



# The Icelandic Economy

Current State, Recent Developments and Future Outlook

# Key Facts



## Did you know?

- The number of tourists visiting Iceland in 2015 is expected to be quadruple the country's population
- Iceland's parliament, Alþingi, was established in 930 AD, making it the world's oldest extant parliamentary institution in the world
- Iceland is one of the least densely populated countries in the world, with only 3.2 inhabitants per km<sup>2</sup>
- Vigdís Finnbogadóttir, the 4th president of Iceland, was the first democratically elected female head of state

# Foreword

In 2008 the Icelandic economy underwent dramatic changes concomitant to the collapse of its financial sector. At the same time, foreign parties interested in Iceland experienced difficulties accessing in English a holistic overview of events and the status of the economy following the crisis.

To remedy this, in October 2008 the Iceland Chamber of Commerce (ICoC) published the first edition of this report. Our aim is to provide an objective overview of the current economic, business and political landscape in Iceland, recent events and developments, and future economic prospects.

Since its first publication, the report has been regularly revised and updated. Considerable changes have been made to the current edition, with more focus on the current economic landscape, on-going challenges and future prospects, with less focus on past events.

This report is divided into three sections. The first section is primarily a fact-based overview of Iceland's current economic landscape. The second section is a more descriptive review of recent developments. Lastly, the third section portrays potential future scenarios and longer term growth prospects.

More detailed information on the financial crisis and its immediate consequences can be found in earlier editions. The current and previous editions of this report, in addition to a presentation based on its contents, can be accessed on the ICoC's webpage.

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



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of Commerce

# Acknowledgements

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Figure 1.1

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

Country rankings, GDP per capita (PPP adjusted)

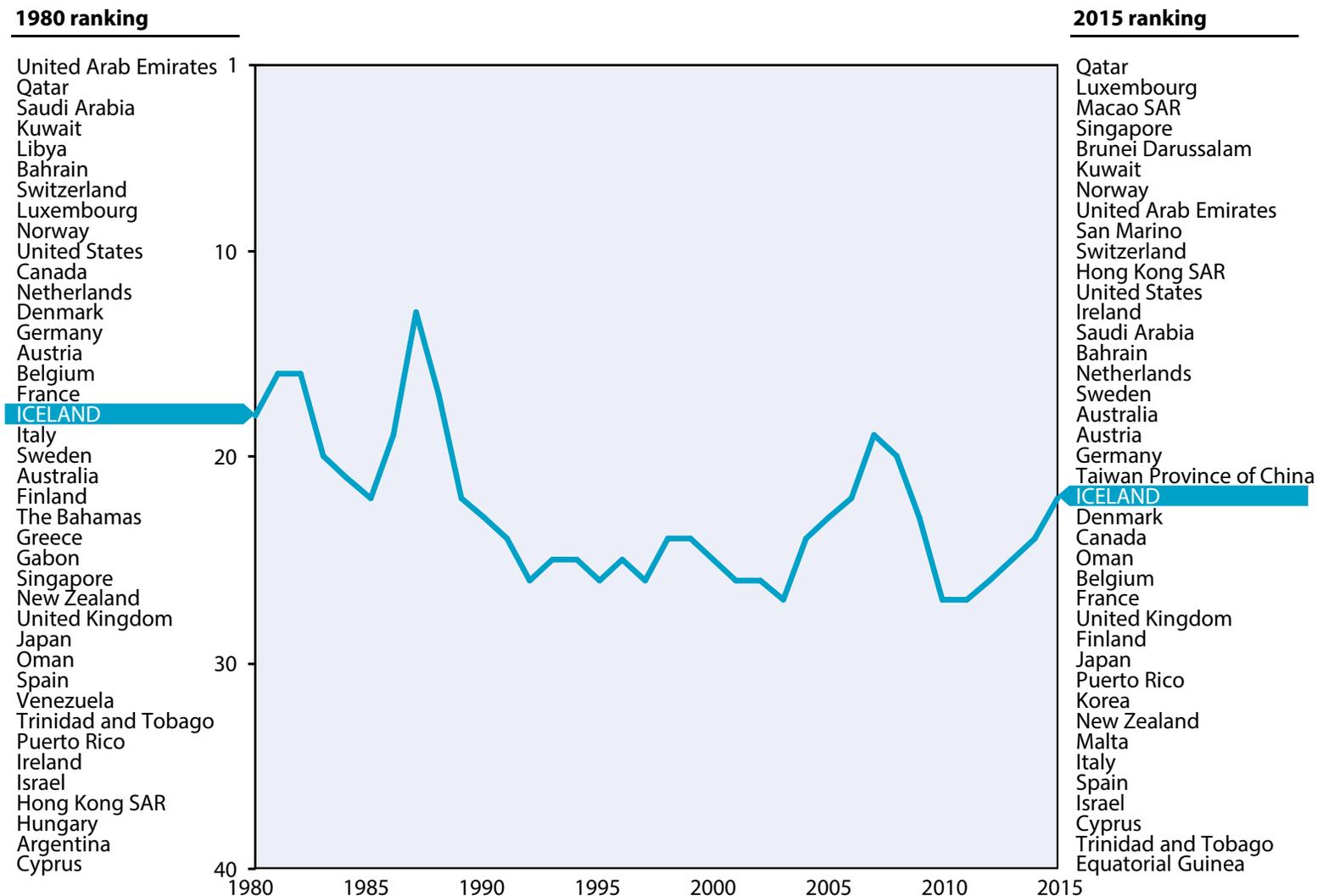


Figure 1.2

# Iceland ranks highly in numerous competitive indices

Competitiveness rankings (Iceland's latest rank and total number of countries in index)

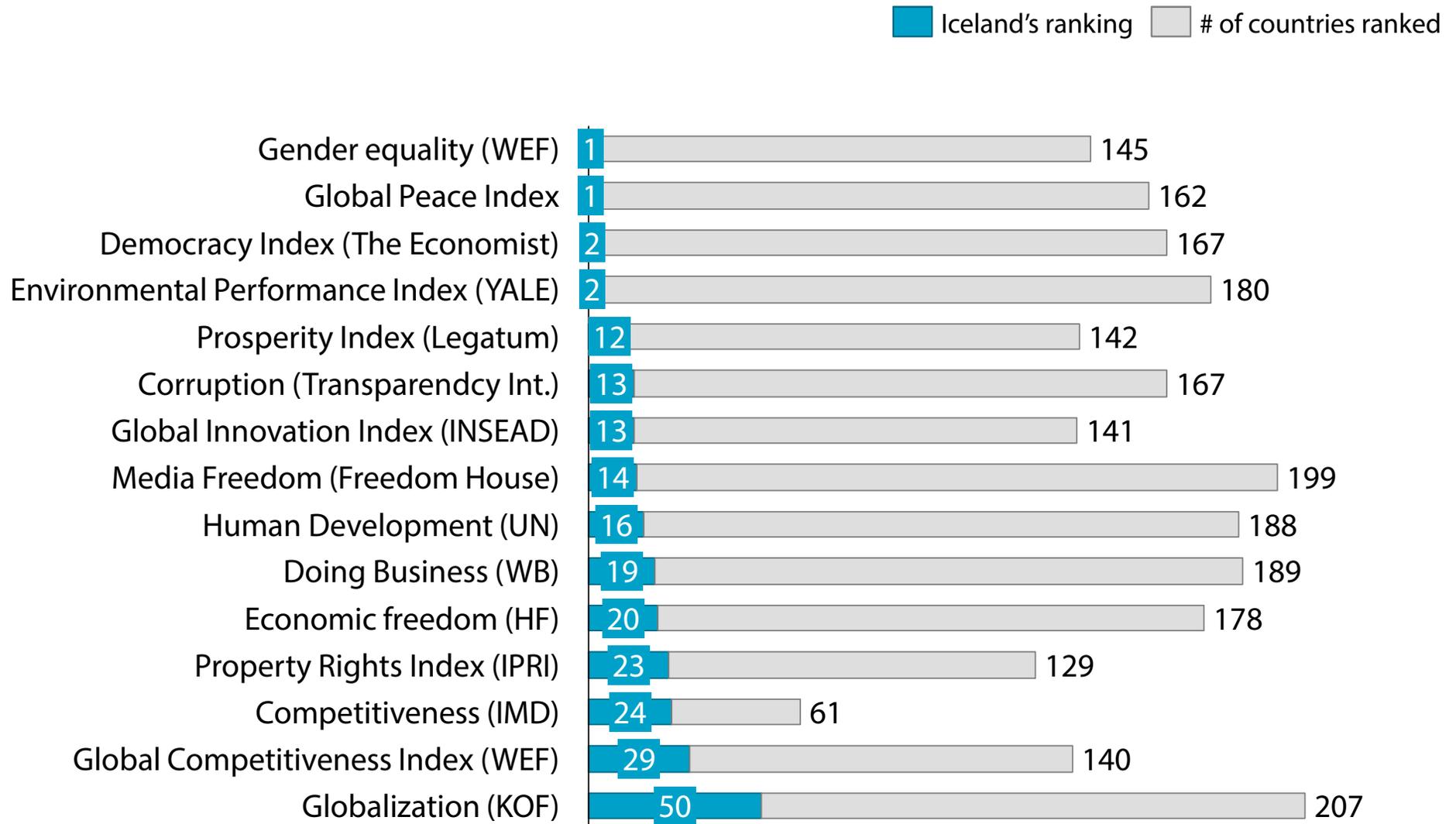


Figure 1.3

# The economy shrank following the crisis in 2008 but is now experiencing growth and a positive future outlook

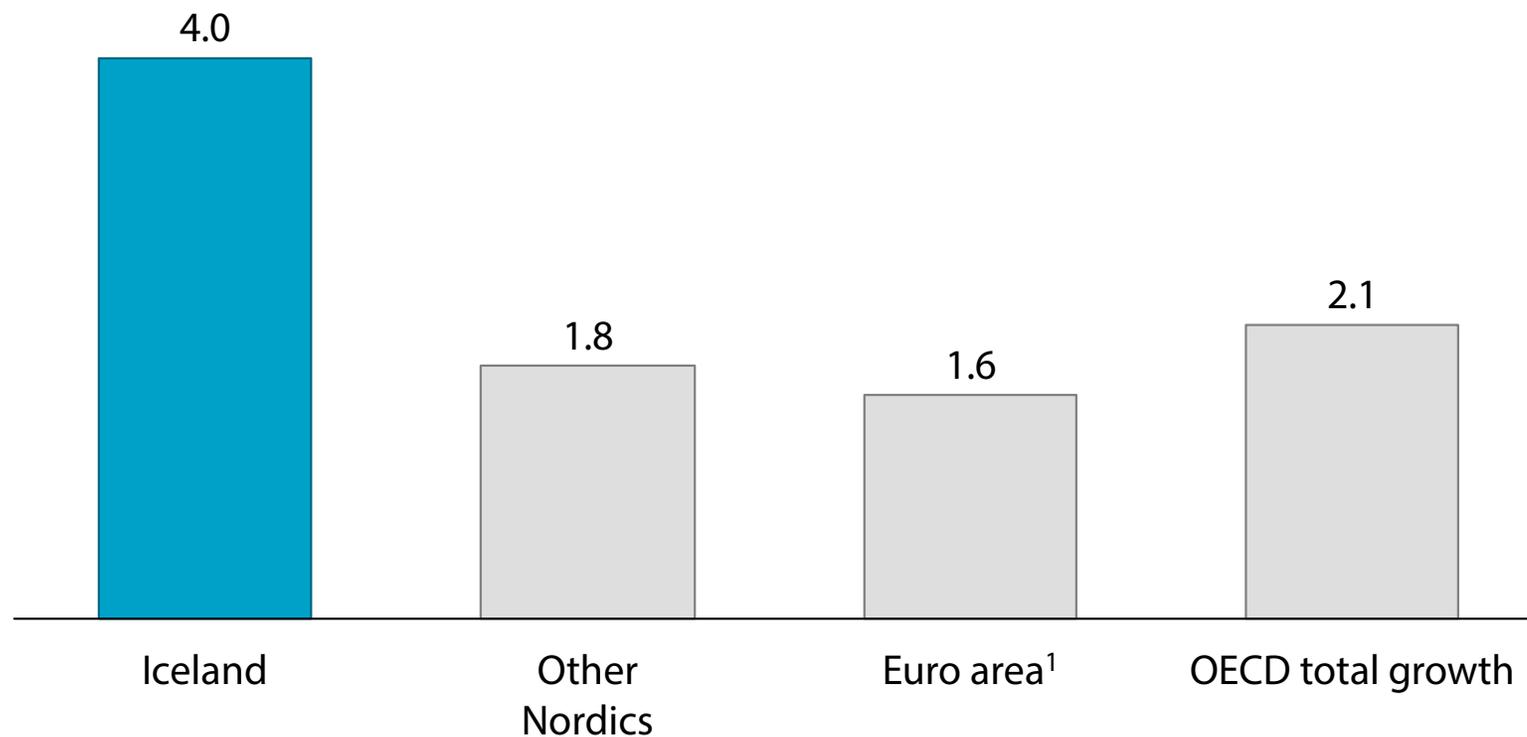
Real GDP growth per capita (percent)



Figure 1.4

# Iceland's growth rate in 2015 was especially strong in global comparison

GDP growth in 2015 (percent)



<sup>1</sup> 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 has decreased after a sharp rise in 2009 and is approaching structural unemployment levels

Unemployment rate, yearly average (percent)

