



The Icelandic Economy

Current State, Recent Developments and Future Outlook



VIÐSKIPTARÁÐ ÍSLANDS
ICELAND CHAMBER OF COMMERCE

Key Facts



Did you know?

- The number of tourists visiting Iceland in 2016 escalated to a record high 1.8 million (40% growth between years)
- Iceland is the biggest per capita electricity producer in the world.
- Iceland's parliament, Alþingi, was established in 930 AD, making it the world's first legislative assembly
- Iceland is one of the least densely populated countries in the world, with 3.2 inhabitants per km²
- Vigdís Finnbogadóttir, the 4th president of Iceland, was the first democratically elected female head of state
- Iceland is a member of NATO but does not have any military forces
- Iceland was the first country in the world to establish an equal pay legislation requiring private companies and government agencies (25 employees +) to prove they offer equal pay regardless of gender

Foreword

In the aftermath of the financial crisis in 2008, when Icelandic authorities let the three largest banks collapse, implementation of strict capital controls, austerity measures and series of reforms followed. Scepticism was rife around this controversial model as Iceland was set to reinvent itself.

Now, after nearly 10 years of rehabilitation, the country has fully recovered and has become one of the world's top performers in terms of GDP growth, 7.2 percent in 2016, with unemployment levels at an all time low or just under 2 percent.

Interest from foreign parties on the Icelandic economic situation after the crisis and the lack of a holistic overview to accommodate that interest was the spark to an idea of this type of status report, which was first published in 2008 on a more frequent basis. Now The Iceland Chamber of Commerce (ICoC) publishes The Icelandic Economy report every year.

Despite some structural changes of the report the aim has always been the same; to provide an objective overview of the current economic, business and political landscape in Iceland, recent events and developments, and future economic prospects.

There are three sections in this report. The first section primarily provides a fact-based overview of Iceland's current economic landscape. The second section gives an overview of the political landscape and then dives into more specific and recent developments of the main sectors of the economy. The categorization used for the different sectors; financial, domestic, international and resource sector, is based on the momentous report "Charting a Growth Path for Iceland" by McKinsey & Company, whose publication was a turning point in the restoration of the Icelandic economy after the financial crisis. Recent changes in the housing and labour markets are addressed as well. Lastly, the third section reflects on future scenarios, longer term growth prospects and the so-called four focus lenses which the Chamber will operate under in the coming years.

It is our hope that this report will be useful to those looking to gain an overview and further insight into the Icelandic economy and the state of its current affairs.



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Acknowledgements

The following companies supported the publication of this report



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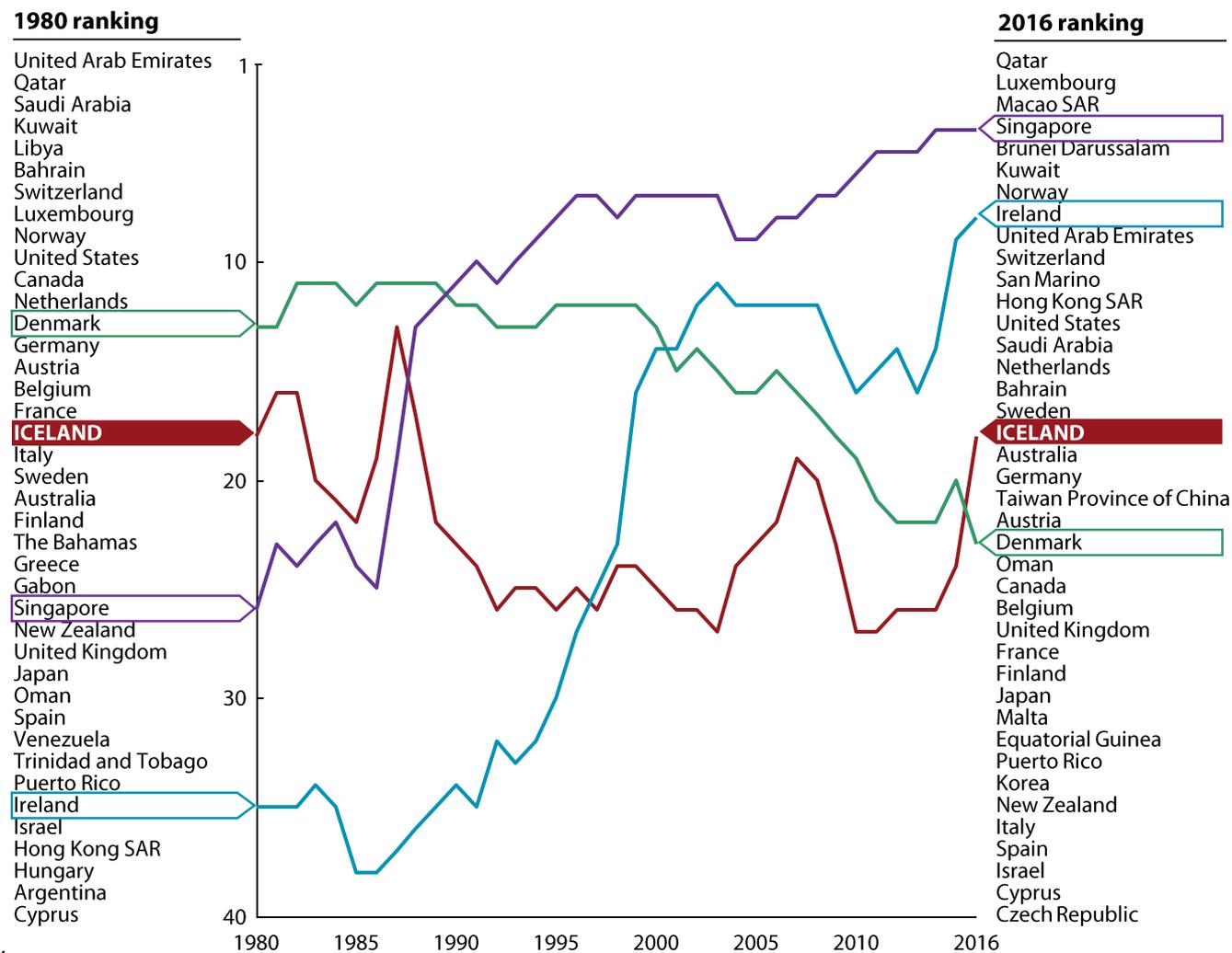


Án titils (2014) - Arnar Birgis

Figure 1.1

Iceland has a high standard of living and has largely recovered from the recession

Country rankings, GDP per capita (PPP¹ adjusted)



¹ Purchase Power Parity

Figure 1.2

Iceland ranks highly in numerous competitive indices

Competitiveness Rankings (Iceland's rank for 2016 / total number of countries)

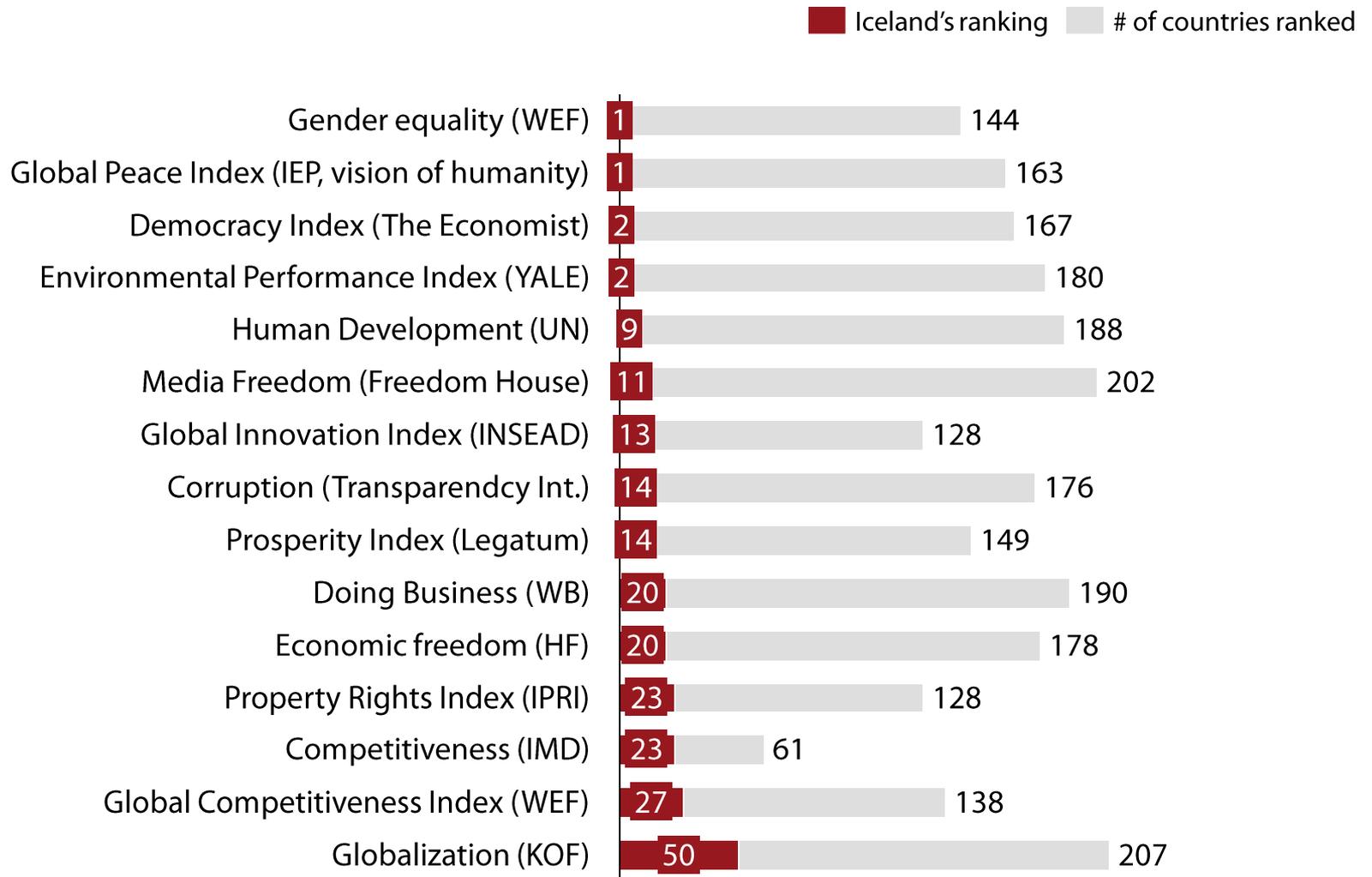


Figure 1.3

The economy shrank following the financial crisis but is now experiencing growth and positive future outlook

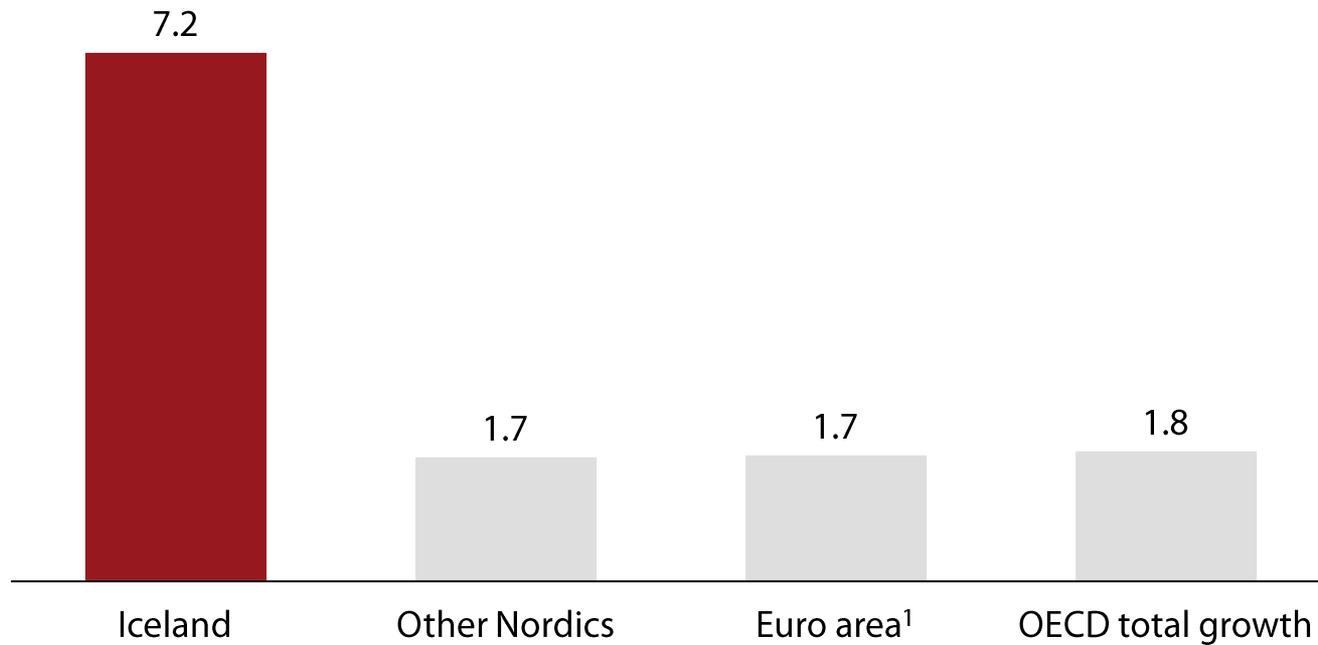
GDP growth per capita (percent)



Figure 1.4

Iceland's economy was one of the fastest growing in the world in 2016

GDP growth in 2016 (percent)



¹ The OECD time series used had 15 euro area countries: Austria, Belgium, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovak Republic, Slovenia and Spain

Figure 1.5

Unemployment decreased after a sharp rise in 2009 and is now near structural unemployment levels

Unemployment Rate (percent; yearly average)

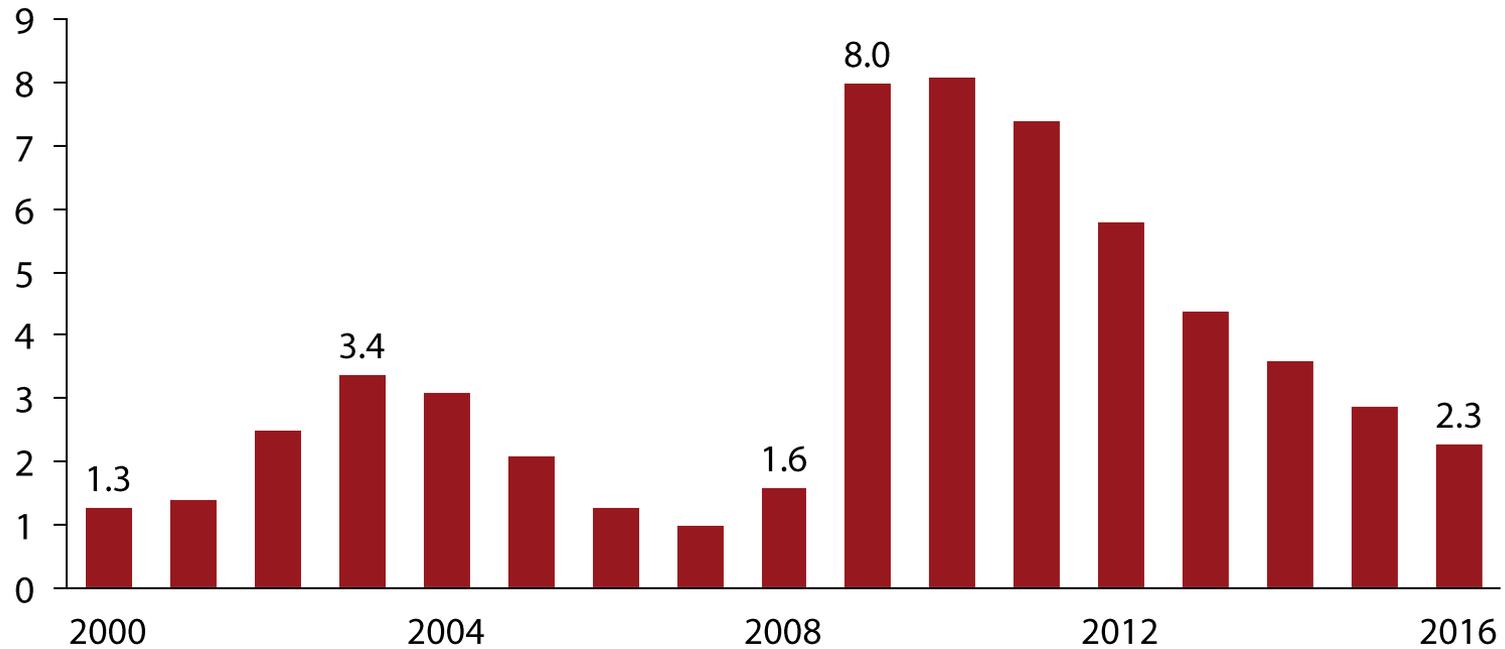


Figure 1.6

To keep up with shortage of labour there has been an influx of foreign workers in the economy

Labour Demand (# of workers; % of companies)

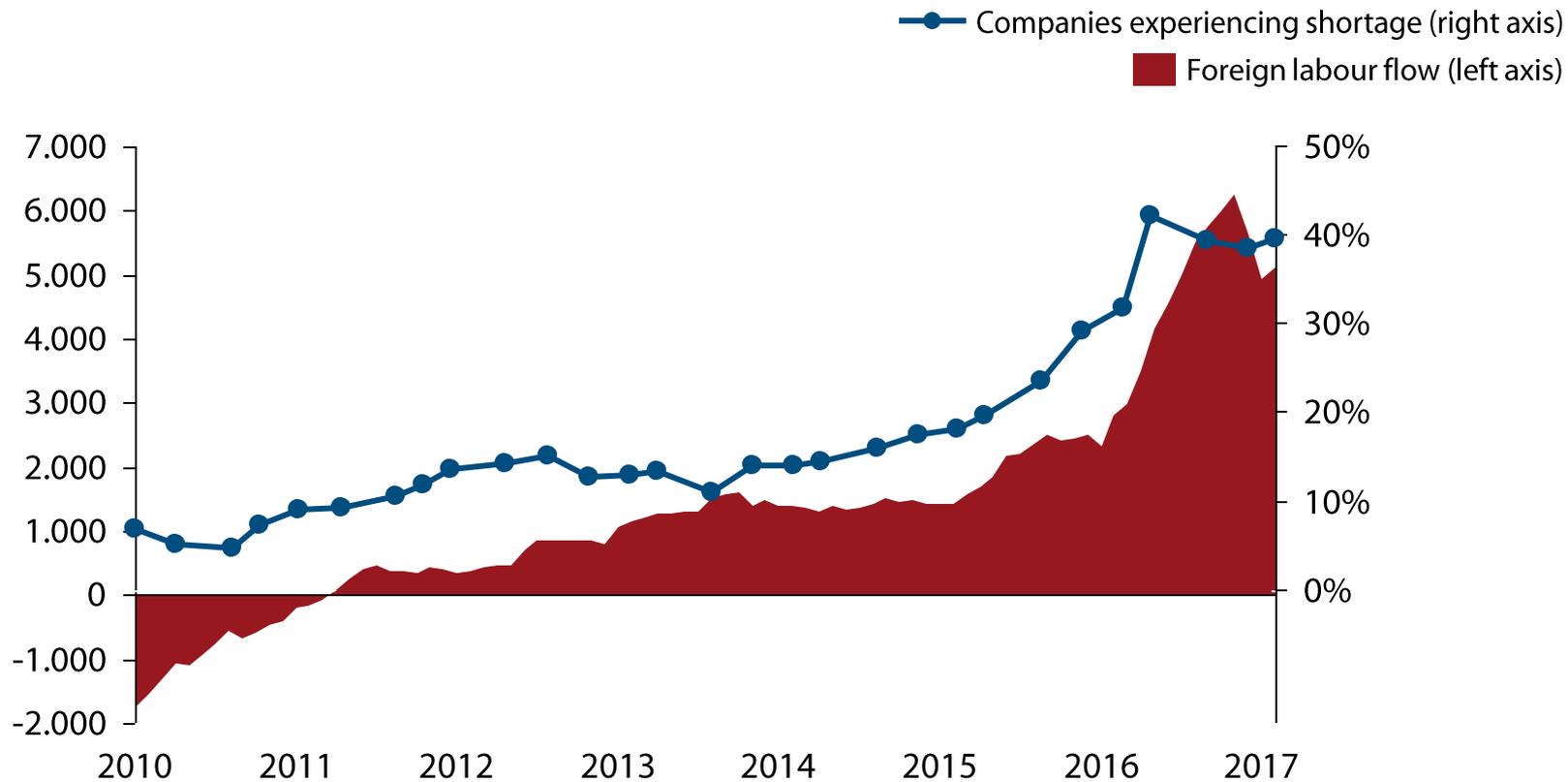


Figure 1.7

Private debt has declined significantly, especially corporate debt, and is now at pre-crisis level

