

Iceland: taming the inflation spectre

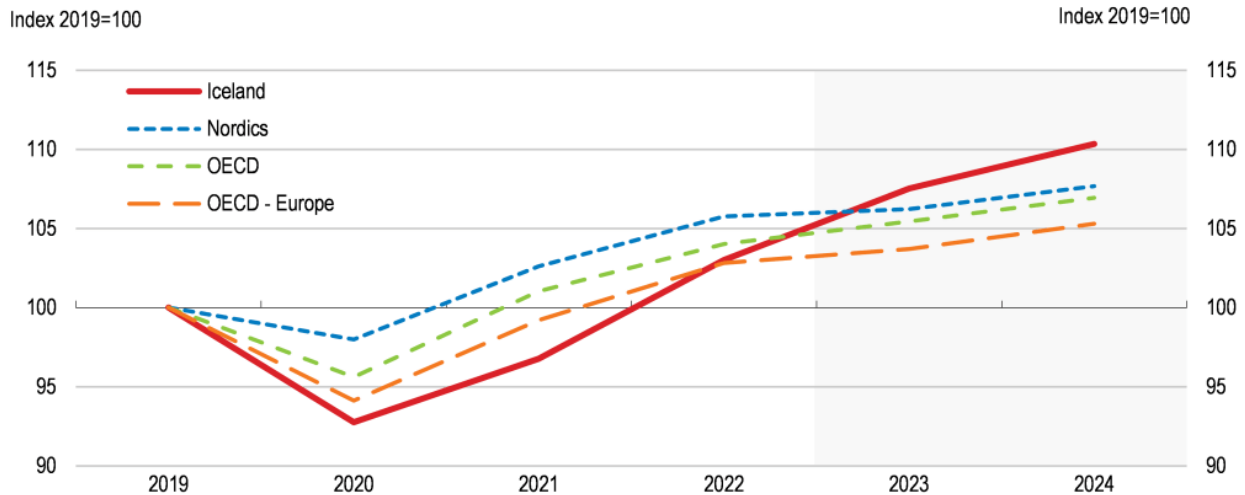


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Iceland's economy is riding high. Since the pandemic, the country's growth has been one of the fastest of the OECD, driven by exports of energy-intensive goods and services and a strong rebound of foreign tourism. Relying on domestic energy sources, the country has largely been spared the power crisis that has strangled other countries, as shown in the Economic Survey of Iceland.

Iceland's performance is strong

GDP level, volume



Source: OECD Economic Outlook No. 113 database.

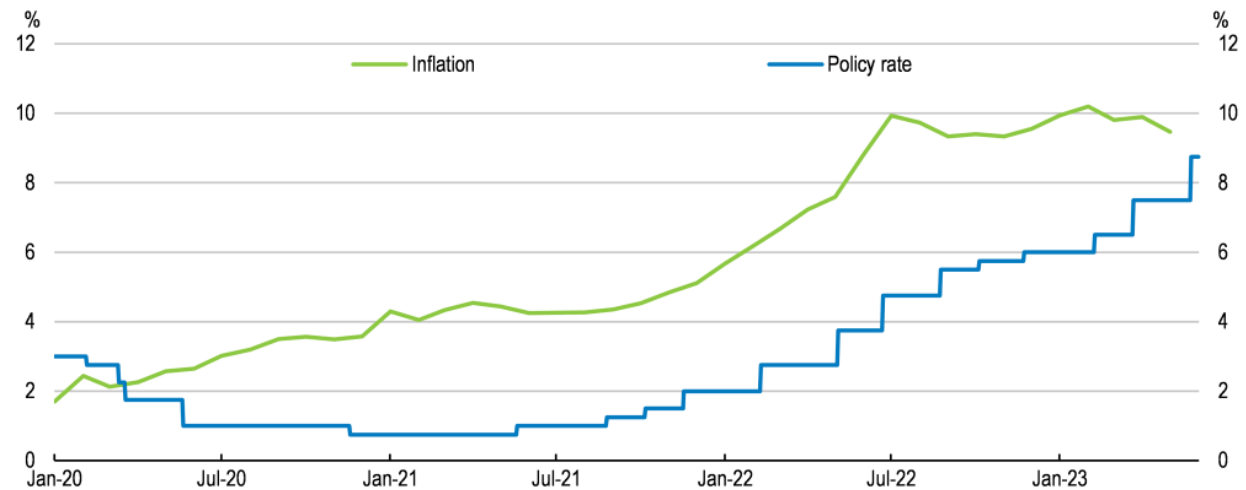
Unemployment is low and stable at around 3.5%, and labour participation of both men and women is again reaching historical highs. Economic growth is expected to moderate from 6.4% in 2022 to 4.4% in 2023 and 2.6% in 2024, still well above the OECD average.

Inflation remains stubbornly high

Yet everything is not cool in Iceland. Since mid-2022, headline inflation has been hovering at around 10%, much above the central bank's target of 2.5%. Unlike in continental European countries, Iceland's inflation surge was initially propelled by house prices. Those shot up by around 50% between mid-2020 and mid-2022, driven by the strong post-pandemic recovery and labour immigration. Inflation is now increasingly transmitted to the wider economy, notably the domestic service sector. Inflation expectations have de-anchored.

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; OECD, Consumer Prices database.

Three decades ago, Iceland succeeded in putting an end to entrenched inflation and repeated inflation bursts. It should do so again, tightening monetary policy further as needed to bring inflation back to the target and avoid a wage-price spiral. Fiscal policy should work in the same direction as monetary policy and avoid any stimulus, while limiting support to vulnerable households.

Structural reform could help raise productivity and tame inflation

Over the past few years reforms opened the tourism sectors to more competition. Despite these improvements, barriers to entry, notably for start-ups, are high. Foreign access to the computer service and construction sectors is more restricted than in any other OECD country. Professional licencing requirements were hardly eased as attempts met with resistance from vested interests.

The government should continue its efforts to improve the business climate. Strengthening competitive forces will not only help raise productivity growth – currently at 1%, which is around the OECD average – but also contribute to bring inflation down.

Building on Iceland's natural capital and reducing carbon emissions

Iceland hosts more tourists per inhabitant than any other OECD country, exerting pressure on infrastructure and the environment. Climate change is altering a part of Iceland's natural capital such as oceans and glaciers, jeopardising several tourism services. Iceland should continue to develop a balanced strategy for productive and sustainable tourism. It should remove the current tax privileges in the tourism sector, notably the reduced VAT rate, and it should introduce a tourism levy to fund local sustainable tourism infrastructure.

The government has strengthened climate policies over the past two years and carried out thorough cost-benefit analysis of abatement measures. Carbon emissions are declining gradually. Yet per capita emissions remain above the OECD average. The government should strengthen climate action further in a sustainable and efficient manner. It should notably strengthen carbon taxation and prioritise climate actions with low abatement cost per tonne of carbon.

References

OECD (2023), *OECD Economic Surveys: Iceland 2023*, OECD Publishing, Paris, <https://doi.org/10.1787/b3880f1a-en>.