



THE ICELANDIC ECONOMY

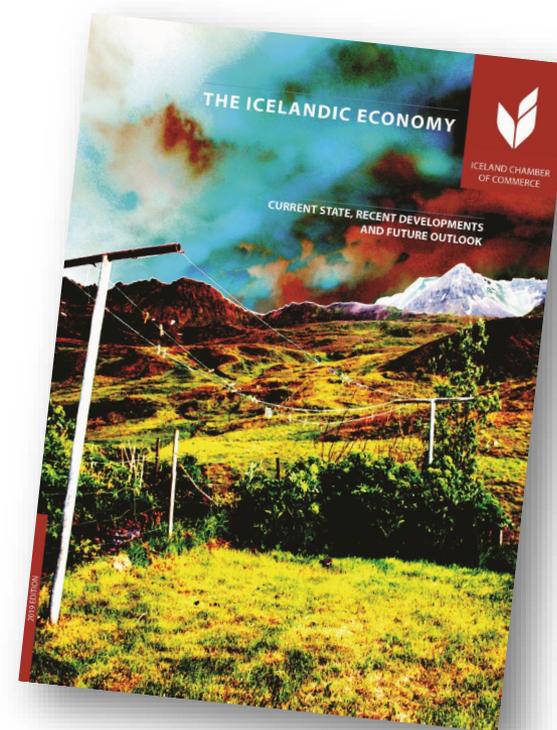
CURRENT STATE, RECENT DEVELOPMENTS
AND FUTURE OUTLOOK



ICELAND CHAMBER
OF COMMERCE

TABLE OF CONTENTS

KEY FACTS	3
FOREWORD	4
1. ECONOMIC LANDSCAPE	5
2. INSTITUTIONAL FRAMEWORK	19
3. FINANCIAL SECTOR	29
4. DOMESTIC SECTOR	37
5. RESOURCE SECTOR	46
6. INTERNATIONAL SECTOR	54
7. FUTURE PROSPECTS	61



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Did you know?

- The total land area is 103,000 km² and the population is 360,384
- Iceland's parliament, Althingi is the oldest surviving parliament in the world, founded in 930 AD
- Former president Vigdís Finnbogadóttir became the first democratically elected female head of state in 1980
- Iceland is a member of NATO but does not have any military forces
- Iceland's search and rescue services are solely volunteer-run

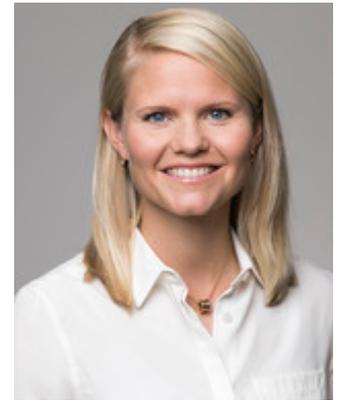
Key facts about the economy

- Iceland's Gross Domestic Product (GDP) per capita in 2018 was USD 55,917 (PPP)
- The currency is Icelandic Króna (ISK), USD 1=ISK 121 (25 July 2019)
- In 2018 unemployment was 2.7% and in July 2019 inflation was 3.1%
- Iceland's current account surplus in 2018 was 2.9% of GDP
- The main exports are tourism (39% of total), seafood (18%) and aluminium (17%)
- Government debt-to-GDP ratio in 2018 was 38%

FOREWORD

ÁSTA S. FJELDSTED

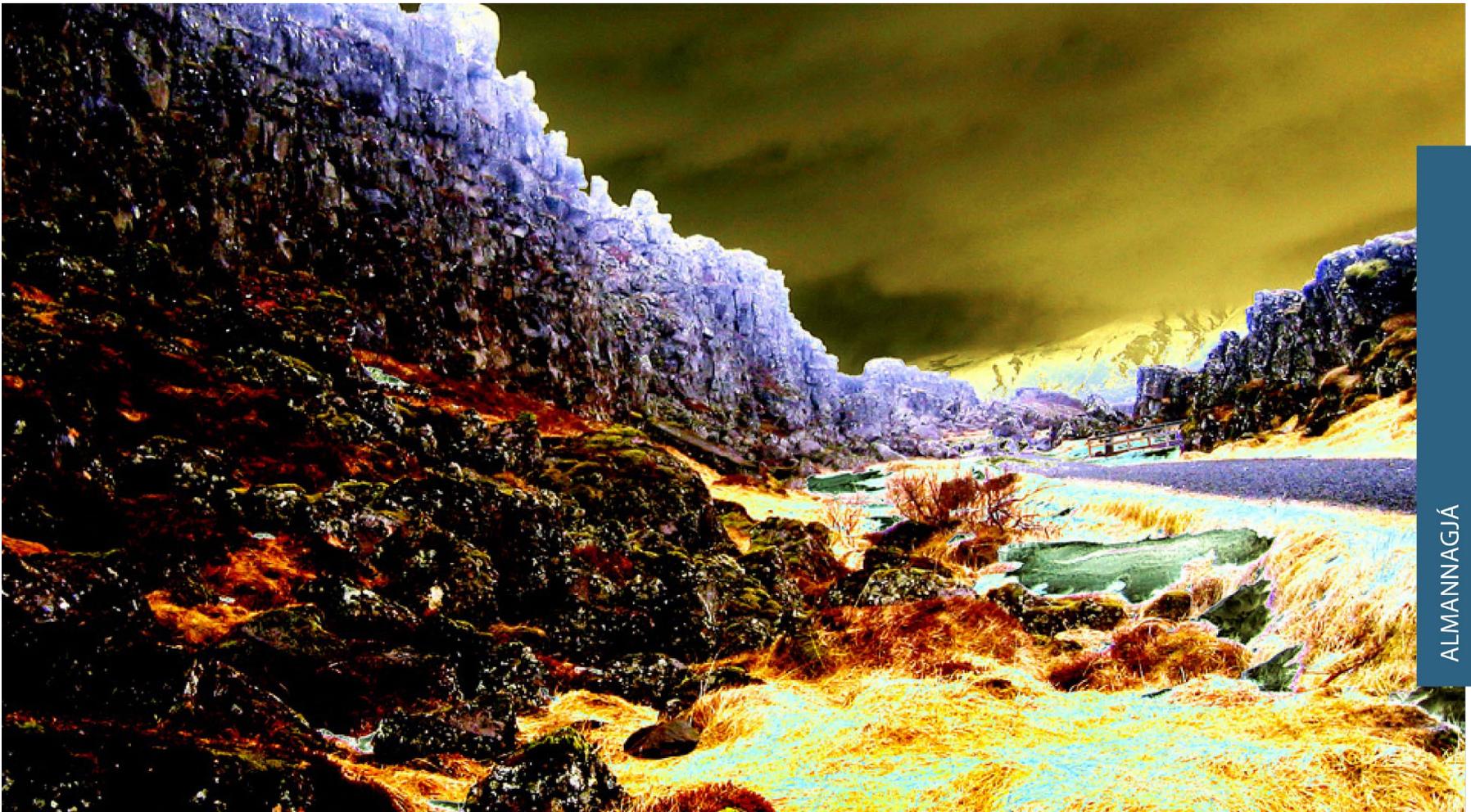
“What goes up must come down.” Those words of Sir Edward Newton have undoubtedly come to someone’s mind in recent years watching the Icelandic economy outgrowing most other OECD countries. Particularly since Iceland faced an unprecedented financial and economic crisis when its three major banks, which assets amounted to over 9-fold GDP collapsed in the matter of days just over a decade ago. This recovery story is something Icelanders and others can learn from and is ingrained in this report.



Ásta S. Fjeldsted
Managing Director,
Iceland Chamber
of Commerce

1

ECONOMIC LANDSCAPE

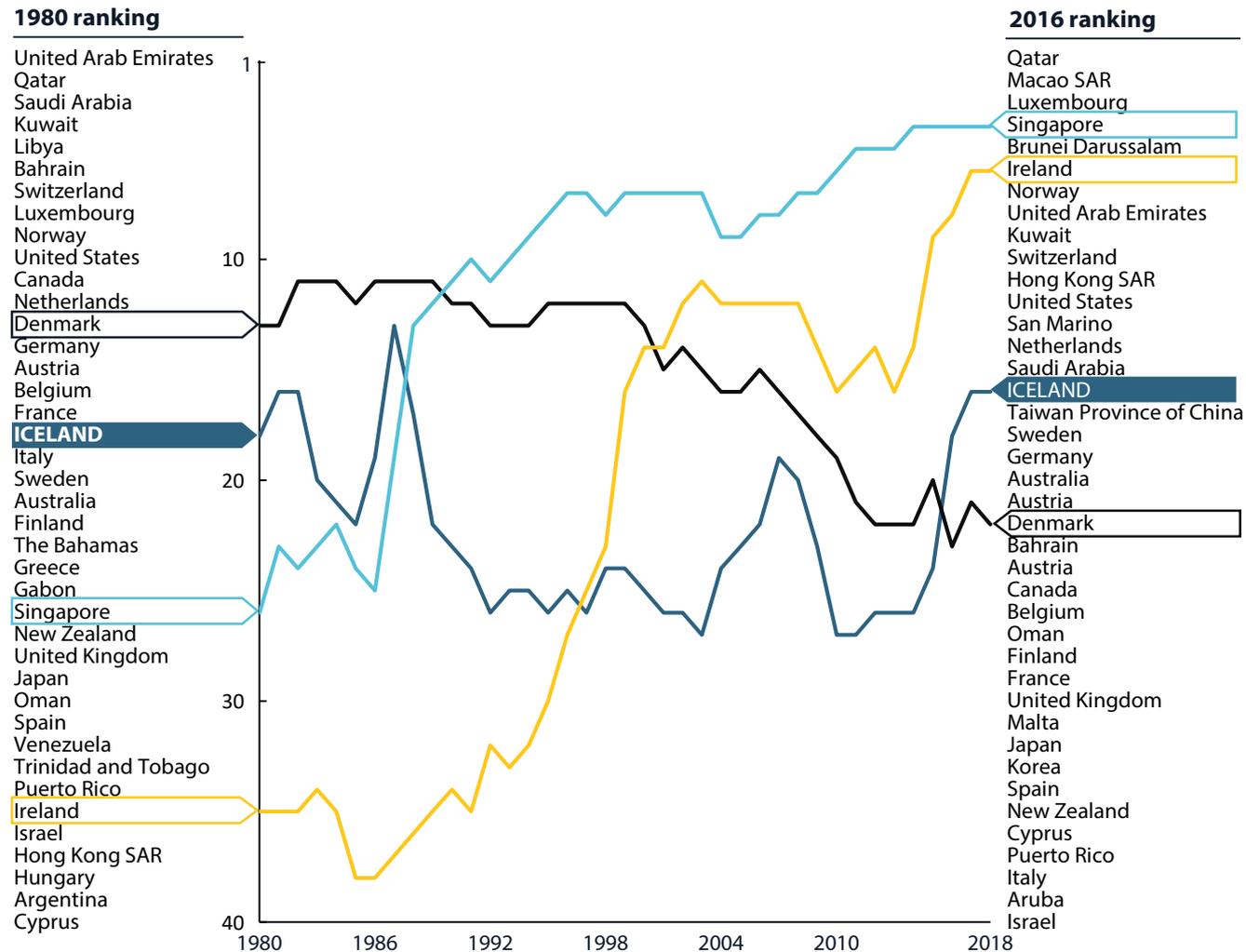


ALMANNAGJÁ

Figure 1.1

Iceland has outgrown most developed countries in recent years

Country rankings, GDP per capita (PPP¹ adjusted)

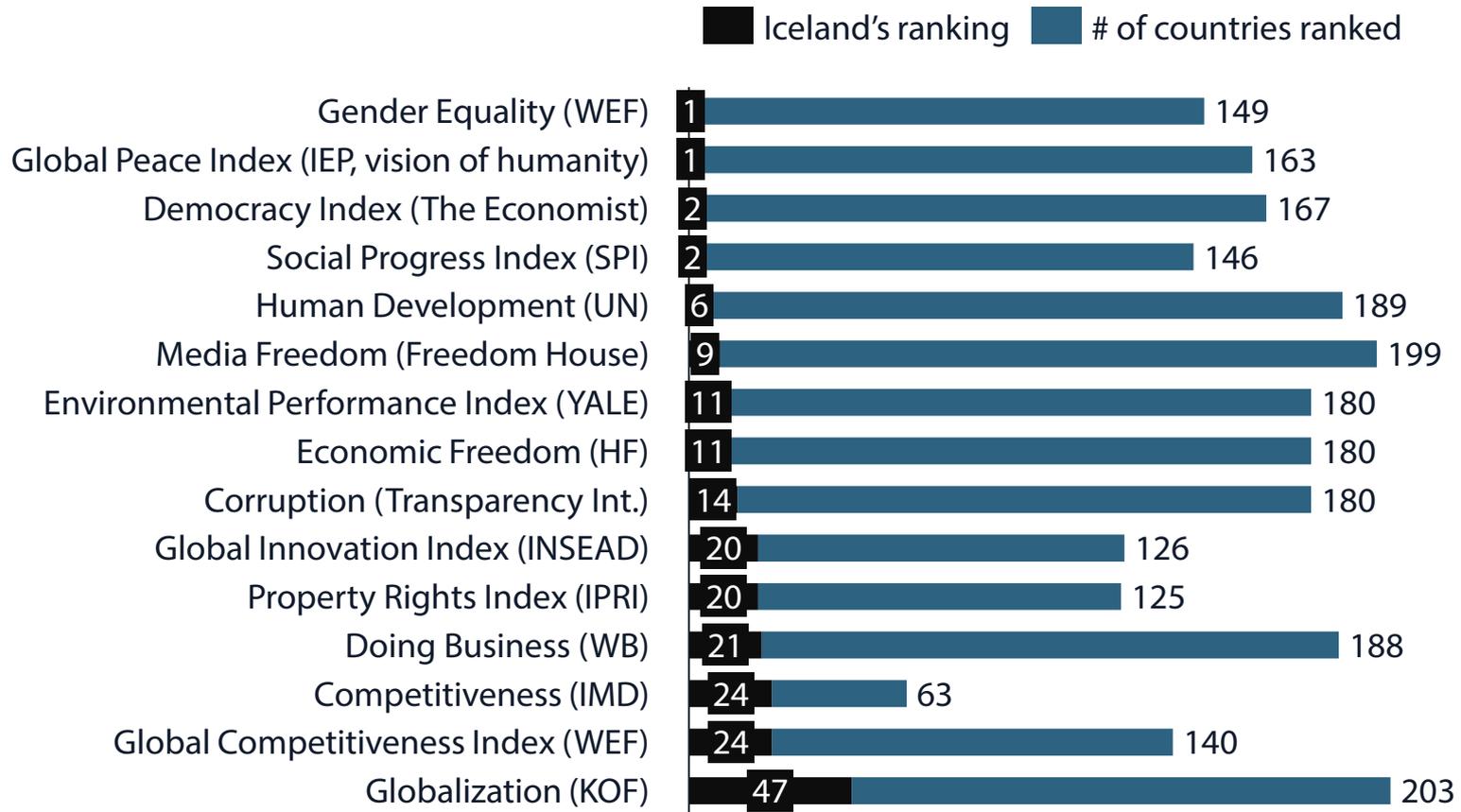


¹ Purchasing Power Parity

Figure 1.2

Iceland ranks highly in numerous competitive indices

Competitiveness Rankings (Iceland's most recent rank¹ / total number of countries)



¹ Sources obtained May 2019, with the exception of the Global Innovation Index, which was obtained in July 2019

Figure 1.3

Iceland's competitiveness has slowly but steadily been improving this decade

Iceland's Competitiveness in IMD's report (Strengths, weaknesses and recent developments)

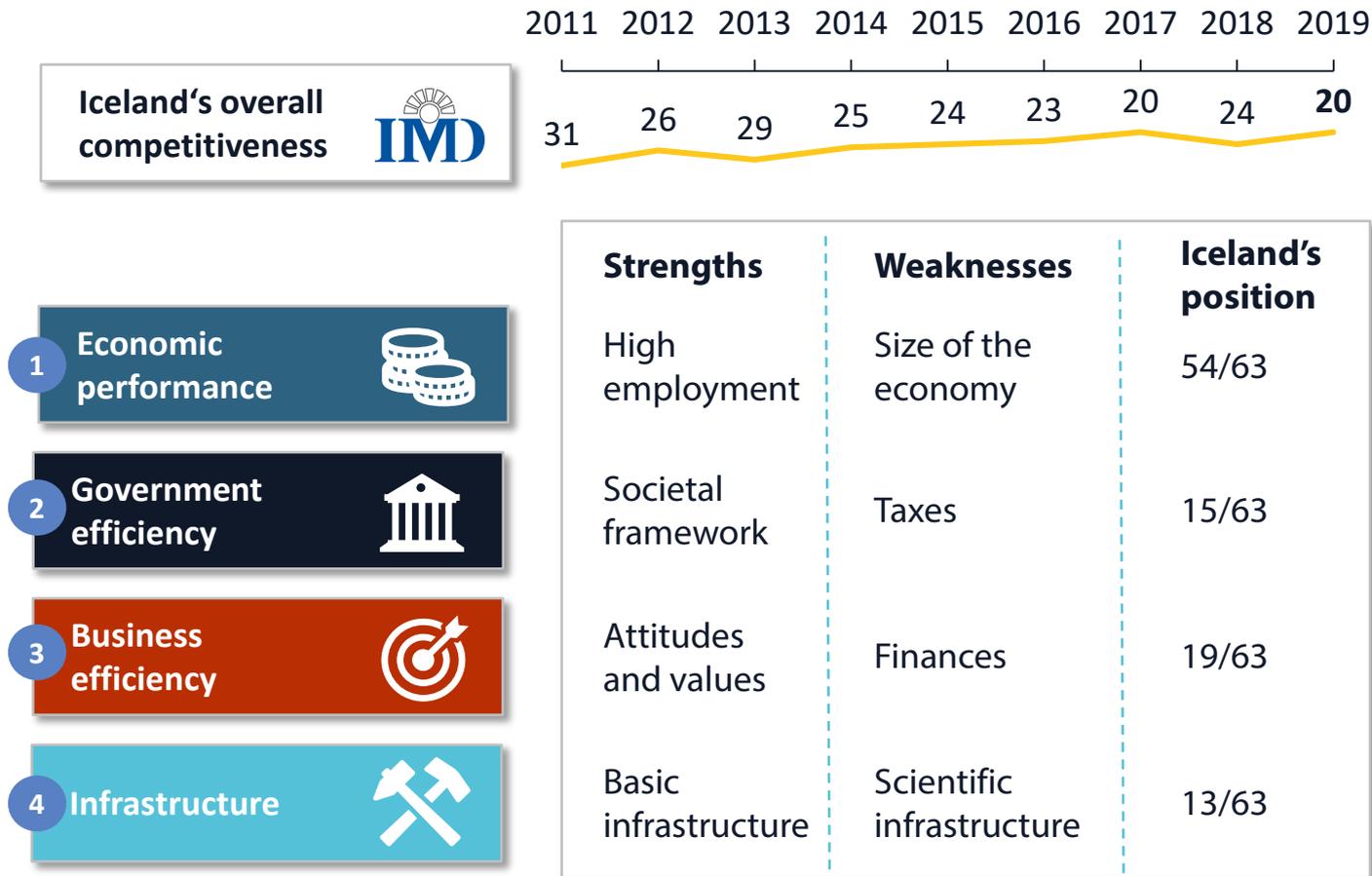


Figure 1.4

The economy has been experiencing robust growth but a mild recession is anticipated this year

GDP growth (Percent)

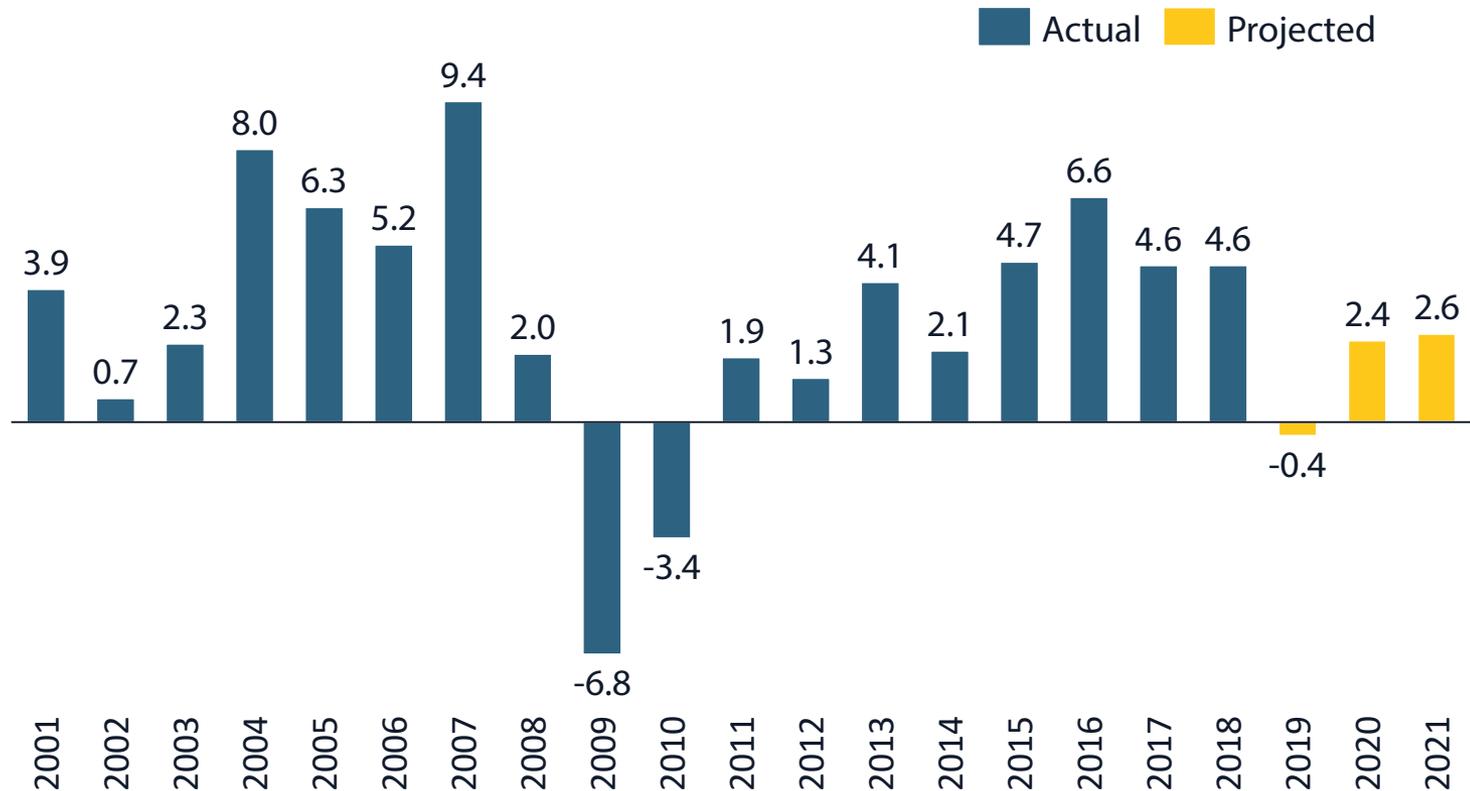


Figure 1.5

Iceland's economy was one of the fastest growing in the world in 2016, but growth has since slowed

Annual GDP growth 2014 to 2018 (Percent)

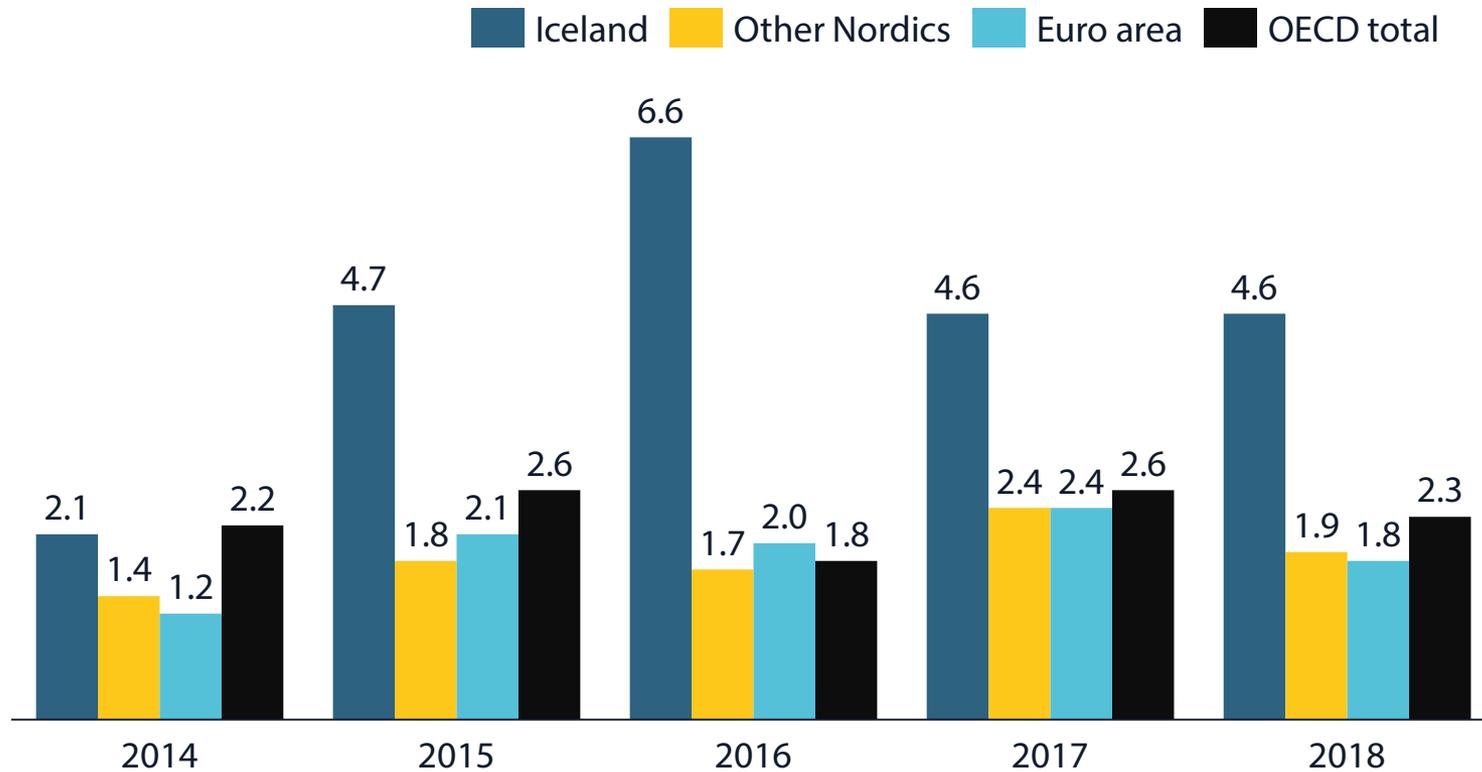


Figure 1.6

Private debt declined significantly after the financial crisis but has increased slightly in the last two years

Corporate and Household Debt (Percent of GDP)

