

The Icelandic Economy

Current State, Recent Developments and Future Outlook



ICELAND CHAMBER
OF COMMERCE

The Icelandic Economy

Current State, Recent Developments and Future Outlook

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About the Chamber

The Iceland Chamber of Commerce (ICoC) is a non-governmental organization consisting of firms and individuals with the mission of improving the business environment in Iceland and increasing economic prosperity.

Iceland Chamber of Commerce

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Iceland



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

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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.



Ásta S. Fjeldsted
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1 Current Landscape

1.1 Overview

The Icelandic economy is an open developed economy operating under the Nordic model, combining a free market economy with a welfare state. It is the smallest economy within OECD, with 20.7 billion USD (2,422 bn. ISK) in annual gross domestic production (GDP).¹ This is equal to about 1/240th of the size of the German economy, 1/1000th of the size of the US economy, or 1/4500th of the global economy.

With only around 330 thousand inhabitants, this domestic production places Iceland among the top ranked countries in GDP per capita comparison (Figure 1.1). Iceland, which in the first half of the 20th century was one of the least affluent countries in Western Europe, has during the last few decades consistently ranked among nations with the highest standard of living worldwide. Its ranking slipped a few places in the aftermath of the financial crisis in 2008, but has risen once more in the past three years, and regained its pre-crisis position. In terms of GDP

In terms of GDP per capita Iceland currently sits in 18th place globally.

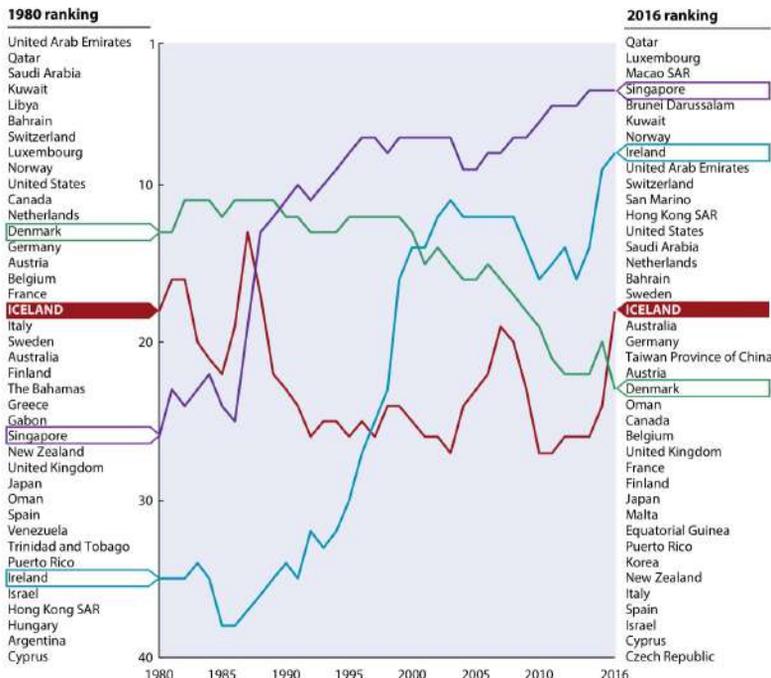
¹ Statistics Iceland, Central Bank of Iceland (ISK/USD = 120,67, average for the year 2016)

Figure 1.1

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

Country Rankings

GDP per capita, PPP adjusted¹



¹ Purchasing Power Parity

Sources: IMF World Economic Outlook; Iceland Chamber of Commerce

The labour market is a key strongpoint of the Icelandic economy, with a high labour participation rate coupled with long average working hours

Figure 1.2

Iceland ranks highly in numerous competitive indices

Competitiveness Rankings

Iceland's rank for 2016 / total number of countries

■ Iceland's ranking
■ # of countries ranked



Source: Respective websites

per capita Iceland currently sits in 18th place globally.

Iceland's success in building a prosperous and globally competitive economy can to some extent be attributed to a number of factors such as; a strong institutional framework, skilled workforce, high degree of economic freedom, sound democracy and low corruption. Various competitive indices reflect these qualities (Figure 1.2). Iceland ranks at the top in terms of gender equality and peace. Female labour force participation is high, measured 70% by the World Bank, which is a significantly higher percentage than elsewhere in Europe. The labour market is a key strongpoint of the Icelandic economy, made evident by a high labour participation rate coupled with long average working hours.

1.2 Domestic Economy

Small open economies are often more volatile than larger economies, as

they lack regional diversification.² This has been the case for Iceland, which has historically experienced more pronounced business cycles than most other developed countries.

GDP Growth

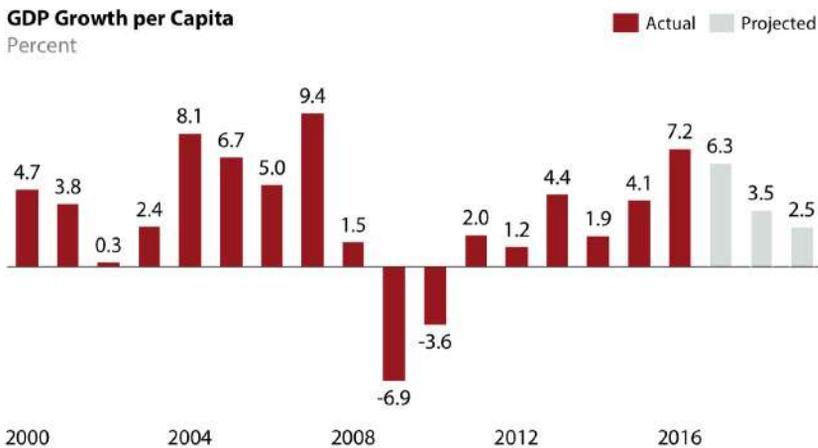
Leading up to the financial crisis in 2008, economic growth in Iceland was unparalleled among high income countries, averaging 6.5% per annum over a four-year period. Conversely, during the two years following the financial crisis the economy contracted by over 10%, a more severe contraction than seen within most other European economies (Figure 1.3).

During the last few years, the Icelandic economy has experienced a robust economic recovery, higher than its neighbouring countries as well as other high-income OECD countries (Figure 1.4). In fact, GDP growth in Iceland in 2016 was the second highest globally, trailing

² Pétursson, Breedon and Rose (2011) Link: <http://faculty.haas.berkeley.edu/arose/BPR.pdf>

Figure 1.3

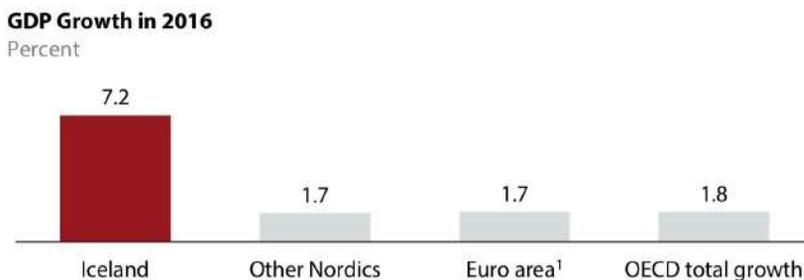
The economy shrank for two consecutive years following the financial crisis in 2008 but is now experiencing robust growth with a positive future outlook



Sources: Statistics Iceland; Central Bank of Iceland (Monetary Bulletin 2017/2); Iceland Chamber of Commerce

Figure 1.4

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



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

only Ethiopia.³ As in recent times, the export sector, particularly the fast-growing tourist industry, was the main growth driver, along with strong contributions from business investment and private consumption. The Central Bank of Iceland predicts that the economy will continue to grow quite robustly over the next few years, although trending closer to an

equilibrium growth rate of around 2.5%. As before, the growth will continue to be driven by tourism but the Central Bank also expects fiscal easing to be a factor.⁴

Labour and Wages

The labour market recovery has followed suit. Unemployment rose from 1% in 2007 to 8% in 2009

³ Only including confirmed GDP numbers. If estimates are included then Iceland's growth was 6th globally. Source: International Monetary Fund (2017). World Economic Outlook, April 2017.

⁴ Central Bank of Iceland, Monetary Bulletin (2017/2), www.cb.is/library/Skraarsafn---EN/Monetary-Bulletin/2017/May-2017/Monetary_Bulletin_2017_2.pdf

following the financial crisis, but has since gradually declined and is now at its lowest levels since early 2008 (Figure 1.5). Although unemployment is currently not as low as pre-crisis levels, it is considered to be close to Iceland's structural unemployment rate.⁵ Historically the structural rate

has trended between 2.5-5%, and increased in the years post-crisis.⁶ The trend of decreasing unemployment looks set to continue. According to a recent study by the Central Bank of Iceland around 25% of Icelandic firms plan to recruit staff and 40% of firms consider themselves short-staffed (Figure 1.6).⁷

5 Structural unemployment is the rate of unemployment consistent with constant wage inflation or constant price inflation, given current economic conditions

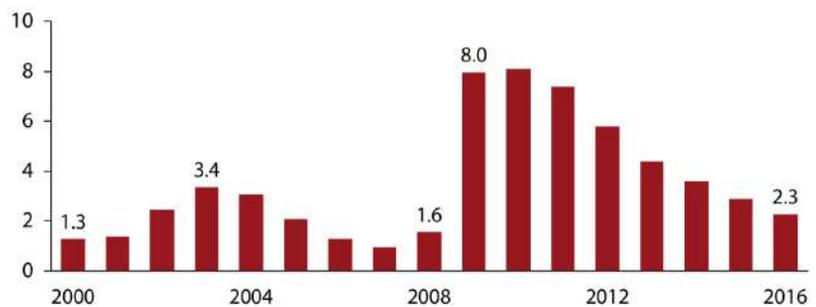
6 OECD Economic Outlook Stats 2012

7 Central Bank of Iceland, Monetary Bulletin (2017/2), www.cb.is/library/Skraarsafn---EN/Monetary-Bulletin/2017/May-2017/Monetary_Bulletin_2017_2.pdf

Figure 1.5

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

Unemployment Rate
Percent; yearly average

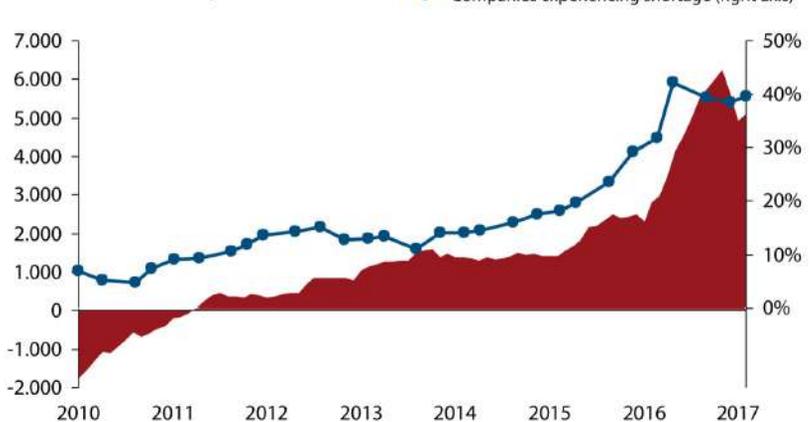


Source: The Directorate of Labour

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



Sources: Central Bank of Iceland, Iceland Chamber of Commerce

Some industries are experiencing strong and persistent labour shortage. Specifically, the construction sector has taken off due to a significant increase in tourism related infrastructure and real estate projects. The labour shortage has remained despite a large increase in imported labour.

Wages have risen substantially in recent years following a number of

collective wage agreements. Just over 80% of the workforce is part of a labour union in Iceland so collective wage negotiations have a big impact on the economy.⁸ Average nominal wage increases were 7.2% in 2015 and 11.4% in 2016.⁹ For comparison, average nominal wages increased 2% in the Nordic countries in 2016.¹⁰

8 SA-Business Iceland (2017)

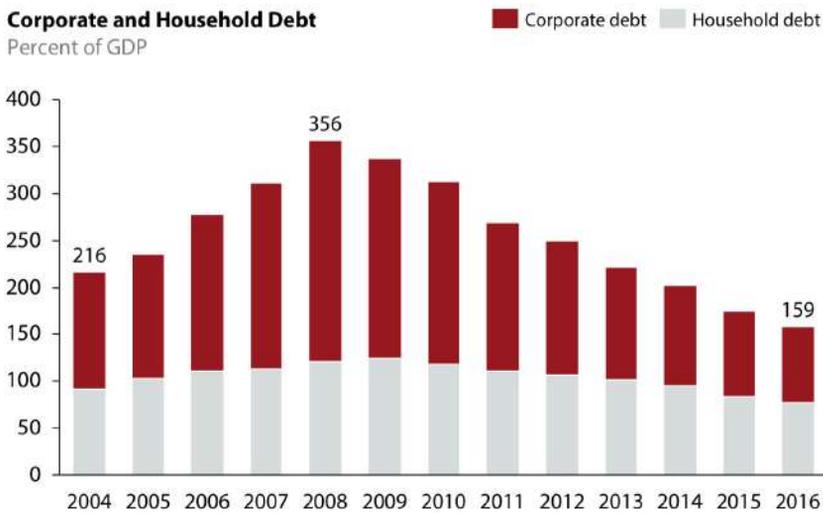
9 Statistics Iceland (2017). Wage index from 1989

10 OECD (2017). Average Annual Wages

The construction sector has taken off due to a significant increase in tourism related infrastructure and real estate projects.

Figure 1.7

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



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

Average nominal wage increases were 7.2% in 2015 and 11.4% in 2016. For comparison, average nominal wages increased 2% in the Nordic countries in 2016.

Moreover, wages in Iceland have risen on average 11% in the first 6 months of 2017. In the second half of 2017 a total of 40 wage agreements will expire and need to be renegotiated.¹¹ About 10% of the Icelandic workforce, mostly public servants, will be a part of these negotiations,¹² which are expected to demand significant wage

increases as top government officials received a substantial one after the last agreements. (See more about the labour market in chapter 2.6)

Debt Levels

Alongside improved labour market conditions, the Icelandic economy has been in a deleveraging phase (Figure 1.7). Following several consecutive years of credit expansion, culminating in the financial turmoil

Debt levels, especially corporate debt, have declined rapidly and are now at lower levels than in 2003.

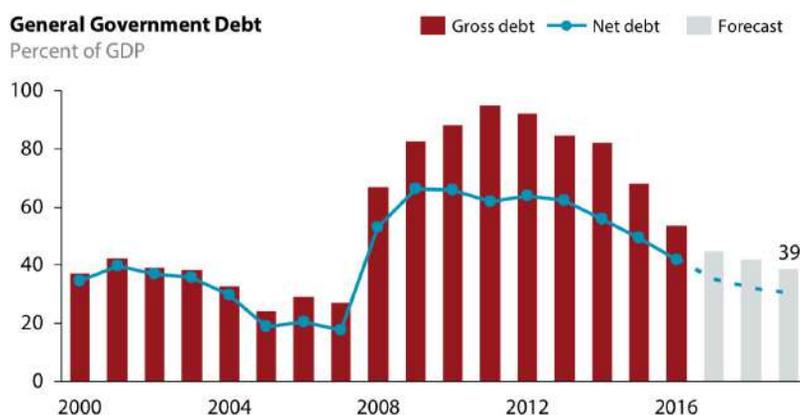
11 State Conciliation and Mediation Officer (2017). Expiration of wage agreements

12 Ríkisútvvarpið (2017), www.ruv.is/frett/kjarasamningar-um-20000-manna-losna-a-arinu

In 2016 the budget surplus amounted to 17% of GDP, a record result historically. However, this result is primarily due to one-off payments, so called “stability contributions”.

Figure 1.8

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



¹ Predictions by the Central Bank of Iceland

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

in Q3 2008, firms and households have been paying down debt. Debt levels, especially corporate debt, have declined rapidly and are now at lower levels than in 2003.

Iceland’s public debt used to be low by international standards but rose in almost a single leap in the aftermath of the financial crisis in 2008 (Figure 1.8). During the crisis the government stepped in and recapitalized both the Central Bank and the large domestic banks, resulting in a cost which the IMF estimates at around 34% of GDP.¹³ Additionally, tax revenues declined as a result of the economic contraction and use of the welfare system increased. All of the above-mentioned events led to a large budget deficit, which persisted for a number of years following the crisis. As a result, some austerity measures were undertaken and public expenditures were reduced. The government achieved a budget surplus in 2014 - the first time since the financial collapse. In 2016

the budget surplus amounted to 17% of GDP, a record result historically. However, this result is primarily due to one-off payments, so called stability contributions, which represent a settlement from the failed financial institutions (see more in chapter 2.2). Recently, public debt levels have gone down again as the government is running a surplus and has sold some of the assets acquired during the financial crisis.

