



The Icelandic Economy

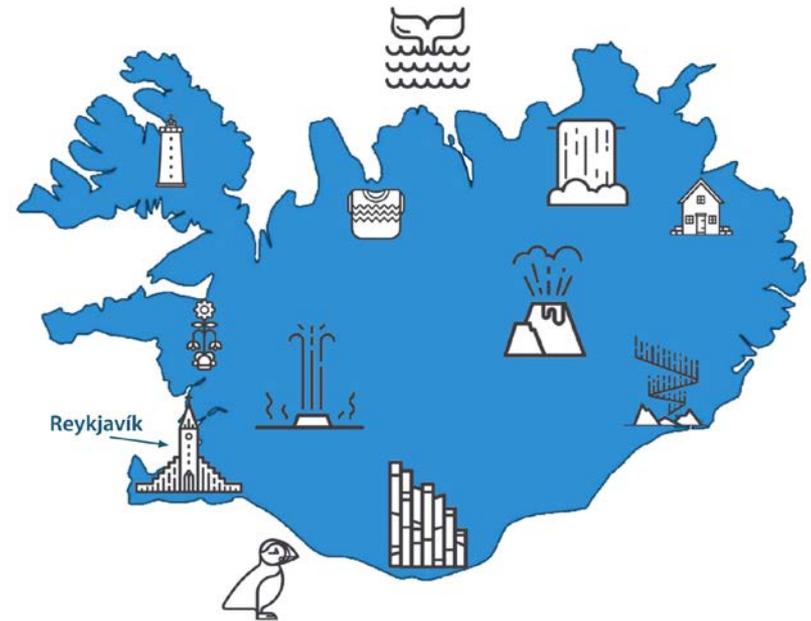
Current State, Recent Developments and Future Outlook
2018 edition



VIÐSKIPTARÁÐ ÍSLANDS
ICELAND CHAMBER OF COMMERCE

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Key Facts

Did you know?

- The total land area is 103,000 km² and the population is 348,000
- Iceland's parliament, Althingi (Alþingi) is the oldest legislative assembly, established 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
- Among European countries, Iceland had the lowest income inequality in 2016

Key facts about the economy

- Iceland's Gross Domestic Product (GDP) per capita in 2017 was USD 52,000 (PPP)
- The currency is Icelandic Króna (ISK), USD 1=ISK 106 (24 July 2018)
- In 2017 unemployment was 2.8% and in June 2018 inflation was 2.6%
- Iceland's current account surplus in 2017 was 3.7% of GDP
- The main exports are tourism (42% of total), aluminium (17%) and seafood (16%)
- Government debt-to-GDP ratio in 2017 was 42%

Foreword

“The transformation of the economy over the past decade has obviously not been as dramatic as over the last century but the results are nevertheless impressive. Iceland is currently on track to its 8th consecutive year of strong economic growth, annual unemployment rate has remained below 3% for three years and Iceland is a net lender to the rest of the world.”



Ásta S. Fjeldsted
Managing Director,
Iceland Chamber
of Commerce

Acknowledgements

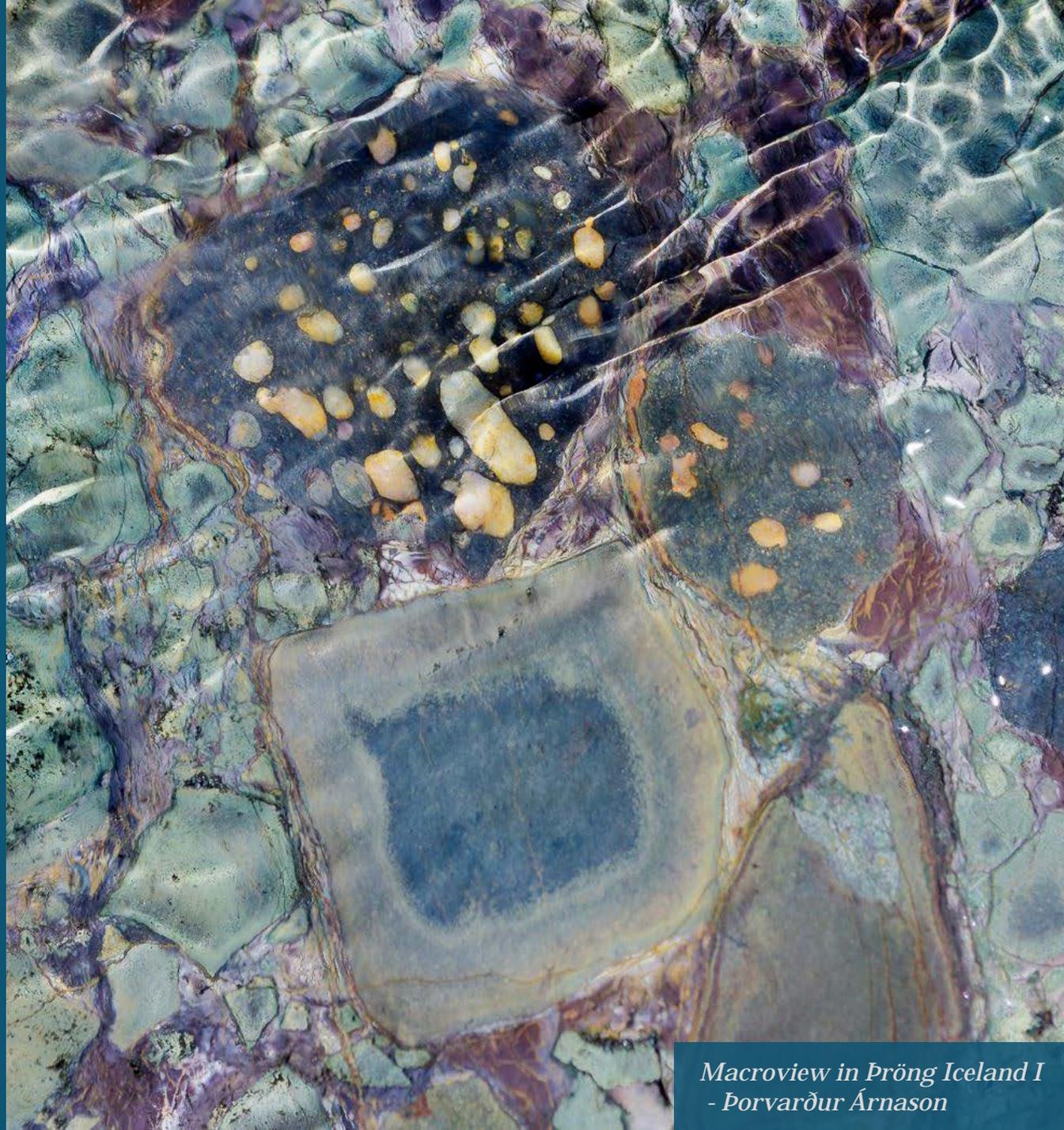
The following companies supported the publication of this report



**Current
Landscape**

**Recent
Developments**

Future Prospects

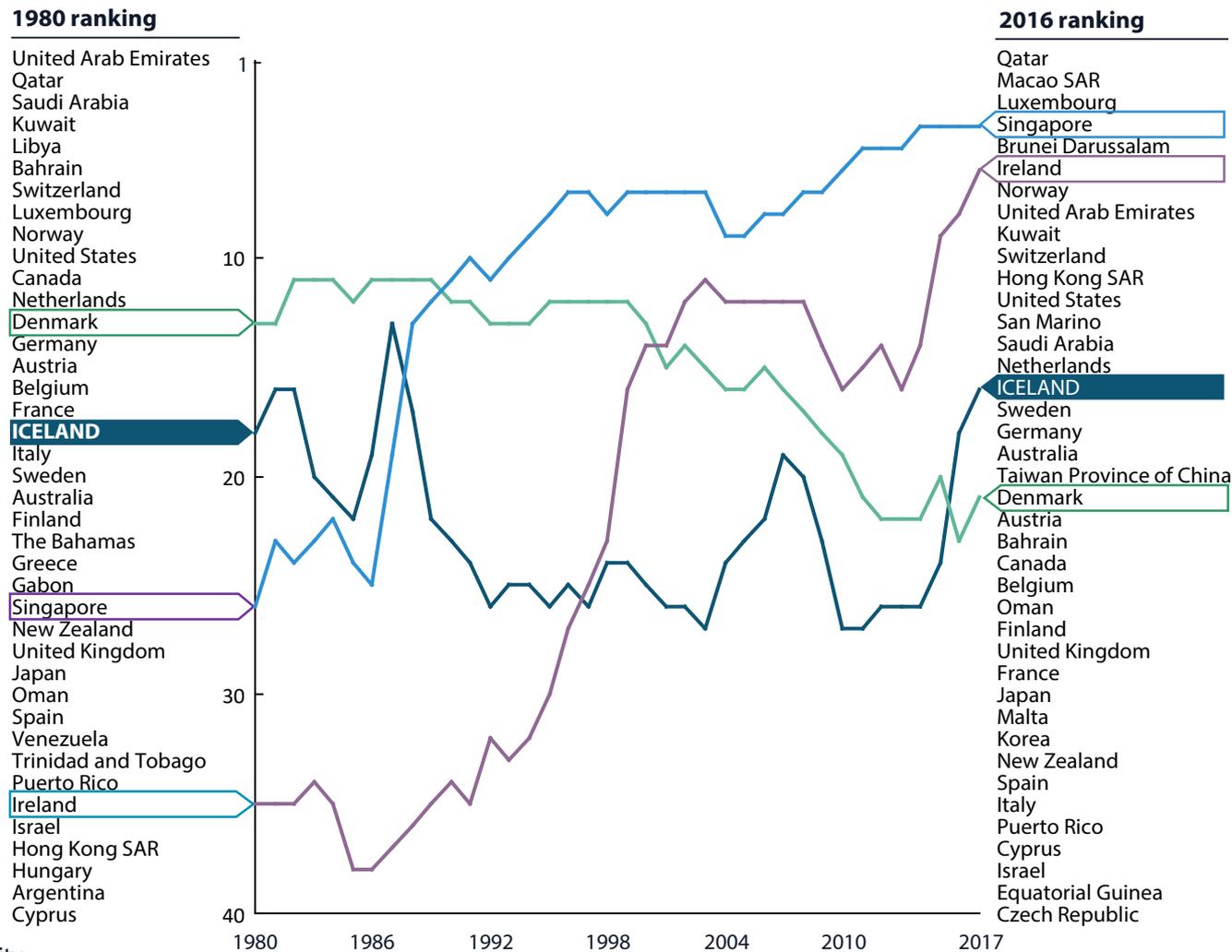


*Macroview in Þróng Iceland I
- Þorvarður Árnason*

Figure 1.1

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

Country rankings, GDP per capita (PPP¹ adjusted)

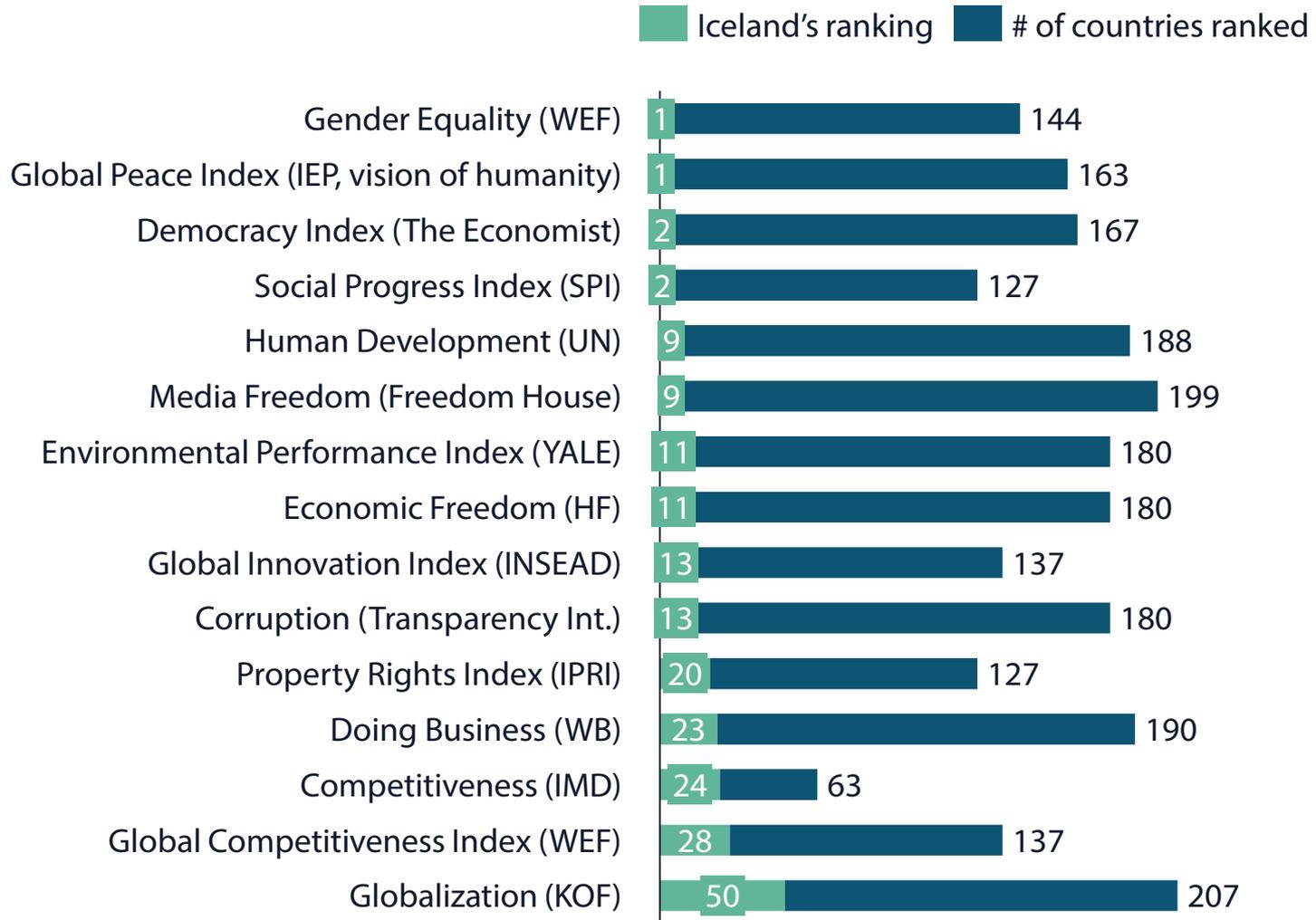


1 Purchasing Power Parity

Figure 1.2

Iceland ranks highly in numerous competitive indices

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



¹ Sources obtained 18/6/2018

Figure 1.3

The economy has been experiencing robust growth and the current outlook is positive

GDP growth (Percent)

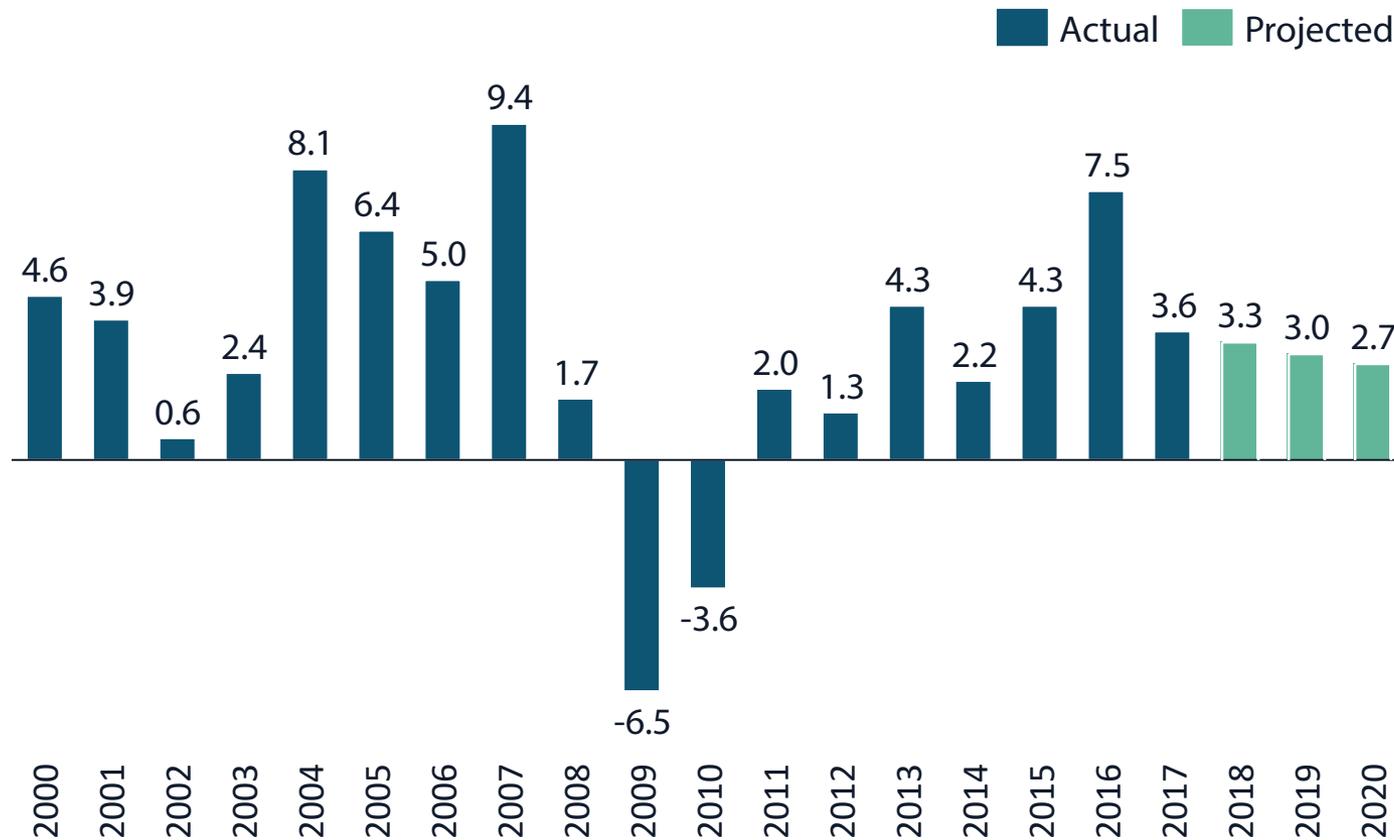
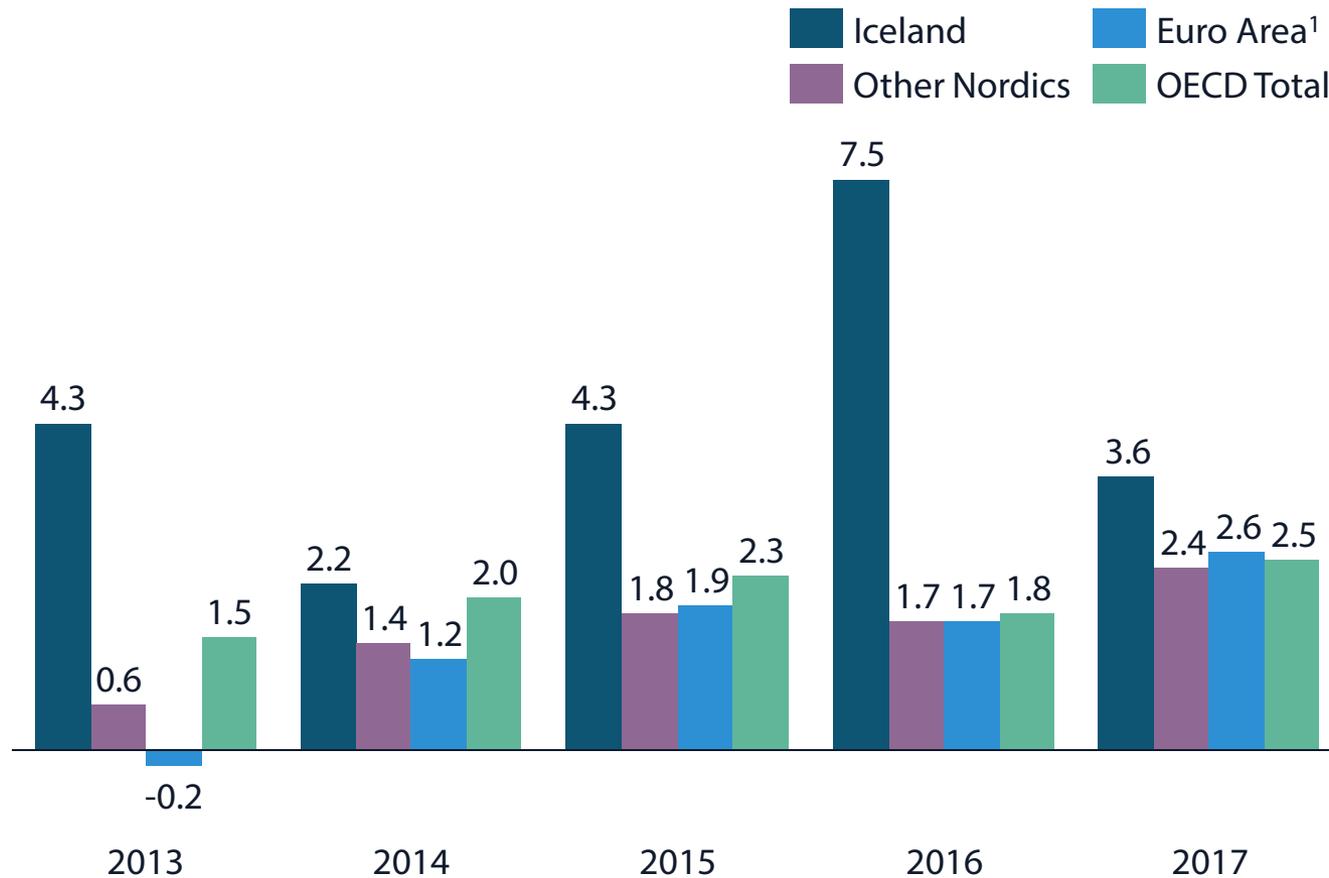


Figure 1.4

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

GDP growth 2013 to 2017 (Percent)