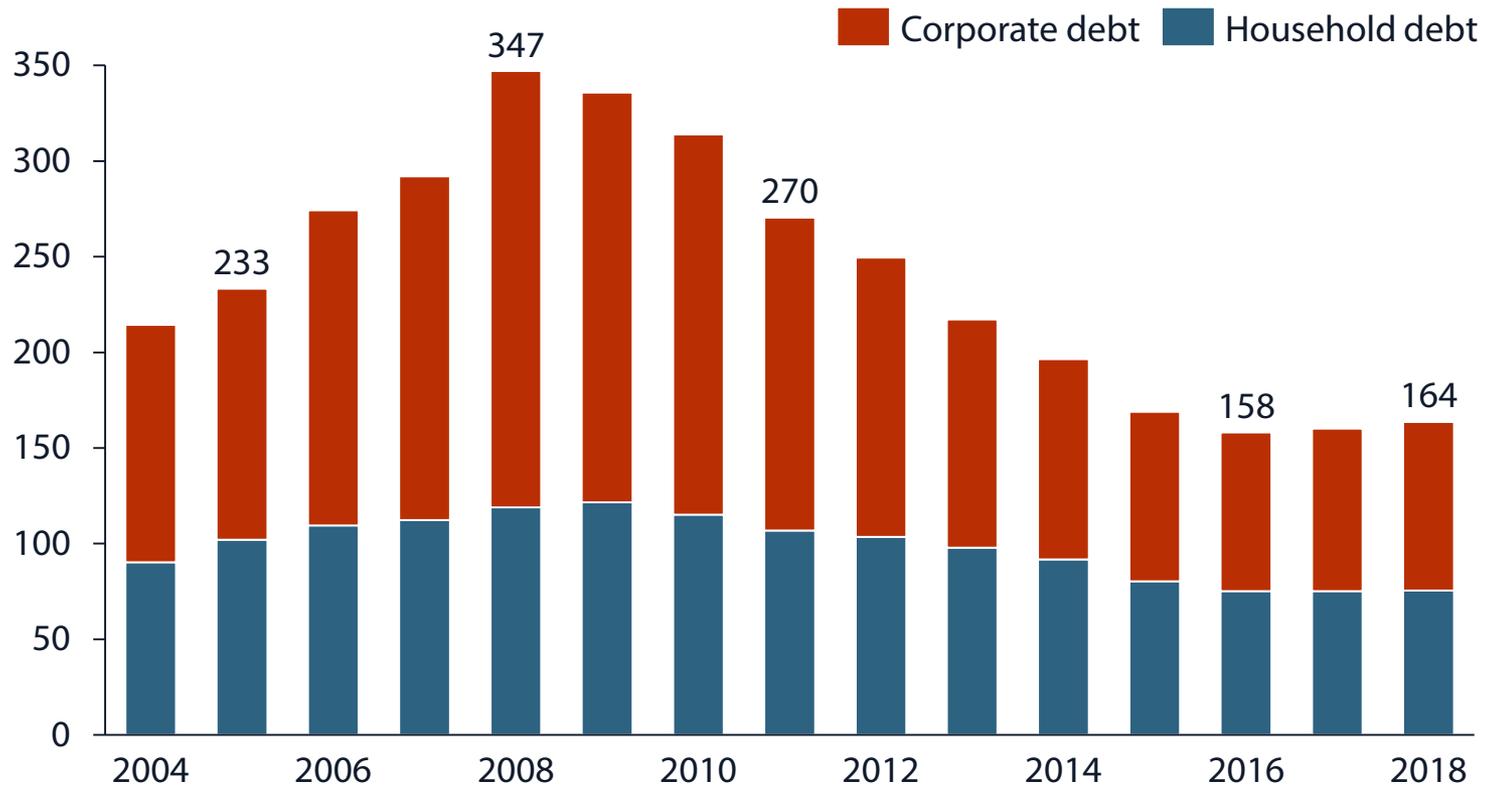
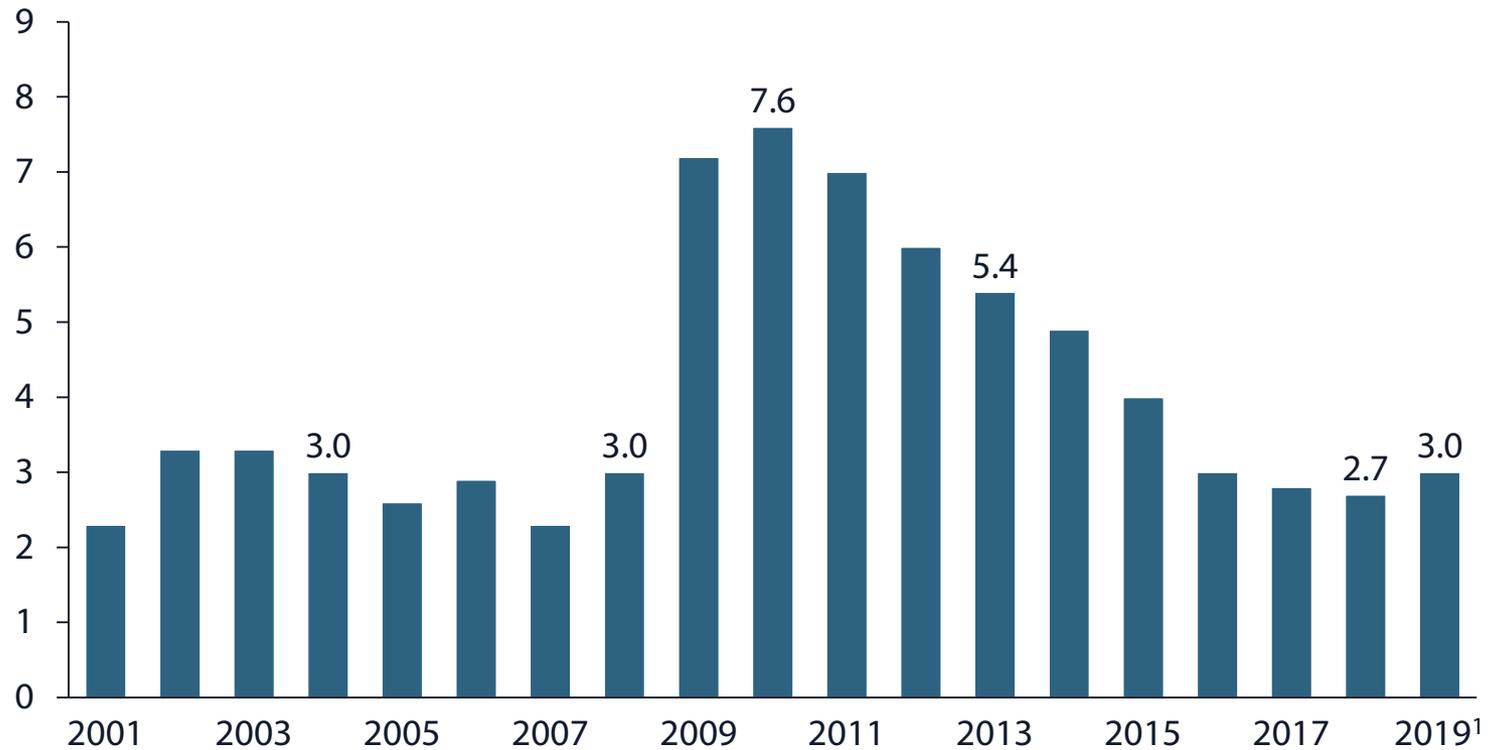


Figure 1.7

Unemployment is rising again after a gradual decline since 2010

Unemployment Rate (Percent; yearly average)



¹ First quarter

Figure 1.8

Inflation has been near the Central Bank's inflation target for over five years

Annual Inflation Rate (Percent)

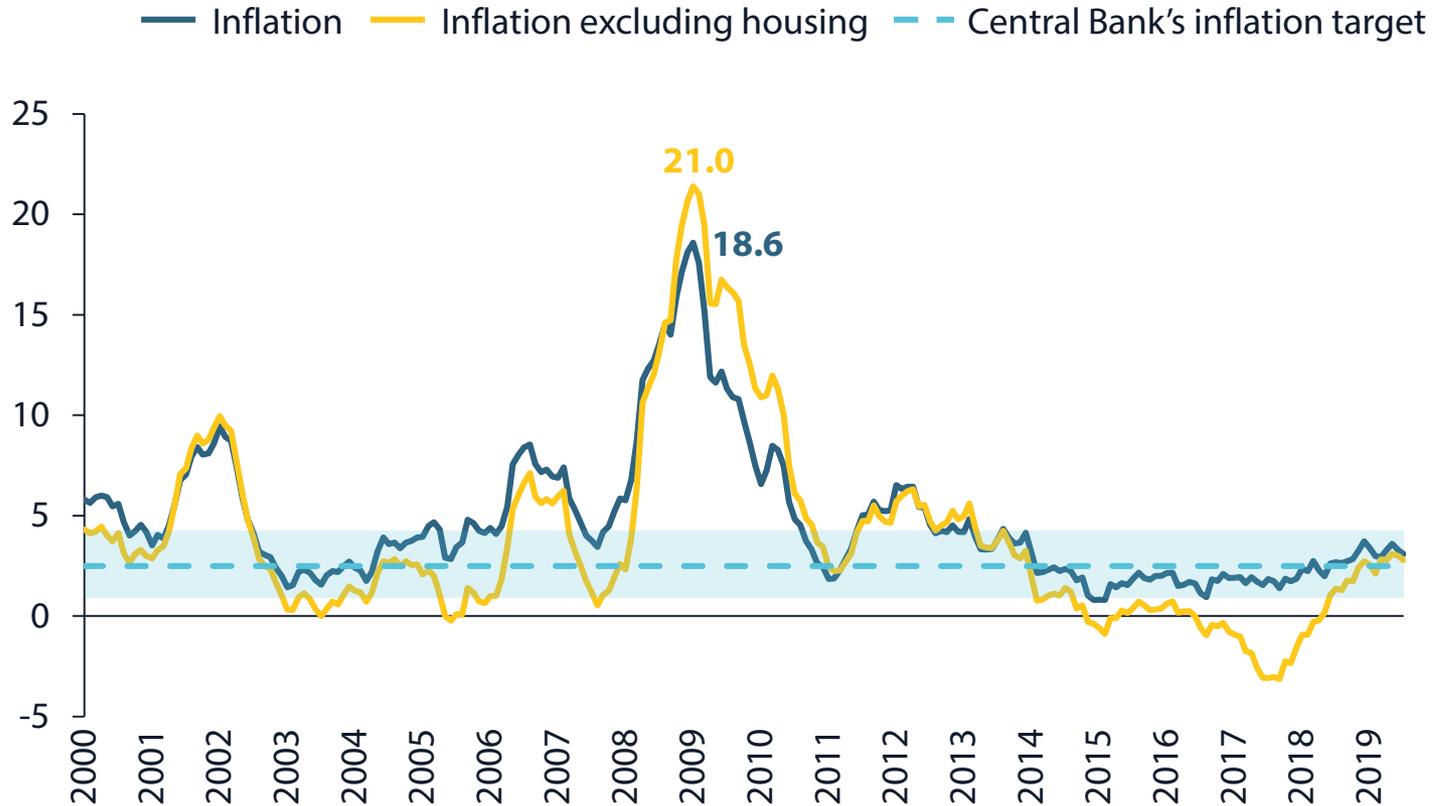


Figure 1.9

Interest rates in Iceland appear to be converging to other developed economies

Central Bank Key Interest Rates (Percent)

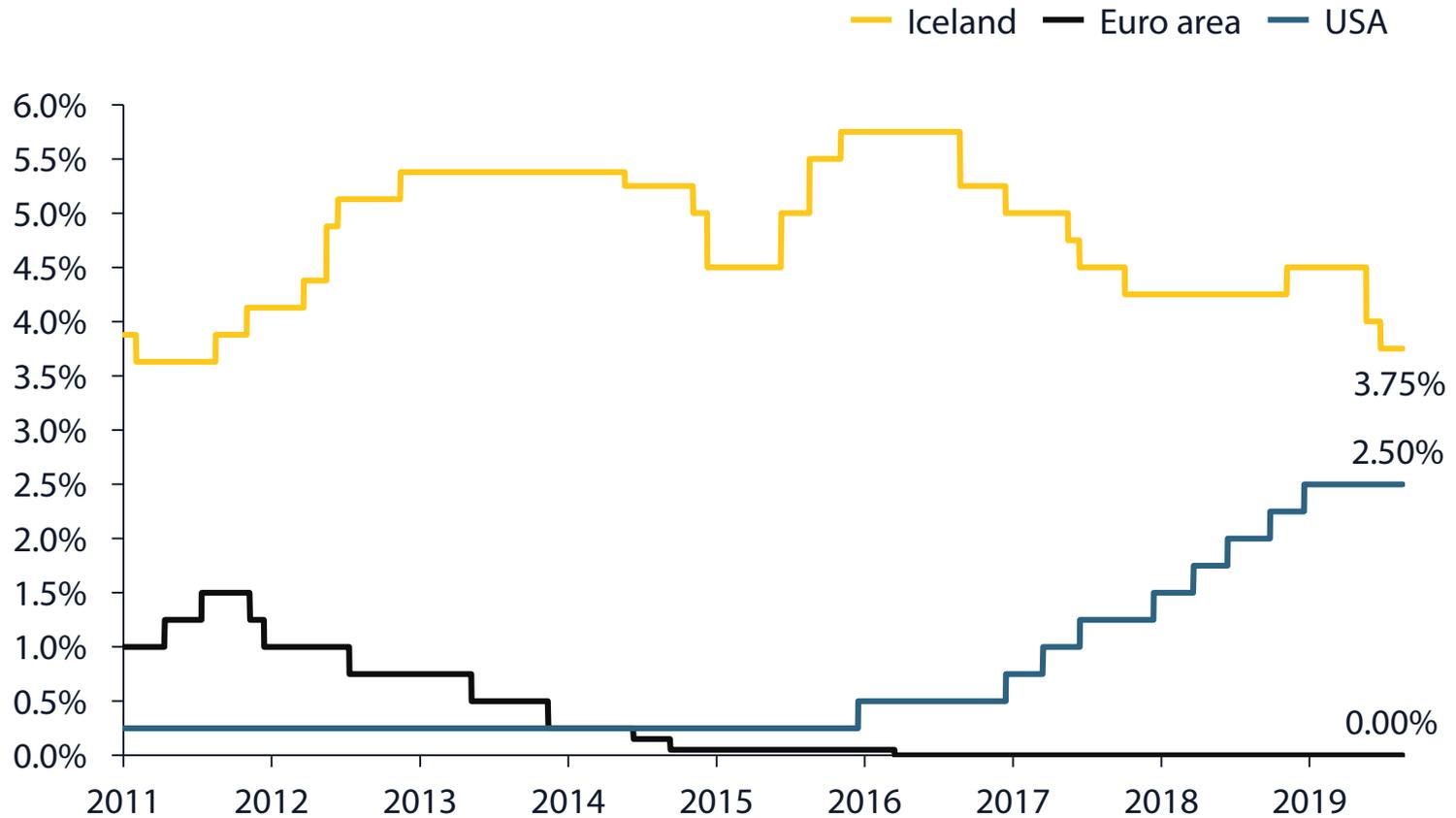
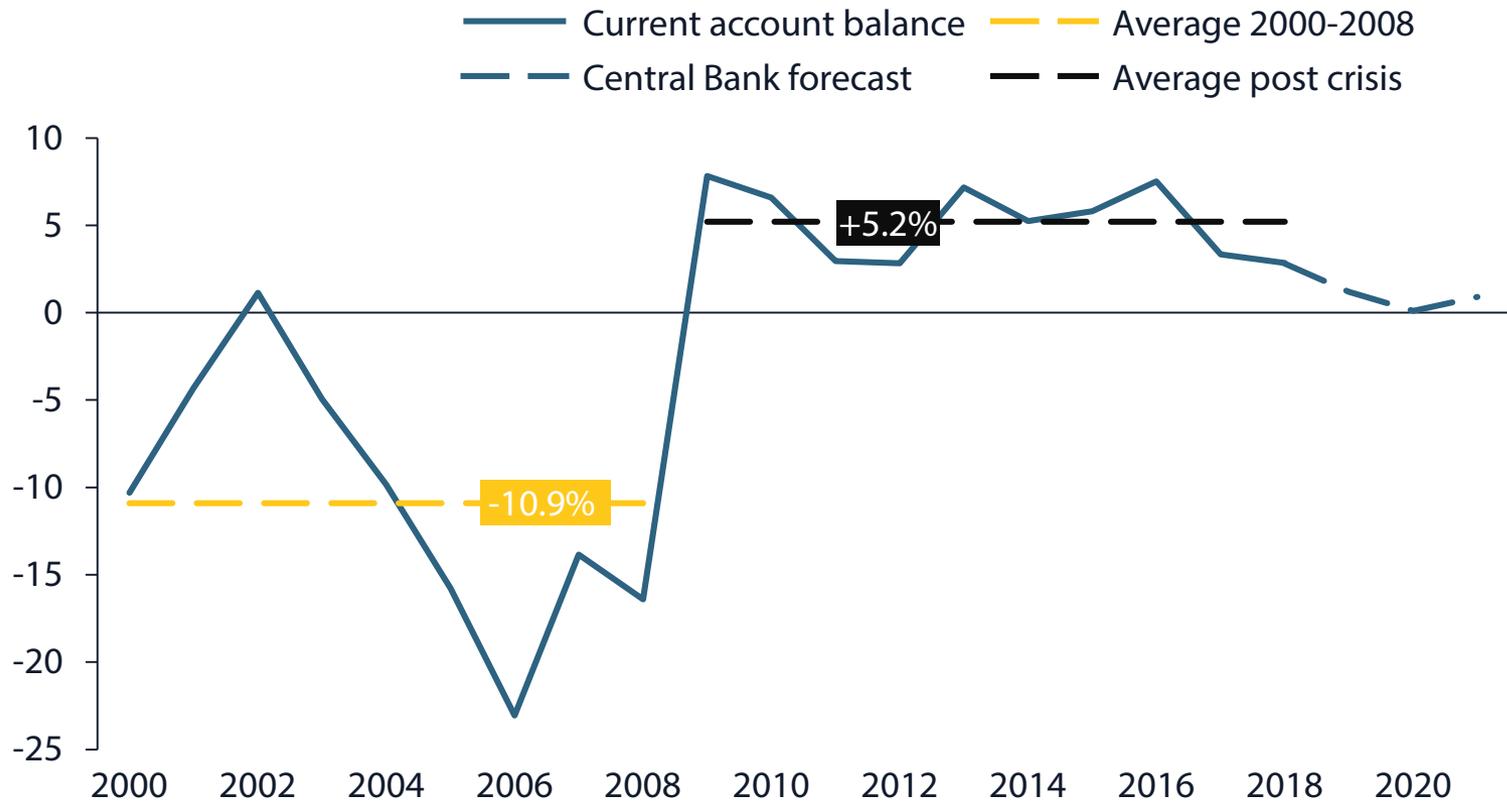


Figure 1.10

The devaluation of the Króna balanced out a persistent current account deficit and supported a surplus since 2009

Current Account Balance¹ (Percent of GDP)

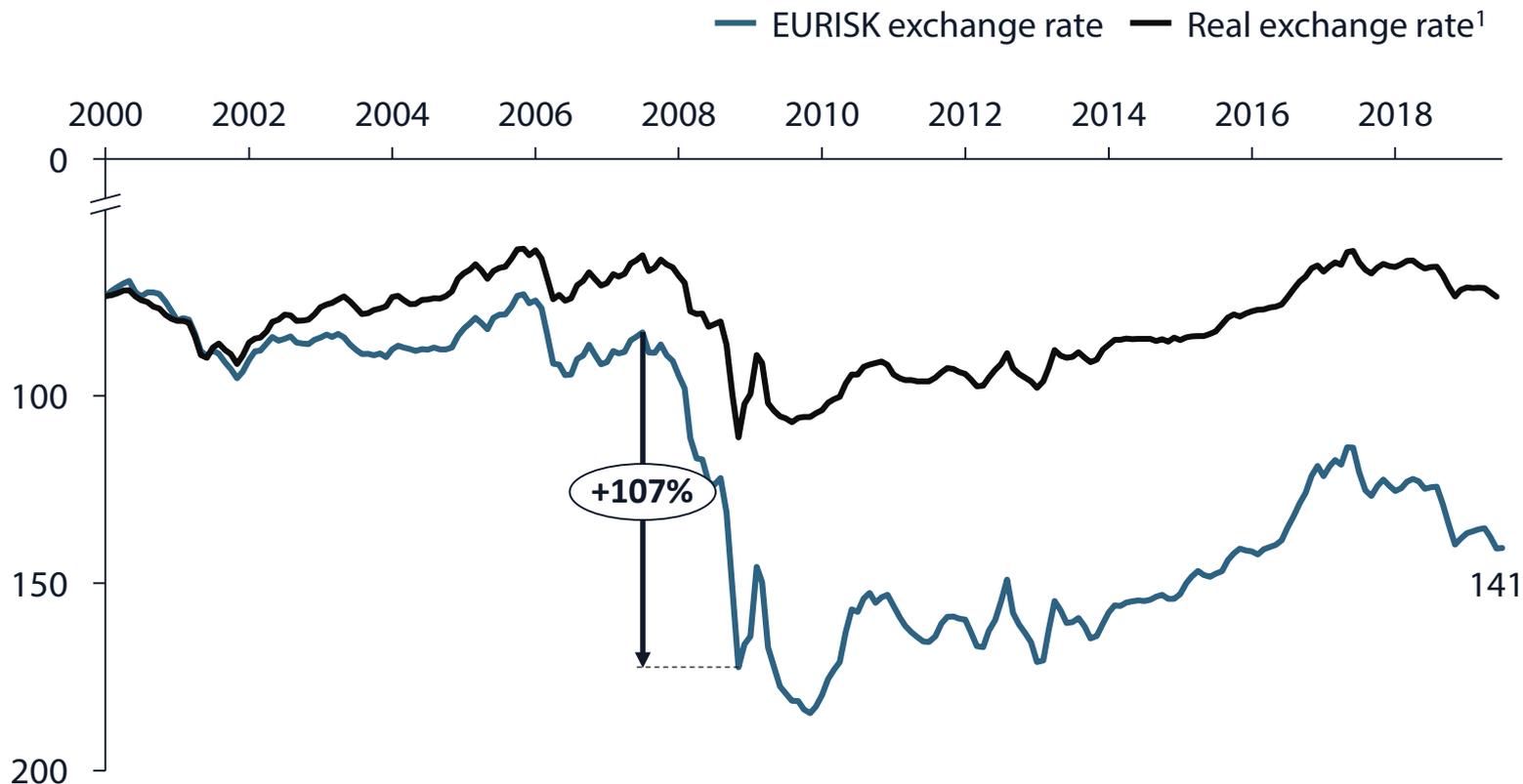


¹ Underlying current account, excludes the effects of the failed banks' estates. The current account is a broader measure than trade balance and also takes into consideration factor income and financial transfers.

Figure 1.11

Even though the Króna has depreciated in the last two years, the real exchange rate remains high

EUR/ISK and Real Exchange Rate (A higher value indicates a weaker Icelandic Króna)

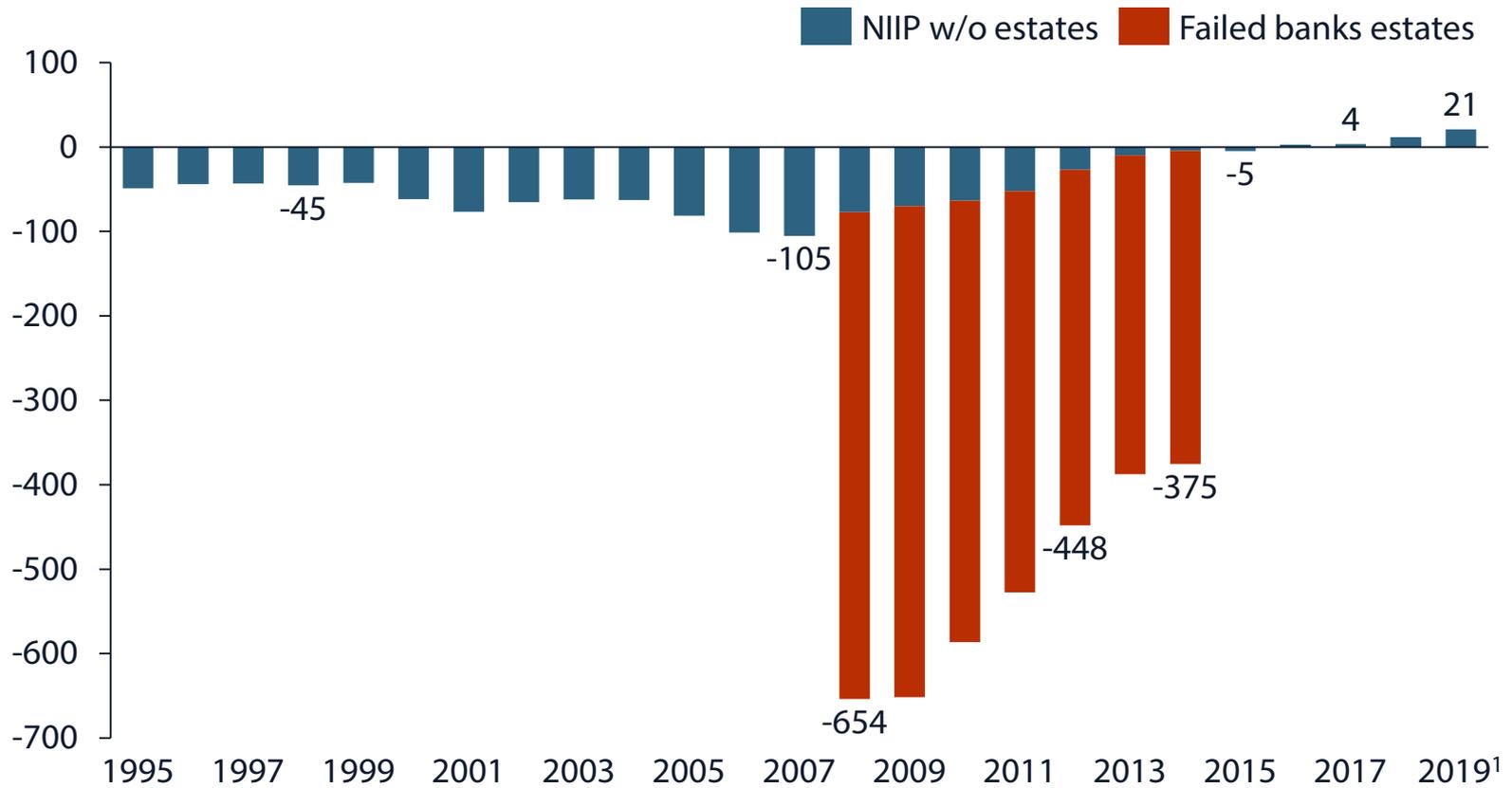


¹ Inversed values, normalised at EUR/ISK's initial value

Figure 1.12

Iceland's net foreign position has transformed with Iceland becoming a net lender to the rest of the world

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



¹ First quarter of 2019

Figure 1.13

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

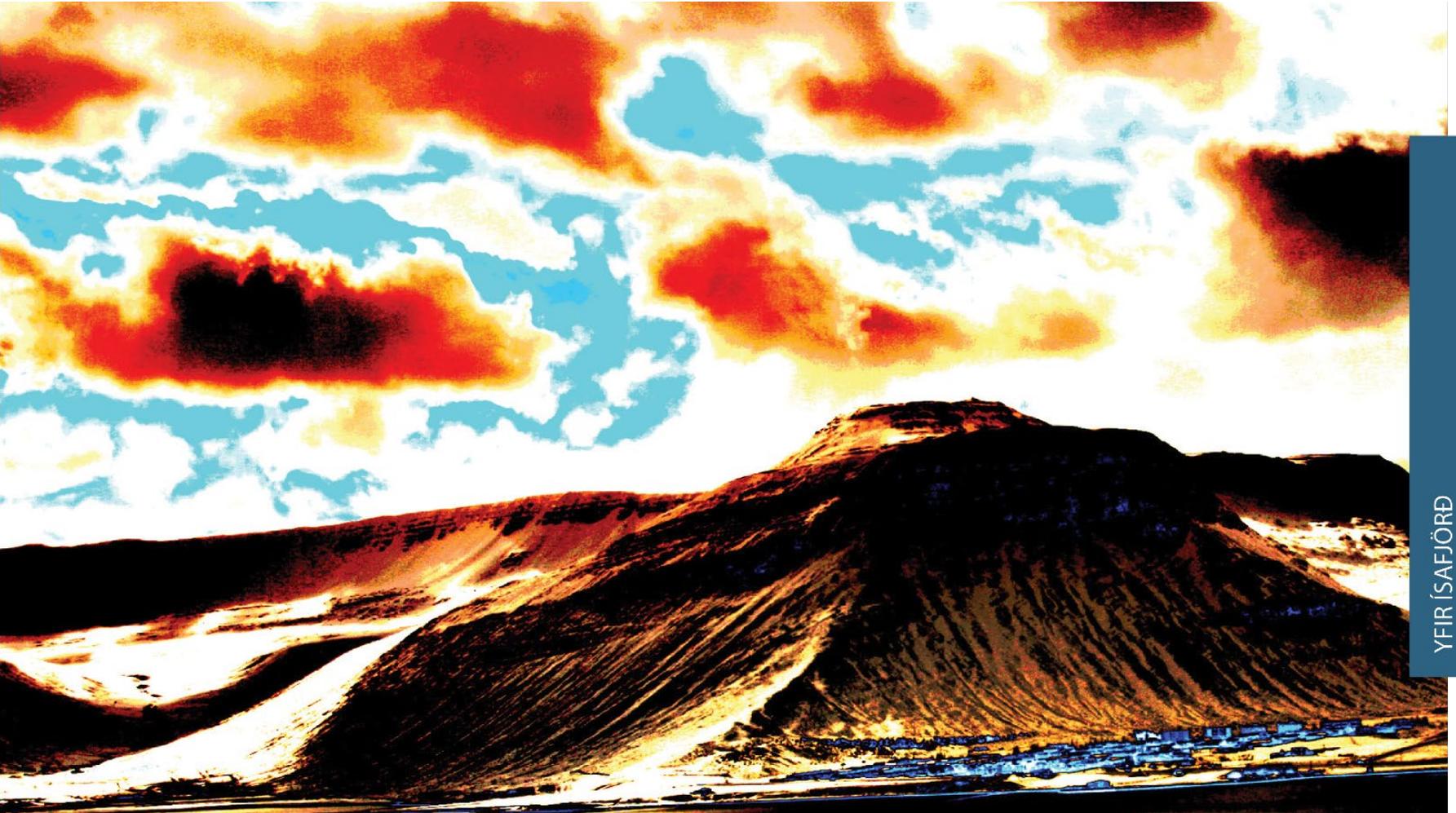
Iceland's Exports by Sectors¹ (Bn. ISK at 2017 prices)



¹ All air transport is included in the tourism sector whereas 50% of passenger transport by air is usually included in the international sector in chamber analysis.