Corporate and Household Debt (percent of GDP)

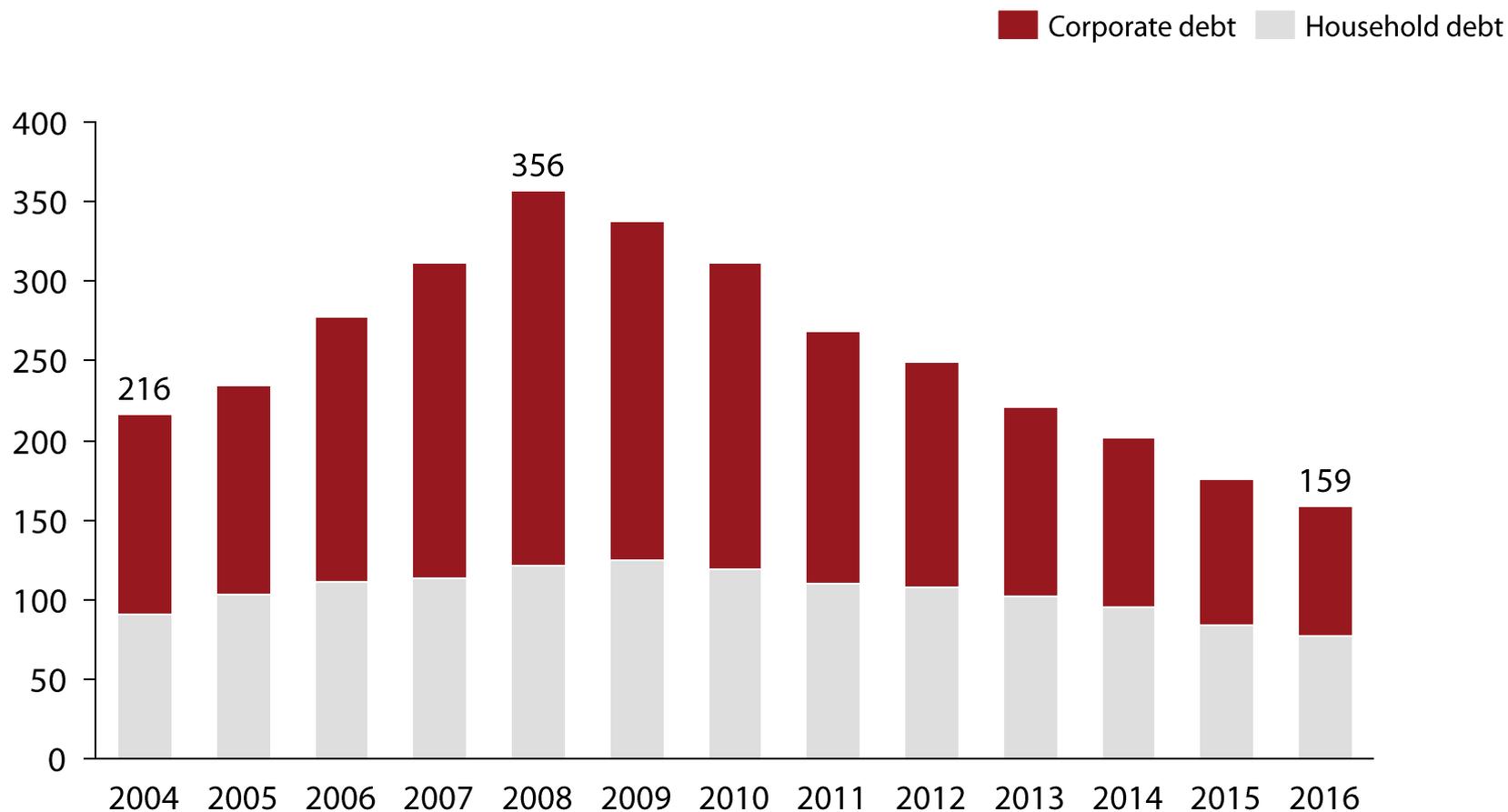
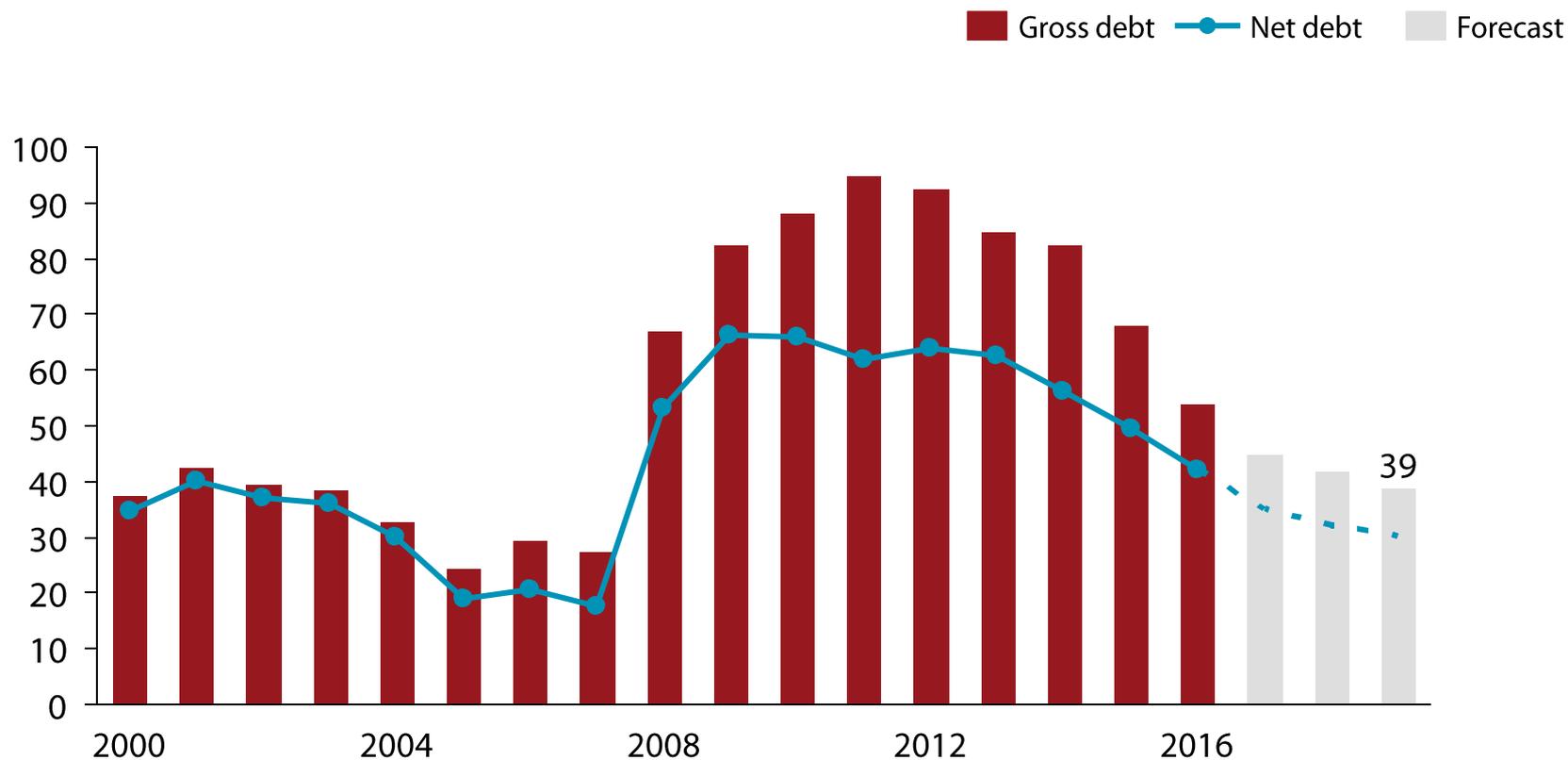


Figure 1.8

Public debt more than tripled following the financial crisis but has fallen significantly in recent years

General Government Debt (percent of GDP)



1 Predictions by the Central Bank of Iceland

Figure 1.9

Inflation rose following a devaluation of the krona but is now within the Central Bank's target range

Annual Inflation Rate (percent)

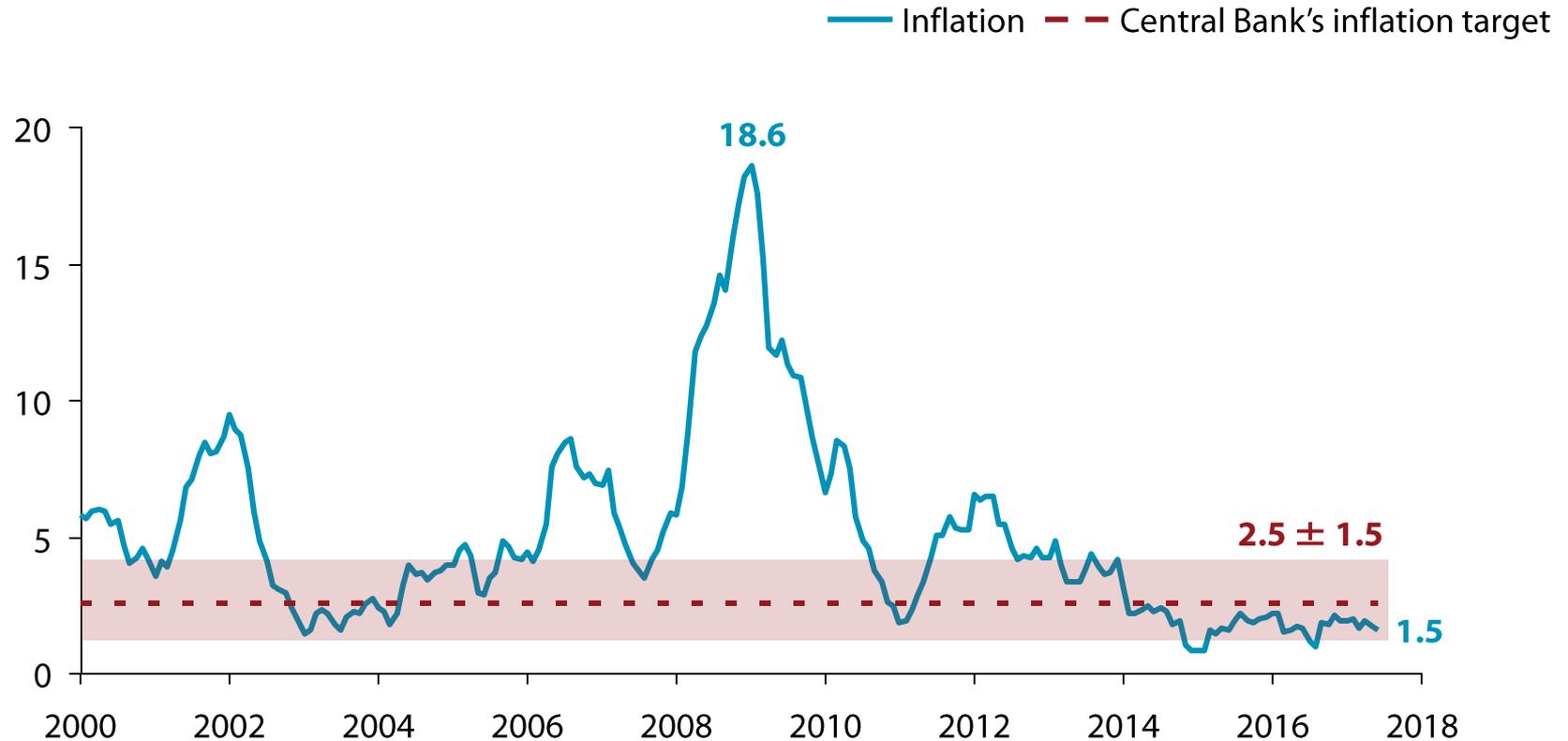


Figure 1.10

Interest rates in Iceland are high compared to developed economies

Central Bank Key Interest Rates (percent)

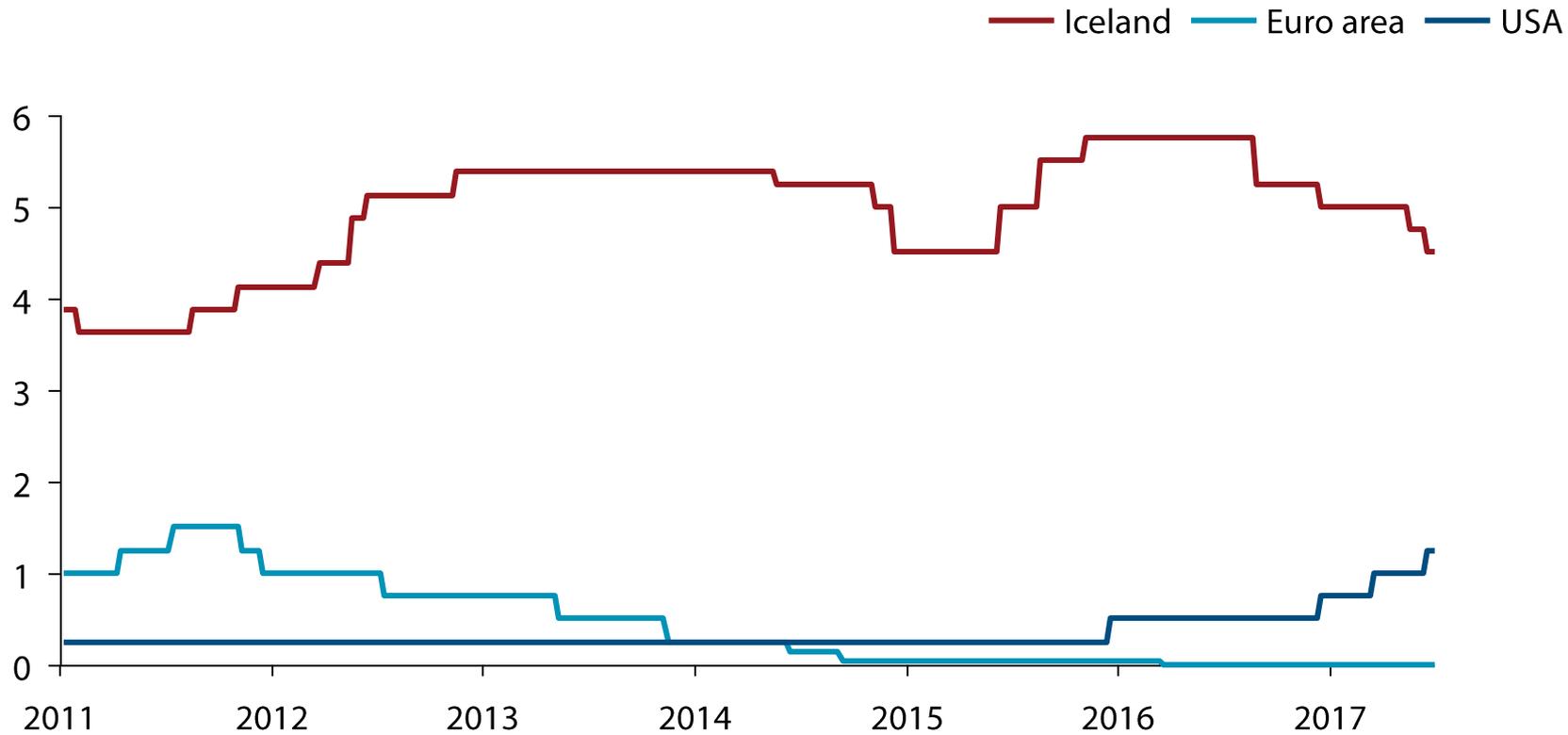


Figure 1.11

After years of high exchange rates the Króna depreciated in the financial crisis, but has now strengthened again

Exchange Rate Index (a higher index value indicates a weaker Icelandic Króna)