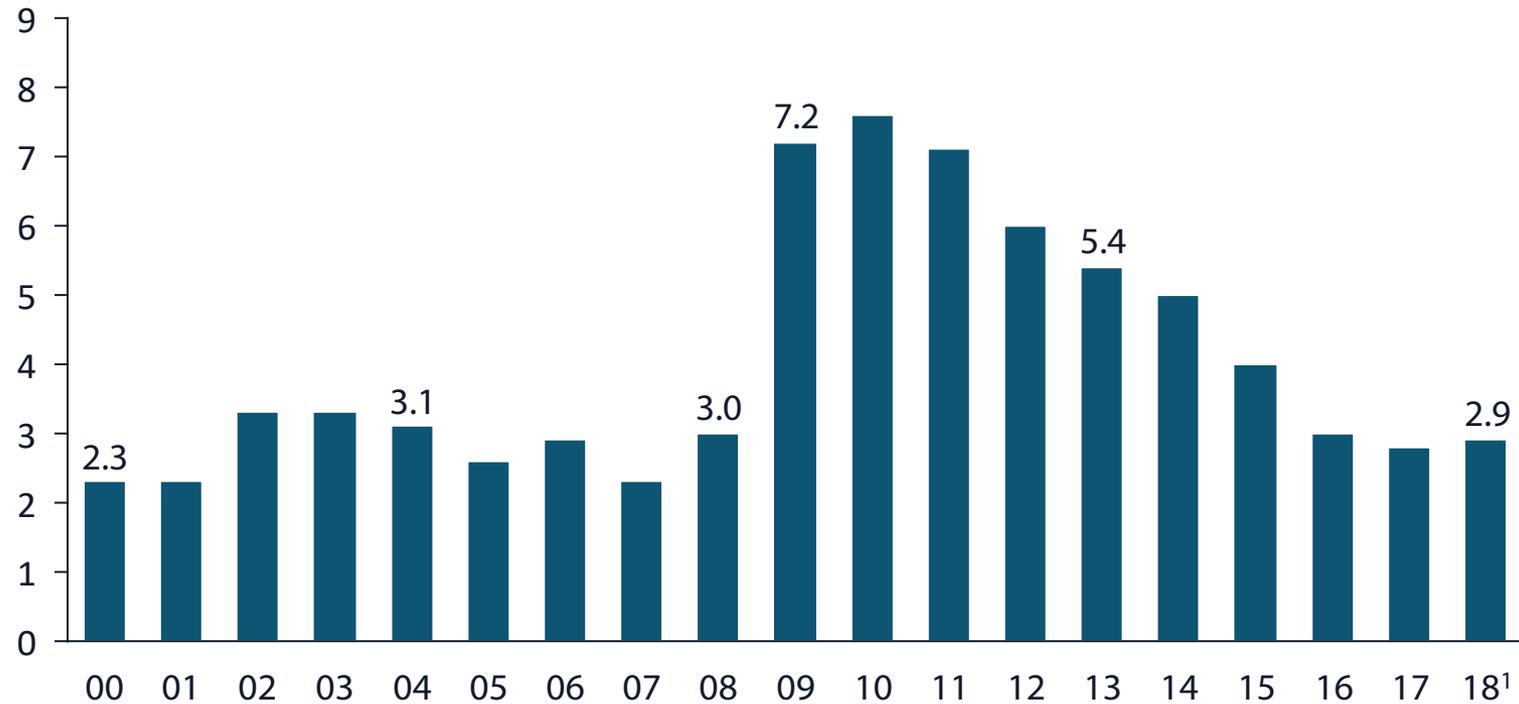


¹ The OECD time series used had 15 euro area countries: Austria, Belgium, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovak Republic, Slovenia and Spain

Figure 1.5

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

Unemployment Rate (Percent; yearly average)



¹ First quarter

Figure 1.6

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

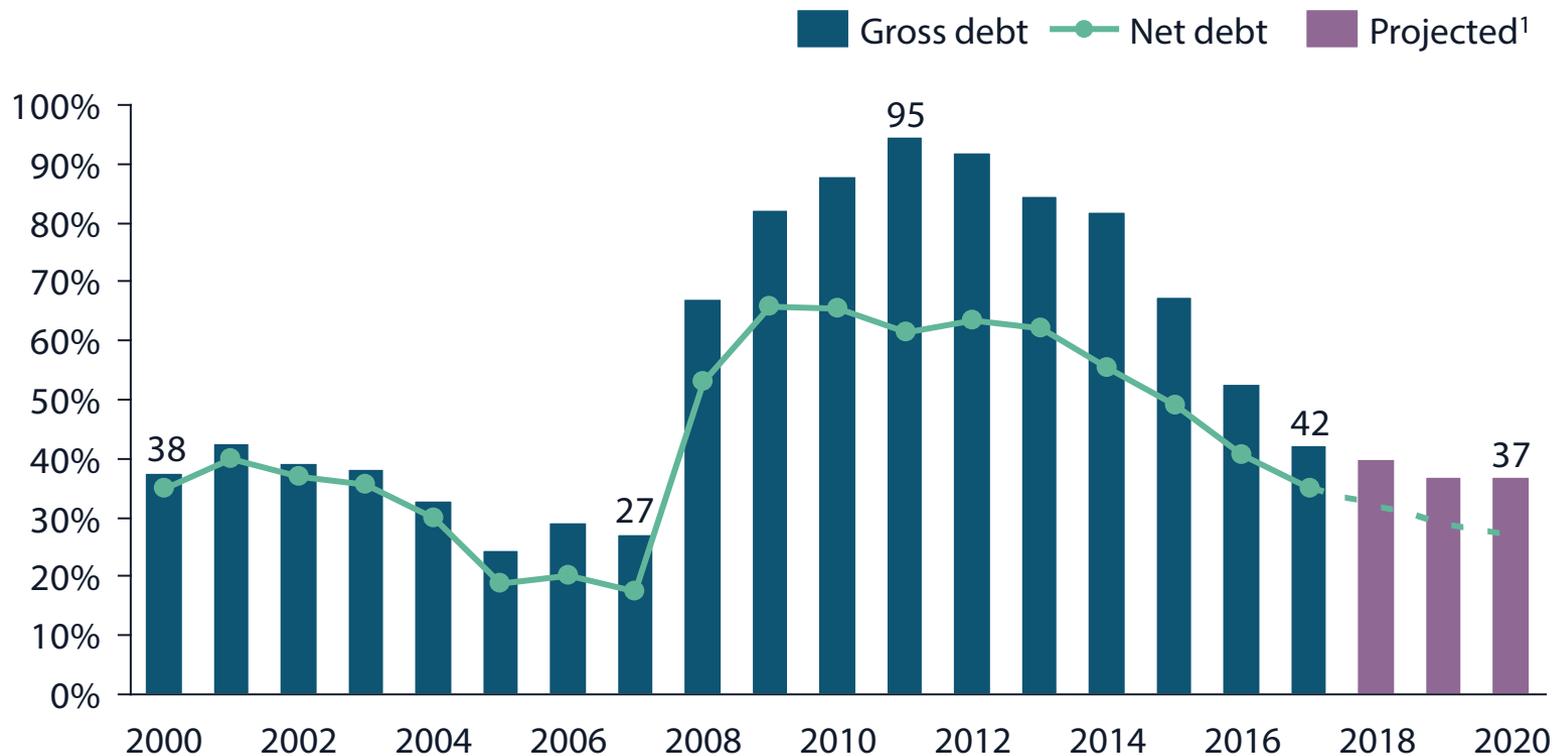
Corporate and Household Debt (Percent of GDP)



Figure 1.7

Public debt has decreased significantly in recent years after having tripled in the years following the crisis

General Government Debt (Percent of GDP)



¹ Predictions by the Central Bank of Iceland

Figure 1.8

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

Annual Inflation Rate (Percent)

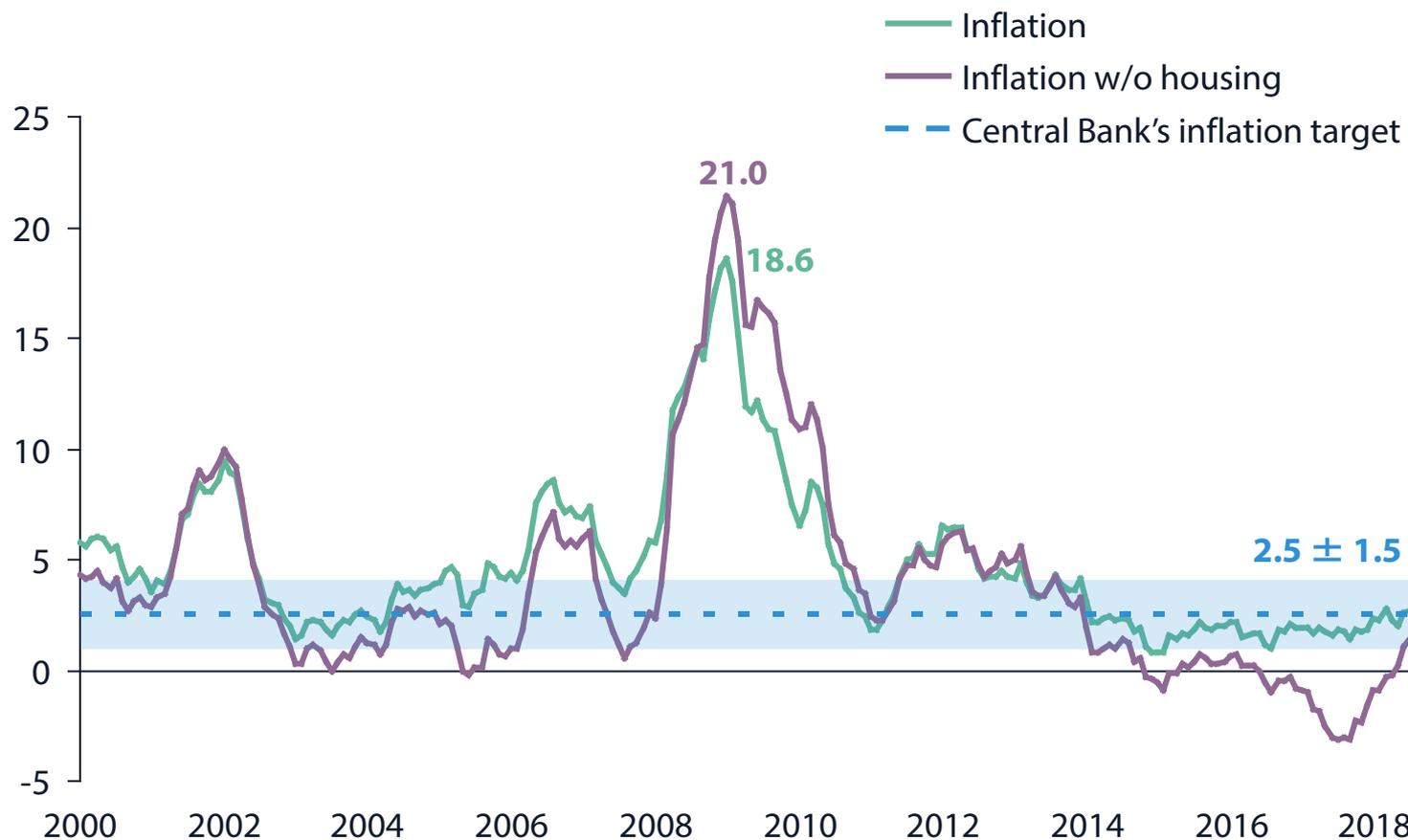


Figure 1.9

Interest rates in Iceland are high compared to developed economies

Central Bank Key Interest Rates (Percent)

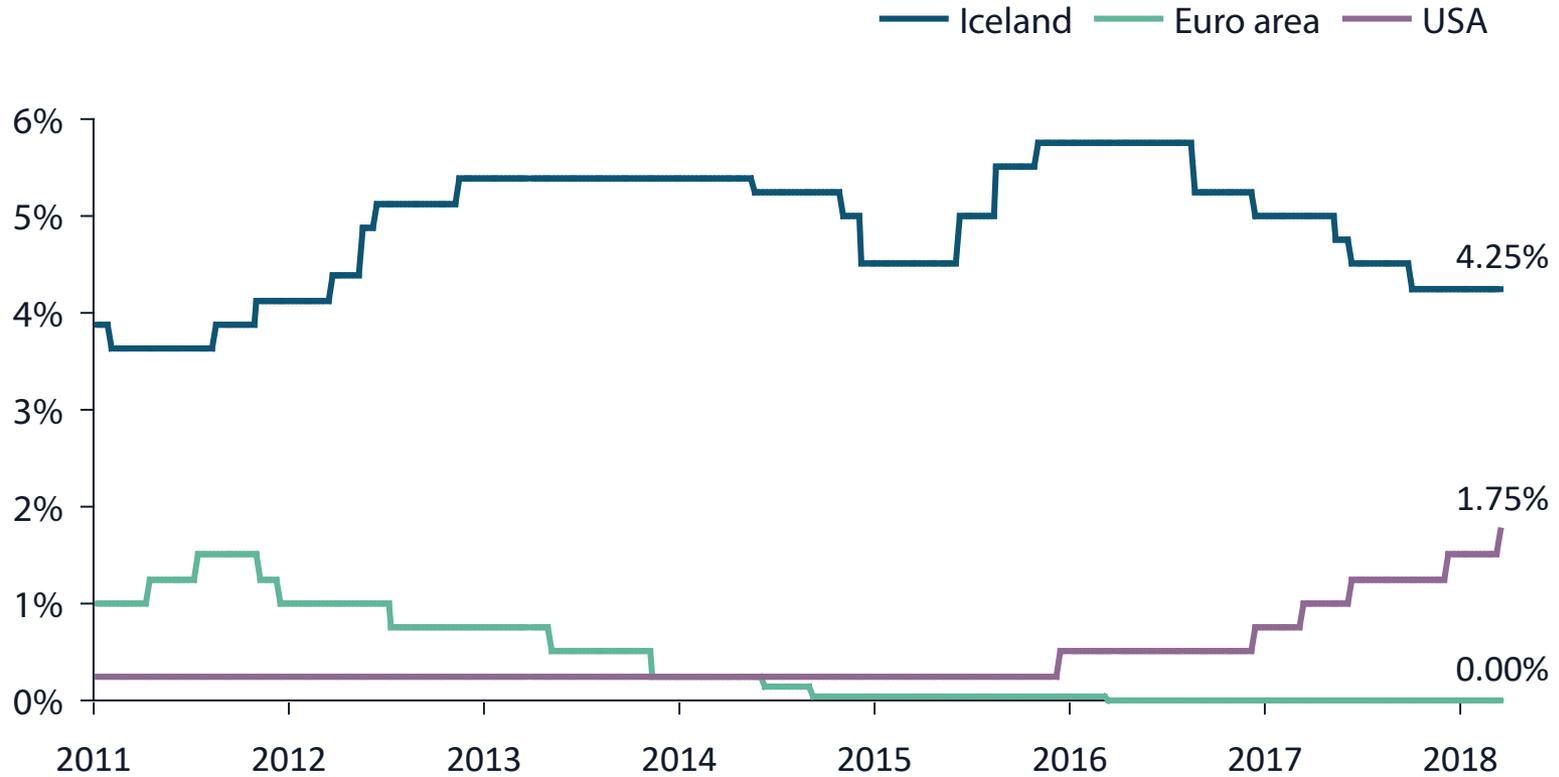
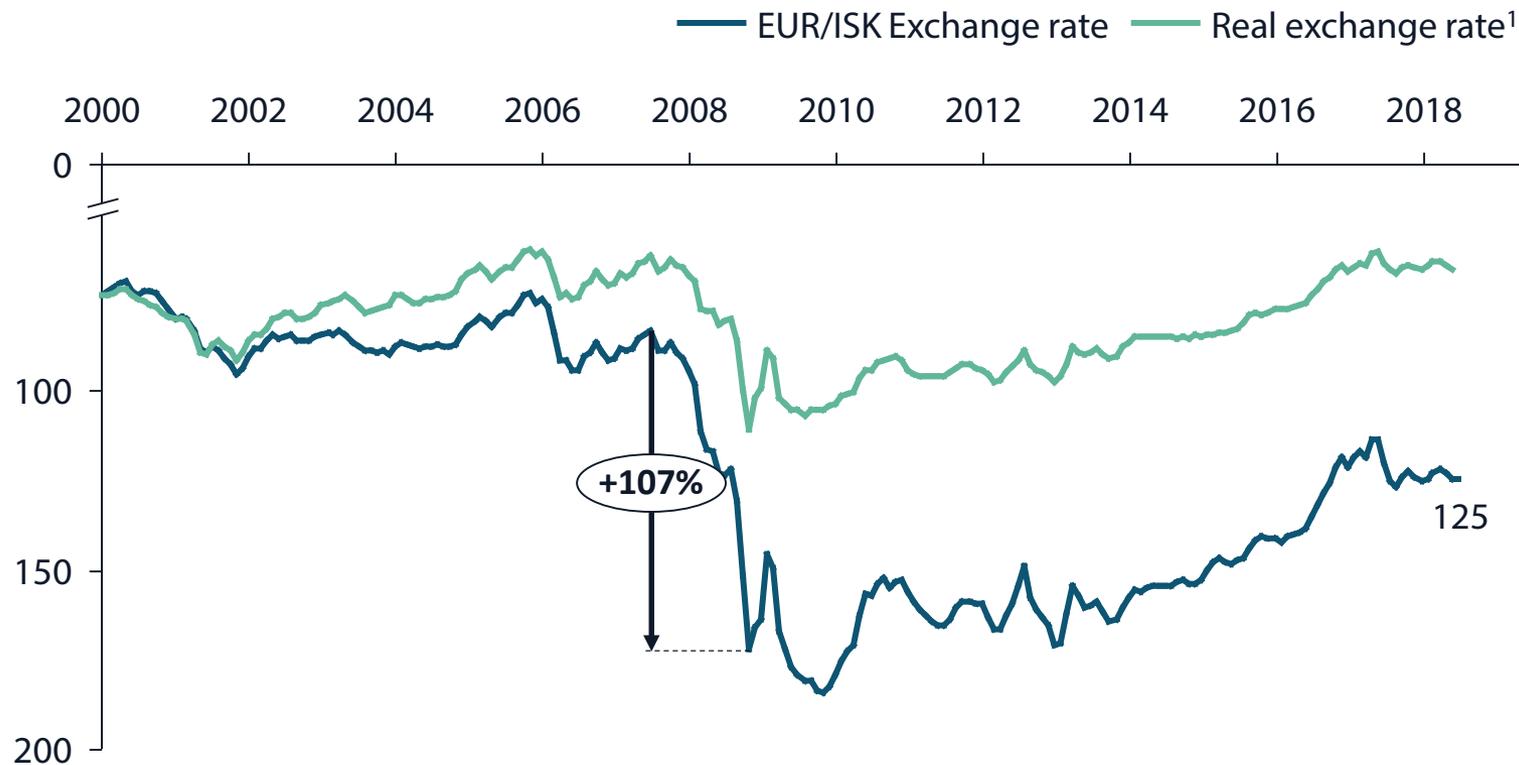


Figure 1.10

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

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

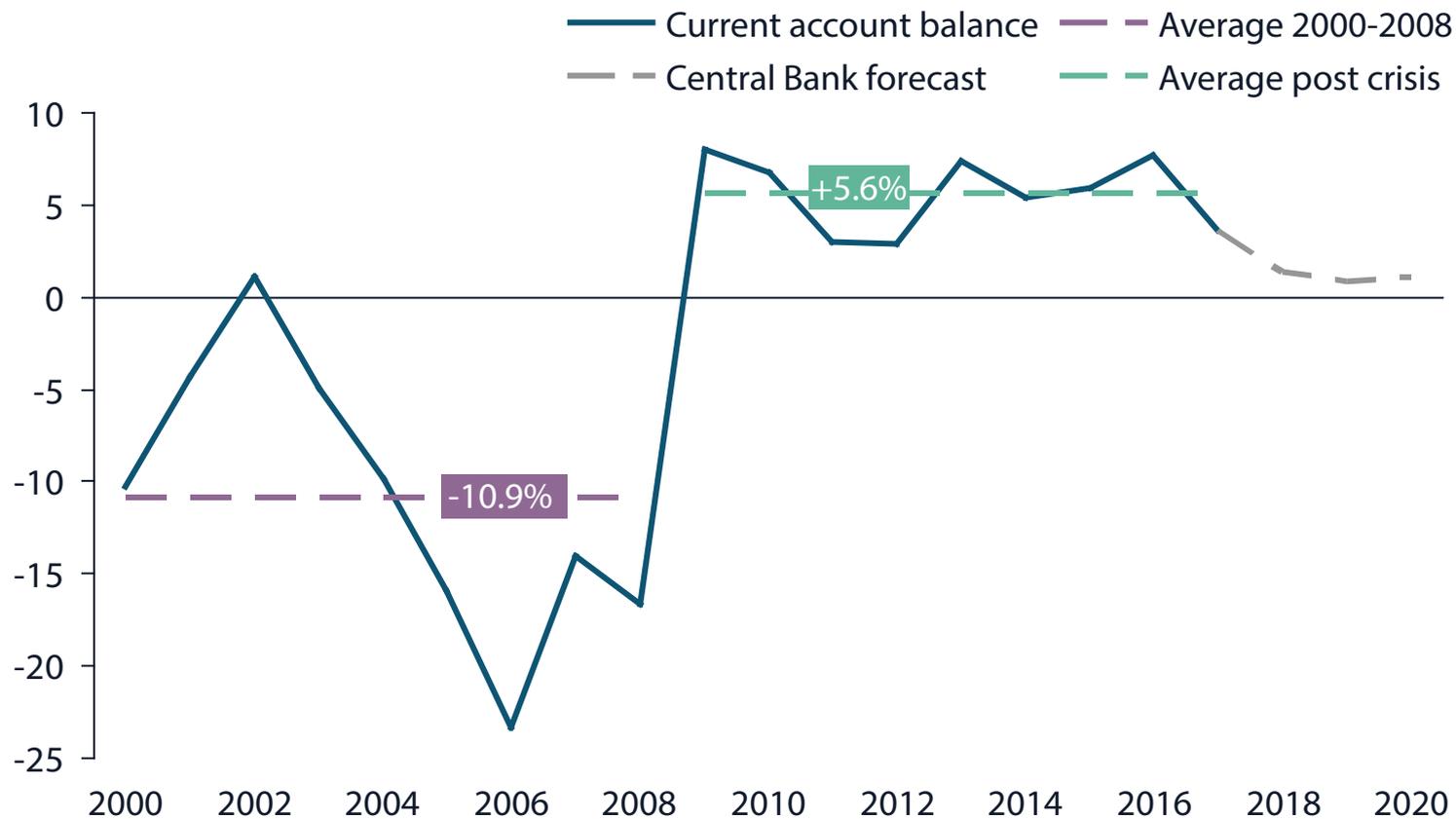


¹ Inversed values, normalised at EURISK's initial value

Figure 1.11

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

Current Account Balance¹ (Percent of GDP)

