

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 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 increasing economic prosperity.

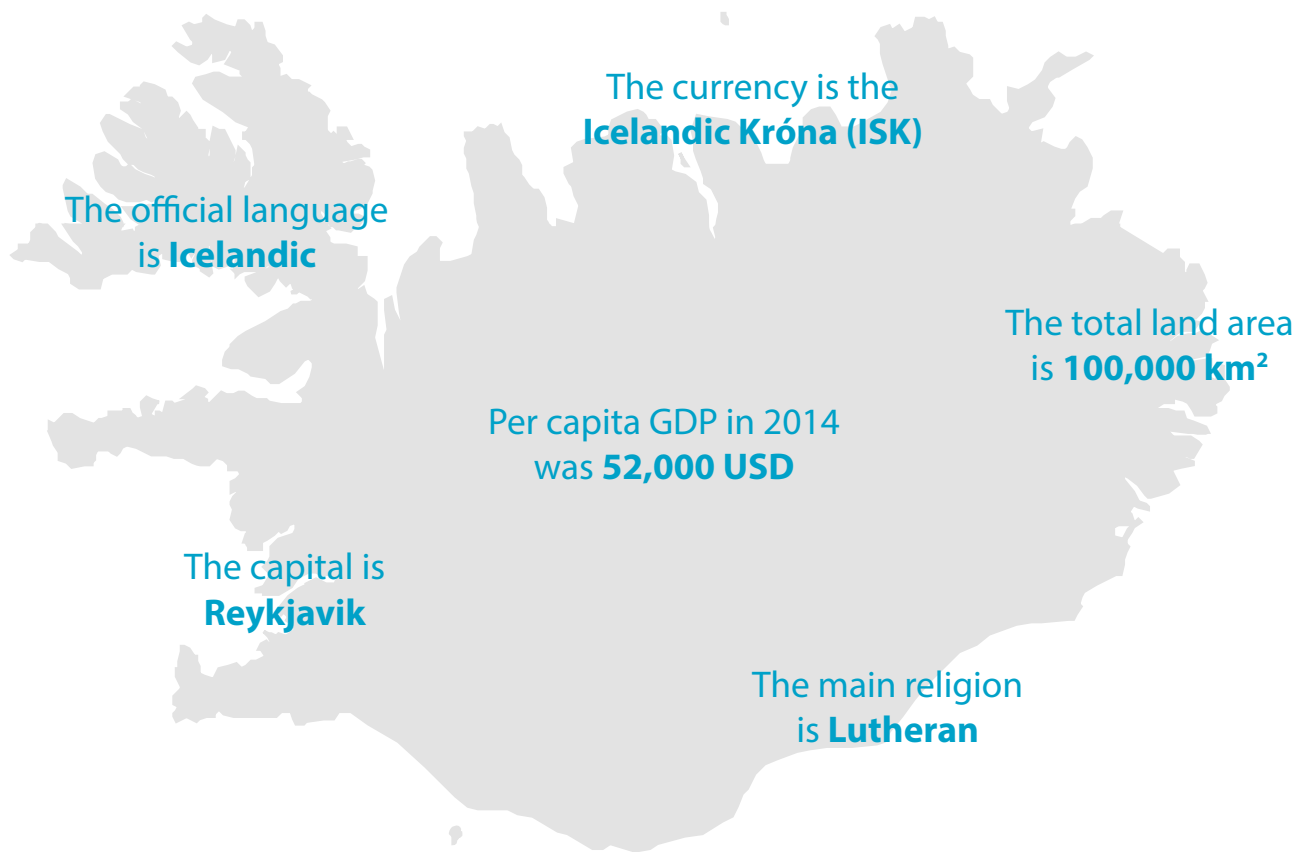


Iceland Chamber of Commerce

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Iceland



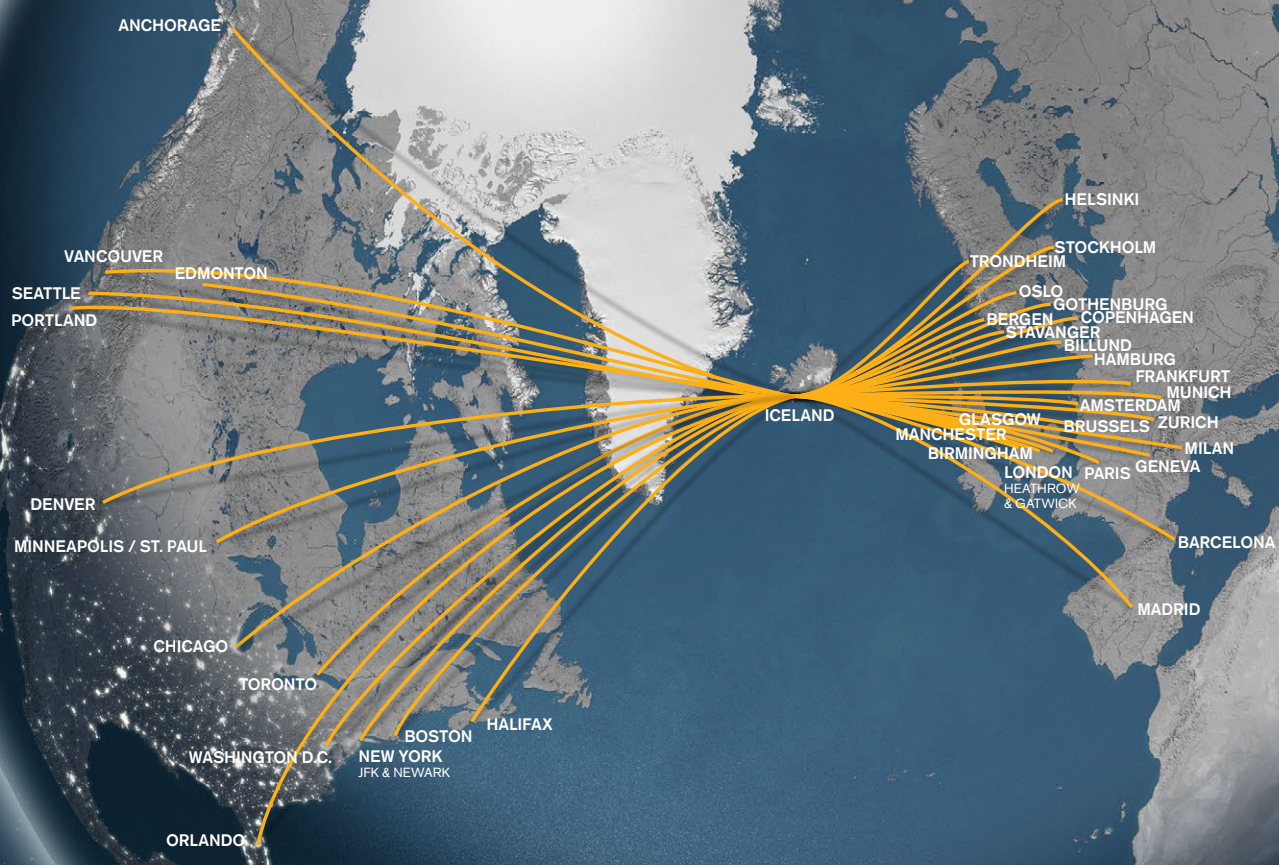
Did you know?

- The number of tourists visiting Iceland in 2015 is expected to be quadruple the country's population
- 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 only 3.2 inhabitants per km²
- Vigdís Finnbogadóttir, the 4th president of Iceland, was the first democratically elected female head of state
- Iceland is a volcanic island with an eruption occurring on average once every three years

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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.



Frosti Ólafsson
Managing Director
Iceland Chamber of Commerce

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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 the OECD, with 15 billion USD (1,990 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 1/5000th of the global economy.

With only 330 thousand inhabitants, this domestic production places Iceland among the top ranked countries in GDP per capita comparisons (Figure 1.1). Iceland, which in the first half of the 20th century was one of the least affluent

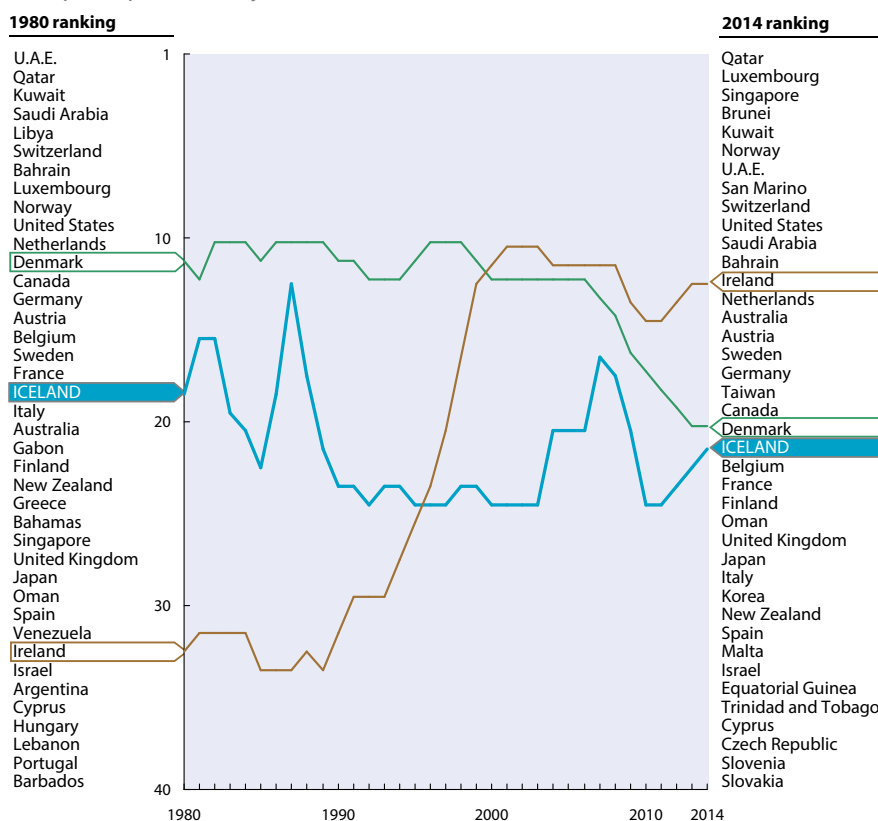
„The Icelandic economy is an open developed economy operating under the Nordic model, combining a free market economy with a welfare state.“