2

INSTITUTIONAL FRAMEWORK



YFIR ÍSAFJÖRD

Figure 2.1

Eight parties have representatives in Althingi – Iceland’s Parliament

Illustrative; Parliamentary parties, number of MP’s and ministerial posts

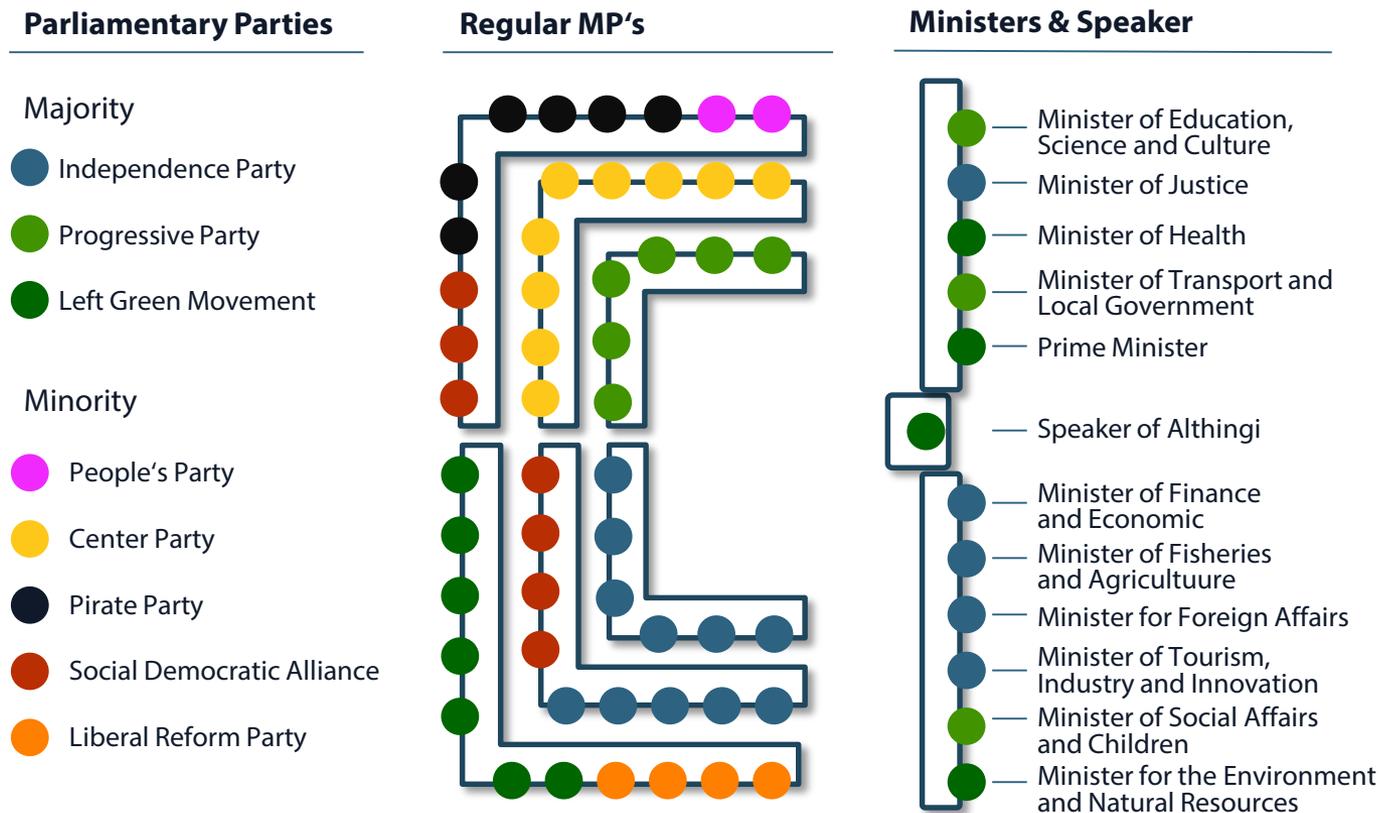
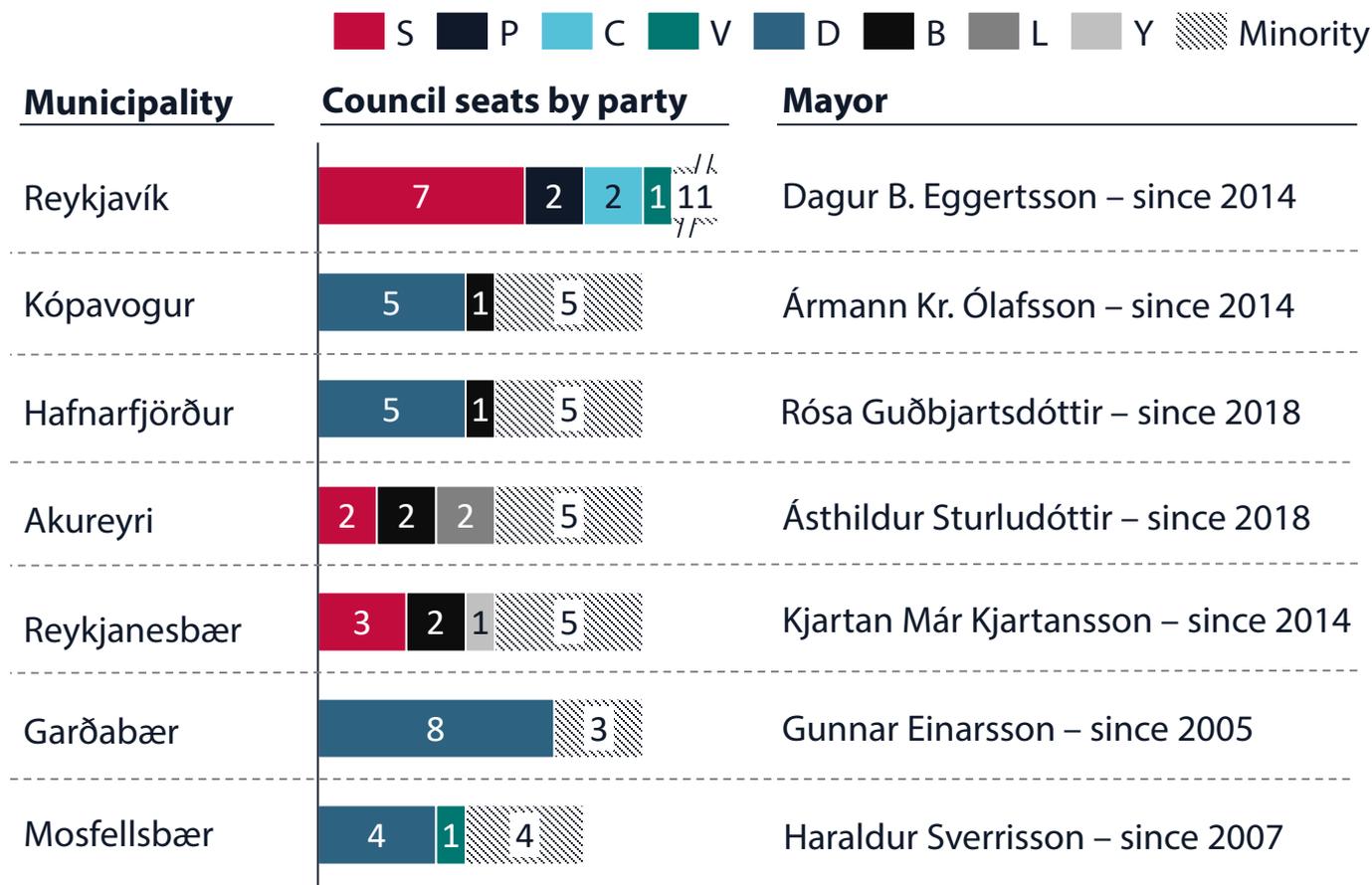


Figure 2.4

Most mayors in the largest municipalities have served longer than one term

Majorities in the Seven Largest Municipalities (Parties by list letter codes)

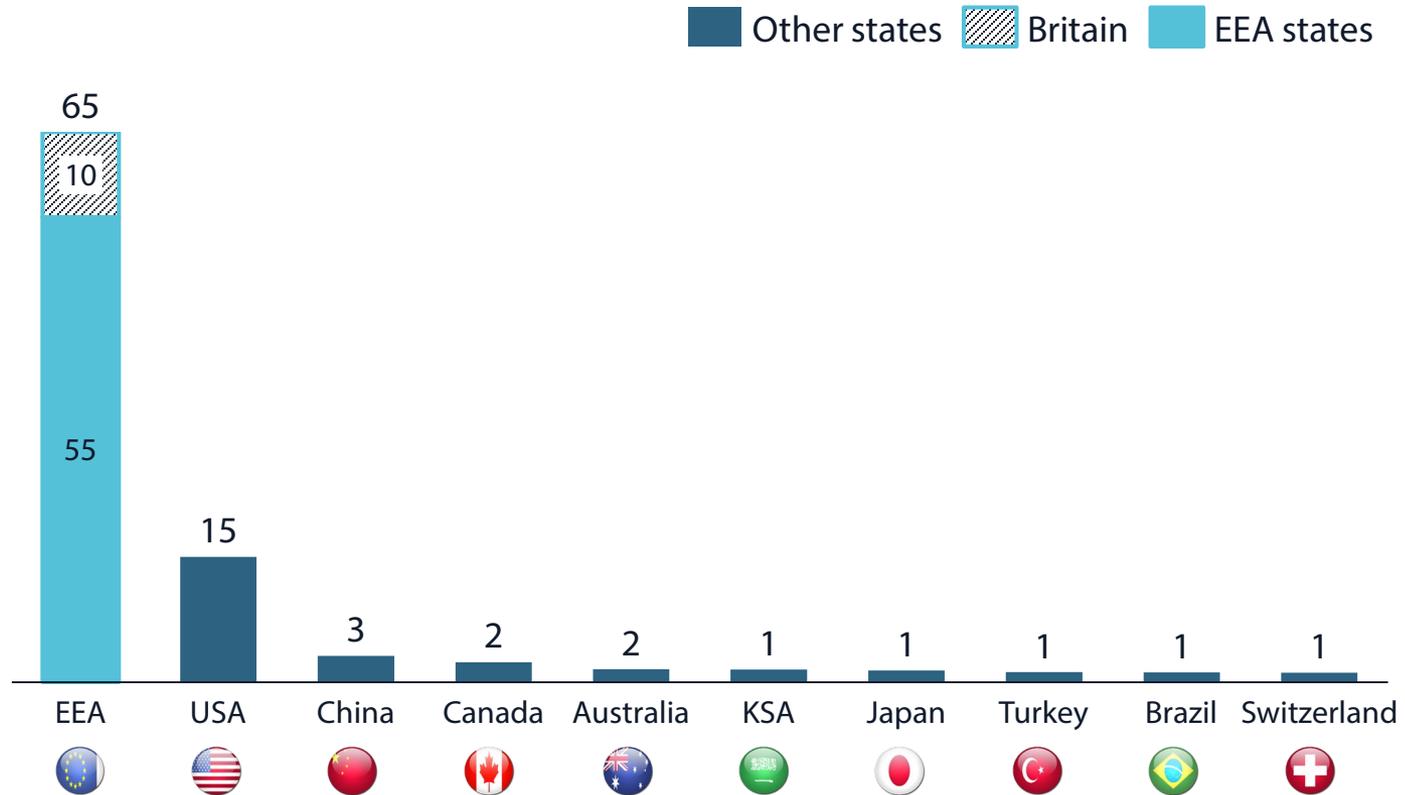


1 S – Social Democratic Alliance, C – Reform Party, D – Independence Party, P – Pirate Party, V – Left Green Movement, B – Progressive Party, L – L-list, Y – Direct way.

Figure 2.3

The EEA member states are some of Iceland's largest trading partners

Iceland's Largest Trading Partners (Percent of total trade in goods and services in 2017)

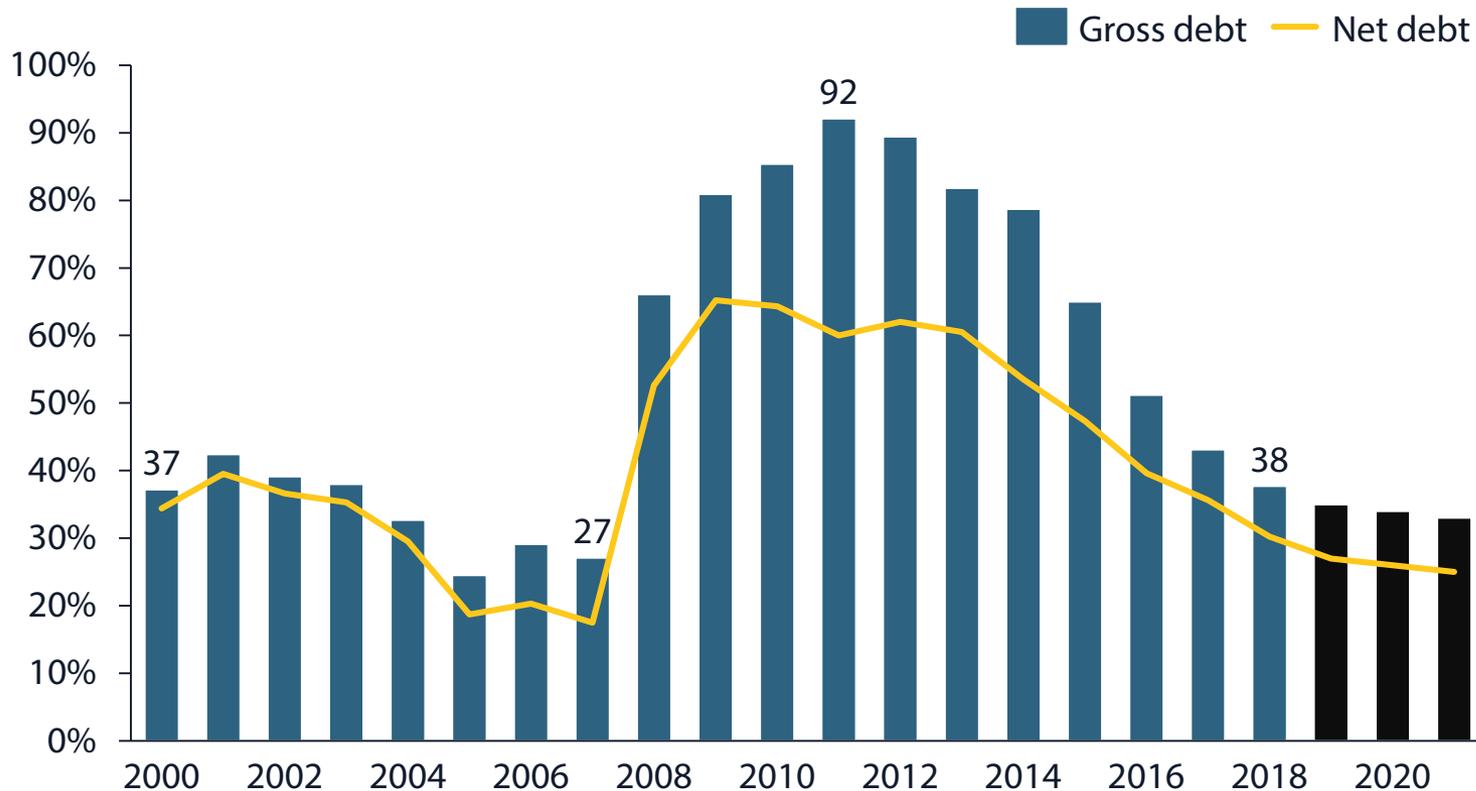


1 Total share of imports and exports combined

Figure 2.4

Public debt has decreased significantly in recent years and is primarily domestic

General Government Debt¹ (Percent of GDP)

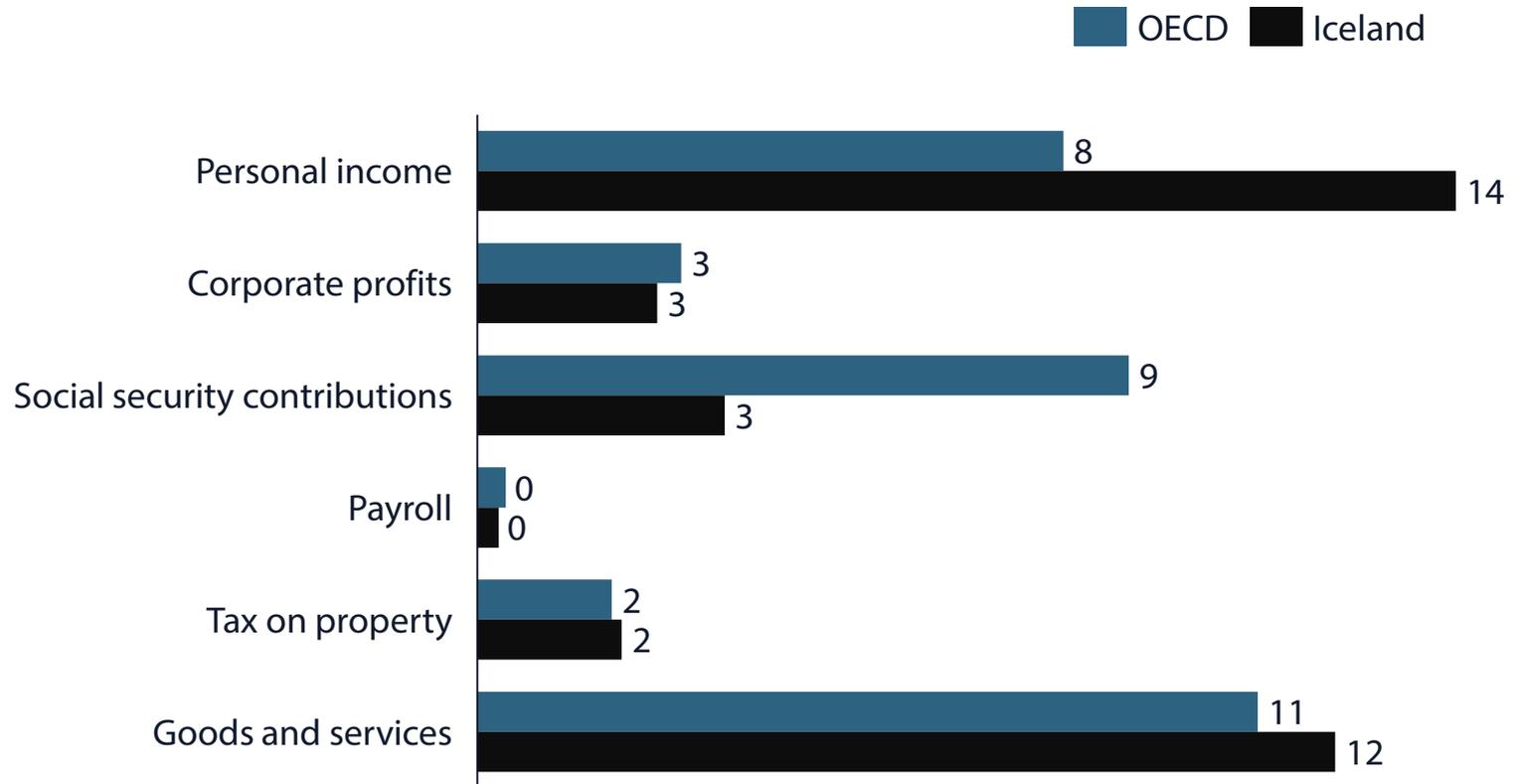


¹ Central Bank forecast after 2018

Figure 2.5

Taxes on personal income are high while social security contributions are low due to private pensions

General Government Tax Revenues in 2016¹ (Percent of GDP)



¹ Tax on property in 2017 for Iceland due to one-off transactions regarding stability contributions of failed bank estates

Figure 2.6

Public spending is relatively high in Iceland with the exception of defence and social protection

General Government Spending in 2016¹ (Percent of GDP)