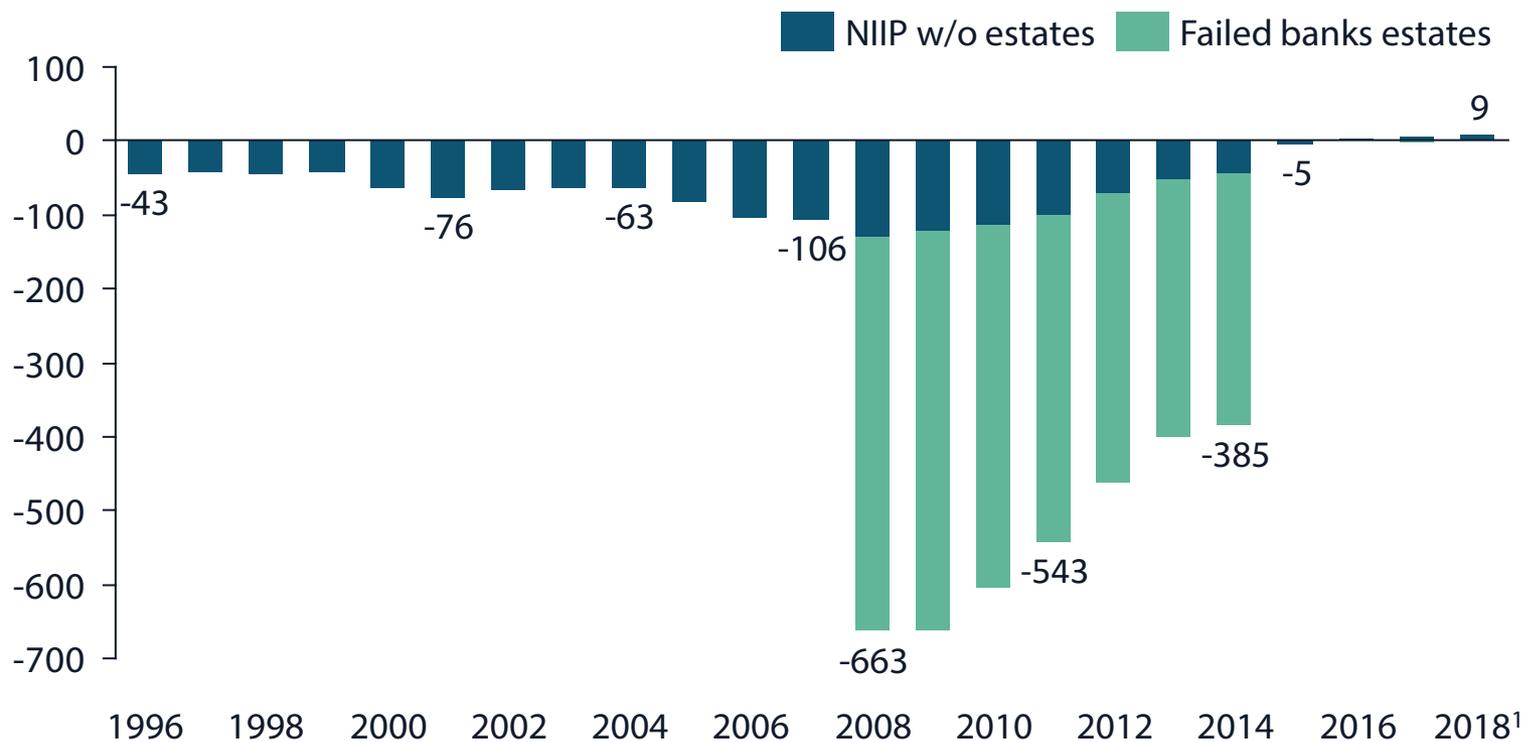


¹ Underlying current account, excludes the effects of the failed banks' estates. The current account is a broader measure than trade balance and also takes into consideration factor income and financial transfers.

Figure 1.12

Iceland's net foreign position has experienced a turnaround after falling to negative 663% of GDP in 2008

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

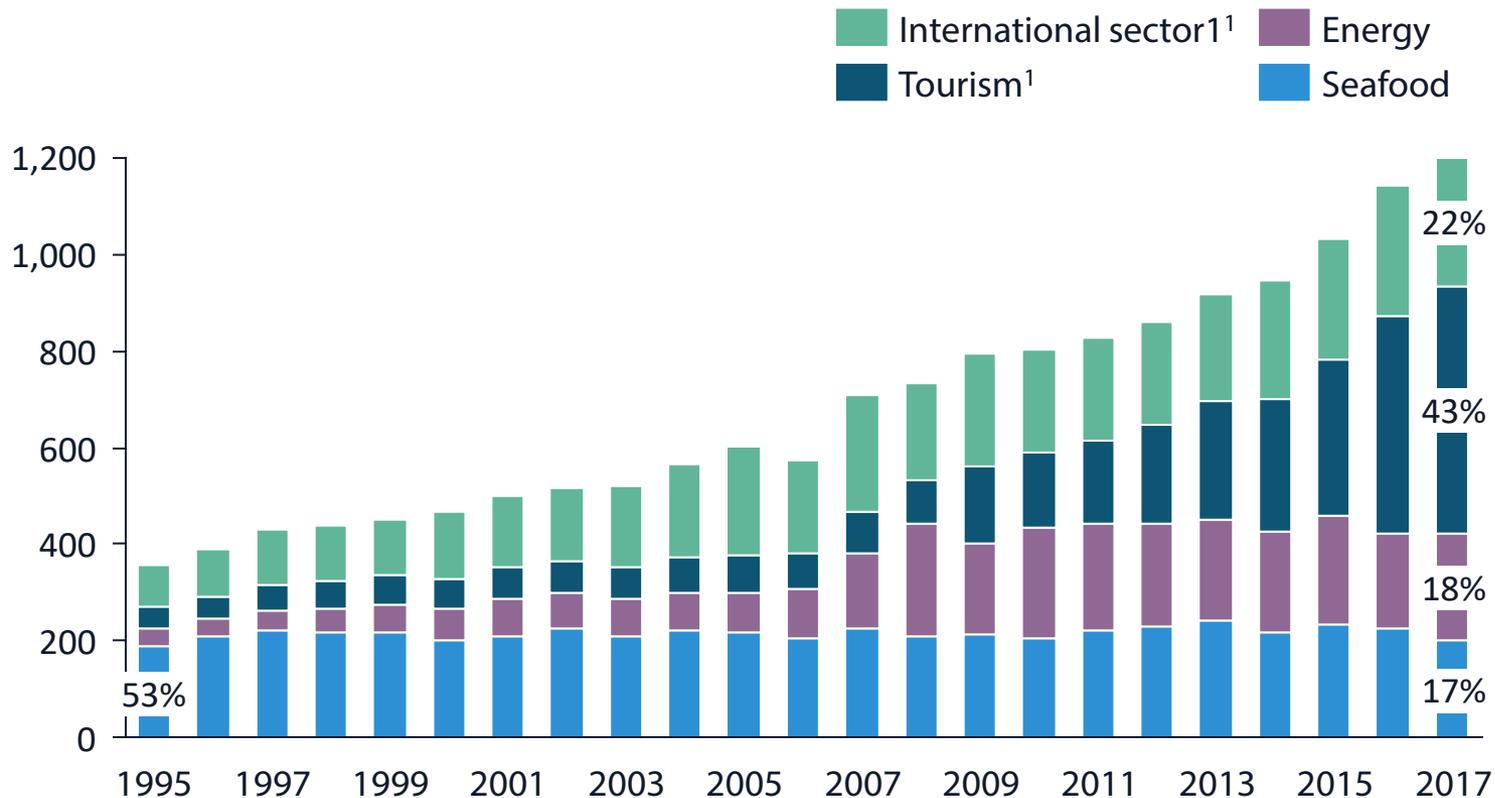


¹ First quarter of 2018

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. Agriculture and aquaculture, less than 2% of total, are not included.

Current
Landscape

Recent
Developments

Future Prospects



*Macroview in Pröng Iceland II
- Þorvarður Árnason*

Figure 2.1

A new government spanning the full political spectrum from left to right was formed in November 2017



Figure 2.2

The Icelandic tax system relies heavily on consumption and labor income

Key Taxes in Iceland

■ Lower bracket ■ Higher bracket

Tax	Rate	Recent and proposed changes
VAT ¹	<p>11% 24%</p>	<ul style="list-style-type: none"> Lowered from 25.5%; lower bracket raised from 7% to 11% in 2015
Labour income ²	<p>37% 46%</p>	<ul style="list-style-type: none"> Lower bracket expected to be lowered by 1% during this government's term
Corporate tax	<p>20%</p>	<ul style="list-style-type: none"> Unchanged since 2011 when it was increased from 18% to 20%
Dividends / Capital gains	<p>22%</p>	<ul style="list-style-type: none"> Increased from 20% to 22% in 2017
Payroll tax	<p>7%</p>	<ul style="list-style-type: none"> Expected to be lowered by 0.25% during this government's term

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.

Figure 2.3

The current government is aiming for a future oriented long-term policy

Four Major Long-term Agendas are in the Works (Forthcoming policy proposals)



- Comprehensive innovation policy until 2030



- Whitepaper on the future of the financial system



- Education agenda until 2030

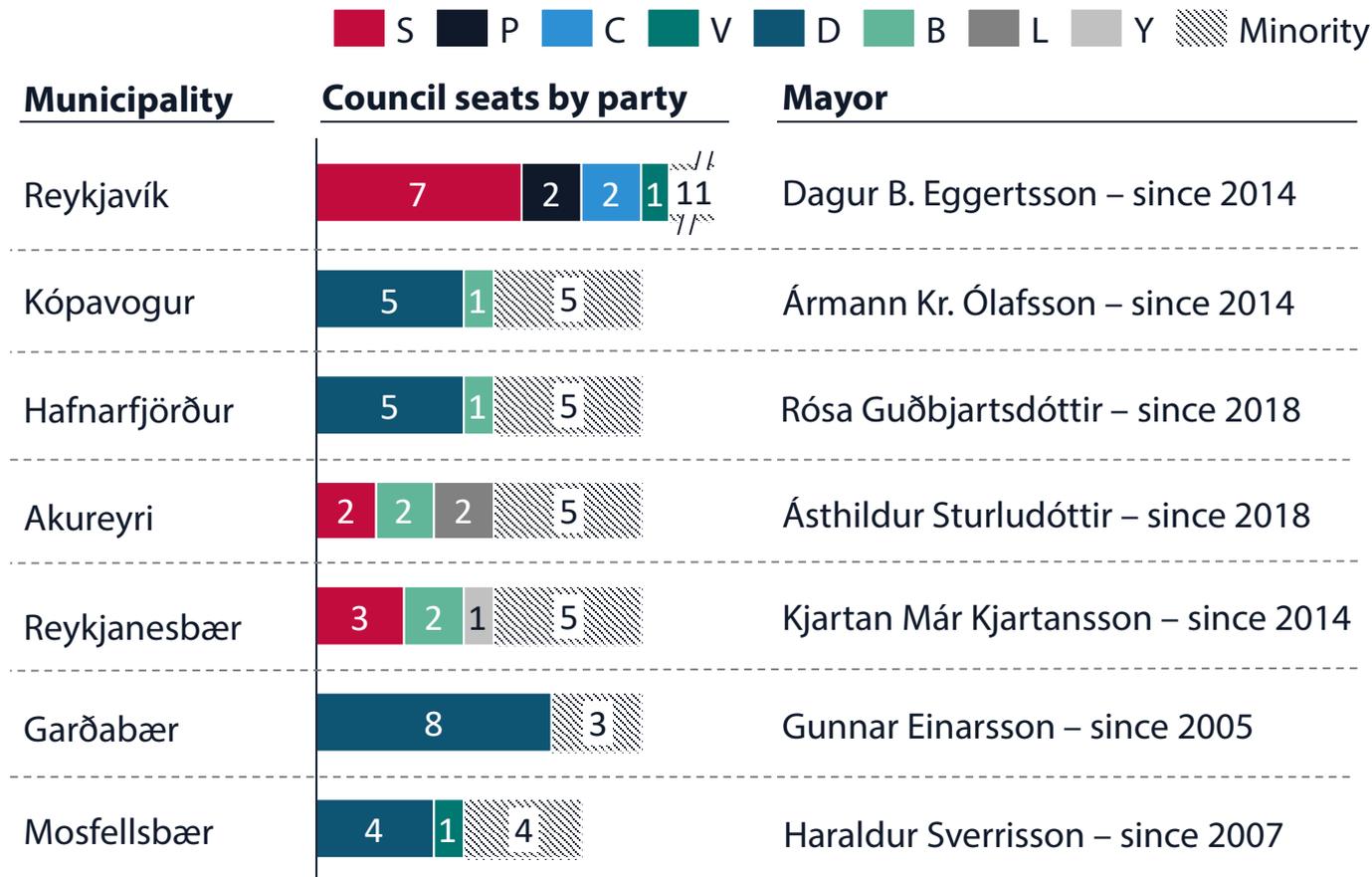


- Carbon-neutral Iceland by 2040

Figure 2.4

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

Majorities in the 7 Largest Municipalities (Parties by list letter codes)

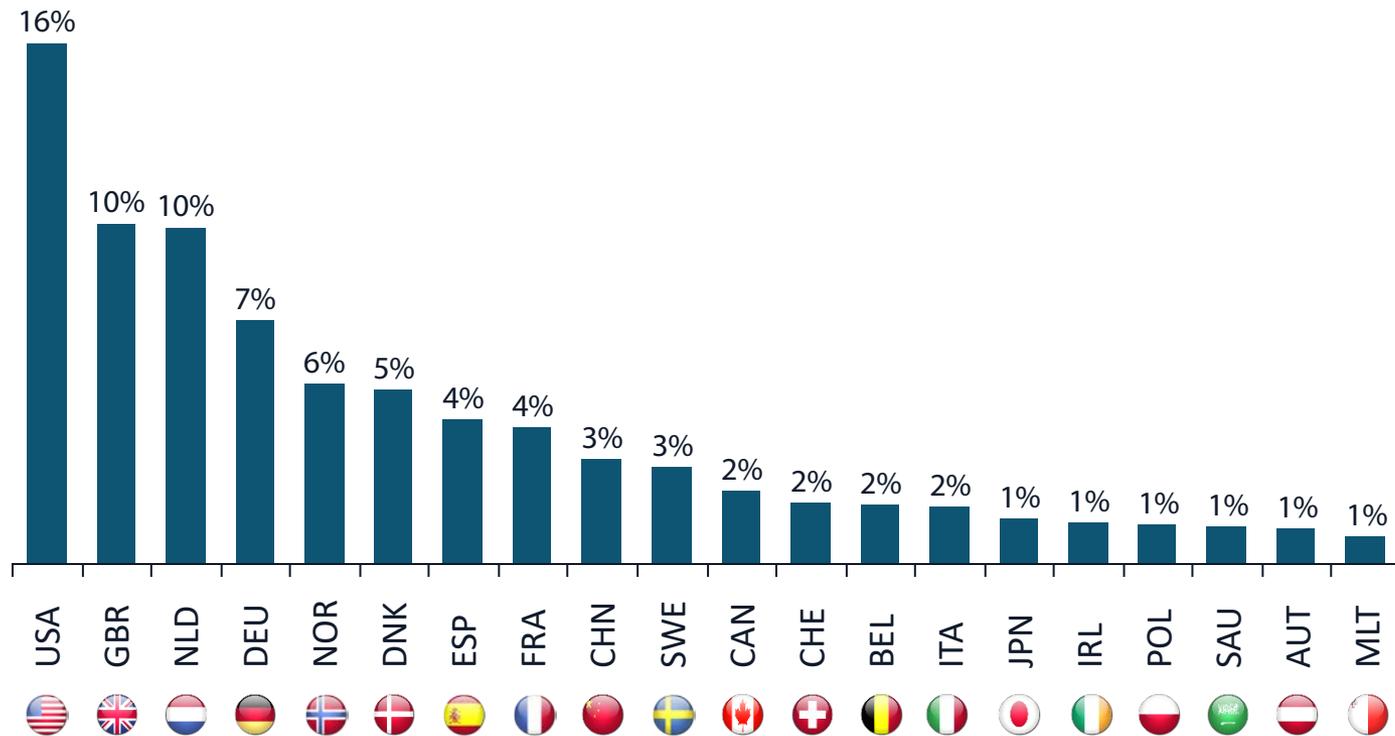


1 S – Social Democratic Alliance, C – Reform Party, D – Independence Party, P – Pirate Party, V – Left Green Movement, B – Progressive Party, L – L-list, Y – Direct way.

Figure 2.5

Iceland relies chiefly on American and European markets for external trade

Iceland's Largest Trading Partner¹ (Percent of total trade in goods and services in 2016)



¹ Total share of imports and exports combined

Figure 2.6

The majority of Iceland's "Big Three" banks are in governmental ownership

Ownership of the Three Largest Domestic Banks (Percent)