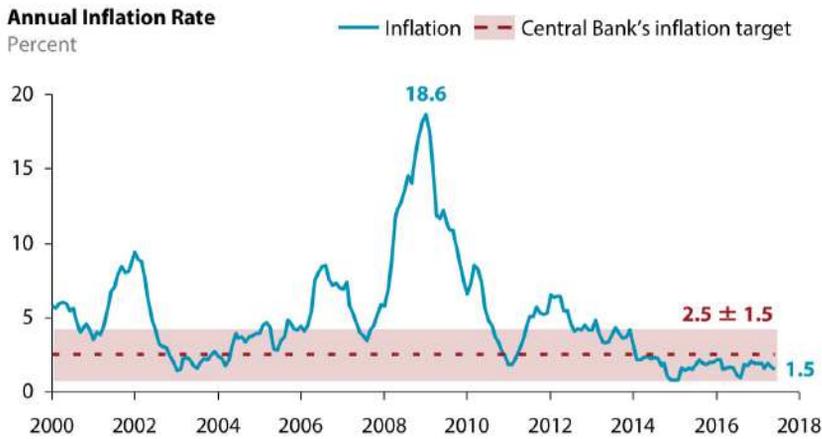
Current government debt is approximately 54% of GDP which is a significant improvement from 2015 when it amounted to 68% of GDP. The government debt level in Iceland has thus fallen rapidly and is for example below that of Germany, the Netherlands and Finland.¹⁴ Furthermore, the Central Bank of Iceland predicts the trend to continue in the next few years, given the current government’s increased emphasis on further debt repayments.

¹³ International Monetary Fund (2016). [www.sedlabanki.is/library/Skraarsafn/Althjodasvid/Iceland_Article%20IV%202016%20-%20Copy%20\(1\).pdf](http://www.sedlabanki.is/library/Skraarsafn/Althjodasvid/Iceland_Article%20IV%202016%20-%20Copy%20(1).pdf)

¹⁴ International Monetary Fund (2017). World Economic Outlook, April 2017.

Figure 1.9

Following a dramatic devaluation of the Króna inflation rose quickly up to double digits but has now stayed within the Central Bank's target range for three years



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

Inflation and Currency

High inflation has long been a concern in Iceland. In March 2001, the Central Bank of Iceland converted from an exchange rate targeting monetary policy and adopted an inflation-targeting policy with a 2.5% inflation target. Since the adoption of the policy, however, inflation has usually

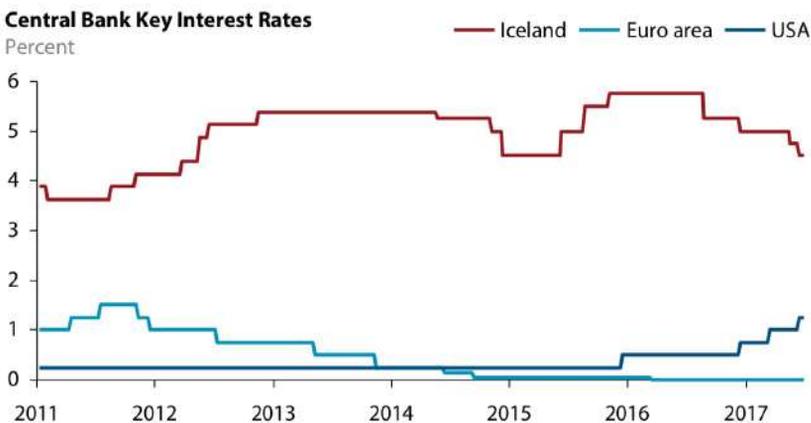
exceeded this target averaging 5% p.a. (Figure 1.9).

One of the characteristics of the Icelandic economy is the volatile currency and the large impact of exchange rate fluctuations on inflation. Currently, imported goods account for roughly 30% of the consumer price index (CPI) used

Exchange rate fluctuations have a large impact on inflation. Currently, imported goods account for roughly 30% of the consumer price index (CPI).

Figure 1.10

Interest rates in Iceland are high compared to developed economies



Sources: Central Bank of Iceland; Iceland Chamber of Commerce

to measure inflation. Furthermore, housing is included in the CPI, contributing around 25% to the index. When the Icelandic Króna (here after Króna) depreciates, import prices of foreign goods and services rise, causing inflation. In 2008 and the beginning of 2009, this effect was particularly pronounced. During this period, the value of the Króna fell by 50%, resulting in inflation peaking at 18.6%. Since this spike, inflation has gradually declined and remained below the Central Bank's inflation target since early 2014.

After the significant nominal wage increases of recent years the Central Bank along with market analysts expected inflation to take off. As a precaution, the Central Bank raised interest rates from 4.50% in June of 2015 to 5.75% in November the same year. However, thanks to low global inflation and a strengthening Króna,

domestic inflation remained subdued. As a result, interest rates have been lowered gradually and are now back at 4.50% (Figure 1.10).

1.3 International Trade and Investment Position

The small size of the domestic economy makes Iceland highly dependent on international trade. Since various goods and services are not produced domestically they need to be imported for domestic use. To fund these imports, a strong export sector is required. Thus, international trade plays an important role when examining Iceland's economic performance.

Balance of Trade

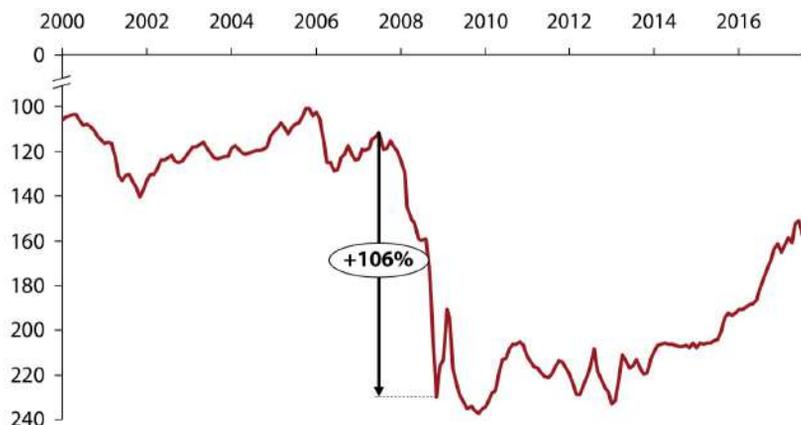
Prior to the financial crisis, Iceland had a significant trade deficit (i.e. imports of goods and services far exceeded

Figure 1.11

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

Exchange Rate Index

A higher index value indicates a weaker Icelandic Króna



Source: Central Bank of Iceland

exports), which led to a build-up of record-high levels of external debt. This trade deficit was in large part due to the appreciation of the Króna, which lowered prices of foreign goods and services (Figure 1.11).

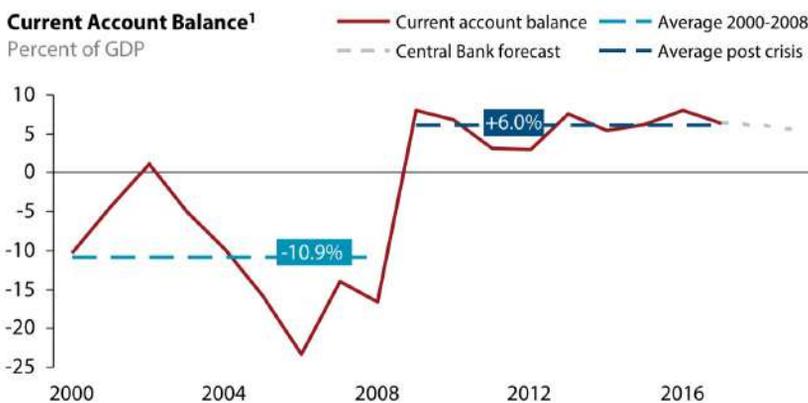
At the onset of the crisis in the fall of 2008, investors pulled out of Iceland, resulting in the rapid outflow of foreign capital and a significant devaluation of the currency. This caused the trade deficit to revert to

a surplus, as many foreign goods became too expensive to import, and revenues in Króna from exports increased. Tourism has been the biggest driver of the turnaround

as of recently. Since early last year the Króna has, however, rapidly strengthened. Simultaneously export growth, specifically of goods, has slowed down and imports increased.

Figure 1.12

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



¹ Underlying current account, excludes the effects of the failed banks' estates
Sources: Central Bank of Iceland; Iceland Chamber of Commerce

During this time, the Central Bank has been actively accumulating foreign currency to slow down the appreciation of the Króna. In 2016, exports of goods and services amounted to around 45% of Iceland's GDP and the trade surplus to around 7%. The accumulated trade surplus in the past seven years following the financial crisis (2009-2016) is equivalent to 61% of 2016 GDP, which is almost unprecedented in the country's economic history. This large trade surplus has contributed to a current account surplus, although not as significant as the trade surplus. The underlying current account surplus¹⁵ has averaged about 6% of GDP since the crisis. This is in strong contrast to the persistent and significant current account deficit that Iceland had been running, especially in the years leading up to the financial crisis in 2008 (Figure 1.12).

Net International Investment

Iceland's negative net international investment position (NIIP) explains why the current account surplus has not been as large as the trade surplus. The NIIP measures assets owned by domestic entities abroad minus domestic assets owned by foreign entities. Thus, a negative NIIP results in a net outward flow of interest and dividends. Iceland's NIIP became progressively more negative in the last decade, reaching unsustainable levels before the 2008 crisis (Figure 1.13). After a restructuring of the banking system in the aftermath of the financial crisis and years of current account surplus, the position has now been reversed.

Today the NIIP is the most favourable it has been in decades and Iceland has gone from being a net borrower

The accumulated trade surplus in the past seven years following the financial crisis (2009-2016) is equivalent to 61% of 2016 GDP

¹⁵ Excludes the effects of the failed banks' estates

Today the NIIP is the most favourable it has been in decades and Iceland has gone from being a net borrower to a net lender.

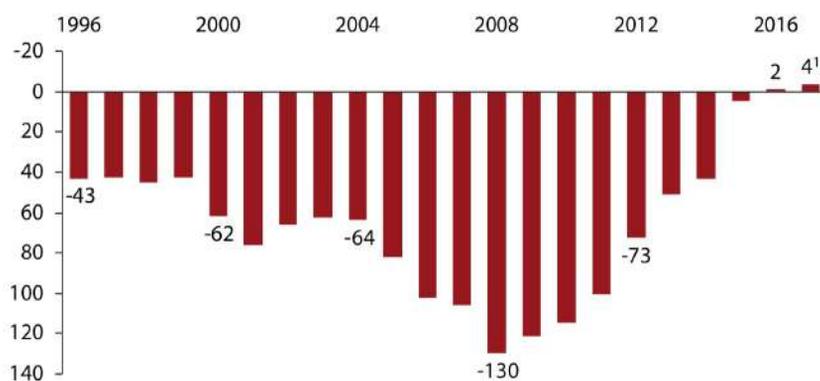
to a net lender. The main driver of the improvement in 2015 and 2016 was a settlement of the failed banks' estates which eliminated the balance of payment risk associated with the estates. The persistent current account surplus has additionally allowed for increased foreign debt repayments,

and debt write-offs associated with private sector bankruptcies has also improved the NIIP. The Króna appreciation has however had negative effects on Iceland's external investment position, if measured in domestic currency.

Leading up to the crisis, Iceland's net foreign position became progressively more negative but has since recovered significantly and is at its lowest level in decades

Iceland's Net Foreign Obligations

Net international investment position (NIIP), percent of GDP



¹ First quarter of 2017

Source: Central Bank of Iceland; Iceland Chamber of Commerce

During the last twenty years, three additional export foundations have emerged: the international sector, the aluminium industry and the tourism industry.

Export Foundations

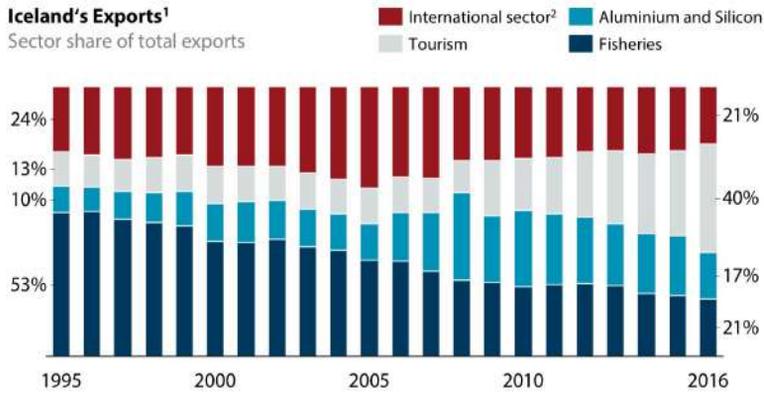
A key challenge for Iceland is to increase its exports to maintain its current account surplus and support ongoing and sustainable growth. Two decades ago the country was heavily dependent on fisheries with more than half of exports originating from the fishing industry (Figure 1.14). Since then, fish-related exports have remained relatively stable, as the industry is limited by the quantity it can harvest, to preserve the size and sustainability of the fishing stock.

During the last twenty years, three additional export foundations have

emerged: the international sector, the aluminium industry and the tourism industry. Around the new millennium the international sector grew rapidly. The sector engages in international competition but is not reliant on natural resources. Then, between 2005 and 2008, exports of aluminium took off following the construction of one new aluminium smelter and the expansion of another. Finally, in the last few years, Iceland has witnessed rapid growth in the tourism industry which now makes up two fifths of Iceland's total export. Overall, Iceland's exports of goods and services have grown rapidly and become more diversified over the last two decades.

Figure 1.14

Iceland has historically been dependent on fishing but three other export foundations have emerged, tourism now being the largest export sector



¹ As agriculture is heavily subsidised and only a small fraction of total exports, it is dropped from this analysis
Sources: Statistics Iceland; Central Bank of Iceland; Iceland Chamber of Commerce



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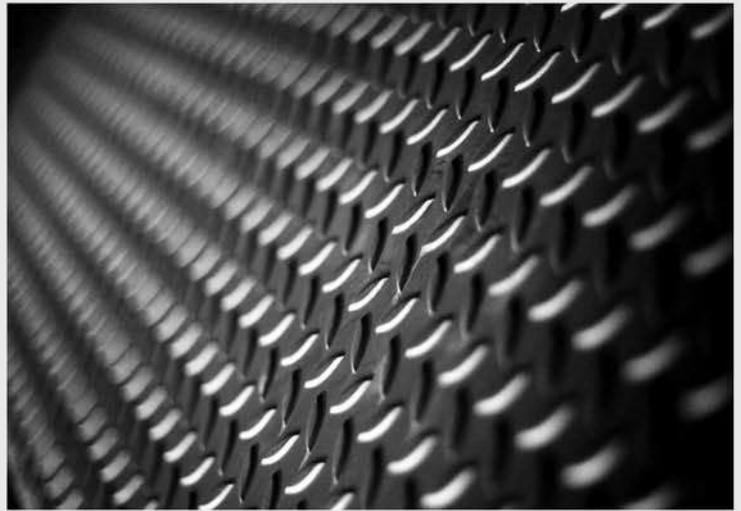
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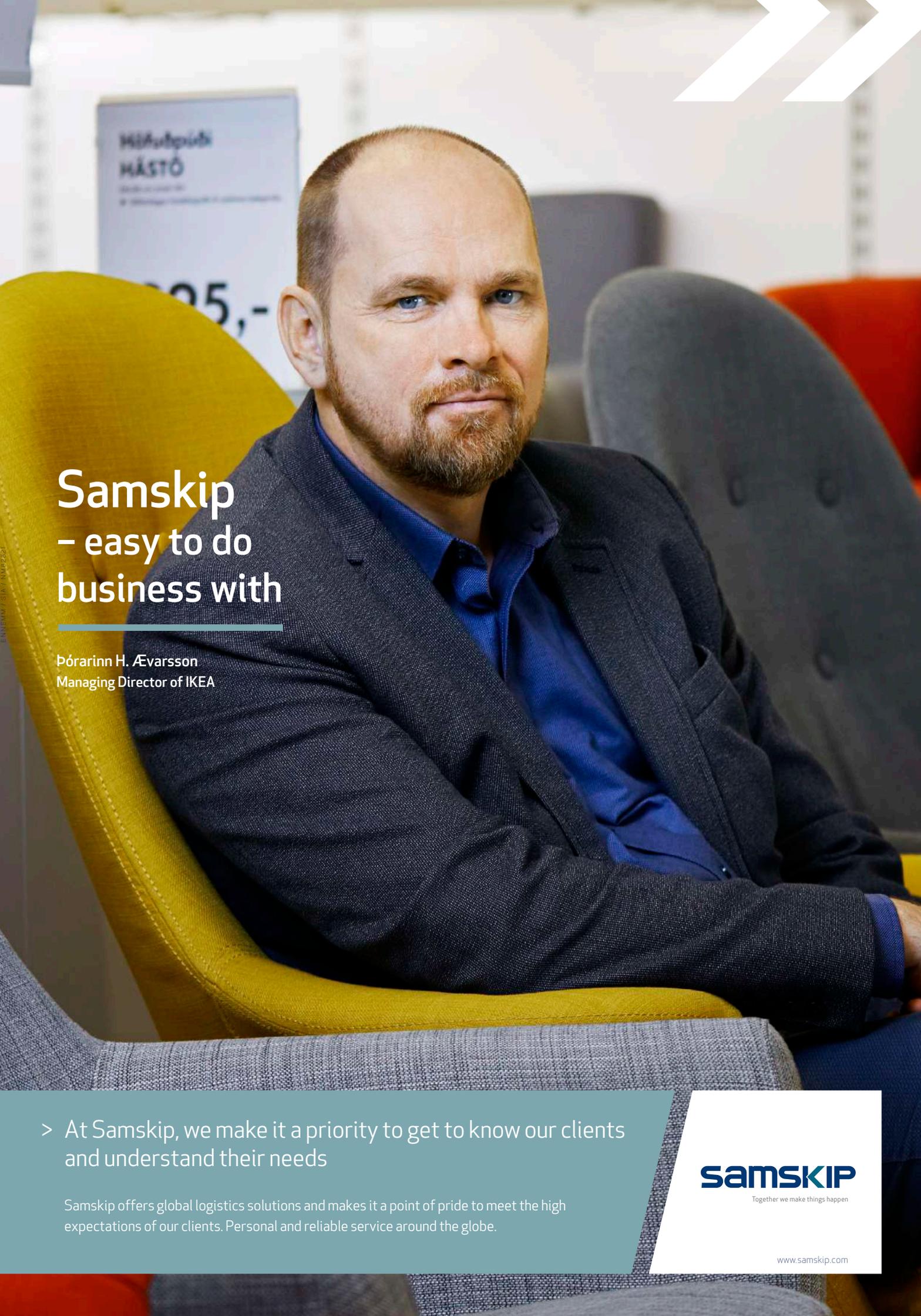
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2 Recent Developments

The categorization used in this overview of the Icelandic economy is inspired by McKinsey & Company's "Charting a growth path for Iceland". This segments the economy into the five different categories the Iceland Chamber of Commerce has focused its work around for the past few years: the financial, domestic, resource and international sectors, and the political landscape. Furthermore, we have included segments on two specific sections of the economy that have been especially eventful over the past year: the housing market and the labour market.