Figure 1.1

Iceland has a high standard of living, illustrated by high per-capita GDP figures, and has largely recovered from the recession

Country rankings

GDP per capita, PPP adjusted



Source: IMF World Economic Outlook; Iceland Chamber of Commerce Analysis

¹ Statistics Iceland, Central Bank of Iceland (ISK/USD = 132, June 23rd 2015)

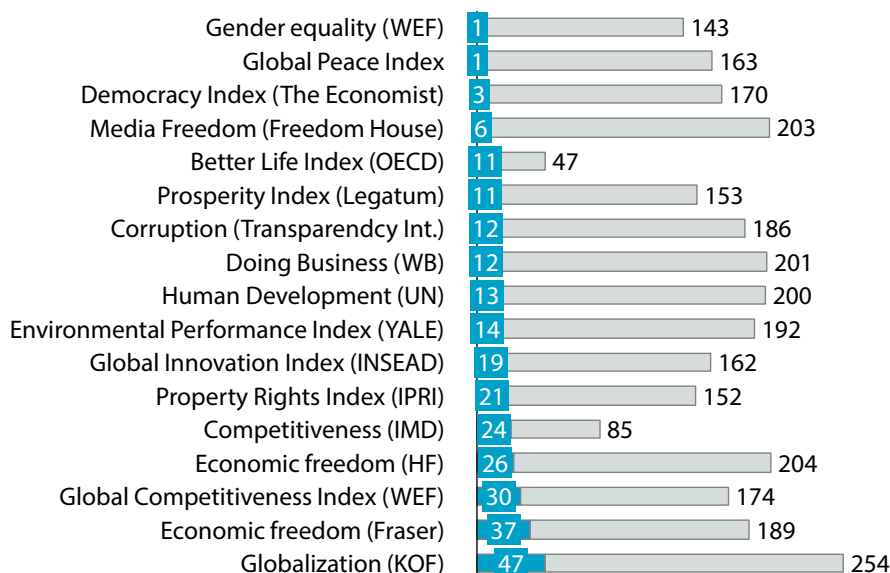
Figure 1.2

Iceland ranks highly in numerous competitive indices

Competitiveness rankings

Iceland's rank for 2014 and total number of countries in index

■ Iceland's ranking
■ # of countries ranked



Source: Respective websites

countries in Western Europe, has during the last few decades constantly ranked among the 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 previous three years, and regained its pre-crisis position. Iceland is currently ranked 22nd globally in terms of GDP per capita.

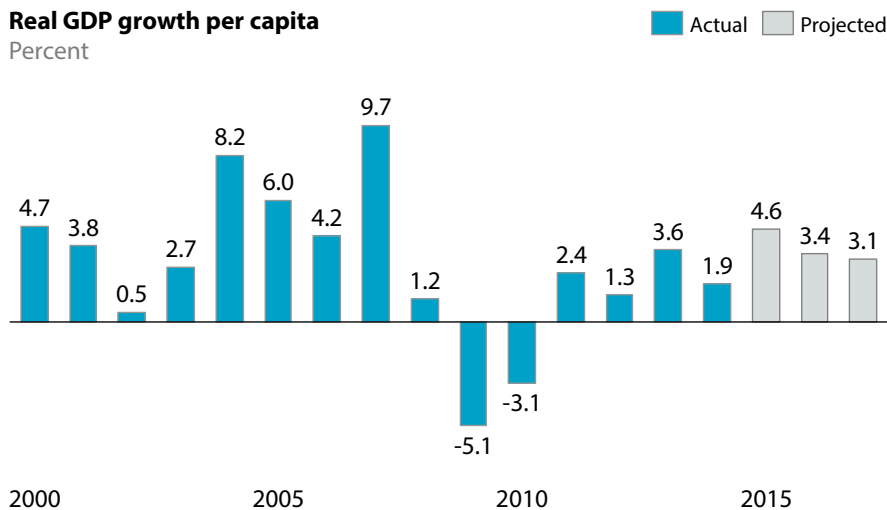
Iceland's success in building a prosperous and globally competitive economy can to some extent be attributed to factors such as a strong institutional framework, a skilled

workforce, a high degree of economic freedom, a sound democracy, and low corruption. These qualities are well portrayed in various competitive indices (Figure 1.2). Iceland ranks at the top in terms of gender equality and peace. Female labour force participation is high, measured 71% by the World Bank, which is a significantly higher percentage than elsewhere in Europe. A high labour participation rate, coupled with high average working hours, contributes toward making the labour market a key strongpoint of the Icelandic economy.

„A high labour participation rate, coupled with high average working hours, contributes toward making the labour market a key strongpoint of the Icelandic economy.“

Figure 1.3

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



Sources: Statistics Iceland; Central Bank of Iceland (Monetary Bulletin 2015/2), Iceland Chamber of Commerce analysis

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 experienced a more pronounced business cycle than most other developed countries, both historically and in recent times.

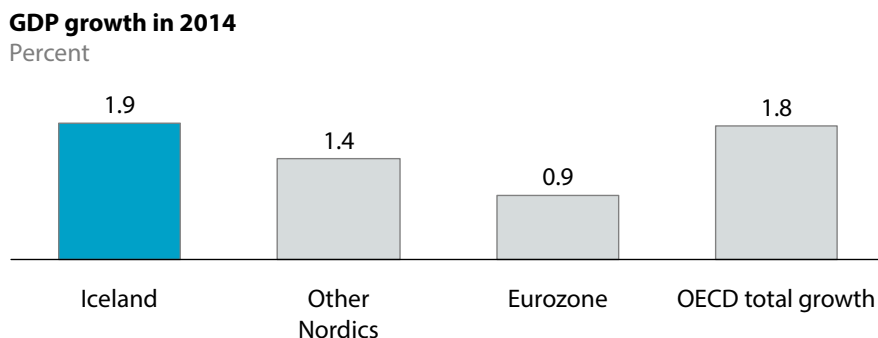
Leading up to the financial crisis in 2008, Iceland was experiencing

economic growth almost unparalleled among high income countries, averaging 6.5% in annual growth over a four year period. Conversely, over the two years following the financial crisis, the economy contracted by more than 10% in total, a more severe contraction than that experienced by most other European countries (Figure 1.3).

„Iceland has experienced a more pronounced business cycle than most other developed countries.“

Figure 1.4

Iceland experienced lower than expected growth in 2014, however it was strong in global comparison



Source: OECD statistics, Iceland Chamber of Commerce analysis

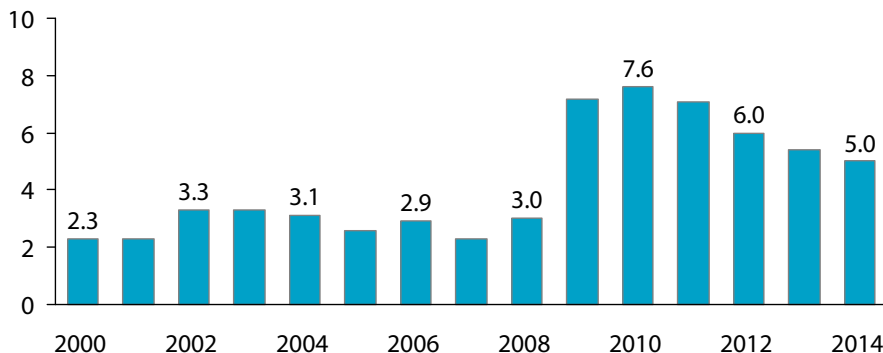
² Pétursson, Breedon and Rose (2011), <http://faculty.haas.berkeley.edu/arose/BPR.pdf>

Figure 1.5

Unemployment has decreased after a sharp rise in 2009 and is approaching structural unemployment levels

Unemployment rate

Percent, yearly average



Source: Statistics Iceland

During the last few years, Iceland has experienced a robust economic recovery, higher than its neighbouring countries or high-income economies in general (Figure 1.4). The economy has now, for the first time, reached the pre-crisis level of total output in real terms. This growth has derived from a sustainable source - the export sector - and been driven mostly by the fast

growing tourist industry. The Central Bank of Iceland predicts that growth will continue and even accelerate over the next few years. However, the main growth drivers will shift from exports to domestic consumption and to some extent new investments.³ This would reduce national savings and could somewhat undermine longer-term growth prospects.