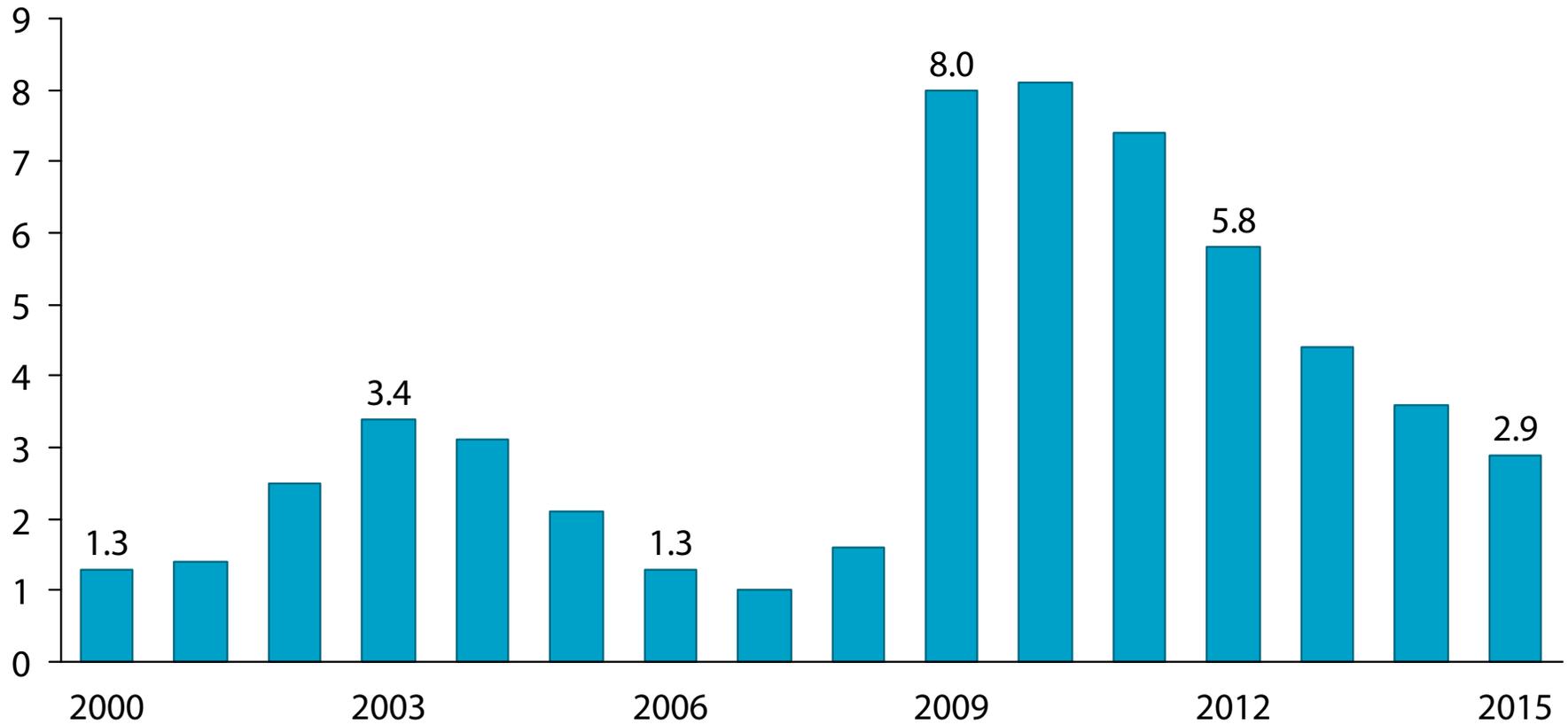


Figure 1.6

# Private debt has gradually declined, especially corporate debt, and is now at pre-crisis levels

Corporate and household debt (percent of GDP)

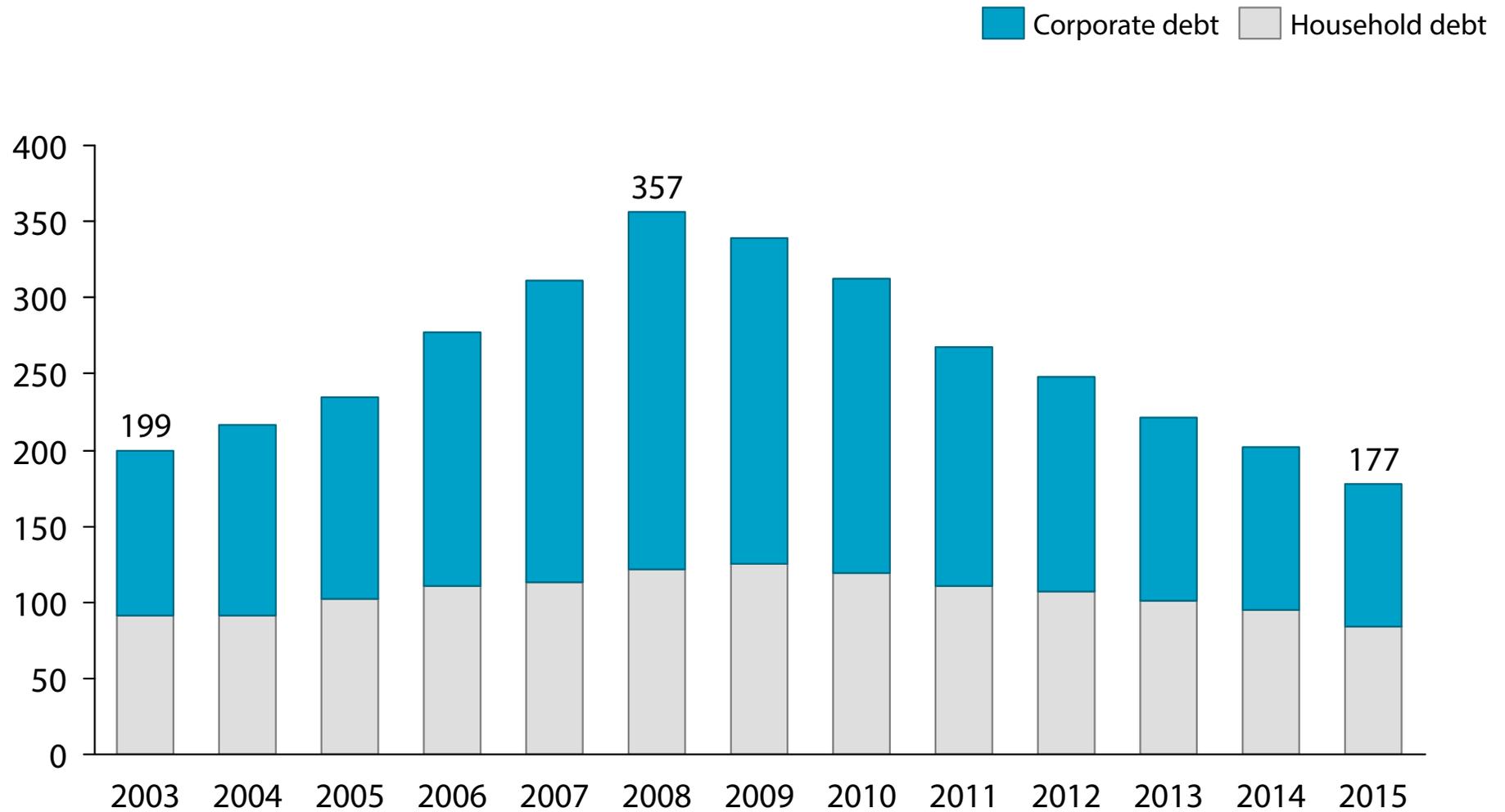
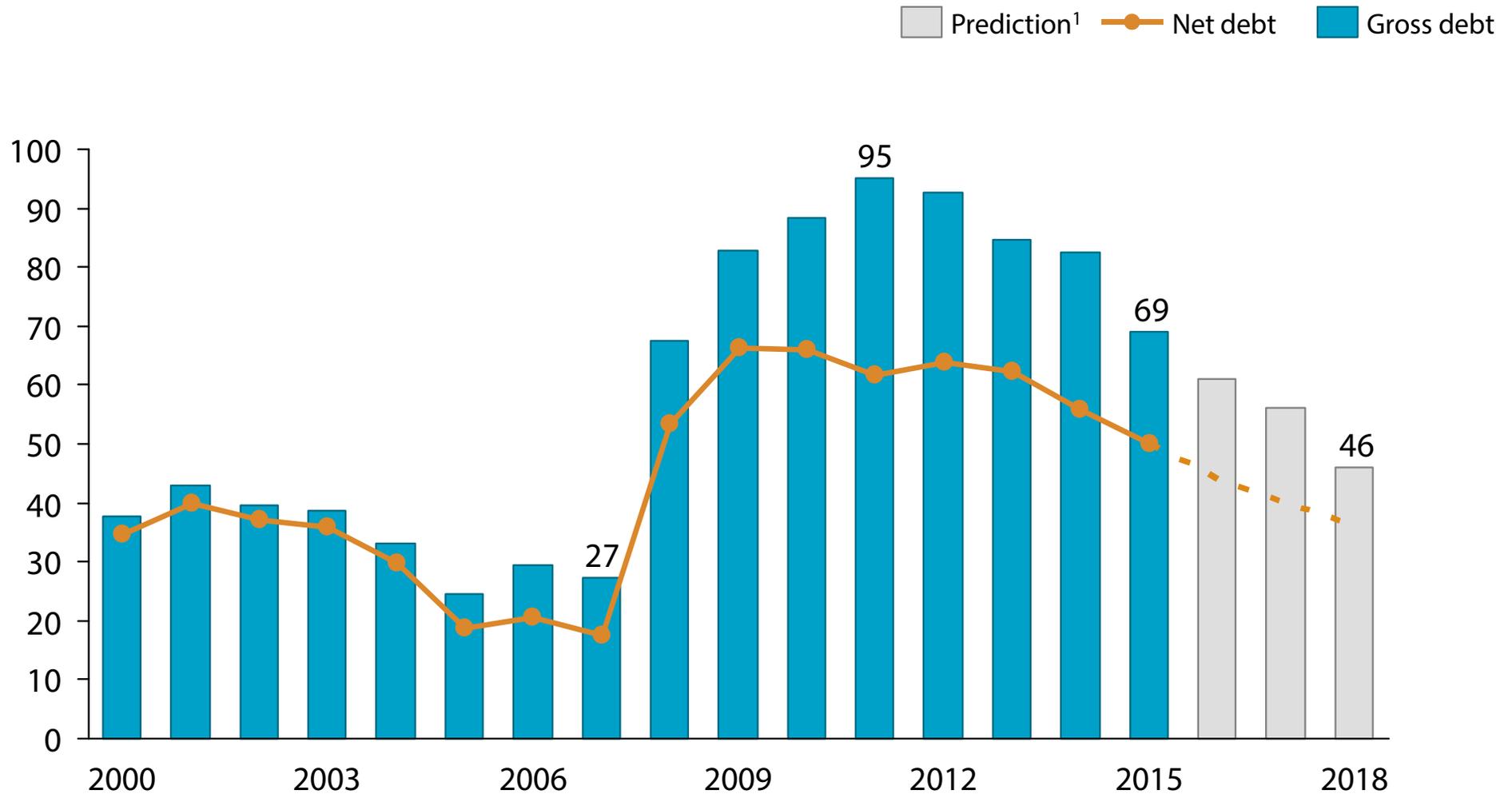


Figure 1.7

# Public debt more than tripled following the financial crisis in 2008, but has gradually declined in recent years

General government debt (percent of GDP)



<sup>1</sup> Central Bank of Iceland's prediction

Figure 1.8

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

Annual inflation rate (percent)

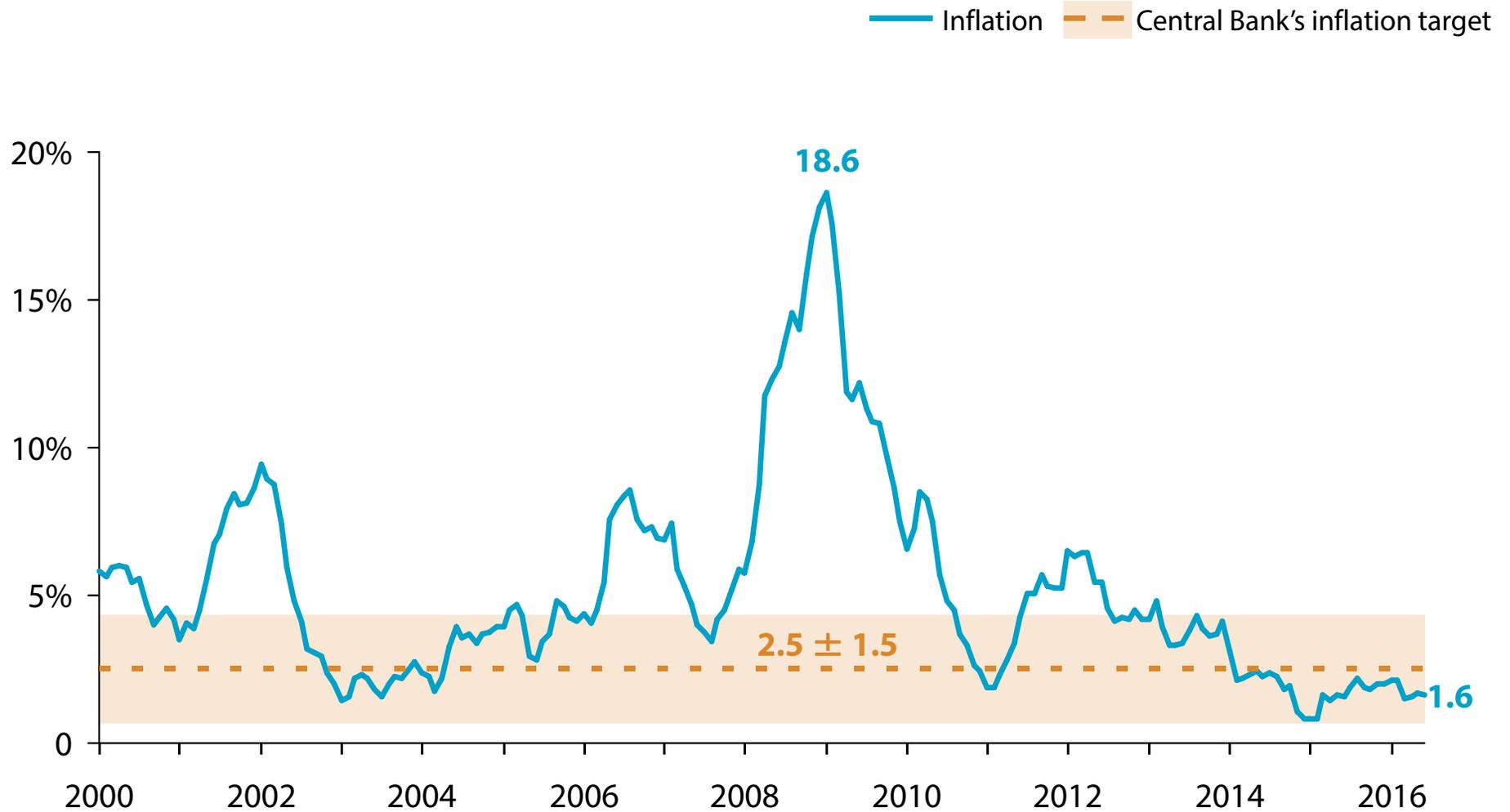


Figure 1.9

# The Icelandic krona devaluated dramatically during the financial crisis but has been strengthening recently

Exchange rate index (ERI). A higher index value indicates a weaker Icelandic krona