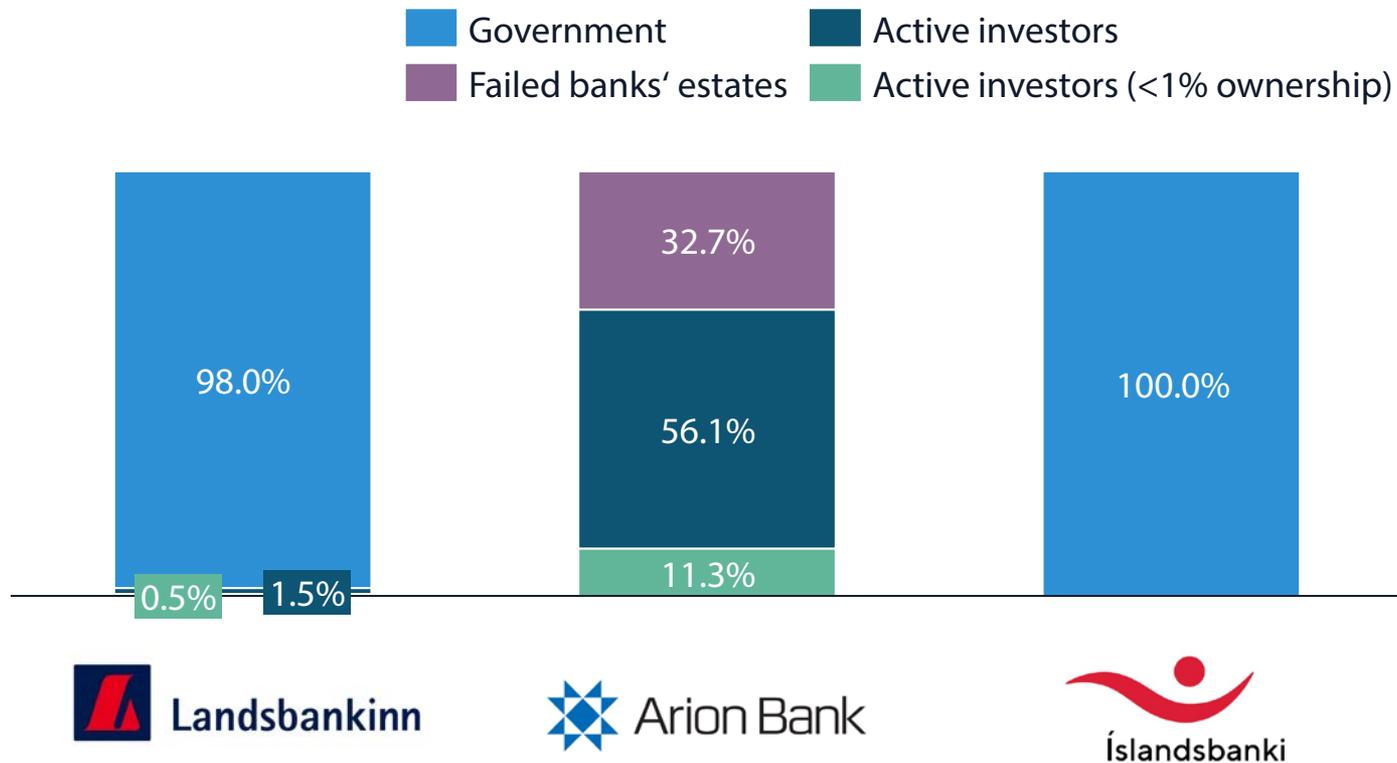


Figure 2.7

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

Action Plan for Lifting Capital Controls since 2008

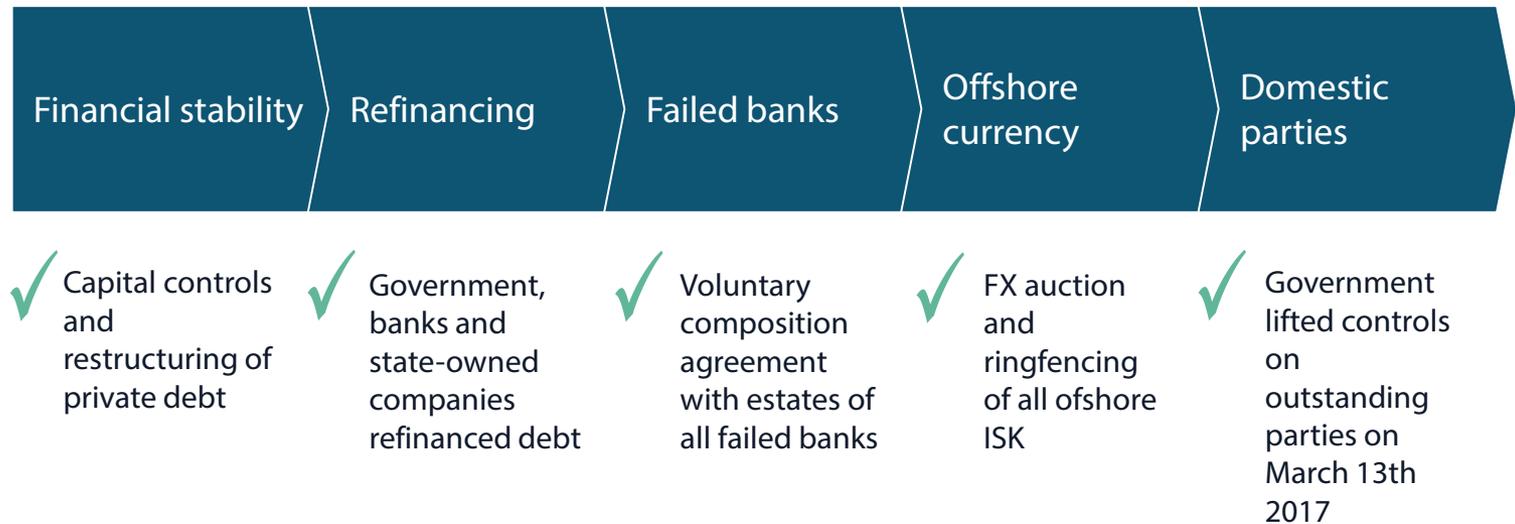
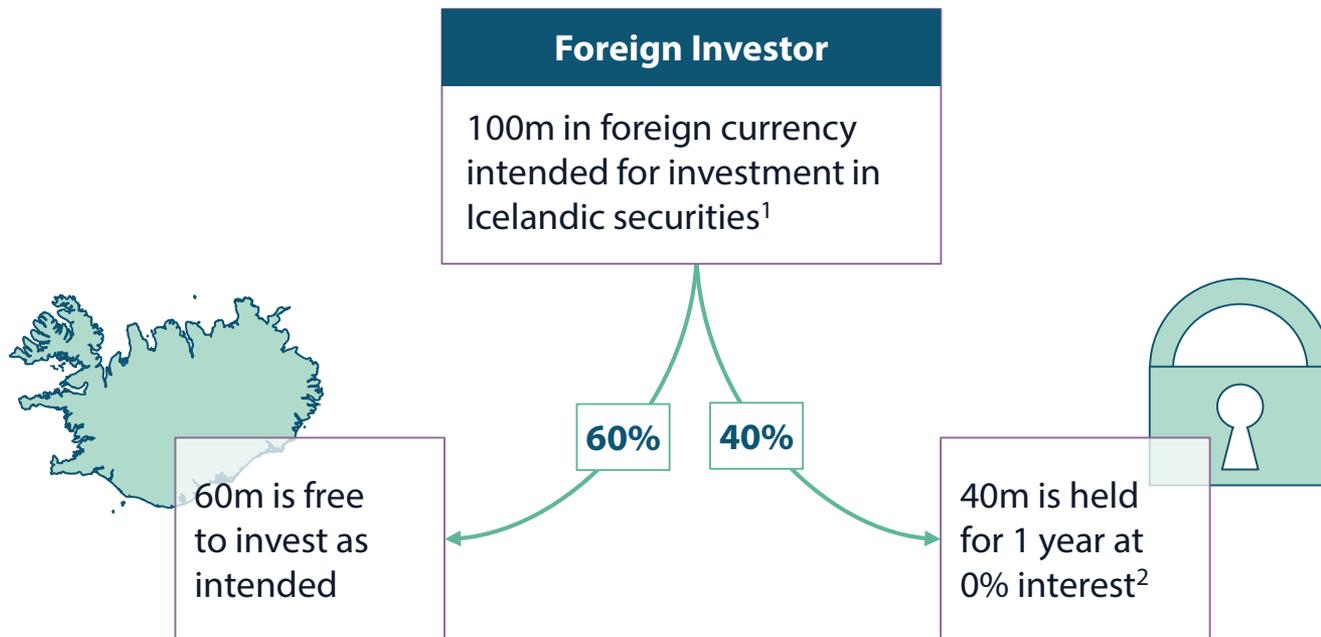


Figure 2.8

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

Iceland's Capital Flow Instrument, The Special Reserve Requirement (Illustrative)



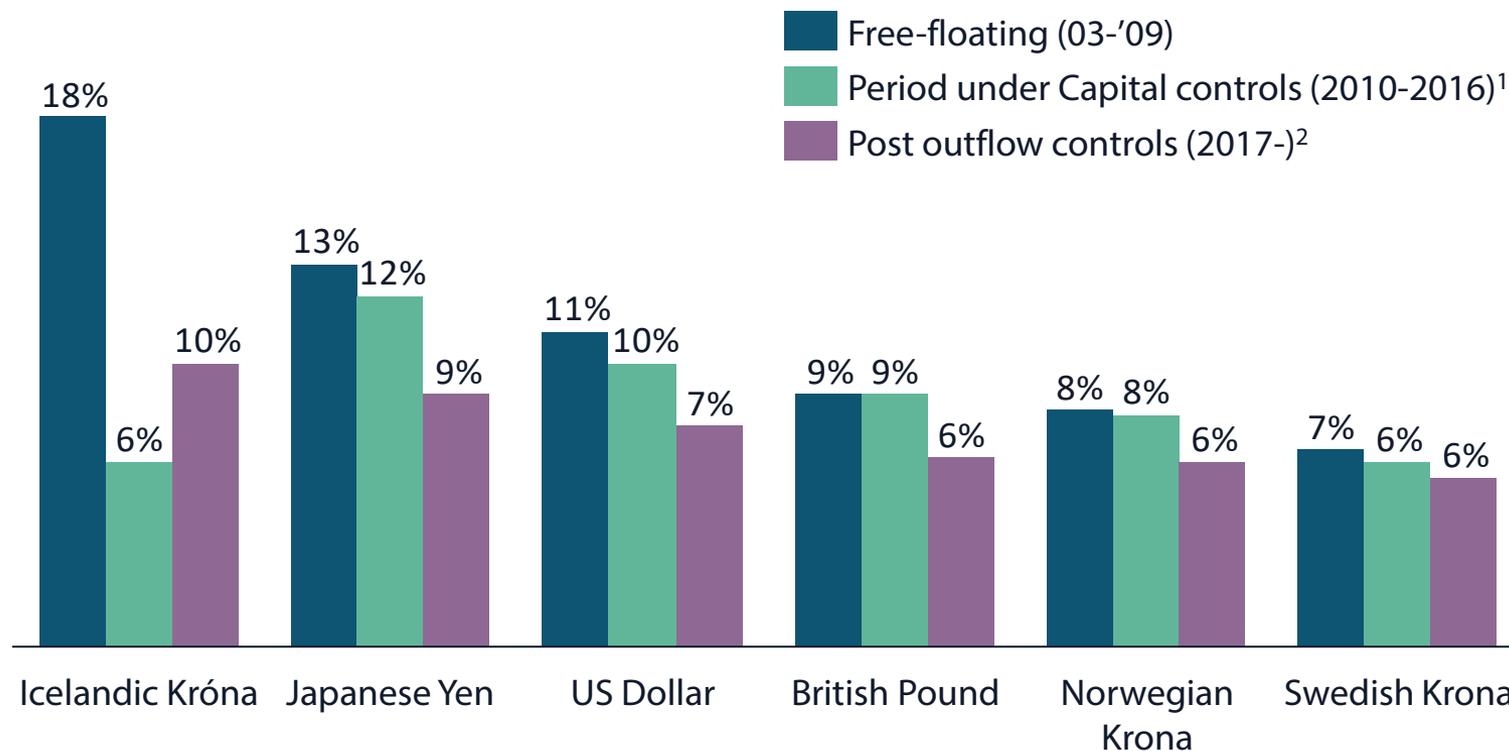
1 The new measurement's scope is new inflow of foreign currency that's in particular intended for new investment in electronically registered bonds and bills, and deposits, as well as new inflow related to loans taken for investment in such instruments. It also applies to imported foreign currency deposited 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 for 1 year but the Central Bank can raise the ratio to up to 75% and the period up to 5 years; the capital is held on a capital flow account with the Central Bank of Iceland with the Icelandic króna as the settlement currency

Figure 2.9

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

Exchange Rate Fluctuations Against the Euro (Annualised volatility)



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

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

Figure 2.10

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

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

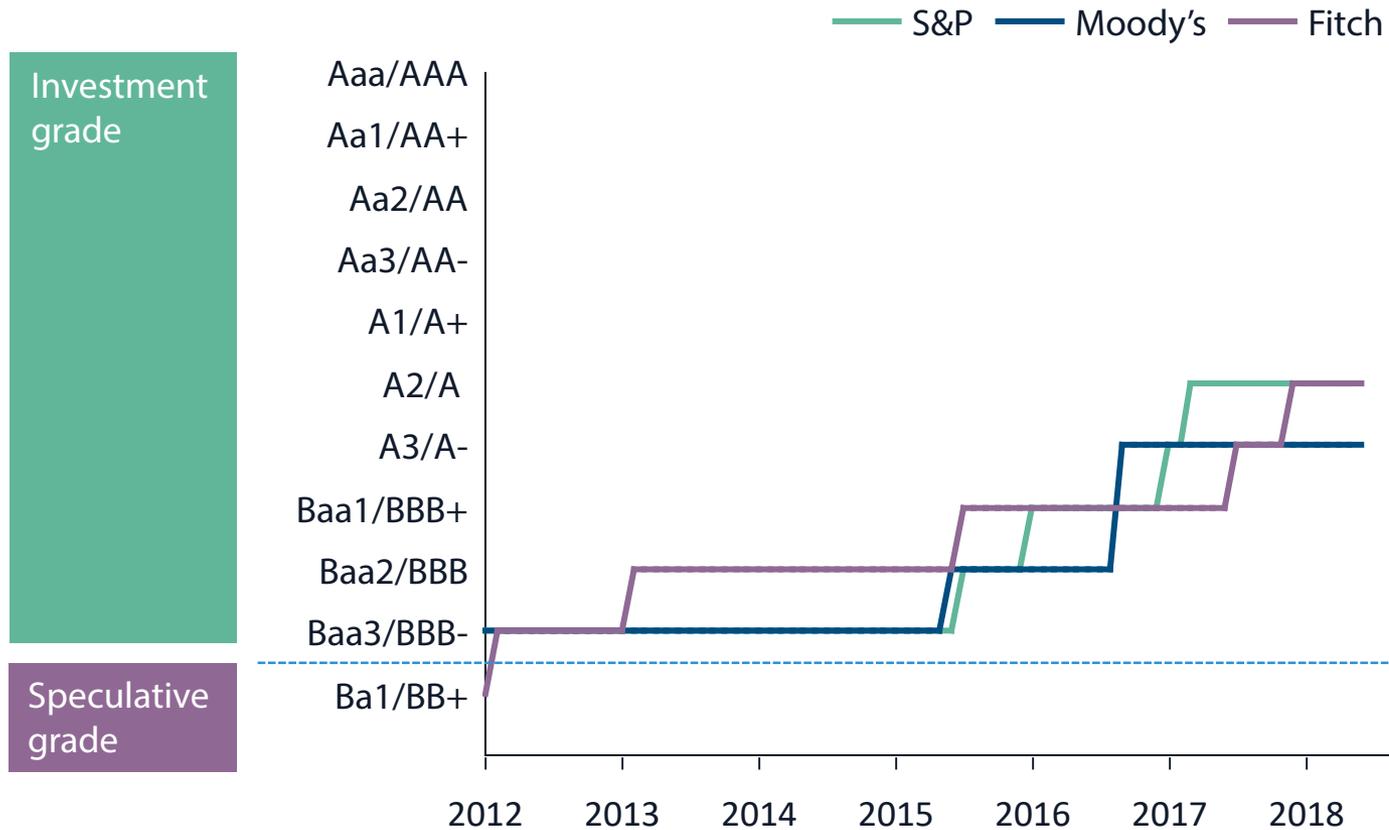


Figure 2.11

Domestic assets appreciated significantly in the last few years but valuation of equities has stagnated after 2015

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

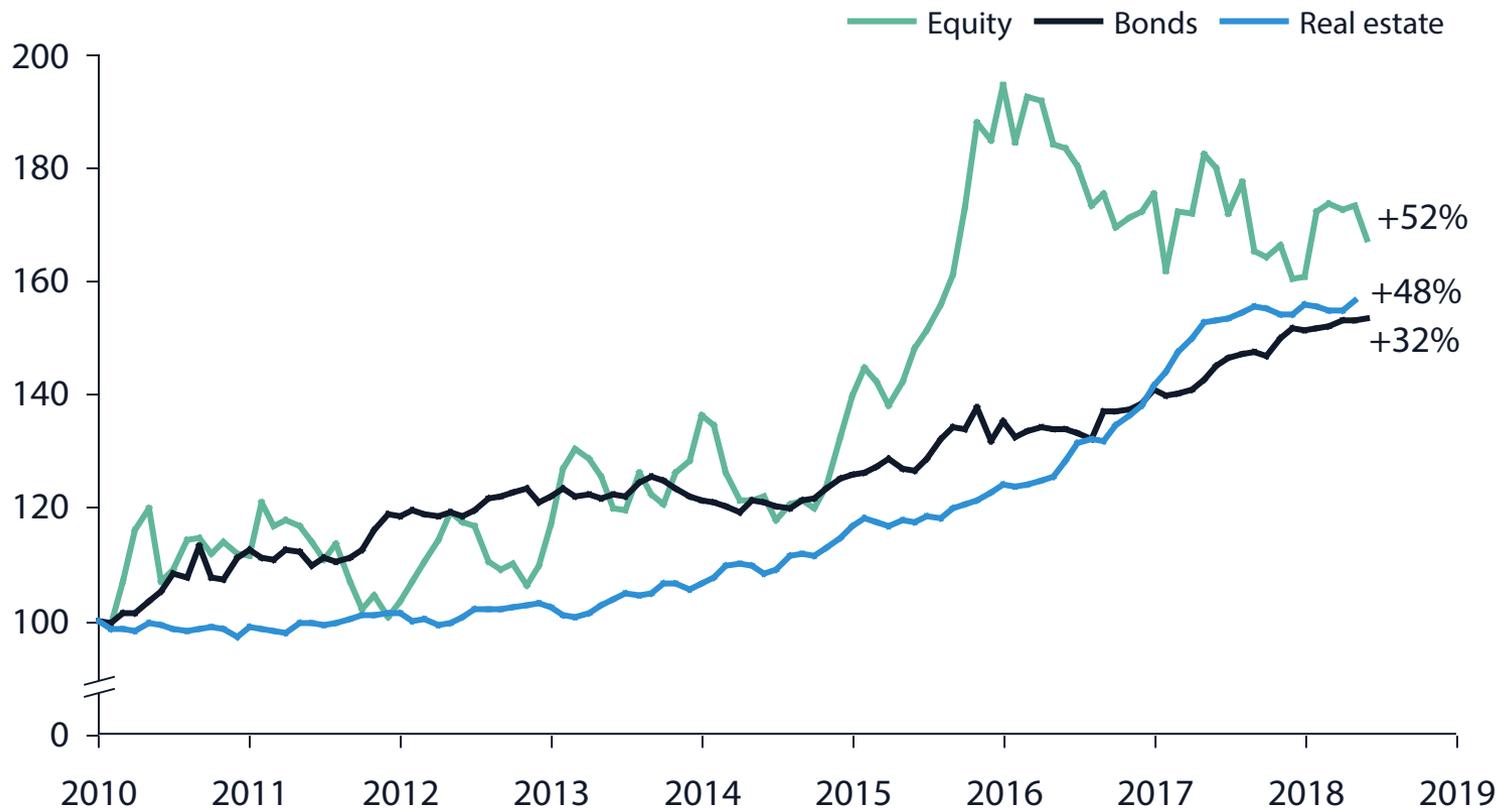
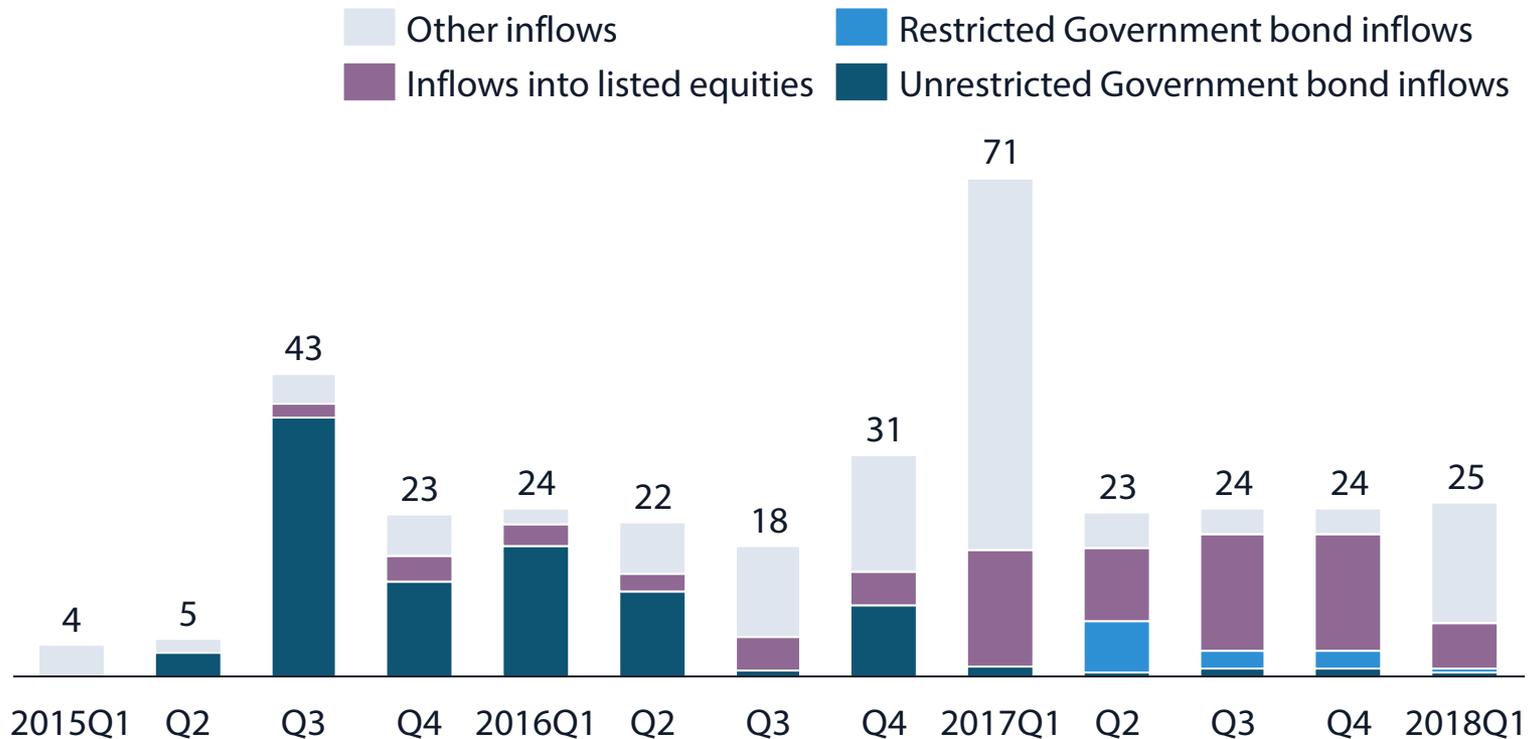


Figure 2.12

Composition of capital inflows changed after the CBI implemented new restrictions¹ on inflows in June 2016

New Investment Inflows (Bn. ISK)



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

Figure 2.13

The Icelandic pension fund system is relatively one of the largest in the world

Private Pension Assets 2016 (Percent of GDP)

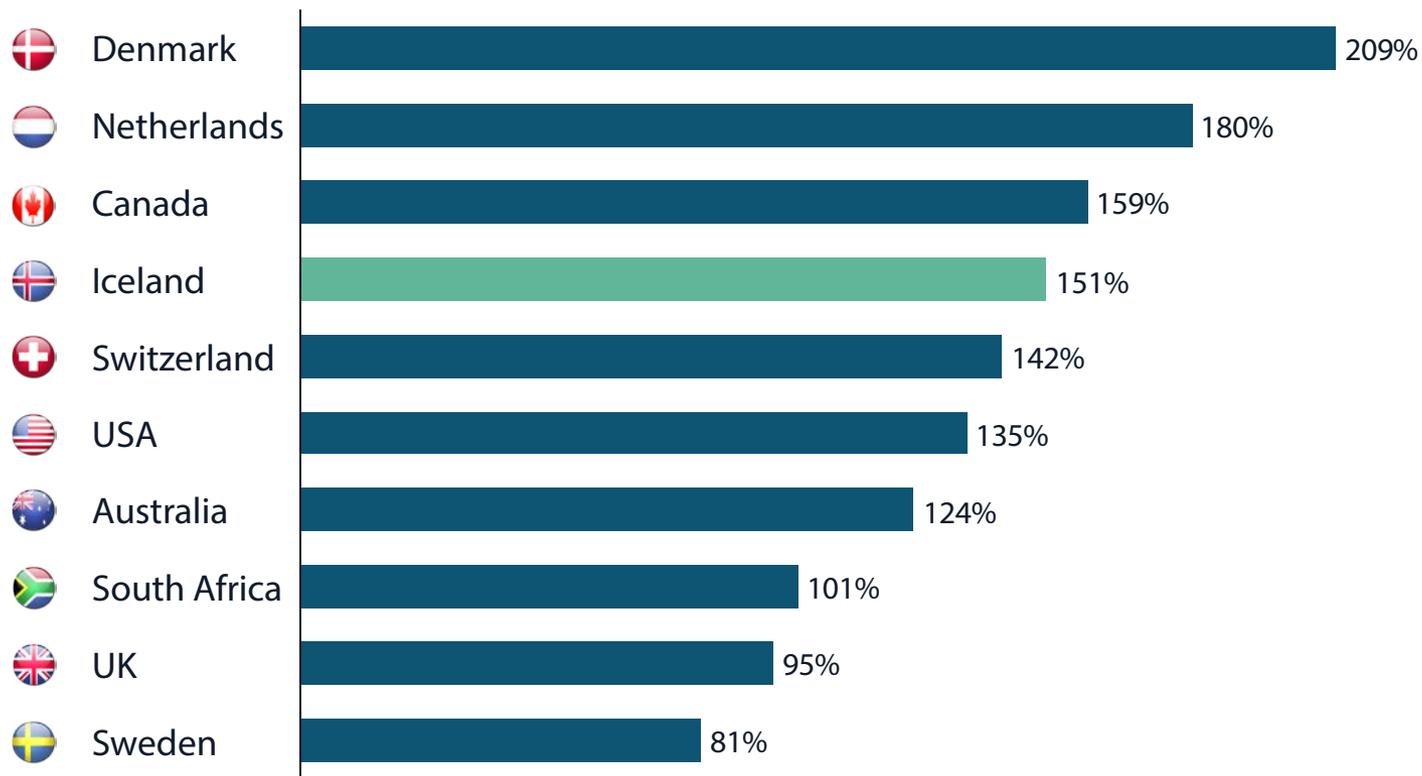


Figure 2.14

Pension fund have become a significant mortgage lender

New Mortgages by Lender (Bn. ISK)