„The Central Bank of Iceland predicts that growth will continue and even accelerate over the next few years.“

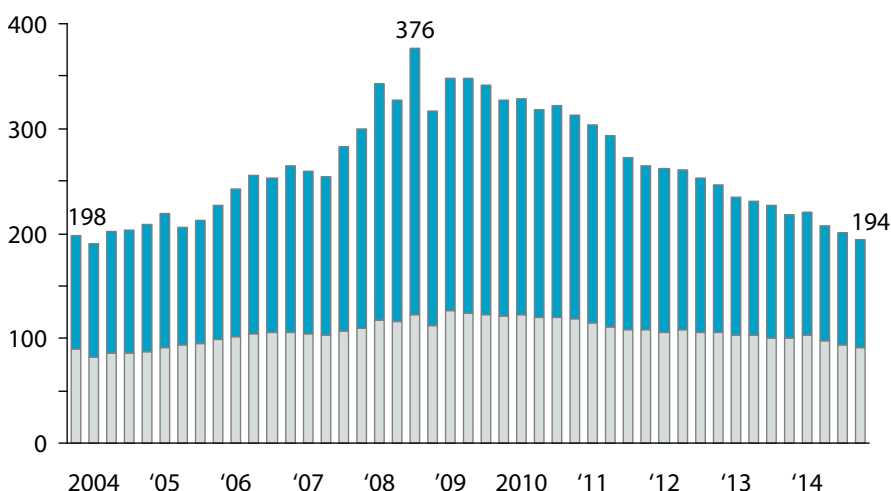
Figure 1.6

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

Corporate and household debt

Percent of GDP

■ Corporate debt ■ Household debt



Source: Central Bank of Iceland

³ Central Bank of Iceland, Monetary Bulletin (2015/2), www.sedlabanki.is/library/Skraarsafn/Peningamal/2015/Mai-2015/Heildarskjal.pdf

Labour market recovery has followed suit. Unemployment rose from 2.3% in 2007 to 7.2% in 2009 following the financial crisis, but has since gradually declined (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. Some labour-force shortage has even begun to be experienced in certain industries, mostly in construction where multiple tourism infrastructure and real estate projects are taking place. Despite positive progress over the last few years there has been some labour market unrest recently. Both public and private sector workers have demanded significant wage increases and the most recent collective agreements negotiations take this into account (see Chapter 2.3)

At the same time improvements have occurred in the labour market, the economy has been in a deleveraging phase (Figure 1.6). Following several consecutive years of credit expansion, culminating in the financial turmoil in Q3 2008, firms and households

have been deleveraging. Debt levels, especially corporate debt, have declined rapidly and are now at similar levels as in 2004.

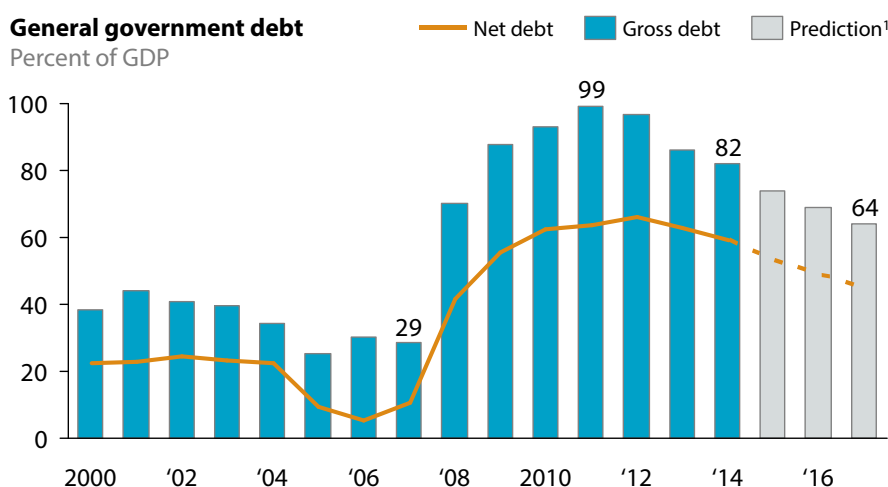
Iceland's public debt used to be low by international standards but rose in almost a single leap in the aftermath of the financial crisis in 2008 (Figure 1.7). The central government is expected to have incurred costs of approx. 20-25% of GDP as a result of the fall of the financial system.⁴ Additionally, tax revenues declined and use of the welfare system increased, resulting in a large budget deficit for the first few years following the crisis. Since then, austerity measures have been undertaken and public expenditure have been reduced annually to adapt to this new situation. The government achieved a budget surplus in 2014 - the first time since the financial collapse.

Current government debt is approximately 86% of GDP, only trailing the PIIGS-countries,⁵ Belgium, France and the United Kingdom in Europe.

„The central government is expected to have incurred costs of approx. 20-25% of GDP as a result of the fall of the financial system“

Figure 1.7

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



¹ Central Bank of Iceland's prediction

Sources: Central Bank of Iceland (Monetary Bulletin 2015/2)

⁴ Matthiasson and Davidsdottir (2013), <http://hhi.hi.is/sites/hhi.hi.is/files/W-series/2013/WP1310.pdf>

⁵ Portugal, Italy, Ireland, Greece and Spain

High inflation has long been a concern in Iceland. In 2001, the Central bank of Iceland converted from an exchange rate targeting monetary policy and adopted an inflation-target policy with 2.5% inflation as its objective. Since then, inflation has usually exceeded this target, averaging 4% p.a. since the adoption of the policy (Figure 1.8).

One of the characteristics of the Icelandic economy is the volatile currency and the high impact of exchange rate fluctuations on inflation. When the Icelandic Krona weakens, 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 Krona fell by 50%, resulting in inflation peaking at 18.6%.

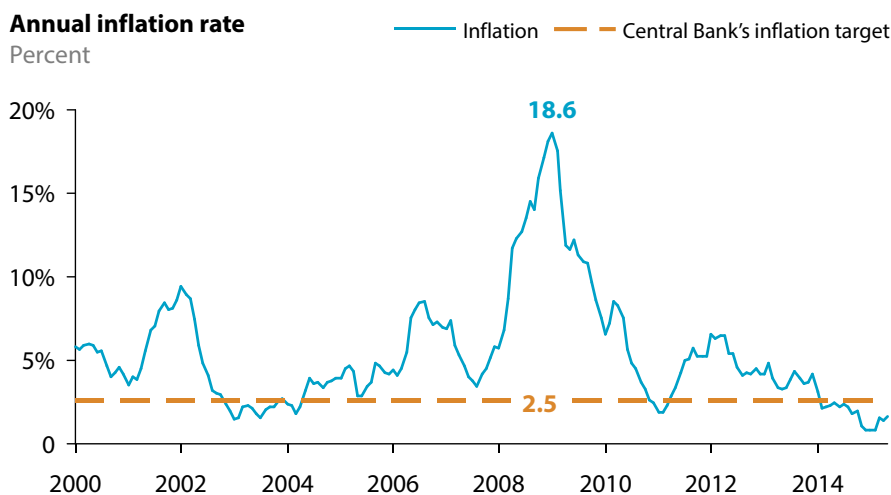
Since this spike, inflation has gradually declined and has remained below the Central Bank's inflation target since early 2014.

Inflation has remained below the inflation rate target the first half of 2015. However it is expected that inflation will again approach the central bank's inflation target towards the end of 2015, as private consumption and investment picks up, and strong economic growth continues. In addition inflation in Iceland's main trade partners has picked up. These inflationary expectations can be seen both in the Central Bank's forecasts and bond-market inflation expectations. The government's household mortgage debt relief plan (detailed in Chapter 2.1) is also likely to cause some upwards inflationary pressure.

„It is expected that inflation will again approach the central bank's inflation target towards the end of 2015, as private consumption and investment picks up, and strong economic growth continues.“

Figure 1.8

Following a dramatic devaluation of the krona inflation rose quickly up to double digits but has decreased again and is now within the Central Bank's target



Source: Central Bank of Iceland, Statistics Iceland, Iceland Chamber of Commerce analysis

1.3 International trade

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 consumption. To fund these imports, a strong export sector is required. International trade thus plays an important role when examining Iceland's economic performance.

Prior to the financial crisis, Iceland's trade balance⁶ was highly negative (i.e. imports far exceeded exports), which led to a build-up of record-high levels of external debt. This trade deficit was in large part caused by a strong exchange rate of the Icelandic krona, which lowered prices of foreign goods and services (Figure 1.9). Then, in 2008, foreign capital started flowing out of Iceland, resulting in a major 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 from exports increased.

In 2014, exports of goods and services amounted to about 53% of Iceland's GDP and there was a surplus in the balance of trade in goods and services of about 6%. In the five years following the financial crisis (2009-2014) there has been a total balance of trade surplus of 42% of one year's 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 surplus⁷ has averaged about 5.6% 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 1.10).