2.1. Political Landscape

Introduction

In the beginning of 2016 a centre-right government was in power. Formed by the Independence party and the Progressive party in May 2013, it received 51% of the popular vote and 38 of possible 63 seats in the Parliament. However, as a response to public distrust following the "Panama papers", a data leak exposing multiple tax havens around the world, Iceland's former Prime Minister, Sigmundur Davíð Gunnlaugsson, resigned. Thus,

the government changed leadership and the Progressive party's vice chairman Sigurður Ingi Jóhannesson took over as interim prime minister. Consequently, elections were held in October 2016, instead of the following spring when the term officially ended.

Following the elections, a three-party centre-right government was formed with the Independence Party, the Reform Party and the Bright Future Party on January 11th 2017, after two months of negotiations (Figure 2.1). The new government is led by the chairman of the Independence Party and former Minister of Finance, Bjarni

Figure 2.1

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



Source: Prime Minister's Office

The Icelandic people elected a new government in 2016, in a snap election following the Panama papers' release. A new president, Mr. Guðni Th. Jóhannesson, was elected the same year, taking over from his predecessor who served for four consecutive terms.

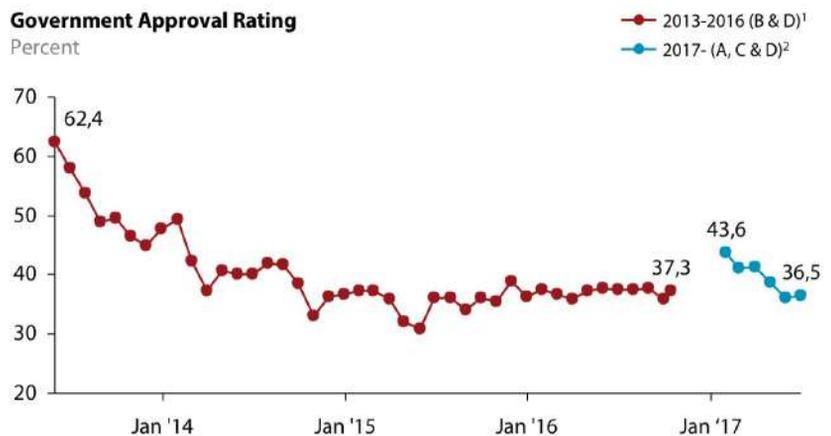
Benediktsson. Together the parties hold 32 seats of 63 in Parliament, the lowest number of seats required to form a majority.

The new government's approval rating has been low throughout its first months in office, standing at 44% shortly after taking office. This compares to the 65% approval rating of the 2009-2013 government and 62% of the 2013-2016 government in similar surveys. In a June 2017 poll the government's approval rating stood at 36.5%, six months into its term in office (Figure 2.2).

Presidential elections were also held in 2016. Mr. Guðni Th. Jóhannesson won the election with 39% of the vote. Iceland had the same president, Mr. Ólafur Ragnar Grímsson, for four consecutive terms (20 years), prior to Mr. Jóhannesson being elected. The President of Iceland is more of a symbolic figure and holds limited political power. However, the President plays a role in the formation of government, signs parliamentary bills into law (and thus has effective veto power) and can grant pardons and amnesty, among other things.

Figure 2.2

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



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

The government's political agenda emphasizes human rights and equality, increased competitiveness and tackling health care system challenges.

Government Agenda

The political agenda of the government sets out its priorities for the next four years. Current emphasis is on human rights and equality, the importance of increasing Iceland's competitiveness, and tackling health care system challenges. Furthermore, fiscal restraint during times of significant economic growth has been stressed. The government plans to reduce its share in the commercial banks and use proceeds to reduce public debt. Since the current

government has only been in office for a few months their political agenda has yet to be meaningfully tested. The past months have, however, provided some indication as to their focus.

Fiscal Policy

Following the financial crisis and its costly aftermath, there was increased demand for more transparent fiscal planning with a long-term focus. With

that in mind, a law was passed in 2015 which requires the acting government to set out a 5-year fiscal plan every year, a rolling 5-year budget so to speak. Every year, the fiscal plan is reassessed and updated before it gets proposed to the Parliament.

The Parliament has approved a fiscal plan for 2018-2022 which acts as a guideline for the future spending policy of the government. The focus is on reforming the tax system, to simplify it and ensure increased effectiveness, and prioritizing health care expenditure as well as infrastructure investment.

With regards to the tax system, the biggest proposed change in the

current 5-year fiscal plan is the sales tax (Figure 2.3). The proposed change is to occur in two steps. Firstly, on July 1st 2018 most segments of the tourism industry are to be moved from the lower sales tax bracket (11%) to the general bracket (24%). Secondly, on January 1st 2019, the general sales tax bracket is to be reduced from 24% to 22.5%. However, these tax changes have yet to be enacted by law and are still up for debate.

The 5-year plan has been approved, but the national budget is not put forward until December of each year. Changes proposed in the 5-year plan are thus not fully implemented until the actual budget is set.

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

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

Equal Pay Certification

Part of the government's agenda was equal pay certification which was adopted by law in June 2017. The certification obliges every company and institution with more than 25 employees to prove they offer equal pay regardless of gender. The aim

of the law is to close the wage gap between men and women. Iceland has thus become the first country in the world to make such a condition mandatory. To be certified, employers need to be audited to prove that they pay equal salaries for equal work or

The aim of the equal pay certification law is to close the wage gap between men and women. Iceland is the first country in the world to make such a condition mandatory.

they could face fines. The Minister of Social Affairs and Equality, Þorsteinn Víglundsson, has said that although the law may be burdensome for companies the benefits should outweigh the costs and effort.

The European Union

Iceland applied for membership to the European Union (EU) in July 2009, and was granted candidate country status one year later (Figure 2.4). During active negotiations, 27 out of 33 policy chapters were opened, and negotiations took place until January 2013, when they were suspended with six remaining chapters unopened. According to a report by The University of Iceland's Institute

of International Affairs on Iceland's accession negotiations¹, neither party was willing to commence negotiations on fisheries, and only the EU was willing to start negotiations on agriculture and rural development.

Despite negotiations progressing well, a dispute regarding mackerel fishing negatively affected the progress and resulted in the fisheries chapter not being opened. In January 2013, the government decided to decelerate the negotiations because of the upcoming parliamentary election in April that same year, effectively halting the admissions process. The government

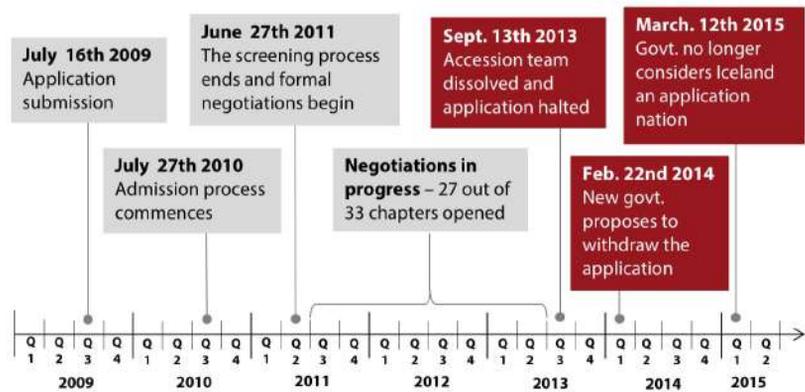
¹ An English summary of the report's conclusions can be accessed via the following link: www.vi.is/files/iia_iceland_eu_report_executive_summary_1818099411.pdf

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



Source: Iceland Chamber of Commerce

The newly elected government is more sympathetic towards the EU than the previous one, in particular the two smaller parties (Reform party and Bright Future party).

formed after the 2013 election made it clear in its coalition agreement that the membership application would remain suspended, pending a referendum on the question of whether or not to continue. In February 2014, a government bill proposing a formal withdrawal of the membership application was submitted to Parliament. The bill was met with public resistance and 53,000 signatures were collected opposing

the bill. As a result, the bill was not approved. However, in March 2015 Iceland's minister of foreign affairs unilaterally announced to the EU that the government no longer considered Iceland an EU candidate country. The EU has since removed Iceland from its list of candidate countries.²

² EU's list of potential candidate countries: https://ec.europa.eu/neighbourhood-enlargement/policy/glossary/terms/potential-candidate-countries_en

The newly elected government is more sympathetic towards the EU than the previous one, in particular the two smaller parties (Reform party and Bright Future party). The coalition's agenda states that the governmental parties are willing to vote on whether or not a national referendum should be held regarding further EU discussions, if the matter is introduced in the Parliament.

A more urgent matter for Iceland is "Brexit"; the future of its relationship with the United Kingdom (UK) after it leaves the EU. The UK is one of Iceland's most important export markets and accounts for 12% of total exports. Although not a member of the EU, Iceland has been a member of the European Free Trade Association (EFTA) since 1970 and entered the European Economic Agreement (EEA) in 1994. The outcome and consequences of Brexit will thus be closely followed in Iceland.

Monetary Policy

As noted in chapter 1, high inflation has long been a concern in Iceland. Currently the Central Bank of Iceland operates under an inflation-targeting policy, with a 2.5% inflation target. Since the adoption of the target in 2001 inflation has, however, usually exceeded this target (see Figure 1.8).

A volatile exchange rate has had a considerable impact on inflation in Iceland given that imported goods account for around a third of the consumer price index.

Given past experience with inflation in Iceland, monetary policy has often been a subject of big debate. Discussions surrounding the suitable interest rate for the economy, set by the Monetary Policy Committee, are common as interest rates have historically been high compared to other developed economies in Iceland (See figure 1.10).

Furthermore, the future of the Króna has been discussed in this context, whether in regards to reverting to an exchange rate targeting policy, pegging the exchange rate to another currency or joining a monetary union (as was discussed during the EU application process in 2009) in order to reduce exchange rate fluctuations.

The current government's agenda addresses the currency issue. It states that effort will be made to reduce exchange rate fluctuations, which contribute to economic volatility and the high interest rates that characterise the Icelandic economy. In that regard, the government aims to reassess the monetary- and exchange-rate policy.

Steps have been taken towards a possible change in Iceland's monetary policy. In March 2017 a three-person panel was appointed to evaluate Iceland's monetary policy framework.

The aim is to identify the framework best suited to promote economic and financial stability in Iceland in the long run. A team of foreign experts has been hired by the panel to address three topics in this regard: Iceland's experience with inflation targeting and possible reforms, alternative monetary policy measures for Iceland aside from the current inflation targeting, and a comparative study of Icelandic Monetary Policy and policies in the other Nordic countries.

The three-person panel will review the external experts' work and hand in a final report and suggestions for measures by end of year 2017.

2.2 Financial Sector

The Icelandic financial system is large compared to the size of the economy and underwent major changes during and following the financial crisis of 2008. Below, an overview of these changes is provided, as

In March 2017 a three-person panel was appointed to evaluate Iceland's monetary policy framework. The panel will hand in their report and suggestions for measures by year end 2017.

Ownership in the banking system has been unorthodox after the crisis and restricted almost exclusively to the government and the creditors of the failed banks. Recent developments have slightly changed this set-up.

well as a description of the current developments in asset markets and in the availability of foreign credit.

The Banking System

The Icelandic banking system underwent a major transformation in 2008, when all three of Iceland’s major commercial banks collapsed within the space of a week (Landsbankinn, Íslandsbanki and Kaupthing). The government feared a complete meltdown of the whole payment system, but had no way of rescuing the banks, as their combined balance sheets amounted to 14 trillion ISK in total, 11 times the GDP of the country. The government’s solution was to pass emergency legislation on October 6th 2008 that granted deposits priority over other claims. Furthermore, it allowed the Icelandic Financial Supervisory Authority to transfer domestic assets and liabilities from the distressed banks into new and functioning domestic banks. The government provided equity for Landsbankinn, the largest commercial bank, but ownership of the other two banks was mostly transferred to the failed banks’ estates following an agreement with the government.

Since the emergency legislation in 2008, Iceland’s domestic banking

system has been relatively healthy financially, although ownership has been unorthodox and restricted almost exclusively to two parties: the government and the creditors of the failed banks via the failed banks’ estates (Figure 2.5). Recent developments over the past year have somewhat changed this set-up. In early 2016 the Treasury acquired all share capital in Íslandsbanki.

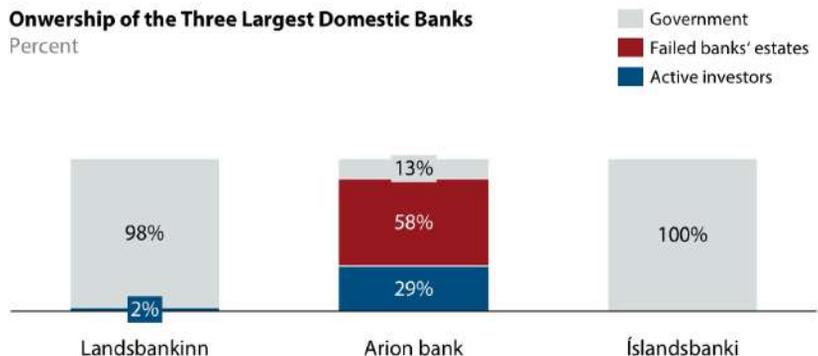
The transfer of share capital was a way for the creditors of the failed banks’ estates to fulfil the so-called “stability conditions” the government imposed on the estates in June 2015. The conditions formed a part of a settlement to neutralize the balance of payments threat that would arise when capital controls were lifted on the failed banks’ estates, so they could repay foreign creditors.³

Furthermore, as of early 2017 a large share of Arion bank is owned by active investors, although the sale is currently being reviewed by the Financial Supervisory Authority.

³ For more details on the settlement see „Settlement of the failed bank estates“ in the IMF’s Iceland country report 2016 (www.imf.org/external/pubs/ft/scr/2016/cr16179.pdf), and the Central Bank of Iceland’s 2015 memorandum on the „Settlement of the failed financial institutions on the basis of stability conditions: impact on the balance of payments and financial stability“

Figure 2.5

Iceland’s “Big Three” banks are mostly in government ownership



Sources: The banks’ webpages; Iceland Chamber of Commerce

The estate associated with the predecessor of Arion bank, Kaupthing, sold a 29% share to active investors, majority of whom were already owners of shares in the Kaupthing estate.⁴

The Icelandic State Financial Investments (ISFI) controls the state's holdings in Landsbankinn in accordance with the state's ownership policy, and the holdings in Íslandsbanki. It has been debated whether the government should be a shareholder in the Icelandic

banking system in the long run and, if so, how big the stake should be. The recent sale of a large share in Arion bank to investors in the Kaupthing estate has also been a point of debate regarding the nature of banking ownership in the country. If approved, three large foreign funds would effectively own 26% of the bank.⁵ Iceland's Minister of Finance has stated that the government plans to sell all of its banking assets, while possibly withholding a 35-40% share in Landsbankinn. This could however take many years, up to a decade.

It has been debated whether the government should be a shareholder in the Icelandic banking system in the long run and, if so, how big the stake should be.