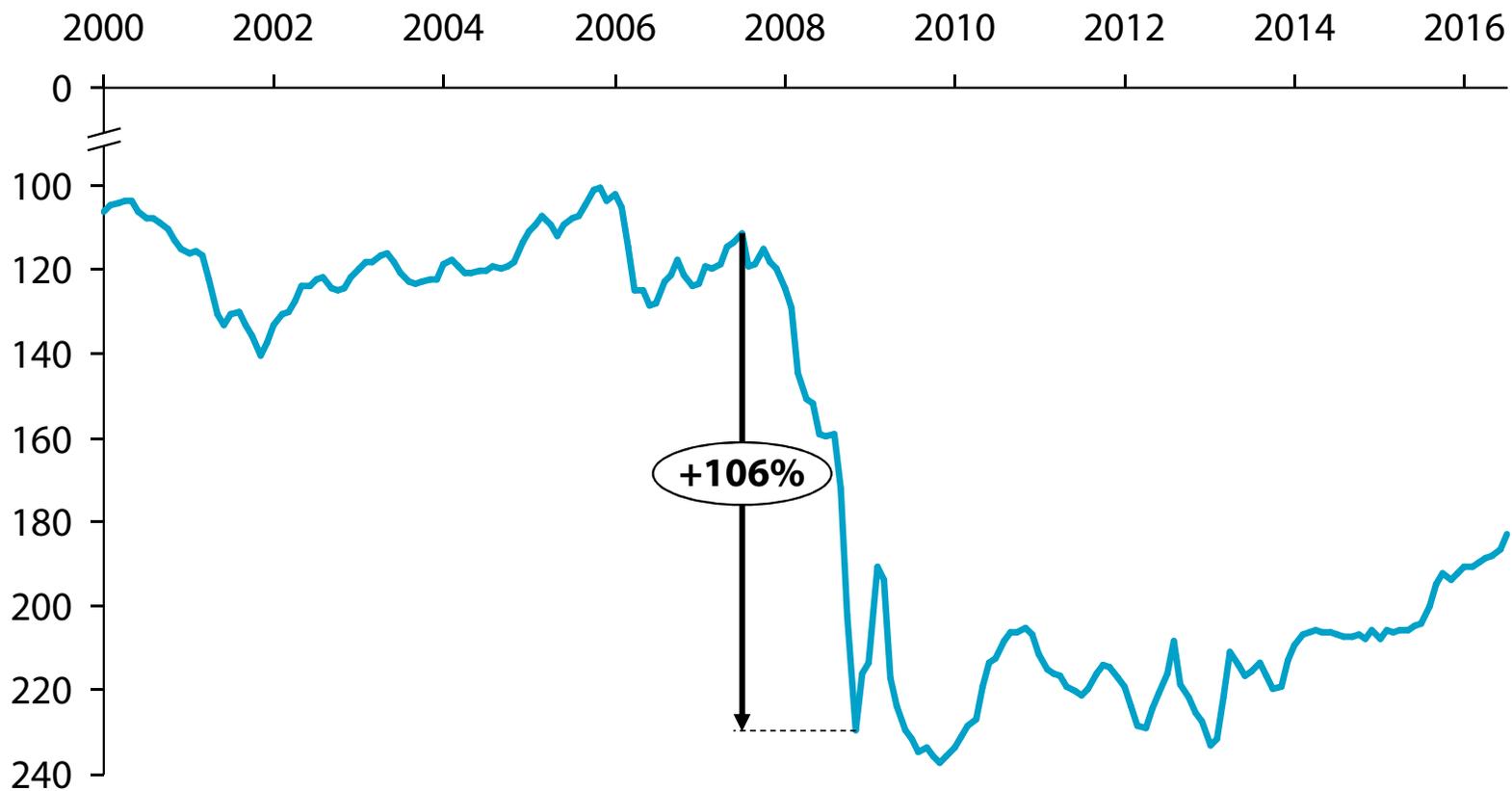
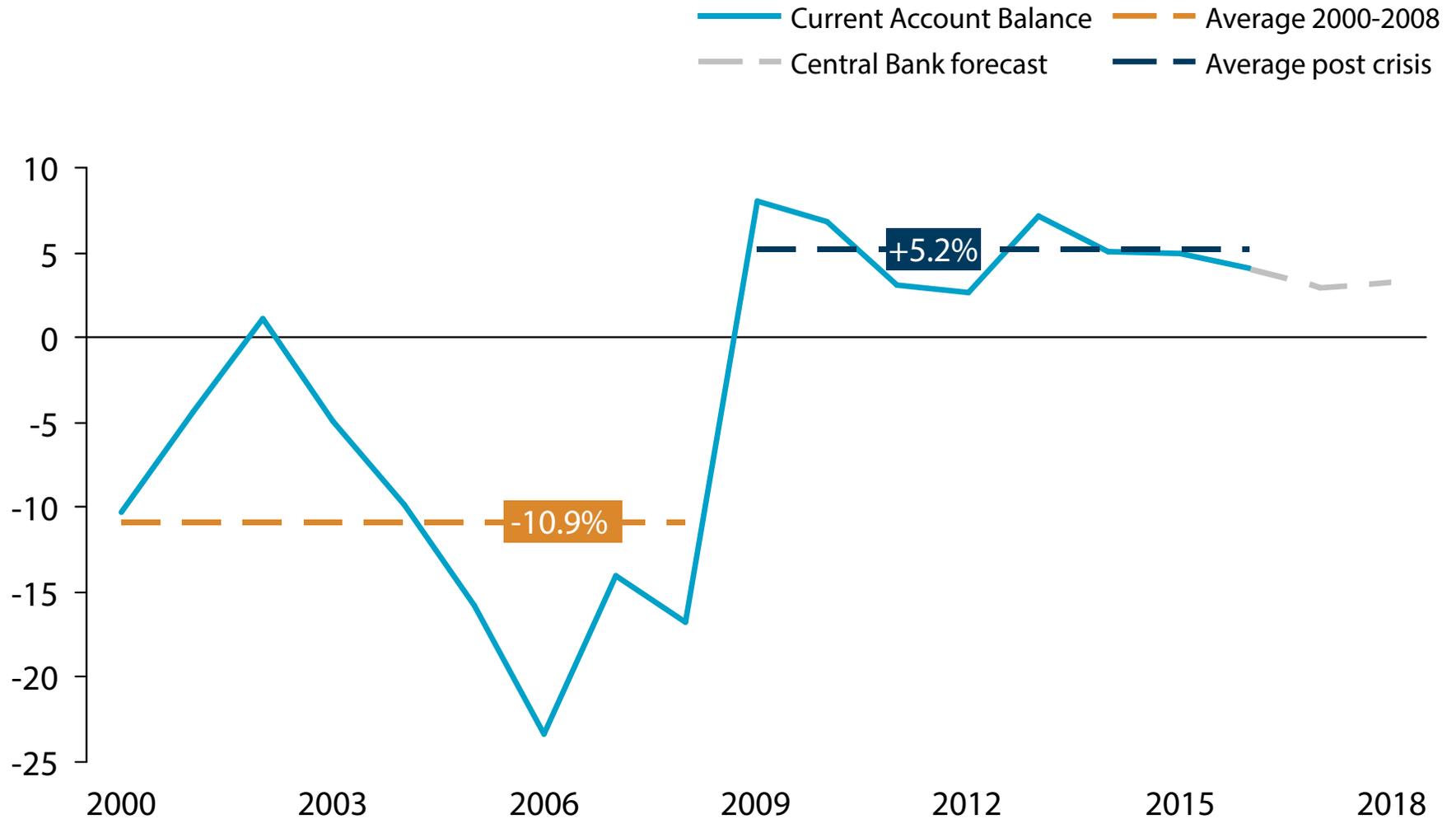


Figure 1.10

# The devaluation of the krona converted a persistent current account deficit into a surplus

Current account balance<sup>1</sup> (percent of GDP)



<sup>1</sup> Underlying current account, excludes the effects of the failed banks' estates

Figure 1.11

# Burdening foreign obligations following the crisis have been dramatically reduced and are at a historical low

Iceland's net international investment position (percent of GDP)

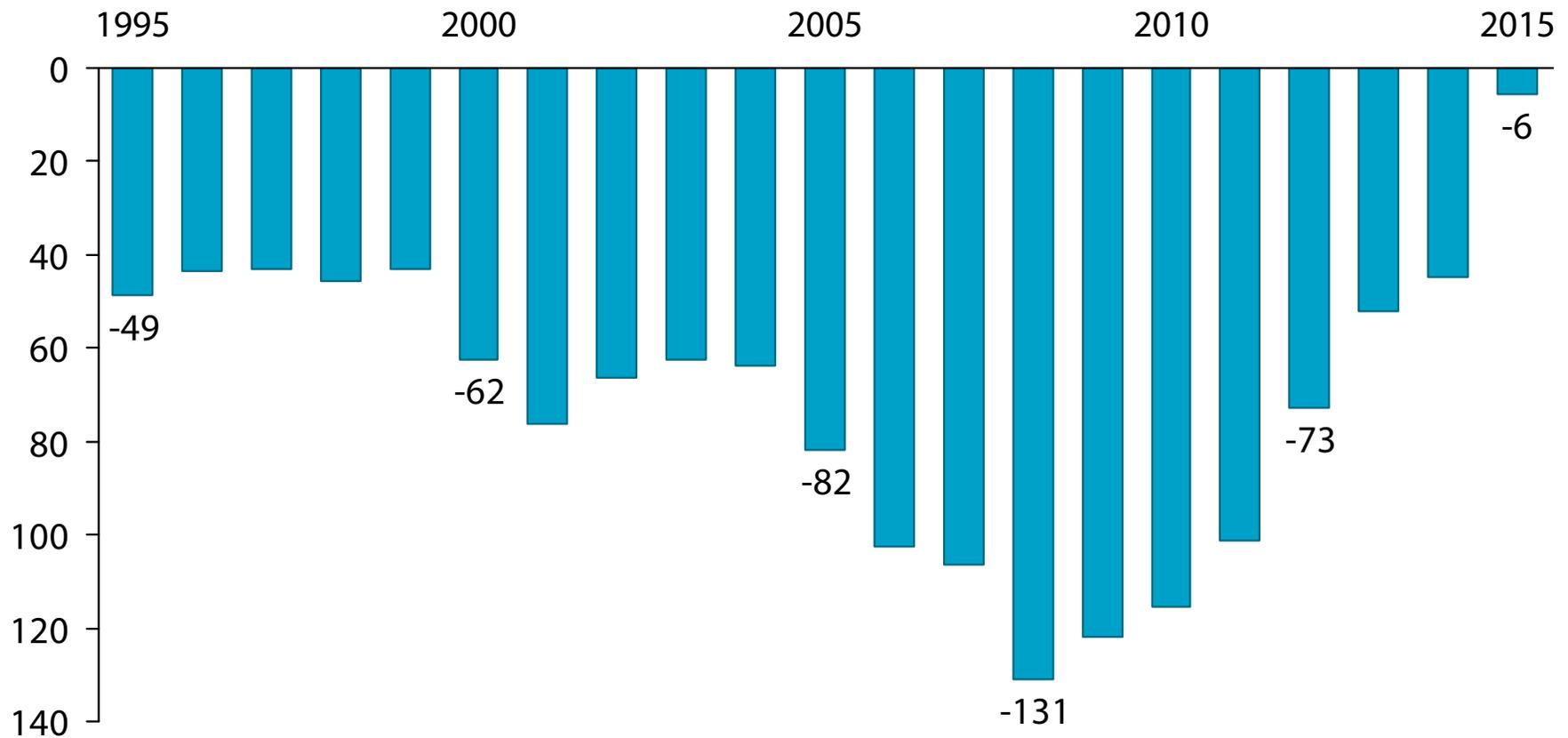
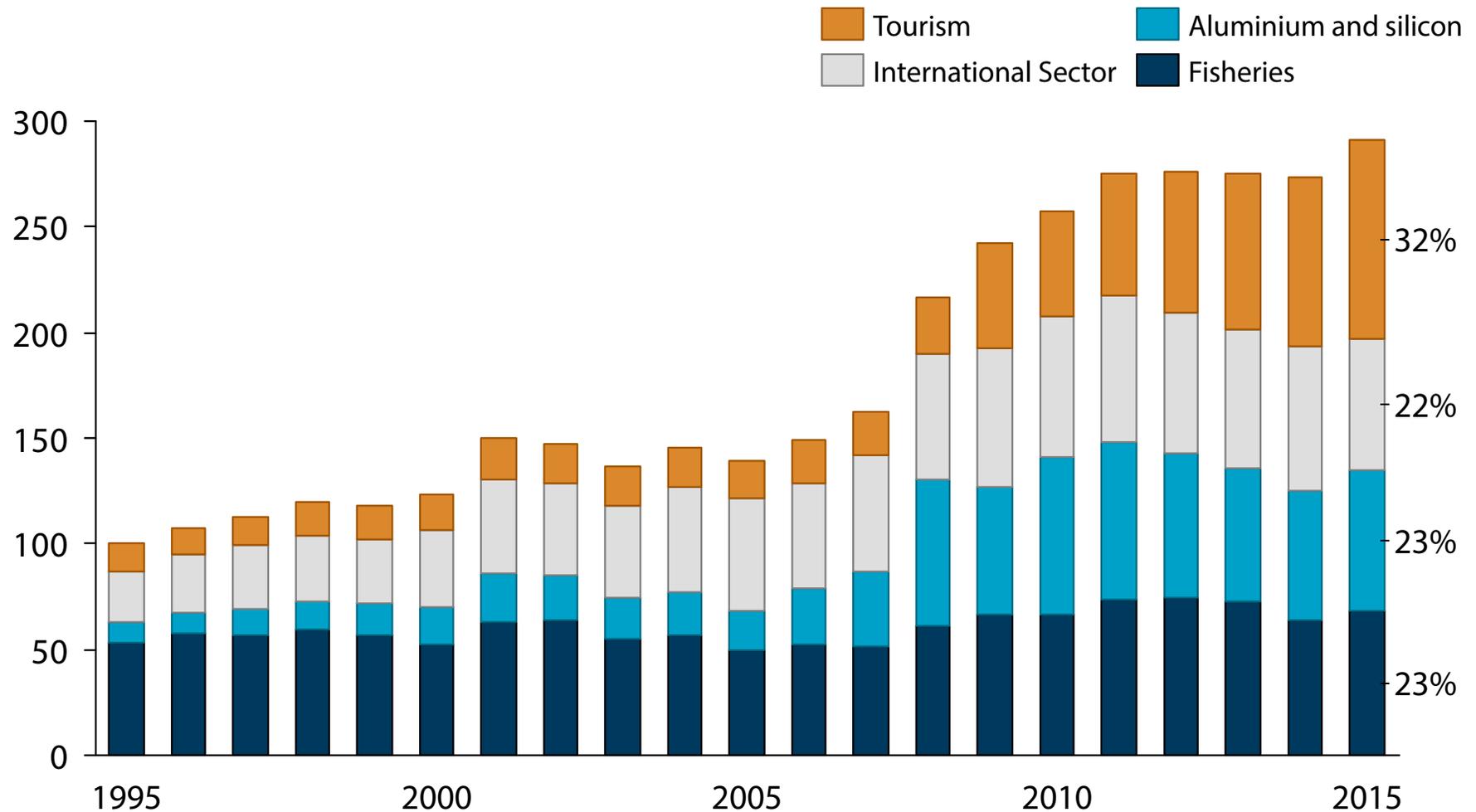


Figure 1.12

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

Iceland's exports<sup>1</sup>, index (1995 = 100), inflation adjusted



<sup>1</sup> As agriculture is heavily subsidised and only a small fraction of total exports, it is not included in this analysis

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Figure 2.1

A new centre-right wing government was formed in May 2013, replacing a centre-left wing government



Figure 2.2

# 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



Figure 2.3

# The Icelandic tax system relies heavily on consumption and labor income

## Key taxes in Iceland

<u>Tax</u>	<u>Tax rate</u>	<u>Recent changes</u>
VAT <sup>1</sup>	24%	<ul style="list-style-type: none"> <li>Lowered from 25.5% / lower bracket raised from 7% to 11%</li> </ul>
Labor income <sup>2</sup>	46%	<ul style="list-style-type: none"> <li>Middle bracket to be removed in 2017</li> </ul>
Corporate profits	20%	<ul style="list-style-type: none"> <li>Unchanged since 2011 when it was increased from 18% to 20%</li> </ul>
Dividends / Capital gains	20%	<ul style="list-style-type: none"> <li>Unchanged since 2011 when it was increased from 18% to 20%</li> </ul>