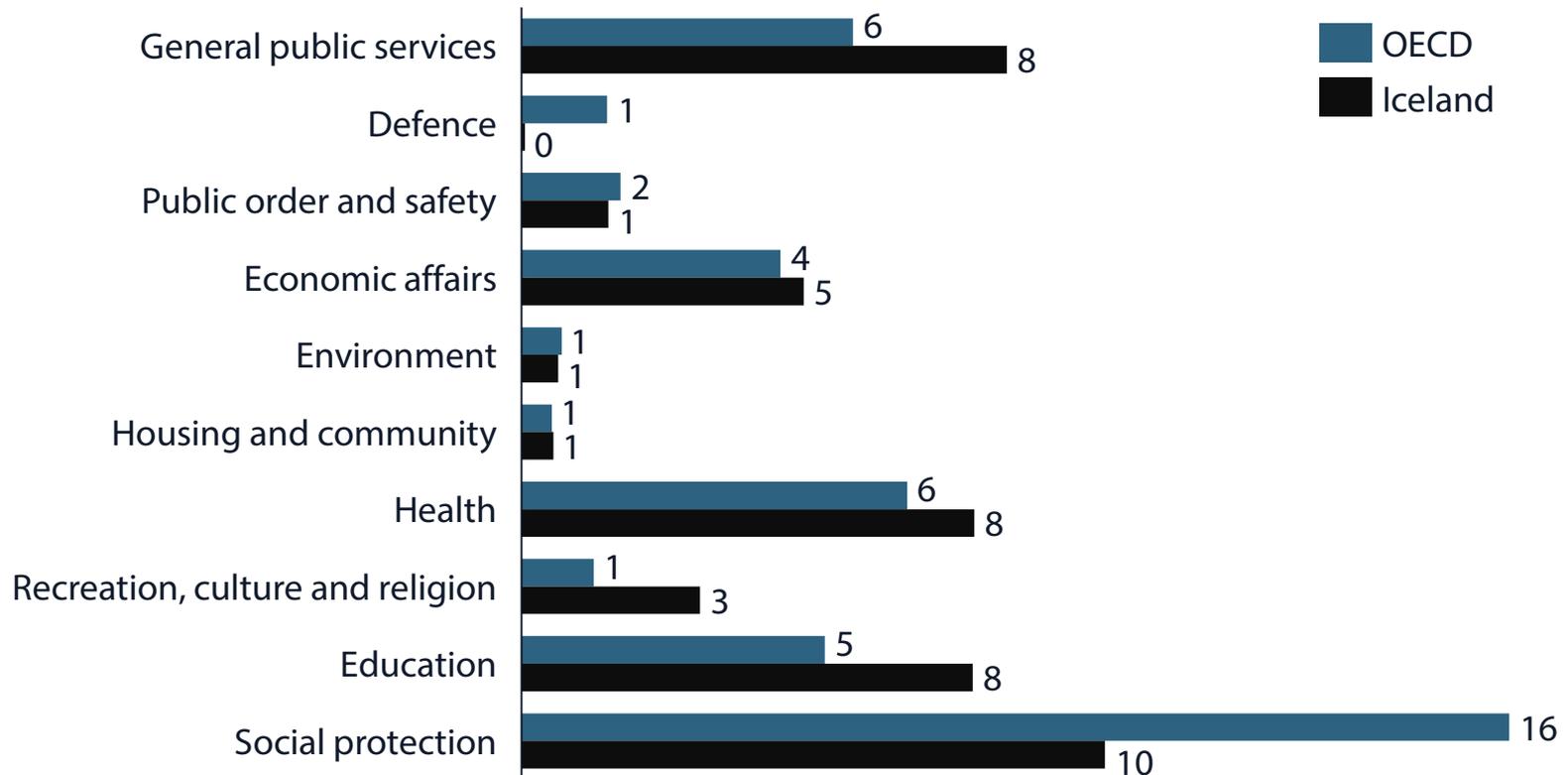
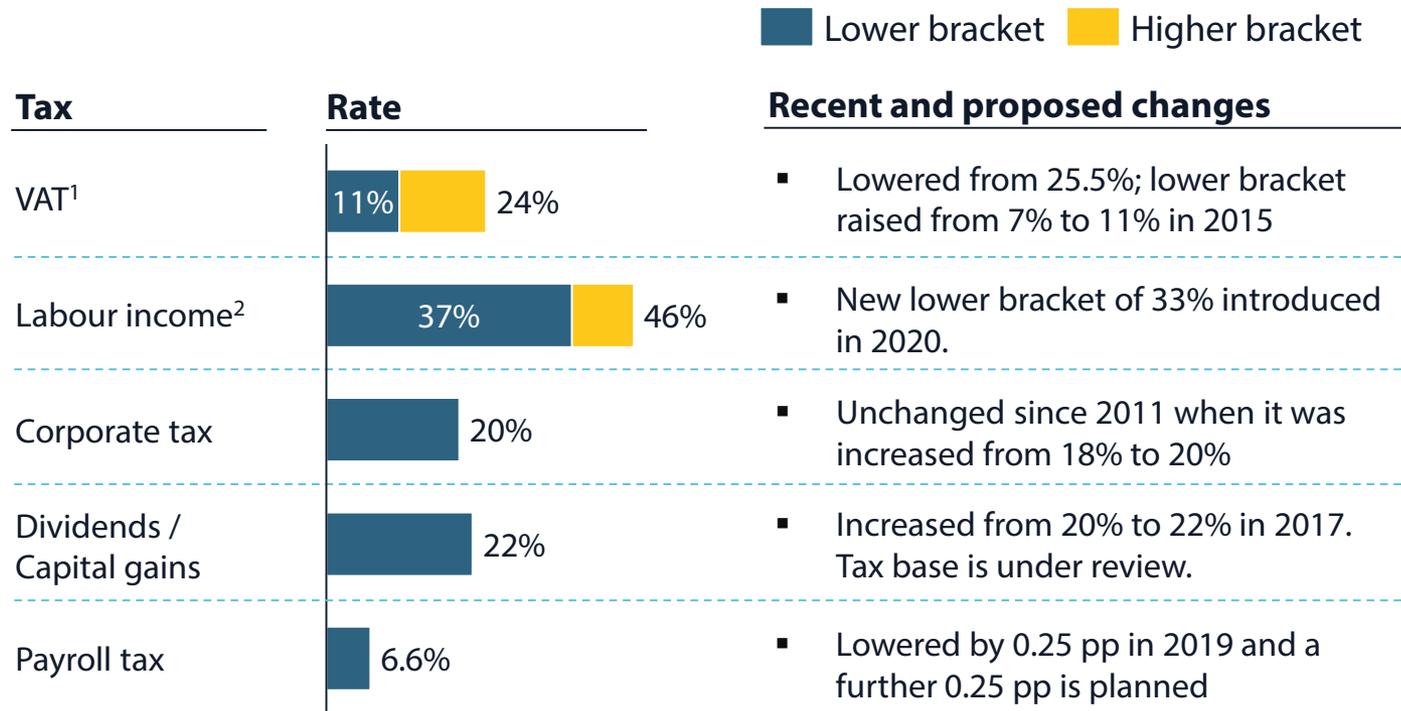


Figure 2.7

The Icelandic tax system relies heavily on consumption and labor income

Key Taxes in Iceland



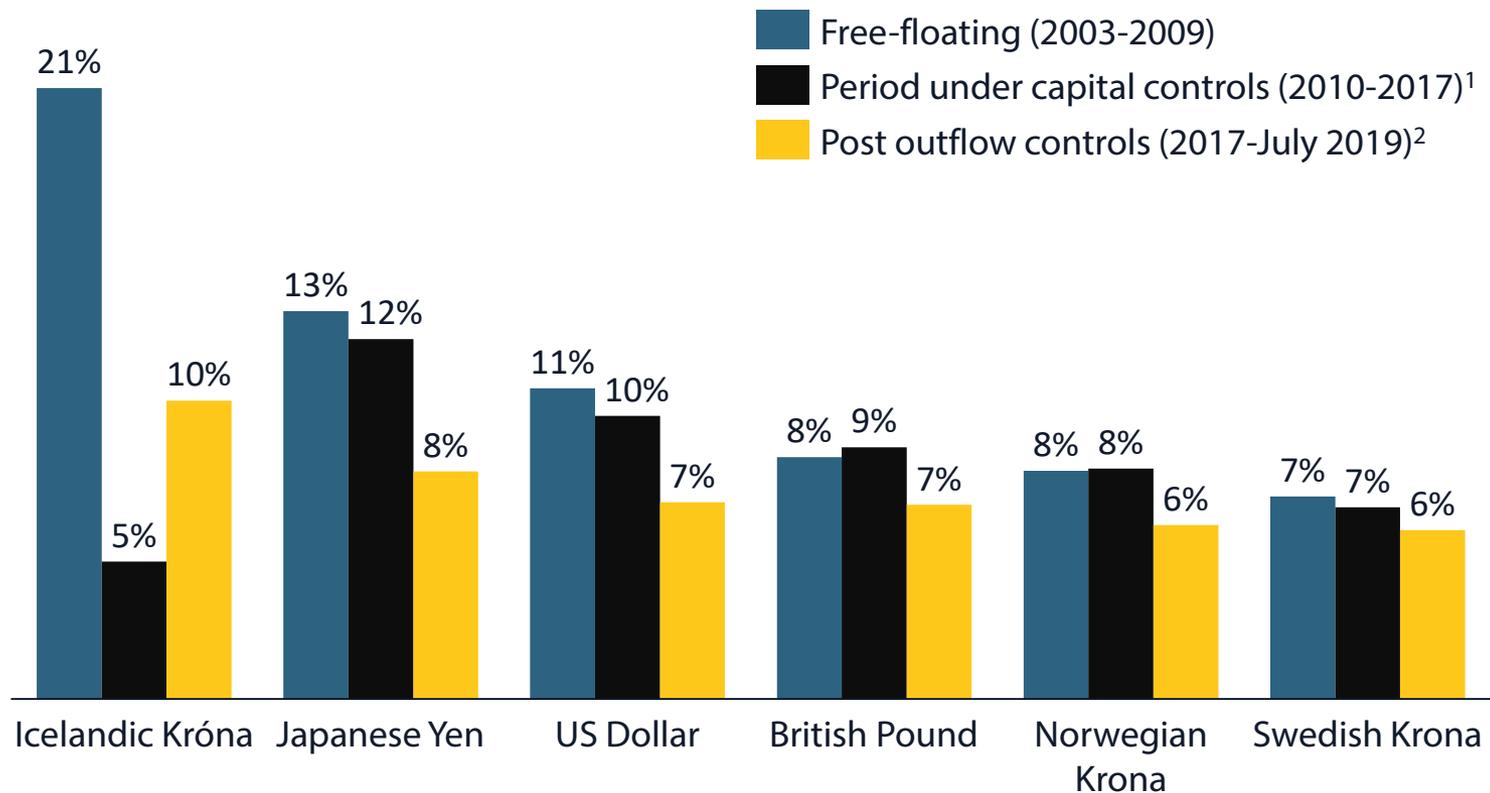
¹ Consumption taxes fall into two brackets, the lower being 11% which includes e.g. tourism related activities, media, books, and groceries; the higher 24% which is the general rate; some service is exempt from consumption taxes, such as health service, public transport and schools.

² Income taxes are divided between two brackets, the lower being 36.94% for the first ~895 thousand ISK of an individual's monthly income, and the higher being 46.24% for income above ~895 thousand ISK. Further, each individual has a tax free allowance in the form of a tax credit, ~56 thousand ISK in 2019, which is subtracted from the gross tax payable each month.

Figure 2.8

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

Exchange Rate Fluctuations Against the Euro (Annualised volatility)



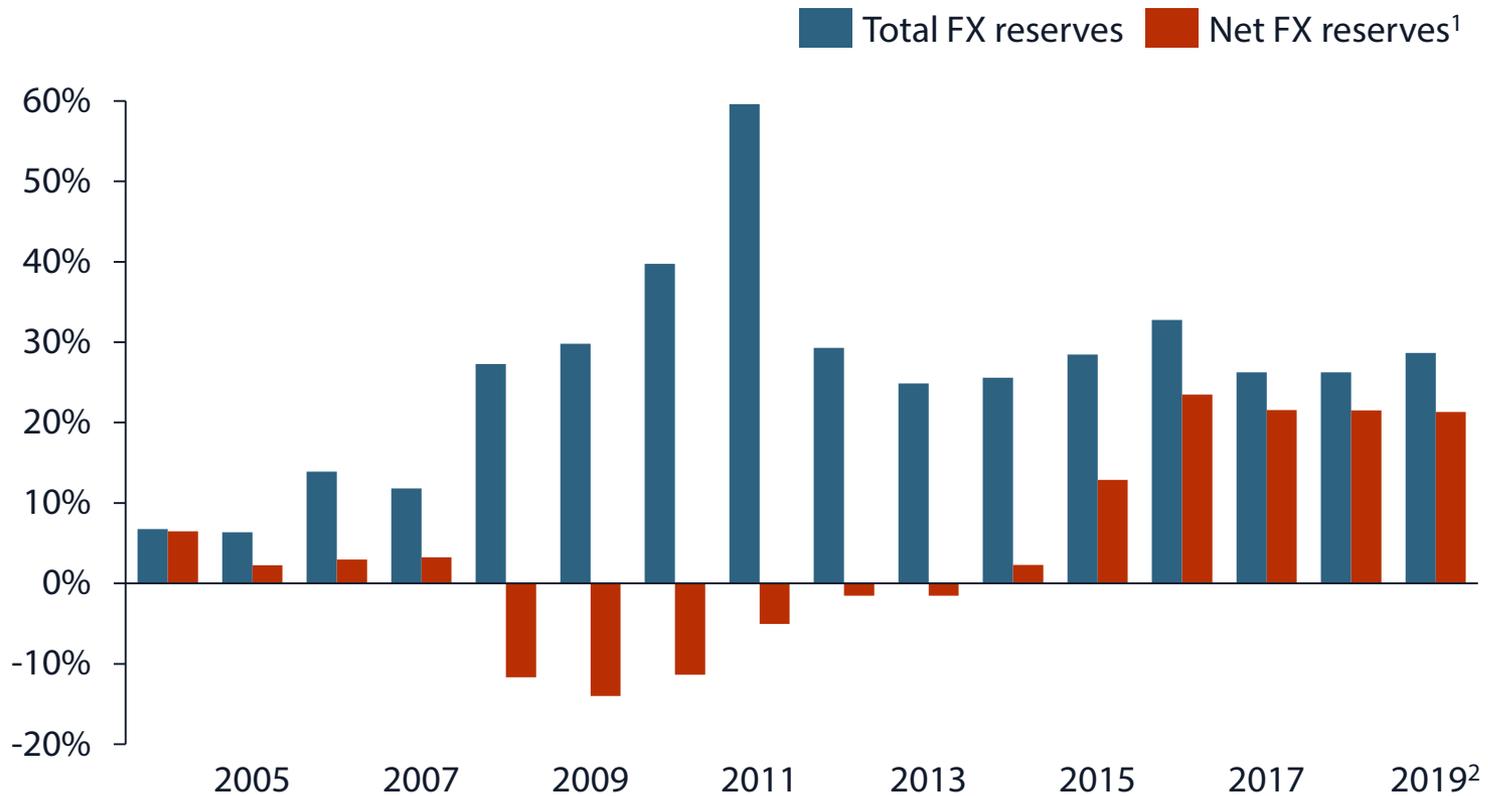
¹ From 1st of January 2010 till 13th of March 2017

² From 13th of March 2017 till 14th of July 2019

Figure 2.9

The Central Bank has a large cushion to fend off short-term exchange rate fluctuations

Foreign Exchange Reserves (Percent of GDP at year-end)

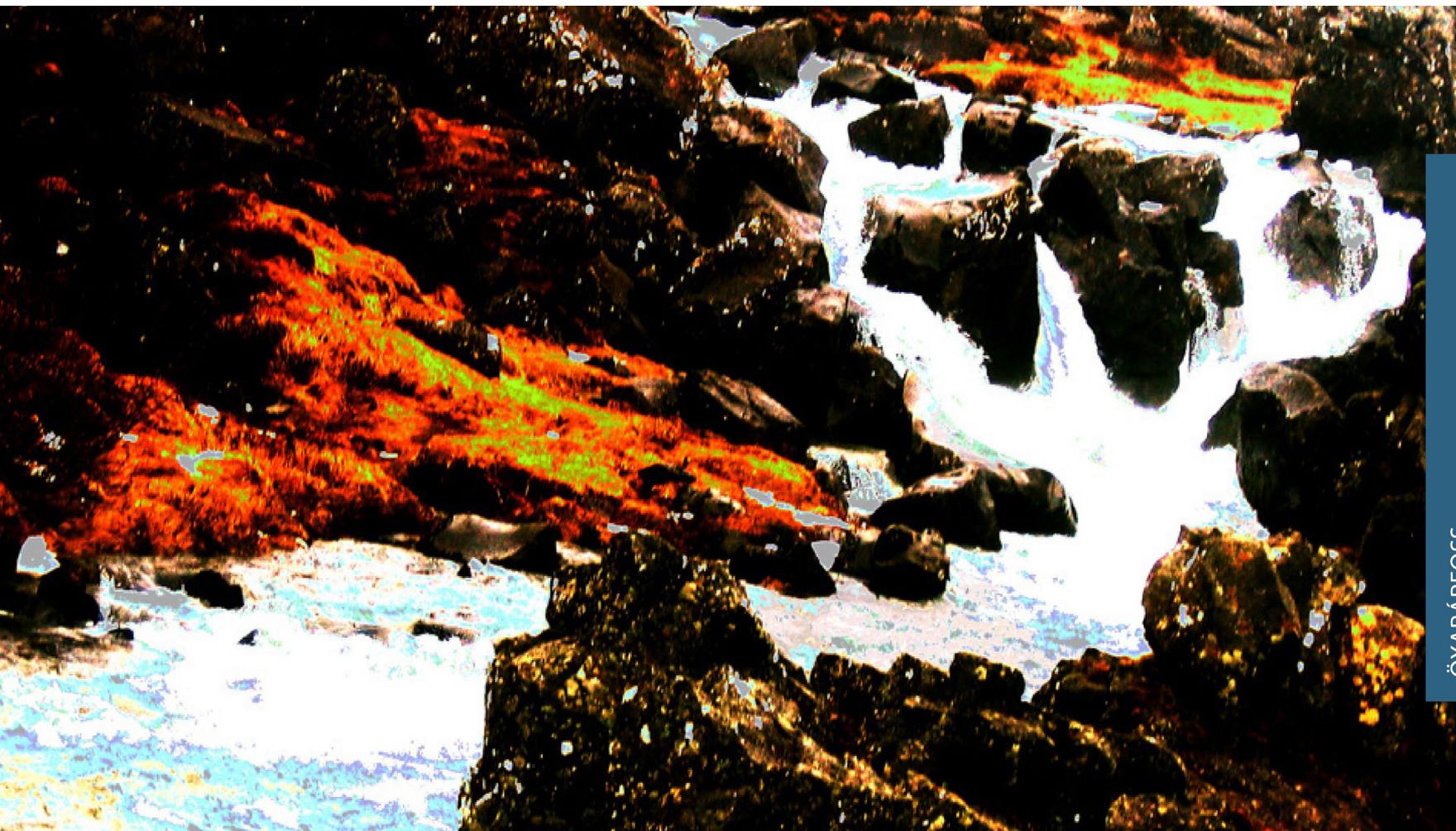


1 FX reserves less Central Bank's foreign currency liabilities, i.e. FX reserves financed in ISK.

2 June 2019

3

FINANCIAL SECTOR

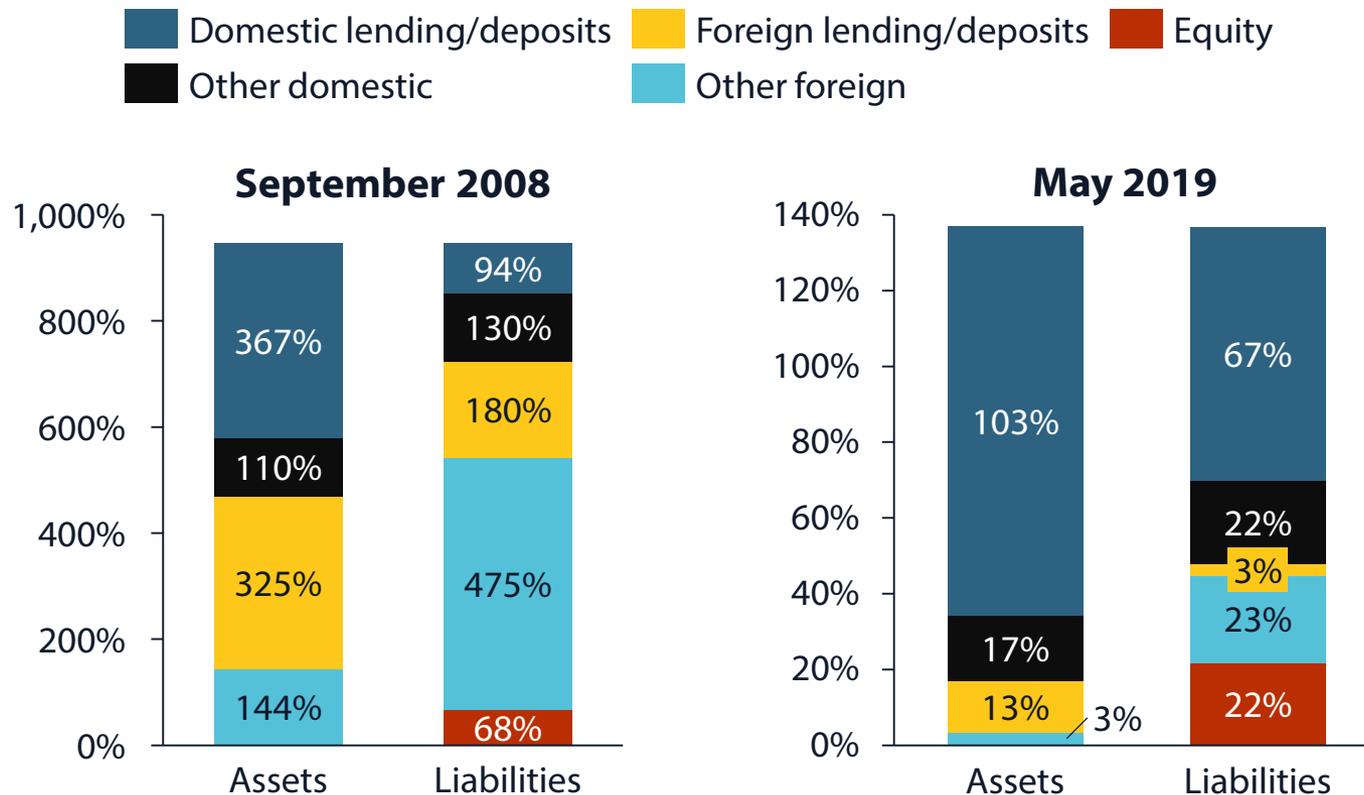


ÖXARÁRFOSS

Figure 3.1

The Icelandic banking system is less leveraged, much smaller and primarily serves the domestic market

Aggregated Deposit-Taking Bank's Balance Sheet¹ (Percent of GDP)

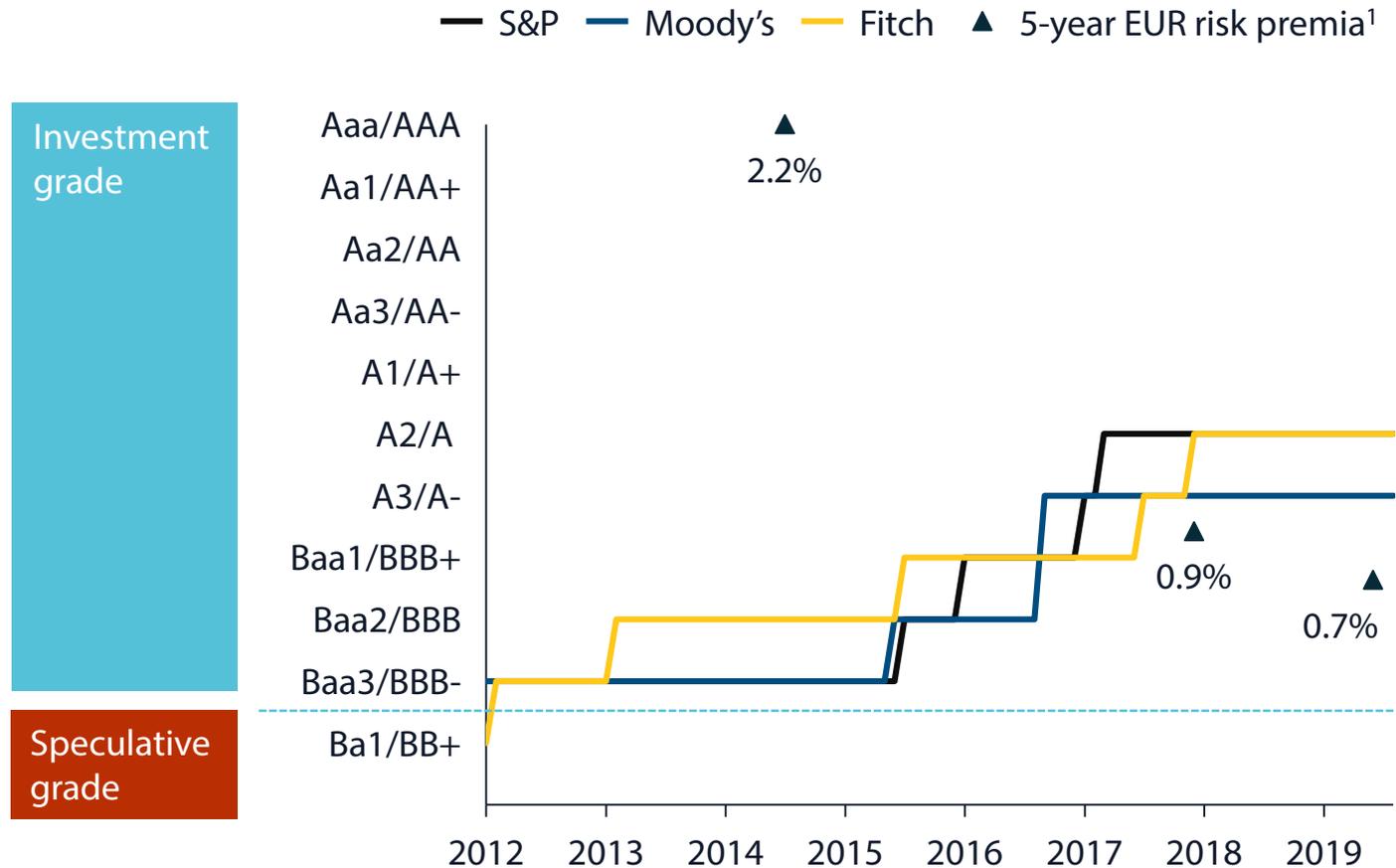


¹ Arion Bank, Íslandsbanki, Kvika, Landsbankinn, savings banks and their predecessors. Assets and liabilities are classified by location, not currency. That means domestic assets can, for instance, be denominated in foreign currency.

Figure 3.2

Iceland's credit rating has improved in recent years but is stagnant due to rising uncertainties

Iceland's Credit Ratings (Sovereign debt; Moody's, Fitch and S&P rating)



¹ Interest rate differential between Icelandic and German government bonds at the time of issuance of Icelandic EUR bonds.