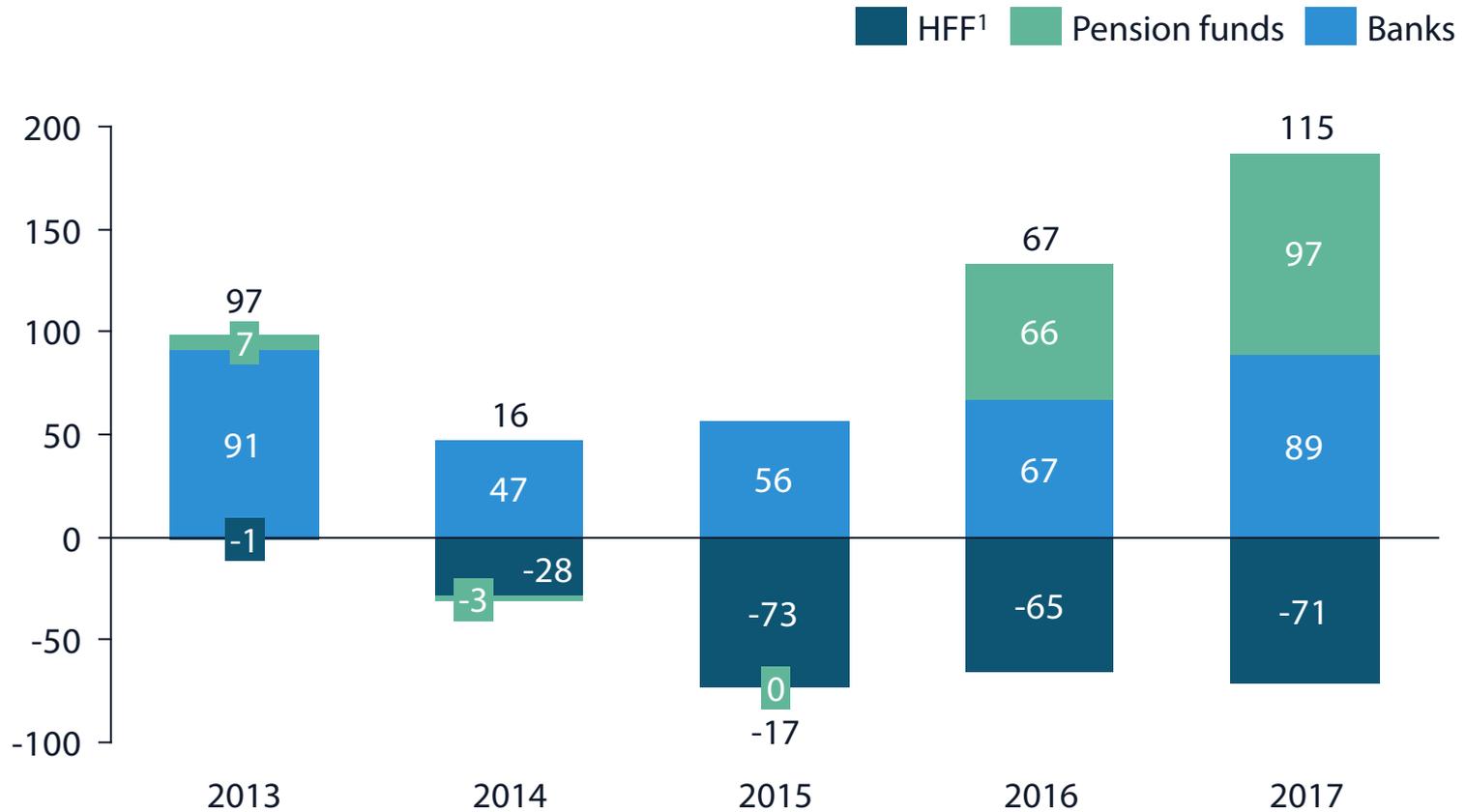
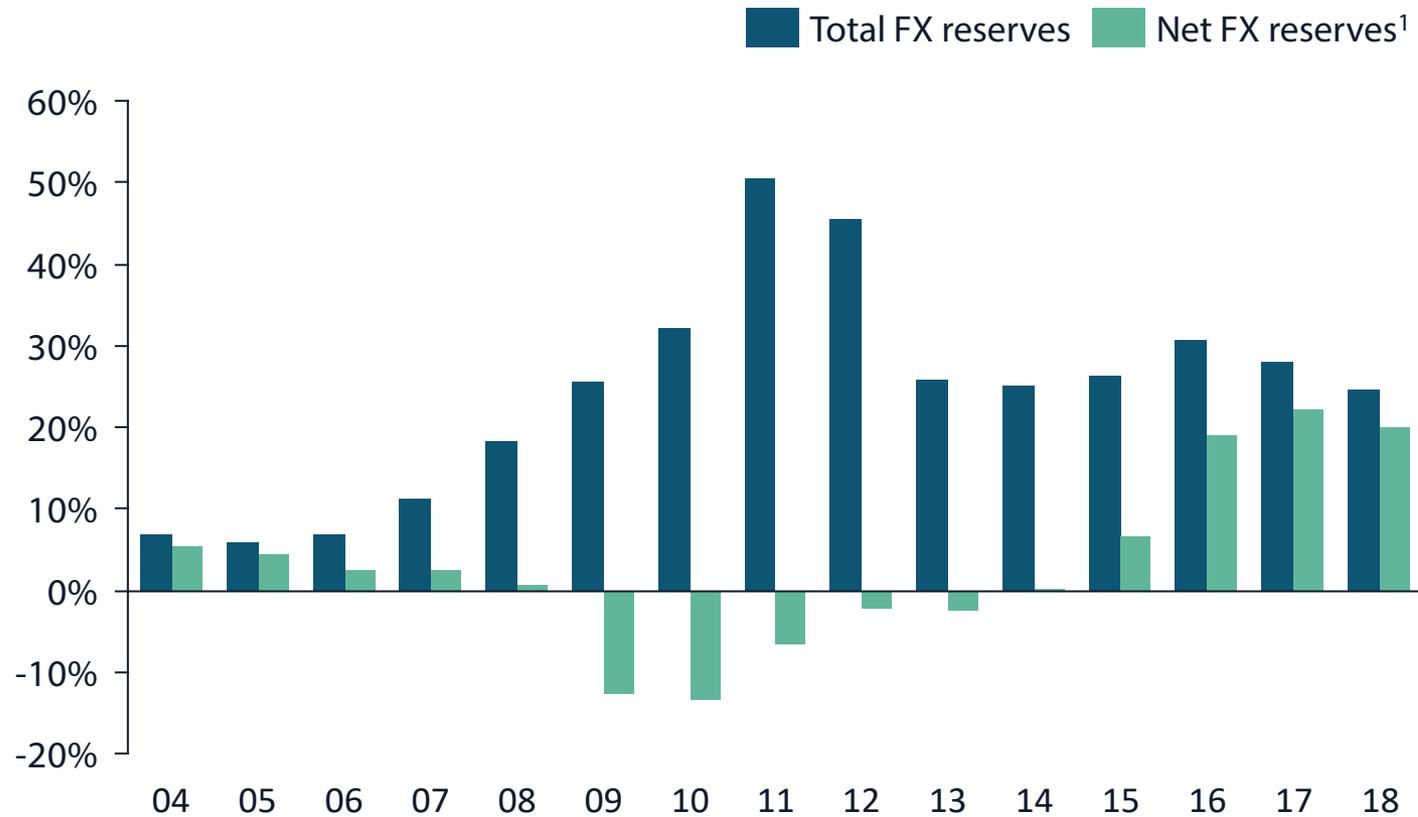


Figure 2.15

The Central Bank has bought large amounts of foreign currency in recent years, mostly to pay down foreign debt

Foreign Exchange Reserves (Percent of GDP)



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

Figure 2.16

The domestic sector accounts for about two thirds of the economy

Composition of the Icelandic Economy (Percent of GDP)

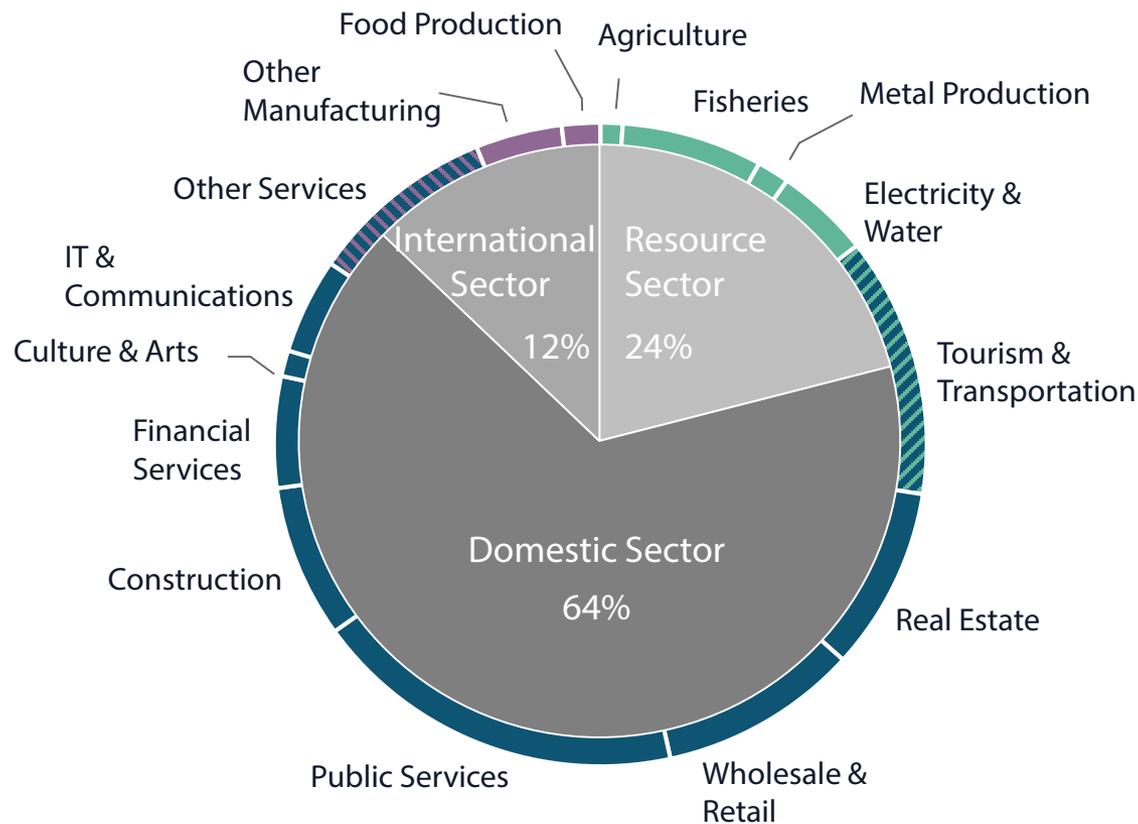


Figure 2.17

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))

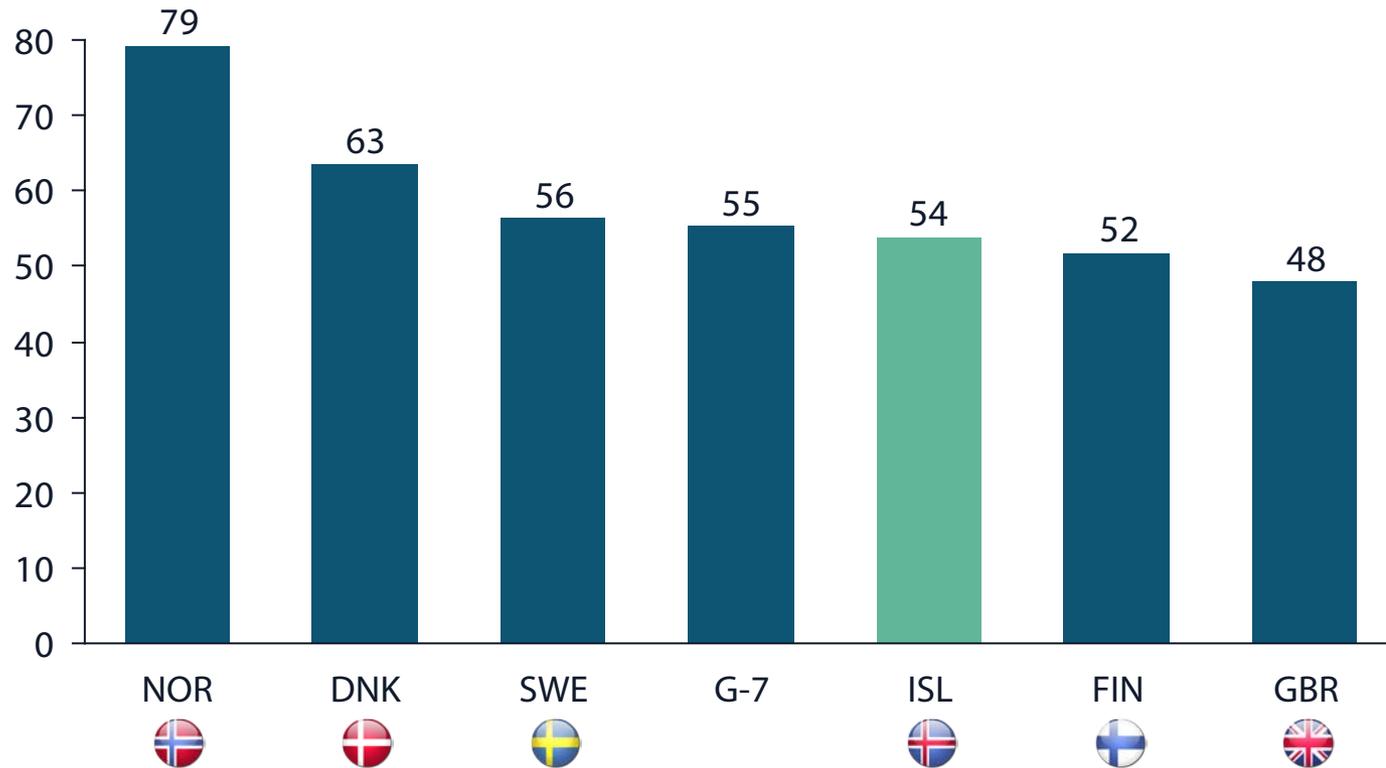
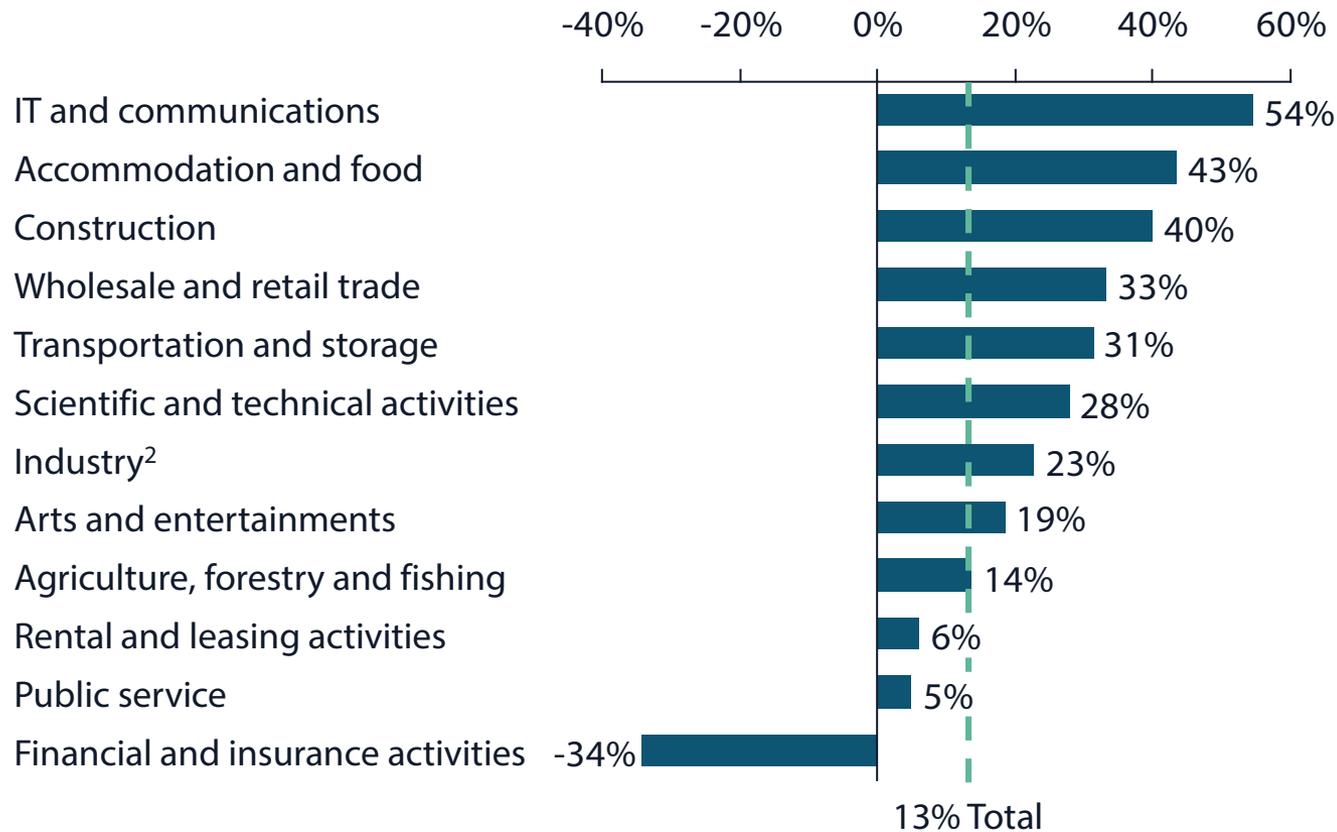


Figure 2.18

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 2017)



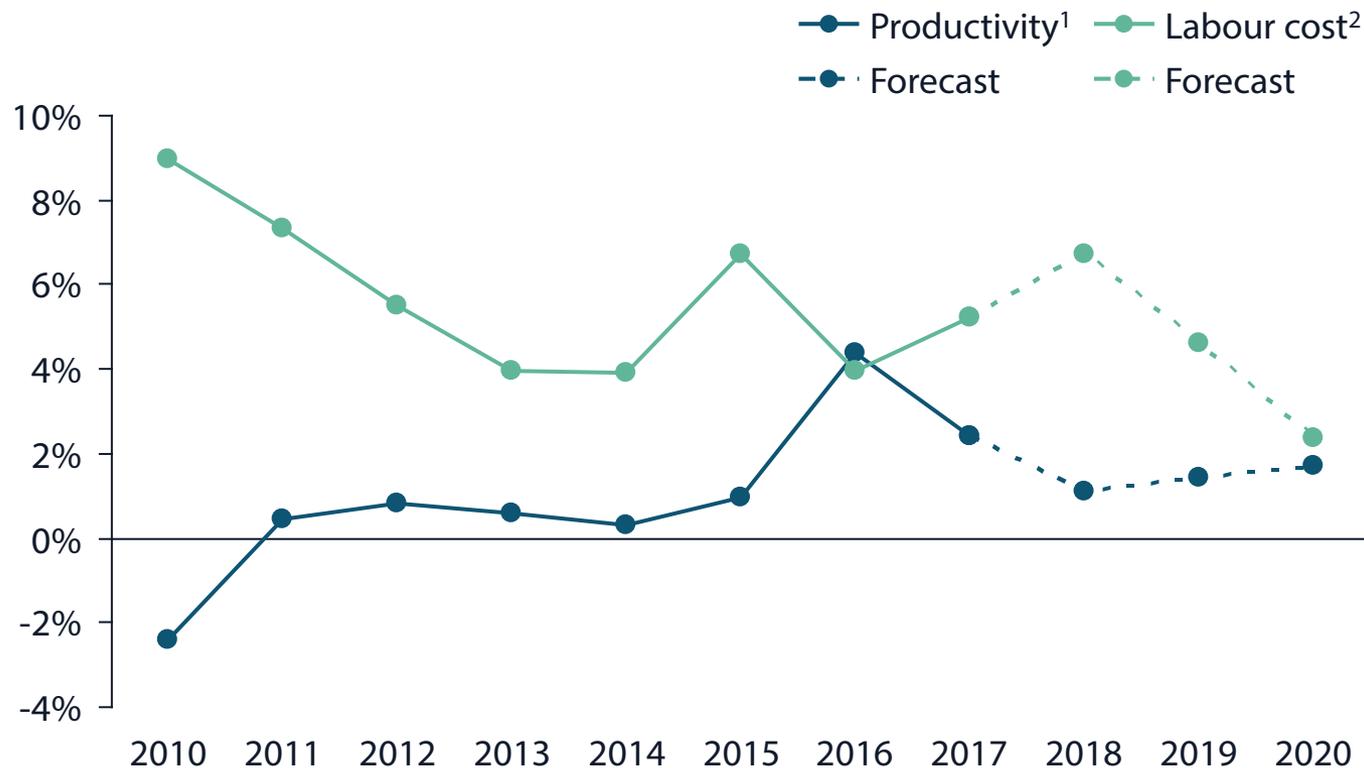
¹ All sector definitions are according to NACE V.2.