The reason the current account surplus has not been as large as the trade surplus is Iceland's negative net international investment position

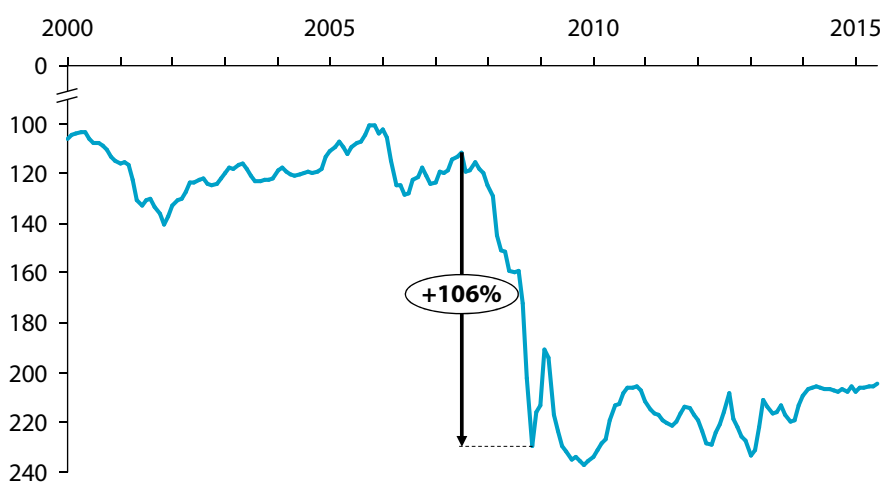
„In 2008 foreign capital started flowing out of Iceland, resulting in a major devaluation of the currency.“

Figure 1.9

After years of high exchange rates the Icelandic krona devaluated dramatically during the financial crisis and has since remained relatively weak

Exchange rate index (ERI)

A higher index value indicates a weaker Icelandic krona



Source: Central Bank of Iceland

⁶ Balance of international trade in goods and services

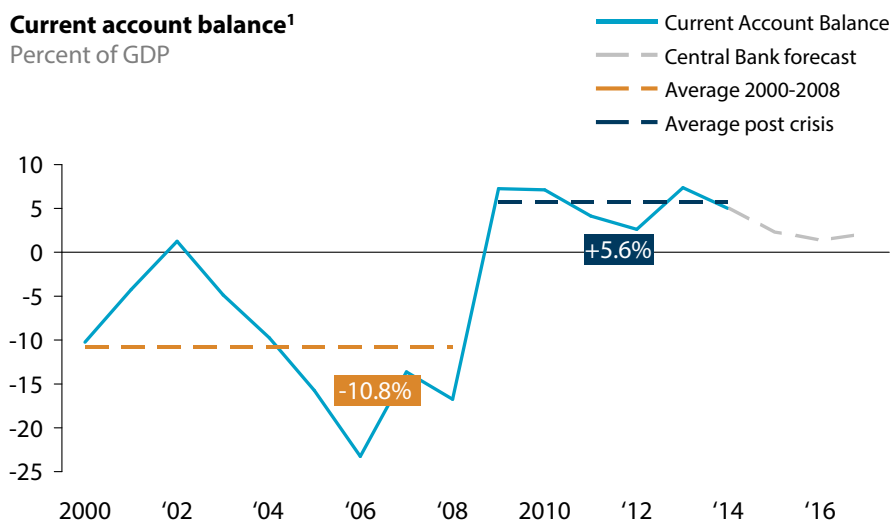
⁷ Excludes the effects of the failed bank's estates

Figure 1.10

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

Current account balance¹

Percent of GDP



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

(NIIP). 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,

reaching unsustainable levels (Figure 1.11). After a restructuring of the banking system in the aftermath of the financial crisis and years of current account surplus, the NIIP position has gradually been becoming less negative.

„After a restructuring of the banking system in the aftermath of the financial crisis and years of current account surplus, the NIIP position has gradually been becoming less negative.“

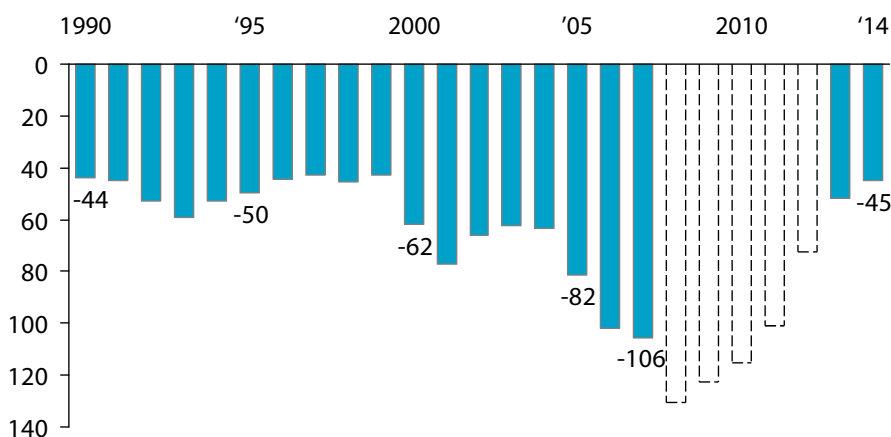
Figure 1.11

A persistent current account deficit in the years leading up to the crisis resulted in a vast amount of foreign obligations that have since then been scaled back

Iceland's net foreign obligations

NIIP¹, percent of GDP

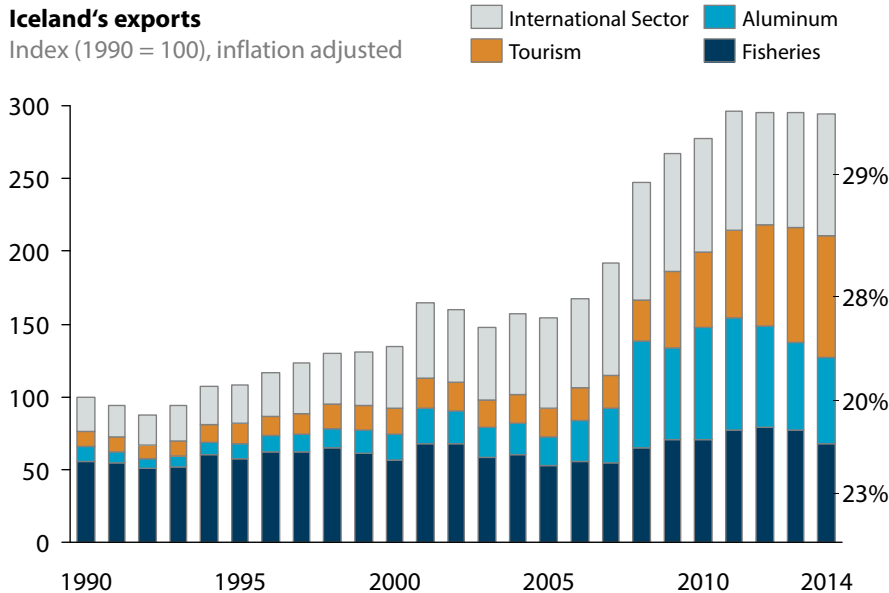
[] Level unclear because of the uncertainty around banks in winding-up proceedings



1 Net International Investment Position
Source: Central Bank of Iceland

Figure 1.12

Iceland has historically been dependent on fishing but three other export foundations have emerged, tourism being the most recent addition



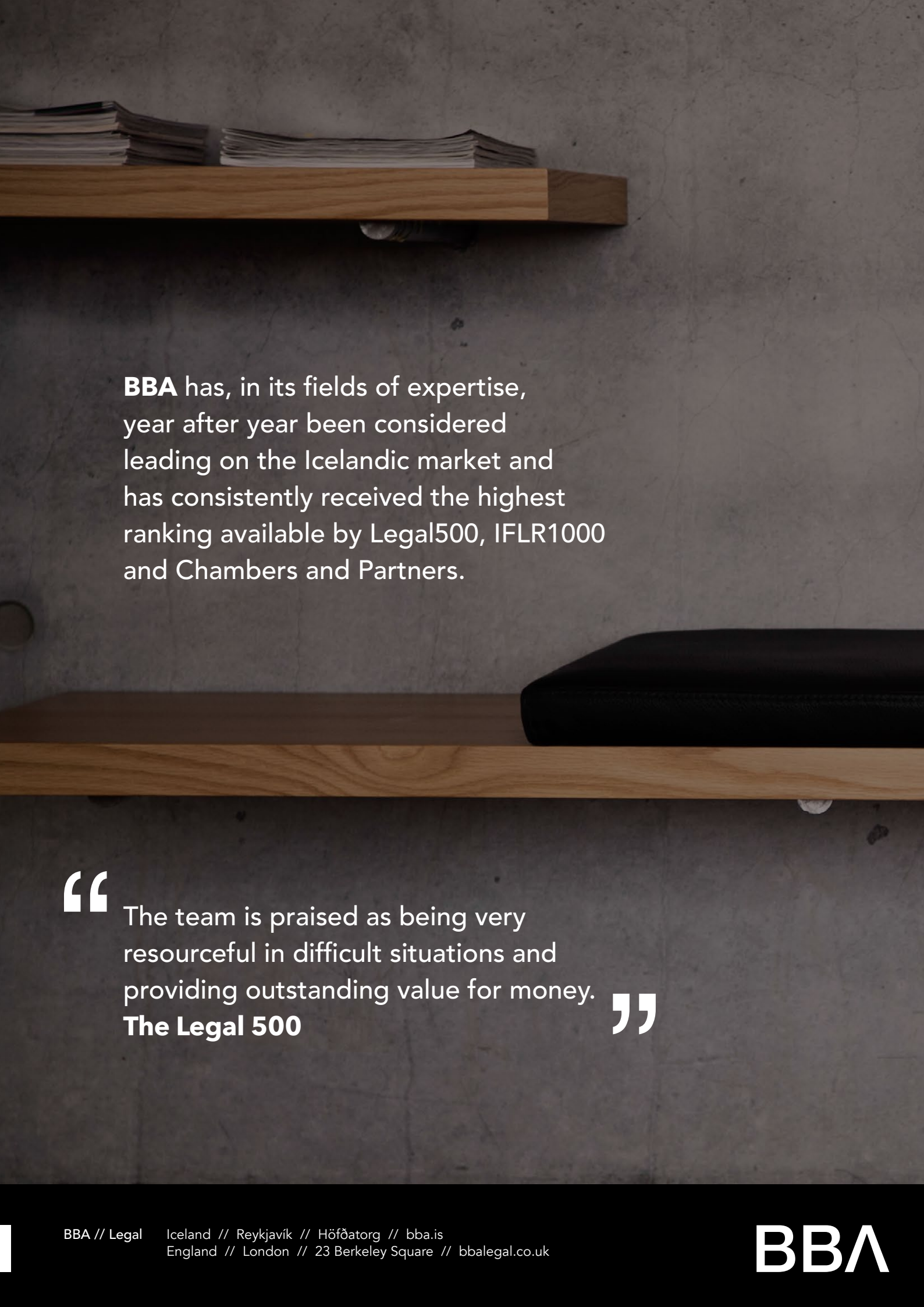
Sources: Central Bank of Iceland; Iceland Chamber of Commerce analysis

A key challenge for Iceland is to increase its exports in order to maintain current account surplus and improve the NIIP (Figure 1.12). Two decades ago the country was heavily dependent on fishing, with more than half of exports originating from the fishing industry. Since then, fish-related exports have remained relatively stable, as the industry is limited by the quantity it can harvest, so as to preserve the size and sustainability of the fishing stock.