Figure 3.3

Domestic assets appreciation has recently slowed down

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

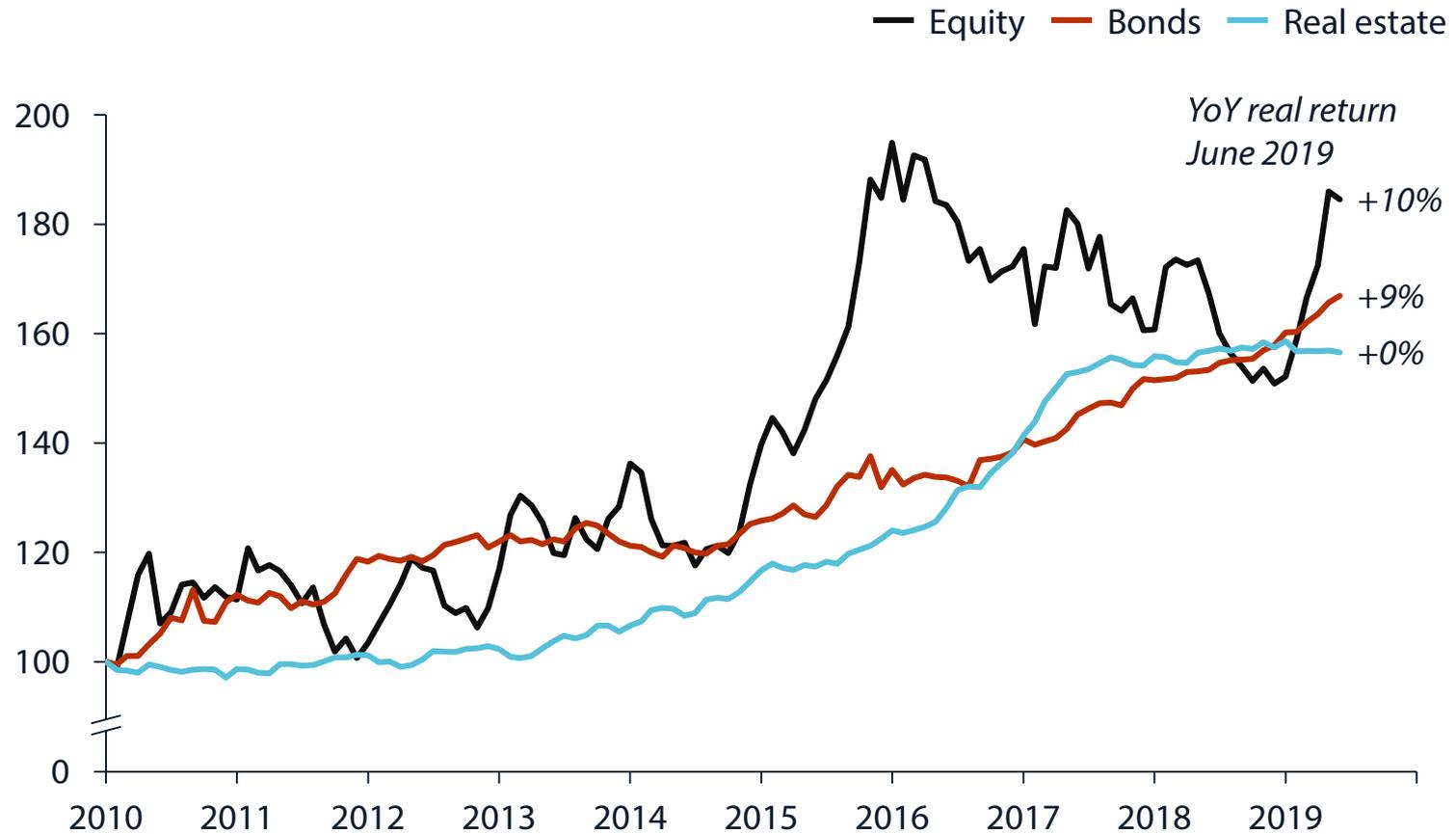
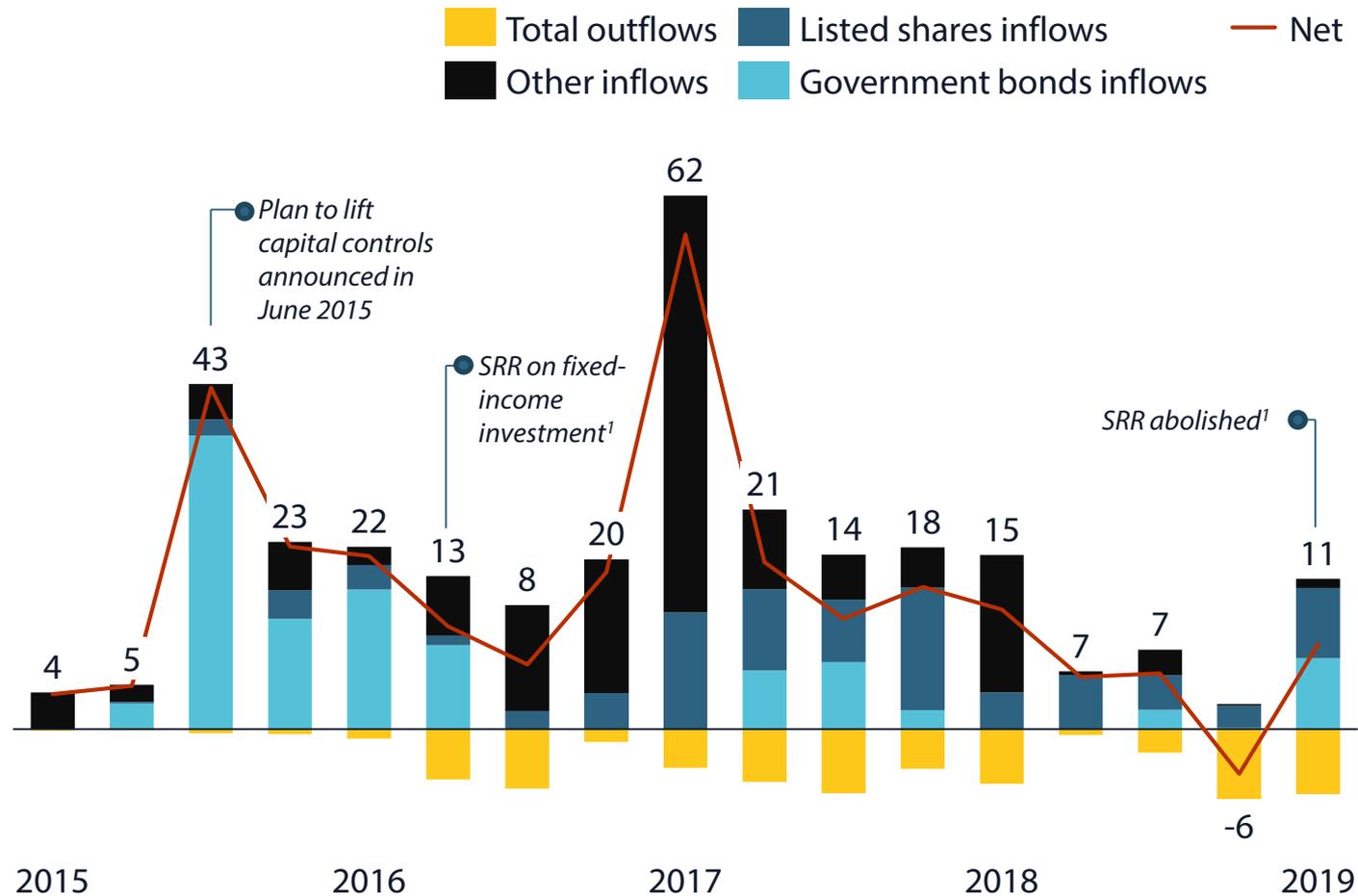


Figure 3.4

Restrictions on capital inflows (SRR), which have now been lifted, have influenced the composition of inflows

New Investment Inflows (Bn. ISK)



Plan to lift capital controls announced in June 2015

SRR on fixed-income investment¹

SRR abolished¹

1 SRR = Special Reserve Requirement

Figure 3.5

Despite a young population, Iceland has relatively one of the largest pension systems in the world

Private Pension Assets 2016 (Percent of GDP)

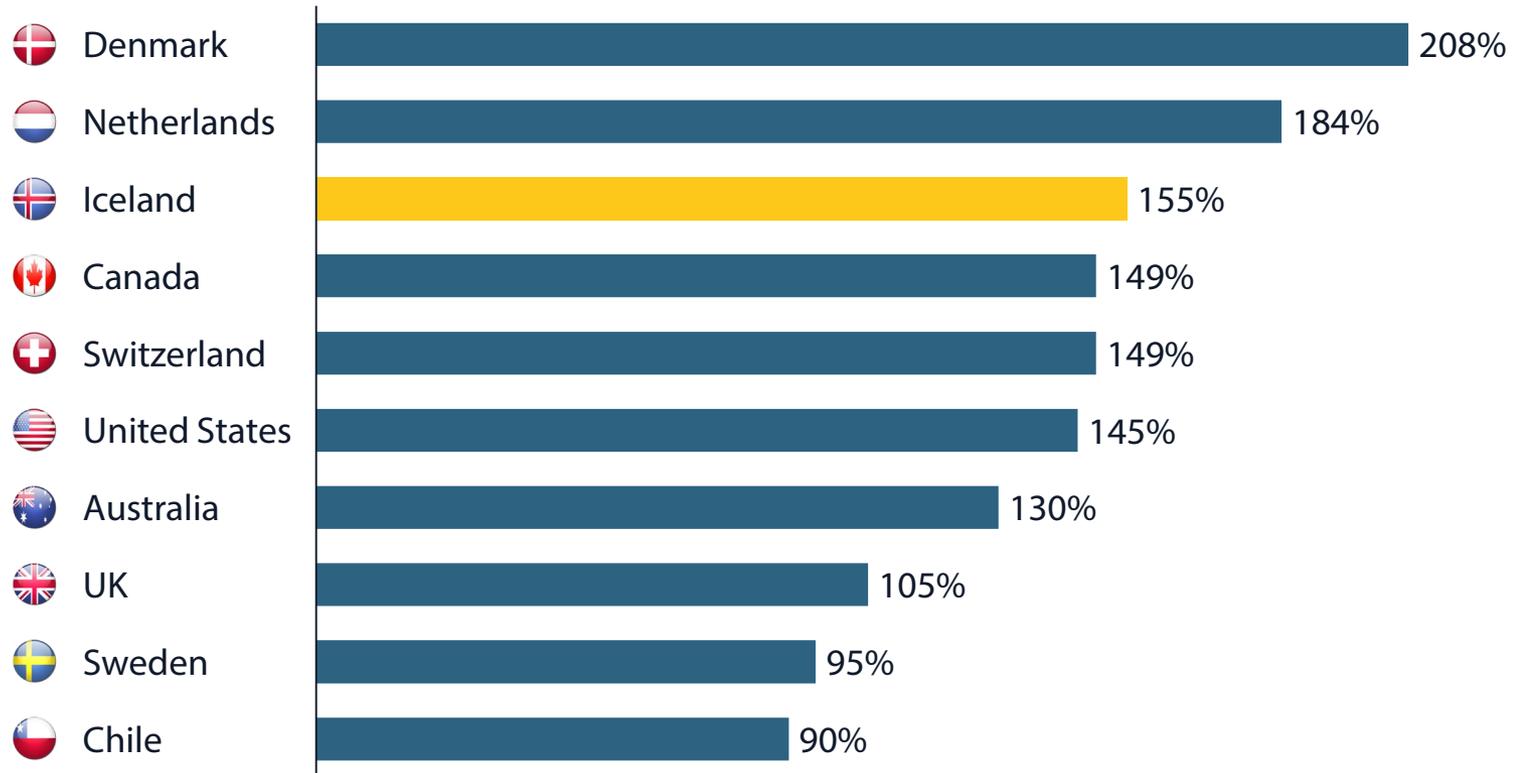


Figure 3.6

Iceland's population is the second youngest in the European Economic Area

Old Age Dependency Ratio in 2018 (Population 65 and over to population 15-64)

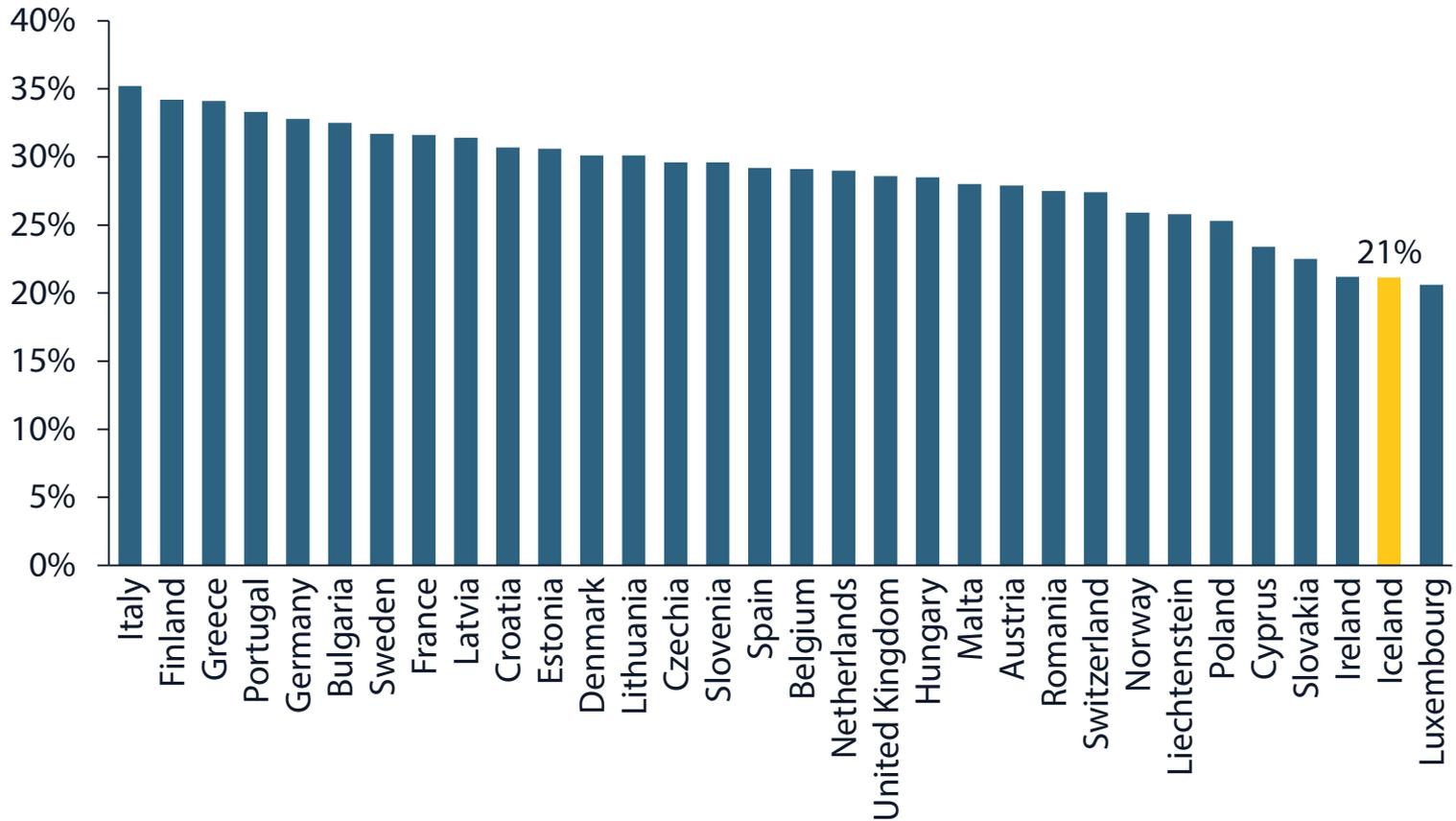
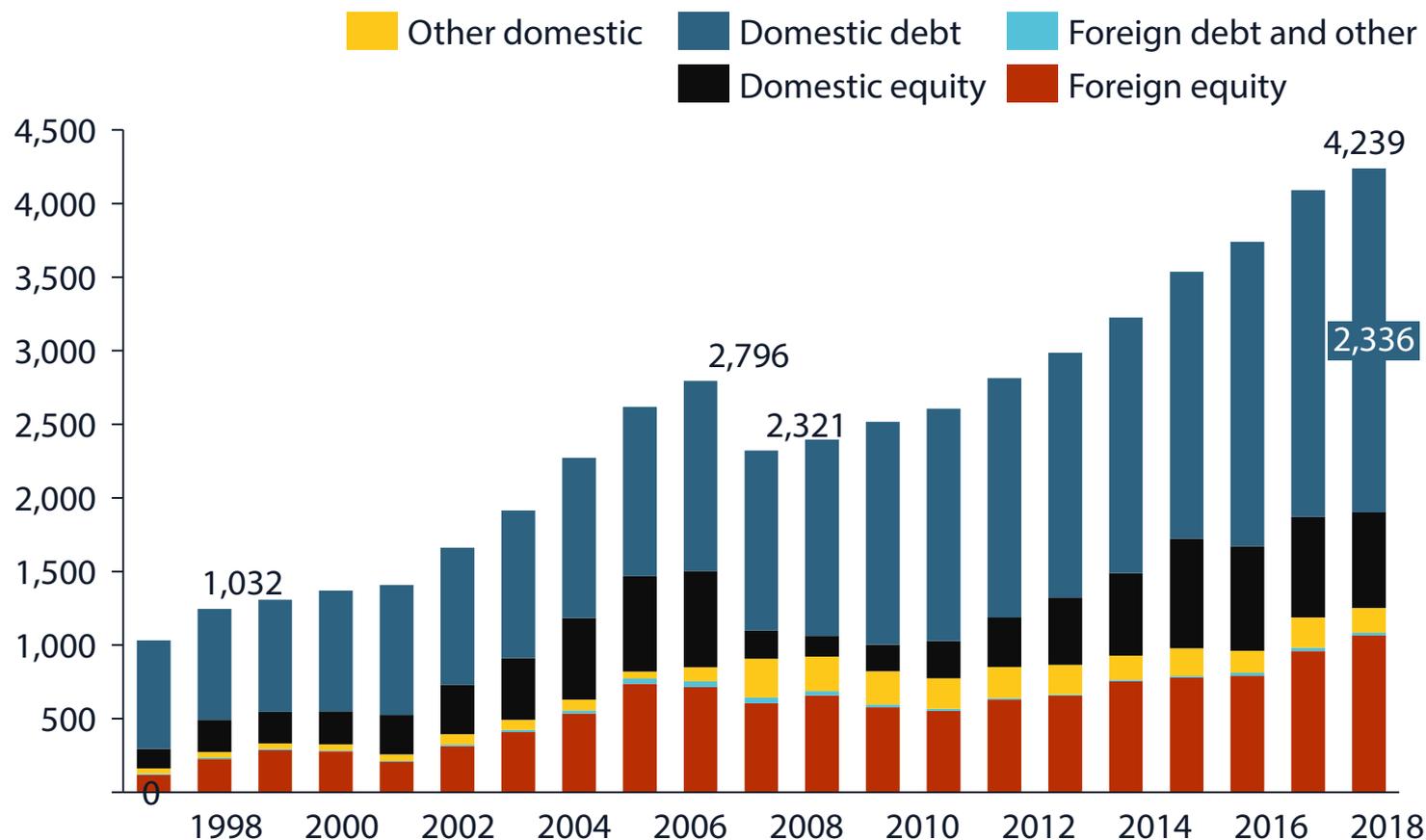


Figure 3.7

Pension funds are outgrowing the economy due to decent returns and high premiums

Pension Fund's Total Assets (Billion ISK at 2018 prices)



4

DOMESTIC SECTOR



BLÁMI

Figure 4.1

The domestic sector accounts for about two thirds of the economy

Composition of the Icelandic Economy (Percent of GDP)

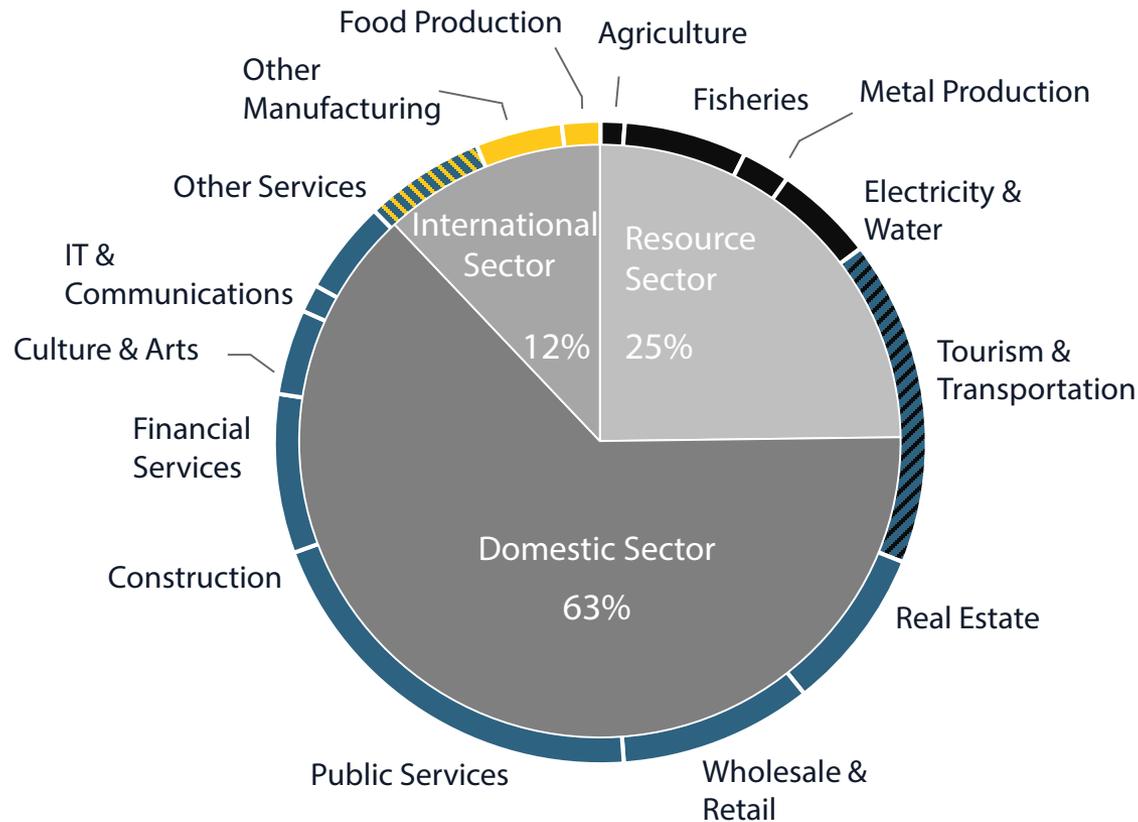


Figure 4.2

Productivity has been increasing in Iceland, putting it above Finland in terms of GDP per hour worked

GDP per Hour Worked in 2016 (US dollars, constant prices 2010 (PPP))

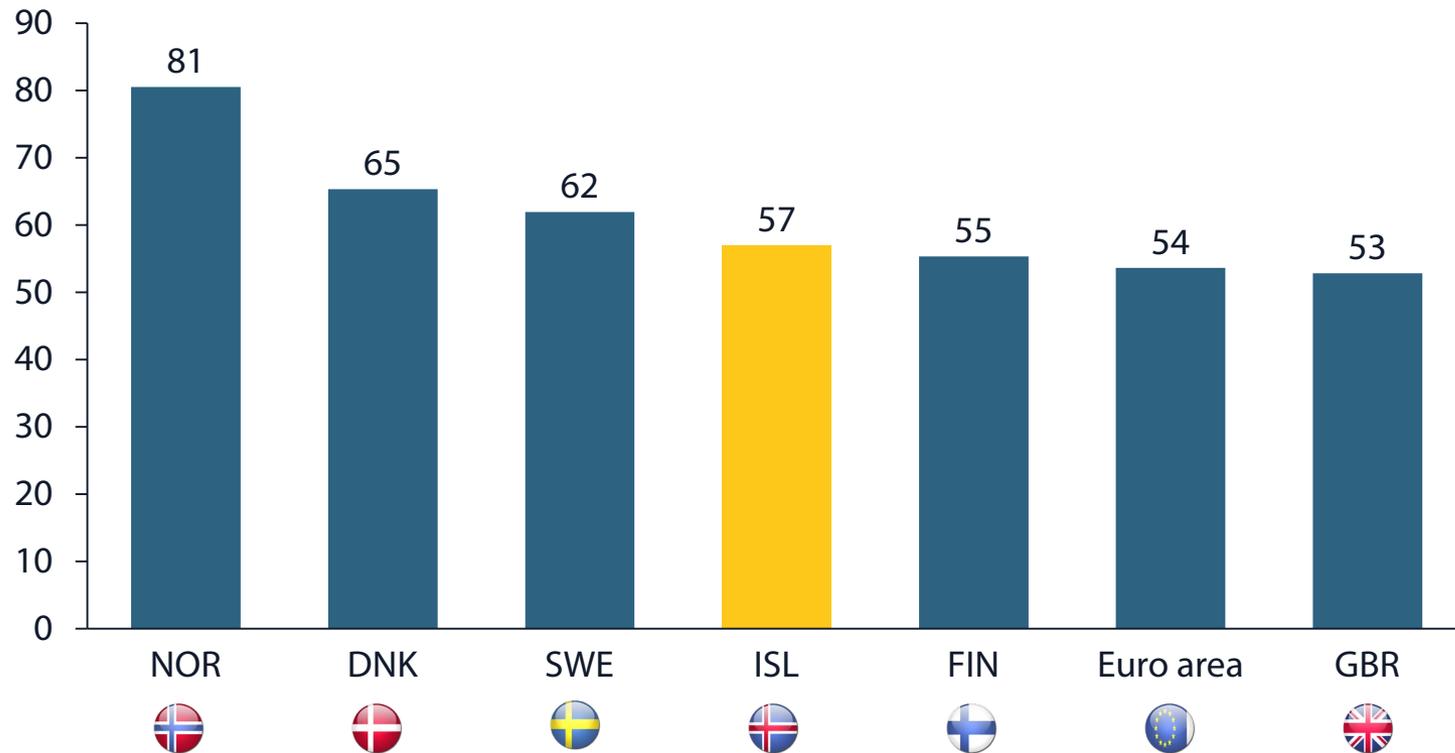
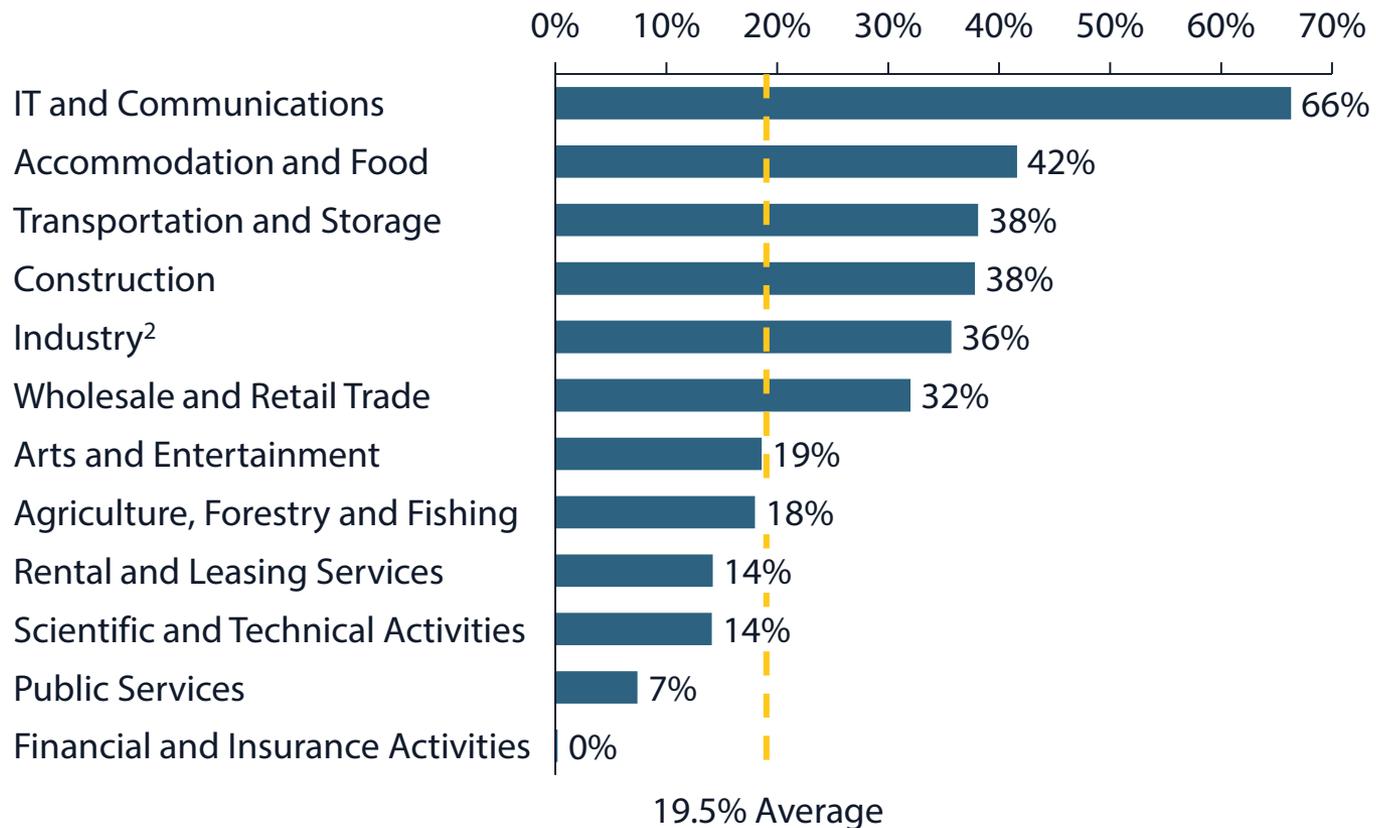


Figure 4.3

Productivity gains are different across sectors but are largest in sectors affected by tourism and technology

Productivity Changes by Sectors¹ (Cumulative percentage change from 2008 to 2018)



