Central Bank stress test 2025 — scenarios

The Central Bank of Iceland's annual stress test is intended to evaluate financial institutions' resilience to a scenario based on a simulated economic shock. The test is a systemic one — i.e., a macroprudential stress test — with a cyclical stress scenario spanning a three-year period. It provides information useful in the formulation of macroprudential policy and in overall financial market risk assessment and supervision, including the supervisory review and evaluation process (SREP). The Bank publicises the main results of the stress test conducted on systemically important banks in the autumn issue of its *Financial Stability* report.

The scenarios used for the stress test are published as well, giving other parties the opportunity to use them in their own stress testing. Parties wishing to do so are advised to conduct an independent appraisal of the scenarios' suitability for their internal stress tests. The design of the stress scenario centres primarily on the risks involved in banking operations. Furthermore, the time horizon of the scenario is selected with an eye to evaluating risk in banking operations, while longer- or shorter-term scenarios may be better suited to other types of risk.

Baseline scenario 2025

The baseline scenario is built on assumptions about economic developments in coming years as described in the Central Bank's baseline forecast in *Monetary Bulletin* 2024/4, with the exception of interest rates. Developments in short-term interest rates are based on the average of forecasts prepared by the three large commercial banks in late 2024, and developments in five-year interest rates are derived from the Treasury yield curve as of 30 December 2024.

The stress scenario for 2025

The stress scenario is based on an analysis and assessment of the current state of the financial system and current risks to financial stability in Iceland (for further information, see *Financial Stability* 2024/2). It should be noted that the stress scenario does not represent the Central Bank's forecast of expected developments in economic variables. The time series for the stress scenario are obtained by simulation using the Bank's quarterly macroeconomic model (QMM).

The shock in the 2025 stress scenario is of external origin. Elevated tensions in international relations cause business relationships to rupture and emphasis on world trade to diminish. The impact of this is severe and lasting. Economic sectors that rely on global supply chains will be affected first, and unemployment will rise as a result. Economies around the world will suffer a contraction. In addition, wars will escalate, pushing energy prices higher. This will then affect commodity prices and, finally, the general price level, whereupon interest rates will rise. Increased defence spending by European countries in response to war, together with interest rate hikes and weaker output growth, will significantly erode their debt ratios. Cyberattacks on European banks increase in tandem with the souring of international relations, so that banks' creditworthiness and risk premia deteriorate over and above those of companies in other sectors.

The direct impact on the domestic economy surfaces in imports and exports, among other things. Tourist arrivals decline in number due to higher unemployment in trading partner countries. Visitors to Iceland will number 2.120 million in 2025, 2.060 million in 2026, and 2.027 million in 2027, as compared with the Icelandic Tourist Board's forecast of 2.300 million in 2025, 2.460 million in 2026, and 2.560 million in 2027. Other export sectors will also have difficulty due to tariffs and declining demand, with the overall effect that exports will contract by an average of 5.3% per year over the horizon of the scenario. For comparison, the contraction is similar to that in 2019, when headwinds in the tourism industry emerged. The effects will also show in declining business investment, as investment has been strong recently in sectors that rely heavily on exports – such as data centres, pharmaceuticals, and land-based aquaculture. Investors can be expected to respond quickly to changed conditions, with the result that business investment will shrink by 17.8% in 2025 and 2026 combined. This will cause unemployment to rise to a peak of 7.7%, on average, in 2026, and GDP to contract by 3.3% in 2025 and 2.4% in 2026. Public investment is assumed to be unchanged relative to the baseline scenario, although tax revenues will fall, unemployment-related expenditures will rise, and terms of Treasury bonds will be unfavourable.

A contraction in the economy will result in output below potential and a decline in inflation. The króna is also relatively stable for the first year, with the real exchange rate rising by nearly a percentage point in 2025. The króna will then depreciate by just over 6 percentage points per year in 2026 and 2027. Inflation will be marginally above the baseline forecast in 2025, or 4.2%. In 2026 it will average 2.9%, and in 2027 it will be 1.1%. Short-term interest rates will fall steeply as a result. In the first year of the scenario they will fall by 1.5 percentage points, and by 2027 they will be down to an average of 0.8%. Long-term interest rates will fall as well: five-year nominal rates will fall by 2.7 percentage points in the first year of the scenario and reach an average of 3.6% in 2027. The nominal yield curve as inferred from these two maturities will be more steeply inverted at the outset and then improve over the course of the scenario, and by mid-2026 it will be upward-sloping.

There will also be a strong impact on key asset markets. Chief among them is the commercial real estate market, where prices will fall between end-2024 and end-2025 by nearly 25.5% in nominal terms and by 28.7% in real terms. At the same time, house prices will fall by 20.2% in nominal terms and 23.6% in real terms. It is assumed as well that the price gap between new and older properties closes, so that homes still on contractors' and construction companies' books fall by an additional 5 percentage points. Share prices fall by 35.6% between end-2024 and end-2025, owing both to contagion from foreign equity markets, where prices fall even more sharply, and to the importance of world trade for the largest companies on the stock exchange.

Because of the aforementioned wars, the price of oil and aluminium rises persistently by nearly 50% in the first year of the scenario. The rise in aluminium prices generates increased revenue for the Icelandic economy, but oil prices push costs higher for aluminium production and for the economy as a whole. Marine product export prices decline by a combined 12.2% in the first two years of the scenario, however, because of tariffs and trade barriers.

Access to financing is not assumed to be restricted, but spreads on corporate bond issues and bank funding are expected to widen, to 150 basis points on CPI-indexed domestic market funding and 200 basis points on non-indexed funding. Premia on the banks' foreign funding are 600 basis points above reference interest rates, while the spread on Icelandic Treasury bonds issued in foreign currencies will be 175 points above the general interest rate level.