The Icelandic Economy
Current State, Recent Developments and Future Outlook
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.
Acknowledgements

The following companies supported the publication of this report

Icelandair
HB Grandi
GA Smíðajárn
Valitor
KPMG
EY
Nasdaq Iceland
Lex Law Offices
Thule Investments
Deloitte
Icelandic Startups
Samskip
Kjarninn
Iceland has a high standard of living and has largely recovered from the recession

Country rankings, GDP per capita (PPP¹ adjusted)
Figure 1.2
Iceland ranks highly in numerous competitive indices
Competitiveness Rankings (Iceland’s rank for 2016 / total number of countries)

- Gender equality (WEF) 1 / 144
- Global Peace Index (IEP, vision of humanity) 1 / 163
- Democracy Index (The Economist) 2 / 167
- Environmental Performance Index (YALE) 2 / 180
- Human Development (UN) 9 / 188
- Media Freedom (Freedom House) 11 / 202
- Global Innovation Index (INSEAD) 13 / 128
- Corruption (Transparency Int.) 14 / 176
- Prosperity Index (Legatum) 14 / 149
- Doing Business (WB) 20 / 190
- Economic freedom (HF) 20 / 178
- Property Rights Index (IPRI) 23 / 128
- Competitiveness (IMD) 23 / 61
- Global Competitiveness Index (WEF) 27 / 138
- Globalization (KOF) 50 / 207

Source: Respective websites
Figure 1.3

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

GDP growth per capita (percent)

Sources: Statistics Iceland; Central Bank of Iceland (Monetary Bulletin 2017/2); Iceland Chamber of Commerce
Iceland’s economy was one of the fastest growing in the world in 2016

GDP growth in 2016 (percent)

<table>
<thead>
<tr>
<th>Region</th>
<th>Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Iceland</td>
<td>7.2</td>
</tr>
<tr>
<td>Other Nordics</td>
<td>1.7</td>
</tr>
<tr>
<td>Euro area¹</td>
<td>1.7</td>
</tr>
<tr>
<td>OECD total growth</td>
<td>1.8</td>
</tr>
</tbody>
</table>

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

Sources: OECD statistics; Iceland Chamber of Commerce
Figure 1.5
Unemployment decreased after a sharp rise in 2009 and is now near structural unemployment levels

Unemployment Rate (percent; yearly average)

- 2000: 1.3%
- 2004: 3.4%
- 2008: 1.6%
- 2012: 8.0%
- 2016: 2.3%

Source: The Directorate of Labour
To keep up with shortage of labour there has been an influx of foreign workers in the economy

Labour Demand (# of workers; % of companies)

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Sources: Central Bank of Iceland; SA-Business Iceland; Iceland Chamber of Commerce
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)

Source: Central Bank of Iceland (Monetary Bulletin 2017/2)
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

Source: Central Bank of Iceland (Economic Indicators 30 June 2017)
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)

Sources: Central Bank of Iceland; Iceland Chamber of Commerce
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)
The devaluation of the Króna balanced out a persistent current account deficit and supported a surplus since 2012

Current Account Balance\(^1\) (percent of GDP)

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

Sources: Central Bank of Iceland; Iceland Chamber of Commerce
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

Source: Central Bank of Iceland; Iceland Chamber of Commerce
Iceland has historically been dependent on fishing but three other export foundations have since emerged

Iceland’s Exports\(^1\) (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.

Source: Statistics Iceland; Central Bank of Iceland; Iceland Chamber of Commerce
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

Sources: Gallup; Datamarket; Iceland Chamber of Commerce
### Figure 2.3

The Icelandic tax system relies heavily on consumption and labor income

#### Key Taxes in Iceland

<table>
<thead>
<tr>
<th>Tax</th>
<th>Rate</th>
<th>Recent changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>VAT(^1)</td>
<td>24%</td>
<td>- Lowered from 25.5%; lower bracket raised from 7% to 11% in 2015</td>
</tr>
<tr>
<td>Labour income(^2)</td>
<td>46%</td>
<td>- Middle bracket (38.35% for 336-501 thousand ISK) was removed in 2017</td>
</tr>
<tr>
<td>Corporate tax</td>
<td>20%</td>
<td>- Unchanged since 2011 when it was increased from 18% to 20%</td>
</tr>
<tr>
<td>Dividends / Capital gains</td>
<td>20%</td>
<td>- Unchanged since 2011 when it was increased from 18% to 20%</td>
</tr>
</tbody>
</table>