¹ All sector definitions are according to NACE V.2

² Mining and quarrying; manufacturing; electricity, gas, steam and air conditioning supply; water supply; sewerage, waste management and remediation activities

Figure 4.4

The labour market had a declining unemployment rate amid very high wage growth but that trend is now shifting

Wage Growth and Unemployment (Percent of workforce, percent change)



¹ Measured as yearly change in the Wage Index

Figure 4.5

Iceland has experienced a strong influx of foreign labour in recent years

Net Changes in Labour Force (Percent change by background)

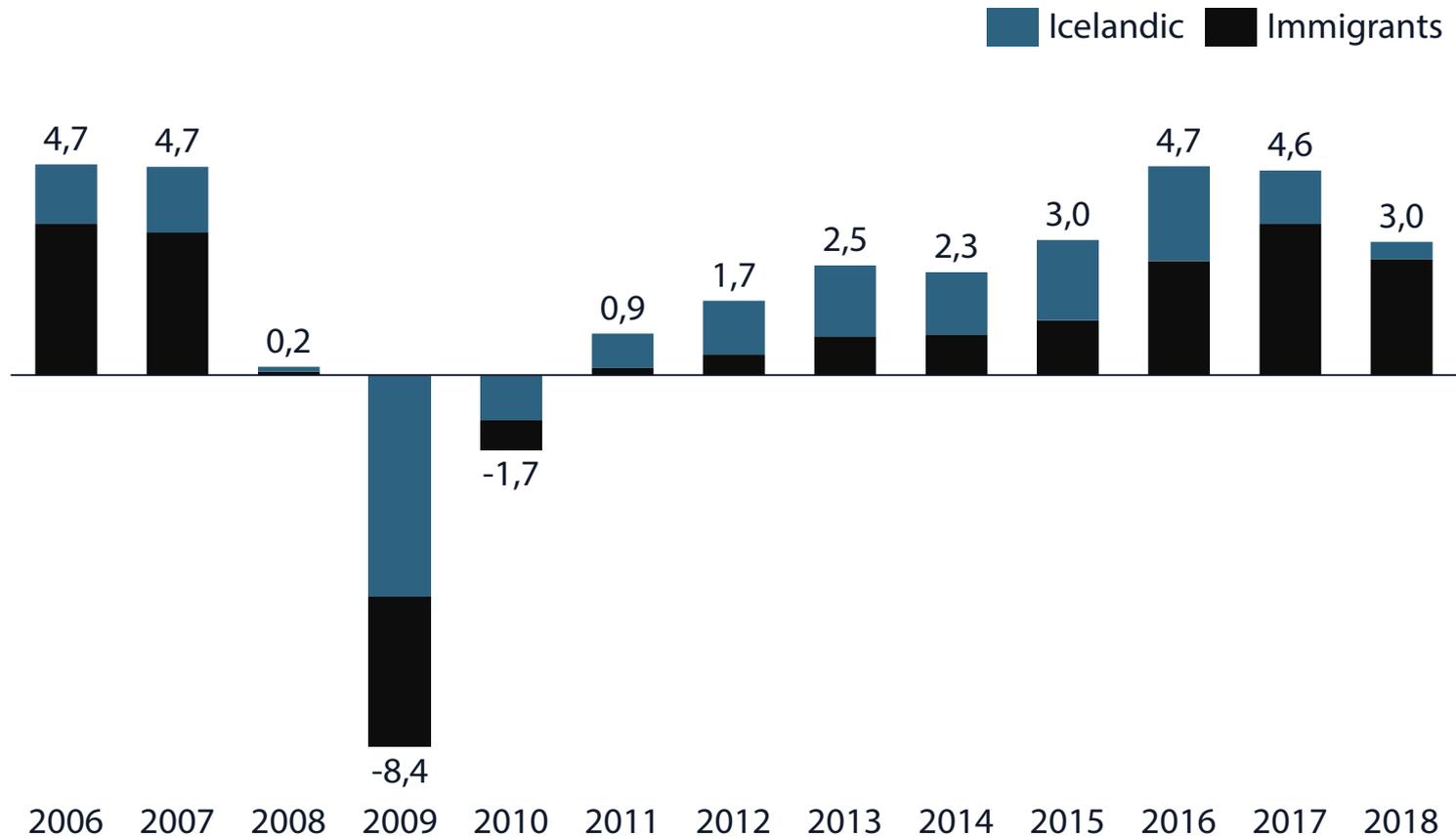
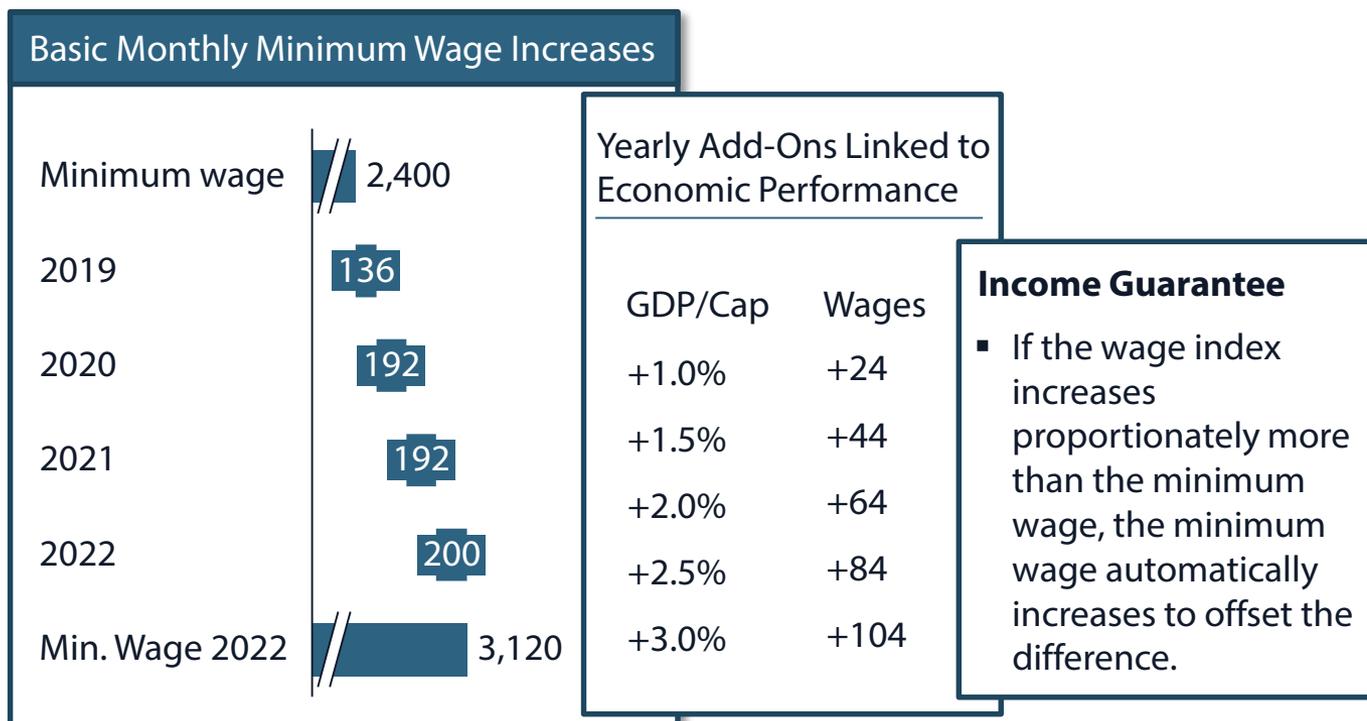


Figure 4.6

The Living Standard Agreement has multiple components with emphasis on absolute wage increases

Wage Increases in the Living Standard Agreement (USD¹)

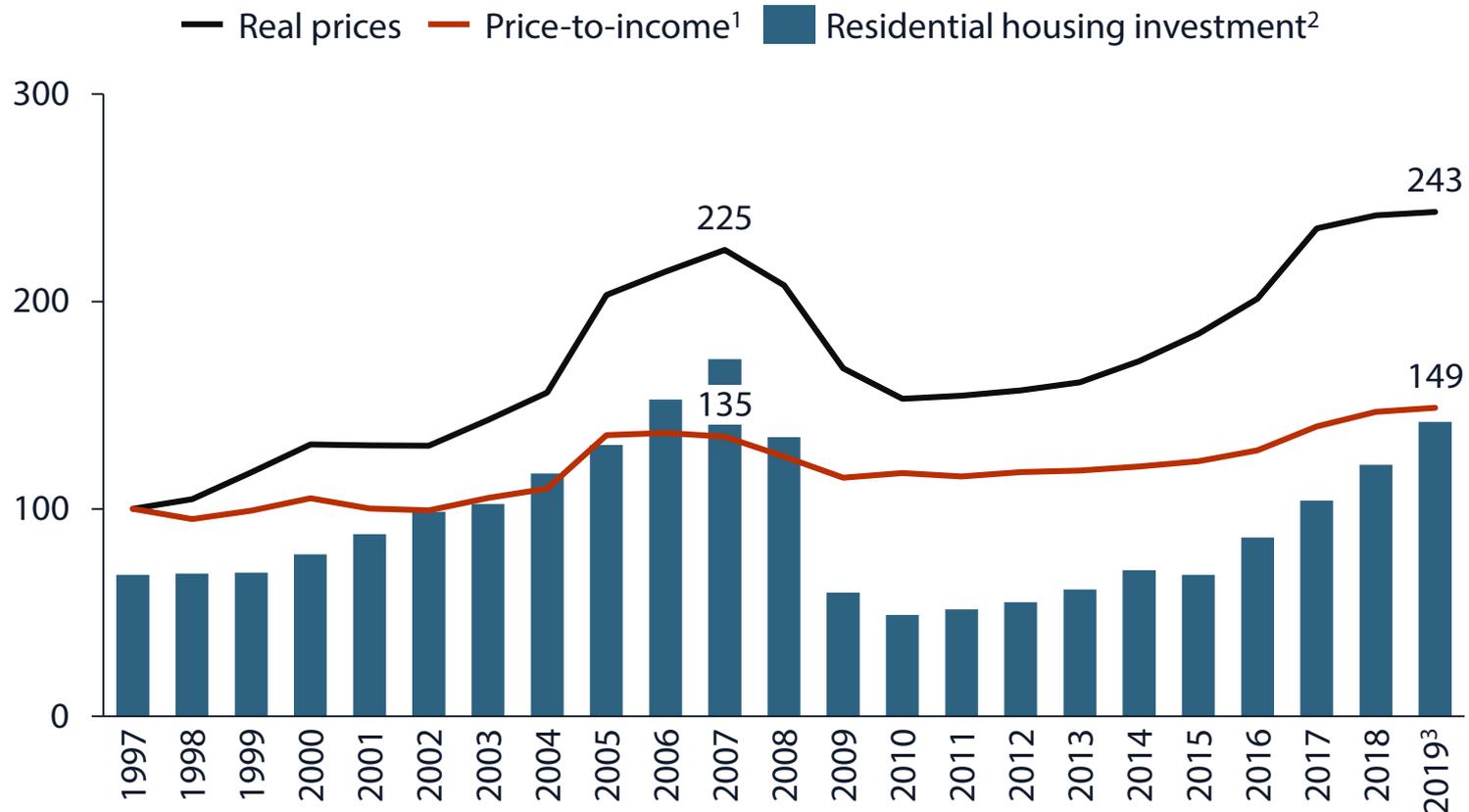


¹ All numbers are USD based on the USDISK Exchange rate of 125

Figure 4.7

Housing prices have increased rapidly in the last few years but since mid-2017 the market has slowed down

Housing Prices and Investment (Indices (Jan. 97=100) until Jun. 18 and b. ISK)



1 Housing prices/Disposable income per individual

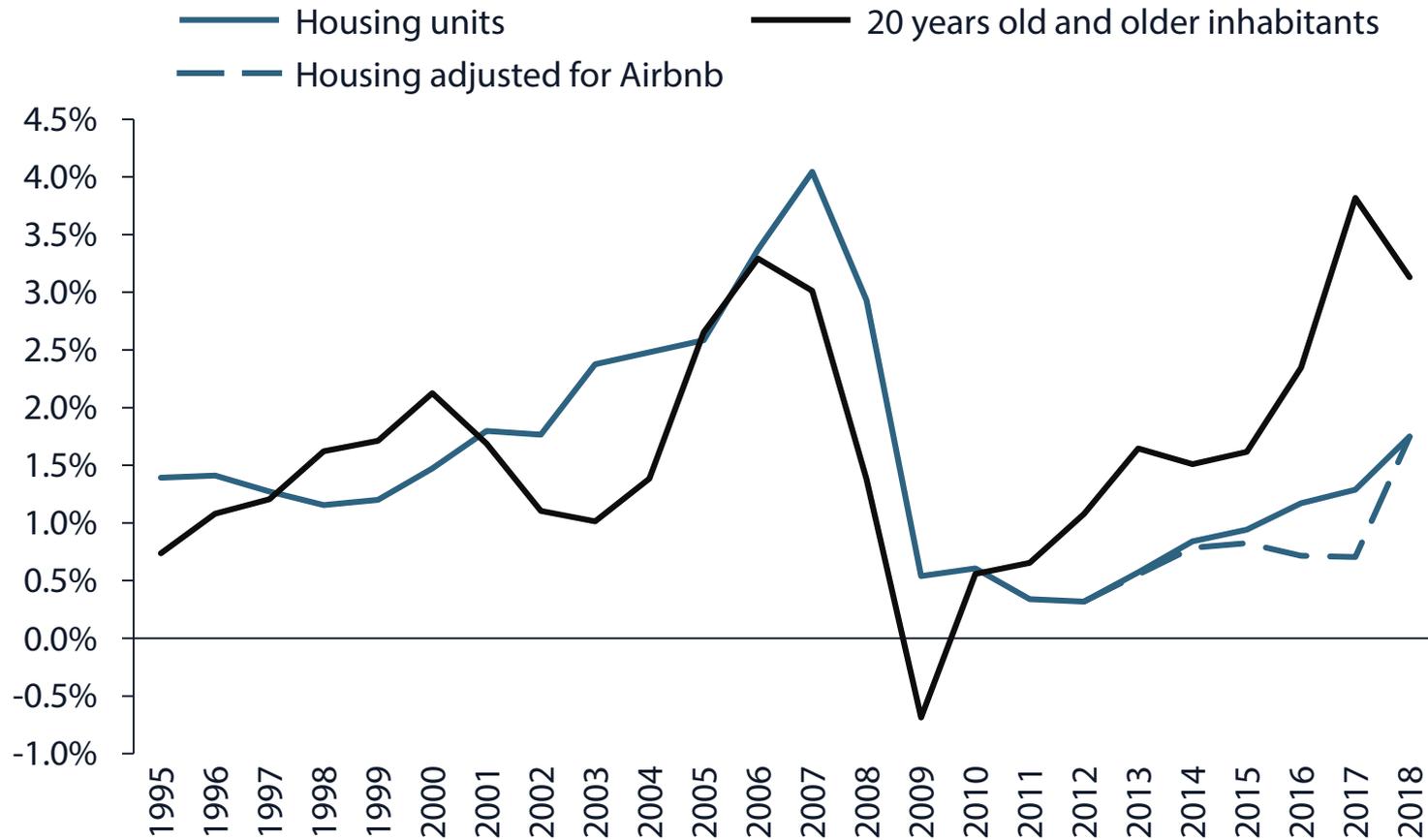
2 Billion ISK at 2017 prices, number for June 2018 is CBI's forecast for the whole year

3 Inflation and housing prices for June 2019 and Investment and income based on CBI forecast for the year

Figure 4.8

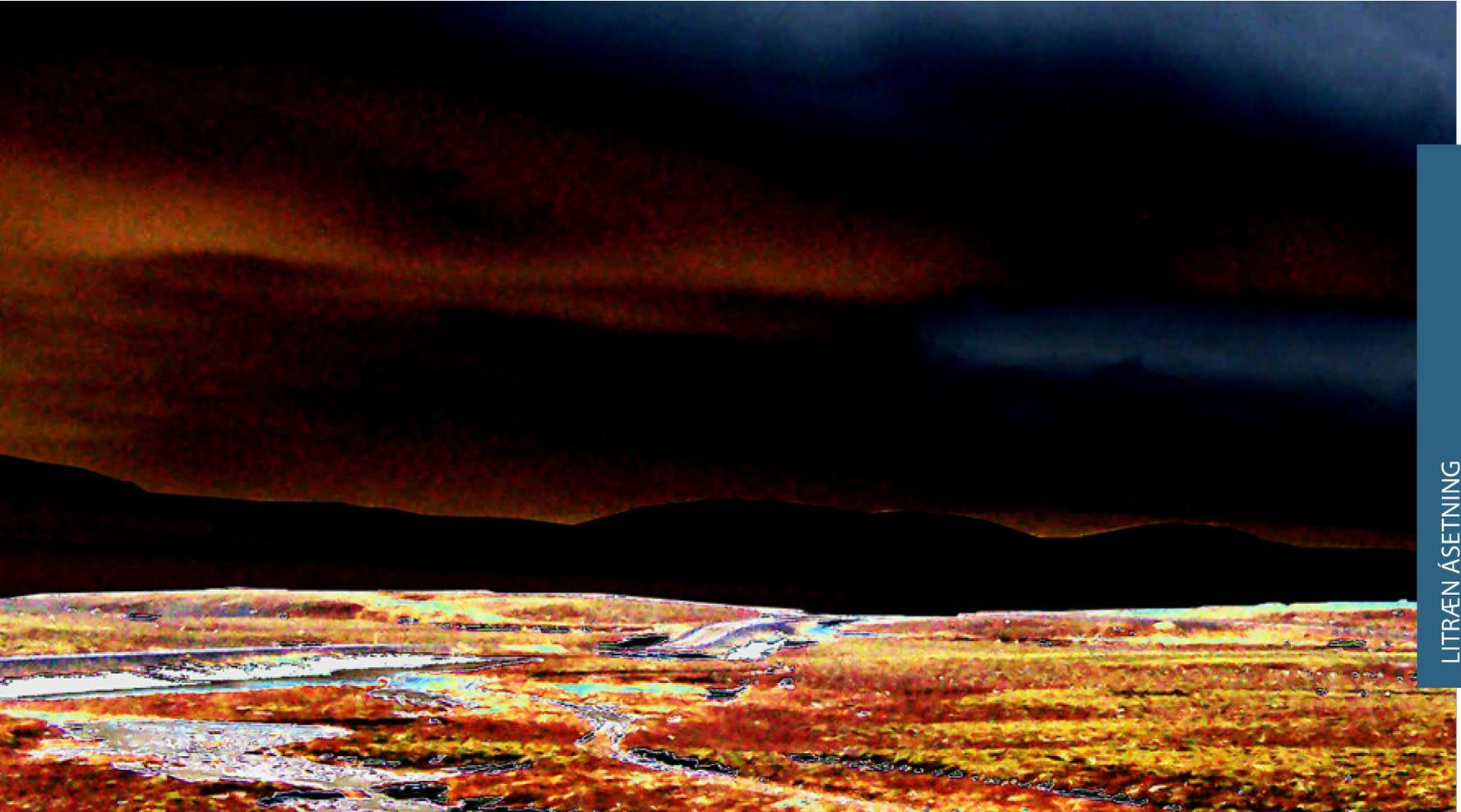
A large gap has emerged between housing construction and population growth which finally appears to be closing

Population and Housing Growth (Percent change YoY)



5

RESOURCE SECTOR

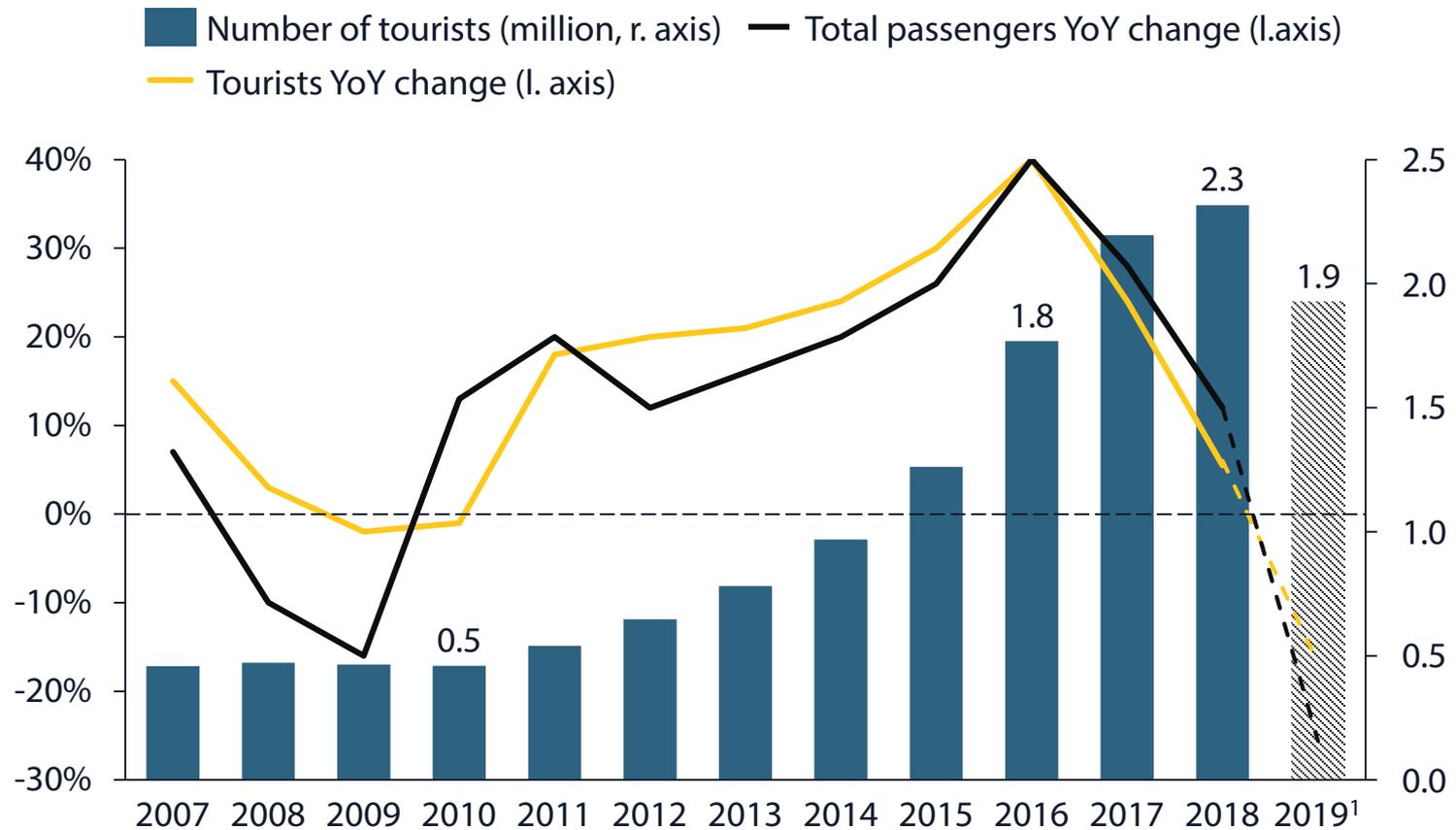


LITRÆN ÁSETNING

Figure 5.1

Tourism is having a set-back this year after double-digit growth for almost a decade

Keflavík Airport Passengers (Total and percent change)



¹ ISAVIA's forecast in June 2019.