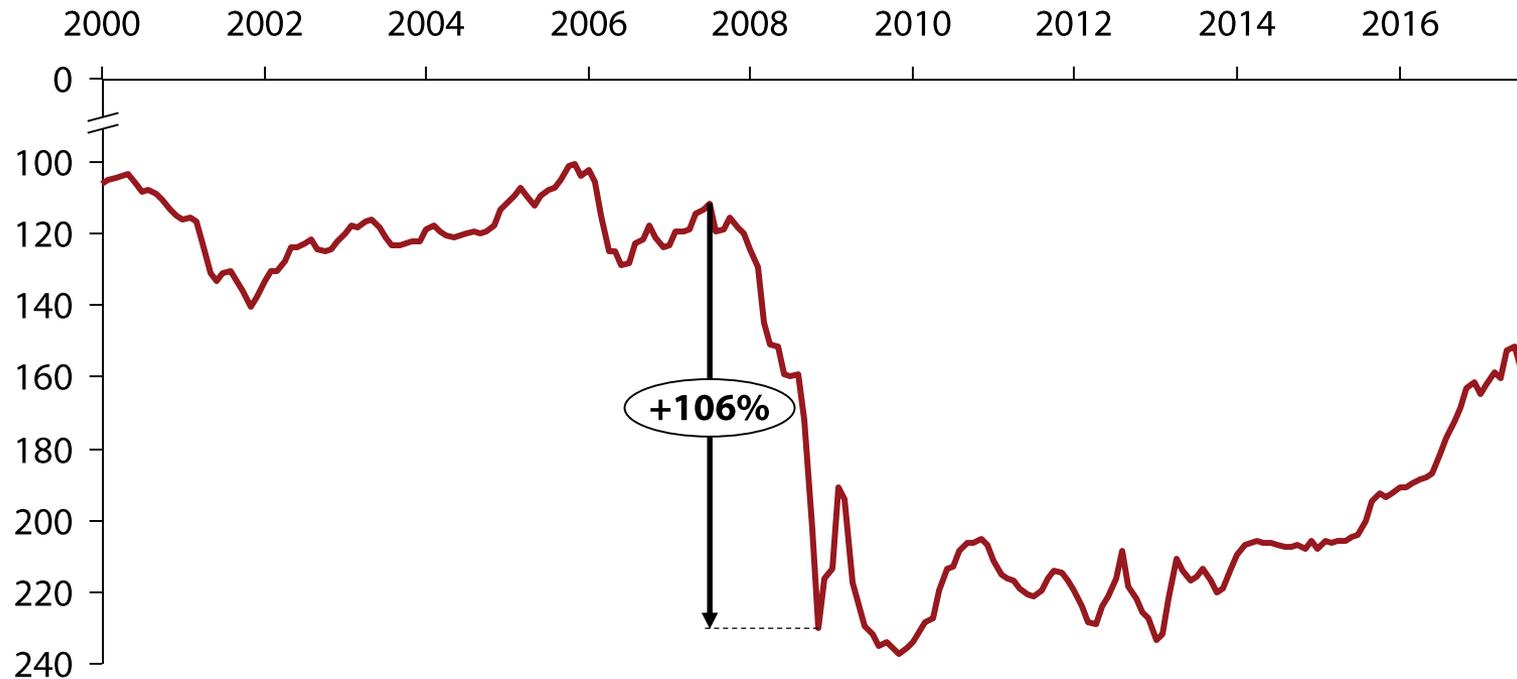
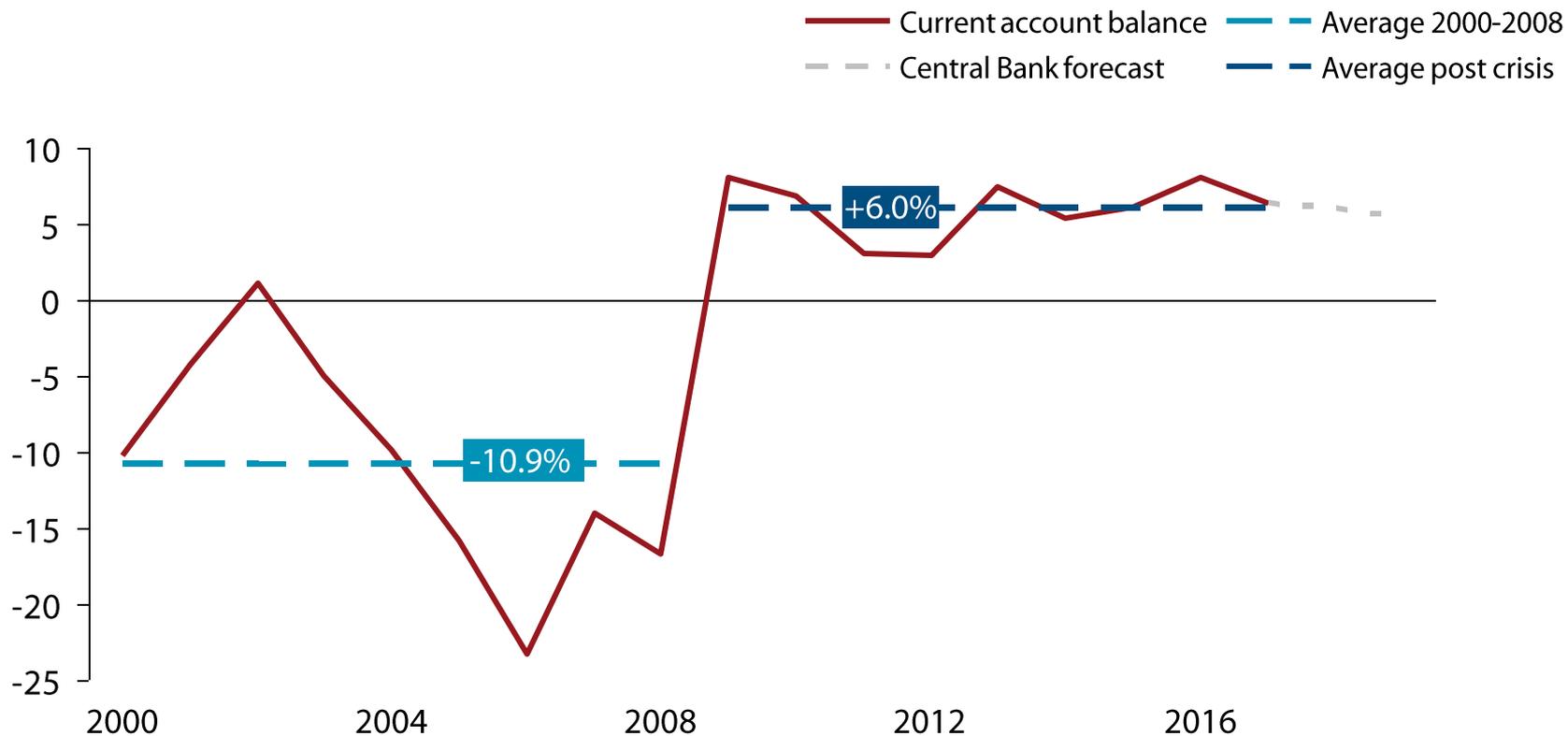


Figure 1.12

The devaluation of the Króna balanced out a persistent current account deficit and supported a surplus since 2012

Current Account Balance¹ (percent of GDP)

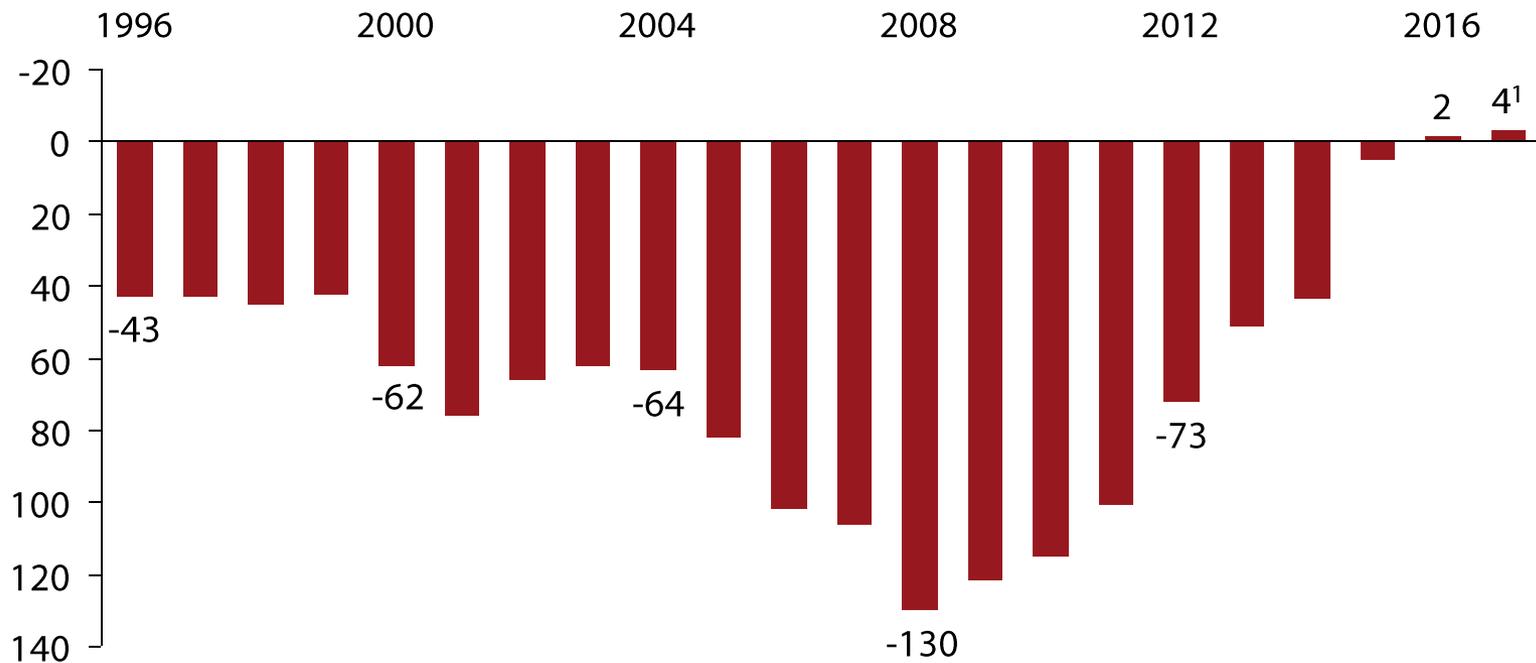


¹ Underlying current account, excludes the effects of the failed banks' estates

Figure 1.13

A persistent current account deficit led to significant foreign obligations which have since been eliminated

Iceland's Net International Investment Position (NIIP) (percent of GDP)

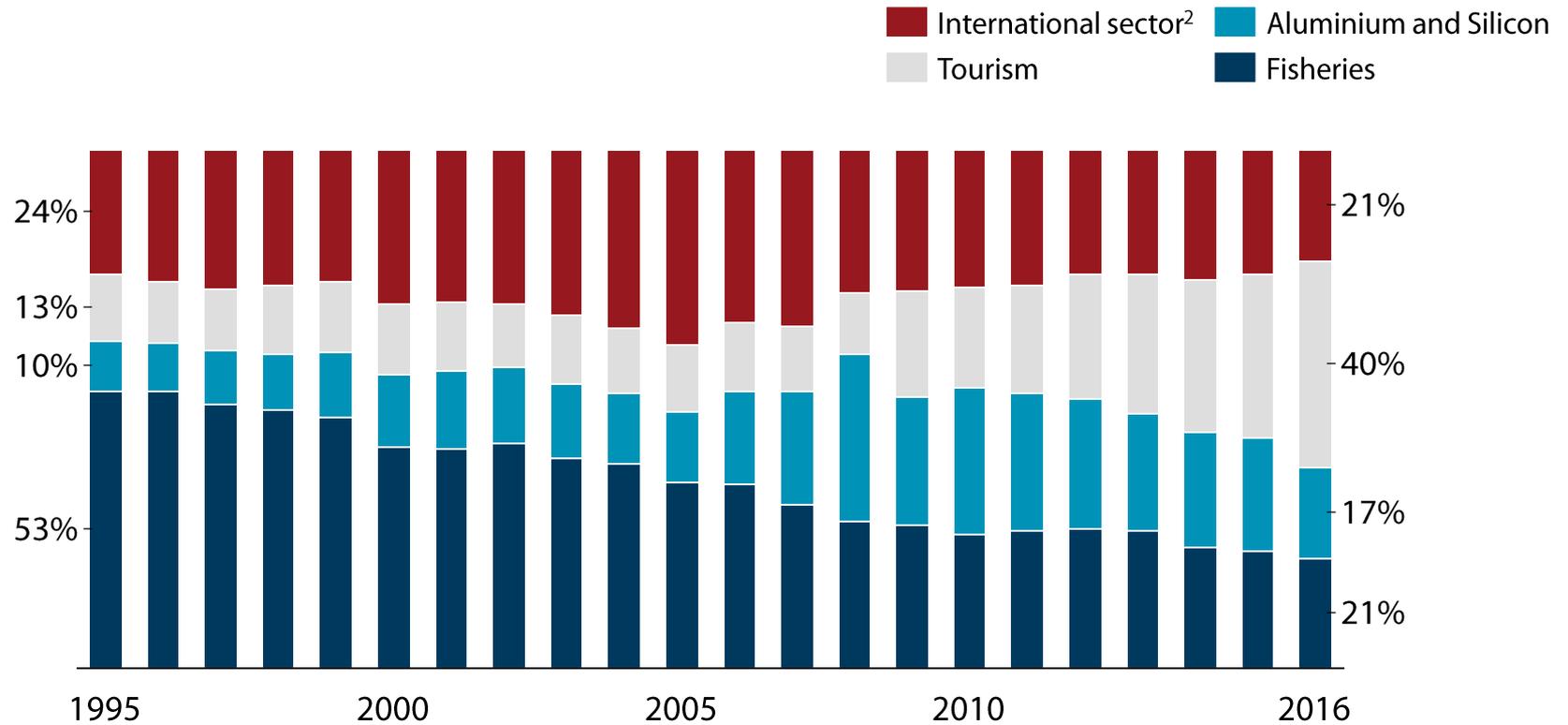


1 First quarter of 2017

Figure 1.14

Iceland has historically been dependent on fishing but three other export foundations have since emerged

Iceland's Exports¹ (sector share of total exports)



¹ As agriculture is heavily subsidised and only a small fraction of total exports, it is dropped from this analysis

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Án titils (2016) - Arnar Birgis

Figure 2.1

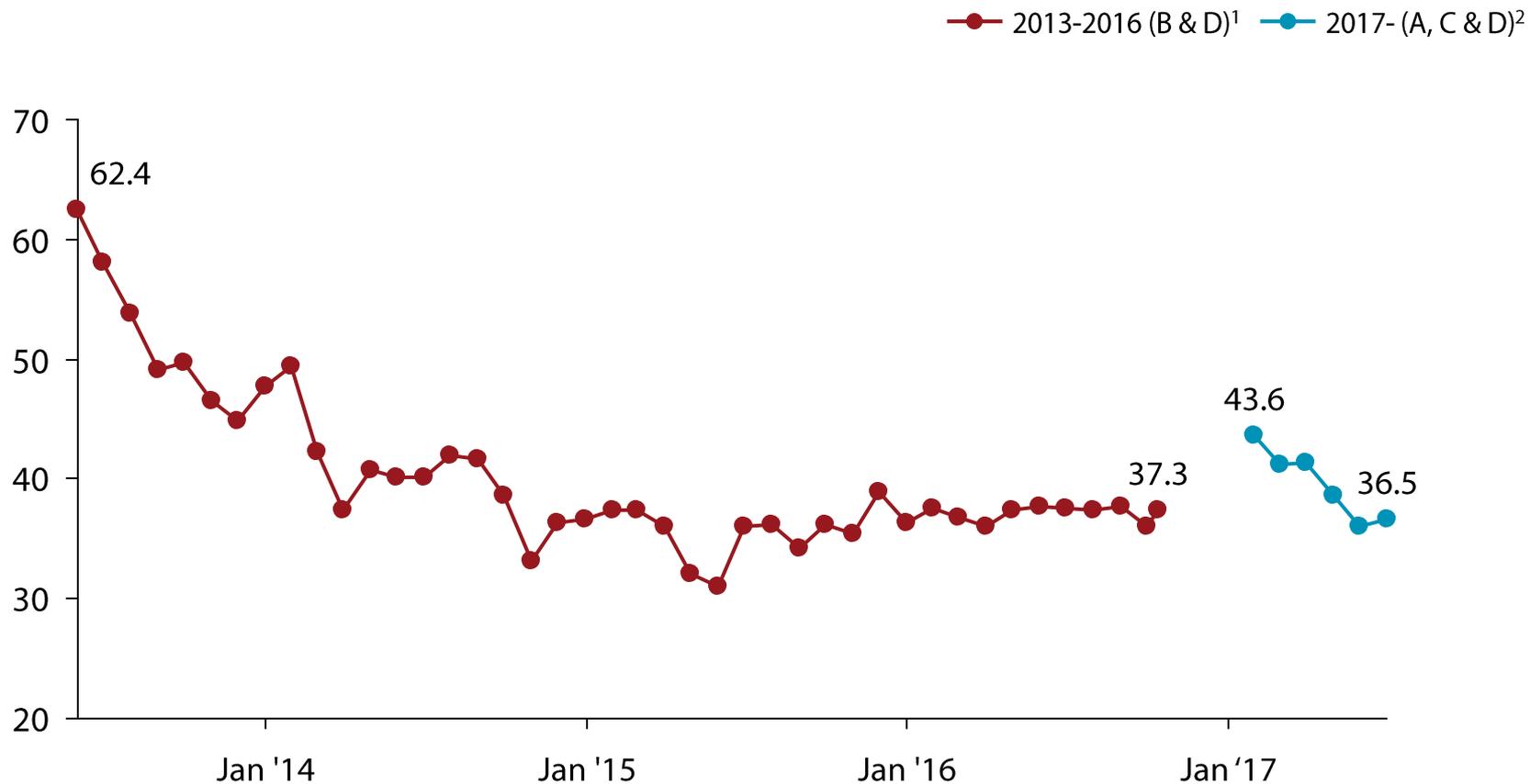
A new centre-right wing government was formed in January 2017, following early elections in October 2016



Figure 2.2

Support for the current government after half a year is lower than the previous one enjoyed

Government Approval Rating (percent)



1 B: The Progressive Party; D: The Independence Party

2 A: The Bright Future Party; C: The Reform Party; D: The Independence Party

Figure 2.3

The Icelandic tax system relies heavily on consumption and labor income

Key Taxes in Iceland

Tax	Rate	Recent changes
VAT ¹	24%	<ul style="list-style-type: none"> Lowered from 25.5%; lower bracket raised from 7% to 11% in 2015
Labour income ²	46%	<ul style="list-style-type: none"> Middle bracket (38.35% for 336-501 thousand ISK) was removed in 2017
Corporate tax	20%	<ul style="list-style-type: none"> Unchanged since 2011 when it was increased from 18% to 20%
Dividends / Capital gains	20%	<ul style="list-style-type: none"> Unchanged since 2011 when it was increased from 18% to 20%

¹ Consumption taxes fall into two brackets, the lower being 11% which includes e.g. tourism related activities, media, books, and groceries; the higher 24% which is the general rate; some service is exempt from consumption taxes, such as health service, public transport and schools; proposed to reduce the general bracket to 22.5% in 2018 and include tourism related activities

² Income taxes are divided between two brackets, the lower being 36.94% for the first ~835 thousand ISK of an individual's monthly income, and the higher being 46.24% for income above ~835 thousand ISK

Figure 2.4

Iceland's application to the EU was halted in 2013 and since 2015 Iceland is no longer a candidate country

Iceland's Negotiations with the European Union (timeline)

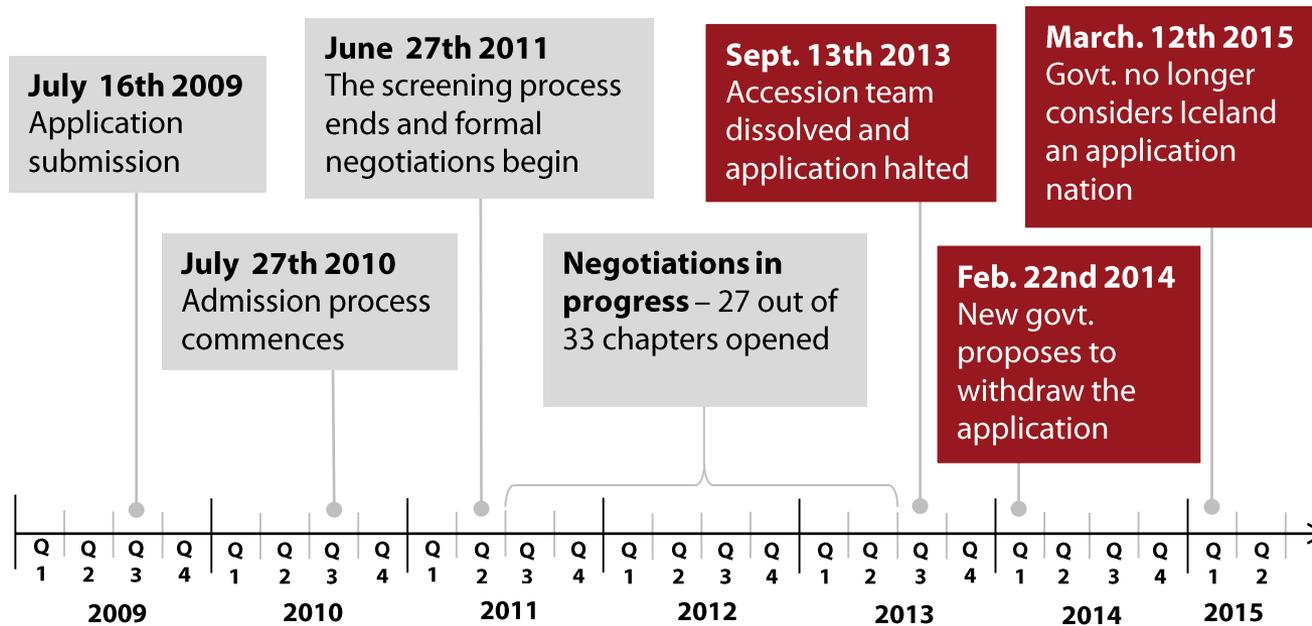


Figure 2.5

Iceland's "Big Three" banks are mostly in government ownership

Ownership of the Three Largest Domestic Banks (percent)