Since then, however, three additional export foundations have emerged.

Around the new millennium there was a large amount of growth in the international sector – the sector of the economy that is engaged in international competition and not reliant on natural resources. Then, from 2005 to 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. Overall, Iceland's exports of goods and services have grown rapidly and become more diversified over the last two decades.

„Iceland's exports of goods and services have grown rapidly and become more diversified over the last two decades.“



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2 Recent developments

2.1 Political landscape

Prior to the parliamentary election in May 2013, the Icelandic government was a centre-left coalition comprising the Social Democratic Alliance and the Left-Green Movement. These parties together received 52% of the popular vote in 2009. However, in the 2013 elections, they failed to get re-elected, receiving only 24% of the popular vote, a decrease of 28% from 2009.

Instead, a new centre-right coalition government was formed (Figure 2.1). The coalition was formed by the two largest political parties in Alþingi, the Icelandic legislature, following

the election; the Independence Party and the Progressive Party. Both parties gained ground from the previous election, the Independence Party receiving 27% of the votes (an increase of 3% from the 2009 election) and the Progressive party 24% (an increase of 10%).

The new government has implemented a number of policy changes since taking office. These changes include a more Eurosceptic stance, fiscal prudence, changes to the tax system and a general mortgage debt relief programme.

„The new government has implemented a number of policy changes since taking office.“

Figure 2.1

A new centre-right wing government was formed in May 2013, following a four-year term by a centre-left wing government



Source: Prime Minister's Office

EU application

Iceland submitted an application for a membership of the European Union (EU) in July 2009, and was granted candidate country status one year later (Figure 2.2). During active negotiations, 27 out of 33 policy chapters were opened, and negotiations were conducted until January 2013, when they were suspended, with the six remaining chapters unopened. According to The University of Iceland's Institute of International Affairs' report on Iceland's accession negotiations⁸, of the six unopened chapters, neither party was willing to commence negotiations on fisheries, and only the EU was willing to start negotiations on agriculture and rural development.

Overall, negotiations progressed well. However, a fisheries dispute regarding mackerel negatively affected their 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 admission process.

The new Government, formed after the election in 2013, 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 the Alþingi. The bill 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 considers Iceland as an EU candidate country. The EU has since removed Iceland from its list of candidate countries.⁹

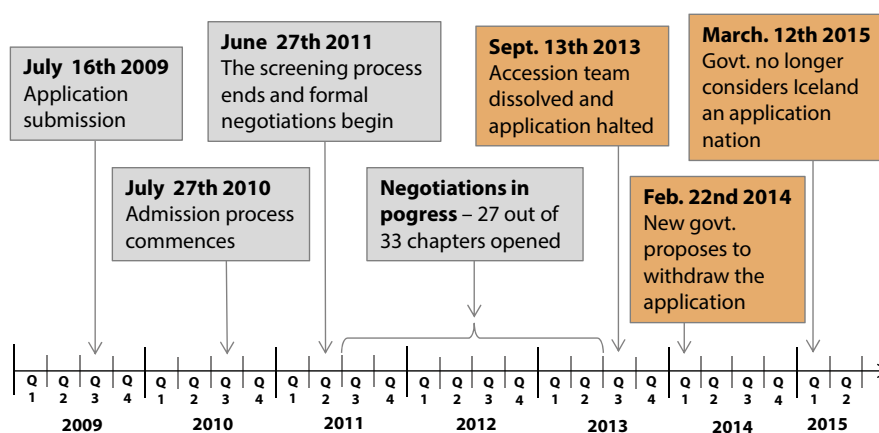
**„In March 2015
Iceland's minister
of foreign affairs
unilaterally announced
to the EU that the
government no longer
considers Iceland as an
EU candidate country.“**

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

Timeline



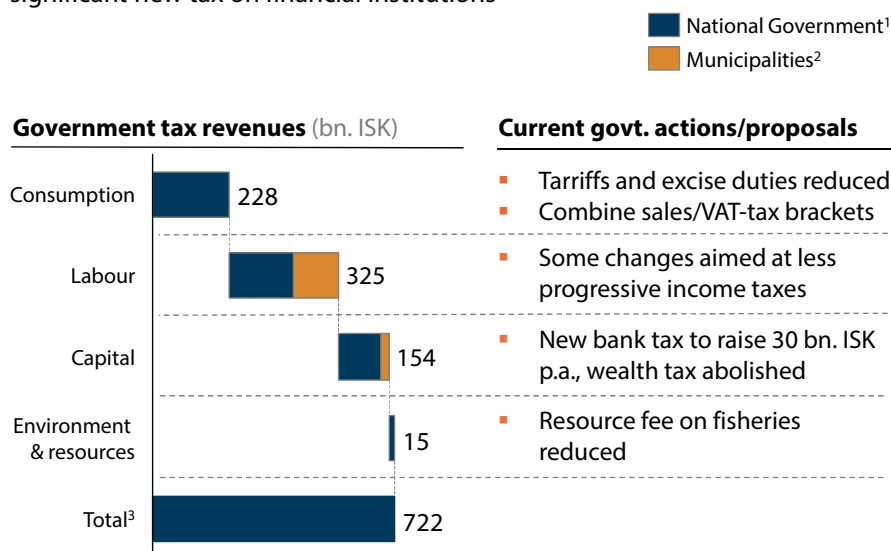
Source: Iceland Chamber of Commerce

⁸ An English summary of the report's conclusions can be accessed via the following link: http://vi.is/files/iaa_iceland_eu_report_executive_summary_1818099411.pdf

⁹ See http://europa.eu/about-eu/countries/index_en.htm

Figure 2.3

The current government aims to reduce consumption taxes but is imposing a significant new tax on financial institutions



1 National Government 2014 draft budget

2 Association of Icelandic Municipalities tax report 2014

3 On top of this the general government gets 53bn. ISK in other revenues, mostly from public services, capital gains and dividend payments

Sources: Ministry of Finance and Economic Affairs; Association of Municipalities; Iceland Chamber of Commerce analysis

Tax and fiscal policy

The new government also emphasised fiscal prudence and a reduction of public debt. The fiscal deficit was eliminated in 2014 for the first time since the financial crisis. In addition the minister of finance has recently advocated selling up to 60% of the government's stake in Landsbankinn,

Iceland's largest bank, in order to further reduce public debt. The tax system has been altered somewhat, and additional changes have been proposed (Figure 2.3). To date, key changes include an extension of and increase of a financial institutions tax, a reduction in a

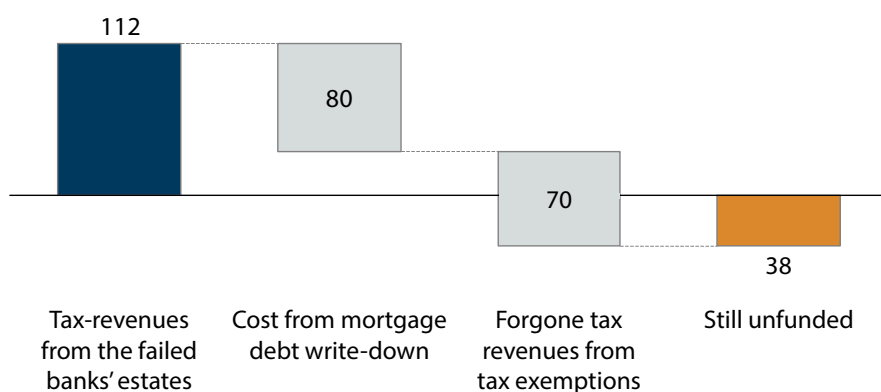
„Tax changes include an extension of and increase of a financial institutions tax, a reduction in a resource fee on fisheries, a reduction in the VAT tax bracket disparity, a small reduction in income taxes and a reduction in tariffs.“

Figure 2.4

The government has largely implemented its plan to allocate 150 bn. ISK to a mortgage debt relief plan – mostly funded by a new tax on the failed banks

Breakdown of the government's mortgage debt-relief financing

Bn. ISK (cost and revenue will realise incrementally over the next four years)



Sources: Prime Minister's Office, Iceland Chamber of Commerce analysis

resource fee on fisheries, a reduction in the VAT tax bracket disparity, a small reduction in income taxes and a reduction in tariffs. The VAT general tax bracket was lowered from 25.5% to 24% and the lower bracket increased from 7% to 11% in January 2015. The most significant planned change lies in reforms of the income tax system by removing one of the three main income steps, set to be completed by 2017.