Figure 5.2

Consumer prices in Iceland are among the highest in Europe

Relative Prices of Restaurants and Hotels (European Union = 100)

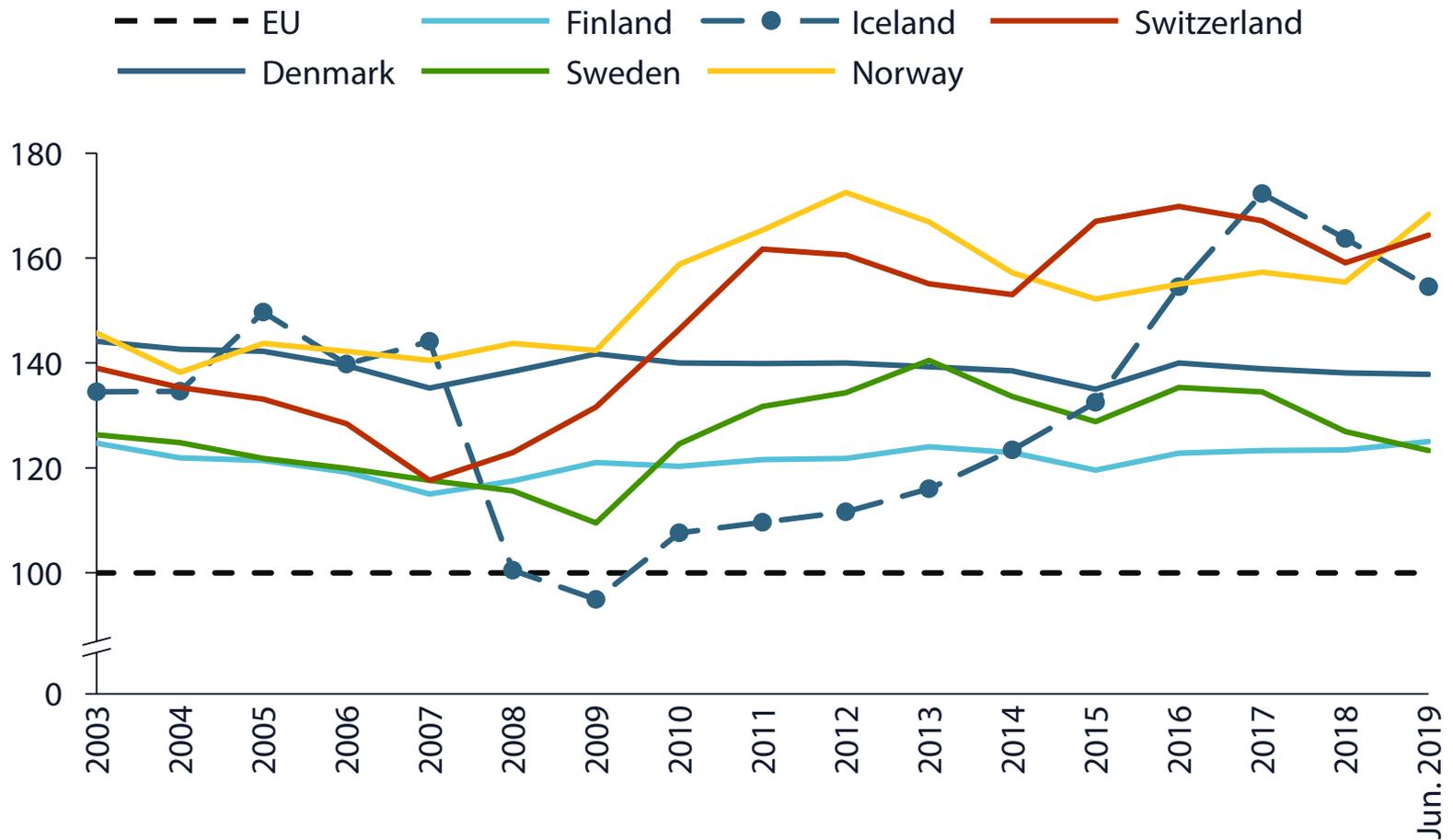


Figure 5.3

Depreciated Króna and more spending per tourist weighs against the drop in the number of tourists

Card Turnover Per Tourist (Year over year change)

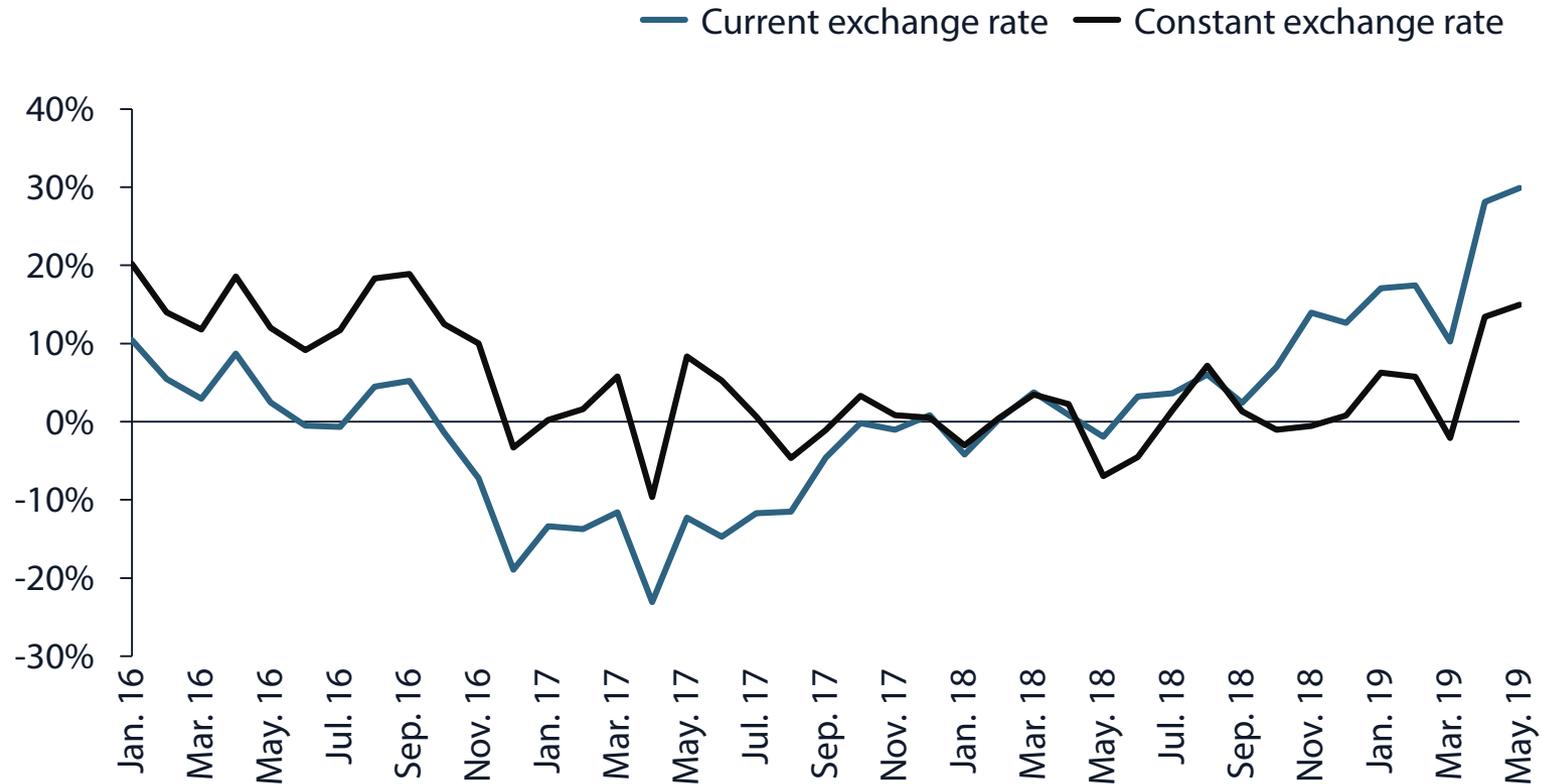
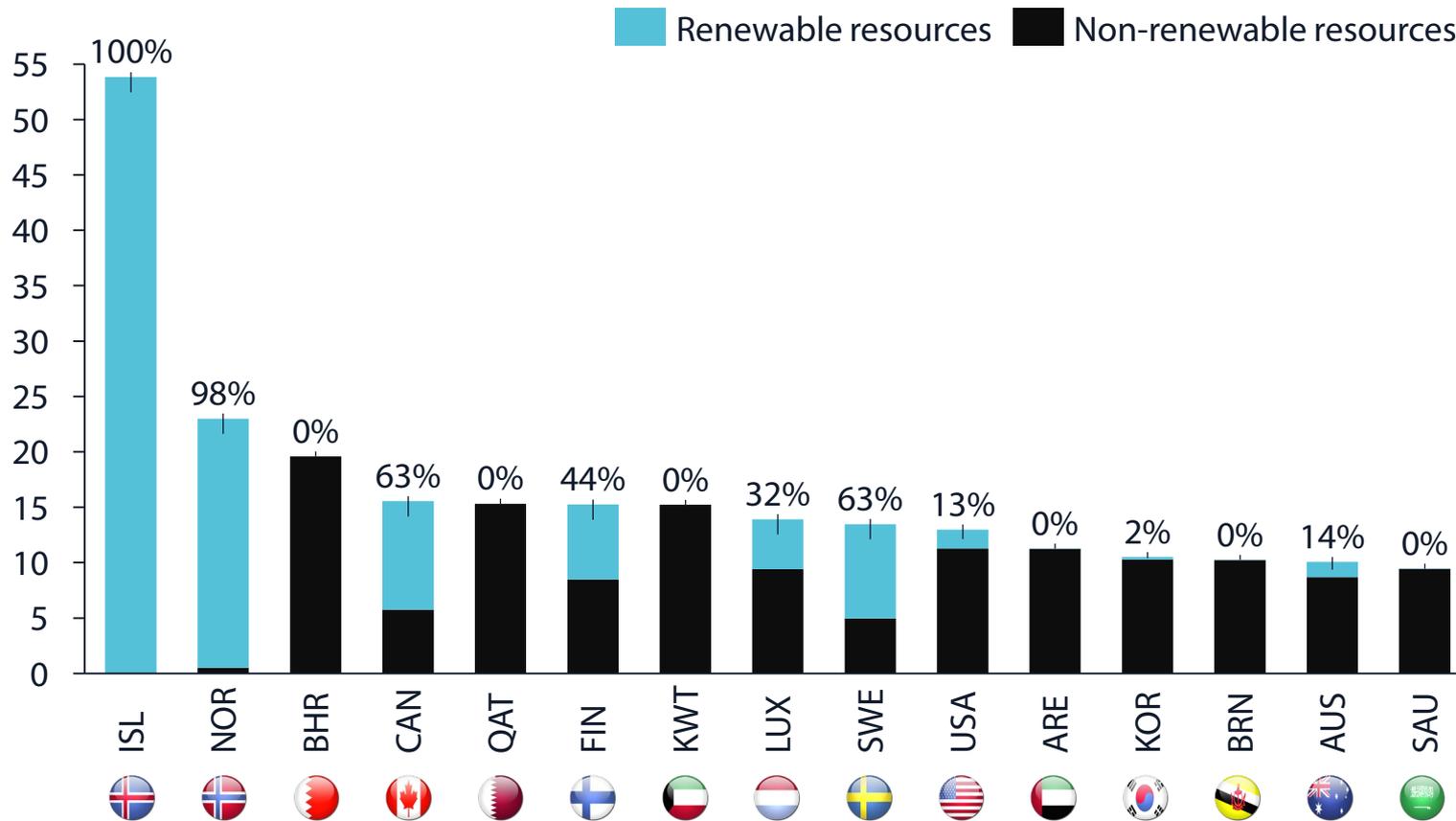


Figure 5.4

Iceland is the largest producer of renewable power per capita in the world

Electricity Consumption (MWh per capita and % from renewables¹)



¹ World Bank only publishes distribution of electricity by output, not consumption, so the distribution between renewables and non-renewables might be slightly inaccurate

Figure 5.5

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

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

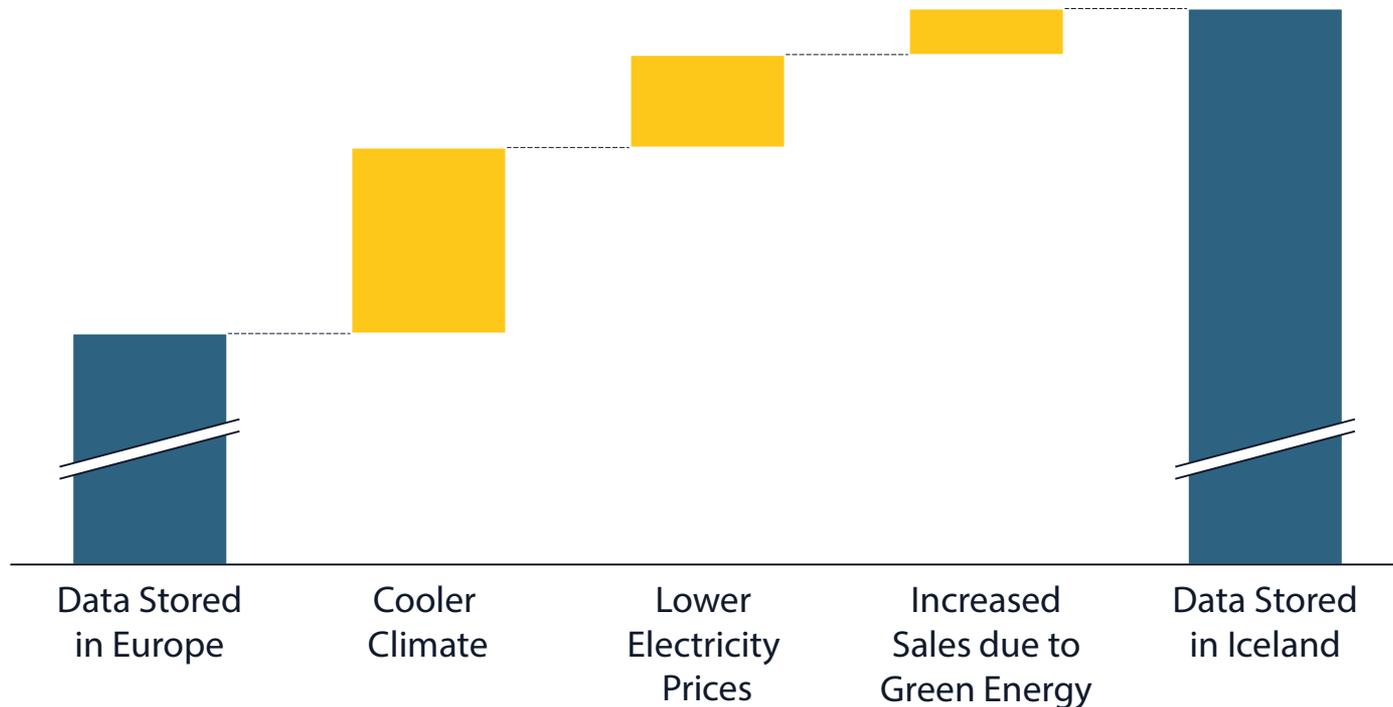
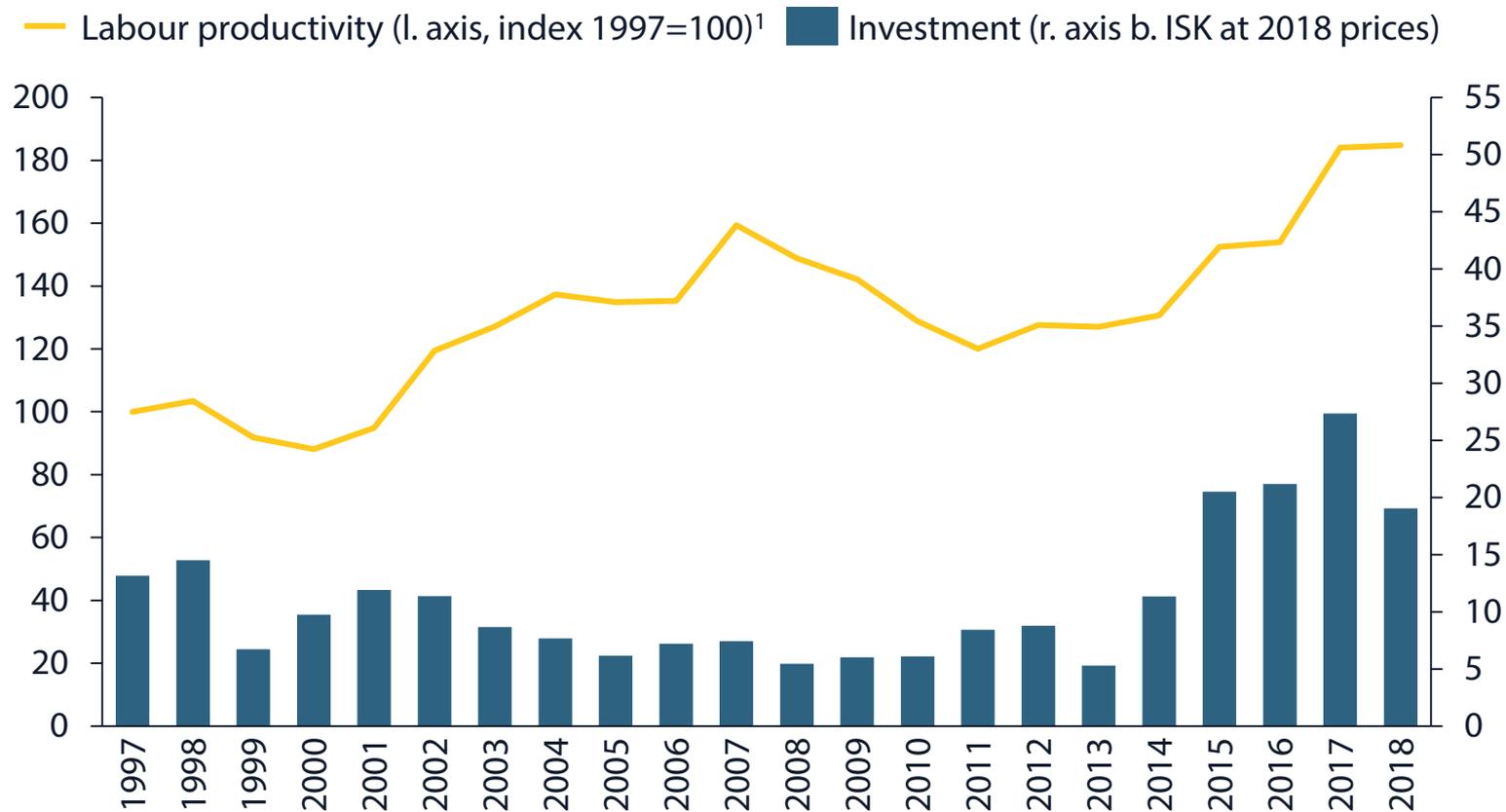


Figure 5.6

Iceland's seafood industry has seen productivity gains amidst erratic business environment

Seafood Industry (Investment and Productivity)

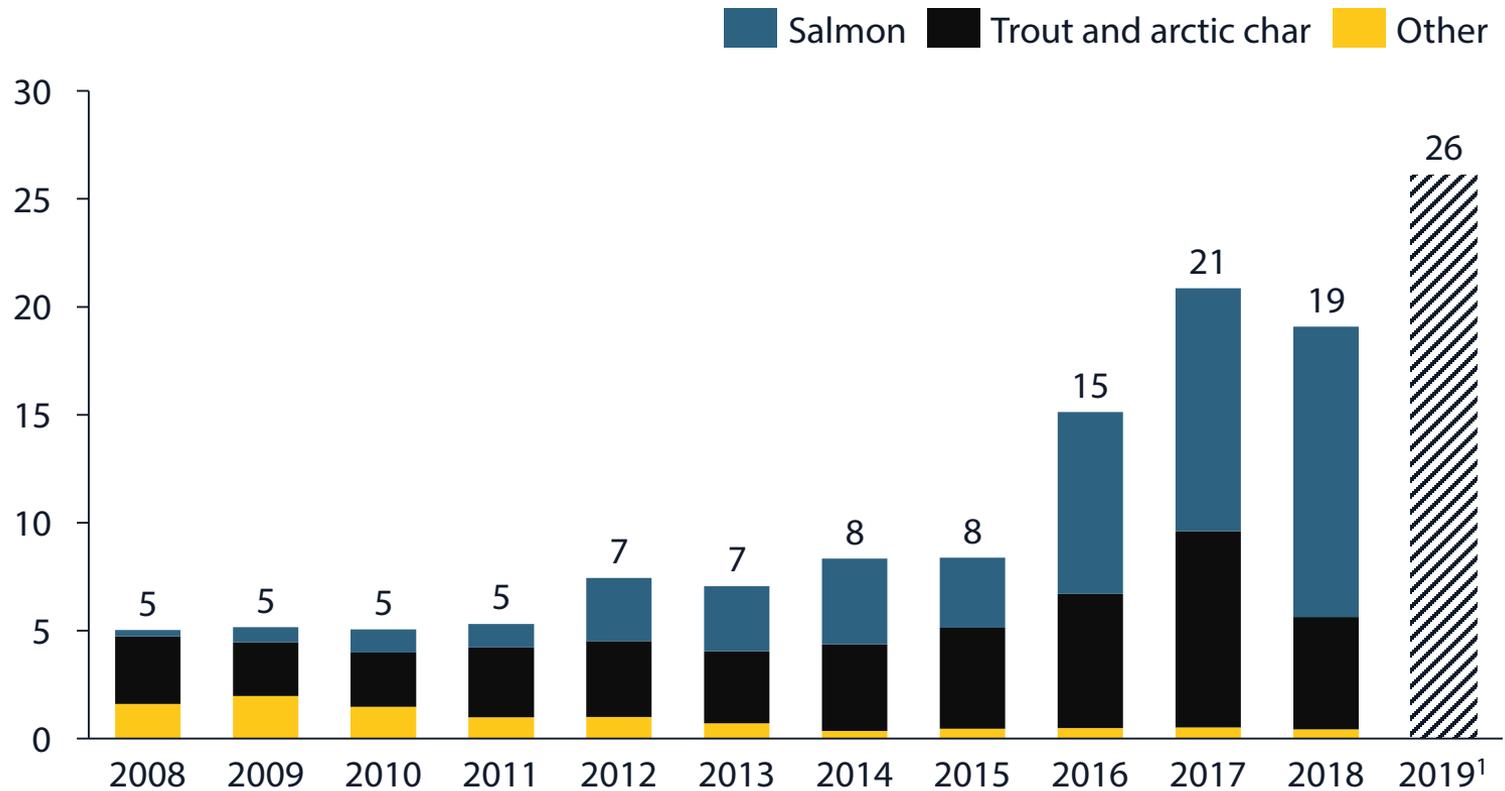


¹ Working hours and thus productivity has a break in series in 2008

Figure 5.7

Aquaculture is expanding fast, salmon production in particular

Aquaculture Production (Thousand tons)



¹ Projection of total production based on growth in January-May 2019

6

INTERNATIONAL SECTOR

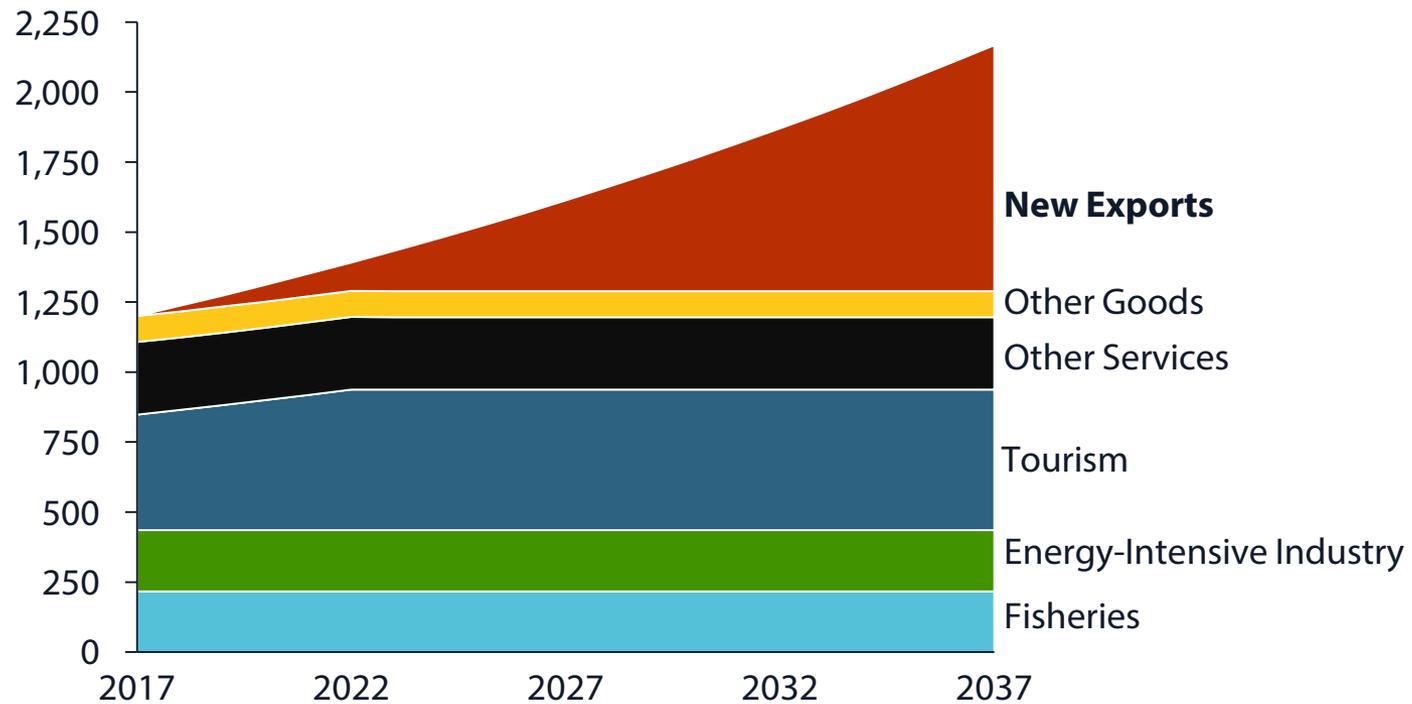


ISLAND

Figure 6.1

New exports in knowledge based goods and services are needed to support a balanced long-term growth trajectory¹

Export Requirements Along a 3% Economic Growth Path (Bn. ISK; Illustrative²)



¹ McKinsey assumed a goal of 4% growth p.a. but the Chamber believes a 3% growth rate is more realistic over the long run. Tourism exports are assumed to grow at a 4% rate until 2022.

² Real ISK.

Figure 6.2

Government grants towards R&D have increased manifold in the last 15 years

Government Contributions to R&D Grants (Real prices, Index 2004 = 100)

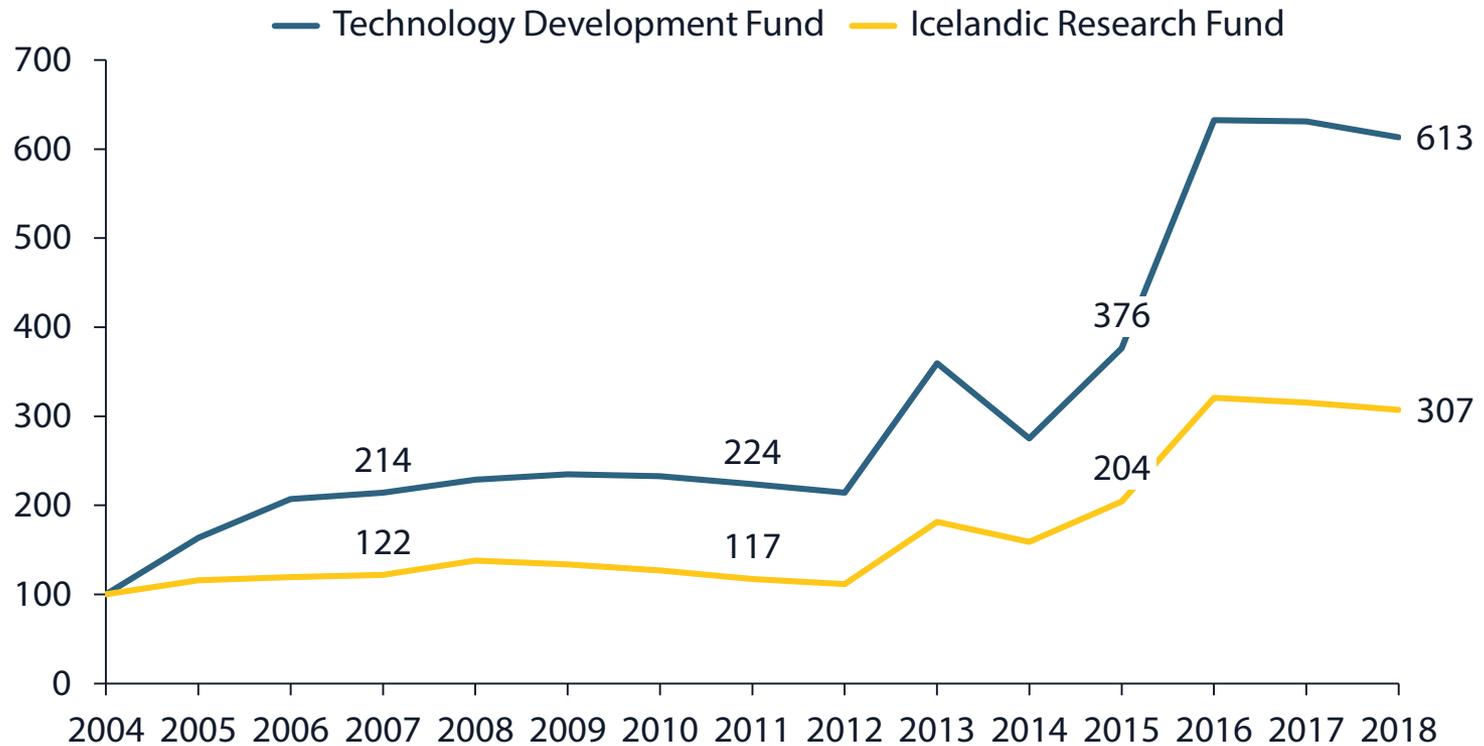


Figure 6.3

Investment in R&D has been steadily increasing over the last few years

R&D Expenditure by Sector (PPP Million USD)