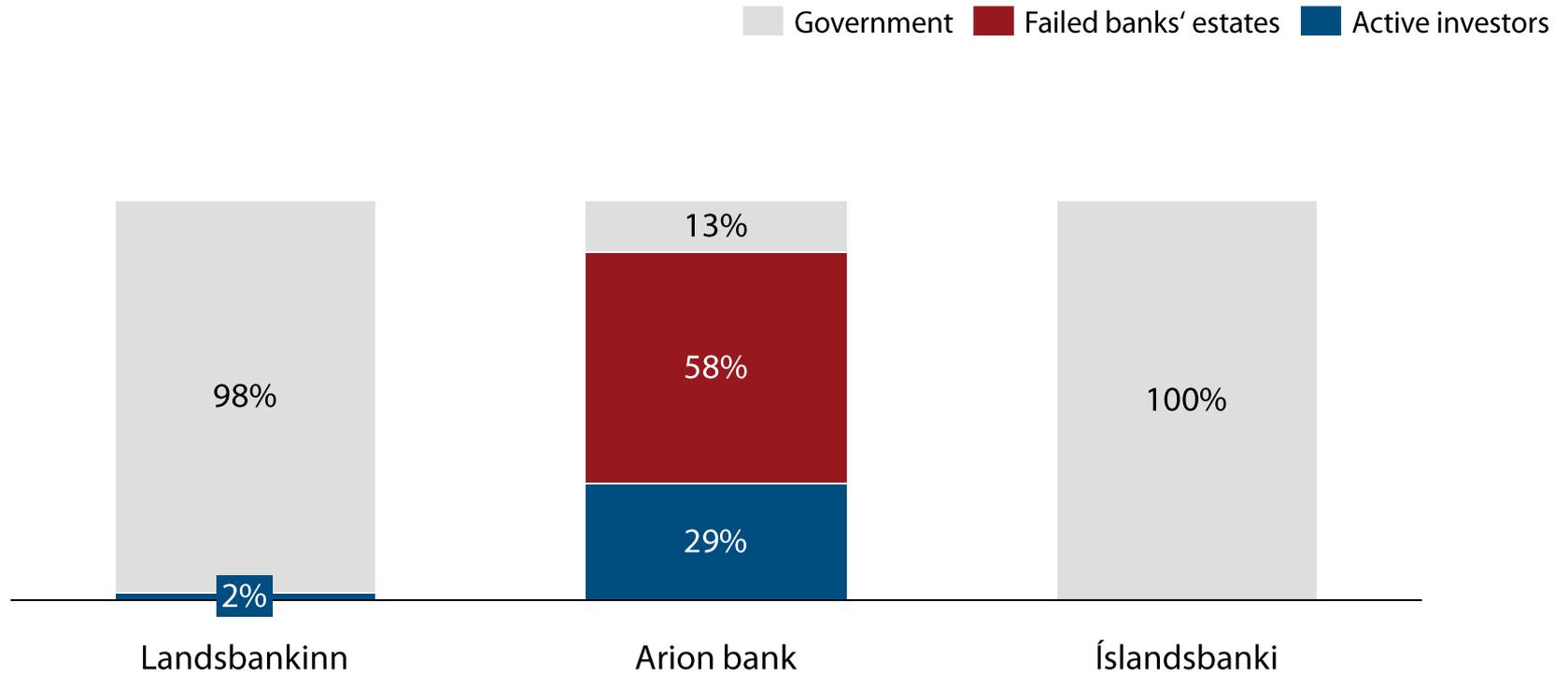


Figure 2.6

The capital controls were imposed to prevent an outflow of capital that could destabilise the economy

Key Parties Inside and Outside of the Capital Controls

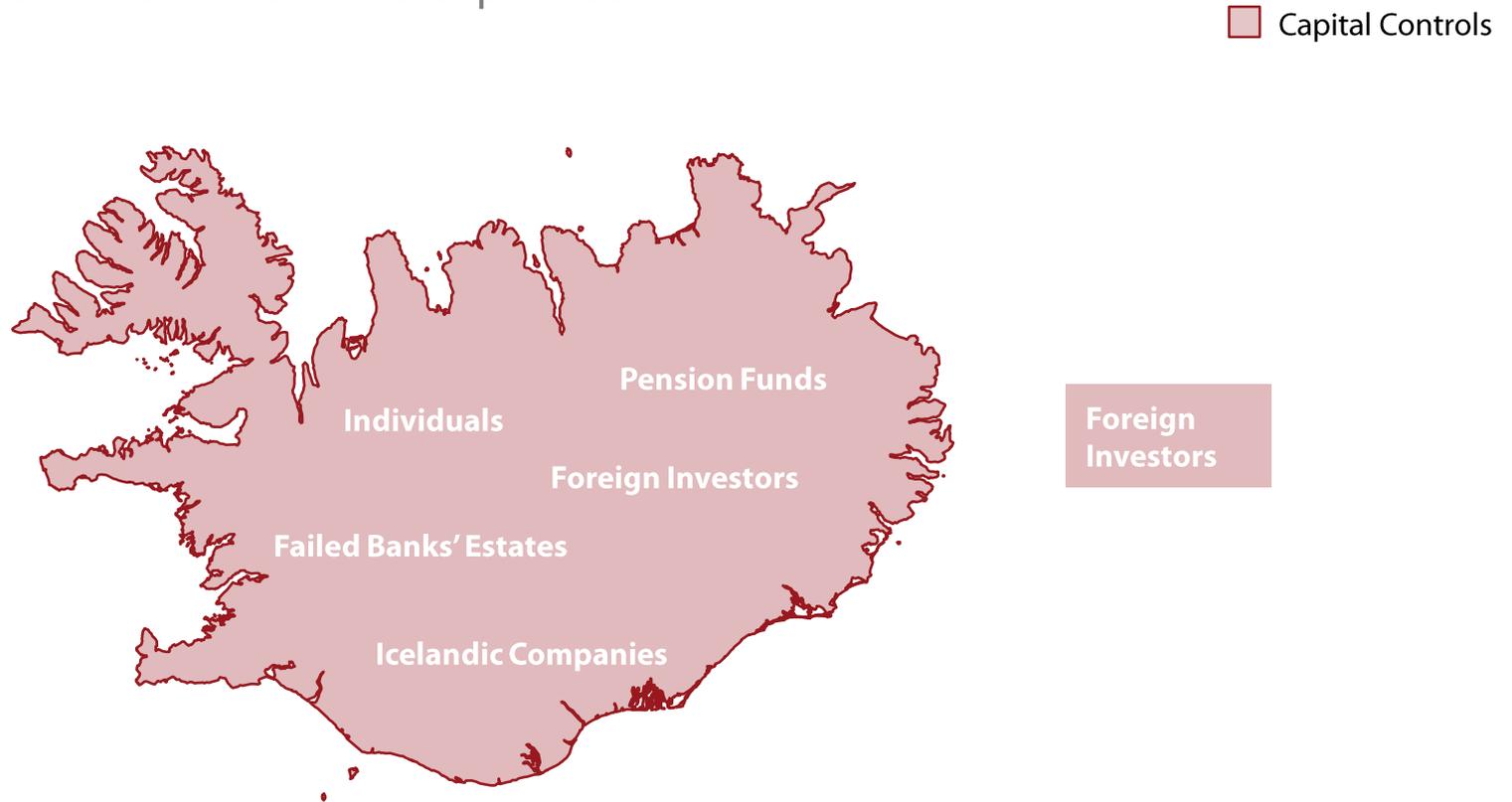


Figure 2.7

The capital controls on domestic parties have been lifted after a long process

Action Plan for Lifting Capital Controls

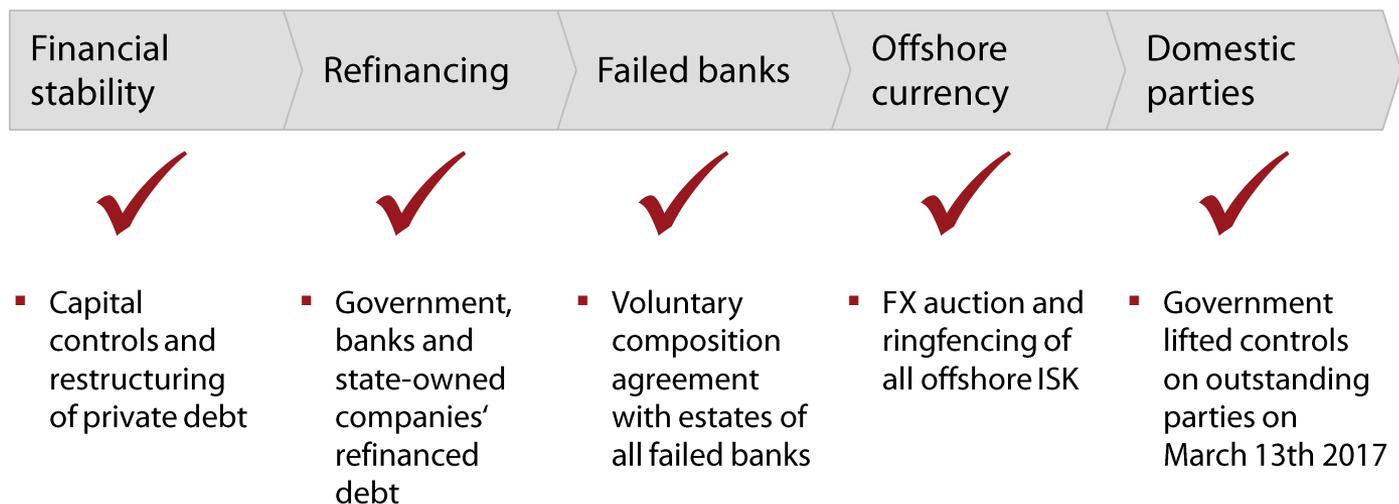
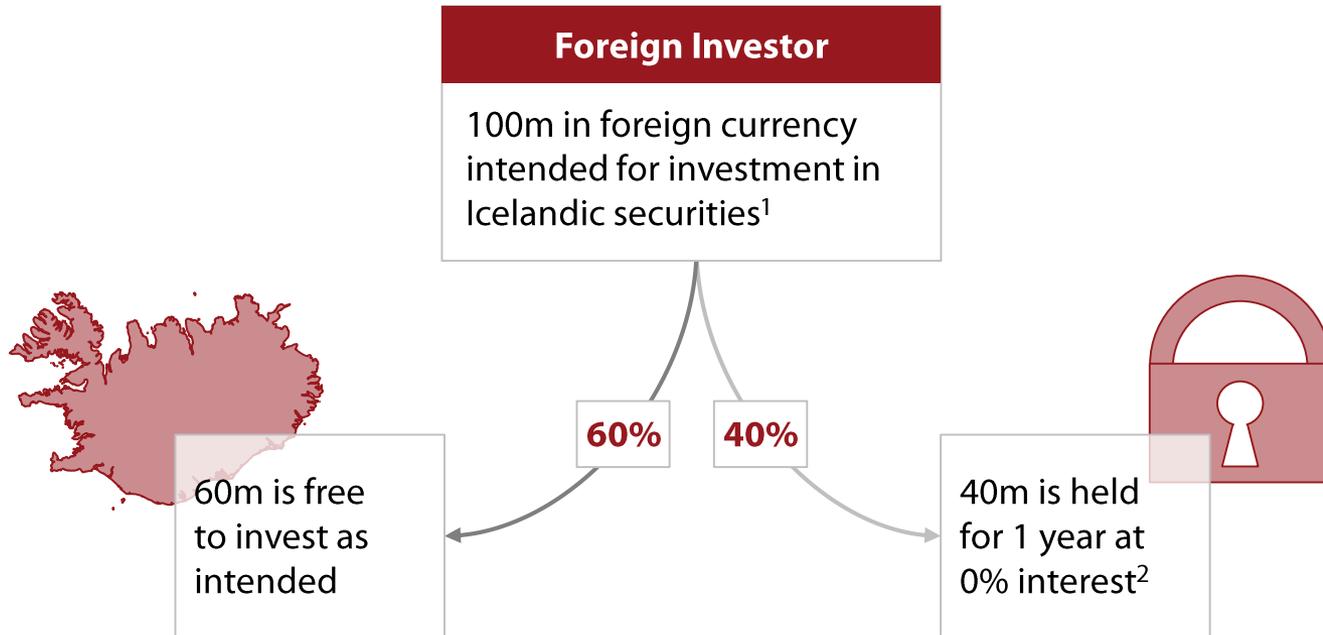


Figure 2.8

A new measurement was introduced in 2016 to reduce volatile capital inflows

Iceland's New Capital Flow Instrument (illustrative)



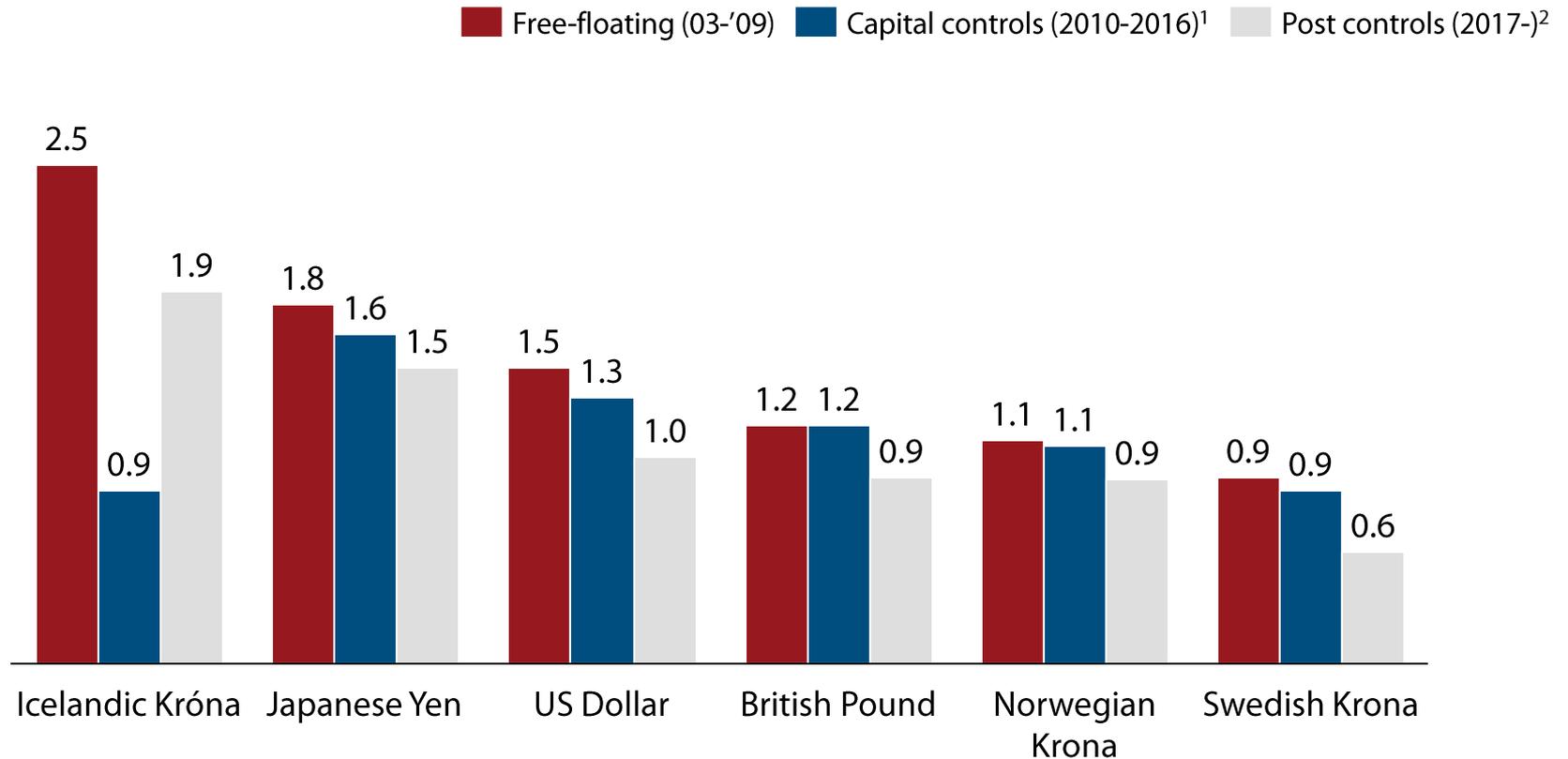
1 The new measurement's scope is new inflow of foreign currency that's in particular intended for new investment in electronically registered bonds and bills, and deposits, as well as new inflow related to loans taken for investment in such instruments. It also applies to imported foreign currency deposited into a domestic currency account with a deposit institution in Iceland if the interest rate is 3.00% or more.

2 The current reserve ratio and period is 40% of the invested amount and 1 year but the Central Bank can raise the ratio to up to 75% and the period up to 5 years; the capital is held on a capital flow account with the Central Bank of Iceland with the Icelandic króna as the settlement currency

Figure 2.9

The Icelandic Króna has been one of the most volatile currencies in the developed world

Exchange Rate Fluctuations Against the Euro (standard deviation of weekly changes)



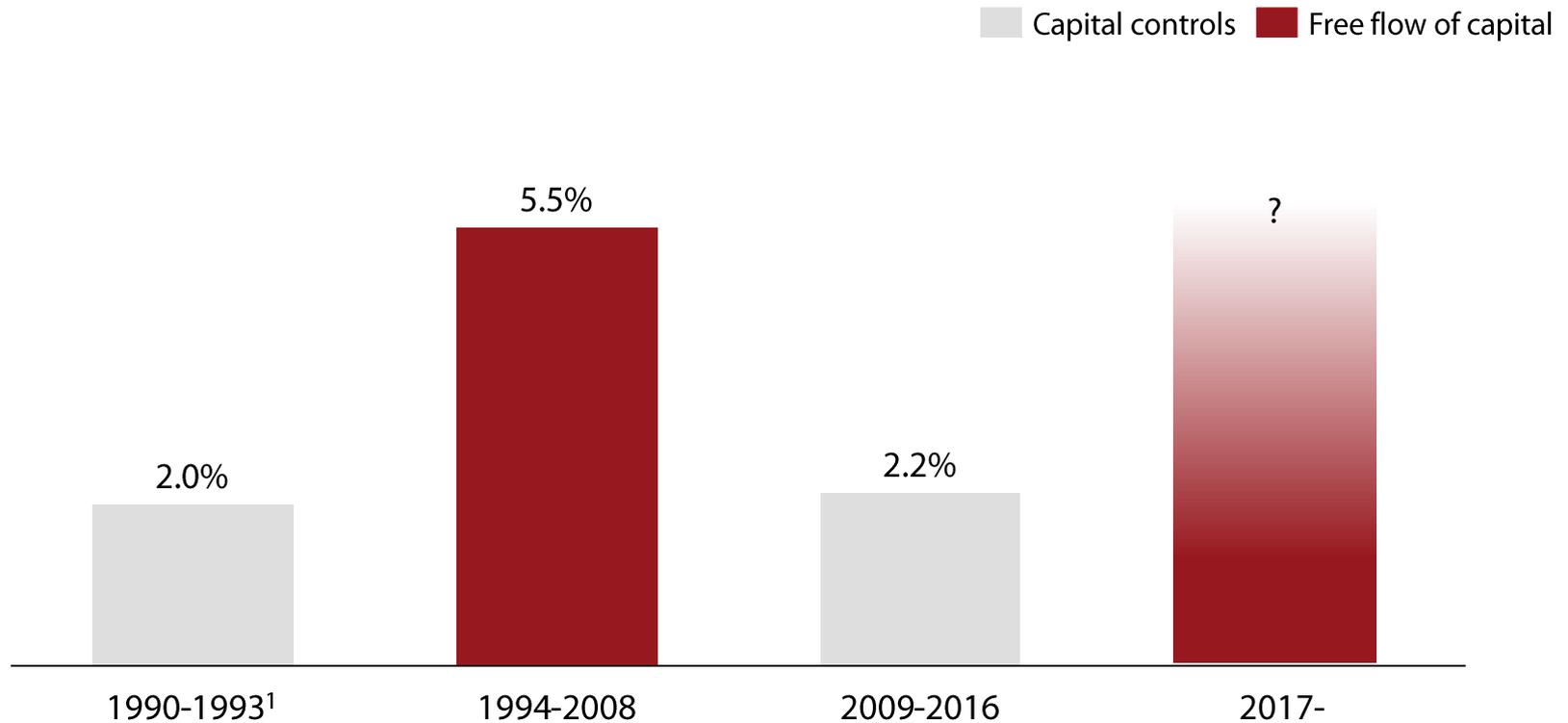
¹ From 1st of January 2010 till 13th of March 2017