4 Announcement from Arion bank and Kaupthing on results of share placing: www.arionbanki.is/english/about-us/media/news/news-item/2017/03/19/Announcement-of-results-of-share-placing/

5 Announcement from Arion bank and Kaupthing on results of share placing: www.arionbanki.is/english/about-us/media/news/news-item/2017/03/19/Announcement-of-results-of-share-placing/

Figure 2.6

The capital controls were imposed to prevent a large outflow of capital that could have destabilised the economy following the crisis

Key Parties Inside and Outside of the Capital Controls

Capital Controls



Source: Iceland Chamber of Commerce

Proceeds of the sale would go towards reducing public debt.⁶

Capital Controls Lifted

Following the financial crisis of 2008, capital controls were introduced as a temporary measure, to prevent a dramatic outflow of capital. Such outflows could have resulted in

the collapse of the Króna, severely destabilizing the economy. The controls were a part of a program set out by the Icelandic government and the International Monetary Fund (IMF), aimed at restoring economic and financial stability in Iceland (Figure 2.6). Originally, only financial outflows were limited under the controls, whereas financial inflows as well as trade in goods and services were still permitted.

After several exemptions from the capital controls were made over the years, controls on individuals, firms and pension funds were officially lifted in March 2017.

6 Viðskiptablaðið, local newspaper, specialising in business related news: www.vb.is/frettir/sala-bankanna-gaeti-tekid-10-ar/135754/

A capital account liberalisation strategy was presented in 2015, suggesting the easing of the capital controls in several steps. After several exemptions from the capital controls were made over the years, controls on individuals, firms and pension funds were officially lifted in March 2017.⁷ It was long feared after the controls were introduced that a large amount of capital would rapidly exit

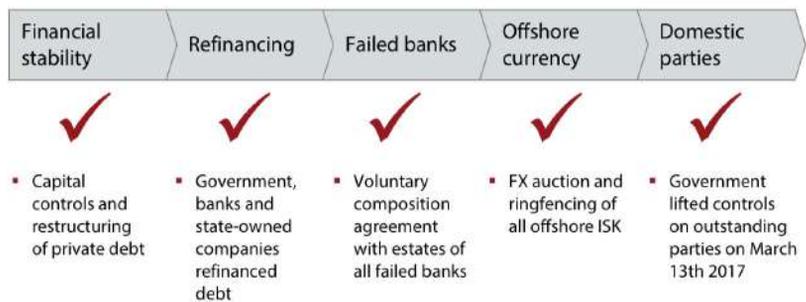
⁷ Ministry of Finance and Economic Affairs. Link: <https://eng.fjarmalaraduneyti.is/news/iceland-lifts-capital-controls>

as soon as the controls were lifted, resulting in a dramatic depreciation of the Króna. The aforementioned “stability contributions”, agreements with the creditors of the failed banks’ estates, were finalized in early 2016, reducing the balance of payments risk associated with payments to foreign creditors. Additionally, multiple FX auctions associated with offshore Króna assets have helped relieve pressure on the currency. As a result of the improved external position of the

Figure 2.7

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

Action Plan for Lifting Capital Controls



Source: Iceland Chamber of Commerce

Strong economic growth in Iceland and the ongoing appreciation of the Króna have increased concerns surrounding foreign currency inflow rather than outflow.

Icelandic economy it was deemed safe to lift controls on domestic parties in March 2017 (Figure 2.7).

Despite this, flows to the country are not completely unrestricted as the Central Bank introduced new restrictions on certain types of inflows in the summer of 2016. Strong economic growth in Iceland and the ongoing appreciation of the Króna have increased concerns surrounding foreign currency inflow rather than outflow. To stem against the possible risk of excess currency appreciation, the Central Bank has imposed a new capital flow instrument (Figure 2.8). The measure consists of a reserve requirement for new foreign currency

inflows that are for investment in liquid Icelandic securities.

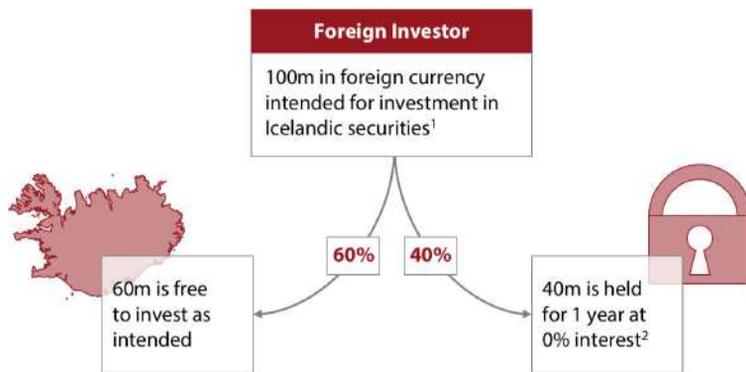
The capital controls introduced in 2008 had the desired effect on the exchange rate of the Króna, which was to reduce fluctuations in the currency and prevent further depreciation after the sharp devaluation in late 2008 (Figure 2.9). Increased exchange rate stability helped the private sector sort out its debt problems; many corporations completed financial restructuring and households reduced their debt levels. This would have proved difficult without the capital controls, as corporate debt was largely in foreign currency and household debt is inflation-linked for the most

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

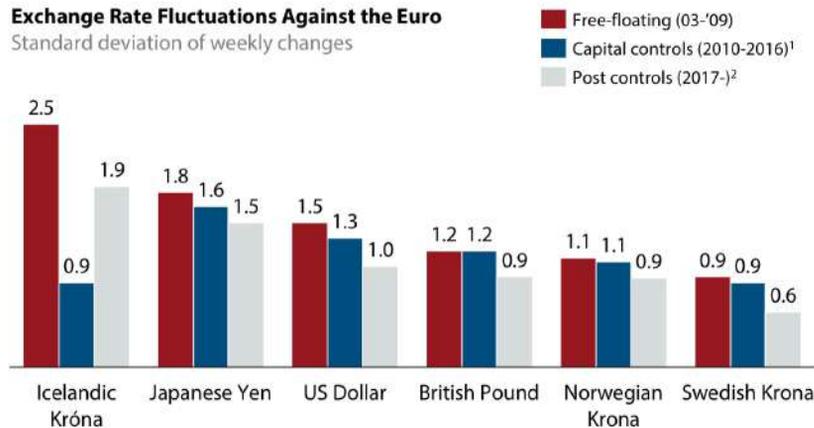
Source: Central Bank of Iceland; Alþingi; Iceland Chamber of Commerce

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

Sources: Central Bank of Iceland; Iceland Chamber of Commerce

part. As such, a volatile exchange rate could have resulted in unforeseeable fluctuations in debt levels.

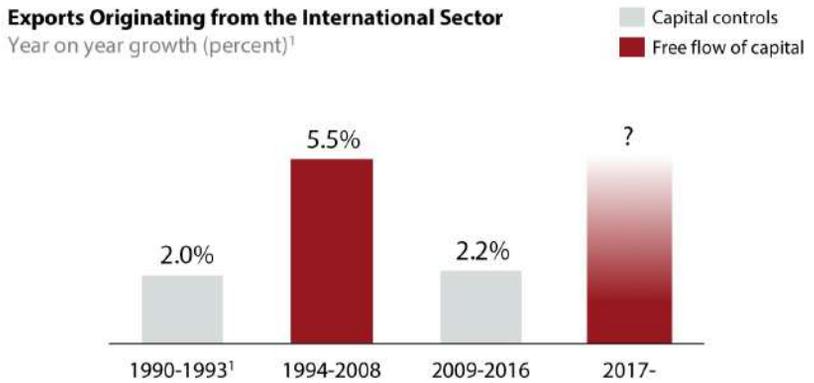
Volatility of the Króna has increased again after the lifting of the capital controls, as was to be expected. However, the Króna did not depreciate immediately after the controls were abolished, as many anticipated, and

has remained relatively strong during the past few months. In fact, the Króna has appreciated over 22% since 2015 (See Figure 1.11). This has been a source of difficulties for Iceland's export sector.

Nevertheless, the adverse effects of the capital controls have also been evident. The largest economic

Figure 2.10

The adverse effects of the capital controls were most visible in the international sector – such exports have grown faster when the flow of capital is free



¹ Because of imperfect data, silicon is included in the international sector for the period 1990-1993
Sources: Statistics Iceland; Iceland Chamber of Commerce

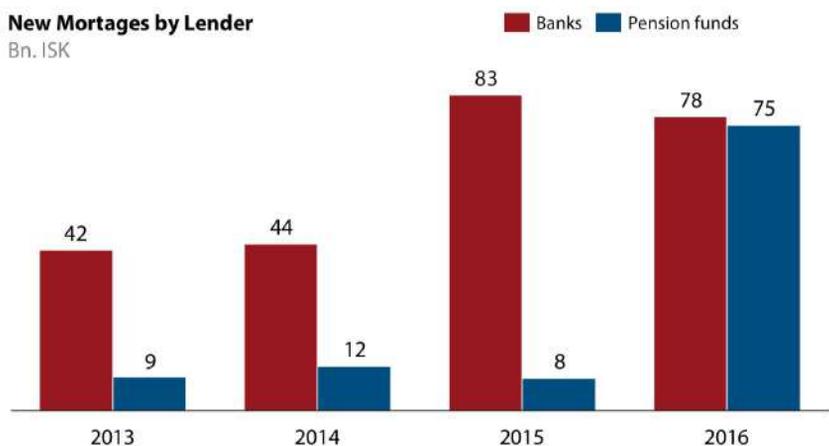
cost has been in the form of slower growth of globally competitive firms, which have difficulties attracting foreign investors and growing their operations externally through mergers and acquisitions due to the capital controls.

As discussed in more detail in chapter 2.4 on the international sector, export

growth in the sector has slowed during the past years, having risen only 2.2% p.a. since 2009 (Figure 2.10). In recent years this has been traced to decreased competitiveness as wages have risen and the currency appreciated – but the capital controls have also been mentioned in regards to slower activity. (See more about the international sector in chapter 2.4.)

Figure 2.11

Pension funds have become a significant mortgage lender



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

Capital Controls and Pension Funds

In addition, the capital controls also caused economic damage by interfering with price mechanisms and skewing asset markets. All domestic savings were trapped in the local economy, and thus restricted to relatively few investment options. For example, Icelandic pension funds have had to invest over 120bn. ISK (5% of 2016 GDP) annually, and with few investment options and markets of limited depth this has led to high concentration of ownership in domestic asset markets. It is estimated that Icelandic pension funds have direct ownership of 40% of the

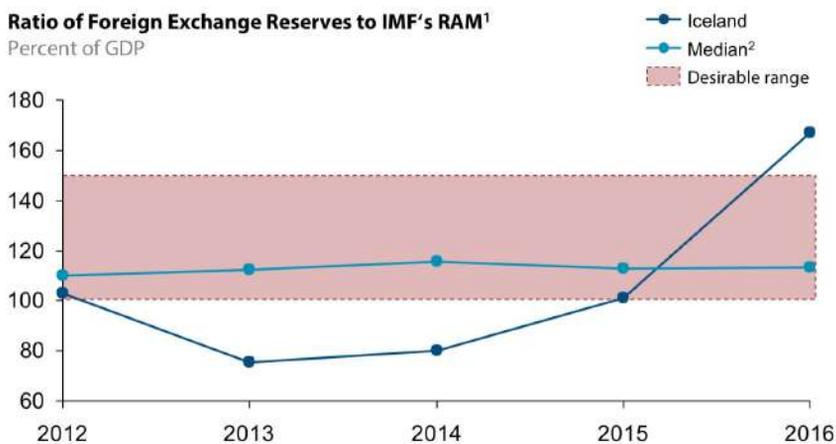
domestic stock market.⁸ Furthermore, pension funds are now active players in the housing loan market, a change from the years before the crisis (Figure 2.11). Currently, only 20% of the Icelandic pension funds' investments are in foreign assets as the funds have only recently been allowed to invest abroad post crisis. This topic has been up for debate recently in Iceland, especially given the strong Króna, as increased outflows from the funds could help stabilize the currency at a lower level.

It is estimated that Icelandic pension funds have direct ownership of 40% of the domestic stock market.

⁸ Vísinding, a weekly newspaper focusing on business and economics. Article by Magnús Harðarson, published on 29 June 2017.

Figure 2.12

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



¹ Reserve adequacy metric

² Excluding Iceland

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

Central Bank FX Reserves

The Central Bank of Iceland's foreign exchange reserves have grown rapidly in the past few years. This is in line with the Bank's intervention policy, to reduce fluctuations in currency markets, in addition to preparing for the lifting of the capital controls in early 2017. Despite these interventions, the Króna has, as of August 1, appreciated 27% since the

beginning of 2014. The reserves have already grown large enough to meet common criteria for reserve adequacy, such as the International Monetary Fund's (IMF) reserve adequacy metric (RAM). The reserves to RAM ratio at the end of 2016 was above the 150% of GDP level that both the Central Bank and the IMF believed necessary before lifting the capital controls in early 2017 (Figure 2.12).

The lifting of the capital controls, as well as strong economic growth and the improved external position of the economy, have helped boost Iceland's credit rating in recent months.

Access to Credit

Iceland was hit particularly hard by the global credit crunch, as it had become heavily reliant on affordable foreign credit in the preceding years. Driving the affordable credit was a high credit rating from international credit agencies. Moody's had the Icelandic sovereign at the highest possible credit rating, Aaa, on foreign currency risk in 2002, reflecting the high confidence in Iceland by foreign investors. The agency then affirmed that rating in March of 2008 – though with a negative outlook (Figure 2.13). As the crisis hit, the Icelandic sovereign's credit rating from both Moody's and Standard and Poor's

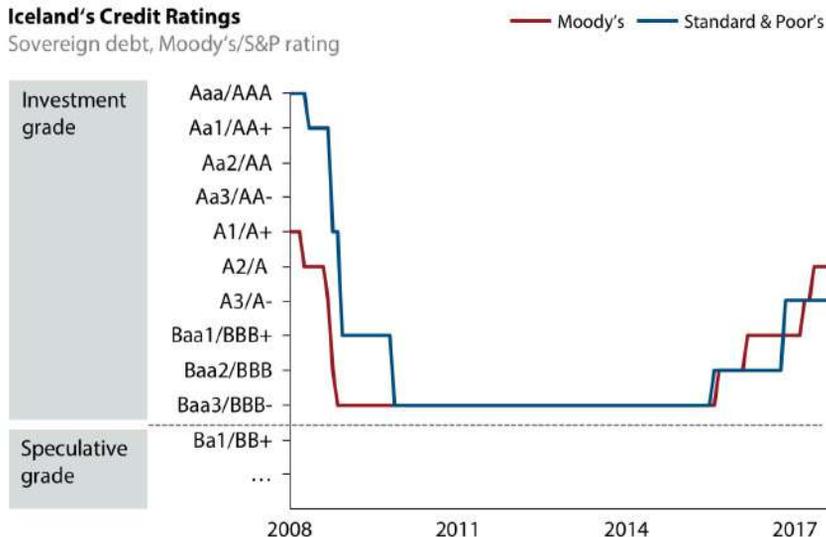
(S&P) plummeted down to the lowest investment grade. The credit rating agency Fitch went a step further and downgraded the Icelandic economy into BB+, or speculative grade in 2010. Since then, however, investors' trust in Iceland has been slowly increasing again, with credit ratings developing positively since 2015. The lifting of the capital controls, as well as strong economic growth and the improved external position of the economy, have helped boost Iceland's credit rating in recent months. Most recently S&P's grade for Iceland's sovereign debt was raised to A, Moody's currently rates the country at A3, and Fitch at A-.

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



Sources: Central Bank of Iceland; Iceland Chamber of Commerce

Asset Markets

A small economy such as Iceland does not encompass asset markets as deep as those typical of larger developed economies, nor as many asset classes. This was especially apparent immediately following the financial crisis of 2008, where most of the public equity market vanished, and almost no new corporate bonds were issued. At that time, only government

and real estate backed bonds had significant market capitalization. Over the past few years, both the public equity market and the corporate bond market have been gradually gaining momentum, thus broadening the asset market and bringing it more into line with foreign asset markets. In December 2011, Hagar, Iceland's largest retail company, went public

Figure 2.14

Domestic assets have appreciated significantly in the last few years but valuation of equities has stagnated since its robust growth in 2015



Sources: GAM Management; Registers Iceland; Statistics Iceland; Iceland Chamber of Commerce

and since then eleven additional firms have followed suit and a few more are expected to do so in the near future. The total market capitalization of the Nasdaq OMX Iceland (including First North, a less regulated listing for smaller firms) has now passed 1000 bn. ISK (over 40% of 2016 GDP). The equity market has yielded high returns over the last few years, an annual real return of 7.4% since the beginning of 2010 (Figure 2.14).

