and spending rationalization measures prove insufficient to create the fiscal space needed to scale up infrastructure investment, the authorities could consider a more gradual convergence toward the debt target. This should be accompanied by clear communication on measures and timing to reinforce the authorities' commitment to the fiscal rules and the medium-term debt anchor.

A strong fiscal framework, supported by timely and accurate data, would bolster the credibility and transparency of the consolidation effort. The amended fiscal rule should help contain spending over the medium term. The existing legislation provides a sound basis to regularly reassess the current 2 percent expenditure growth limit, given uncertainty around Iceland's future growth prospects, exposure to shocks, and changes in the composition and costs of public spending. Ongoing efforts to strengthen the Fiscal Council are welcome and will require a meaningful increase in its capacity and resources. Regular publication of timely and independently verifiable quarterly fiscal data consistent with the fiscal rule perimeter would further strengthen fiscal transparency. In this context, the recent uncertainty surrounding the 2025 outcome of the general government deficit underscores the importance of timely information

sharing and inter-institutional coordination. Finally, expanding the coverage of the budget and the fiscal rules to encompass the entirety of the central government would increase transparency.

#### Monetary Policy: Ensuring a Durable Return to Target

The monetary policy stance remains appropriately restrictive, but vigilance is warranted. With inflation and inflation expectations persistently above target, monetary policy has limited scope to look through external shocks, including those stemming from higher global energy prices due to the war in the Middle East. The recent policy rate increase reflects these pressures, and further tightening may be needed in the near term should inflationary pressures persist or intensify.

A sustained and durable reduction in inflation will require maintaining an appropriately restrictive stance for some time. Once inflationary pressures begin to ease, a gradual reduction in the policy rate would be appropriate, but policy should remain restrictive until inflation and expectations are firmly anchored at the target. Staff analysis suggests that the projected path of inflation would be consistent with a gradual reduction in the policy rate over time, but the pace of easing should remain cautious and contingent on incoming data. Upside risks to inflation—notably from wages or energy prices—would warrant keeping rates higher for longer, while a sustained undershooting of the target would allow for faster easing.

Clear communication and a data-dependent approach will be essential in the current environment of elevated uncertainty. Strengthening communication—particularly through the systematic use of alternative scenarios linking wage developments, inflation expectations, and policy responses—would enhance transparency and anchor expectations. As uncertainty declines, a gradual transition toward a more forecast-based inflation targeting framework would improve predictability and reduce volatility.

Further strengthening external buffers would bolster resilience. The accumulation of foreign exchange reserves—including through the Central Bank of Iceland’s regular FX purchase program—has improved resilience. While reserves are adequate for precautionary purposes, increasing them toward the upper end of the IMF’s reserve adequacy (ARA) range would further mitigate risks from external shocks and exchange rate volatility. Complementary efforts to deepen the foreign exchange market—including derivatives markets—would support investor participation, enhance hedging opportunities, and improve overall market functioning.

#### Financial Sector: Preserving Stability Amid Emerging Risks

The banking sector remains resilient and systemic risks are contained, but pockets of vulnerability persist. Banks are well capitalized, profitable, and liquid, with strong asset quality. However, vulnerabilities are emerging in specific sectors, notably construction

and tourism-related activities, where weaker demand and rising inventories have increased risks. The housing market has cooled, with declining real prices and rising inventories, reducing earlier pressures but also increasing downside risks to household balance sheets.

The current macroprudential stance is broadly appropriate. Capital buffers remain high and have strengthened the resilience of the financial system. Borrower-based measures (BBMs) have been effective in containing risks and should remain broadly unchanged, particularly in the current environment of declining housing market activity. Recent easing of such measures helped offset tighter financial conditions following legal developments in the mortgage market. With housing-market risks now receding, BBMs should remain on hold to avoid reinforcing the housing slowdown while continuing to serve as a structural backstop. Efforts to reduce reliance on CPI-indexed mortgages may strengthen the transmission of monetary policy, but should be carefully timed and sequenced given their role in supporting borrower resilience and financial stability.

Sustaining the momentum in implementing Financial Sector Assessment Program (FSAP) recommendations will require continued efforts. Staff welcome the significant progress achieved in implementing the recommendations from the 2023 FSAP. Further progress in strengthening pension fund governance and enhancing the financial independence of financial supervision remains important.