² From 13th of March 2017 till 14th of July 2017

Figure 2.10

Capital controls had a large impact on the international sector - export growth slowed during controls

Exports Originating from the International Sector (year on year growth, percent)¹

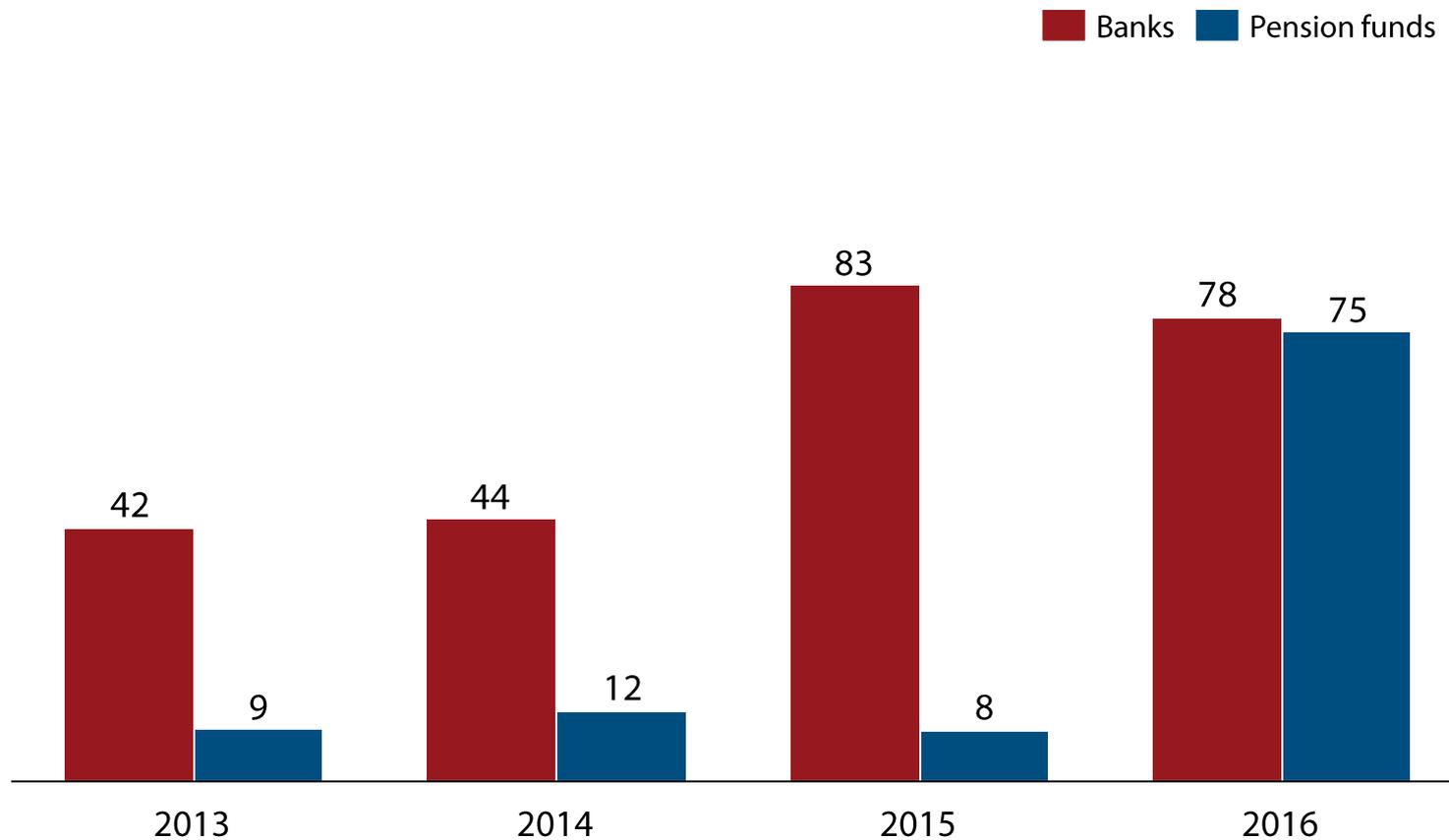


¹ Because of imperfect data, silicon is included in the international sector for the period 1990-1993

Figure 2.11

Pension funds have become a significant mortgage lender

New Mortgages by Lender (bn. ISK)

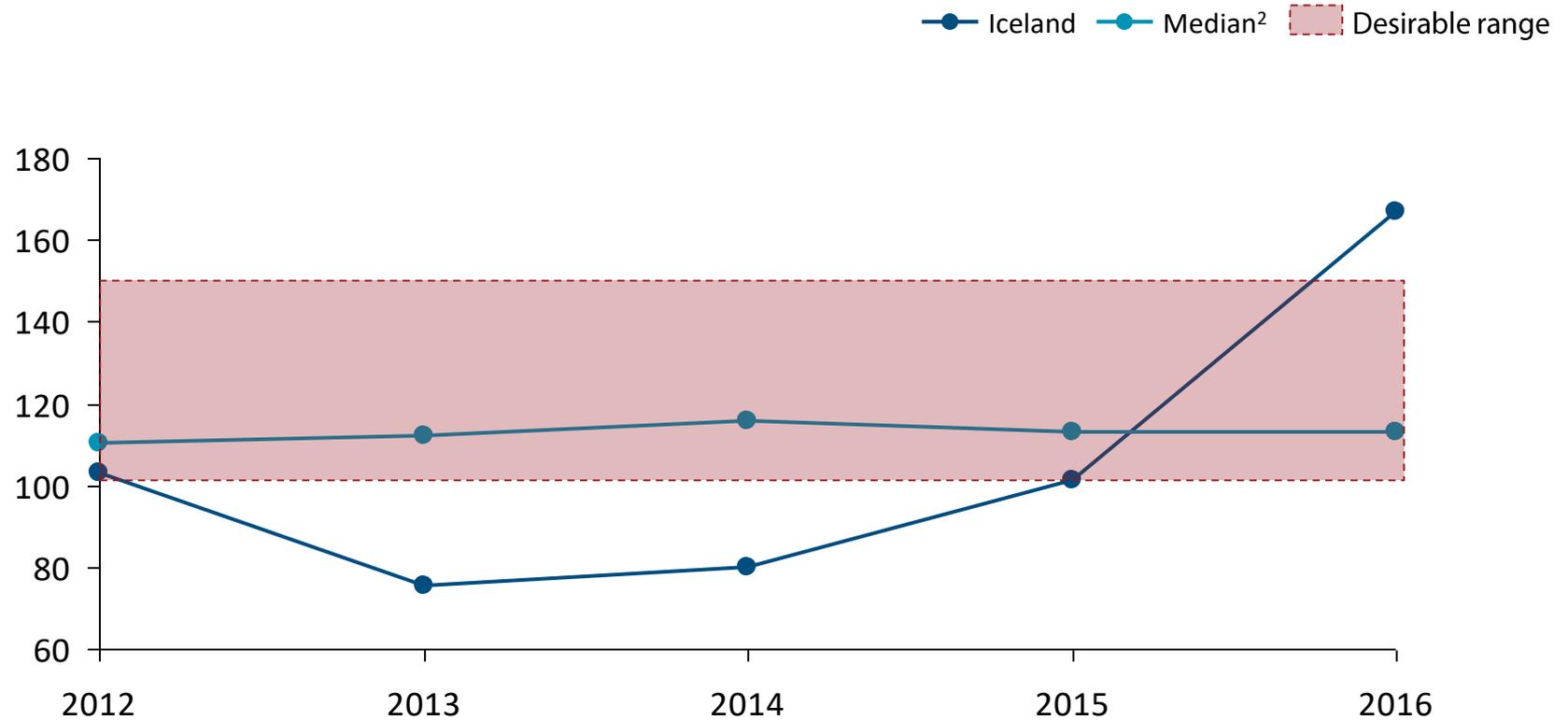


1 The Housing Financing Fund

Figure 2.12

The Central Bank of Iceland has large foreign exchange reserves compared to the IMF's recommendations

Ratio of Foreign Exchange Reserves to IMF's RAM¹ (percent of GDP)



1 Reserve adequacy metric

2 Excluding Iceland

Figure 2.13

Iceland's credit rating has improved in recent years and the outlook is stable

Iceland's Credit Ratings (sovereign debt, Moody's/S&P rating)

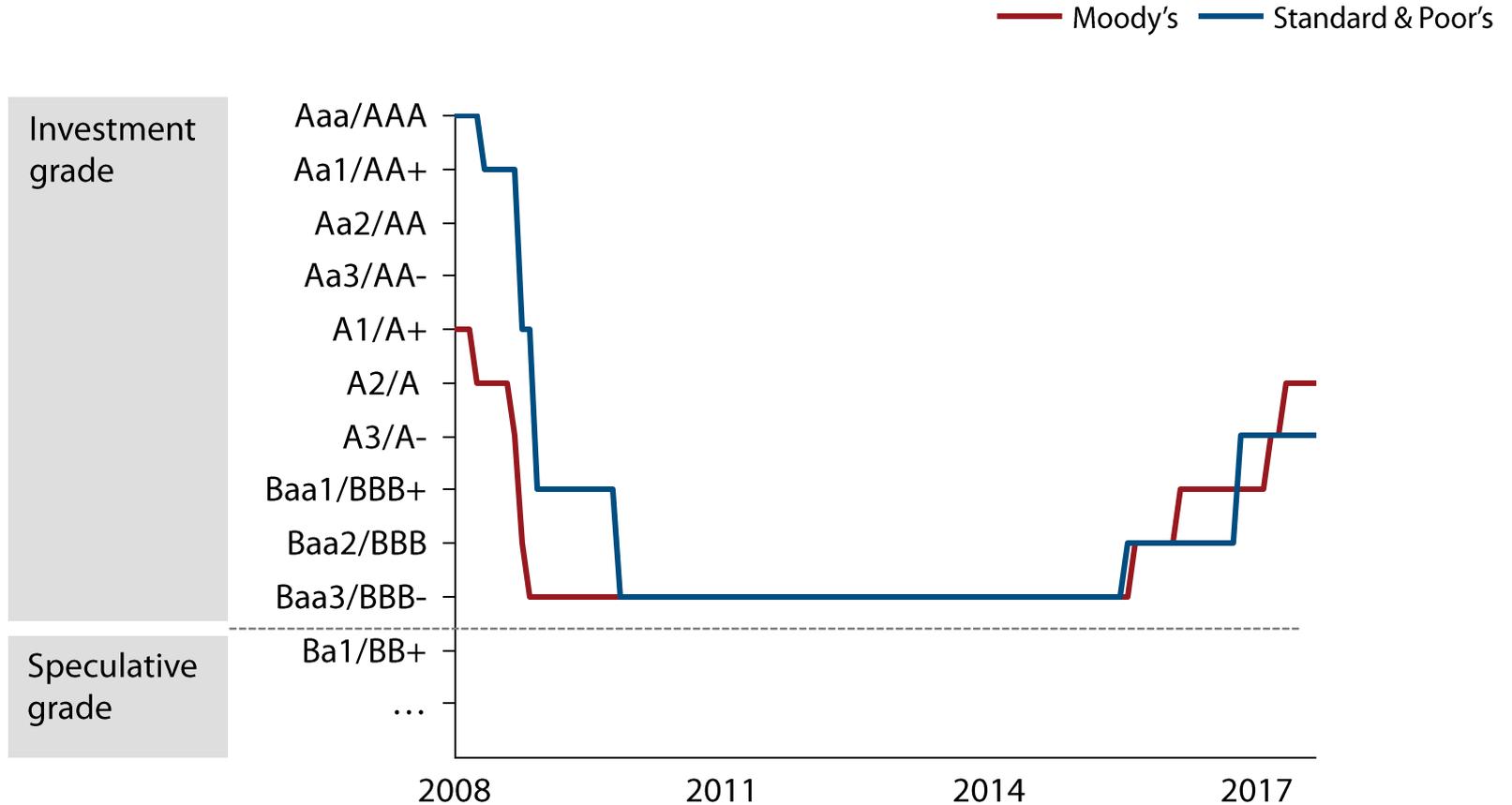


Figure 2.14

Domestic assets appreciated significantly in the past few years but valuation of equities came down after 2015

Asset Value (index, inflation adjusted, Jan. 2010 = 100)

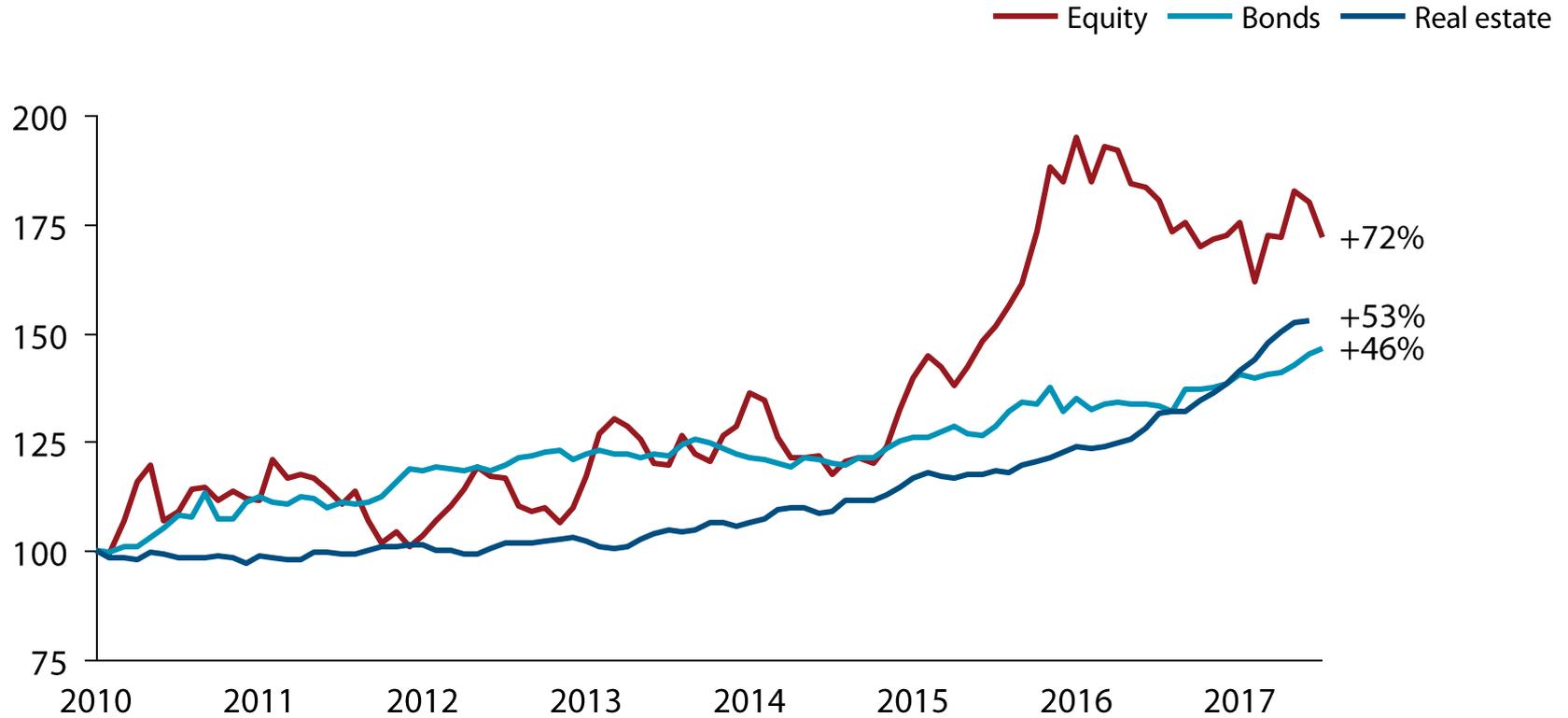
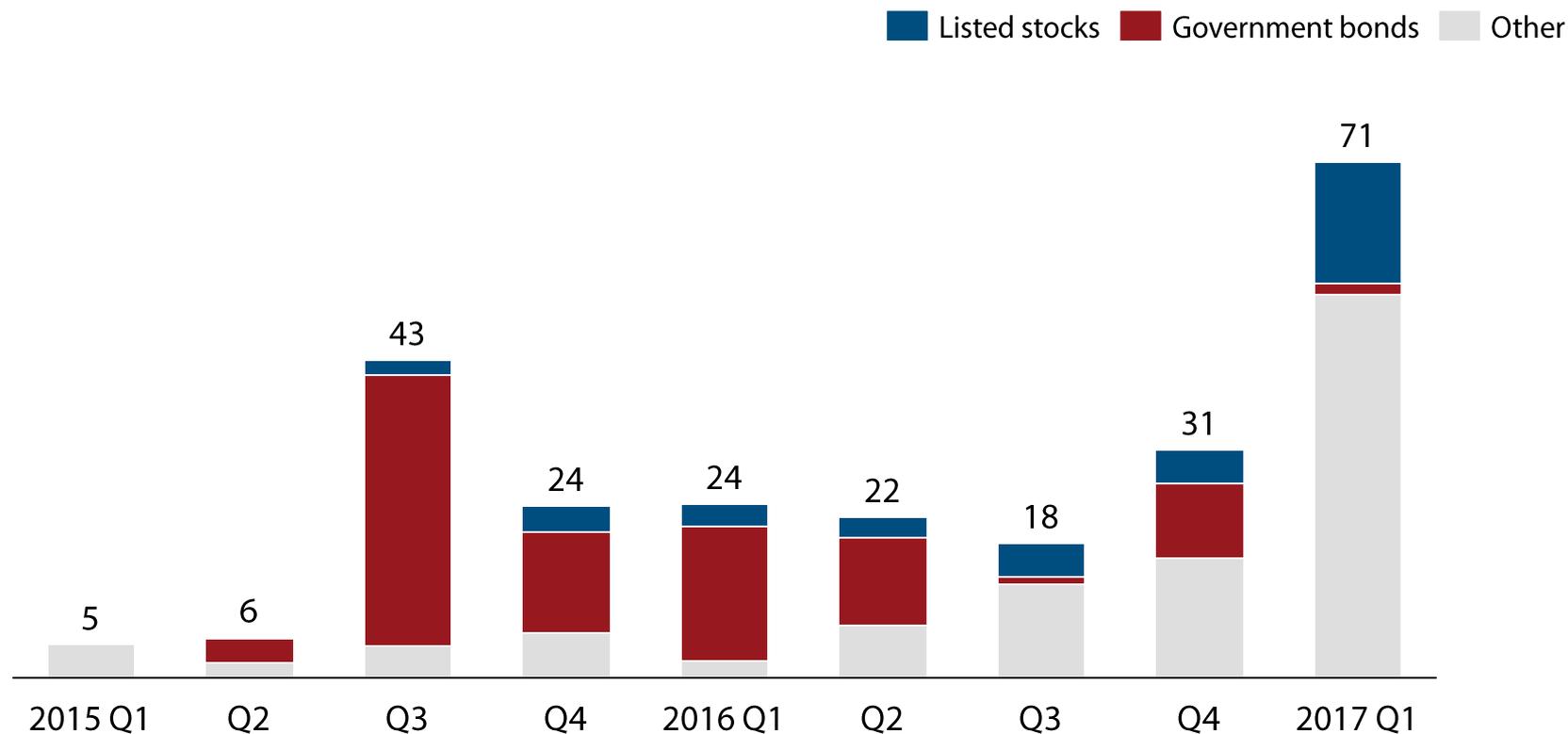


Figure 2.15

Composition of inflows changed after the Central Bank introduced new restrictions¹ on inflows in June 2016

New Investment Inflows (bn. ISK)



¹ The restrictions are known as capital flow measures and are in rules no. 490/2016; the measures consists of a reserve requirement for new foreign currency inflows that are for investment in liquid Icelandic securities and into domestic deposits that carry 3.00% interest rates or higher.