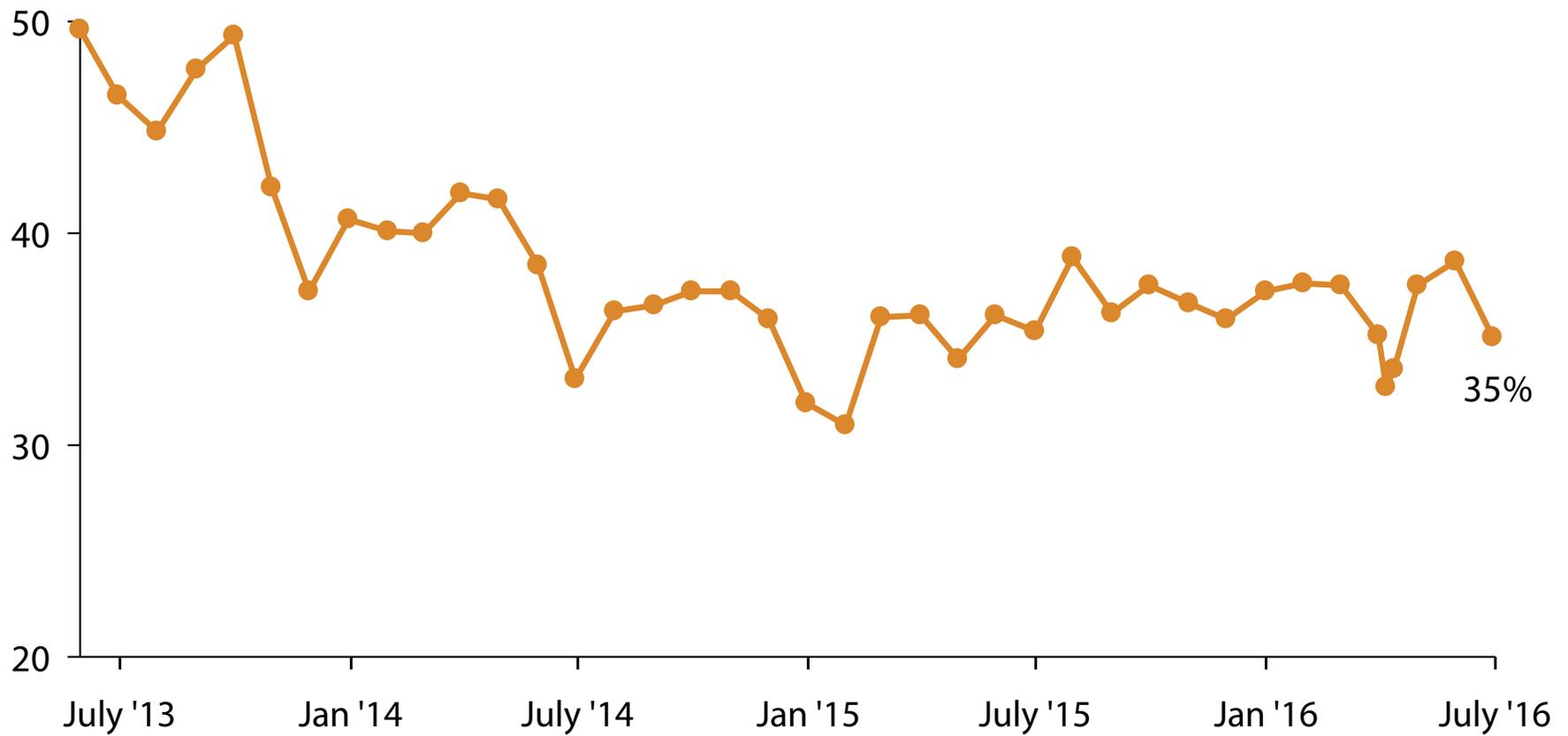
1 Consumption taxes in are divided between two brackets, the lower being 11% which includes and the higher 24% which is the general rate; some service is exempt from consumption taxes, such as health service, public transport and schools

2 Income taxes are divided between three brackets, the lowest being 37.13% for the first ~336 thousand ISK of an individual's monthly income, the middle bracket being 38.35% for the next ~501 thousand ISK and the highest being 46.25% for income above ~837 thousand ISK

Figure 2.4

# Support for the government declined in its first year and has remained low

Government approval rating (percent)



35%

Figure 2.5

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

Key parties inside and outside of the capital controls

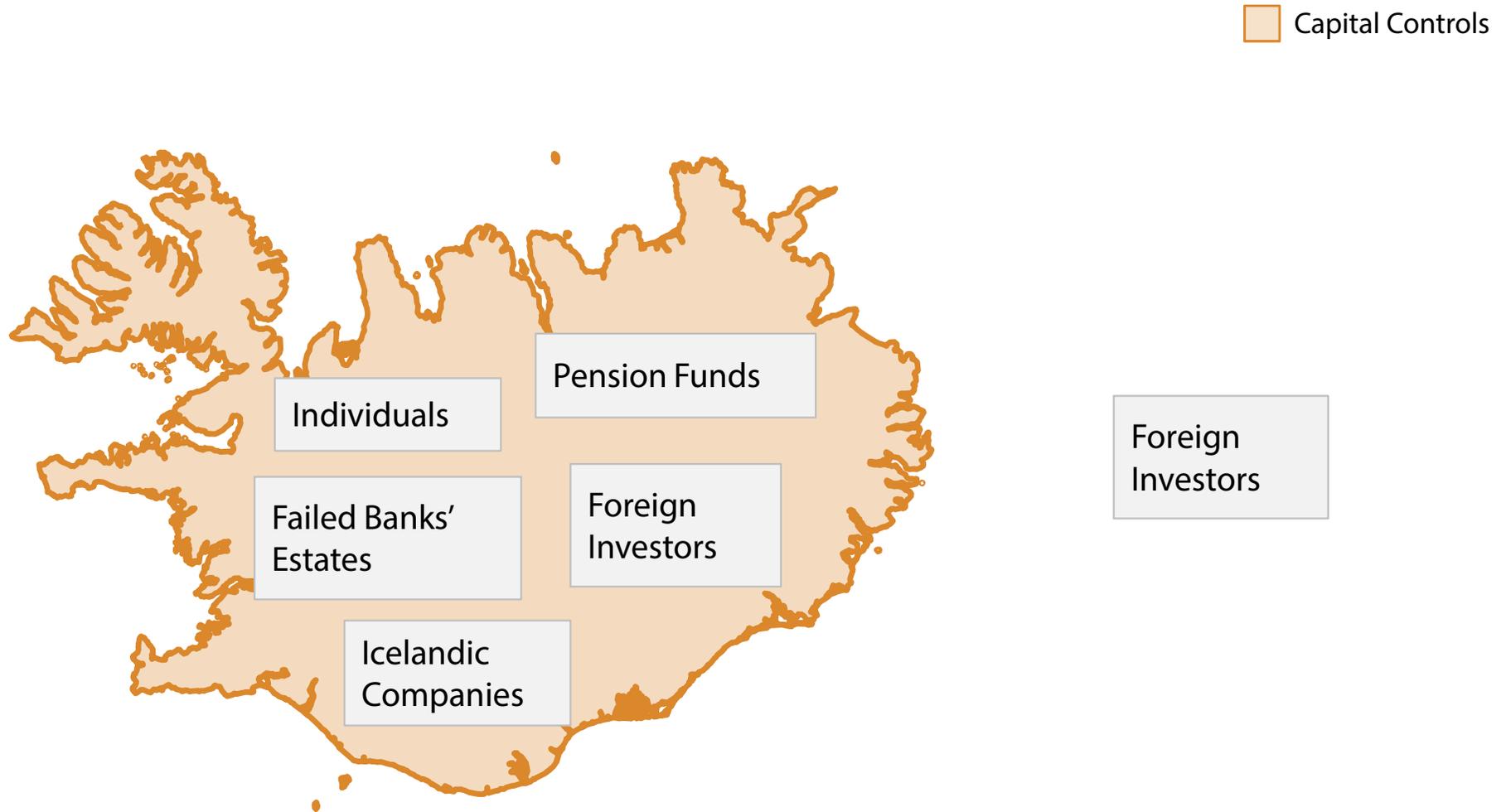
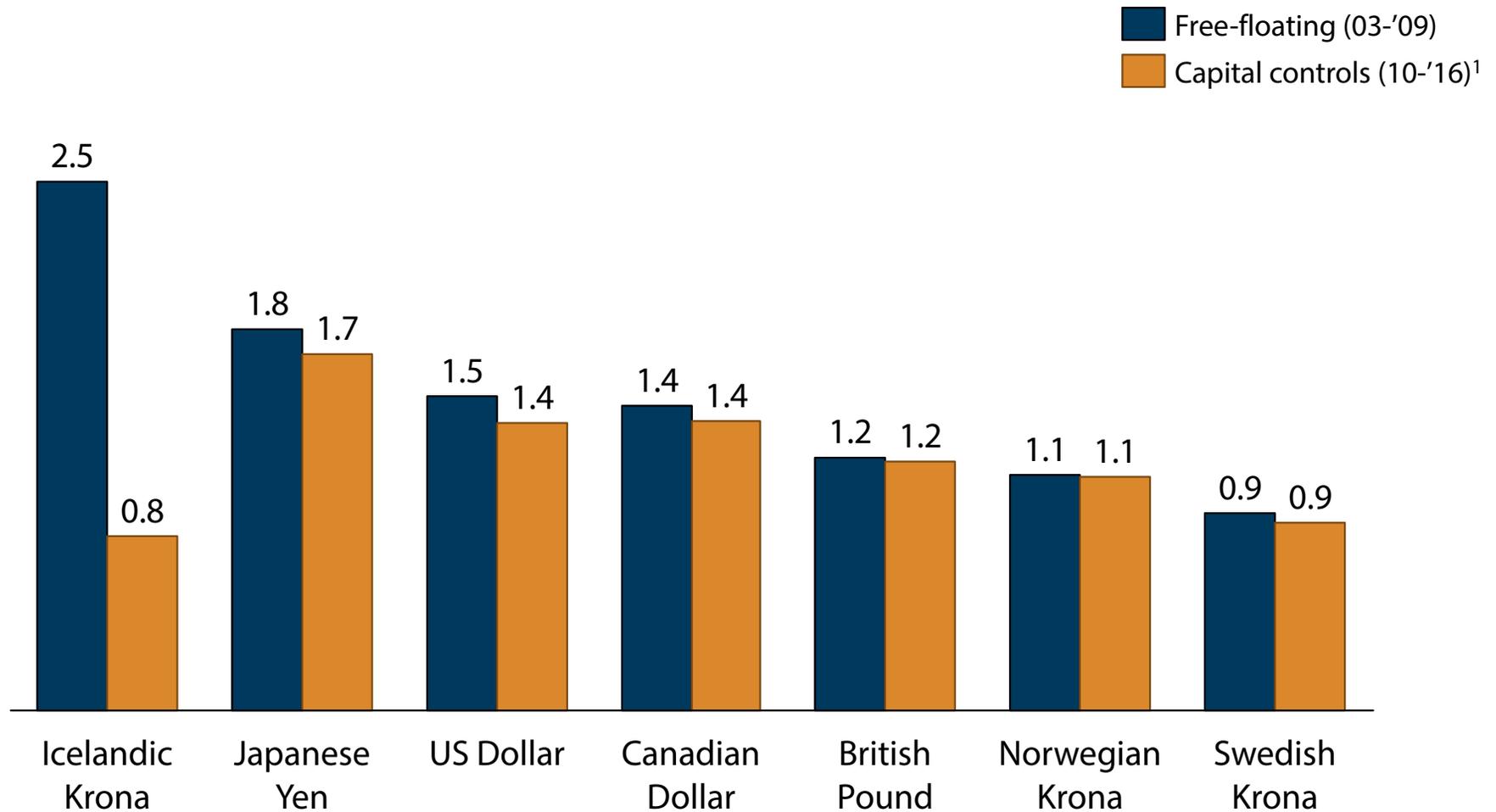


Figure 2.6

# The Icelandic krona was one of the most volatile currencies in the developed world before the controls

Exchange rate fluctuations against the Euro (standard deviation of weekly changes)

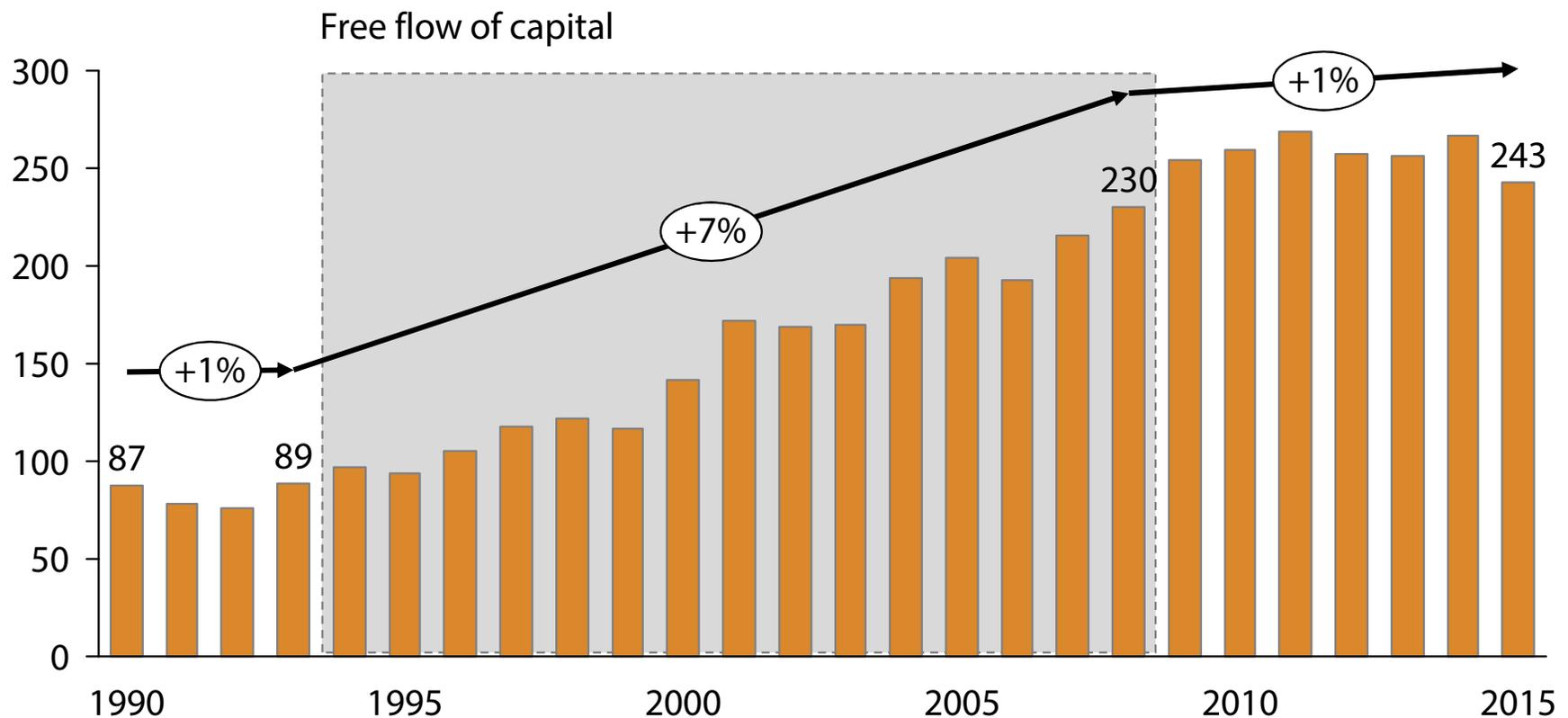


<sup>1</sup> From 1<sup>st</sup> of January 2010 till 12<sup>th</sup> of July 2016