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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 services are 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

**Sources:** PwC; Directorate of Internal Revenue; Iceland Chamber of Commerce
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)

- **Landsbankinn**
  - Government: 98%
  - Failed banks’ estates: 2%

- **Arion bank**
  - Government: 29%
  - Failed banks’ estates: 58%
  - Active investors: 13%

- **Íslandsbanki**
  - Government: 100%

Sources: The banks’ webpages; Iceland Chamber of Commerce
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

- Individuals
- Pension Funds
- Foreign Investors
- Failed Banks’ Estates
- Icelandic Companies

Source: Iceland Chamber of Commerce
The capital controls on domestic parties have been lifted after a long process

Action Plan for Lifting Capital Controls

<table>
<thead>
<tr>
<th>Financial stability</th>
<th>Refinancing</th>
<th>Failed banks</th>
<th>Offshore currency</th>
<th>Domestic parties</th>
</tr>
</thead>
<tbody>
<tr>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
<td>✔️</td>
</tr>
</tbody>
</table>

- Capital controls and restructuring of private debt
- Government, banks and state-owned companies’ refinanced debt
- Voluntary composition agreement with estates of all failed banks
- FX auction and ringfencing of all offshore ISK
- Government lifted controls on outstanding parties on March 13th 2017
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.

Sources: Central Bank of Iceland; Alpingi; Iceland Chamber of Commerce
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)

- Icelandic Króna
- Japanese Yen
- US Dollar
- British Pound
- Norwegian Krona
- Swedish Krona

<table>
<thead>
<tr>
<th>Currency</th>
<th>Free-floating (03-'09)</th>
<th>Capital controls (2010-2016)</th>
<th>Post controls (2017-)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Icelandic Króna</td>
<td>2.5</td>
<td>1.9</td>
<td>0.9</td>
</tr>
<tr>
<td>Japanese Yen</td>
<td>1.8</td>
<td>1.6</td>
<td>1.5</td>
</tr>
<tr>
<td>US Dollar</td>
<td>1.5</td>
<td>1.3</td>
<td>1.0</td>
</tr>
<tr>
<td>British Pound</td>
<td>1.2</td>
<td>1.2</td>
<td>0.9</td>
</tr>
<tr>
<td>Norwegian Krona</td>
<td>1.1</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Swedish Krona</td>
<td>0.9</td>
<td>0.9</td>
<td>0.6</td>
</tr>
</tbody>
</table>

1 From 1st of January 2010 till 13th of March 2017
2 From 13th of March 2017 till 14th of July 2017

Sources: Central Bank of Iceland; Iceland Chamber of Commerce
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)\(^1\)

- 1990-1993\(^1\): 2.0%
- 1994-2008: 5.5%
- 2009-2016: 2.2%
- 2017-: ?

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

Sources: Statistics Iceland; Iceland Chamber of Commerce
Pension funds have become a significant mortgage lender

New Mortgages by Lender (bn. ISK)

<table>
<thead>
<tr>
<th>Year</th>
<th>Banks</th>
<th>Pension funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>42</td>
<td>9</td>
</tr>
<tr>
<td>2014</td>
<td>44</td>
<td>12</td>
</tr>
<tr>
<td>2015</td>
<td>83</td>
<td>8</td>
</tr>
<tr>
<td>2016</td>
<td>78</td>
<td>75</td>
</tr>
</tbody>
</table>

1 The Housing Financing Fund

Sources: Central Bank of Iceland (Financial Stability 2017/1); Iceland Chamber of Commerce
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 RAM\(^1\) (percent of GDP)

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1 Reserve adequacy metric
2 Excluding Iceland

Sources: Central Bank of Iceland (Financial Stability 2017/1); Iceland Chamber of Commerce
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)
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)

Sources: GAM Management; Registers Iceland; Statistics Iceland; Iceland Chamber of Commerce
Figure 2.15
Composition of inflows changed after the Central Bank introduced new restrictions 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.