Ownership within the Icelandic stock market has been rather homogeneous over the past few years. General public stock market investment decreased significantly after the crisis, and is currently only around 4%, compared to 11-17% in 2002-2007. Meanwhile, mutual funds' share of the market has increased from 4-6% pre-crisis to around 10% today. Indirect ownership through pension funds has, however, increased significantly given the funds' limited opportunities in recent years for foreign investment. Icelandic pension funds' direct ownership

in listed companies in Iceland is estimated at around 40%, compared to 9% ten years ago.⁹

Foreign investment in Icelandic asset markets has picked up again after the crisis, although at a slow pace. After the Central Bank introduced a new capital flow instrument, meant to temper and affect the composition of capital inflows in domestic bond markets, there was a notable slowdown in bond investments coming from abroad (Figure 2.15). Thus, investments are now increasingly directed towards the domestic stock market. In early 2017 there were substantial capital inflows into unlisted equities, tied to the sale of the holding of Arion Bank to foreign investors.¹⁰

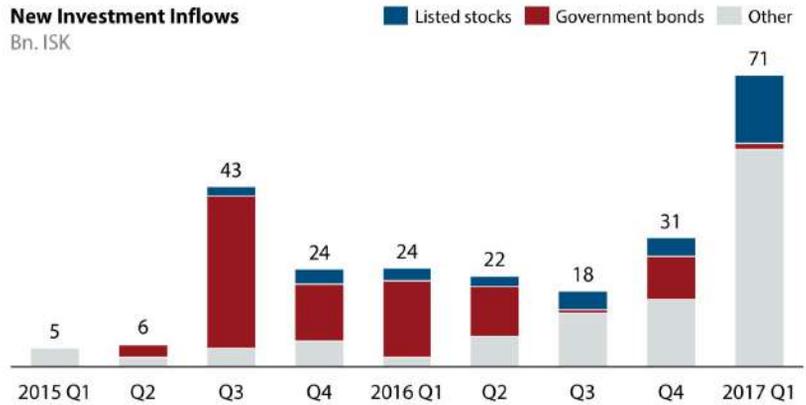
General public stock market investment decreased significantly after the crisis, and is currently only around 4%, compared to 11-17% in 2002-2007.

⁹ Visbending, a weekly newspaper focusing on business and economics. Article by Magnús Harðarson, published on 29 June 2017.

¹⁰ Financial Stability Report. Link: www.cb.is/library/Skraarsafn---EN/Financial-Stability-Report/2017-1/FS_2017_1_Heildarskjal_.pdf

Figure 2.15

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



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

2.3 Domestic sector

Introduction

The domestic sector includes wholesale & retail, construction, arts & entertainment, financial services and the public sector, as well as the domestic component of tourism & logistics, information & communication and business services. The domestic sector in Iceland accounts for approximately two

thirds of the nation's GDP with public services accounting for more than a third of that (Figure 2.16). The sector's development therefore plays a vital role in the economy's performance.

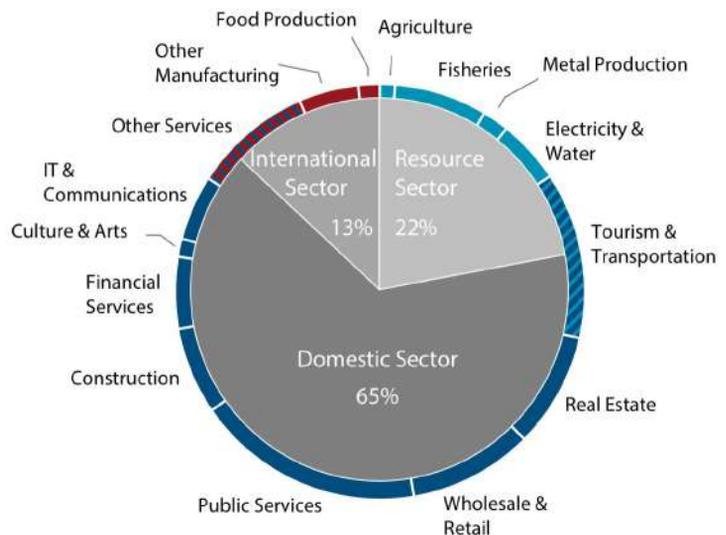
Productivity in Iceland has lagged behind neighbouring countries for years (Figure 2.17). Given

Figure 2.16

The domestic sector accounts for about two thirds of the economy

Composition of the Icelandic Economy

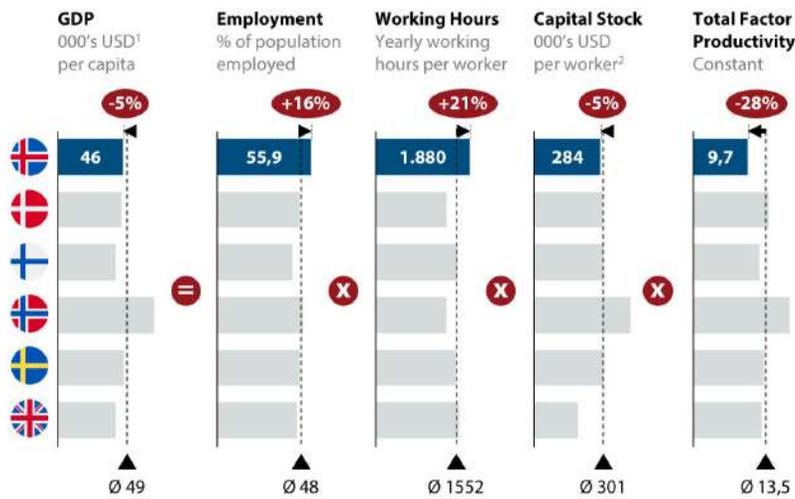
Percent of GDP



Sources: Statistics Iceland; McKinsey & Company; Iceland Chamber of Commerce

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

Official statistics note a 4% increase in GDP per hours worked in 2016.

the large share of the domestic services sector in GDP, it is clear that productivity improvements in the economy are impossible without increased efficiency in the domestic segment. Icelandic manufacturing of goods and services has required substantially more labour and hours than comparable manufacturing in neighbouring countries. As a result Iceland's GDP has not been boosted by the extra hours put in by domestic workers to the same degree as in comparable economies.

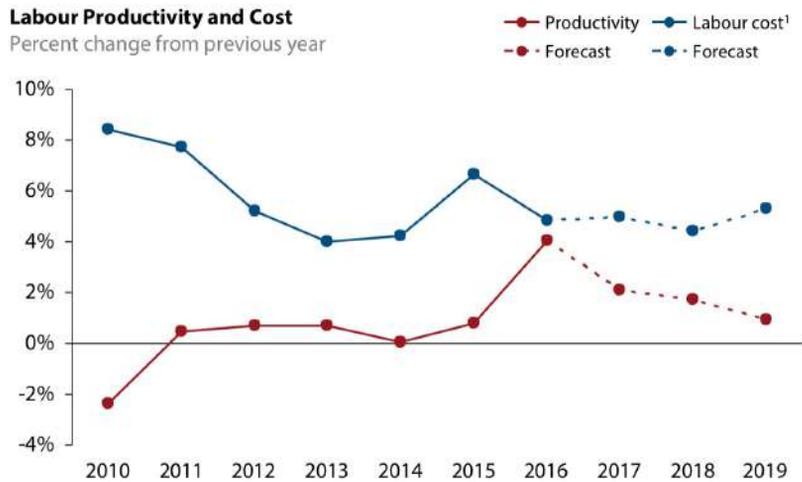
Recent economic data does, however, suggest some pick-up in labour productivity (Figure 2.18). Official statistics note a 4% increase in GDP

per hours worked in 2016. The Central Bank of Iceland currently forecasts an ongoing improvement of around 2% in 2017, after limited productivity growth in the years before.

These numbers may however be somewhat inflated due to a large influx of unregistered foreign labour in the economy. Additional labour may thus be contributing to GDP, whereas their working hours are not taken into consideration in productivity measurements. If the productivity estimates prove to be correct Iceland still has some catching up to do to match neighbouring countries in terms of labour productivity.

Figure 2.18

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



New Competition

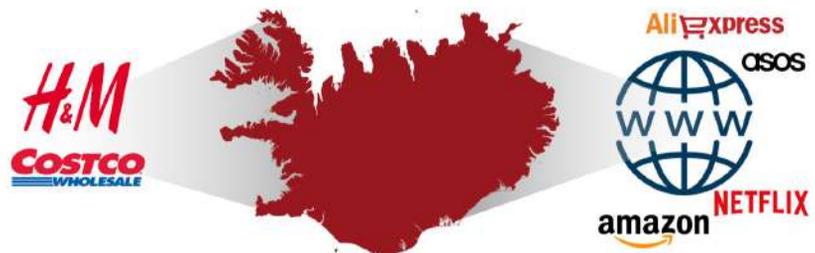
Costco's opening took the market in Iceland by storm. One month after the opening more than 60,000 people were paying members, one in every four eligible Icelanders

The landscape in Icelandic retail has changed considerably in recent months (Figure 2.19). In May 2017 the American membership-only warehouse club Costco opened a superstore in Iceland, their first in the Nordic countries. Ten months earlier Swedish clothing retailer H&M announced plans to open up stores in three different locations in Iceland

over the course of the next two years. Costco's opening took the market in Iceland by storm. One month after the opening more than 60,000 people were paying members, one in every four eligible Icelanders. This is the retailer's biggest opening in a new market area yet. As a result, segments of the Icelandic market that have not faced substantial foreign competition

Figure 2.19

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



Source: Iceland Chamber of Commerce

before, such as the convenience goods market, now have to adjust to an increasingly competitive landscape.

In the meantime, big Icelandic retail chains have set forth plans to merge. All three of the country's largest gas station retailers recently announced plans to merge with the three largest supermarket retailers in the market. Domestic prices measured in Króna have been steadily declining for the past year. Since 2015 the consumer price index (CPI) without housing costs has fallen by 1%, while the wage index has increased 24% over the same time-period. Purchasing power of goods has therefore increased almost 25% in the span of two years (Figure 2.20). This rapid increase in purchasing power can, amongst other things, be traced to a rapidly appreciating Króna, abolishment of various customs and tariffs on imported goods, lower retail prices due to increased competition in domestic markets and technology

developments, and new labour union agreements.

As mentioned, customs and tariffs on all imported goods, excluding food supplies, were abolished in two stages. In early 2016 tariffs on clothing and footwear were revoked and on January 1st 2017 tariffs on all other products, excluding food and other animal products, were abolished.

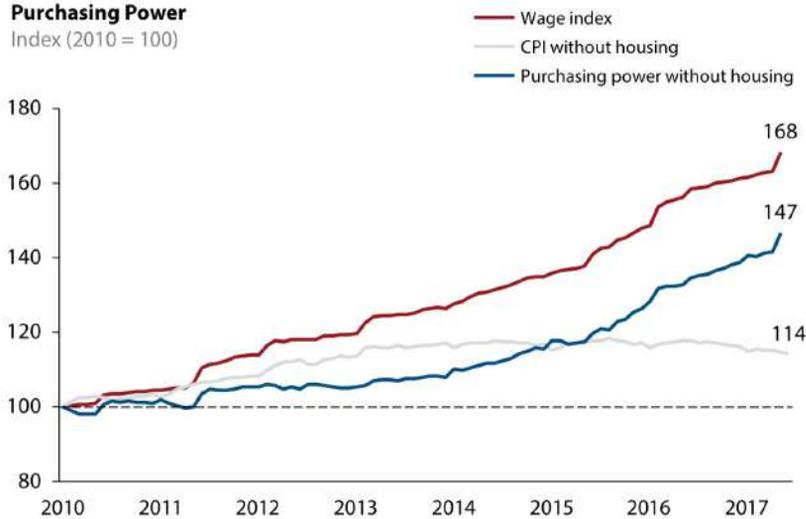
Construction

After the 2008 financial crisis construction and real estate development in Iceland slowed to a halt. Since then both public and private construction has increased but is still far from the levels seen in the mid 2000s. The current construction level is still only around half of where it stood at its pre-crisis peak. This has led to a significant under-supply of real estate in the market resulting in increases in housing prices.

Figure 2.20

Purchasing power has increased substantially because of low inflation and significant wage increases as a result of new collective agreements

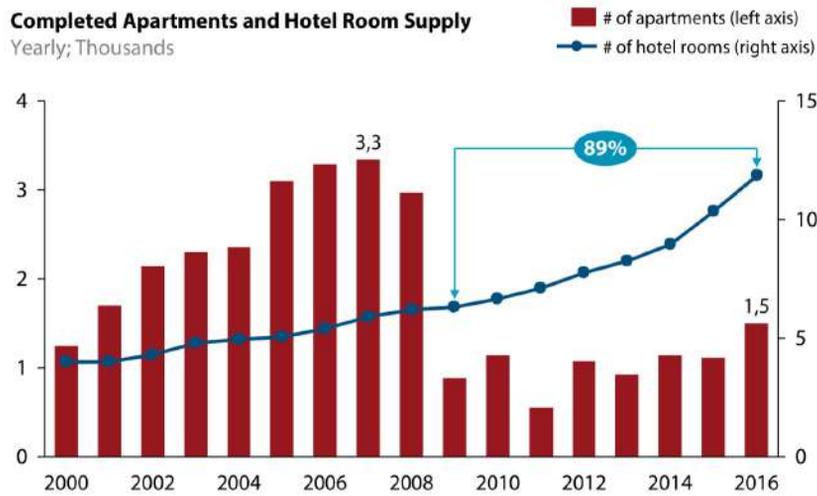
Purchasing Power
Index (2010 = 100)



Sources: Statistics Iceland; Iceland Chamber of Commerce

Figure 2.21

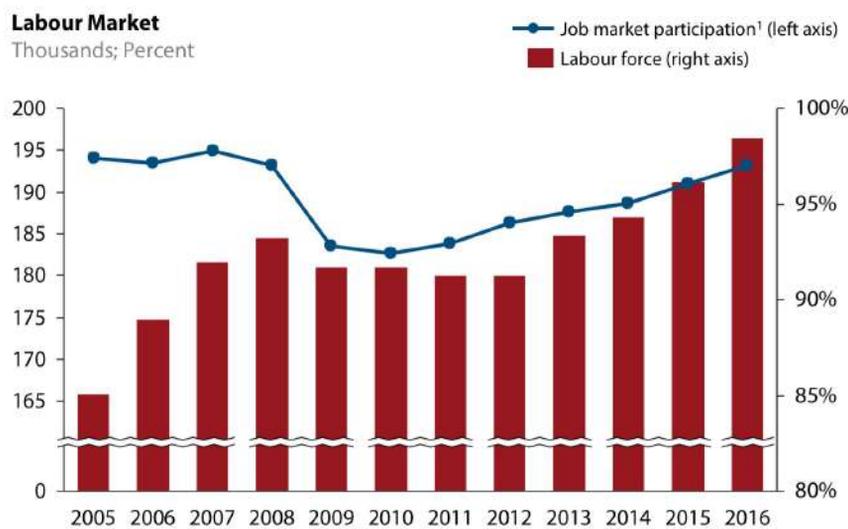
Residential housing construction has been subdued for the past 8 years, while hotel construction has spiked



Sources: Statistics Iceland; Iceland Chamber of Commerce

Figure 2.22

The number of working people in the economy has increased recently due to an expansion of the labour force and a higher participation rate



¹ Calculated by dividing total employed persons with the labour force

Sources: Statistics Iceland; Iceland Chamber of Commerce

Hotel construction has however been on the rise due to the tourist boom Iceland, with the supply of hotel rooms nearly doubling since the crash in 2008 (Figure 2.21).

In the aftermath of the 2008 financial crisis, the labour force shrank considerably. It has been rising rapidly over the past few years, reaching a new high of 196,500 persons last year (Figure 2.22).

Increased activity in construction work and a spike in tourism and tourism related services have been the main driving force of new employment. Participation in the job market has risen to 83%, setting a new 25 year high, driven by robust economic growth over the past couple of years.

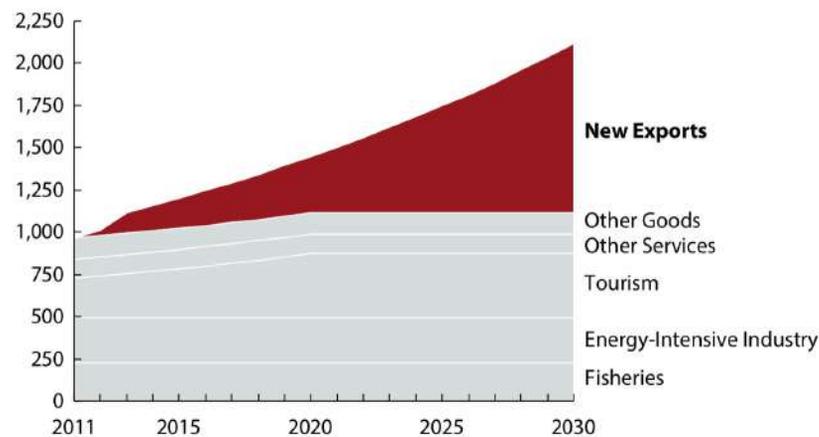
Participation in the job market has risen to 83%, setting a new 25 year high.

Figure 2.23

In a 2012 report by McKinsey & Company, the need for new sources of exports to support a balanced long-term growth trajectory was demonstrated

Export Requirements Along a 4% Real Economic Growth Path

Bn. ISK; Illustrative¹



¹ Real ISK

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

2.4 International Sector

Iceland will face a challenge in making sure that future growth is sustainable. Economic growth was largely fuelled by a negative trade balance and build-up of external debt in the years leading up to the 2008 financial crisis (see chapter 1). This led to instability and made the recession particularly deep for the Icelandic people. A lesson to be learned from this experience is to aim for growth of exports to be at least equal to the growth of the economy as a whole. If that condition is satisfied, exports will support a balance in international trade and ensure that the growth is sustainable, but not borrowed from abroad.