Figure 2.7

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

Iceland's exports originating from the international sector, bn. ISK (inflation adjusted)



1 For the years 1990-94, the international sector is inflated as agriculture, silicon and ships and planes are included

Figure 2.8

# Most of the major steps needed to lift the capital controls on domestic parties have been taken

Timeline for lifting capital controls

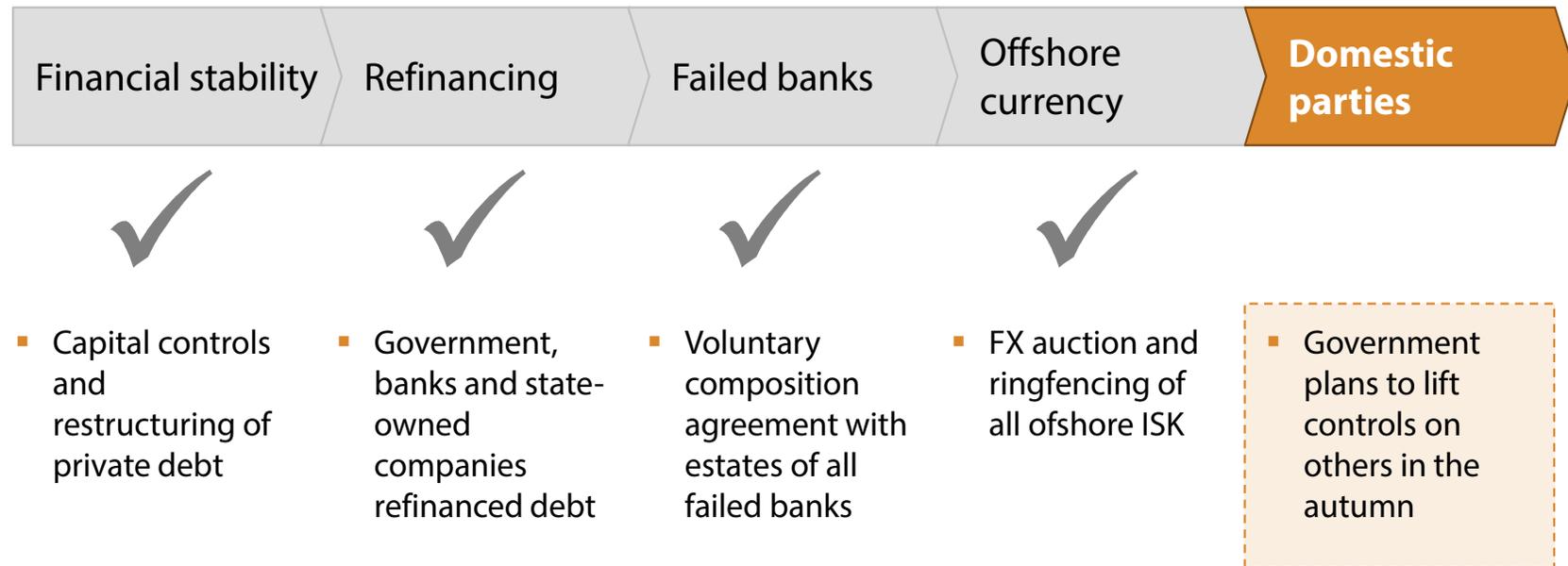
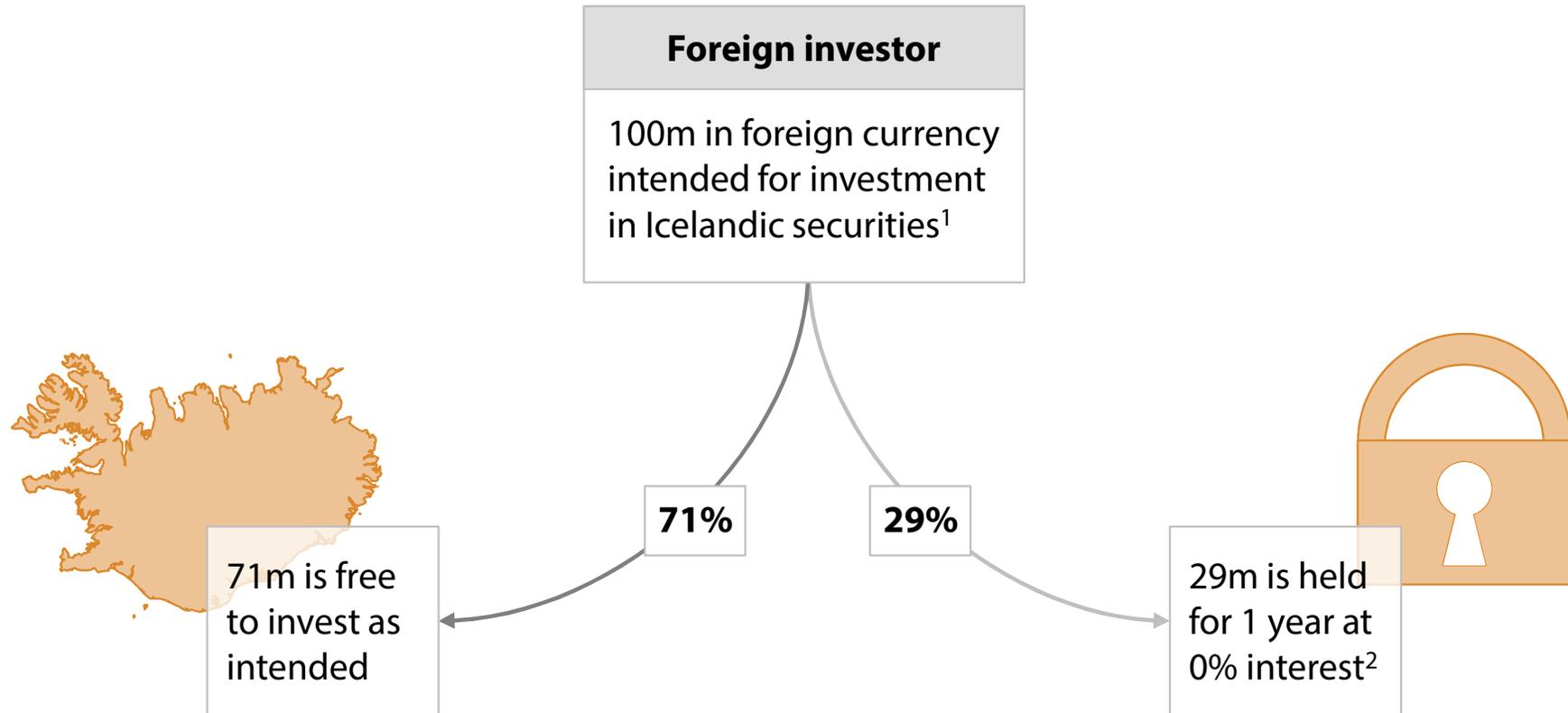


Figure 2.9

# A new measurement has been introduced to reduce volatile capital inflows

Iceland's new capital flow instrument, illustration



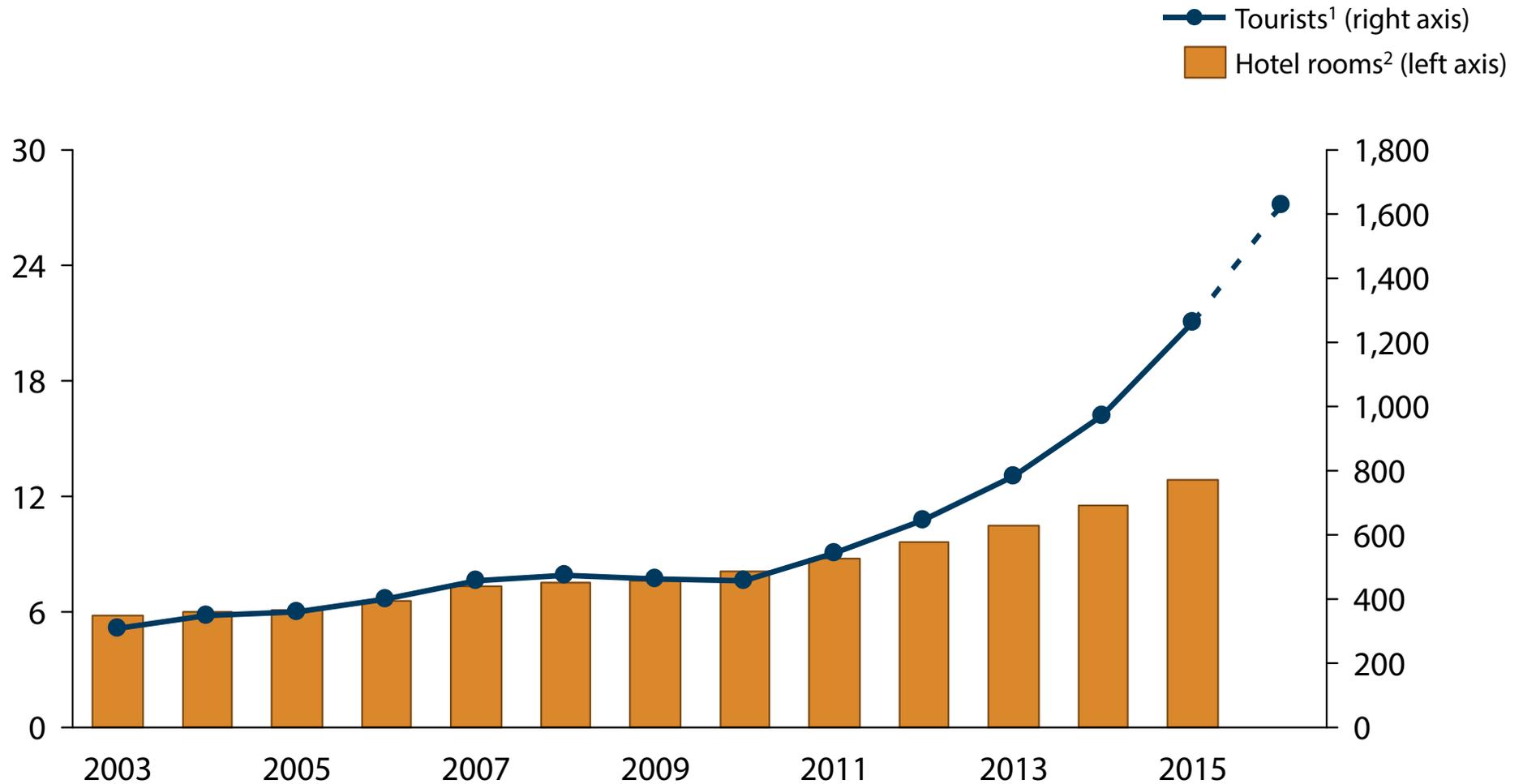
1 The new measurement's scope is new inflow of foreign currency that's in particular intended for new investment in electronically registered bonds and bills, and deposits, as well as new inflow related to loans taken for investment in such instruments

2 The current reserve ratio and period is 40% of the invested amount (29% of the total) and 1 year but the Central Bank can raise the ratio to up to 75% and the period up to 5 years; the capital is held on a capital flow account with the Central Bank of Iceland with the Icelandic króna as the settlement currency

Figure 2.10

# The supply of hotel rooms has not kept up with tourism demand, but new infrastructure is under construction

Number of tourists and hotel rooms (thousands)