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

Figure 2.19

There has been a pickup in productivity, although the same can be said of labour cost

Labour Productivity and Cost (Percent change from previous year)



1 A different measure on productivity than in figure 2.17. See more on p. 45-47 in full report.

2 Labour cost per unit produced (Unit labour costs).

Figure 2.20

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



Figure 2.21

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

Purchasing Power and Prices (Index, 2010 = 100)

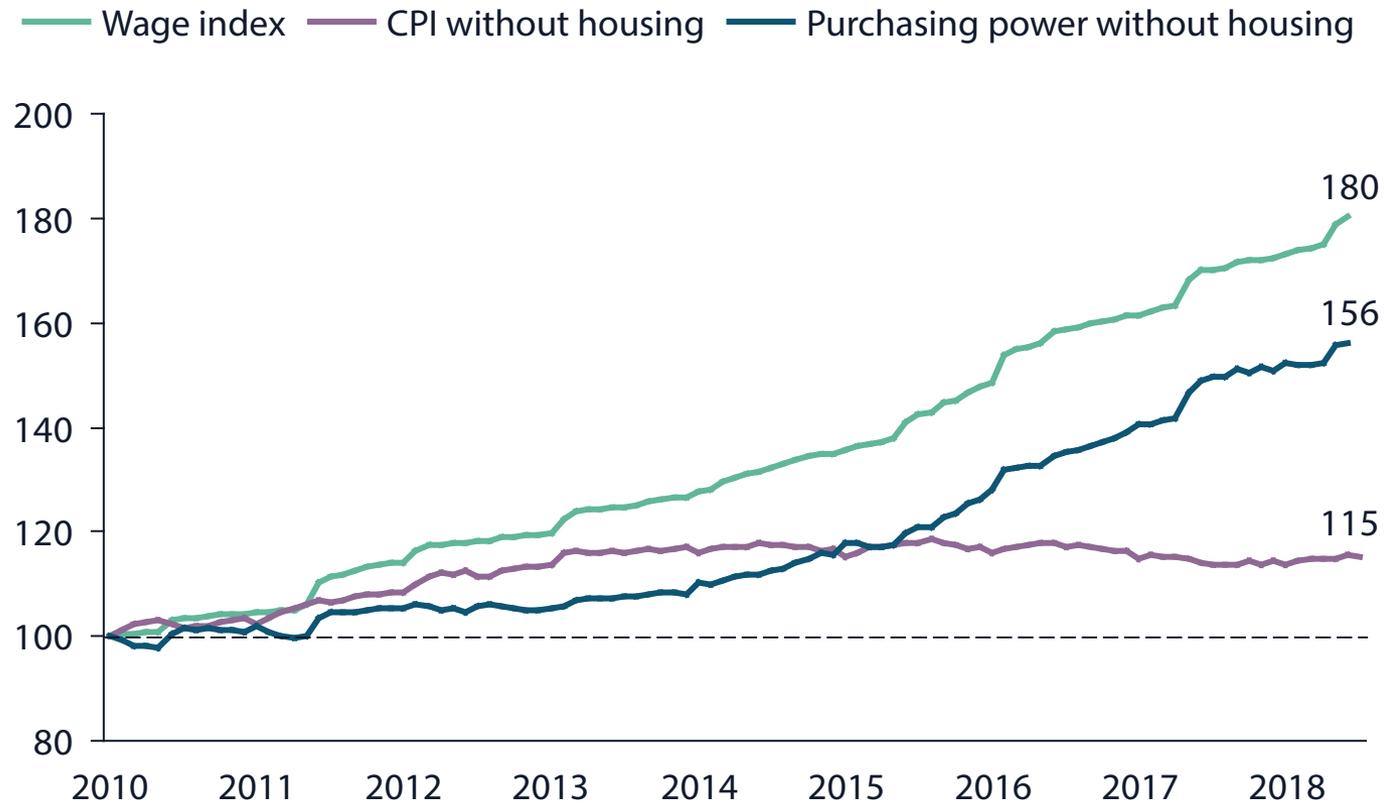
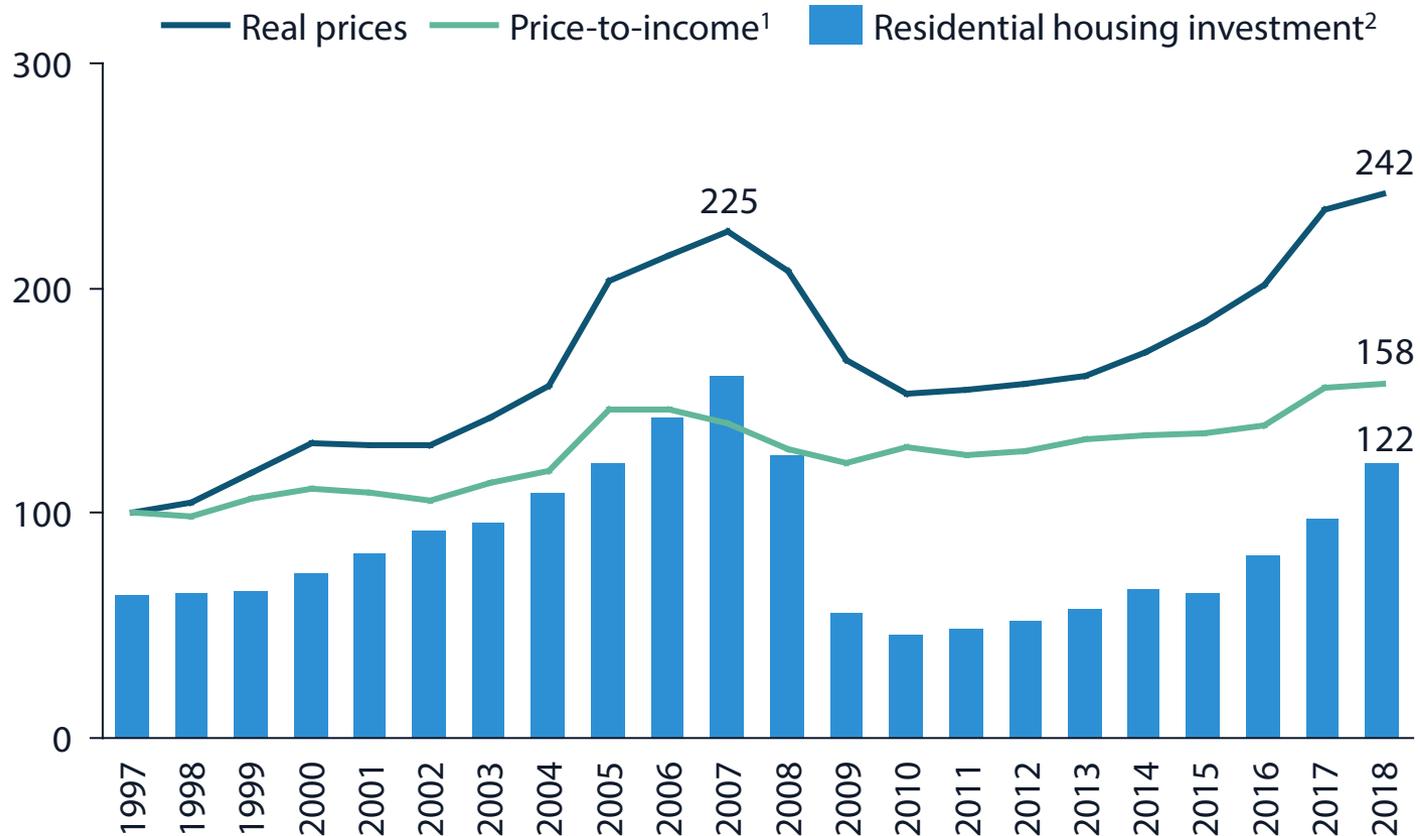


Figure 2.22

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 bn. ISK)



1 Housing prices/Disposable income per capita.

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

Figure 2.23

Historically, housing construction has kept up with population growth but in recent years they have diverged

Population and Housing Growth (Percent change YoY)

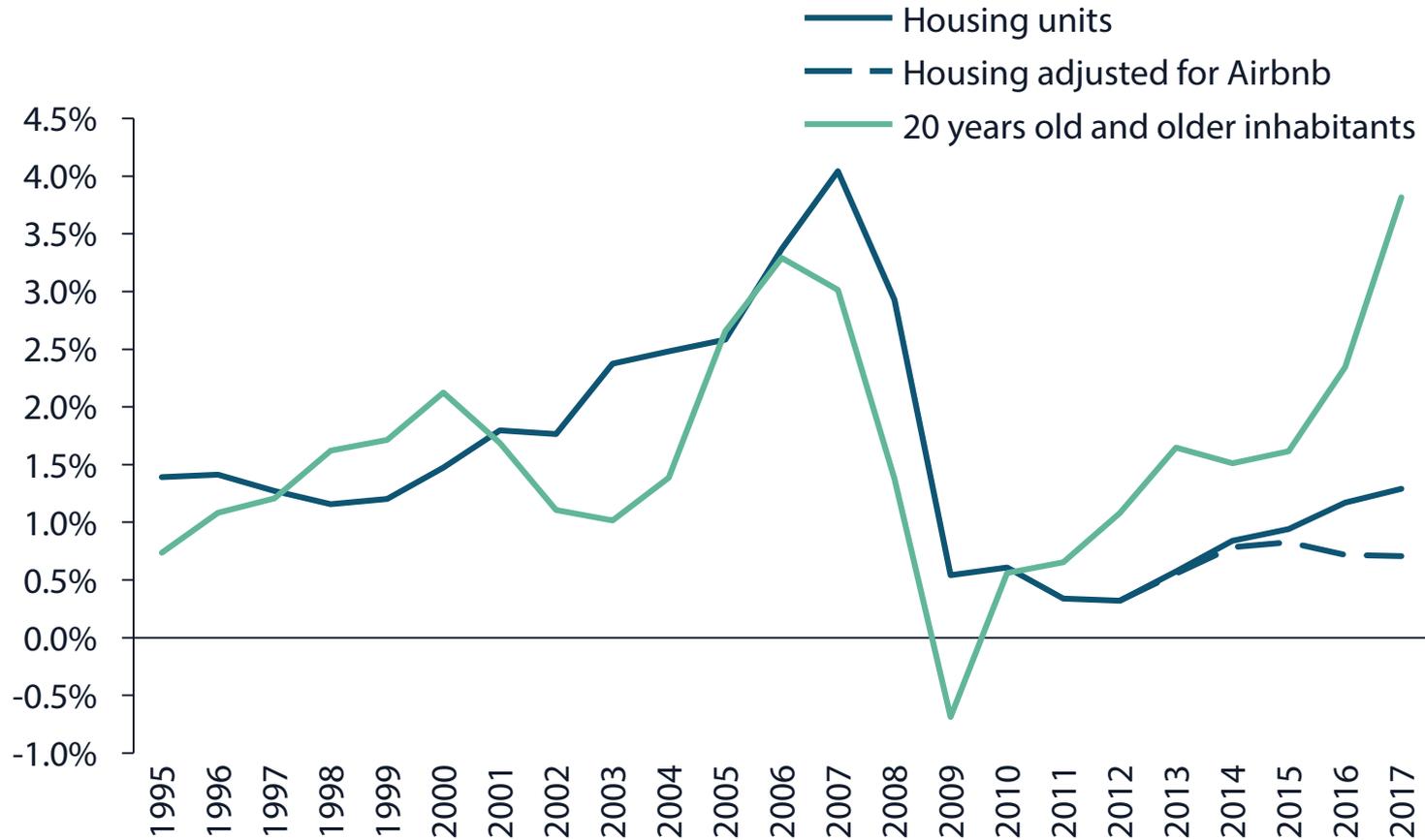


Figure 2.24

The economy is experiencing an influx of foreign labour once again

Net Changes in Labour Force (Percent change by background)

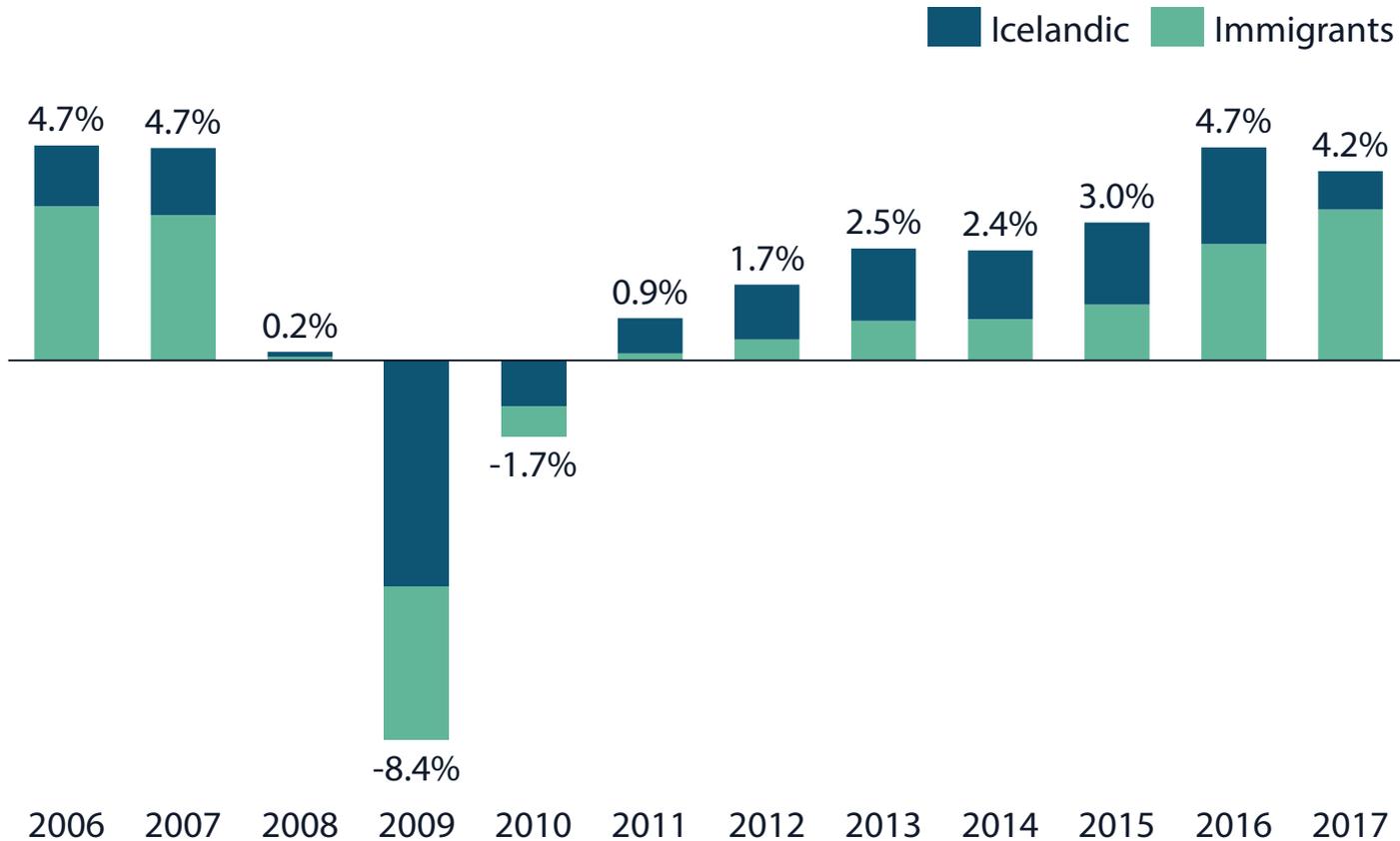


Figure 2.25

Wage increases have exceeded the cap in the SALEK agreement

Private and Public Market Increases (Wage index, percentage increases from 2013 level)

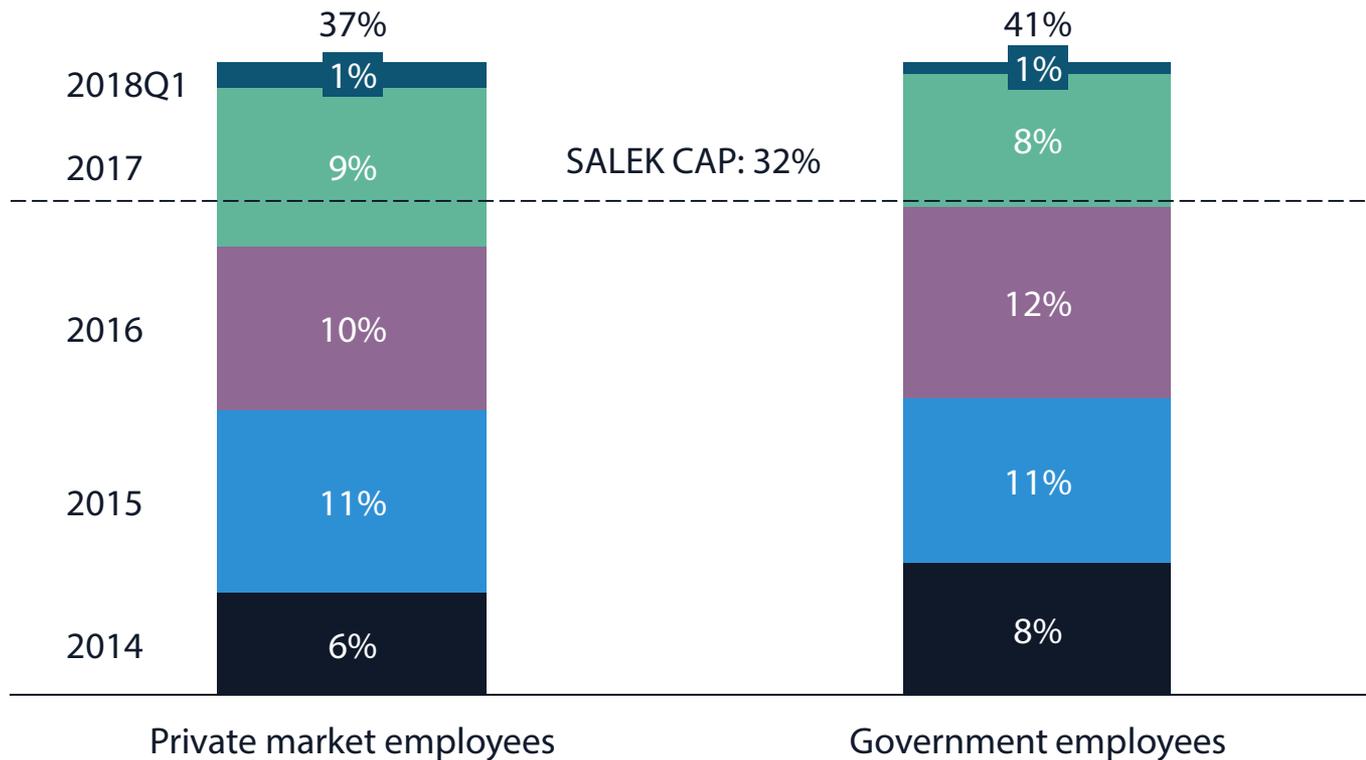
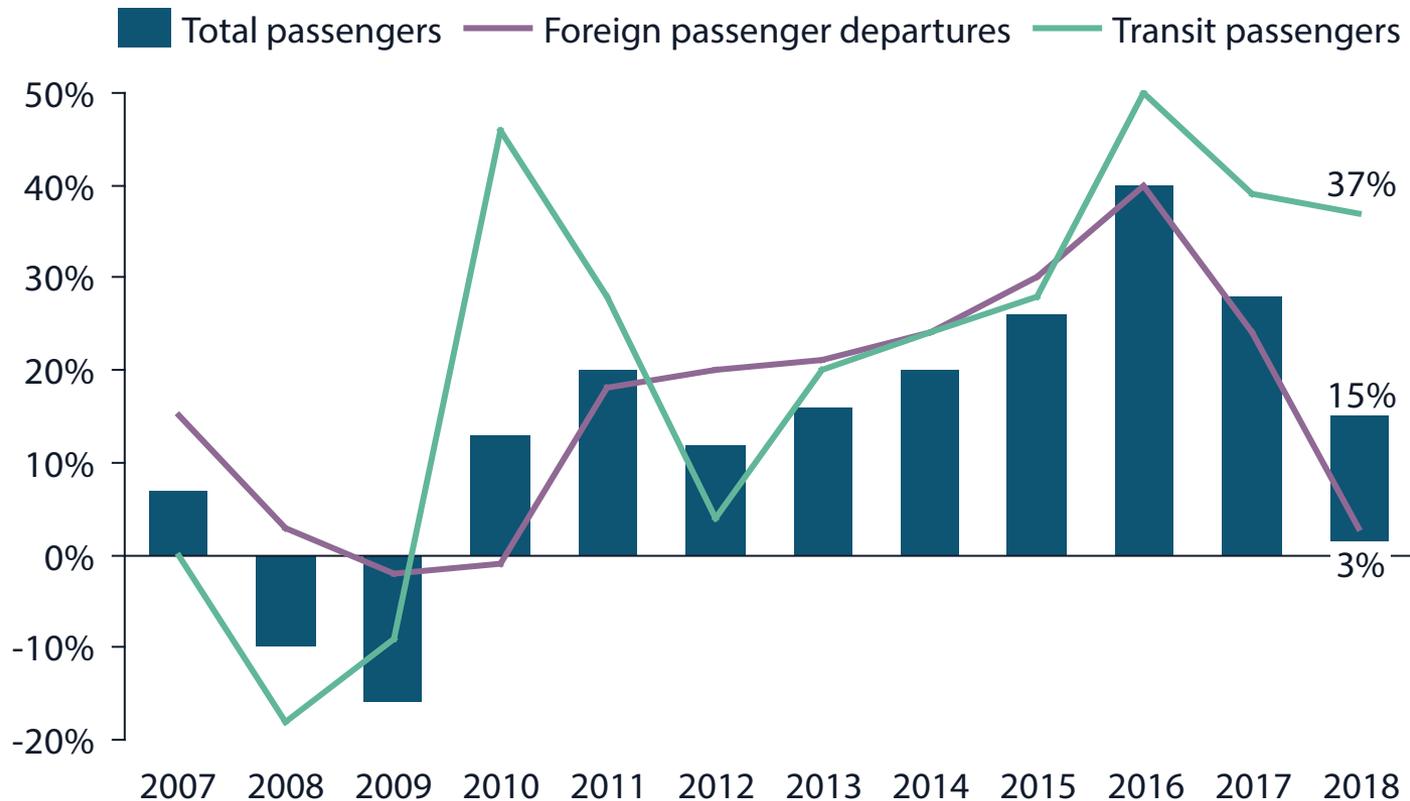


Figure 2.26

99% of incoming tourists go through Keflavík airport which has seen extraordinary growth in the last 3 years

Keflavík Airport Passengers¹ (Percent change)



¹ ISAVIA forecast for 2018.