The 1000 Billion ISK Challenge

Export growth in Iceland needs to follow headline growth to prevent external debt from accumulating once again. The publication of the McKinsey report on the Icelandic Economy in 2012 raised several questions surrounding the sustainability of growth post-crisis.¹¹ At the time, two main issues weighed on Iceland’s economic growth potential: Persistent current account imbalance exacerbating the economy’s external debt position and low productivity

Export growth in Iceland needs to follow headline growth to prevent external debt from accumulating once again.

¹¹ McKinsey report; Charting a Growth Path for Iceland. Link: www.stjornarradid.is/media/forsaetisraduneyti-media/media/Skyrslur/charting-a-growth-path-for-iceland-2012.pdf

Today around four fifths of Iceland's exports are based on the utilization of natural resources (fish, renewable energy, and natural tourist attractions).

compared to neighbouring nations, which Icelanders have compensated for by working more hours than their peers. The report included a scenario forecasting the export growth needed to sustain 4% yearly GDP growth (Figure 2.23). To support such growth, total yearly exports would have had to double throughout the period (from 2012 until 2030), equivalent to a 1000 billion ISK increase (40% 2016 GDP). This policy suggestion has since been referred to as the '1000 billion challenge'.

The composition of this export growth is important, however. To ensure lasting and sustainable GDP growth a balanced current account is needed. Additionally, this requires the sustainable use of Iceland's natural resources. Today around four fifths of Iceland's exports are based on the utilization of natural resources (fish, renewable energy, and nature based tourist attractions). As these resources are limited in volume, export growth will eventually need to derive from non-resource based industries. This may be in the form of knowledge or manufacturing exports. This has been referred to as the "international

sector", which last year accounted for a fifth of Iceland's exports. Improved competitiveness of the Icelandic business environment can support further growth in this sector, and here the abolishment of capital controls was crucial. As the international sector is not dependent on natural resources and Iceland is small in global comparison, its growth potential is essentially unlimited. Therefore, it is crucial that the international sector be a large contributor to new exports in order to maintain a sustainable GDP growth (Figure 2.24).

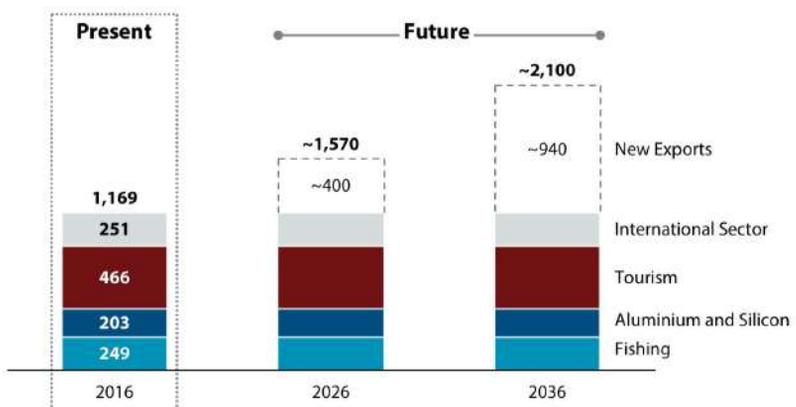
Additionally, increased productivity in Iceland, specifically in the domestic services sector (see chapter 2.34), would support further growth in the international sector. Increasing productivity in the domestic services sector would open up opportunities to transfer labour from the sector to the knowledge driven export sectors. In its 2012 report, McKinsey estimated that 13,000 jobs could be moved between the two sectors were productivity in the Icelandic domestic services sector to reach similar levels as seen in Scandinavia.

Figure 2.24

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

Iceland's Exports

Total exports; ISK billions (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

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

Resource Driven Export Growth

Since the release of the 2012 McKinsey report, GDP growth has been robust in Iceland and the economy's external position has improved significantly (see chapter 1). Export growth has been robust but can primarily be

traced to the resource sector - in particular, tourism. In real terms, other resource driven industries, such as fisheries and energy intensive production have fallen. Furthermore, exports traced to the international

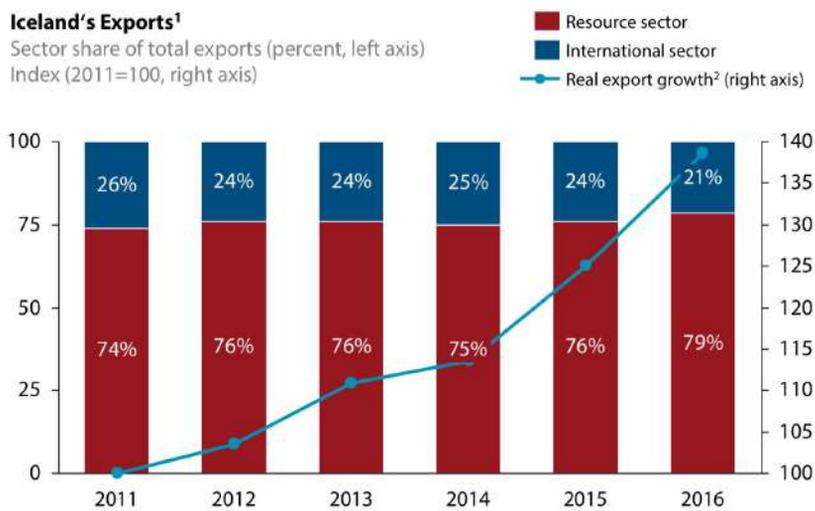
Export growth has been robust but can primarily be traced to the resource sector - in particular, tourism.

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 total 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

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

sector have mostly stood still since 2012. This is at odds with the policy suggested by McKinsey in 2012, where the international sector was to be the main driver of export growth.¹² As a result, the combination of exports has actually become less diverse over the course of the last few years (Figure 2.25).

Shifting to a Knowledge Based Economy

Given the global nature of companies operating in the international sector, there is risk they will move their operations abroad if the domestic operating environment is not globally competitive.

¹² McKinsey report; Charting a Growth Path for Iceland. Link: www.stjornarradid.is/media/forsaeisraduneyti-media/media/Skyrslur/charting-a-growth-path-for-iceland-2012.pdf

As noted in chapter 2.2, the capital controls weighed particularly heavily on the international sector in Iceland over the past few years. This was visible in the slower growth of globally competitive firms, which had difficulties attracting foreign investors and growing their operations externally through mergers and acquisition (see figure 2.10). It is too early to tell from economic indicators whether the recent lifting of the controls has already benefitted these companies. However, the capital account liberalisation is a step in the right direction for increased activity in the sector.

A number of incentives have been introduced as of recently to support the international sector. Tax breaks and expedited work visa arrangements for foreign specialists

Progress has been made in terms of improving the operating environment of companies in the international sector, with the lifting of the capital controls the most significant change. However, there is still a lot of work to be done.

have been introduced, although companies operating in the sector note that the process is still very cumbersome, especially in regards to non-EEA nationals.¹³ The cap on reimbursements for research and development was recently raised, from 100 million ISK to 300 million.¹⁴ This cap is, however, still being contested as too low compared to neighbouring countries. Furthermore, tax breaks up to 50% are now available in regards to individual investments in start-up companies, given certain conditions.¹⁵

There is increased awareness of the importance of increasing the number of technically trained individuals at the university and technical college level. Additionally, the changing nature of jobs –most of which are being created in the knowledge based sector around the world today – requires not just technical and science training but also a creative mind. A review of the Icelandic education system is thus an important pillar for the growth of the international sector in Iceland going forward.

Progress has been made in terms of improving the operating environment of companies in the international sector as some of these examples suggest, with the lifting of the capital controls the most significant change. However, there is still a lot of work to be done. Particularly, the discussion surrounding the future of the sector currently revolves around the educational system in Iceland.

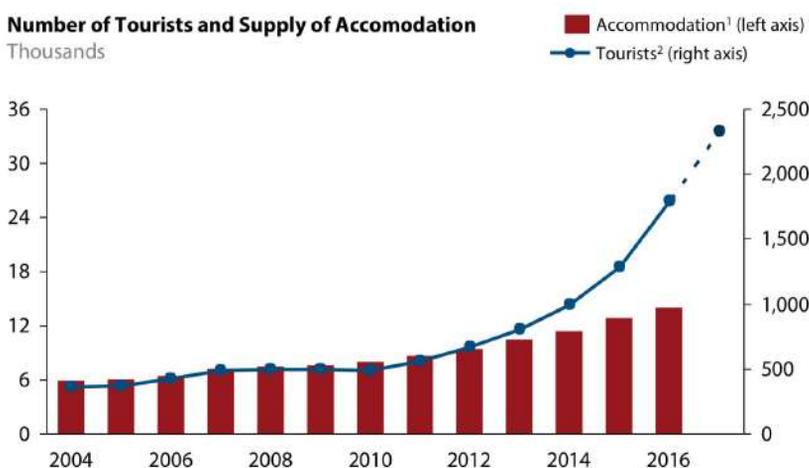
13 A new Act on Foreigners took force on 1st January 2017.

14 Article 10(1) of Act No 152/2009 on support for innovation companies.

15 Article 30(1) section B of Act No 90/2003 on Income Tax.

Figure 2.26

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



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

2.5. The Resource Sector

Iceland is a country rich of natural resources, which the economy has historically been dependent on. About 80% of the country's total exports can be traced to the resource sector in Iceland, with the rest coming from the international sector (see chapter 2.4). In this section, the resource sector is divided into its main industries: Tourism, fisheries, aluminium and silicon production. Additional detail will be provided in regards to other, smaller parts of the sector.

Tourism

Nature based tourism is the main attraction for tourists in Iceland. Most of the scenic sites that tourists visit have limited capacity when it comes to visitors. In this regard the Icelandic tourism industry is, in a sense, a resource sector.

The largest recession remedy for the Icelandic economy has been the booming tourism sector. The number of tourists has increased at a rapid pace, 24% p.a. on average from 2010 to 2016 (Figure 2.26). Last year around 1.8 million tourists visited Iceland, an increase of just under 40%

year-on-year, far exceeding analysts' predictions of roughly 30%. In 2017 the trend is set to continue, as the number of tourists visiting Iceland is expected to surpass 2.3 million – a growth of 30%.¹⁶

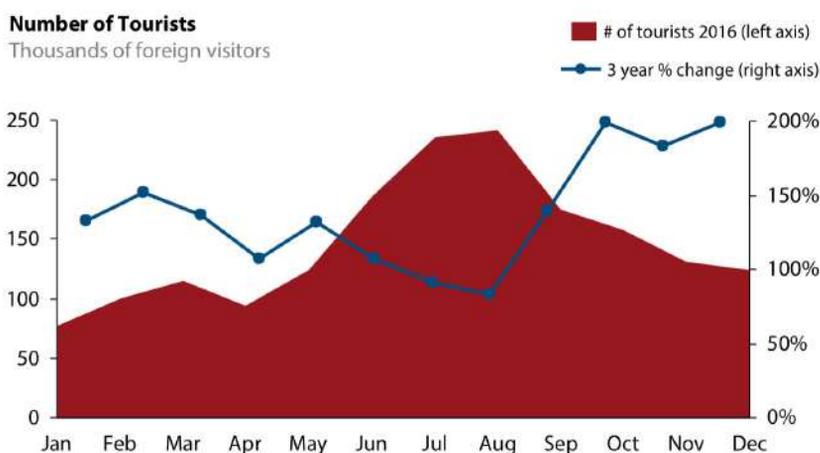
Authorities face three major challenges stemming from the large inflow of tourists: Effects on the housing market, on prices and the exchange rate, and the environment. The fast growth of the tourism sector has had a great impact on the Icelandic economy. Most significantly, job creation by tourism-related companies has been rapid and capital has been allocated for the construction of new hotels and other infrastructure across the country. Since 2010, around 12,000 new jobs can be directly traced to tourism.¹⁷ This translates into roughly 46% of all new jobs since 2010, which does not take into account indirect jobs arising from tourism such as in the construction and retail sector.

¹⁶ Report by Íslandsbanki. Link: www.islandsbanki.is/library/Skrar/Fyrirtaeki/Islenksferdathjonustaskyrsla2017-LQ.PDF
¹⁷ Report by Landsbankinn. Link: www.landsbankinn.is/Uploads/Documents/Hagsja/2017-04-21-Fjolgun-starfa.pdf

Last year around 1.8 million tourists visited Iceland, an increase of just under 40% year-on-year, far exceeding analysts' predictions of roughly 30%.

Figure 2.27

The productivity of the Icelandic tourism has historically suffered from high seasonality – recently this has changed in a favourable way



Sources: Iceland Tourist Board; Iceland Chamber of Commerce

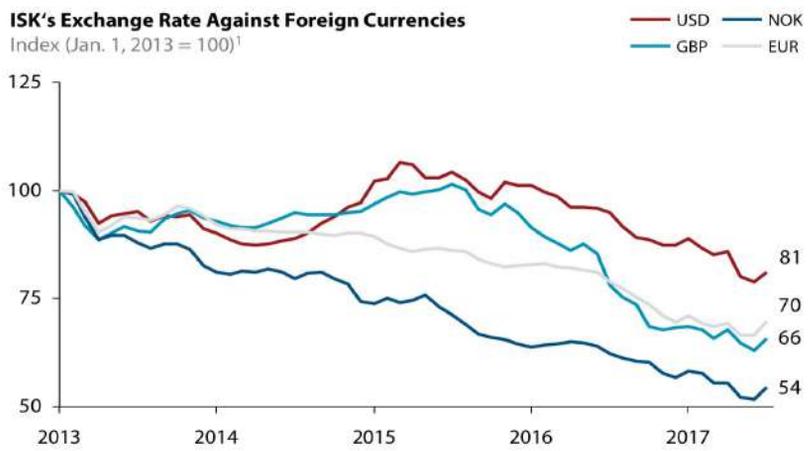
In 2010, when the tourism industry started to take off, investment in tourism-related infrastructure failed to keep up with increased demand. This lag can be partially attributed to the high seasonality of tourism (Figure 2.27). Demand peaked during the summers resulting in a lower overall utilization and productivity of tourism related investments, such as hotels, relative to other industries. However, over the last few years, tourism in Iceland has become less seasonal, increasing the return on tourism-related investments.

The average utilization of hotels in Reykjavik was 84% last year, the highest of capitals in the Nordic countries. However, hotel investments have not kept up with demand, and the increase in hotel rooms in 2017 is estimated at only a third of the required growth.¹⁸ At the same time, Airbnb has flourished and the average number of active accommodations doubled in between 2015 and 2016, exceeding the rate

¹⁸ Report by Íslandsbanki. Link: www.islandsbanki.is/library/Skrar/Fyrirtaeki/Islenkferdathjonustaskyrsla2017-LQ.PDF

Figure 2.28

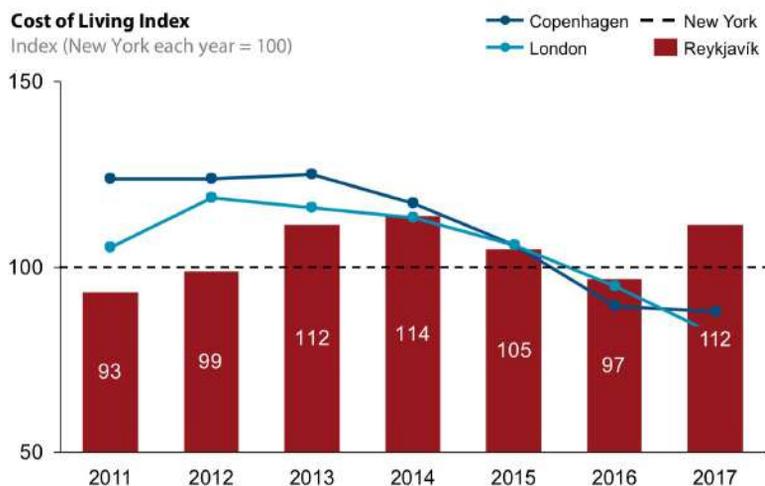
The Icelandic Króna has appreciated significantly against major currencies



¹ Reduction in Index implies appreciation of ISK
Sources: Central Bank of Iceland; Iceland Chamber of Commerce

Figure 2.29

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



Sources: Numbeo; Landsbankinn; Iceland Chamber of Commerce

of construction growth of new houses.¹⁹ Consequently, the housing market, especially in the capital of Reykjavik, has been showing signs of overheating given the mismatch between demand and supply of accommodation. (See more about housing in chapter 2.6.)