1 The figure for 2016 is an estimate by Íslandsbanki

2 Yearly average

Figure 2.11

# The Icelandic tourism industry has suffered from high seasonality, but recently the it has been reduced

Number of foreign visitors, thousands

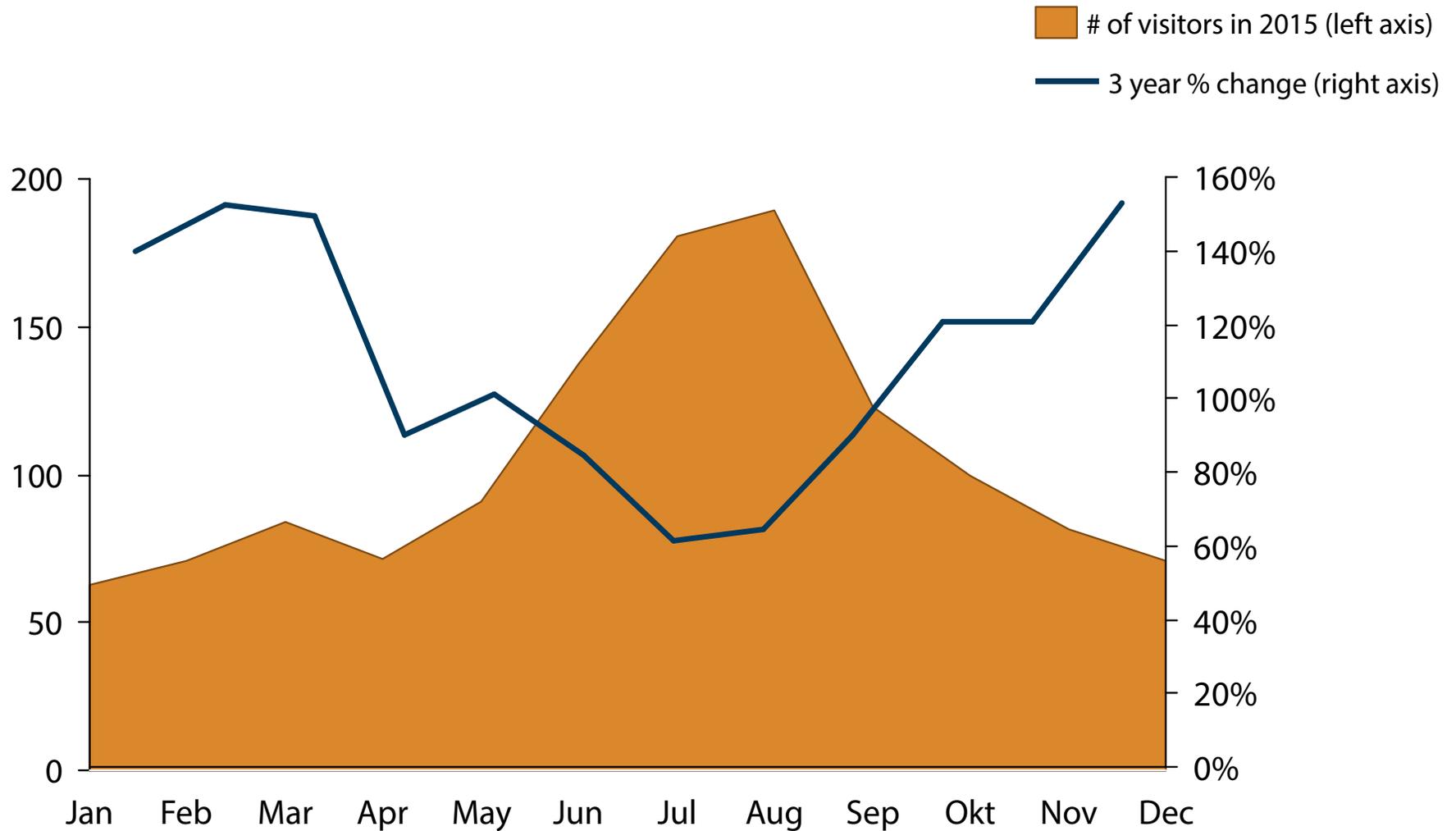
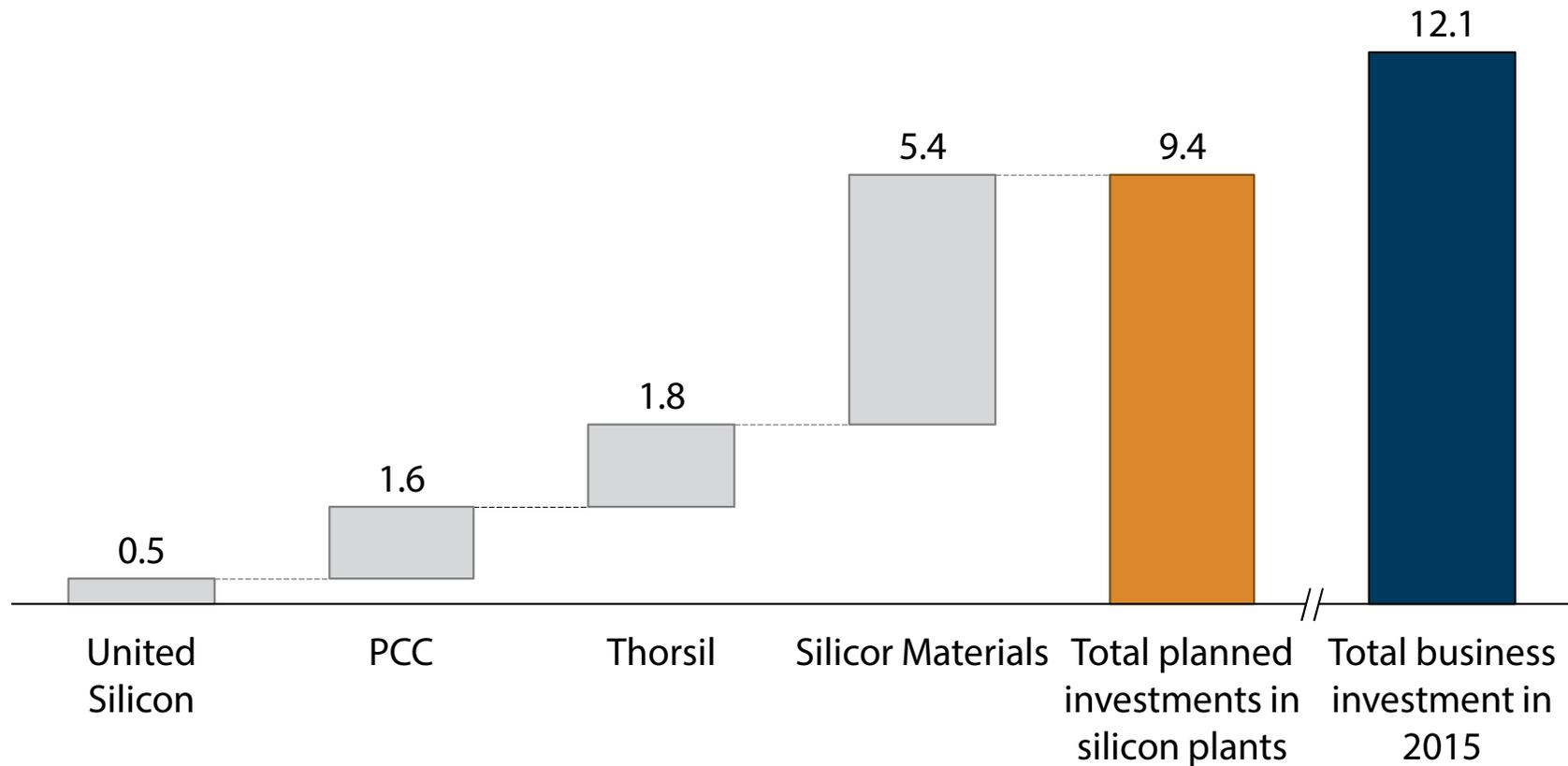


Figure 2.12

# Four silicon plant construction project agreements have been signed, resulting in significant new investments

Signed silicon plant investment projects (percent of GDP<sup>1</sup>)



<sup>1</sup> United Silicon, PCC and Thorsil have signed both investment agreements with the government and power purchase agreements with Landsvirkjun. Silicor Materials and Thorsil have not made their final investment decision yet.

Figure 2.13

# Favourable climate in addition to affordable energy makes Iceland an attractive location for data centers

Potential increase in profitability by storing data in Iceland (illustrative)

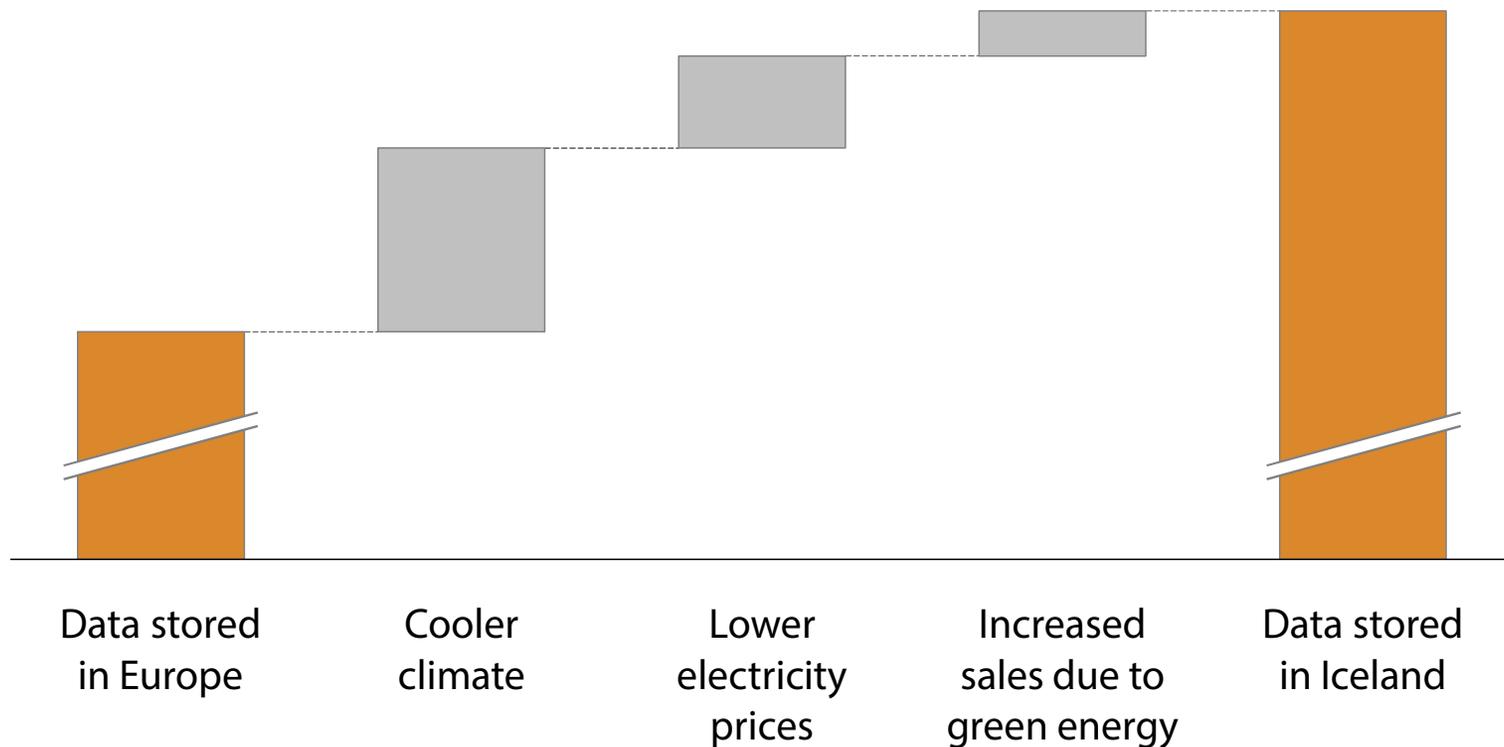


Figure 2.14

# A proposed interconnector from Iceland to the UK would be one of the longest in Europe, if constructed

Interconnectors in northern Europe, length and capacity

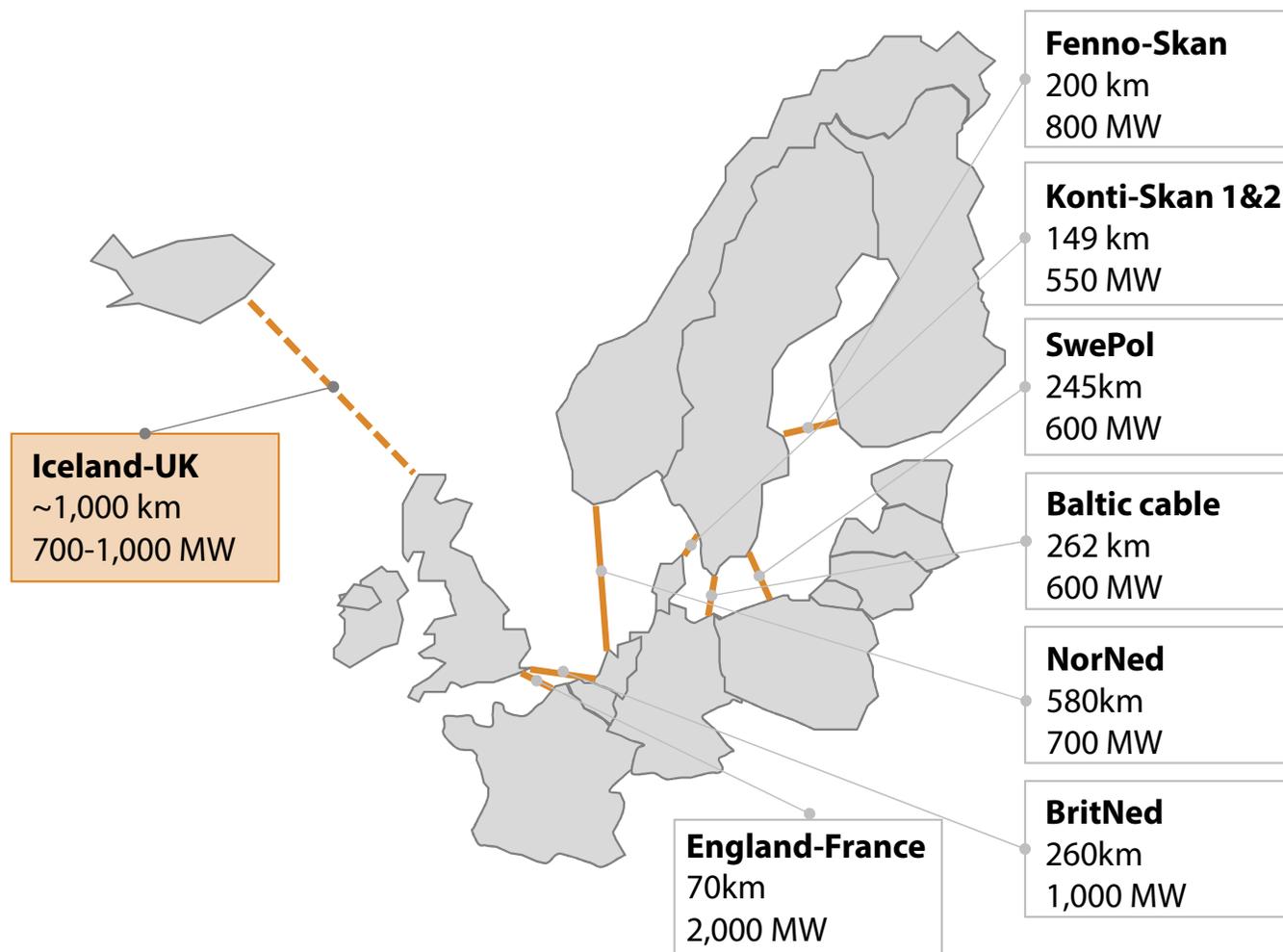


Figure 2.15

# Iceland's "Big Three" banks are all in inactive ownership, either through the government or estates

Ownership of the three largest domestic banks (percent, EOY 2015)



Figure 2.16

# Iceland's credit rating has recovered recently and the outlook is stable

Iceland's credit ratings (sovereign debt)