A tax on financial institutions has been extended to the estates of the failed Icelandic banks, raising significant new revenues. The additional funds will be earmarked to fund a

new mortgage relief programme, beginning in 2014 (Figure 2.4). The programme is comprised of two components. The first component is a publicly financed write-down of inflation-linked household mortgages. These mortgages rose in value in 2008 and 2009, when the currency depreciated and inflation soared, resulting in trouble for many homeowners, as real estate prices decreased simultaneously. The second component is a partial tax exemption for workers using a proportion of their salary to pay down their mortgages. The combined cost of the programme is expected to be approximately 150 bn. ISK (8% of GDP).

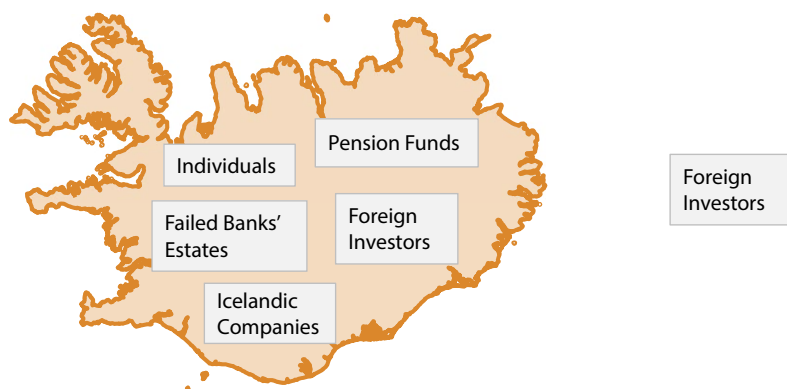
„The combined cost of the programme is expected to be approximately 150 bn. ISK (8% of GDP).“

Figure 2.5

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 the capital controls

Capital Controls



Source: Iceland Chamber of Commerce

2.2. Capital Controls

Following the financial crisis of 2008, capital controls were introduced as a temporary measure, in order to prevent a dramatic outflow of capital, which could have resulted in a collapse of the Icelandic krona, severely destabilising the economy. The controls were a part of a programme on the part of the Icelandic government and the International Monetary Fund (IMF), aimed at restoring economic and

financial stability. Only financial outflows are limited under the controls; financial inflows as well as trade in goods and services is still permitted.

The capital controls remain in place and affect multiple parties (Figure 2.5). The controls have been tightened a number of times since they were first imposed, almost six years ago. For example, in March 2012, the estates

„Following the financial crisis of 2008, capital controls were introduced as a temporary measure, in order to prevent a dramatic outflow of capital.“

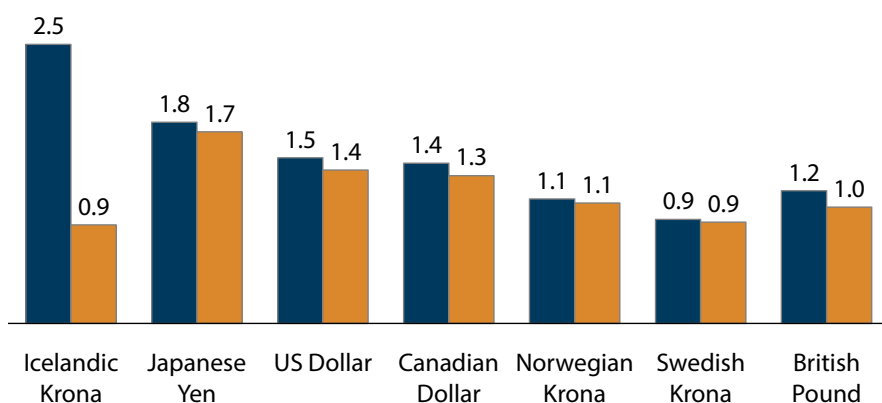
Figure 2.6

The Icelandic krona was one of the most volatile currencies in the developed world – this has changed after the implementation of capital controls

Exchange rate fluctuations against the Euro

Standard deviation of weekly changes

Free-floating (2003-2009)
Capital controls (2010-2015)



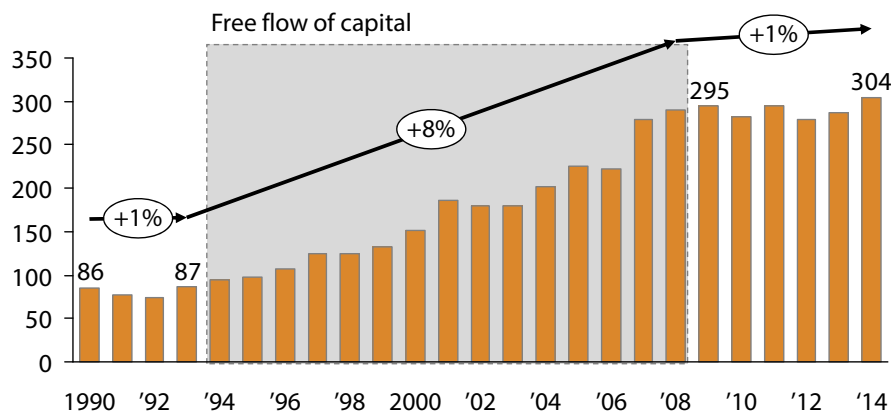
Sources: Central Bank of Iceland; Iceland Chamber of Commerce analysis

Figure 2.7

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

Iceland's exports originating from the international sector

Bn. ISK (inflation adjusted)



Sources: Statistics Iceland; Iceland Chamber of Commerce analysis

of the failed domestic banks were forbidden to transfer payments to creditors abroad. Also, in June 2014, individuals were forbidden to allocate their pension savings to insurance companies abroad.

Since their imposition, the controls have had the desired effect on the exchange rate of the Icelandic krona (Figure 2.6). The currency has become increasingly stable and a further weakening has been halted. This 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 inflation-linked. A volatile exchange rate could have resulted in unforeseeable fluctuations in debt levels.

Nevertheless, the adverse effects of the capital controls are also evident. The largest economic cost is in the form of a 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

(Figure 2.7). The Chamber has noted that when the flow of capital was free, export revenues generated by globally competitive firms grew by 8% p.a. However, since the implementation of the capital controls, their operations have grown by only 1% p.a. Such a slowdown reduces export revenues to the Icelandic economy and hampers economic growth.

In addition, the capital controls could also be causing economic damage by interfering with price mechanisms and skewing asset markets. All domestic savings are trapped in the local economy, and thus restricted to relatively few investment options. For example, Icelandic pension funds must invest over 120bn. ISK (6.0% of GDP) annually, and with few investment options and markets of limited depth, this could lead to over investment and asset bubble formations.

Lifting the controls has proven difficult (Figure 2.8). Since the controls were introduced in order to prevent financial outflows, a large amount of capital could seek a rapid exit as soon as they are lifted. Large outflows could then significantly weaken the exchange rate and thus threaten economic stability. The Chamber

„The largest economic cost is in the form of a slower growth of globally competitive firms.“

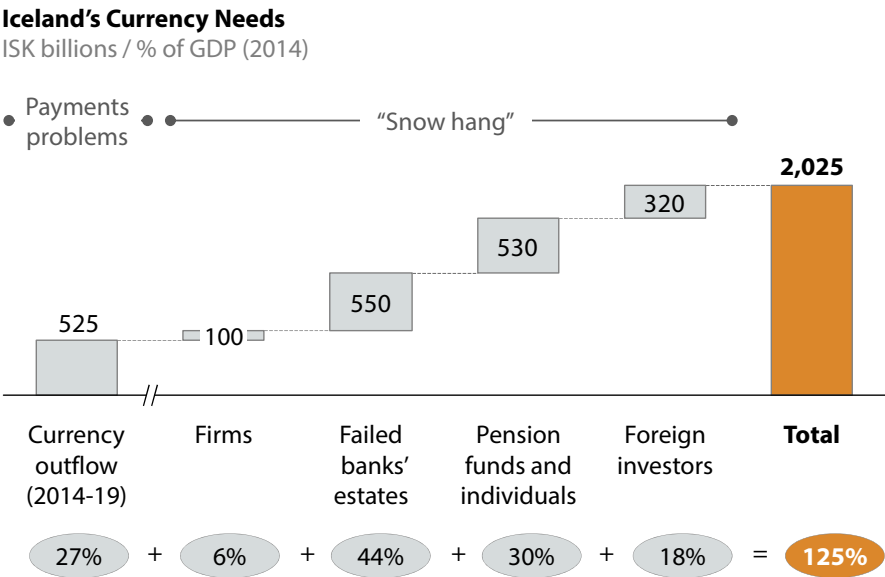
estimated in 2014 that Iceland's shortage of currency could at worst amount to 125% of GDP. To bridge this gap, foreign credit and investments will need to counter these potential outflows.