Figure 2.16

The domestic sector accounts for about two thirds of the economy

Composition of the Icelandic Economy (percent of GDP)

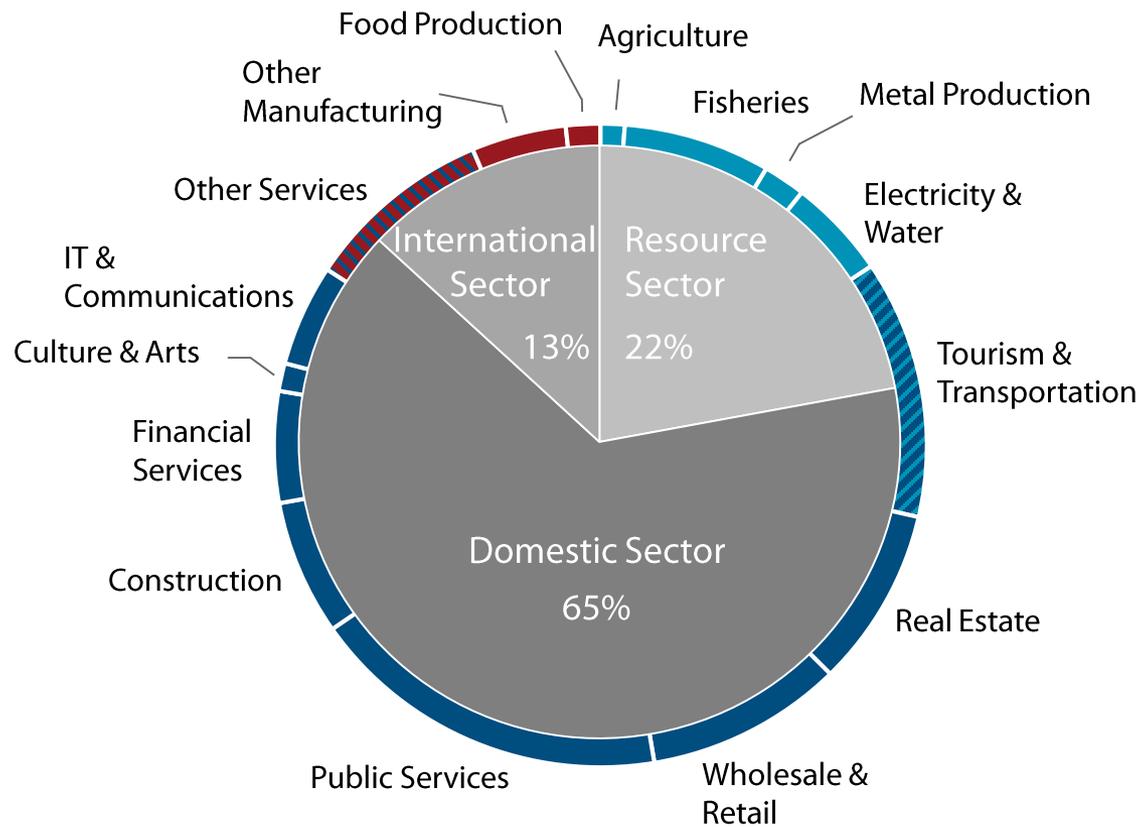
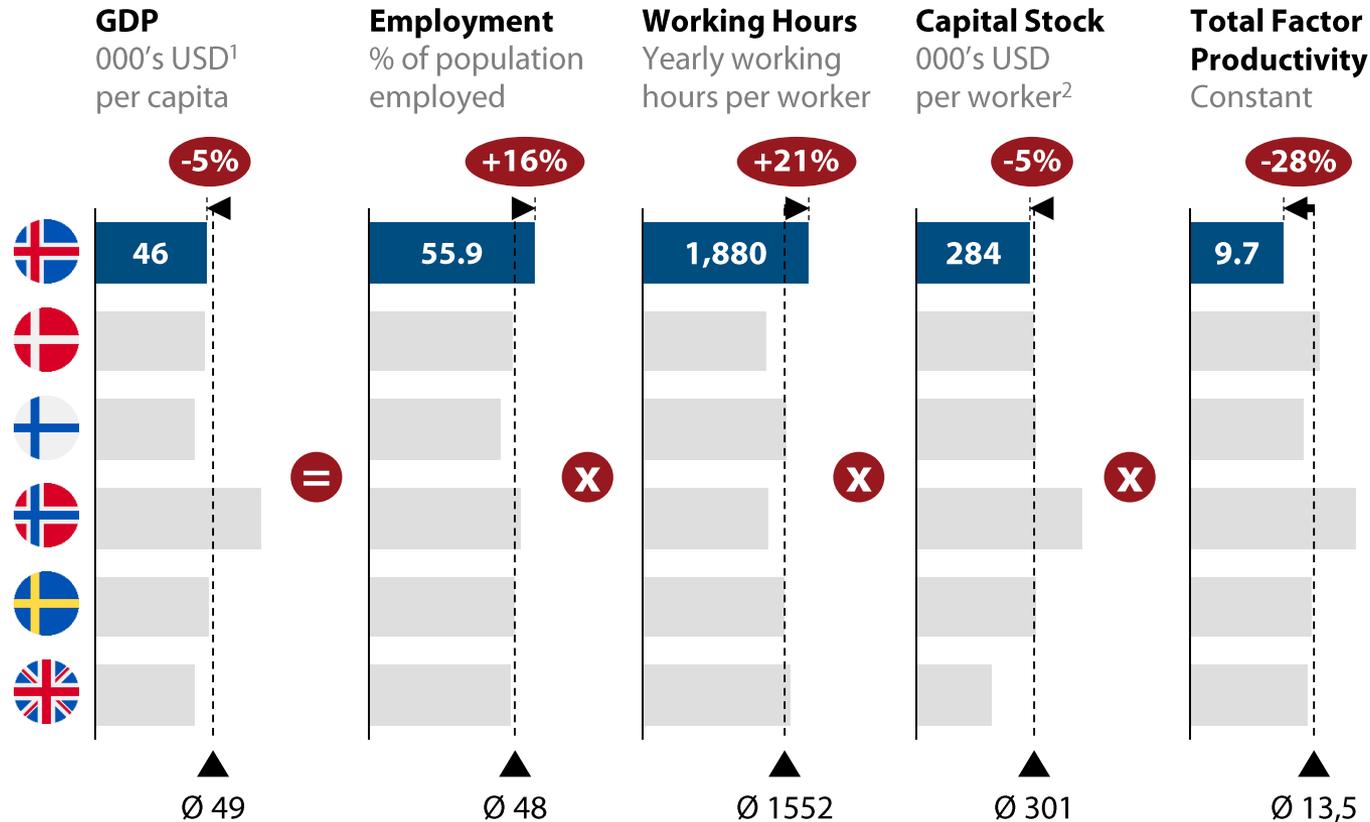


Figure 2.17

Low productivity is the main weakness of the Icelandic Economy compared to neighbouring countries



1 Gross domestic product based on purchasing-power-parity per capita (2015)

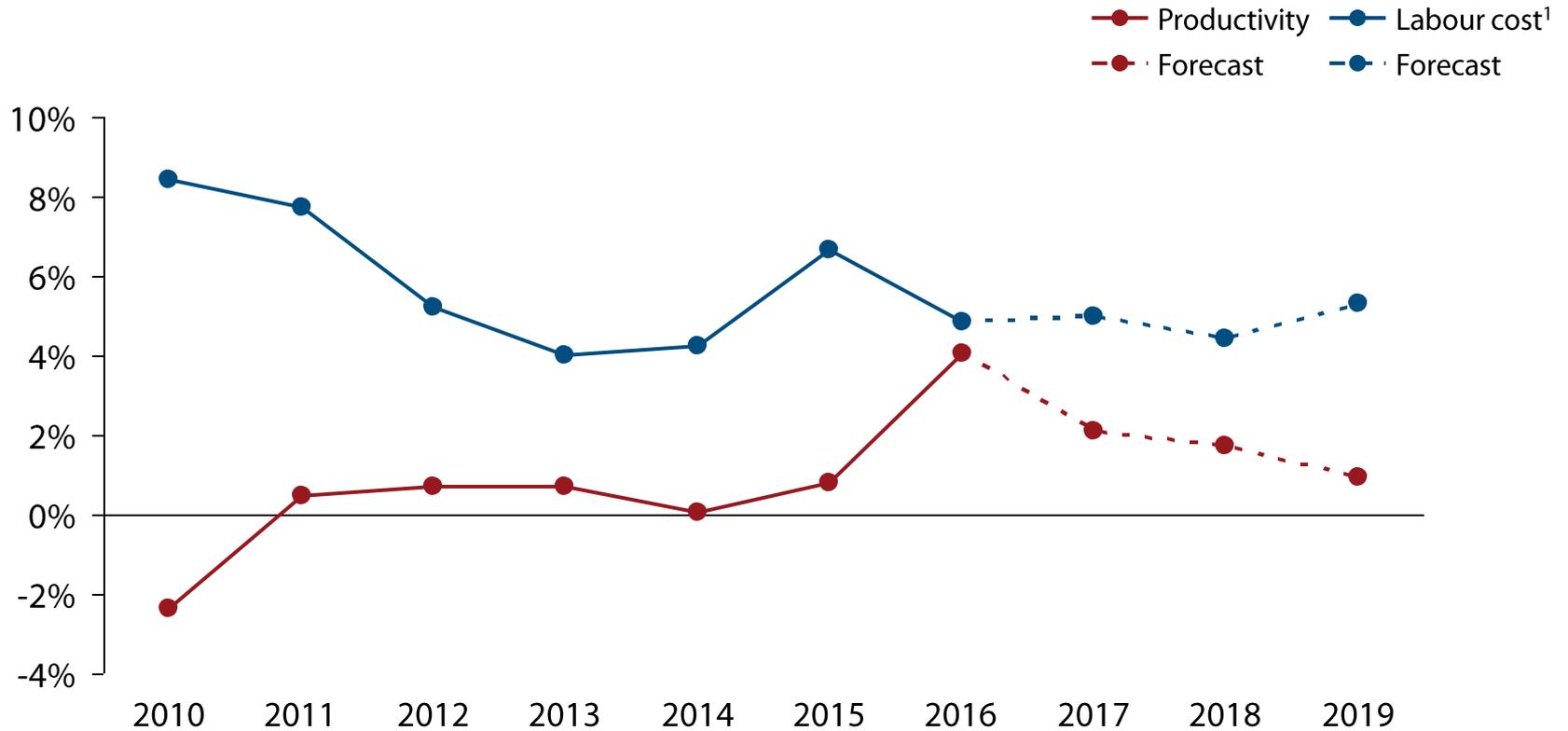
2 Numbers for Sweden's capital stock for 2015 were unavailable and were therefore calculated based on average growth for past 7 years

3 Productivity is measured by the Solow residual with capital in the power 0.3 (alpha) and labour in the power 0.7 (1-alpha)

Figure 2.18

There has been a pickup in productivity, although labour cost increases are still in excess of productivity

Labour Productivity and Cost (percent change from previous year)



¹ Labour costs per unit manufactured

Figure 2.19

The Icelandic domestic sector is facing strong competition from various global forces on different fronts

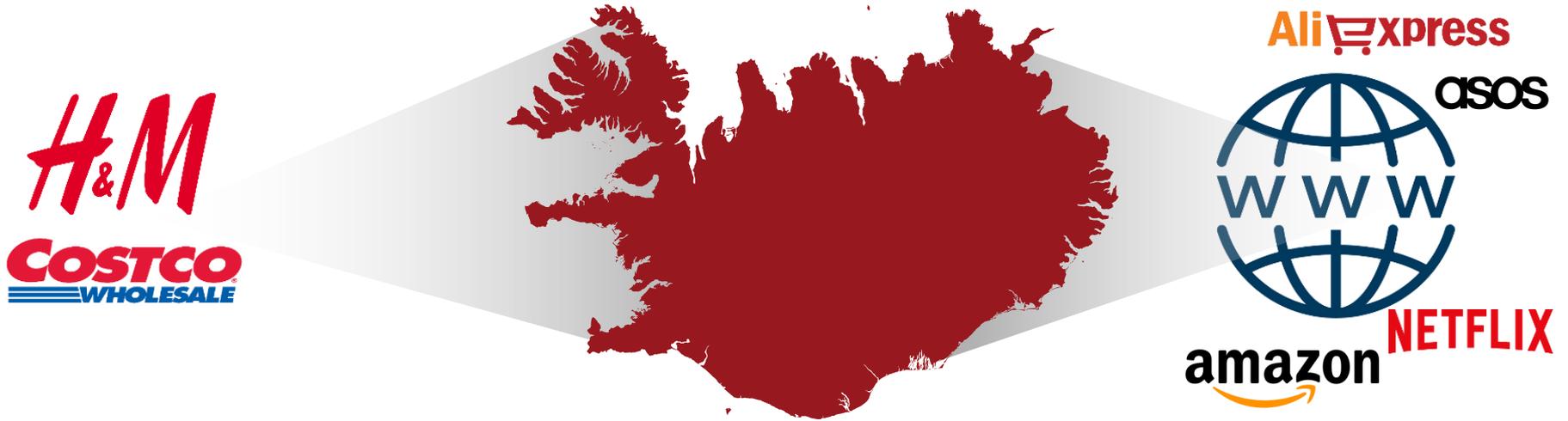


Figure 2.20

Purchasing power has increased substantially because of low inflation and significant wage increases

Purchasing Power (index, 2010 = 100)

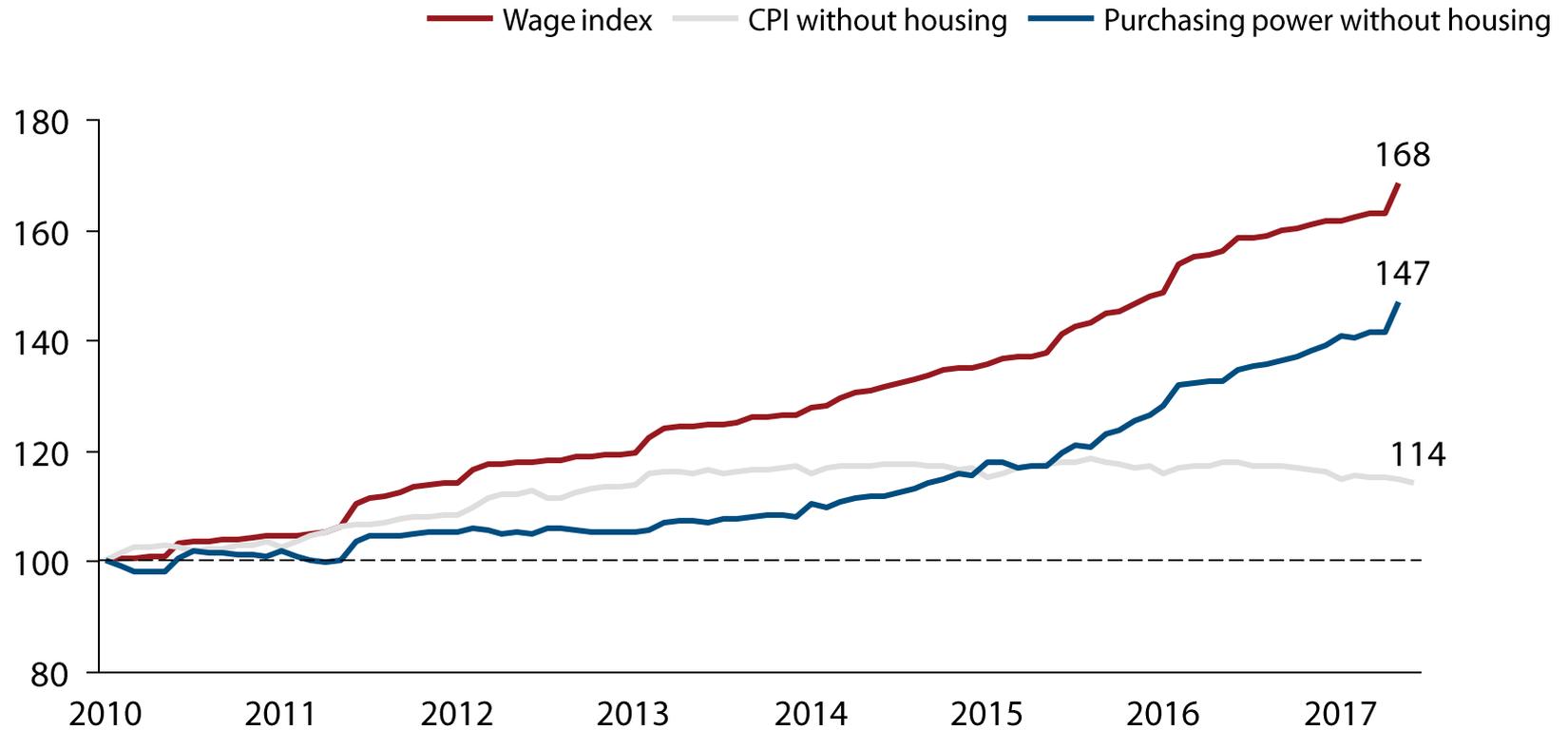


Figure 2.21

Residential housing construction has been subdued for the past 8 years, while hotel construction has spiked

Completed Apartments and Hotel Room Supply (yearly; thousands)

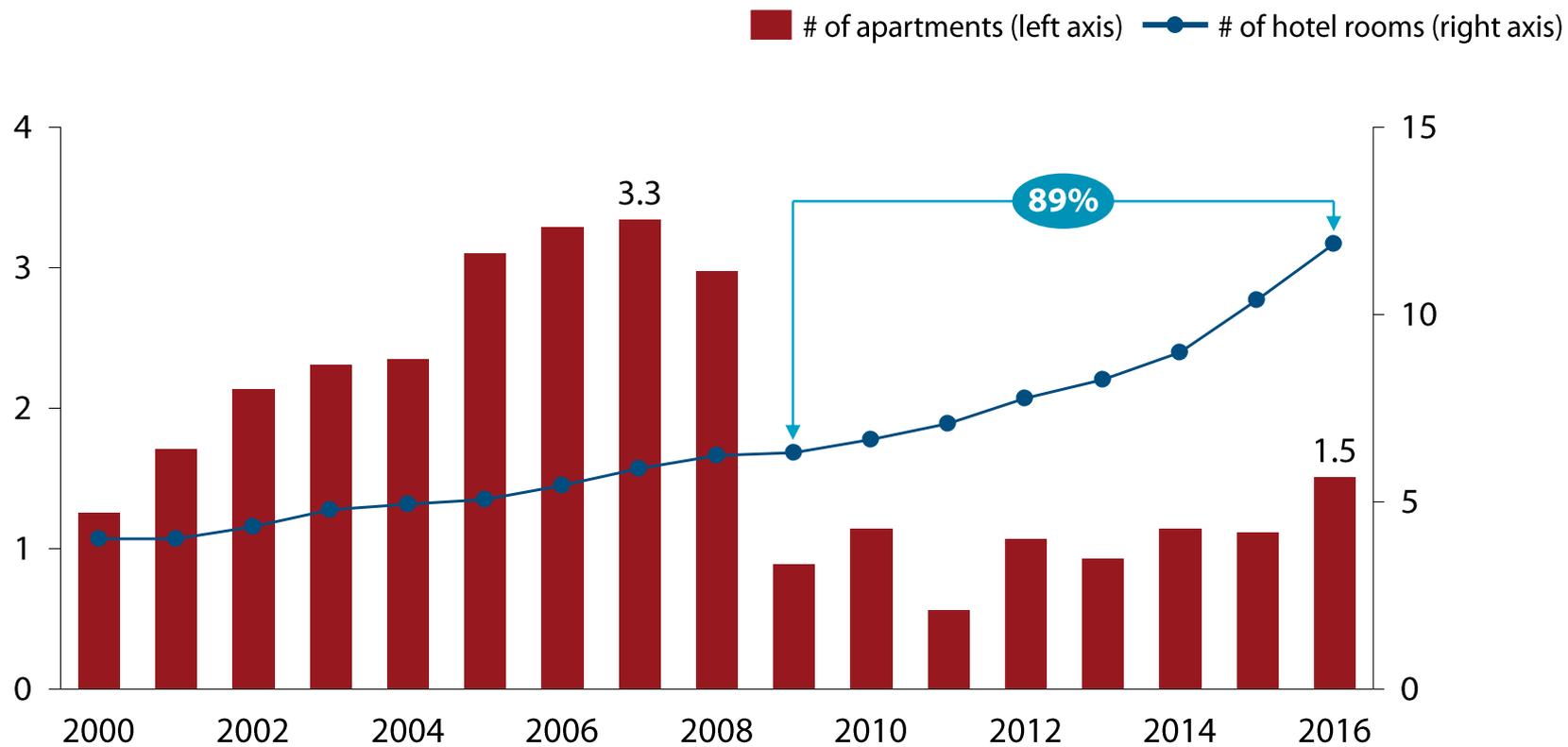


Figure 2.22

The number of working people has increased due to a larger labour force and a higher participation rate