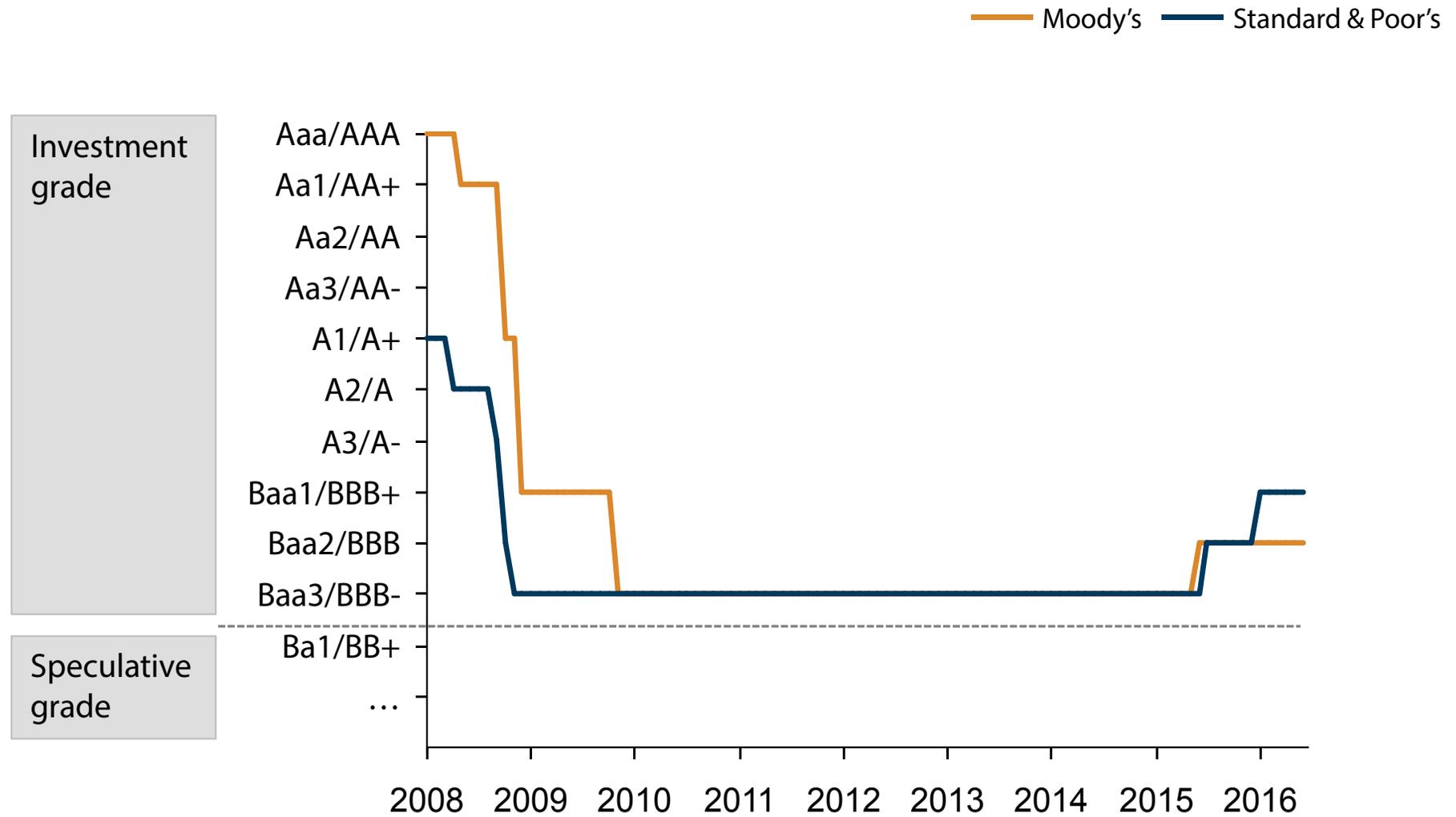
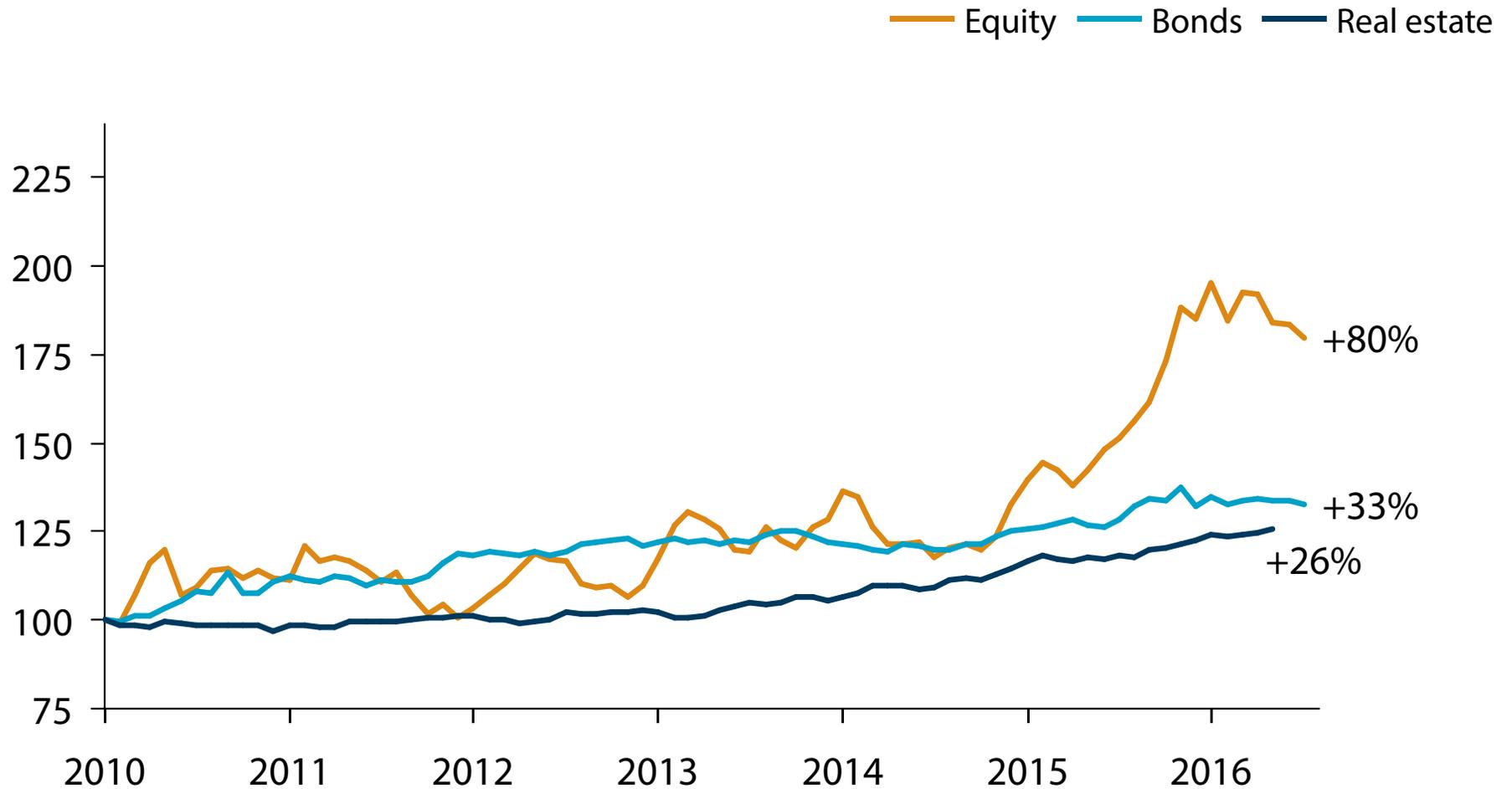


Figure 2.17

# Domestic assets have gained significant value in the last few years

Asset value, inflation adjusted (BOY 2010 = 100)



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Figure 3.1

# Iceland has a strong labour market compared to peers, but productivity level is lagging behind

Iceland's GDP composition (2014)

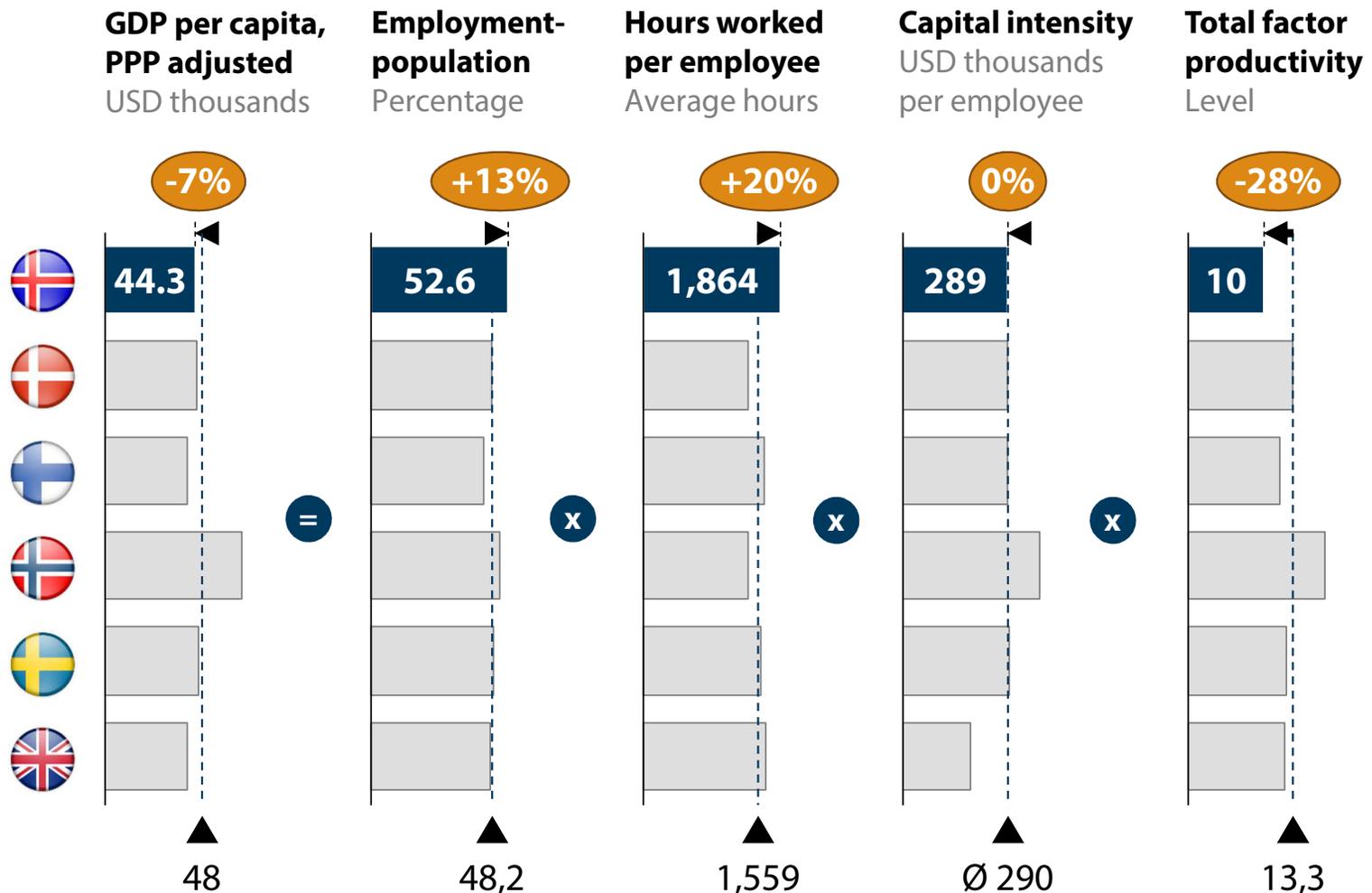


Figure 3.2

# The Icelandic workforce's contribution compared to that of neighbour countries has increased even more

Work effort of Icelandic and neighbour countries' labour

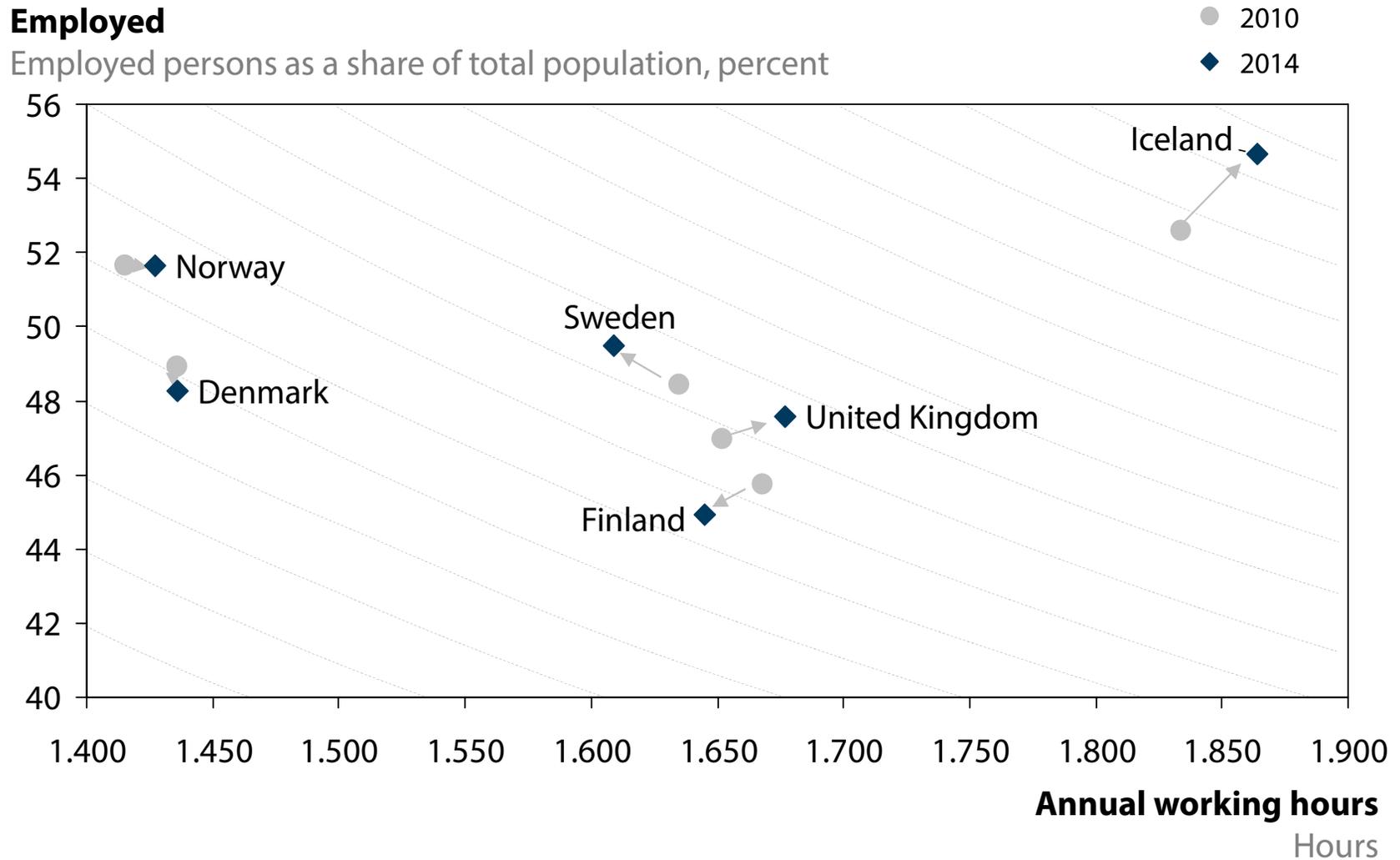


Figure 3.3

# Capital per employer has contracted in recent years

Capital stock per employer, million ISK (inflation adjusted, 2015)