Figure 2.27

Despite a 110% increase in no. of hotel rooms since 2007, occupancy rates have increased, particularly during winter

Hotel Occupancy Rate in Iceland (Per month)

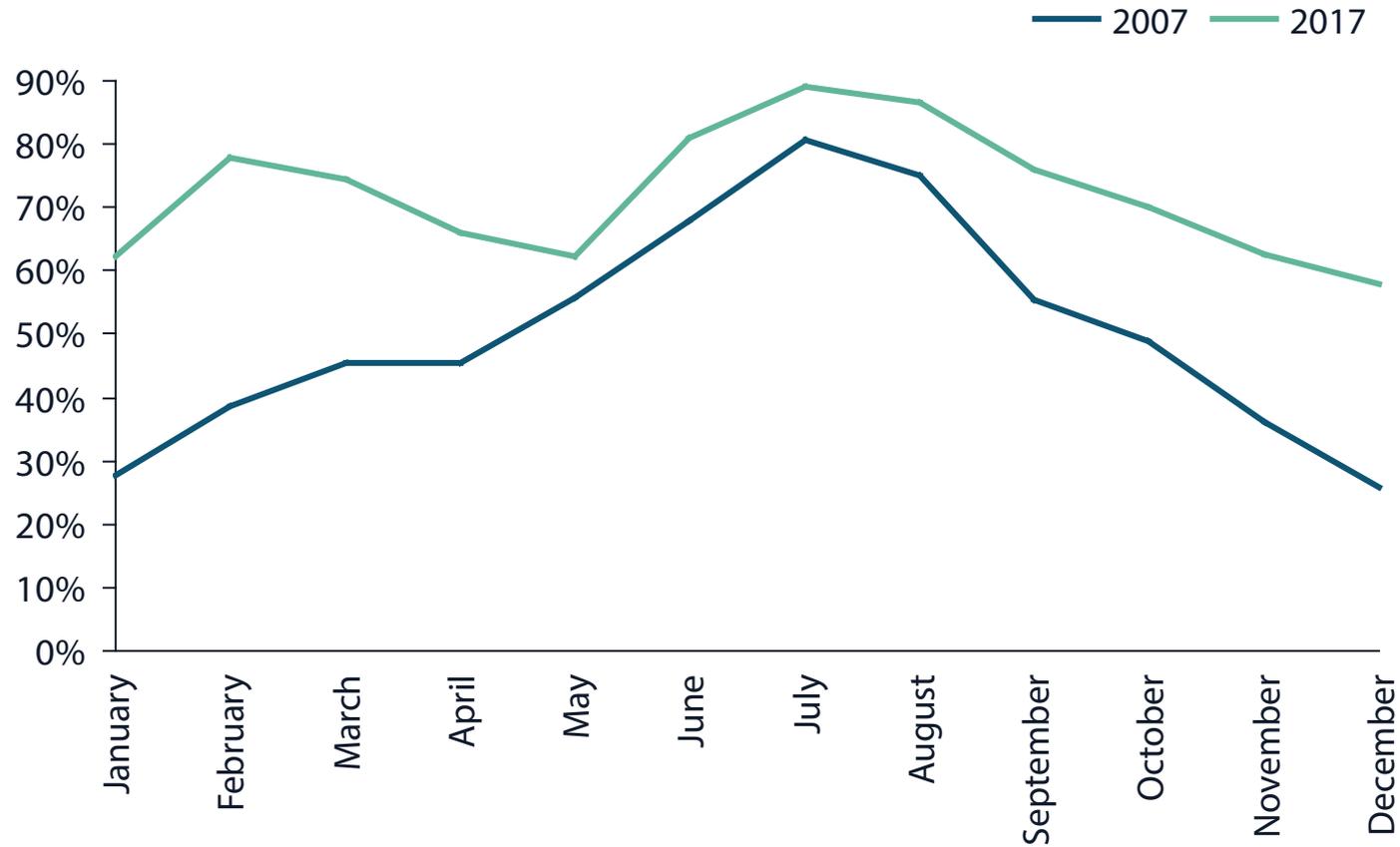


Figure 2.28

Iceland is once again one of the most expensive destinations

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

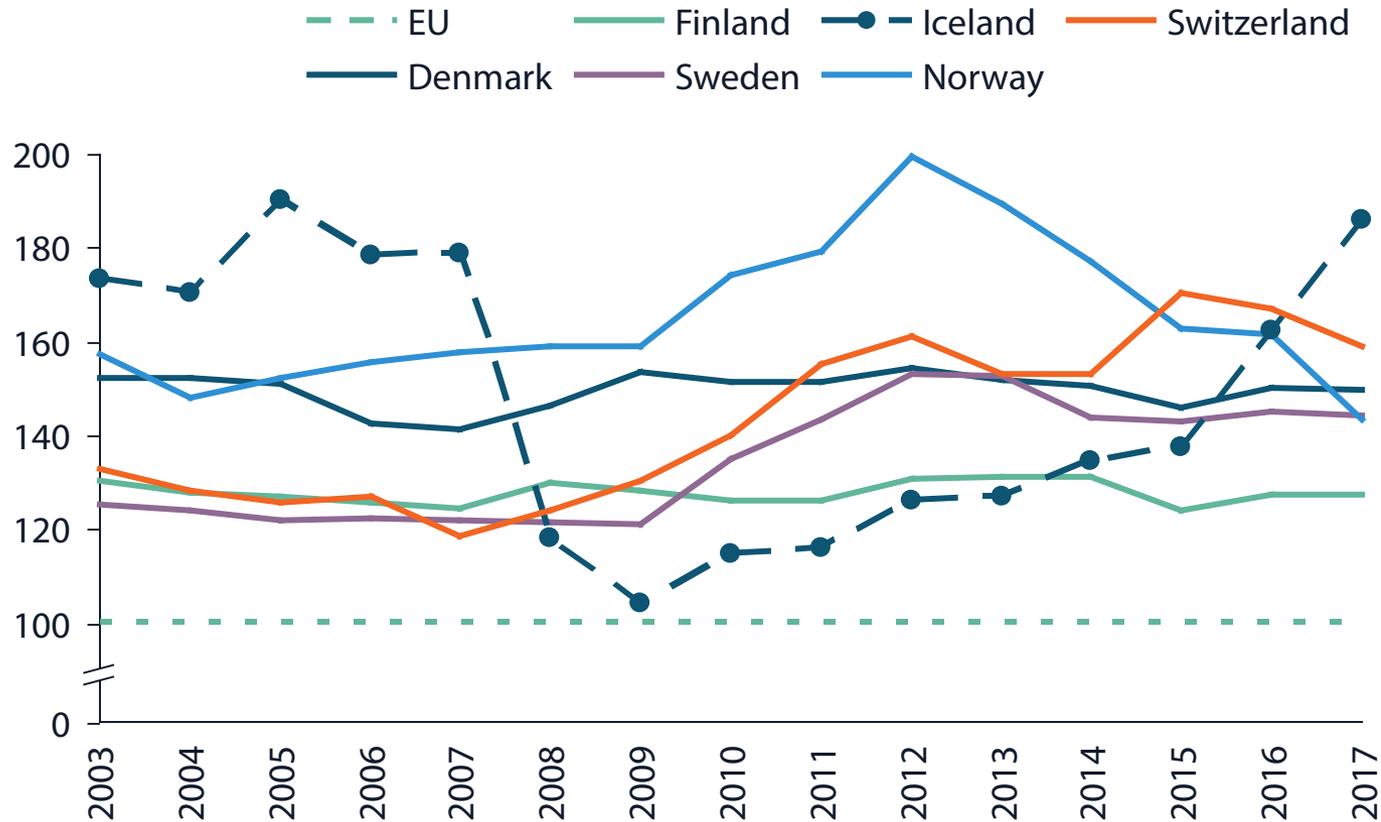


Figure 2.29

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

Cost of Living Index (Index, New York = 100)

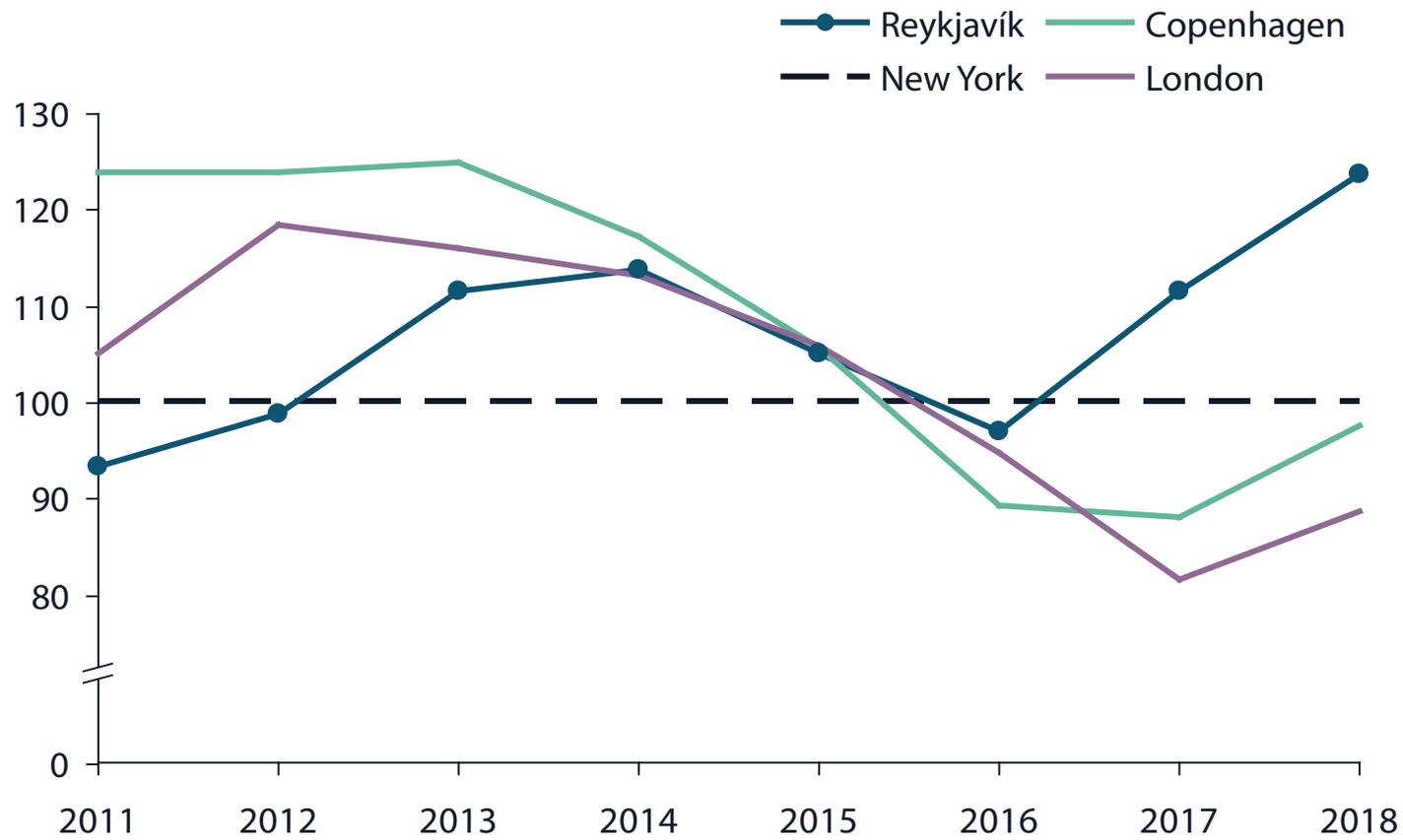
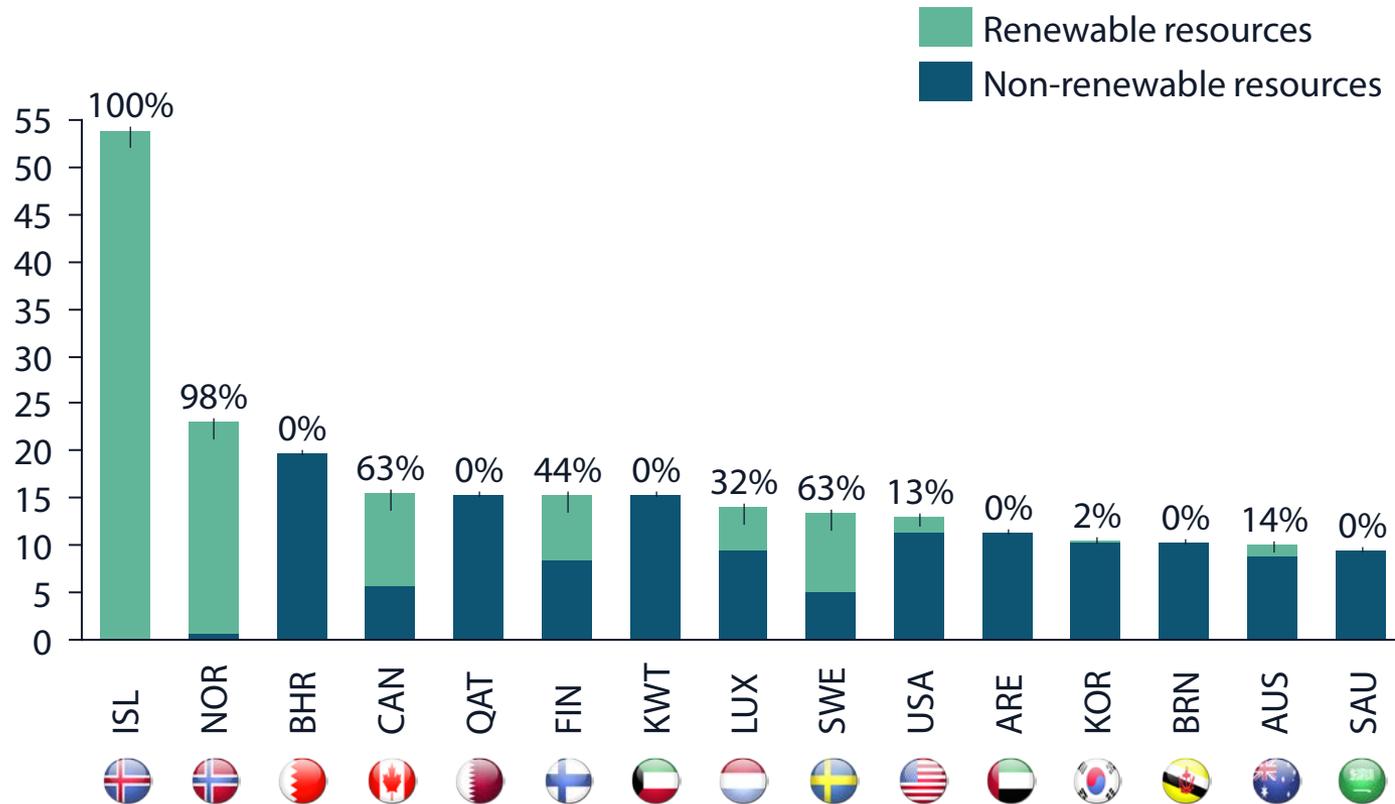


Figure 2.30

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 2.31

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

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

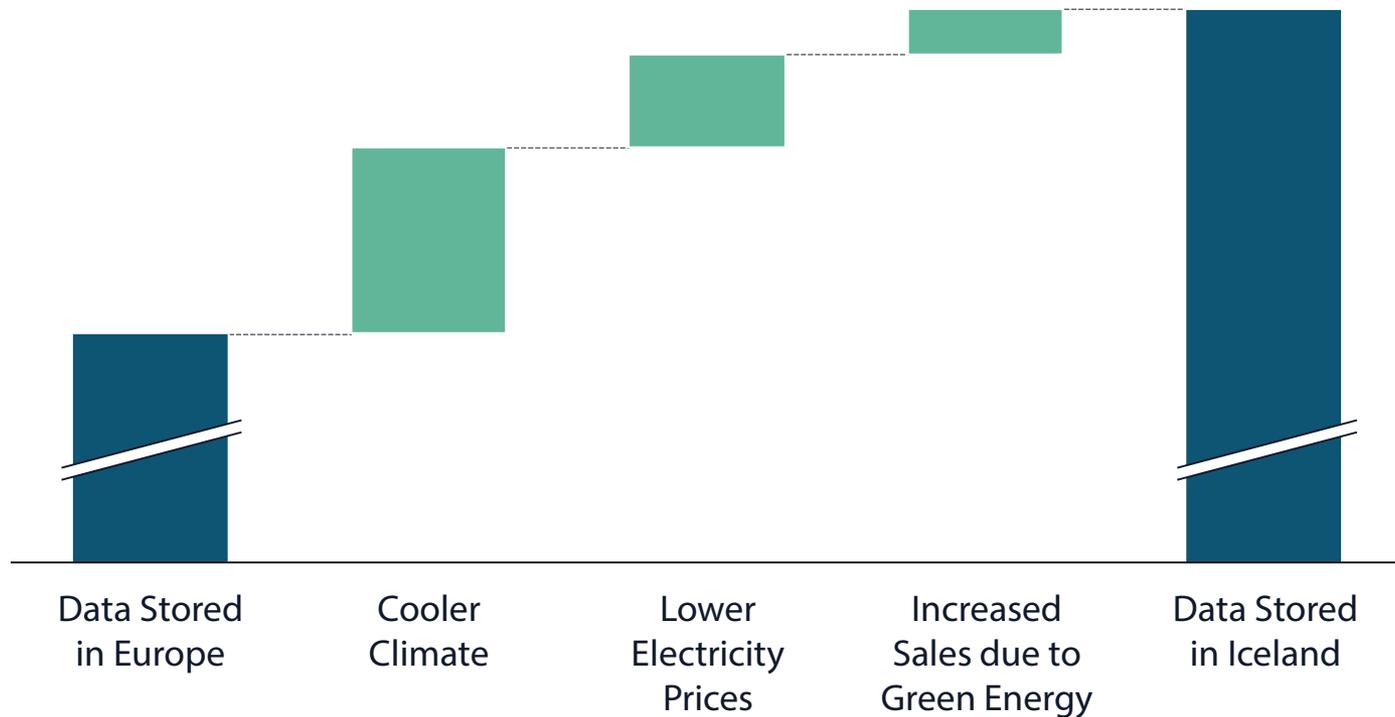


Figure 2.32

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

Seafood Industry (Investment and Productivity)

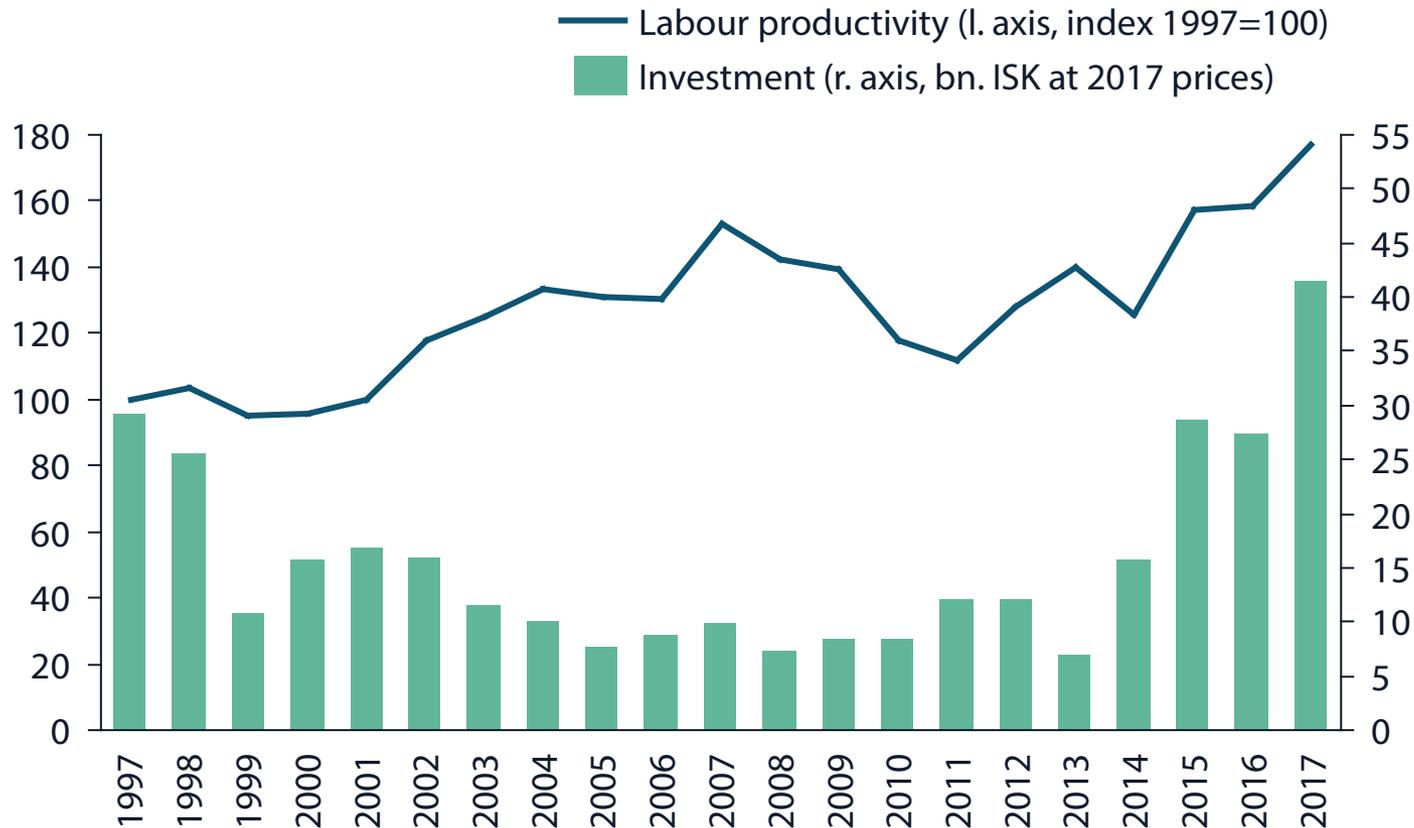
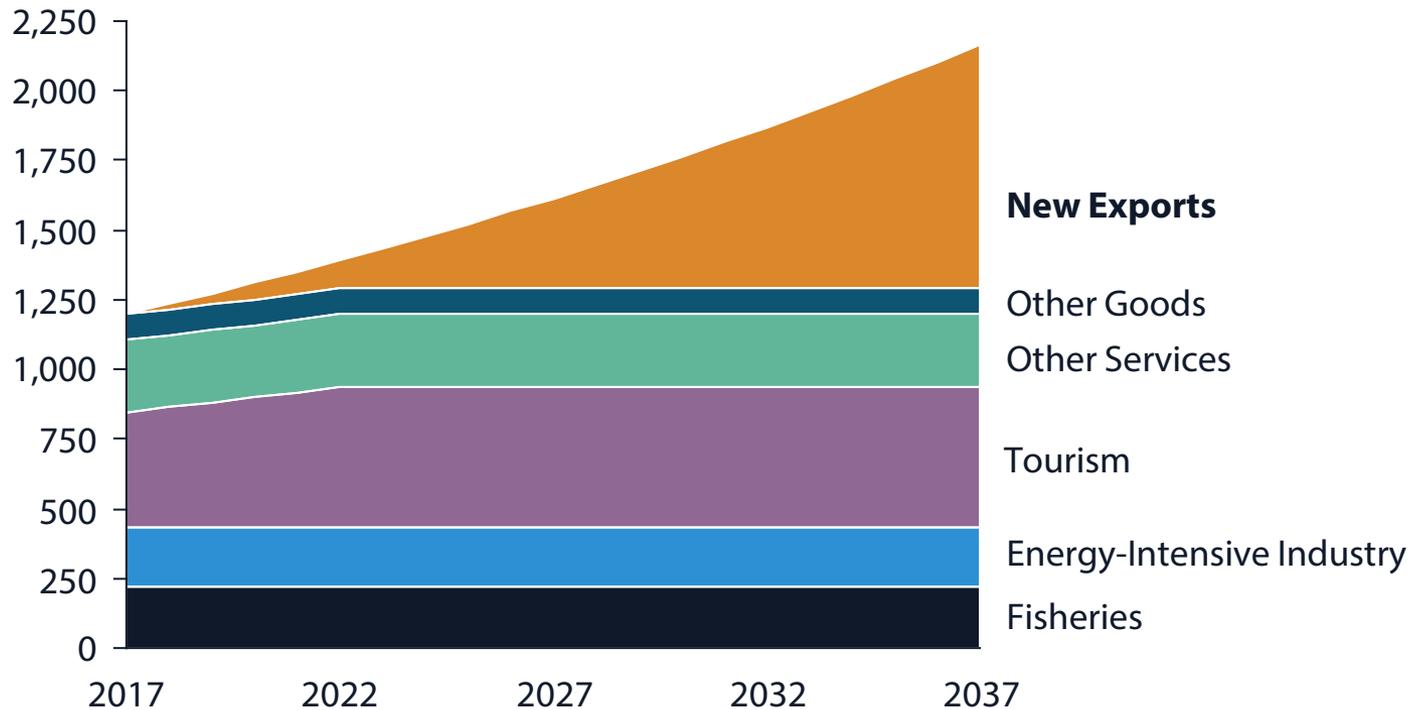