In June 2015 the government announced a new plan to lift the capital controls. The aim of the plan is to prevent a significant currency outflow from the failed banks' estates. To achieve that the estates can either fulfil set stability conditions aimed at eliminating any negative effects on capital flows or pay a stability tax

estimated to be worth 630 bn isk total.¹⁰ Additionally, offshore kronas, which are held by foreign residents, will be allowed to exit either via an FX auction that will include a 30% reduction in the EUR/ISK exchange rate or through a non-tradable government bond. In response to these proposed plans Moody's has upgraded Iceland's credit rating from Baa3 to Baa2, citing the new plan, improving debt position and regulatory improvements as key drivers.¹¹

„The Chamber estimates that Iceland's shortage of currency could at worst amount to 125% of GDP“

Figure 2.8
Iceland's shortage of foreign currency combined with the needs of multiple parties to invest abroad is a challenge when lifting the capital controls



Sources: Central bank of Iceland; Iceland Chamber of Commerce estimates

¹⁰ According to estimates by the Iceland Chamber of Commerce

¹¹ See <http://cb.is/publications/news/news/2015/06/29/Moodys-upgrades-Iceland's-rating/>

2.3 Labour Market Disputes

Following a positive development of general domestic purchasing power for 2014, led mainly by low imported inflation, high domestic worker demands led to collective bargaining agreements of 17-20% general wage increases over the next four years and up to 30% for workers with the lowest salaries. This increase is over the Central Bank's estimated economic sustainability for nominal wage increases during the period. The stability and performance of Iceland's macro economy over the coming years will partly be shaped by the inflationary effects of these agreements.

The capital to labour ratio, which measure the distribution of wealth in society between workers and capital owners, is just over 60% in Iceland, among the highest within the OECD. Therefore an excessive wage increase would have a greater effect on Icelandic companies and most likely lead to a mix of increased inflation, increase in unemployment, higher frequency of bankruptcies and in turn lower GDP growth. The central bank has estimated that a 30% increase in nominal wages might increase inflation by an average of 2.8% and lower GDP growth by an average of -0.8% over the next few years (Figure 2.9).¹²

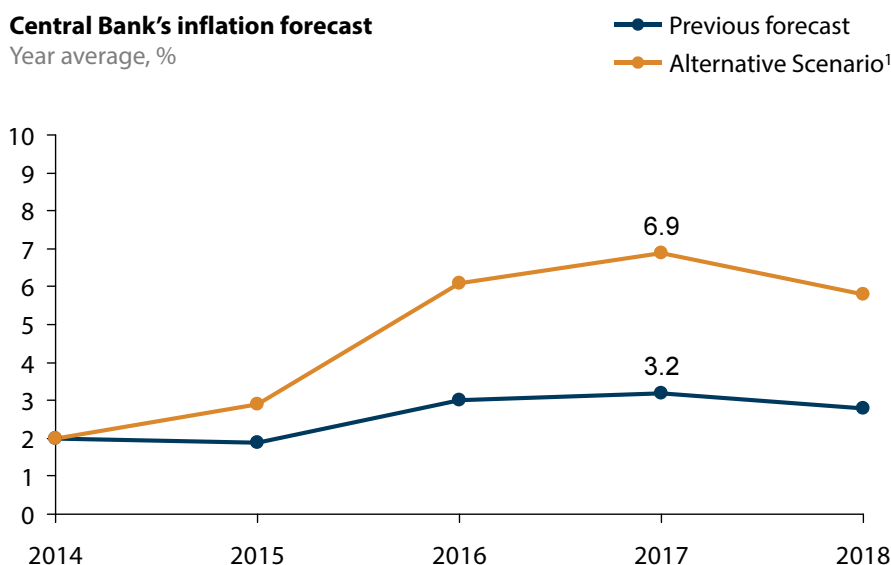
„The stability and performance of Iceland's macro economy over the coming years will partly be shaped by the inflationary effects of collective bargaining agreements.“

Figure 2.9

The most recent labour market collective agreements are expected to increase inflationary pressures over the next few years

Central Bank's inflation forecast

Year average, %



¹ This forecast assumes 30% nominal wage increases, consistent with the most recent collective agreements

Source: Central bank of Iceland; Iceland Chamber of Commerce analysis

¹² Estimate obtained from Monetary Bulletin 2015/2. Assumes that long-term inflation expectations still hold. Average for the years 2015-2018.

2.4 Investment Projects

The Icelandic economy has recovered from the financial crisis and is projected to maintain strong growth during the next few years. This can, in part, be attributed to a number of large projects that support this

growth, particularly in tourism and energy intensive industries. The following is an overview of a few of these, both planned and potential.

Tourism

The largest recession remedy for the Icelandic economy has been a booming tourism sector (Figure 2.10). The number of tourists has increased at a rapid pace, 18% p.a. on average from 2010 to 2014. In 2015, the number of tourists visiting Iceland is expected to exceed 1 million – more than three times the population. This has implications across the Icelandic economy. Most significantly, new jobs have been created in tourism-related companies, and capital has been allocated for the construction of new hotels and other infrastructure across the country.

In 2010, when the tourism industry was starting to take off, investment in tourism-related infrastructure failed

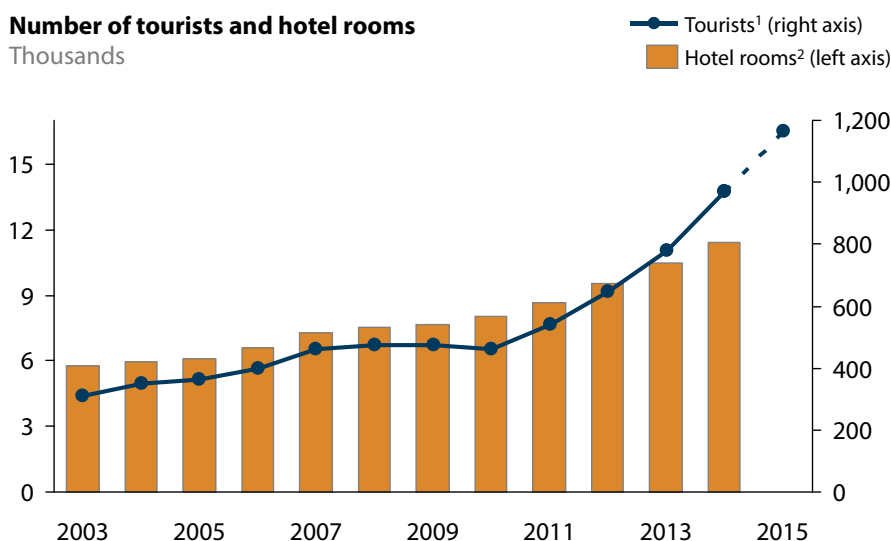
to keep up with increasing demand. This lag can be partially attributed to the high seasonality of tourism (Figure 2.11). Demand peaked during the summers resulting in a lower overall utilisation and productivity of tourism-related investments, such as hotels, relative to other industries. Hotel room utilisation was over 85% on average nationwide in June, July and August 2014 relative to 57% for the winter months. However, over the last three years, tourism in Iceland has been becoming less seasonal, increasing the return on tourism-related investments.

A current challenge for the authorities is dealing with the environmental effects of such a high number of visitors. A number of tourist

„The largest recession remedy for the Icelandic economy has been a booming tourism sector.“

Figure 2.10

The supply of hotel rooms has not kept up with demand, however significant hotel infrastructure is now under construction



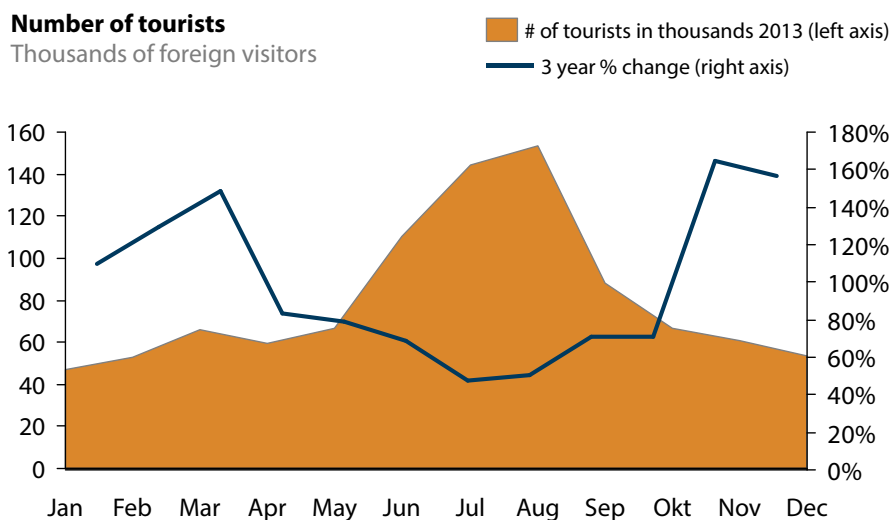
¹ The figure for 2015 is an estimate by the Economic Research department of Landsbankinn

² Yearly average

Sources: Statistics Iceland; Icelandic Tourist Board; Landsbankinn Economic Research; Iceland Chamber of Commerce analysis

Figure 2.11

The Icelandic tourism industry's productivity has historically suffered from high seasonality – recently this has changed in a favourable way



Sources: Iceland Tourist Board; Iceland Chamber of Commerce analysis

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 these issues and establishing a framework where visitor flow can be managed, whether by visitors' fees or other measures.

Silicon plants

Four large foreign investment projects are likely to be realised in the immediate future, due to the planned construction of four new energy intensive silicon plants. An investment of this scale could significantly boost economic growth, as the total value of the four planned investments is about 150 bn. ISK (7.3% of GDP), close to total business investment in 2014 (Figure 2.12). This would also strengthen the export sector by increasing its volume and making it more diversified.

Investment agreements and a power purchase agreement (PPA) have been signed by the Government and Landsvirkjun, Iceland's biggest energy company, with all of these proposed projects, and construction has begun in some cases.