Sources: Central Bank of Iceland (Financial Stability 2017/1); Iceland Chamber of Commerce
The domestic sector accounts for about two thirds of the economy

Composition of the Icelandic Economy (percent of GDP)
Low productivity is the main weakness of the Icelandic Economy compared to neighbouring countries

<table>
<thead>
<tr>
<th>GDP 000’s USD(^1) per capita</th>
<th>Employment % of population employed</th>
<th>Working Hours Yearly working hours per worker</th>
<th>Capital Stock 000’s USD per worker(^2)</th>
<th>Total Factor Productivity Constant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norway 46</td>
<td>Iceland 55.9</td>
<td>Iceland 1,880</td>
<td>Iceland 284</td>
<td>Iceland 9.7</td>
</tr>
<tr>
<td>Denmark 48</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sweden 1552</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK 301</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Iceland 13,5</td>
</tr>
</tbody>
</table>

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)

Sources: IMF World Economic Outlook; OECD; The Countries’ Statistic Bureaus; McKinsey & Company; Iceland Chamber of Commerce
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)

Source: Central Bank of Iceland

1 Labour costs per unit manufactured
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)

- **Wage index**
- **CPI without housing**
- **Purchasing power without housing**

Sources: Statistics Iceland; Iceland Chamber of Commerce
Residential housing construction has been subdued for the past 8 years, while hotel construction has spiked.

Figure 2.21
Completed Apartments and Hotel Room Supply (yearly; thousands)

Sources: Statistics Iceland; Iceland Chamber of Commerce
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

Sources: Statistics Iceland; Iceland Chamber of Commerce
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 Real ISK

Source: McKinsey & Company (Charting a Growth Path for Iceland)
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)\(^2\)

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

Iceland’s Exports\(^1\) (sector share of exports, percent, left axis) (index, 2011=100, 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.

Sources: Central Bank of Iceland; Statistics Iceland; McKinsey & Company; Iceland Chamber of Commerce
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)

- Accommodation¹ (left axis)
- Tourists² (right axis)

1 Yearly average
2 The figure for 2017 is an estimate by Íslandsbanki

Sources: Statistics Iceland; Icelandic Tourist Board; Íslandsbanki (Report on the Icelandic Tourism); Iceland Chamber of Commerce
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

Source: Iceland Chamber of Commerce
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 Reduction in index implies appreciation of ISK

Sources: Central Bank of Iceland; Iceland Chamber of Commerce
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)

Sources: Numbeo; Landsbankinn; Iceland Chamber of Commerce
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)

Source: Iceland Chamber of Commerce
An interconnector from Iceland to the UK would be one of the longest in Europe and requires significant investment
Housing prices have increased rapidly in the last years but adjusted for wages the increase is less dramatic

Housing Prices (index, Jan 1994 = 100)
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

<table>
<thead>
<tr>
<th>Lenses</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Digitisation</strong></td>
<td>▪ Embrace technological changes to drive productivity improvements across sectors</td>
</tr>
<tr>
<td></td>
<td>▪ Improve services and achieve cost efficiency through digitization</td>
</tr>
<tr>
<td></td>
<td>▪ Use big data insights to connect with customers and transform operations</td>
</tr>
<tr>
<td><strong>Regeneration</strong></td>
<td>▪ Support and grow knowledge driven export sectors of the Icelandic economy</td>
</tr>
<tr>
<td></td>
<td>▪ Reshape generations to match talent to new composition of the society</td>
</tr>
<tr>
<td></td>
<td>▪ Welcome the world’s talents and early stage entrepreneurs</td>
</tr>
<tr>
<td><strong>Environmental Sustainability</strong></td>
<td>▪ Maximize value creation of Icelandic resource industries</td>
</tr>
<tr>
<td></td>
<td>▪ Protect nature with focus on productivity and sustainability</td>
</tr>
<tr>
<td></td>
<td>▪ Focus on origin, purity and quality of Icelandic products for global marketing</td>
</tr>
<tr>
<td><strong>Global Connections</strong></td>
<td>▪ Boost global position of Iceland as the country to base and do business in</td>
</tr>
<tr>
<td></td>
<td>▪ Improve the business environment through tax and regulatory reform</td>
</tr>
<tr>
<td></td>
<td>▪ Focus on new business development, M&amp;A and alliance building as well as new market-entry strategy</td>
</tr>
</tbody>
</table>

Source: Iceland Chamber of Commerce
Rétt handan við Indiánagil (2014) - Arnar Birgis