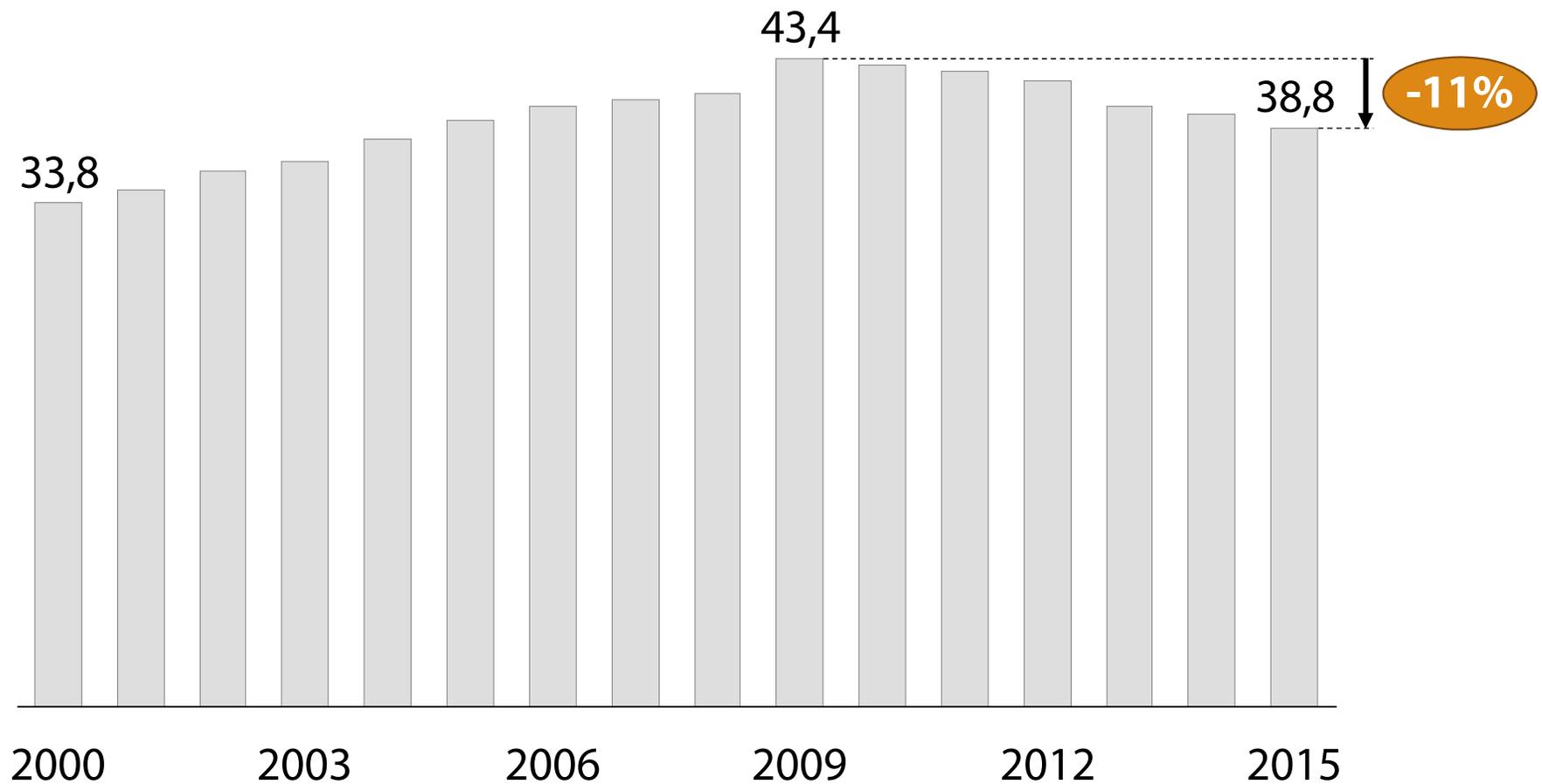
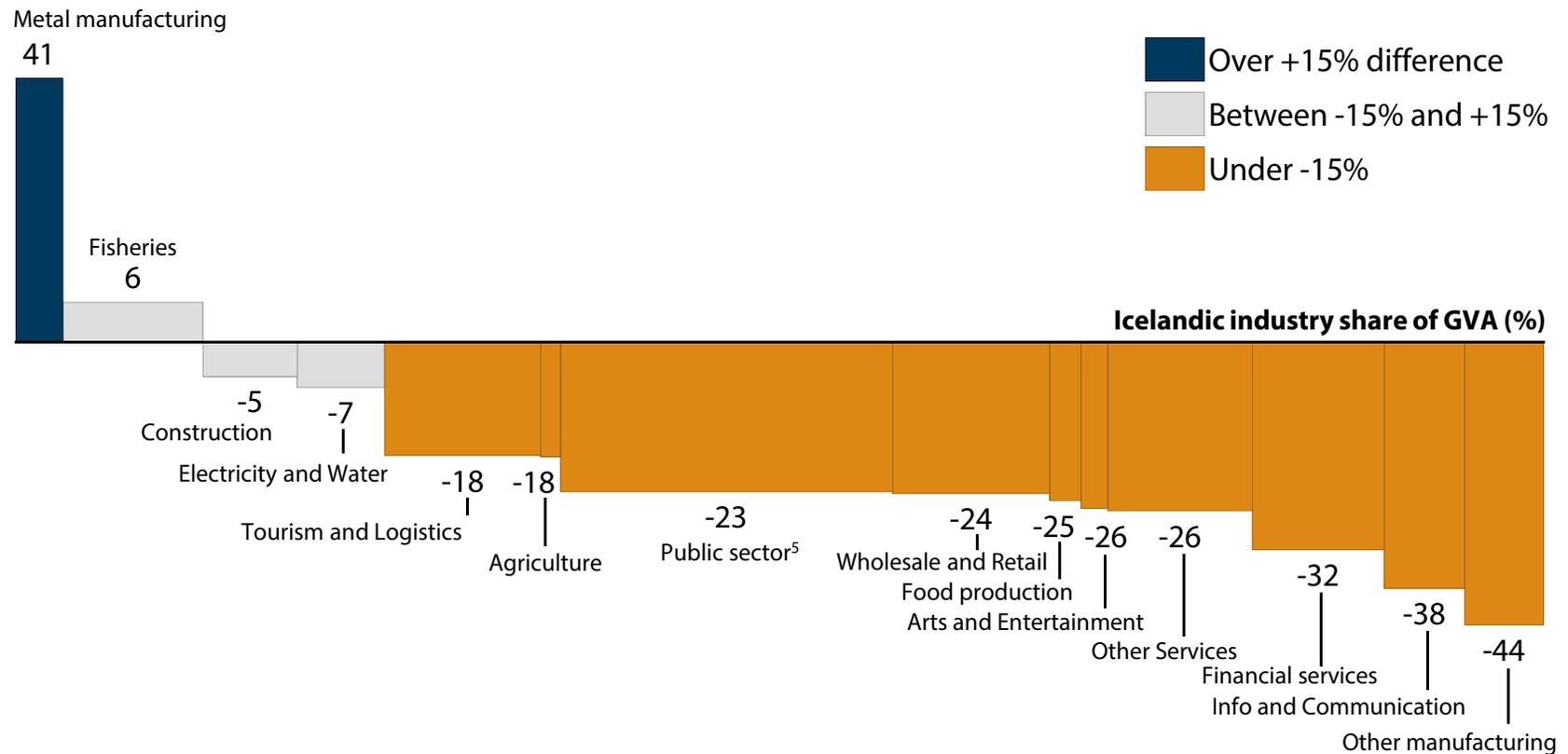


Figure 3.4

# There is a big labour productivity gap between most Icelandic industries and the Scandinavian counterparts

Relative comparison of labour productivity in various industries (2014)<sup>1,2,3,4</sup>



1 Comparison of Gross Value Added (GVA) per employer in each industry, compared to Denmark, Norway and Sweden; GVA measures production value before indirect taxes and subsidies

2 All industries are PPP adjusted except for export industries, as they are adjusted for USD exchange rate

3 Data for Sweden for 2014 wasn't available so it is extrapolated assuming average growth of GVA and average industry share of total GVA from the years 2009-13

4 As was done in the McKinsey's report: „Charting a growth path for Iceland“, quarry, oil and real estate comparison was skipped, because of irregular comparison

5 GVA of the public sector measures it's operating cost, not it's quality

Figure 3.5

# Exports need to increase by one trillion ISK in the next 20 years to support a GDP per capita growth of 2.6% p.a.

Iceland's exports, ISK billions (2013 prices)<sup>1</sup>

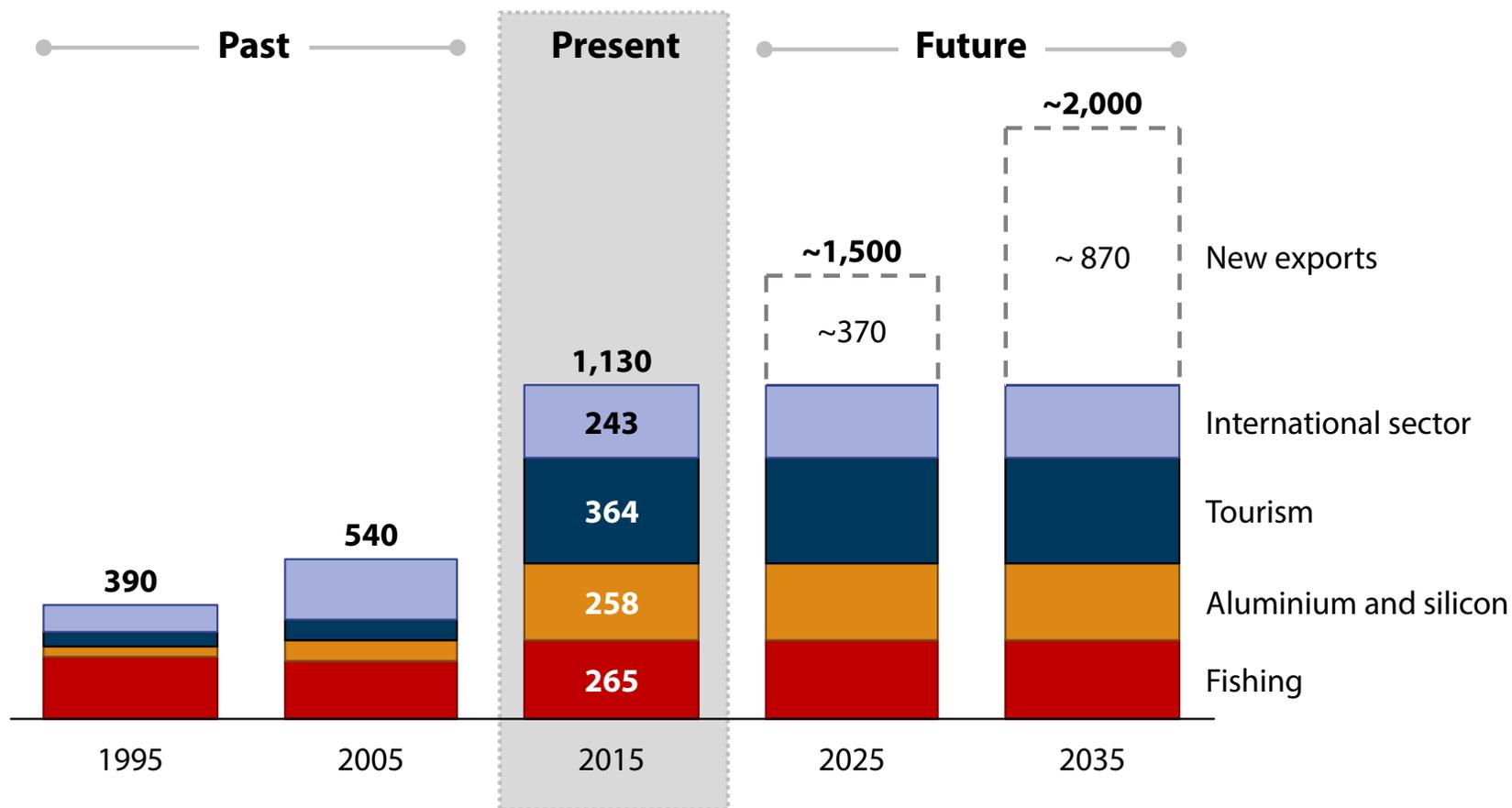


Figure 3.6

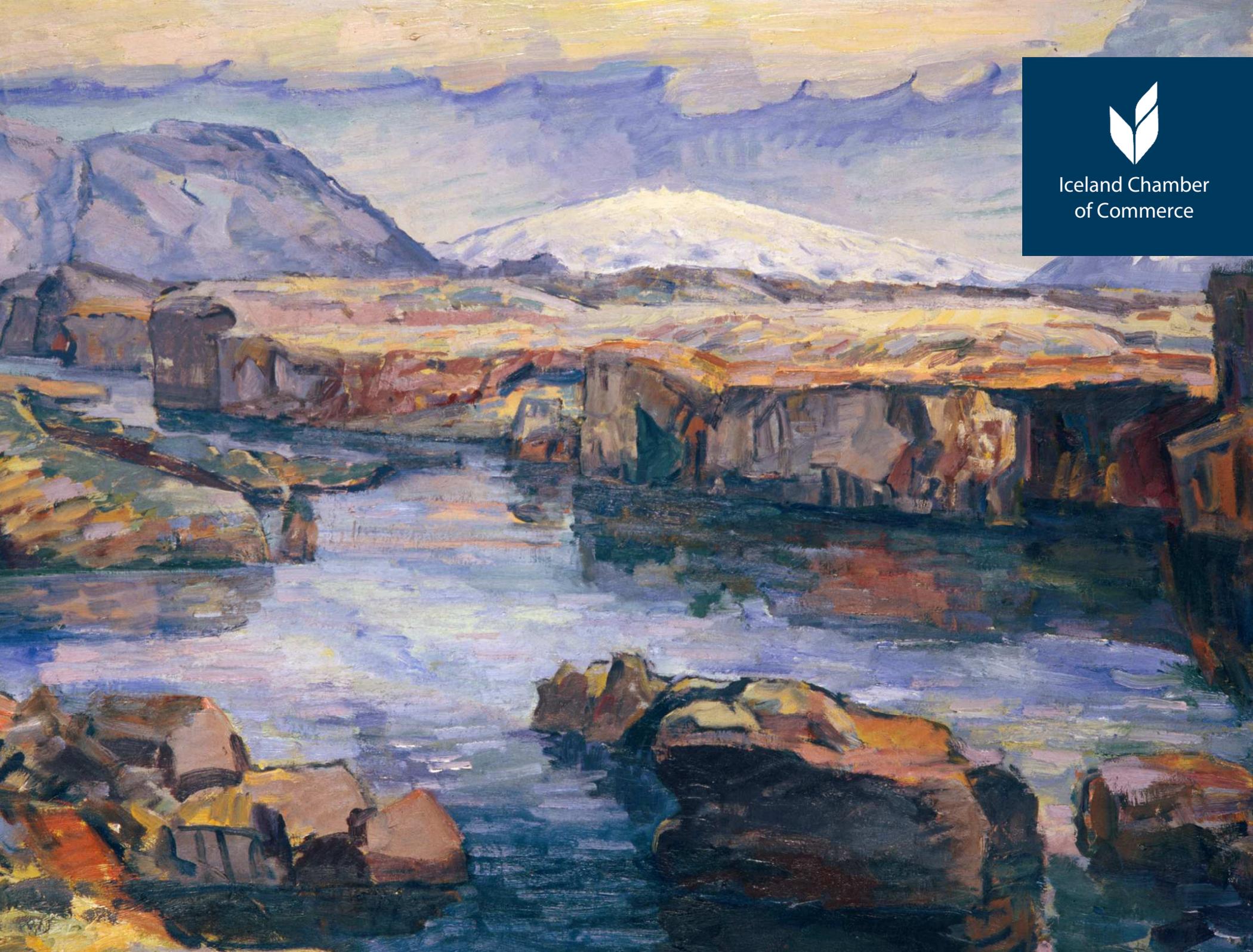
# McKinsey introduced a growth plan in their report about the Icelandic economy that outlined different priorities to each segment of the economy



Figure 3.7

# The Iceland Growth Forum presented approx. 40 reform proposals to support a sustainable growth trajectory





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