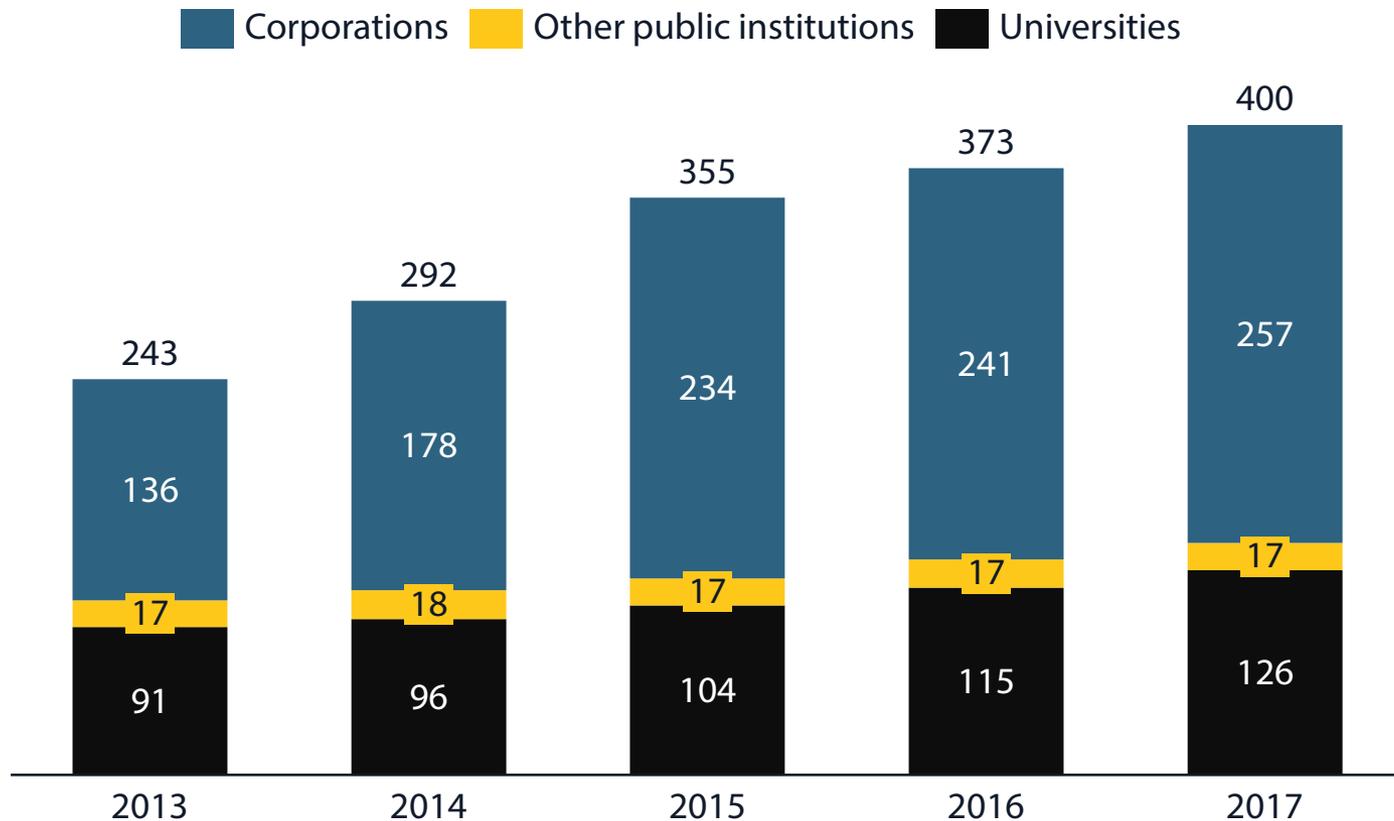
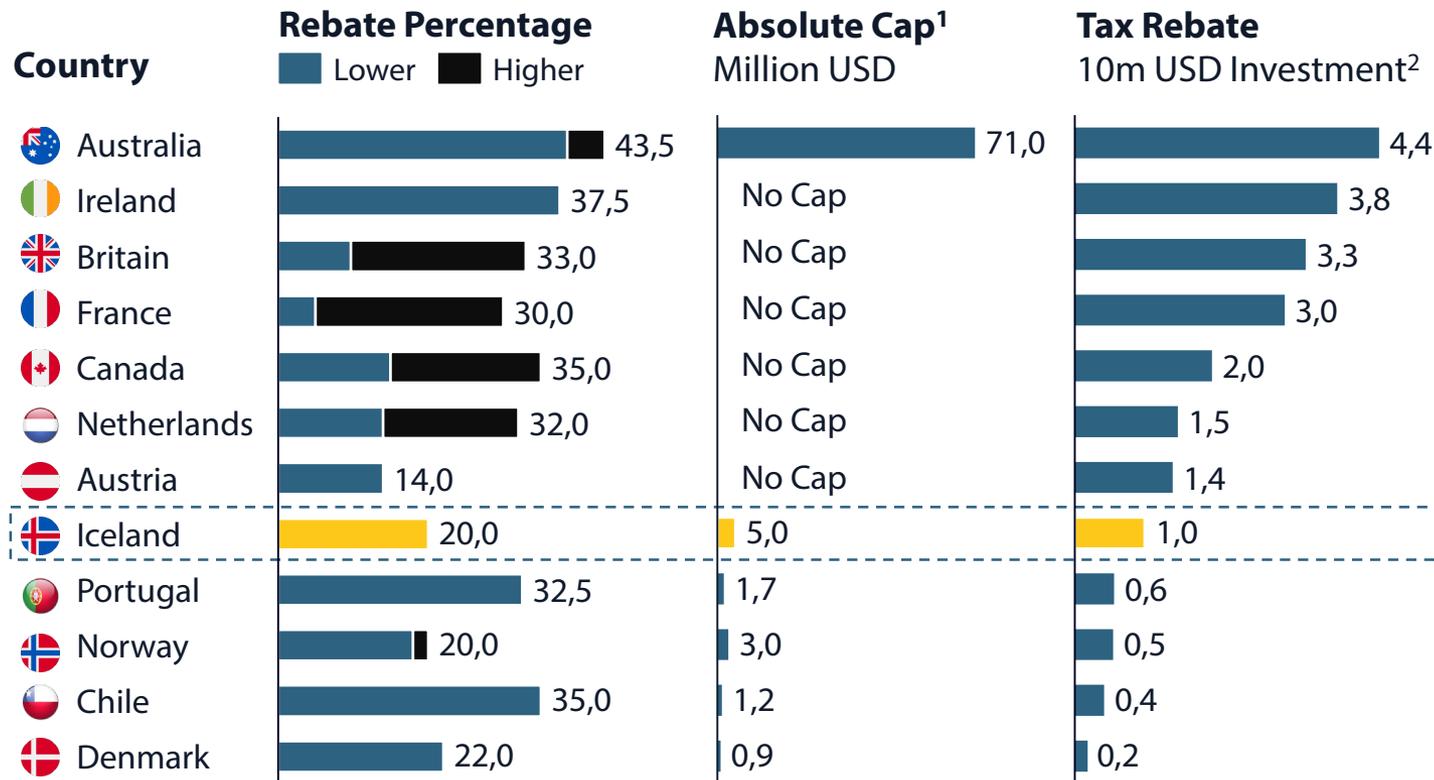


Figure 6.4

While Iceland has been improving incentives to conduct R&D it still trails a number of countries in terms of tax credits

Government R&D Tax Credits and/or Rebates (Percent by bracket, million USD)



1 Australia: Higher bracket only available to companies whose revenue does not exceed 13,5m USD, lower bracket only available to companies whose revenue does not exceed 14,2m USD; France: Higher bracket cap is 115,8m USD, no cap on lower bracket; Netherlands: Higher bracket cap is 0,4m USD, no cap on lower bracket; Britain: Higher cap only available to companies who do not employ more than 500 people.; Norway: Higher bracket only available to SME's

2 The tax rebate/credit is calculated based on a gross investment in R&D of 10m USD.

Figure 2.20

2015 was the breakout year for the VC industry in Iceland

Timeline of Iceland Based Venture Capital Funds (Year, Type of ownership, USD)

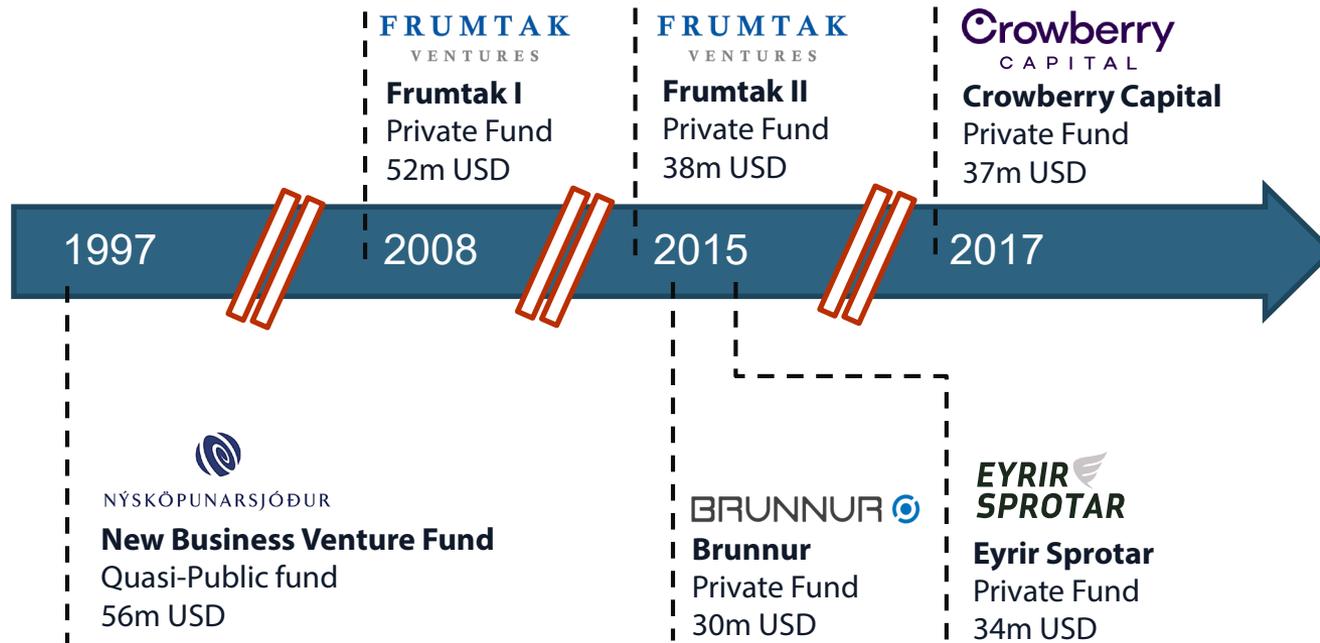
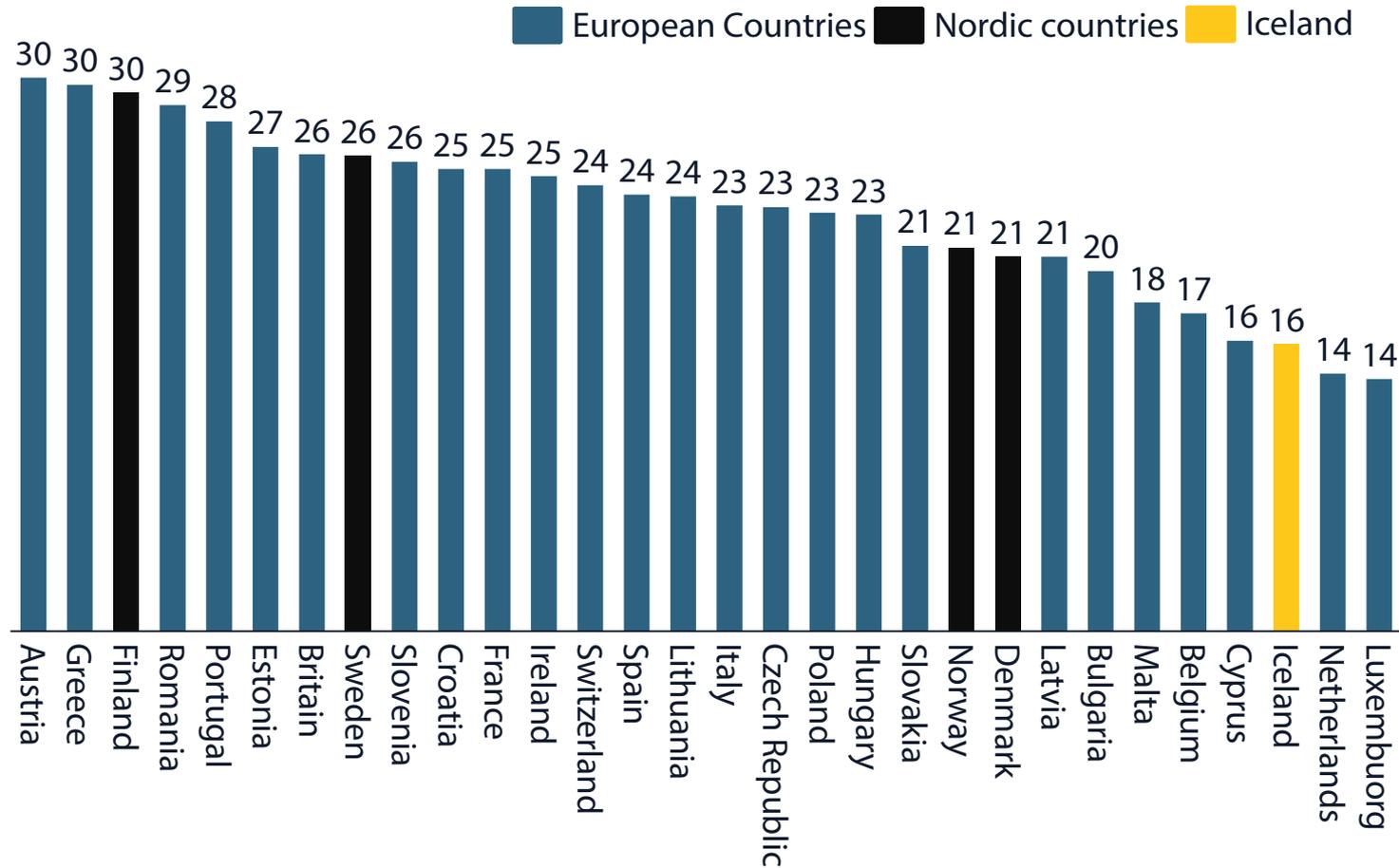


Figure 6.6

Iceland has a relatively low proportion of students graduating with STEM degrees

STEM Degree Graduates as Percentage of Total Number of Graduates (Percent)



7

FUTURE PROSPECTS



UNDIR FJÖLLUNUM

Figure 7.1

The Iceland Growth Forum had 37 reform proposals to support a long term sustainable growth trajectory

“Let’s look outside... And see the big picture”

Kíkjum út ...



... og horfum á heildina



Figure 7.2

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

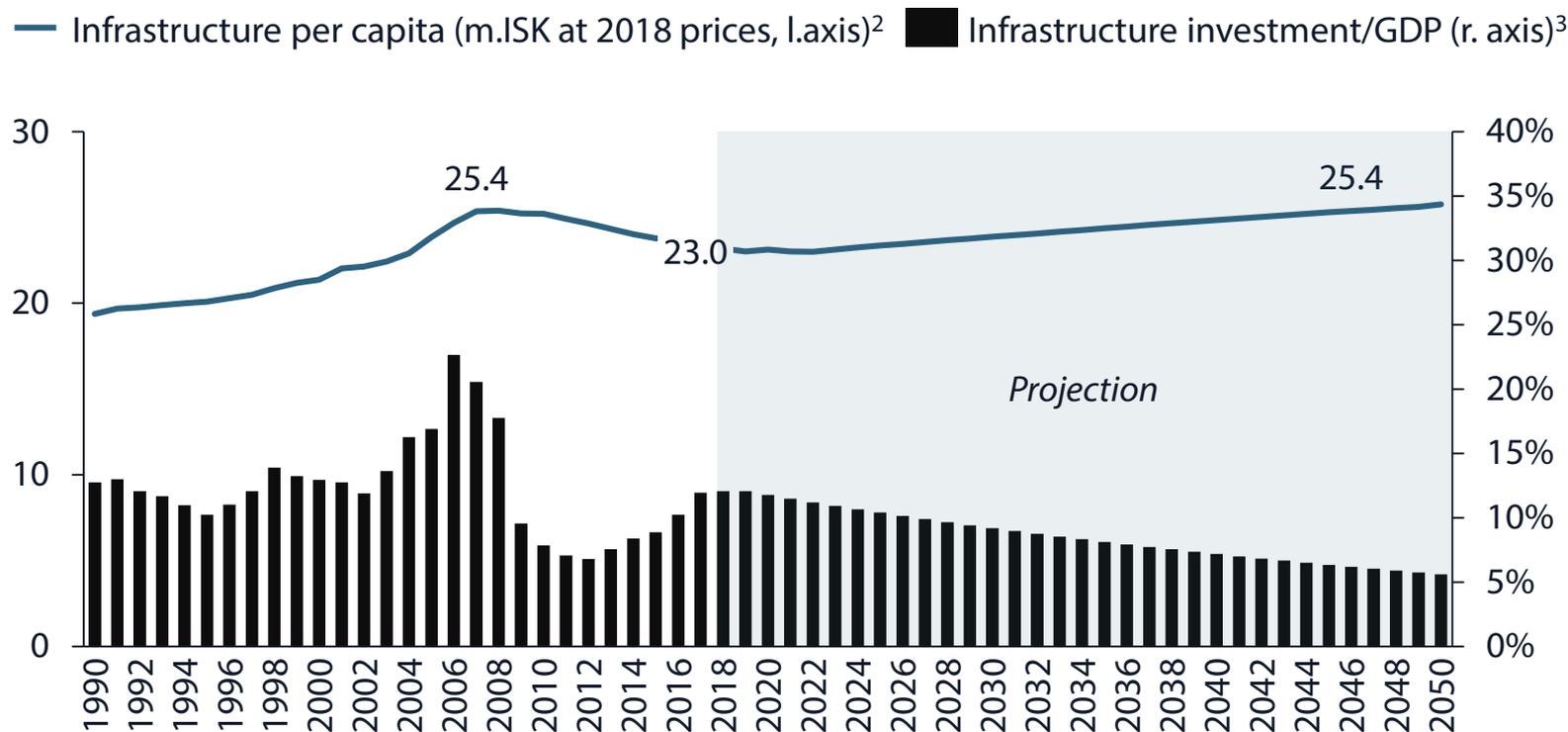
The Four Focus Lenses of Disruptive Trends

Lenses	Examples
 Digitisation	<ul style="list-style-type: none">▪ Embrace technological changes to drive productivity improvements across sectors▪ Improve services and achieve cost efficiency through digitization▪ Use big data insights to connect with customers and transform operations
 Regeneration	<ul style="list-style-type: none">▪ Support and grow knowledge driven export sectors of the Icelandic economy▪ Ensuring that all generation's talents match the need of the society• Determining how business leaders can navigate through present challenges
 Environmental Sustainability	<ul style="list-style-type: none">▪ Maximize value creation of Icelandic resource industries▪ Protect nature with focus on productivity and sustainability• Leverage Iceland's unique situations to fight climate change
 Global Connections	<ul style="list-style-type: none">▪ Boost global position of Iceland as the country to base and do business in• Safeguarding Iceland's position in the EEA and openness to trade• Focus on business development in new markets

Figure 7.3

More investment in infrastructure is required to soon reach previous infrastructure levels

Infrastructure Stock and Investment (Broadly defined¹)



1 Infrastructure is the total amount of capital stock and capital formation(investment) in housing and other buildings, roads, bridges, sewers and business sector construction.

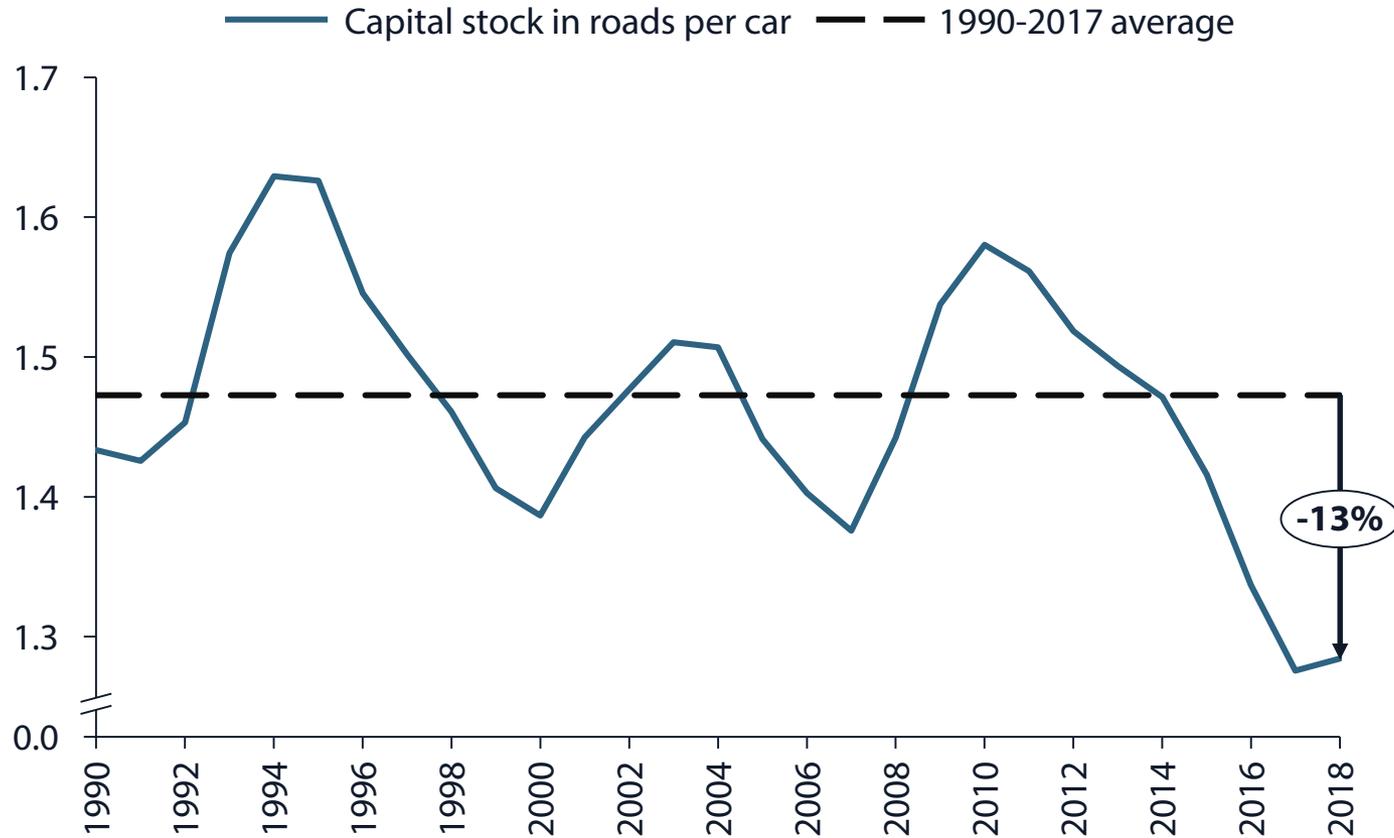
2 See 3 for investment. Population based on Statistics Iceland projections.

3 Assuming constant investment level in real terms 2019 onwards, 0% GDP growth in 2019 and 2,5% growth 2020 onwards

Figure 7.4

Lack of investment on top of traffic increasing by half in less than a decade indicates that investment needs to pick-up

Capital Stock in Roads and Bridges (Million ISK per car¹)

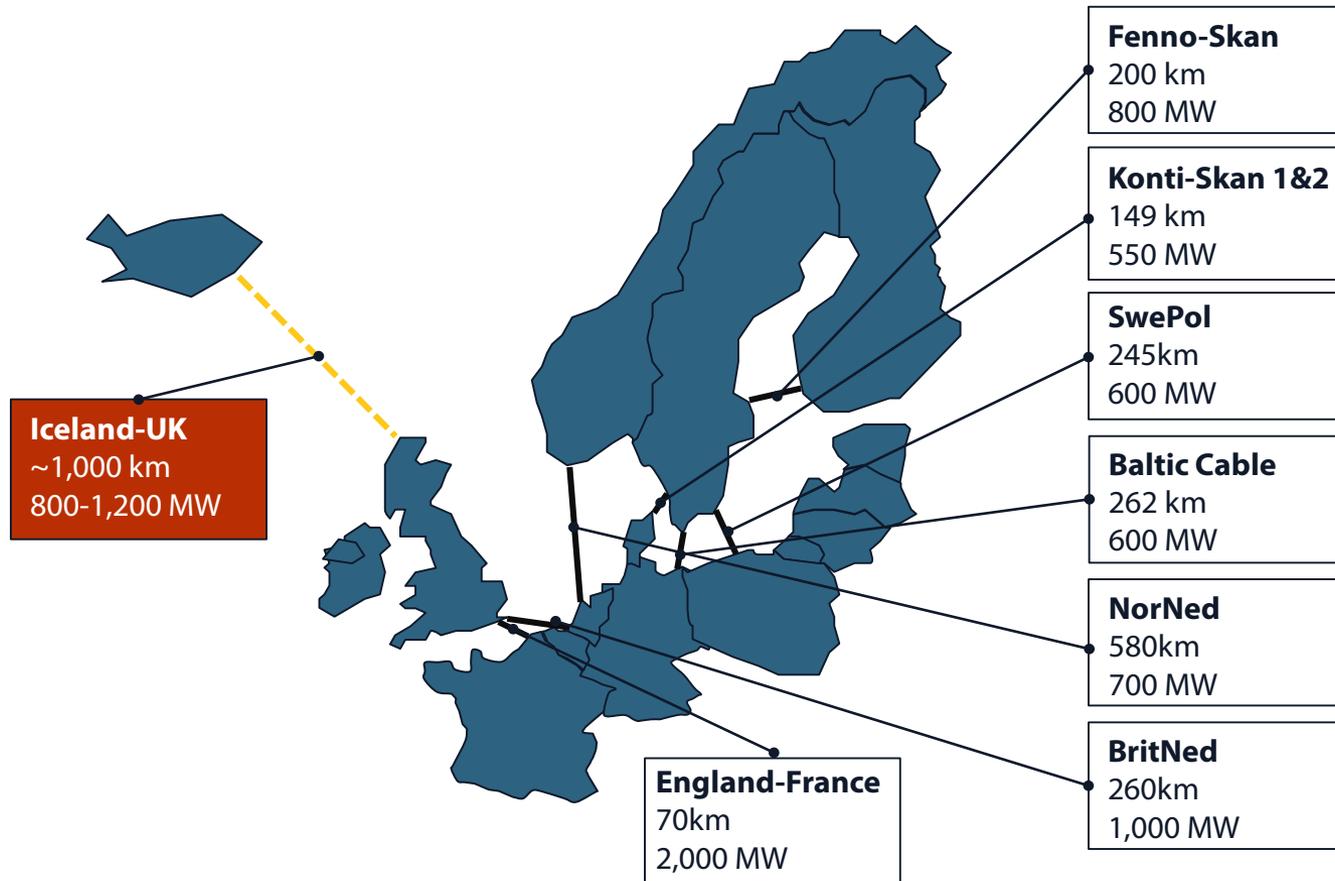


1 ICoC projection for 2018 based on Althingi's budget. Number of cars growth projected the same as GDP growth in 2017-18

Figure 7.5

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

Interconnectors in Northern Europe (Length and capacity)





ICELAND CHAMBER OF COMMERCE