Figure 2.33

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)



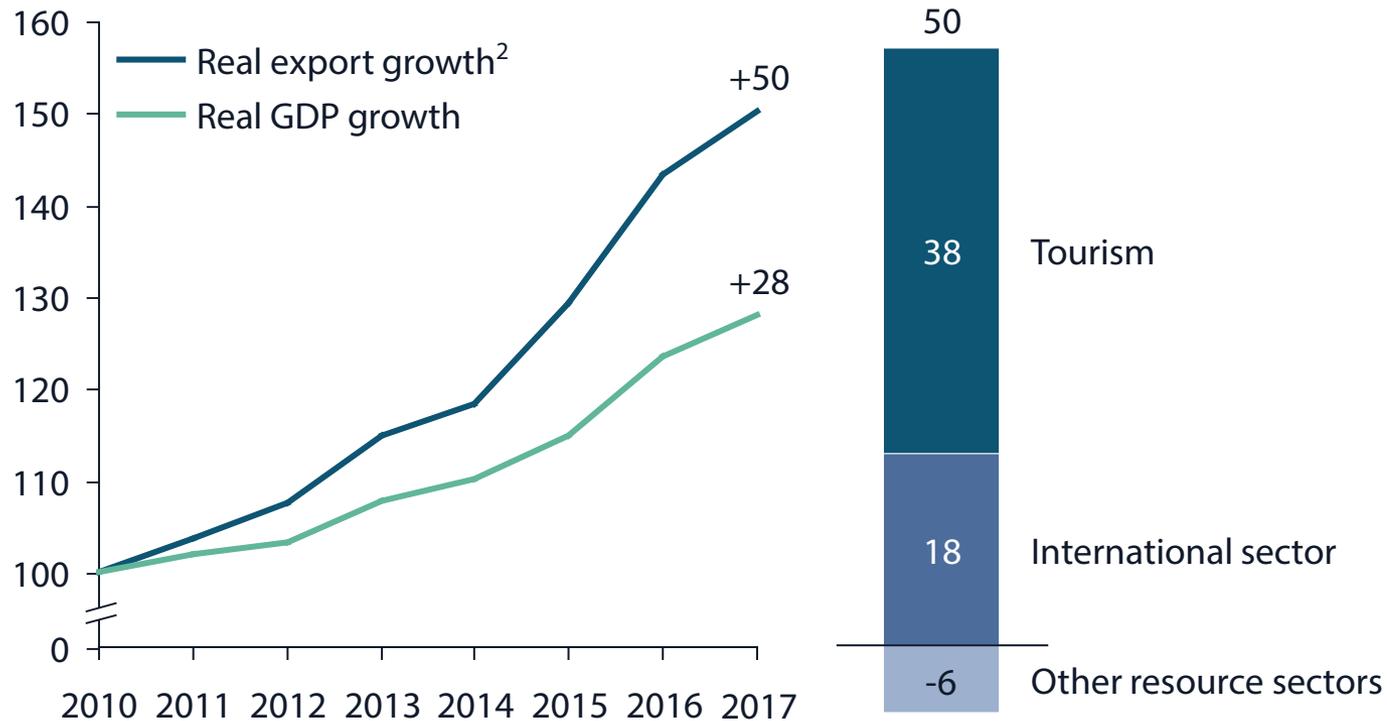
¹ McKinsey assumed a goal of 4% growth p.a. but the Chamber believes a 3% growth rate is more realistic over the long run. Tourism exports are assumed to grow at a 4% rate until 2022.

² Real ISK.

Figure 2.34

Export growth has exceeded headline growth in real terms

Real GDP & Export Growth by Sector¹ (Chain linked volume, inflation adjusted, 2010 = 100)



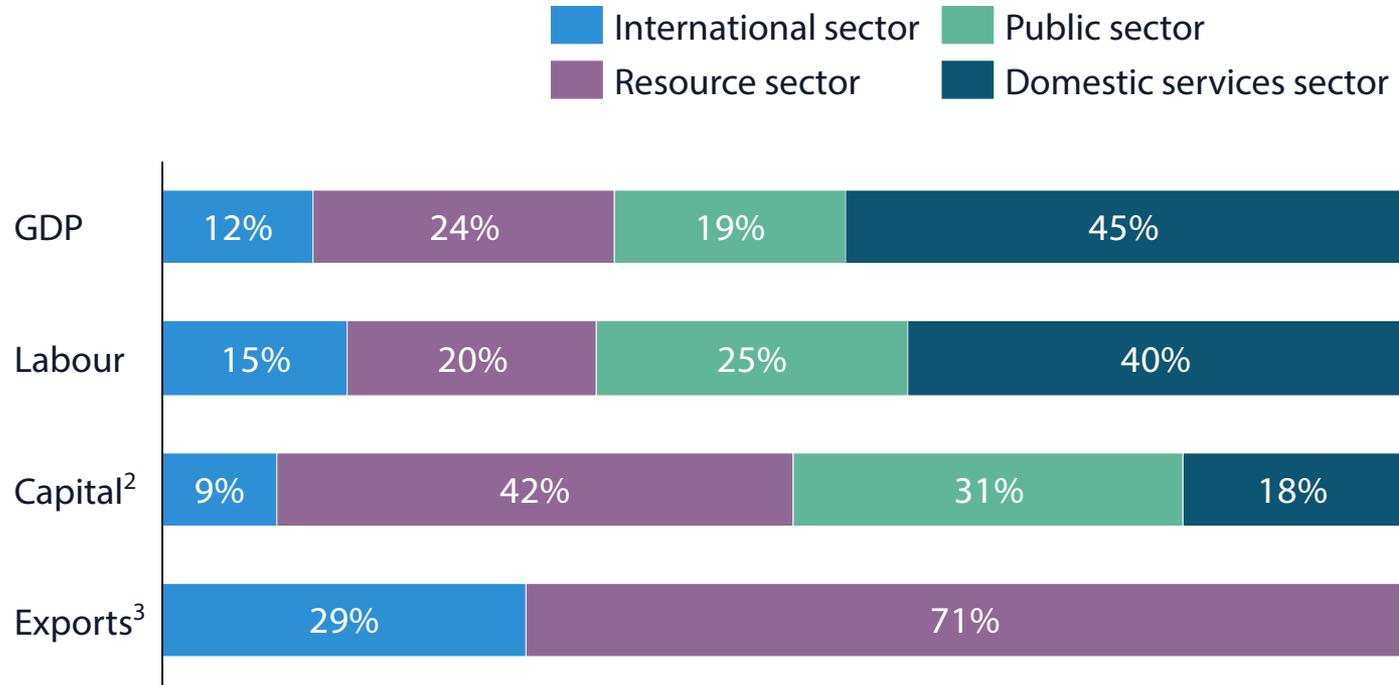
¹ International sector is defined as total exports net of seafood, agriculture, tourism, aluminum, silicon and 50% of air transportation.

² Chain linked volume.

Figure 2.35

The international sector is holding on to its share of the economy despite the tourism boom

GDP, Labour, Capital and Exports by sector¹ (Percentage of total, 2017)



1 i) International sector: NACE REV 2: CA, C; 50% of M, S; 40% of J; 20% of N ii) Resource sector: NACE REV 2: A, B, CA, CH, D, E; 60% of H, I; 20% of R. iii) Public sector, NACE REV 2: O, P, Q. iv) Domestic services sector, NACE REV 2: F, G, K, L, ; 80% of R; 60% of J; 50% of M, S; 40% of H, I; 20% of N.

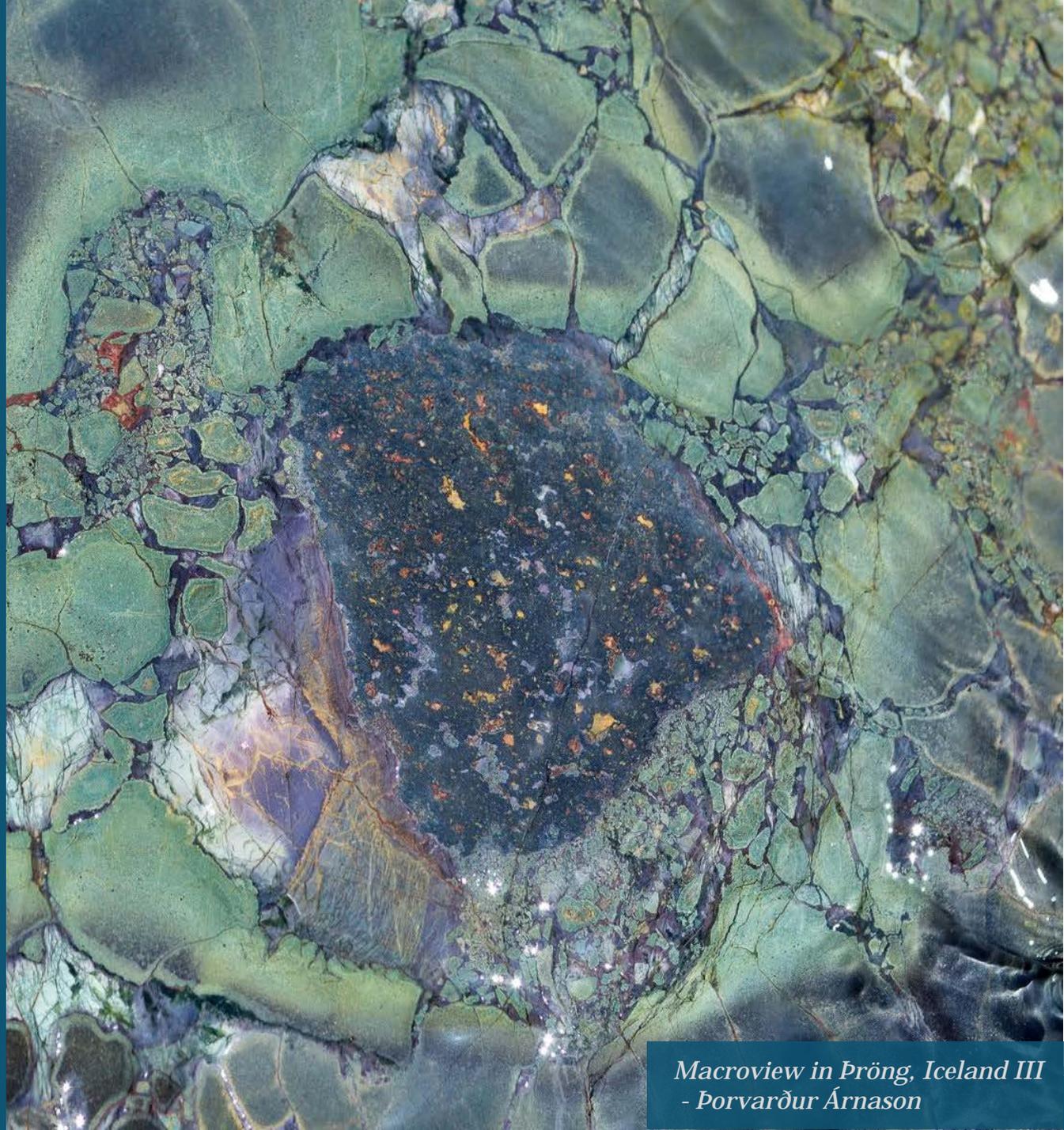
2 Capital stock does not include residential capital or unclassified activities.

3 Resource sector exports defined as fisheries, aquaculture, tourism, aluminum, silicon and 50% of air transportation, International sector accounts for everything else.

Current
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*Macroview in Þróng, Iceland III
- Þorvarður Árnason*

Figure 3.1

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 3.2

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

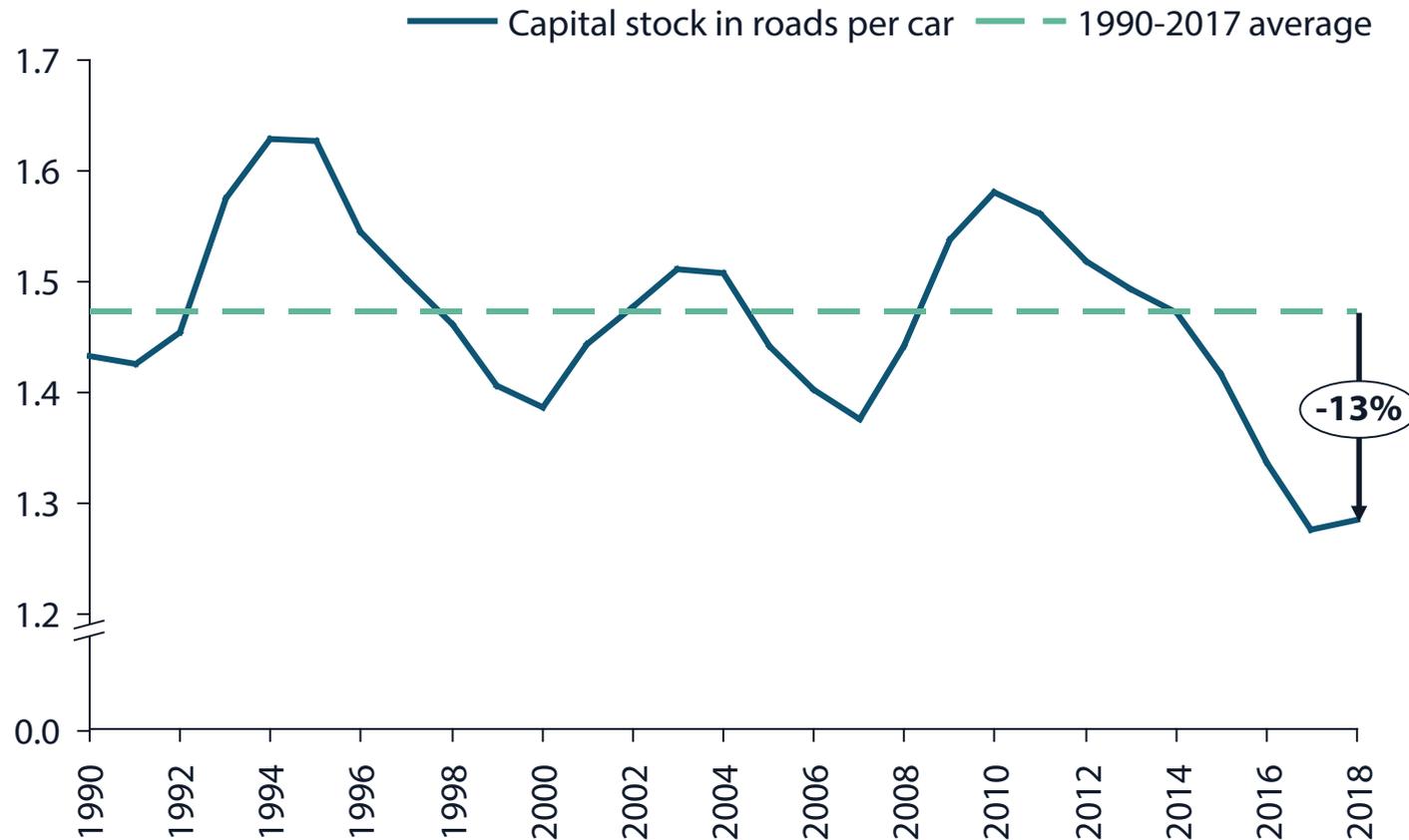
The Four Focus Lenses of Disruptive Trends

Lenses	Examples
 Digitisation	<ul style="list-style-type: none">Embrace technological changes to drive productivity improvements across sectorsImprove services and achieve cost efficiency through digitizationUse 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 economyEnsuring that all generation's talents match the need of the societyWelcome the world's talents and early stage entrepreneurs
 Environmental Sustainability	<ul style="list-style-type: none">Maximize value creation of Icelandic resource industriesProtect nature with focus on productivity and sustainabilityFocus 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 inImprove the business environment through tax and regulatory reformFocus on new business development, M&A and alliance building

Figure 3.3

Lack of investment on top of increasing traffic indicates that investment in roads and bridges needs to pick-up

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

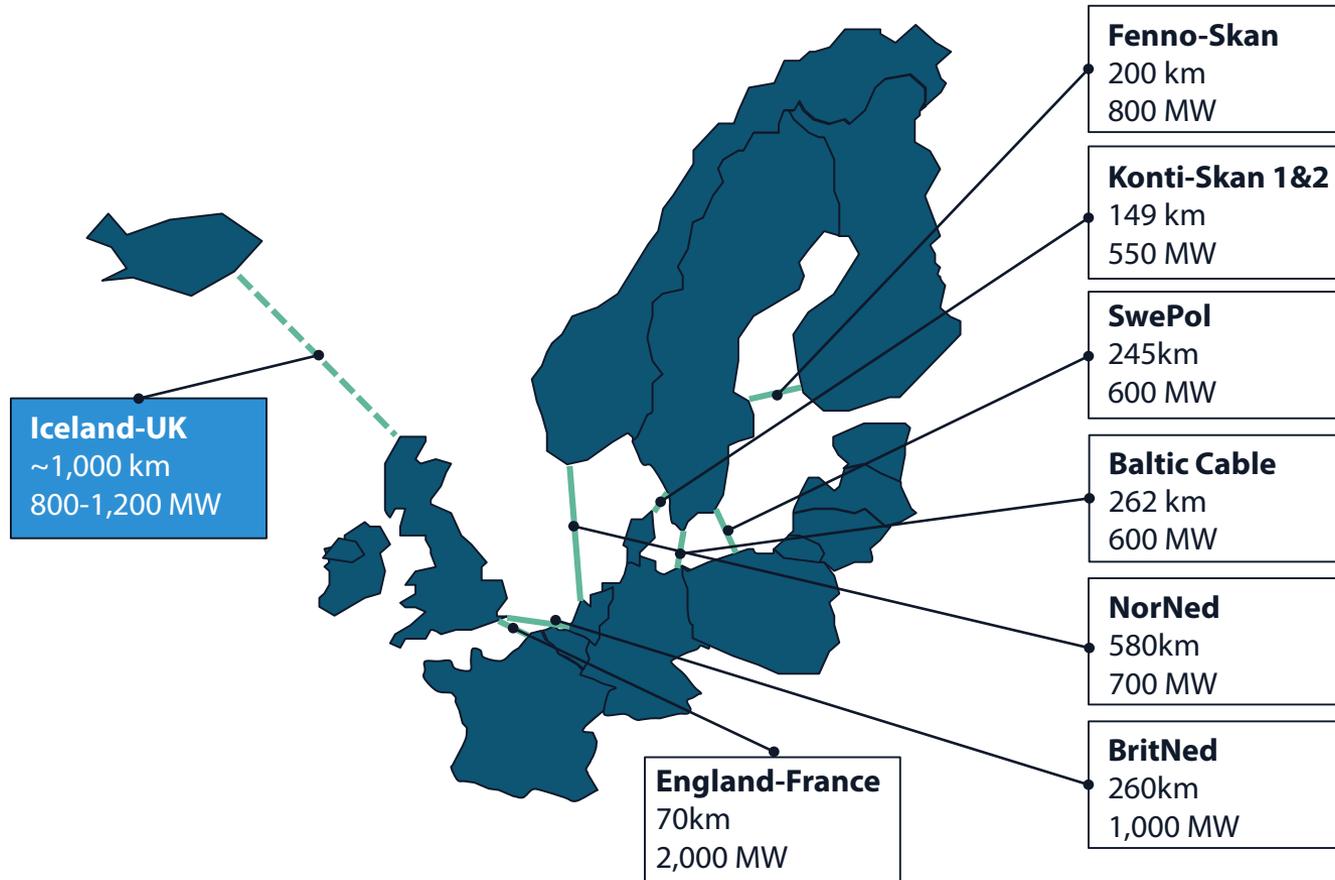


¹ ICoC projection for 2018 based on Althingi's budget. Number of cars growth projected the same as GDP growth in 2017-18

Figure 2.31

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

Interconnectors in Northern Europe (Length and capacity)





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