Exports of services have been the main driver of the positive trade balance in Iceland over the last few years - in particular tourism. As a result, the Króna has appreciated considerably against most foreign currencies (Figure 2.28). A stronger Króna translates into higher prices for tourists that visit Iceland. As such, the country has in a short amount of time become one of the most expensive destinations in the world (Figure 2.29). Other export industries have felt the heat from this appreciation, with export levels at a stand-still or declining in most export sectors except tourism.²⁰ Rising wages in Iceland over the past few years have also played a part in the decreased competitiveness of many export sectors. (See more about the labour market in chapter 2.6)

Finally, the authorities are also faced with the challenge of minimizing the negative environmental effects of such a high number of visitors. This is especially important given that Iceland's tourism is first and foremost driven by nature based attractions. Many tourist attractions around the country are suffering from congestion and littering. Some landowners have responded to this by charging visitors a fee, but there have been disputes as to the legality of such actions. The Ministry of Industries and Innovation has been working towards resolving

19 Report by Íslandsbanki. Link: www.islandsbanki.is/library/Skrar/Fyrirtaeki/Islenksferdathjonustaskyrsla2017-LQ.PDF

20 Report by Arion banki. Link: www.arionbanki.is/lisalib/getfile.aspx?itemid=48394899-4463-11e7-877f-d8d385b75e5c&_cldee=c2lnZ2l0b21tOTFAZ21haWwY29t&recipientid=lead-b2cb1d48eba7e511a1e6005056a469cd-8f95306790594933ab19724703371b22&esid=9e860d55-6344-e711-80ec-005056a47ca3&urlid=3

these issues and establishing a framework where visitor flow can be managed, whether by visitors' fees or other measures, but little progress has been made.

Energy Intensive Industries

Iceland is located on the Mid-Atlantic Ridge between two tectonic plates. As a result of its geology, Iceland has been able to produce renewable energy at a low cost. The largest source of power is hydropower, accounting for 73% of all power generated, whereas geothermal power accounts for 27%.²¹ Wind power is not yet a significant energy source in Iceland but its exploration has begun. Total installed electricity power capacity in 2015 was 3 MW.²² Landsvirkjun, the National Power Company of Iceland, is the country's largest energy company and is in state ownership. It generates 72% of all electricity produced in Iceland and almost all hydro generation, with the rest mostly being produced by ON Power and HS Orka.²³ The power generators are connected with distribution networks through the public company Landsnet, which operates the electricity transmission grid.

Energy intensive industries consume 77% of all electricity generated in Iceland. Aluminium plants are the biggest consumer and purchase around 70% of the electricity. Other energy intensive consumers include the second largest ferrosilicon plant in the world, run by Elkem Iceland, a few new silicon plants (one of which has started production whereas the other three are in their start-up phase) and data centres.

21 Information from Samorka, a federation of energy and utility companies in Iceland. Link: www.samorka.is/en/electricity/

22 Information from Askja Energy, an Independent Icelandic and Northern Energy Portal. Link: <https://askjaenergy.com/iceland-introduction/iceland-energy-sector/>

23 Information from Samál, Federation of Aluminium Manufacturers. Link: www.samal.is/

Exports of services have been the main driver of the positive trade balance in Iceland over the last few years - in particular tourism.

Many tourist attractions around the country are suffering from congestion and littering. Some landowners have responded to this by charging visitors a fee, but there have been disputes as to the legality of such actions.

The largest source of power is hydropower, accounting for 73% of all power generated, whereas the rest is geothermal power.

Three large aluminium plants are situated in Iceland, with the industry accounting for approximately 15% of Iceland's total exports in 2016.

Iceland's cold temperate climate, low electricity prices and renewable energy production has made it an attractive location for data centres.

Aluminium

Three large aluminium plants are situated in Iceland, with the industry accounting for approximately 15% of Iceland's total exports in 2016. The largest plant is Alcoa Fjarðaál, located in Reyðarfjörður in East Iceland. It began its production in 2007 and has capacity of 346,000 tons a year. Norðurál, a part of Century Aluminium, is based in Grundartangi port in the west of Iceland. Its plant capacity is 313,000 tons a year. The third aluminium plant, ISAL, is located in Straumsvík in Hafnarfjörður. It is a part of Rio Tinto and the oldest of the three, opening in 1970. Today, ISAL has production capacity of 190,000 tons a year. These three aluminium plants purchase about 70% of all energy produced in Iceland.²⁴

Silicon

Four large investment projects are currently in progress. These are energy intensive silicon plants. One plant, United Silicon, has already begun production while the other three are currently in construction phase. The total value of the four planned investments has been estimated at around 207 bn. ISK²⁵, or 8.5% of GDP. The four plants will produce about 128,000 tons per annum, of which 19,000 will be solar silicon.

United Silicon, located in Helguvík near Reykjanesbær, is expected to produce 23,000 tons a year of silicon. However, the plant has had a rocky start after its launch in end of 2016, mostly related to environmental complaints from the surrounding area.

²⁴ Statistics Iceland (2017).

²⁵ Viðskiptablaðið, local newspaper, specialising in business related news: www.vb.is/frettir/verd-kisilmalmi-snarlaekkar/124948/?q=s%C3%B3lark%C3%ADsill

As a result, The Environmental Agency of Iceland had to shut the plant down periodically but it seems that the issues are being resolved.

PCC BakkiSilicon's plant is located near Húsavík in the northeast part of Iceland, and is expected to start producing in year-end 2017. Its yearly production will be 33,000 tons of metallurgical grade silicon.

The future of the other two projects, Thorsil and Silicor Materials, is uncertain. Thorsil, whose plant will be in Helguvík like United Silicon's, had its operating license revoked in 2016 but had it reconfirmed in the beginning of 2017.²⁶ However, its financing has not been completed.²⁷ Silicor Materials, which will be based in Grundartangi Port, has also still to finalize its funding.²⁸ Furthermore, the necessary licenses to start the construction phase have not been granted. As a result, the local authorities have extended the company's deadline to complete its financing and licensing to September 2017.

Data Centres

The data centre industry is a rapidly growing industry in Iceland. Multiple data centres have been constructed in recent years and total investment to date has been estimated at between 20-25 bn. ISK (190-240 bn. USD). Furthermore, the centres' energy consumption increased from 0.5 MW in 2013 to 40 MW in 2016. Iceland's cold temperate climate, low electricity prices and renewable energy production has made it an attractive

²⁶ Morgunblaðið newspaper: www.mbl.is/frettir/innlent/2017/07/11/starfsleyfi_thorsil_stendur/

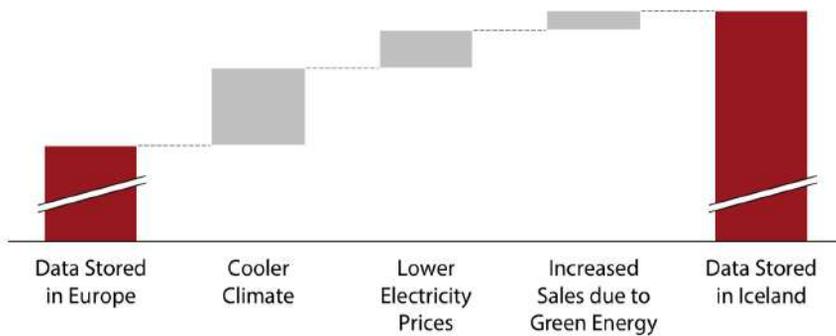
²⁷ Viðskiptablaðið, local newspaper, specialising in business related news: www.vb.is/frettir/fjarmognun-thorsil-tefst/131240/
²⁸ Morgunblaðið newspaper: www.mbl.is/frettir/innlent/2017/01/21/silicor_materials_faer_lokafrest/

Figure 2.30

Favorable climate in addition to affordable and 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

location for such operations (Figure 2.30).

Landsvirkjun, Iceland’s national power company, has however announced that demand for energy has surpassed supply and that the company cannot service all future demand without further harnessing of power. Thus, in order for the industry to grow it

needs to acquire energy from other buyers such as the aluminium and silicon plants but most have long-term energy contracts with Landsvirkjun.²⁹ Another challenge is Iceland’s connection to Europe and America, as Iceland only has three marine cables. This could become an obstacle for

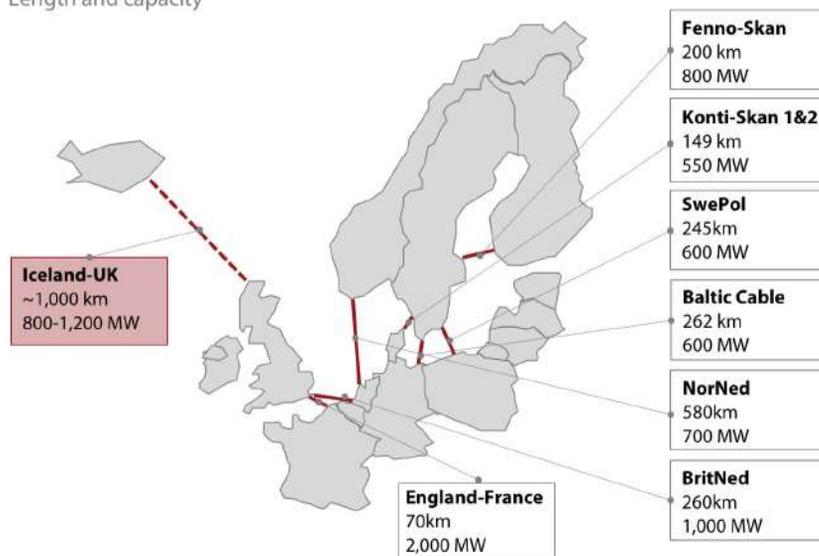
²⁹ Information from Landsvirkjun. Link: www.landsvirkjun.is/Media/landsvirkjun-kyninga-uppgjori-2016.pdf

Figure 2.31

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

Interconnectors in Northern Europe

Length and capacity



Sources: Kvika banki; GAM Management; Iceland Chamber of Commerce

further growth of the data centre sector.

Interconnector

The Icelandic and British authorities are currently exploring the possibility of constructing an electrical interconnector between the two countries (Figure 2.31). Such an interconnector could be a source of new export revenues for the Icelandic economy. The interconnector would be over 1000 km long, and between 800 and 1200 MW.³⁰

As noted, Iceland produces a significant amount of geothermal and hydropower electricity, most of which is currently utilized by aluminium smelters. The smelters require a low delivery risk, but the amount of hydropower available may vary between seasons and years. This has led to Icelandic energy companies having periods of excess capacity and thus with an estimated waste of energy of approximately 2 TWh each year.

An interconnector could integrate the markets and enable energy companies to sell this excess electricity to Europe. In addition, energy prices in the UK are higher than in Iceland, making an interconnector an attractive option for power generators in Iceland, most of which are publicly owned. An interconnector between Iceland and the UK would be one of the longest in the world and would require a significant investment. Landsvirkjun, Iceland's largest power generator, is currently examining the engineering and financial aspects of construction to assess its viability. A report from 2016 estimated the total cost at 800 billion ISK, or about a third of Iceland's 2016 GDP.³¹ Because of this hefty cost Landsvirkjun believes foreign investors and the UK government will need to be involved in the project.

³⁰ Information from Landsvirkjun. Link: www.landsvirkjun.com/researchdevelopment/research/submarinecablotoeurope/

³¹ Information from Kvika. Link: <https://en.kvika.is/ice-link-report>

Fisheries

The fishing industry has long been the backbone of the Icelandic economy. The sector is the source of 21% of Iceland's export revenues. The Icelandic fisheries catch management system is a quota system. It was established in the 1980s and 90s after years of instability in sector. The system's main objective is to protect and ensure sustainability of the fish stock, and thus maximize the value of the scarce resource. As a result quota can be bought and sold in the market, with the quota system making it easier for companies to plan and invest with a long-term view.

The Icelandic fishing industry is internationally renowned for its adherence to a sustainable fisheries policy, resulting in a strong fish stock. The Icelandic cod population, a vital export product for the Icelandic economy, has not been larger since systematic measurements began in 1985.³² Furthermore, other key commercial fish species are also close to historic highs.

Although the value of the stock has increasingly grown, with improved use of the resource and increased innovation, the sector still tends to be cyclical depending on market conditions and the exchange rate. This is often the case with resource dependent sectors, although the fisheries cycles are not as pronounced as they were in the mid to late last century. 2016 was a challenging year for the fishing industry. A strong exchange rate reduces operating profit measured in Króna, while the weaker exchange rate seen in the years after the crisis bolstered profits in the industry as a whole. On top of that, three of the Iceland's largest export markets have experienced difficulties recently: Russia, Nigeria and the United Kingdom (UK).

³² Iceland Magazine: <http://icelandmag.visir.is/article/thanks-sustainable-fisheries-icelands-cod-stock-now-larger-any-time-1985>

An interconnector could integrate the markets and enable energy companies to sell excess electricity to Europe.

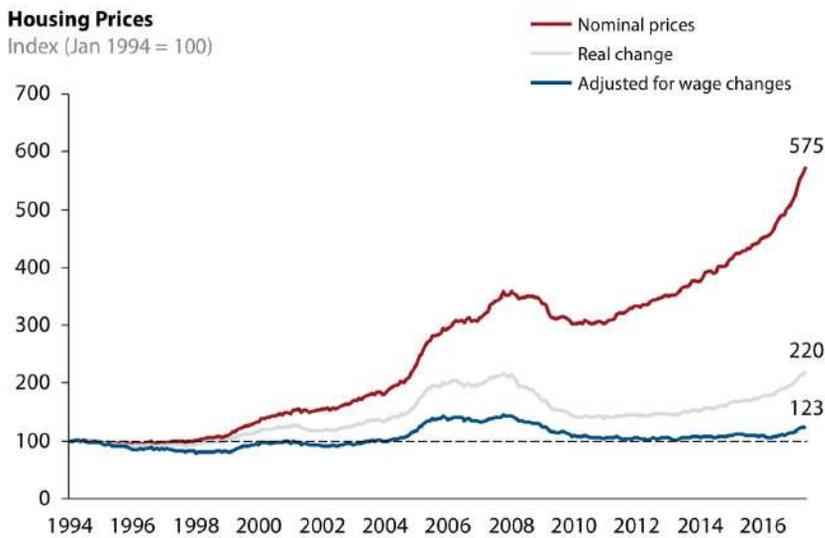
The Icelandic cod population, a vital export product for the Icelandic economy, has not been larger since systematic measurements began in 1985.

Following EU's economic sanctions on Russia after the annexation of Crimea, Russia imposed economic sanctions of their own on Iceland's imports to Russia. As a result, exports to Russia have decreased

drastically. The country was the second largest export destination in 2014 for Iceland, falling to 23 in 2016. Secondly, Nigeria's economy has been struggling in recent years due to lower oil prices. Like Russia, it was one of

Figure 2.32

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



Sources: Statistics Iceland; Registers Iceland; Iceland Chamber of Commerce

Iceland's largest seafood markets, and the second largest outside the USA in 2015. Finally, although the UK is still Iceland's biggest market, the depreciation of the pound and uncertainty when it comes to trade deals and the future of UK outside the EU, could propose a challenge for the Icelandic fishing industry.

The sector has also experienced difficulties on home soil. The appreciation of the Króna has had negative effects on revenue at the same time as wages in Iceland have risen substantially (see chapter 2.6 on the labour market). Furthermore, following disagreement over labour agreements, fishermen went on a two-month strike between December 2016 and February 2017 halting production. Lastly, the resource rent that arises from the sector and how it is taxed has long been hotly debated. Currently,

holders of quota pay special fishing fees in addition to normal corporate taxes.

Fish farming has been increasing in recent years, although it is still very small compared to the catch of wild fish stock. In 2016 around 15,000 tons of farmed fish was harvested, an 80% increase year-on-years.³³ The industry is growing rather quickly, with around 360 people directly employed in 2016 compared to 40 in 2009. Production is expected to be around 40,000 tons in 2020.

2.6 Other Developments

Housing Market

The real estate market in Iceland has been one of the main topics of concern over the past year in Iceland,

³³ Aquaculture in Iceland. Link: www.lf.is.

Since January 2011 apartment prices in Iceland have risen 45% (to March 2017) measured in constant prices, with single family homes up 19%.

In 2015, available Airbnb apartments in Reykjavik were on average 300. In 2016 the number had increased to 809, or by 170%.

The Icelandic labour market is quite strongly unionized, with union density over 80%.

in light of significant price increases (Figure 2.32). Since January 2011 apartment prices in Iceland have risen 45% (to March 2017) measured in constant prices, with single family homes up 19%. Price increases have been particularly prominent in the Greater Reykjavik area, where prices have increased 55% in real terms. Adjusting for rising wages throughout this time period, however, the increase is closer to 17% in the Reykjavik area.³⁴

Insufficient supply and increased demand have contributed to an imbalance in the housing market, resulting in sharp price increases. Wage increases also play a part here, evident when adjusting housing prices for wage increases. New building construction slowed to a halt after the 2008 crisis and has only recently picked up (see chapter 2.3). In the years prior to 2008, construction output of new real estate projects in the Greater Reykjavik area averaged just over 1600. This number dropped to 780 in the years following the crisis. As a result, construction has not kept up with underlying demand due to population growth. It has been estimated that the accumulated need for new apartments in Greater Reykjavik in the next three years is roughly 9000.³⁵

On the demand side the growth of tourism has led to increased demand for housing. Short-time rentals, via services such as Airbnb, have thus affected the availability of general housing. In 2015, available Airbnb apartments in Reykjavik were on average 300. In 2016 the number had increased to 809, or by 170%. For comparison, just under 400 apartments were finalized in Reykjavik in 2016.³⁶ Additionally, lack of hotel

rooms has led to an increase in hotel builds in Iceland, although particularly in Greater Reykjavik. This has slowed down apartment construction as labour supply to respond to these demand spikes is limited.