Labour Market (thousands; percent)

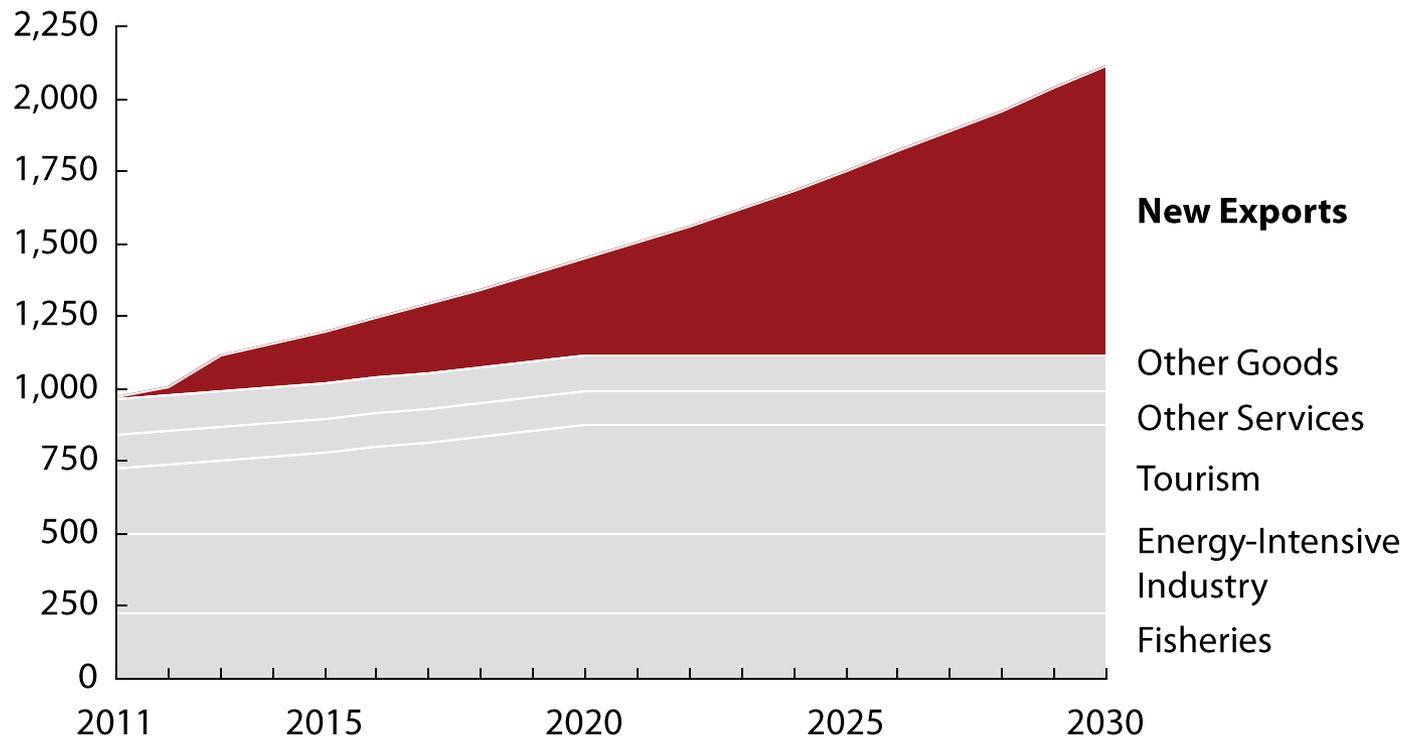


¹ Calculated by dividing total employed persons with the labour force

Figure 2.23

New sources of exports were needed to support long-term growth according to a 2012 McKinsey & Company report

Export Requirements Along a 4% Real Economic Growth Path (bn. ISK; Illustrative)¹

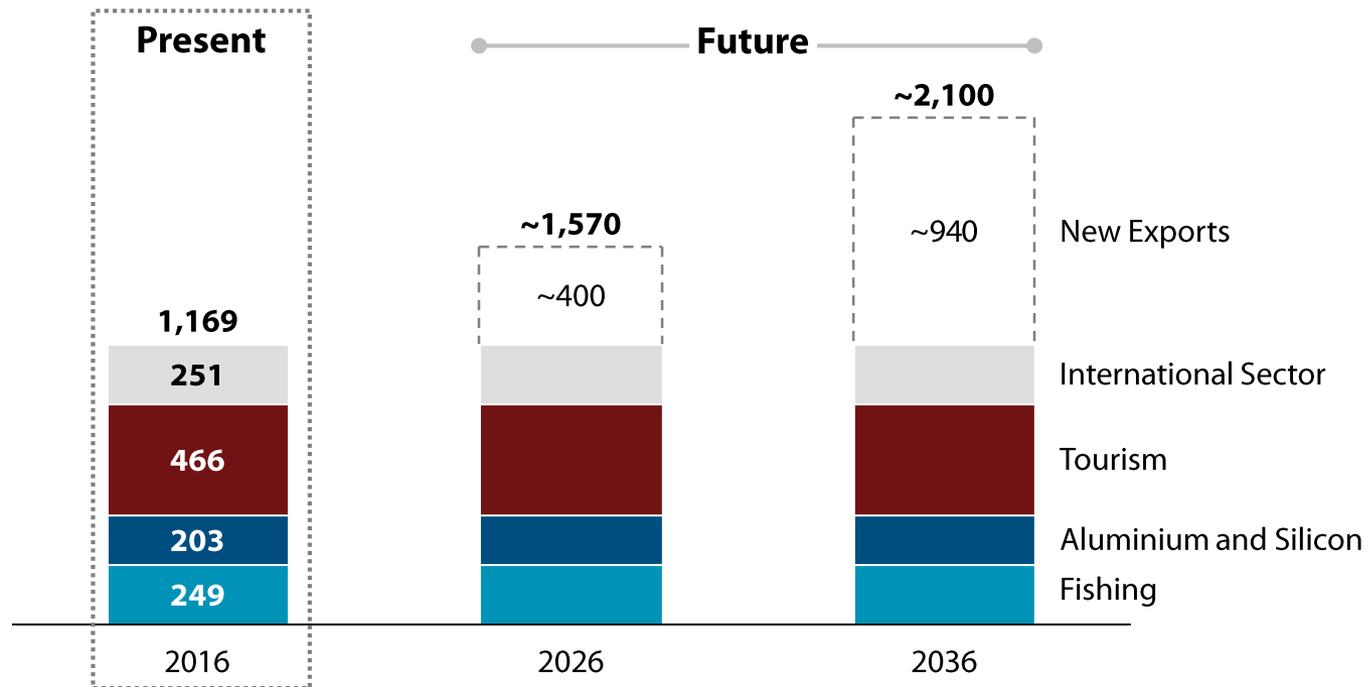


¹ 1 Real ISK

Figure 2.24

Exports need to increase by around 940 bn ISK in the next 20 years to support a sustainable GDP growth of 3.0%¹ p.a.

Iceland's Exports (total exports; bn. ISK, 2016 prices)²



¹ The Chamber believes McKinsey's aspiration of a 4% growth p.a. is highly ambitious, and a 3% growth rate is more realistic in the long run

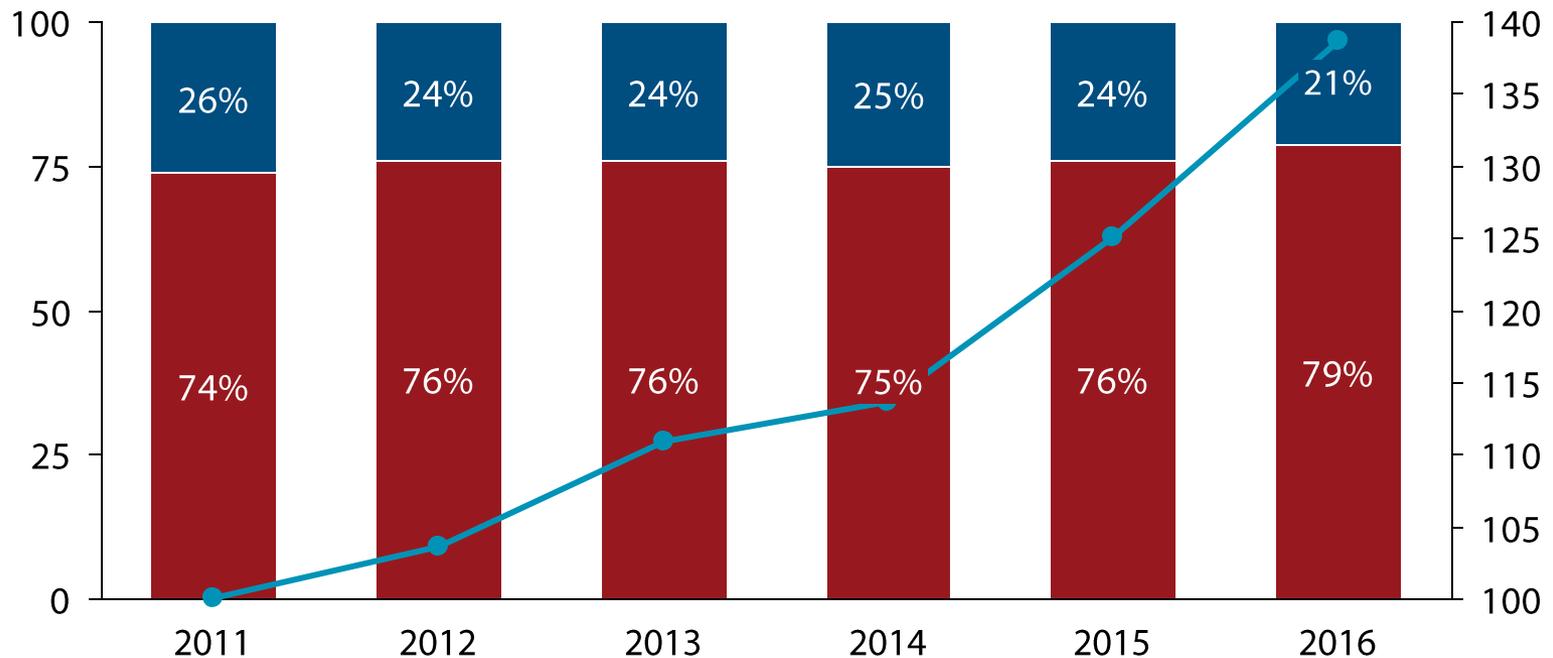
² As agriculture is heavily subsidised and only a small fraction of total exports, it is dropped from this analysis

Figure 2.25

Exports have increased significantly in recent years but the growth is almost entirely driven by the resource sector

Iceland's Exports¹ (sector share of exports, percent, left axis) (index, 2011=100, right axis)

■ Resource sector ■ International sector —●— Real export growth² (right axis)



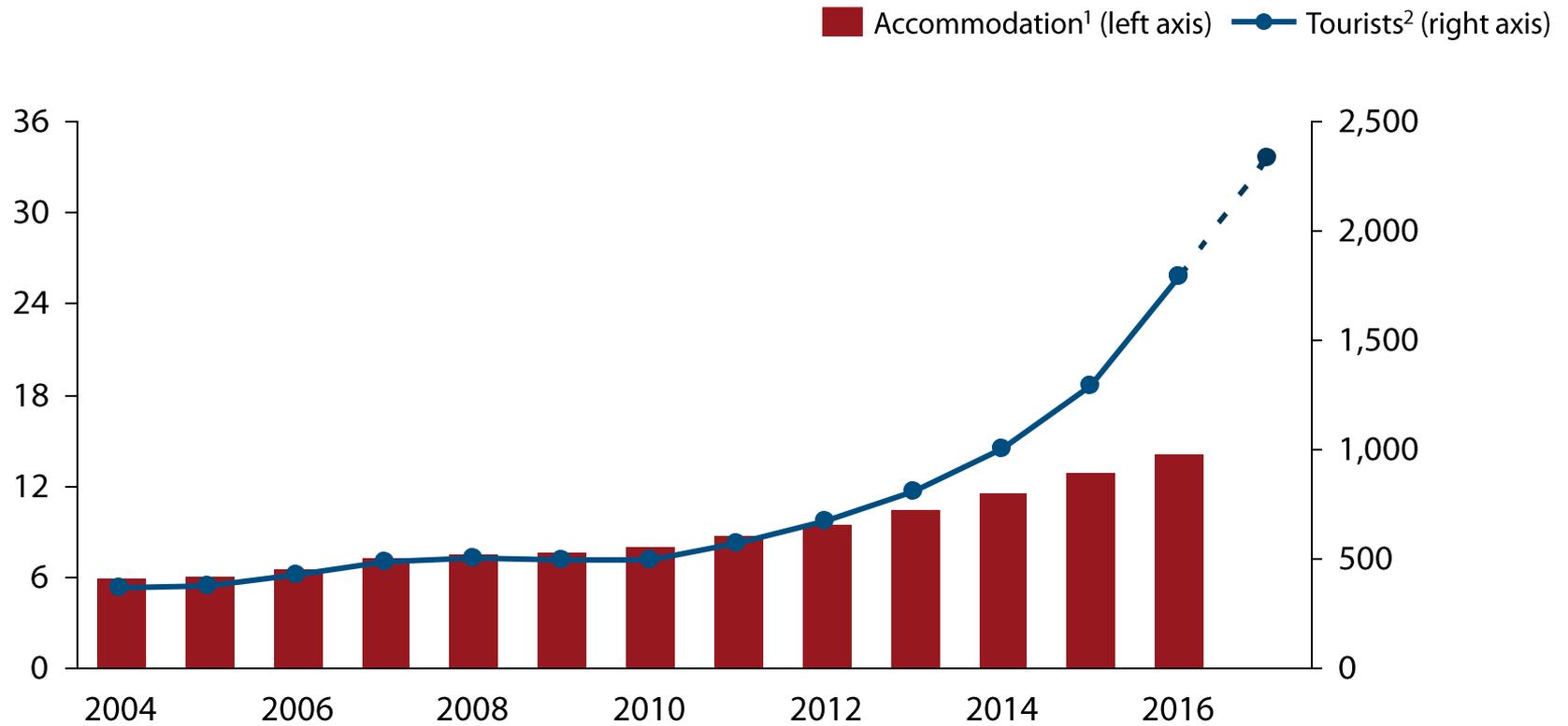
¹ As agriculture is heavily subsidised and only a small fraction of total exports, it is dropped from this analysis

² Chain linked volume

Figure 2.26

Number of tourists visiting Iceland has increased in recent years, resulting in excess demand for hotel rooms

Number of Tourists and Supply of Accommodation (thousands)



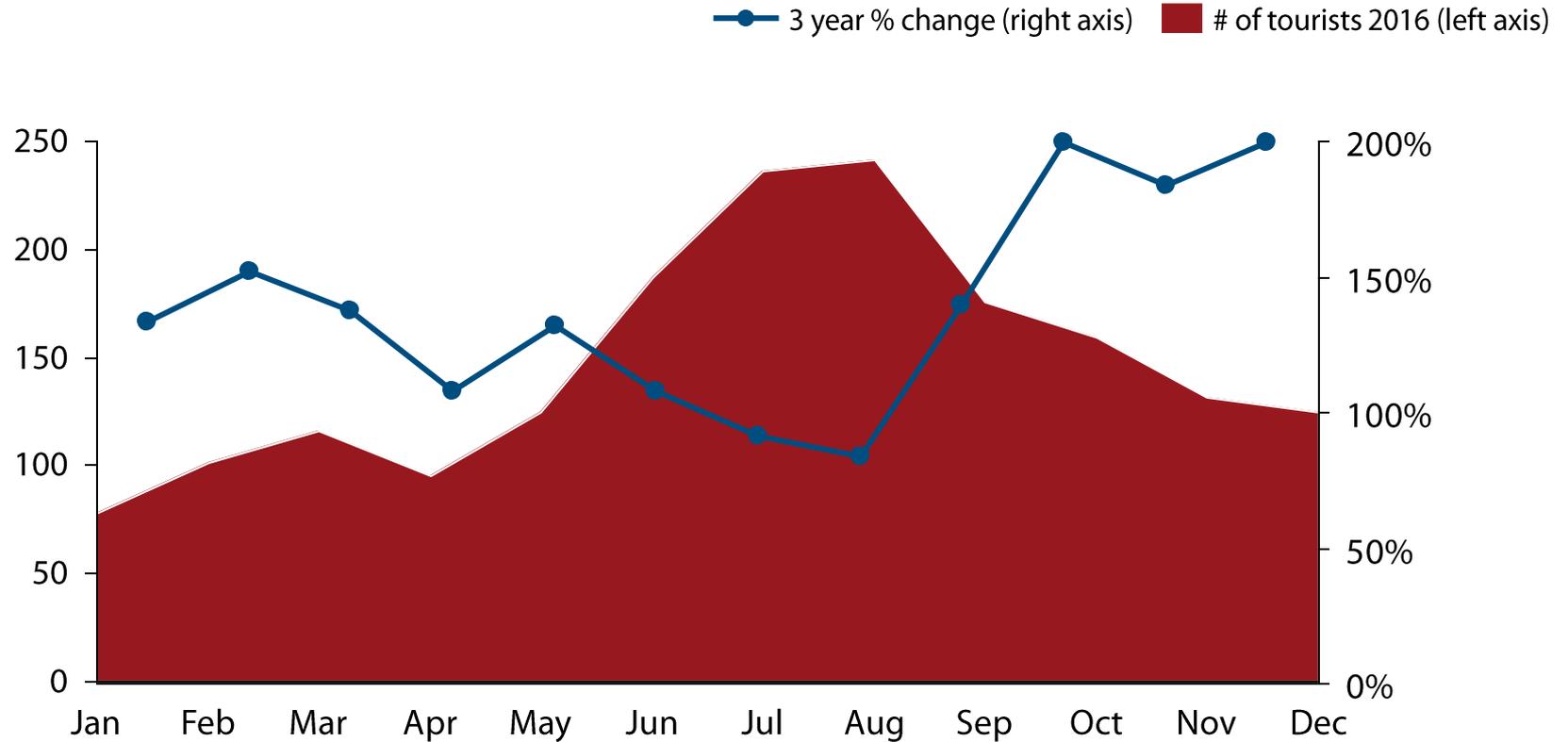
1 Yearly average

2 The figure for 2017 is an estimate by Íslandsbanki

Figure 2.27

Productivity of Icelandic tourism has historically suffered from high seasonality – a trend that has recently changed

Country rankings, GDP per capita (PPP¹ adjusted)