#### Structural Policies: Boosting Productivity and Diversification

Sustaining medium-term growth will require stronger productivity growth and economic diversification. As the tourism sector matures and its contribution to growth stabilizes, future gains in living standards will increasingly depend on productivity-enhancing structural reforms and the expansion of higher value-added sectors. Iceland's strong fundamentals—including high human capital and digital readiness—provide a solid basis for such a transition.

Reforms should focus on enhancing business dynamism, innovation, and labor market efficiency.

Reducing regulatory barriers and streamlining licensing and permitting processes would support competition and firm growth. Iceland maintains relatively high barriers to entry in parts of the services sector, leading to large productivity gaps between firms, suboptimal resource reallocation, and higher markups, which contributes to persistently elevated service-sector inflation. While ongoing efforts to simplify the regulatory framework to boost dynamism and increase competition are welcome, future priorities should include further streamlining licensing and permitting procedures, reducing overly restrictive FDI/foreign entry regulation, and simplifying the insolvency regime for small and medium enterprises (SME) to reduce exit costs and facilitate the reallocation of resources to more productive firms/sectors.

Addressing skills shortages and reforming wage-setting arrangements are critical to sustaining competitiveness and supporting the disinflation process. Stepping up implementation of education reform, expanding vocational training, and improving reskilling opportunities would help reduce skill mismatches and support labor reallocation toward higher value-added sectors. On wage-setting, including public-sector unions in the coordinated bargaining round alongside the private sector and better synchronizing negotiation rounds would strengthen coordination and help align economy-wide wage growth with productivity and the inflation target. Strengthening the state mediator's authority to trigger binding votes on proposed settlements would help resolve protracted bargaining impasses.

Closing infrastructure gaps is essential to support diversification and remove binding supply constraints. Expanding energy generation and transmission capacity, improving transport infrastructure, and enhancing digital connectivity and skills would alleviate bottlenecks and support economic diversification. Streamlining project approval processes and improving planning frameworks would facilitate timely implementation.

Improving the efficiency of R&D; support and strengthening the innovation ecosystem would further support firm scaling and diversification. Despite high R&D; spending, innovation outcomes have been mixed: Iceland produces fewer innovation outputs than expected given its level of R&D; spending. While Iceland's venture capital ecosystem has grown, the challenge remains in scaling firms beyond the startup phase. Improving the efficiency and targeting of R&D; incentives and further developing the nascent venture capital ecosystem will be critical to achieving stronger innovation outcomes.

The authorities' recent reform package aimed at boosting long-term growth aligns well with staff's key structural reform recommendations. The policy priorities in the authorities' Growth Plan to 2035—particularly on energy infrastructure, regulatory simplification, STEM education, and innovation support—focus on key areas essential for raising productivity and potential growth. As the agenda is ambitious both in scope and timeline, with 35 proposed measures across ten ministries in the Action Plan 2026-27, sustained cross-ministerial coordination, prioritization of high-impact actions, and continued monitoring and reporting of progress will be critical for effective and timely implementation.

EU accession and euro adoption are ultimately political choices that involve balancing deeper integration and potential credibility gains against reduced macroeconomic policy autonomy. Joining the EU (and, ultimately, the euro area) would deepen trade and financial integration, eliminate exchange rate risk vis-à-vis the euro area, and could support investment and productivity. Euro adoption could also help anchor inflation expectations over time, facilitate the gradual convergence of market interest rates toward euro area peers, and provide access to euro area financial architecture,

including the Banking Union. However, adopting the euro would entail the loss of independent monetary policy and exchange rate flexibility—tools that have helped absorb large and sometimes asymmetric shocks over the last decade and a half. Losing monetary autonomy would increase reliance on sound fiscal policy for stabilization, placing greater demands on a strong countercyclical fiscal framework. As labor market flexibility is already high, the focus should be on aligning wage growth with productivity gains and advancing productivity-enhancing structural reforms—important factors for external competitiveness, but especially critical in the absence of the exchange rate as an adjustment tool. Should the process move forward, these considerations also underscore the importance of adopting the euro from a position of low inflation, sustainable public finances, and a parity consistent with fundamentals to avoid locking in an overvalued real exchange rate that would undermine competitiveness and force adjustment through internal devaluation.

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