Labour Market

The Icelandic labour market is quite strongly unionized, with union density over 80%. The market is for the most part regulated by means of collective bargaining, with collective agreements covering approximately 88% of the workforce.³⁷ Over the past decades, the Icelandic labour force has seen high nominal wage increases, often in excess of productivity increases. As a result, this has led to higher levels of inflation, counteracting benefits to the workforce.

In early 2016 the representatives of employees and employers in Iceland signed an agreement in order to ensure a "sustainable increase in wages", often referred to as the SALEK-agreement. The purpose of the agreement, which was modelled after Nordic wage agreements, was to increase the purchasing power of wages, by reducing the risk of big leaps in average nominal wages in excess of productivity increases.

In the first 17 months since the agreement was penned the index for average wages in Iceland rose over 13%. Simultaneously, the consumer price index went up by 3%.³⁸ As a result, there has been a measurable increase in purchasing power recently. The exchange rate plays a large part here, as cheaper imported goods have weighed against wage inflation. The Central Bank of Iceland projects increased tension in the economy that will most likely result in rising levels of inflation if wages continue to increase rapidly, given it is unlikely that the exchange rate will continue

34 Registers Iceland. Link: www.skra.is/markadurinn/talnaefni/visitotur-kaups-og-leiguverds/

35 News published by the Icelandic Government: www.stjornarradid.is/verkefni/allar-frettir/frett/2017/04/11/Telur-4.600-ibudir-vanta-a-markad-svo-jafnvaegi-naist/

36 Report by Íslandsbanki. Link: www.islandsbanki.is/library/Skrar/Fyrirtaeki/Isensk-ferdathjonustaskyrsla2017-LQ.PDF

37 The Icelandic Confederation of Labour: www.asi.is/engpol/

38 Statistic Iceland: <https://hagstofa.is/talnaefni/samfelag/laun-og-tekjur/launavisitala/>

to appreciate at the same speed as it has over the past year. Furthermore, labour shortages and increased economic activity suggest increased bargaining power of employees going into the coming negotiations.

The decision of the Official Remuneration Council, which determines the wages of several public employees, to increase the salaries of Members of Parliament by 44% in the beginning of 2017 caused turbulence in the labour market. Furthermore, the Council again ruled in favour of several senior employees of public companies in summer 2017, raising their wages (sometimes retroactively) considerably. Representatives of both employee- and employer unions referred to it as a major setback to the SALEK agreement, as it encouraged unsustainable wage rises.

From August 2017 until March 2019 a total of 266 collective agreements will go up for renegotiations. The inflation prospects of coming years will, to a large extent, depend on the results of these renegotiations and whether they will follow the suggestions set out by the SALEK agreement.

From August 2017 until March 2019 a total of 266 collective agreements will go up for renegotiations.



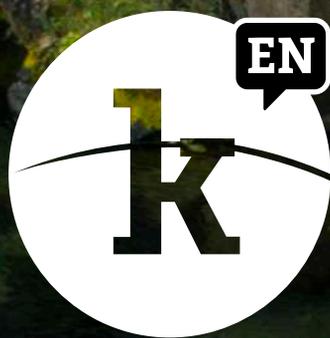
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INVESTING IN THE FUTURE



Ég er ástfanginn af bleikum (2016)

3 Future Prospects

Iceland has largely recovered from the financial crisis. Growth has been robust recently and is projected to continue to be so for the next couple of years. The external imbalance of the economy, arising from a persistent trade deficit and significant foreign debt obligations, has now been mostly erased as exports have increased and settlements with foreign creditors finalized. However, more uncertainty prevails regarding longer-term growth prospects. Looking further than a few years ahead, growth will largely be determined by two factors. Firstly, on a specific note, whether Iceland will be able to realise economic growth in the longer term through an increase in productivity and exports. And secondly, in more general terms, how prepared the country is to face the number of disruptive trends that are now shaping the global economy.

3.1 Economic Growth

In 2012, the global management consulting firm McKinsey & Company published a report titled "Charting a Growth Path for Iceland", where Iceland's long term growth prospects and key challenges were assessed.¹ The report has had a significant impact on public debate in Iceland and provided insights to the future prospects of the Icelandic economy. One of the key messages of the McKinsey report concerns the composition of Iceland's production compared to neighbouring countries. Iceland's production is characterised by high labour contributions, both through high employment and high average hours worked per employee

¹ McKinsey report; Charting a Growth Path for Iceland. Link: www.stjornarradid.is/media/forsetisraduneyti-media/media/Skyrslur/charting-a-growth-path-for-iceland-2012.pdf

(See Figure 2.17). Additionally, capital intensity is at a similar level as elsewhere. However, Iceland's weakness is low productivity. Although the economy has recovered well since the report was issued in 2012, productivity remains an issue. In order for Iceland to achieve a long-term sustainable economic growth, increasing productivity is critical.

Recent numbers for 2016 do suggest a pick-up in productivity, 4% according to official statistics, which is a positive sign. However, there are indications that this may be due to an underestimation of the number of working hours in the economy.² As discussed in chapter 1 the current economic boom has led to labour shortages in many sectors, in particular construction and tourism. This has led to an increase in foreign workers, often temporary, in Iceland. In this context, the question has been raised whether these temporary workers are adequately represented in labour numbers in Iceland. If not, their contribution to GDP is being noted, but not the increased working hours associated with the extra labour supply (see chapter 2.3).

Increased competition domestically and market openness on a global scale would help improve domestic productivity. In this regard, market participants are closely examining the effects of the recent entry of foreign companies such as Costco on the convenience goods market, as an example (see chapter 2.3). Improvements could also be made through public sector reform, as public employees account for up to

² Statistics Iceland and the Central Bank of Iceland

Growth has been robust recently and is projected to continue to be so for the next couple of years.

One of the key messages of the McKinsey report concerns the composition of Iceland's production compared to neighbouring countries

Improvements could also be made through public sector reform, as public employees account for up to a fifth of employed individuals in the economy.

Over the past four years the work of the Chamber has focused specifically on the four sectors discussed in the report; public, domestic services, resource and international sector.

a fifth of employed individuals in the economy.

Although exports have grown over the past few years, as discussed in previous chapters (see chapters 1.3, 2.4 and 2.5), this has mostly arisen from an increase in tourism – a resource based sector. Given the limited nature of resource based sectors the importance of the international sector needs to be emphasized, as a sustainable source of export revenue, as highlighted in chapter 2.4.

Following the publication of the McKinsey report, the so-called Iceland Growth Forum was established (Figure 3.1) in order to develop further its policy recommendations. The forum's aim was also to increase alignment and facilitate cooperation between key stakeholders in the economy; political party leaders, CEOs from a broad range of significant Icelandic companies, academia and labour

organizations. Additionally, the Forum established a secretariat which created proposals for public policy reform. Many of the proposals put forth in the Forum have already been implemented, with the aim of supporting Iceland's long term growth prospects.

The Iceland Chamber of Commerce has been an avid supporter of the Iceland Growth Forum and suggestions set out in the McKinsey report. Over the past four years the work of the Chamber has focused specifically on the four sectors discussed in the report; public, domestic services, resource and international sector. Although the underlying focus will remain on the challenges associated with the sectors, the Chamber now seeks to shift its focus more outward, acknowledging the global disruptive trends that undeniably shape economies around the world. Iceland's economy is no exception there.

Figure 3.1

The Iceland Growth Forum established a secretariat which presented approx. 40 reform proposals to support a long-term sustainable growth trajectory



Source: Iceland Growth Forum website

3.2 Disruptive Trends

Part of shifting focus is acknowledging that Iceland is getting more and more affected by global trends. Advancement in technology and increased connectivity is changing the way people do business. Iceland needs to surf this wave of change and

master it to support a prosperous and sustainable future.

To capture these trends the Chamber will operate under four focus lenses in the coming years (Figure 3.2). These lenses are Regeneration, Digitization, Environmental Sustainability and Global Connections. All of these

topics tie into current challenges in Iceland, and provide the Chamber with additional perspective through which to analyse policies for further improvement across the four sectors.

Regeneration or human capital development ties into educational matters which are of great relevance in regards to the international sector and growth of the knowledge economy in Iceland. Generations need to be reshaped to match talent to new compositions and needs of the society. Digitization and how the Icelandic society will embrace technological changes could help drive productivity and service improvements across sectors. Environmental Sustainability is of

great relevance for a natural resource rich economy such as Iceland where origin, purity and quality plays a key role in global branding and sale. Finally, Global Connections is the undercurrent within all these themes, as shorter pathways of information, capital, production and increased flexibility of labour will change the way markets operate. There is thus great reason to be optimistic about the future of the Icelandic economy, if policymakers, business leaders and the general public are willing to embrace the upcoming changes. The Chamber will continue to cooperate broadly with its members, policy makers, academia and other stakeholders to support sustainable economic growth in Iceland.

Advancement in technology and increased connectivity is changing the way people do business. Iceland needs to surf this wave of change and master it to support a prosperous and sustainable future.

Figure 3.2

To capture the disruptive trends that are shaping the global economy, 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 	<ul style="list-style-type: none"> Improve services and achieve cost efficiency through digitization 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Reshape generations to match talent to new composition of the society 	<ul style="list-style-type: none"> Welcome the world's talents and early stage entrepreneurs
Environmental Sustainability	<ul style="list-style-type: none"> Maximize value creation of Icelandic resource industries 	<ul style="list-style-type: none"> Protect nature with focus on productivity and sustainability 	<ul style="list-style-type: none"> 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 	<ul style="list-style-type: none"> Improve the business environment through tax and regulatory reform 	<ul style="list-style-type: none"> Focus on new business development, M&A and alliance building as well as new market-entry strategy

About the Iceland Chamber of Commerce

The Iceland Chamber of Commerce (ICoC) is a voluntary association of companies and individuals with the mission of improving the operating environment of business in Iceland and to increase economic prosperity. The Chamber has been diligent in its mission, celebrating its 100th anniversary, this year.

Operations of the Chamber

The Chamber strives for positive changes to the law, regulation, and administrative decisions concerning the business community.

Safeguarding of Interests

As an organization of the business community, the Chamber works in the interests of everyone conducting business. The Chamber is a powerful tool for the business community in its work towards improvements to the business environment and enhanced (improved) working conditions.

A Representative Towards the Authorities

The Chamber strives for positive changes to the law, regulation, and administrative decisions concerning the business community. The Chamber reviews all legislative bills that concern the business community. Comments are made in collaboration with members, and are presented to the relevant parliamentary committees.

Annual Business Forum

The Chamber's Annual Business Forum is the largest and most attended event in the Icelandic business community. The Forum is attended by members, politicians, and governmental officials, as well as others with an interest in Iceland's business community. The Chamber issues a report in connection with the Forum that outlines ways to potentially improve the operating business environment.

Corporate Governance

The Chamber has taken the initiative in publishing guidelines for corporate governance, in collaboration with the Confederation of Icelandic Employers and Nasdaq OMX Iceland. The guidelines were first issued in 2004, and have since been updated and published several times. The fifth and latest edition was issued in June and is available online here: www.corporategovernance.is

Communication of Information

Since 2008, the Chamber has regularly published an overview of the Icelandic economy. The report is published in English, and aims to provide a factual description of events following the financial crisis, as well as a summary of the current economic, business, and political landscape in Iceland. The Chamber has also taken on the role of communicating the key messages of the report to foreign parties interested in Iceland's business and economic environment.

Legal Counsel and Arbitration

The Chamber's General Counsel supervises various projects for members, free of charge. The Counsel assists members with matters such as: the import and export of goods, employee / employer relations, and specific laws or regulations concerning or impacting the business environment of its members.

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A Backbone for Business Education

The ICoC is an active advocate of technological and business education. Globalization, as well as the openness of the Icelandic economy has resulted in increased demand for educated individuals in Icelandic companies. To meet this demand, the ICoC owns and operates the following educational institutions:

The Commercial College of Iceland

The Commercial College of Iceland is a four year secondary school for students 16 years or older who have completed Icelandic elementary school, grades 1-10. The College has over one thousand students. Its main stated objectives are to promote the competitiveness of Icelandic business, both domestically as well internationally, by providing and furthering education in general, and business education at the secondary and lower tertiary level.



Reykjavik University

Reykjavik University is an international university located in Reykjavik, the capital of Iceland. Reykjavik University (RU) is Iceland's largest private university having more than 3,500 students.

The university's stated focus is on research, excellence in teaching, entrepreneurship, law, technological development, and co-operation with the business community. The university's stated objective is to educate students to become leaders in business, technology, and society.

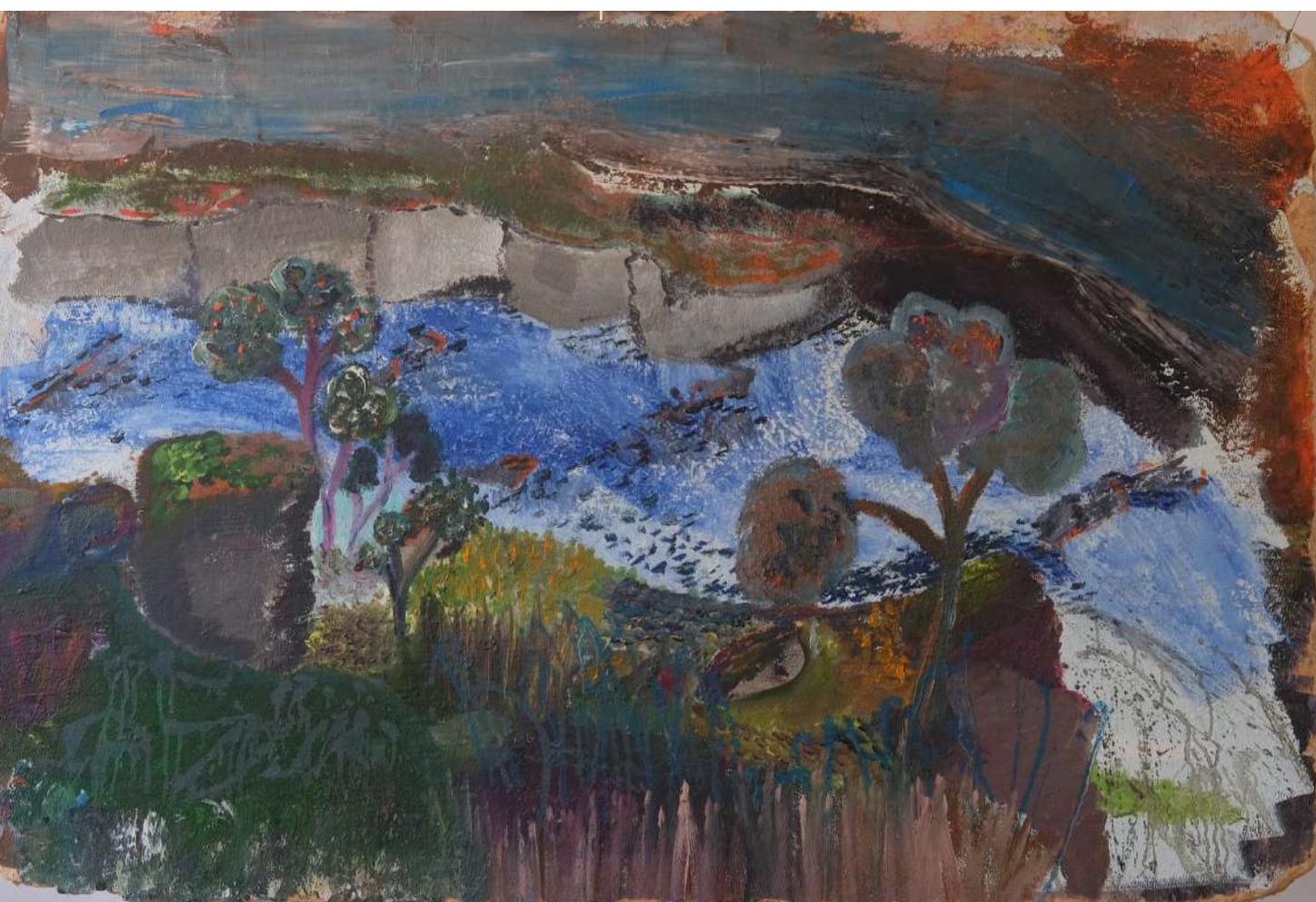


Joining the Iceland Chamber of Commerce

Membership of the Chamber provides companies an opportunity to influence its strategy and to promote their interests in a robust forum. The issues that the Chamber deals with on a daily basis relate both to the business community as a whole, as well as to specific interests of individual member companies. More information on joining the Iceland Chamber of Commerce may be found on its webpage: www.chamber.is.

Iceland Chamber of Commerce Bilateral Chambers





*Painting: Rétt handan við
Indíánagil (2014) by Arnar Birgis*