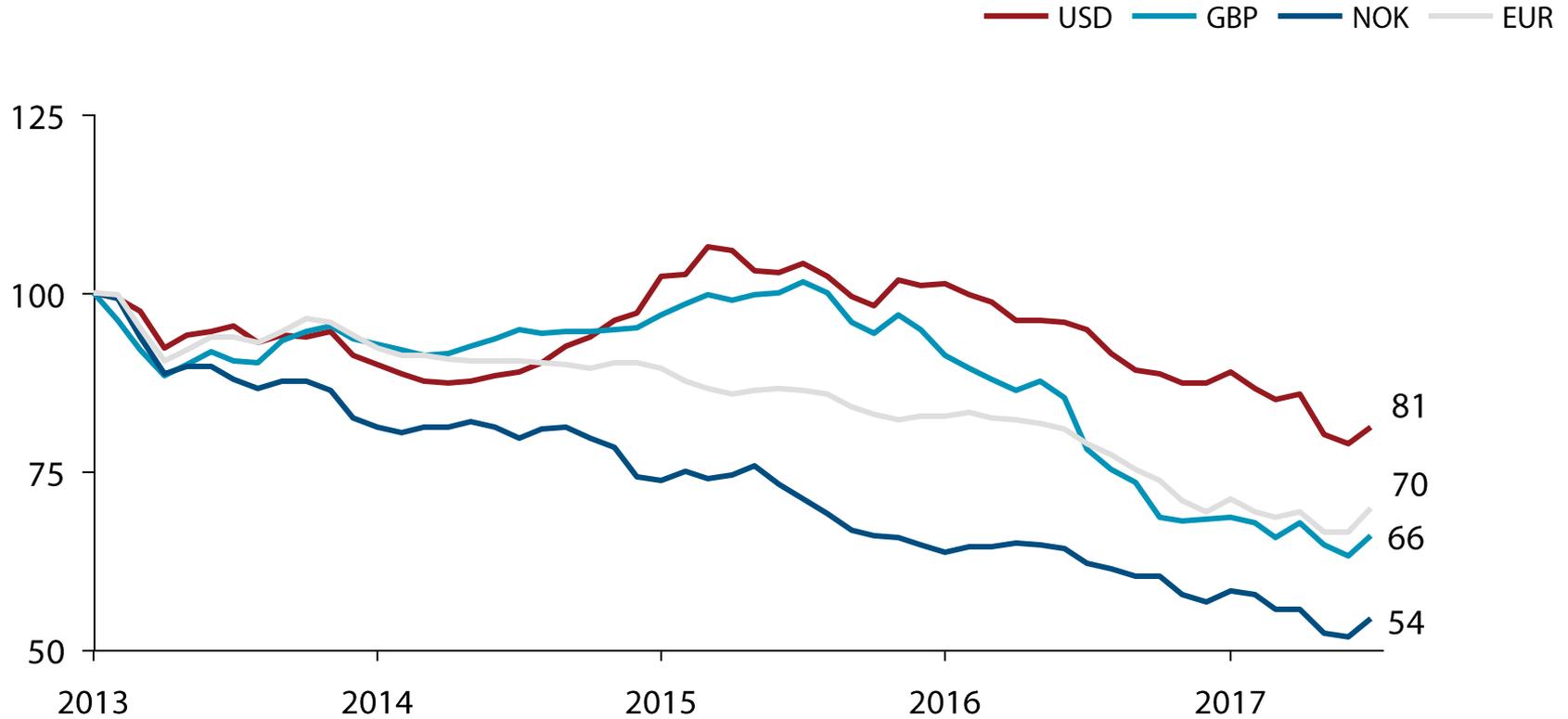


¹ Purchase Power Parity

Figure 2.28

The Icelandic Króna has appreciated significantly against major currencies

ISK's Exchange Rate Against Foreign Currencies (index, Jan. 1, 2013 = 100)¹



¹ Reduction in index implies appreciation of ISK

Figure 2.29

Reykjavík has become one of the most expensive cities in the world to live in

Cost of Living Index (index, New York each year = 100)

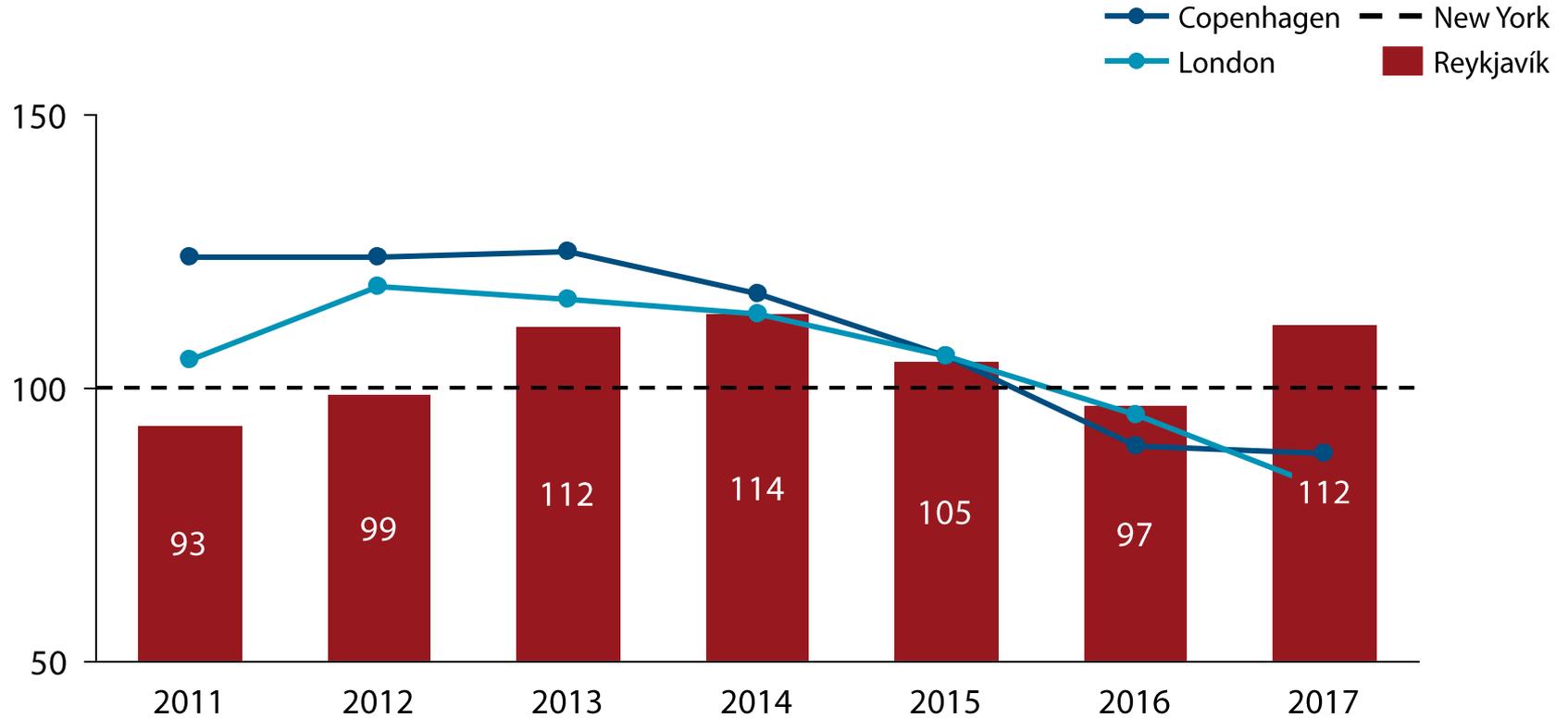


Figure 2.30

Favorable climate and affordable, renewable energy makes Iceland an attractive location for data centers

Potential Increase in Profitability by Storing Data in Iceland (profits; illustrative)

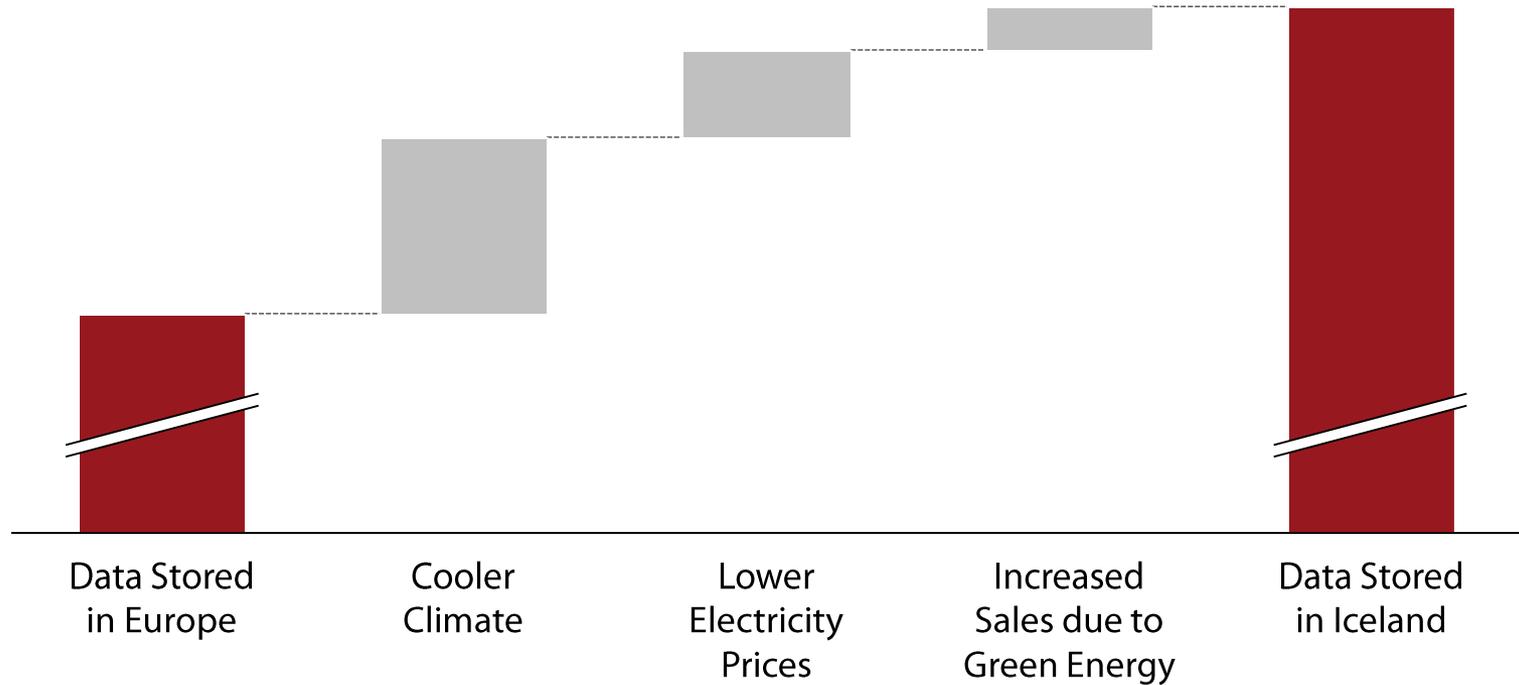


Figure 2.31

An interconnector from Iceland to the UK would be one of the longest in Europe and requires significant investment

Interconnectors in Northern Europe (length and capacity)

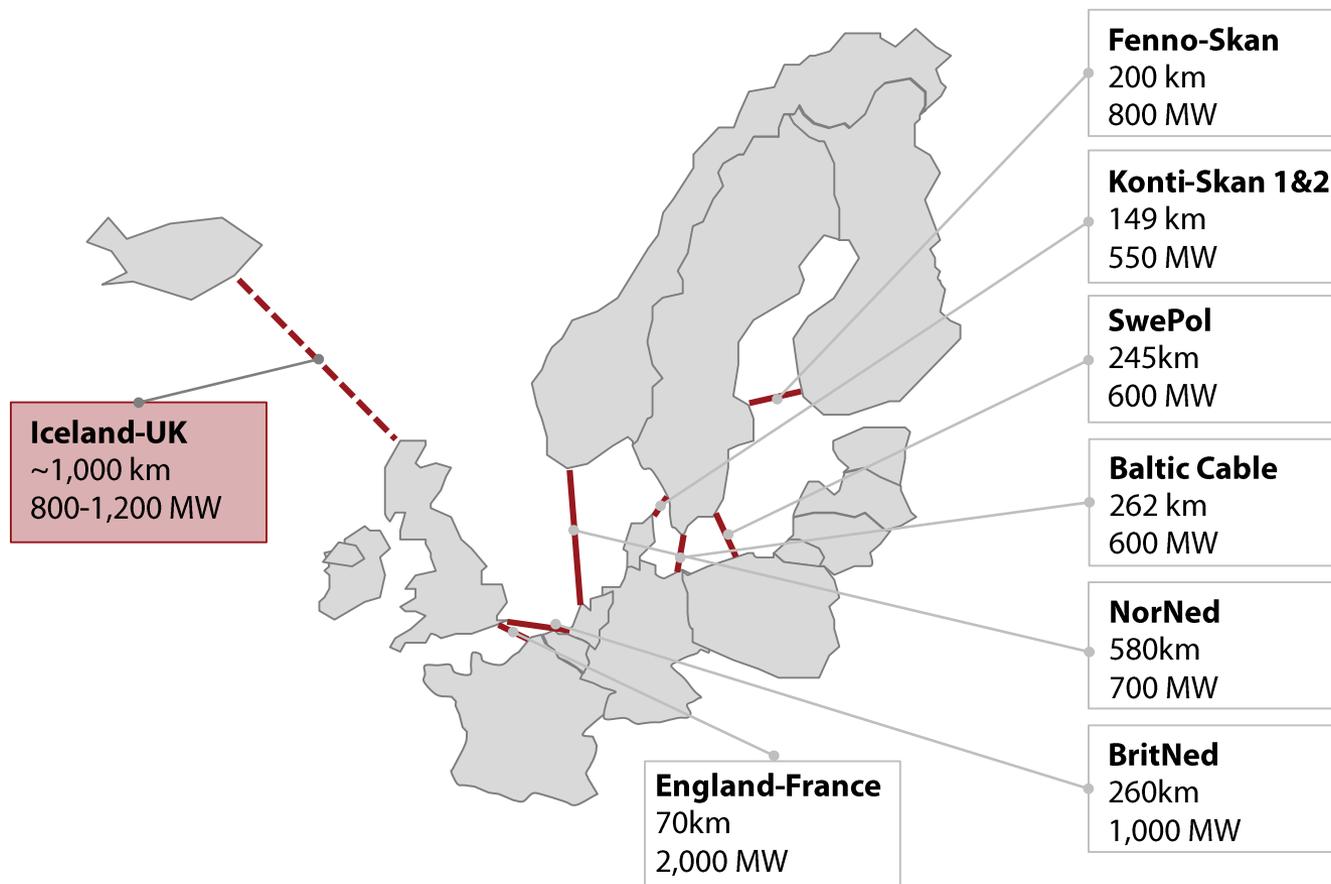
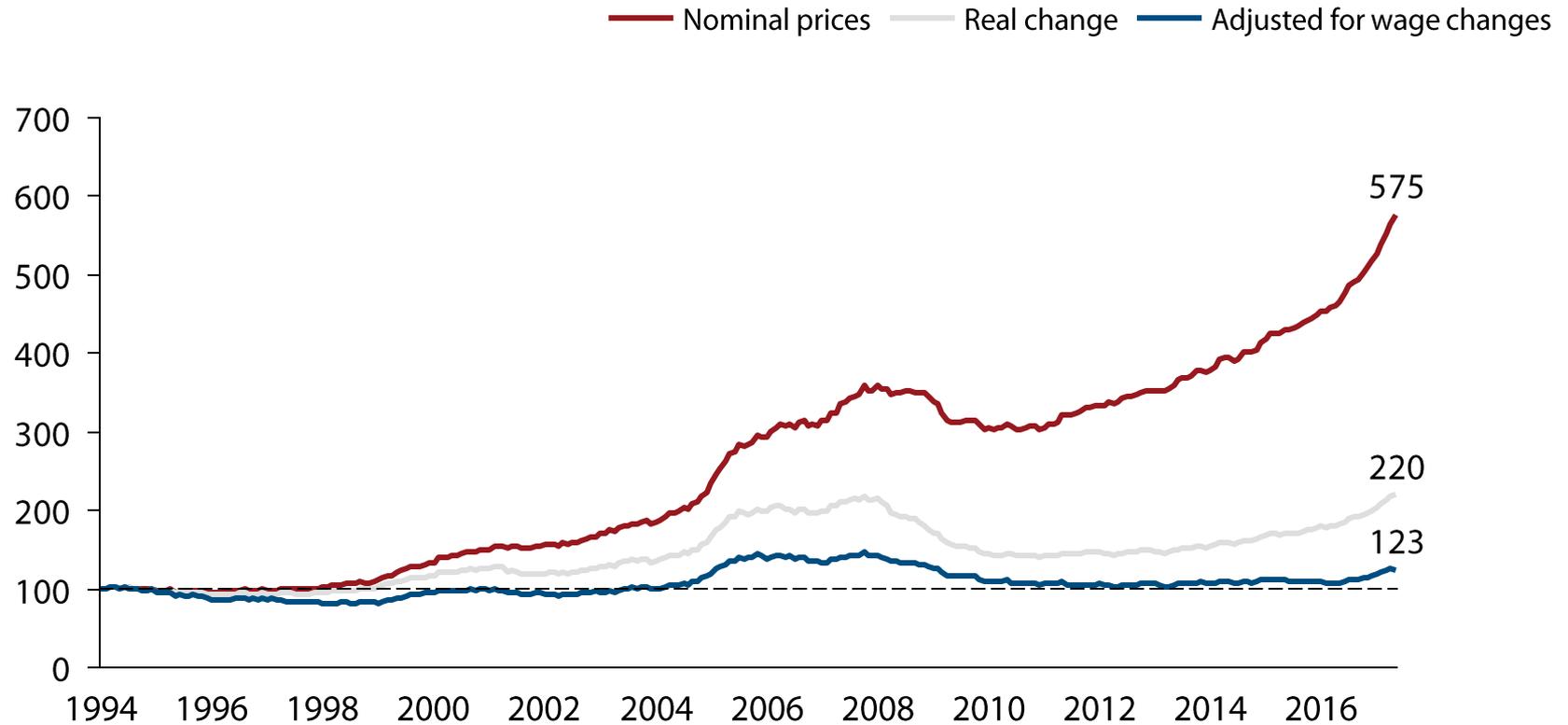


Figure 2.32

Housing prices have increased rapidly in the last years but adjusted for wages the increase is less dramatic

Housing Prices (index, Jan 1994 = 100)



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Ég er ástfanginn af bleikum (2016) - Arnar Birgis

Figure 3.1

The Iceland Growth Forum established a secretariat which presented reform proposals to support long-term growth



Figure 3.2

To capture the disruptive trends that are shaping the world, the Chamber will operate under four focus lenses

The Four Focus Lenses of Disruptive Trends

Lenses	Examples
 Digitisation	<ul style="list-style-type: none">▪ Embrace technological changes to drive productivity improvements across sectors▪ Improve services and achieve cost efficiency through digitization▪ Use big data insights to connect with customers and transform operations
 Regeneration	<ul style="list-style-type: none">▪ Support and grow knowledge driven export sectors of the Icelandic economy▪ Reshape generations to match talent to new composition of the society▪ Welcome the world's talents and early stage entrepreneurs
 Environmental Sustainability	<ul style="list-style-type: none">▪ Maximize value creation of Icelandic resource industries▪ Protect nature with focus on productivity and sustainability▪ Focus on origin, purity and quality of Icelandic products for global marketing
 Global Connections	<ul style="list-style-type: none">▪ Boost global position of Iceland as the country to base and do business in▪ Improve the business environment through tax and regulatory reform▪ Focus on new business development, M&A and alliance building as well as new market-entry strategy



Rétt handan við Indíanagil (2014) - Arnar Birgis