In May of this year, United Silicon began construction of a 20,000 ton metallurgical grade silicon metal production plant in Helguvík near Reykjanesbær. The investment is about 12 bn. ISK and 200-250 people will be employed during the construction of the plant, which is expected to take two years.

PCC Bakki Silicon aims to start constructions of a 32,000 tonne metallurgical grade silicon metal production plant as early as August of this year. Construction is envisioned to take 2-3 years, and the total investment will be 28 bn. ISK. The plant will be located at Bakki near Húsavík in the northeast part of Iceland.

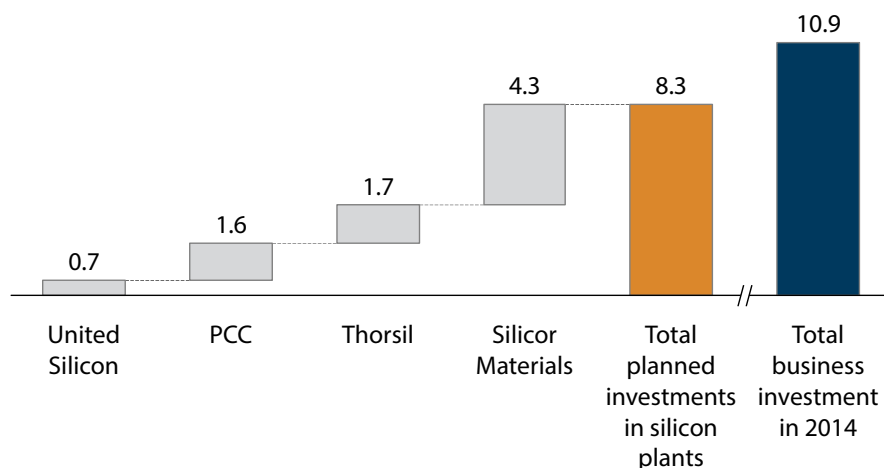
„Four large foreign investment projects are likely to be realised in the immediate future, due to the planned construction of four new energy intensive silicon plants.“

Figure 2.12

Four large silicon plant investment project agreements have been signed recently, which will significantly increase total business investment

Signed silicon plant investment projects

% of GDP¹



¹ United Silicon, PCC and Thorsil have signed both investment agreements with the government and power purchase agreements with Landsvirkjun.

Sources: Statistics Iceland; News reports; Iceland Chamber of Commerce estimates

Thorsil hopes to start construction of a 30 bn. ISK silicon metal production plant in Helguvík near Reykjanesbær later this year, which could produce 54,000 tons per year upon completion. Roughly 300 people will be employed during the construction phase, and 160 people once production is underway. Construction is expected to take about two years.

Silicor Materials have signed a contract to build a solar silicon plant at Grundartangi Port in the west of Iceland, an investment of 80 bn. ISK. The plant is expected to produce up to 16,000 tons of solar silicon annually. Construction could begin as soon as this year and the construction phase is expected to take about three years.

Pharmaceutical

An international privately-owned pharmaceutical company, Alvogen, plans to invest 25 bn. ISK in Iceland over the course of the next few years.¹³ Of these 25 bn. ISK, approximately 6 bn. will be used to construct a research and development centre adjacent to The University of

Iceland, which will house Alvogen's international offices and facilities for the development and production of biotechnologically based pharmaceuticals. Construction of the centre has already begun, and once completed it will employ over 200 people in the pharmaceutical industry.

„An international privately-owned pharmaceutical company, Alvogen, plans to invest 25 bn. ISK in Iceland over the course of the next few years.“

¹³ See http://english.hi.is/frettir/alvogen_and_uoi_science_park_collaborate

Data centres

The data centre industry is a rapidly emerging industry in Iceland. A new data centre was constructed in Iceland in 2012, operated by Verne Global, and construction of two additional data centres is currently underway, operated by Advania and Borealis

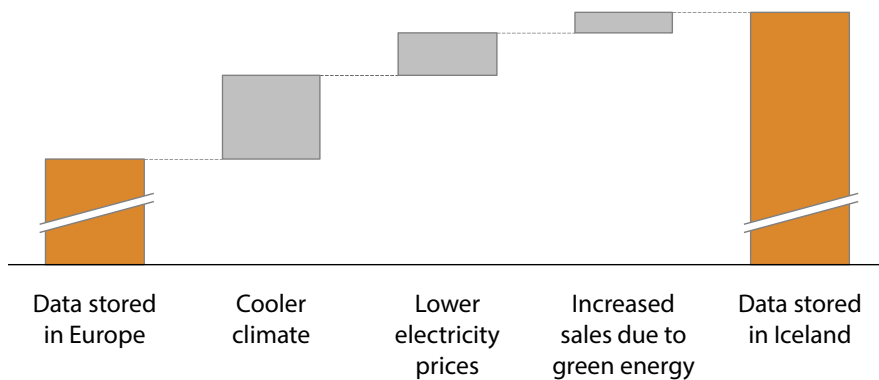
Data Centres, respectively. Iceland's cold temperate climate, low electricity prices and renewable energy production has made it an attractive location for such operations (Figure 2.13).

„The data centre industry is a rapidly emerging industry in Iceland.“

Figure 2.13

Favourable 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 (illustrative)



Source: Iceland Chamber of Commerce

Interconnector

The Icelandic and British authorities are currently exploring the possibility of constructing an electrical interconnector between the two countries (Figure 2.14). Such an interconnector could be a source of new export revenues for the Icelandic economy.

Iceland produces a significant amount of geothermal and hydropower electricity, most of which is currently utilised 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 approx. 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.

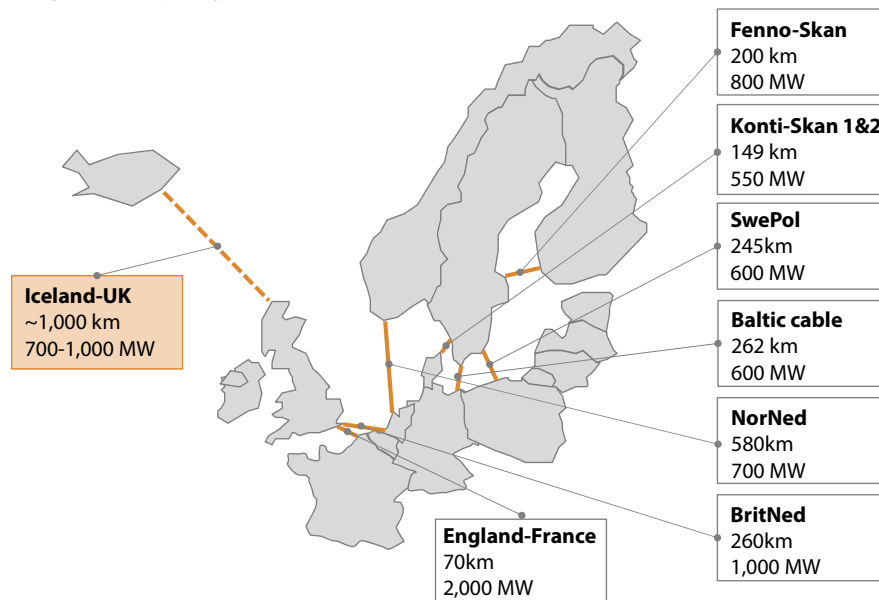
„An interconnector between Iceland and the UK would be one of the longest in the world and would require a significant investment.“

Figure 2.14

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

Interconnectors in northern Europe

Length and capacity



Sources: GAM Management; Iceland Chamber of Commerce

2.5 The Financial System

The Icelandic financial system is large compared to the size of the economy and has undergone major changes during and following the financial

crisis of 2008. Below is a detailing of these changes, access to foreign credit and asset market developments.

The banking system

The Icelandic banking system underwent a major transformation in 2008, when all three of Iceland's major retail banks collapsed within the space of a week. The government feared a complete meltdown of the whole payment system, but had no way of rescuing the banks, as they had balance sheets amounting 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 that granted deposits priority over other claims and 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 retail bank, but ownership of the other two banks was mostly transferred to the failed banks' estates following an agreement with the government.

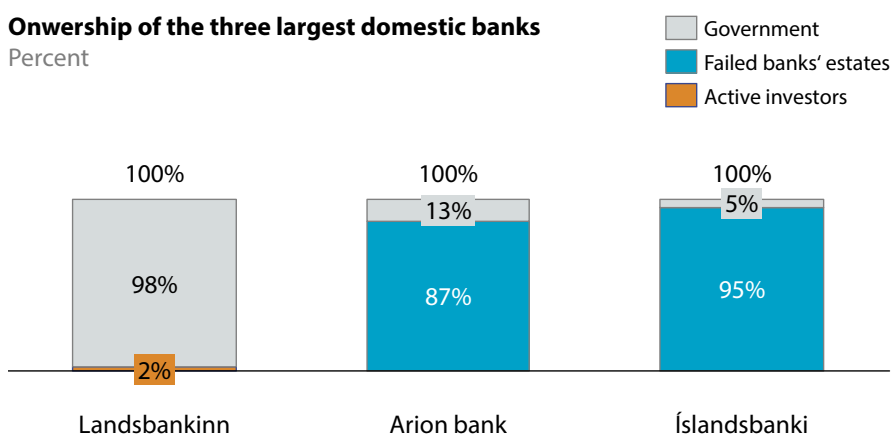
Since then, Iceland has had a financially healthy domestic banking system, although ownership has been unorthodox and restricted almost exclusively to two parties: the government and the creditors of the failed banks via the failed banks' estates (Figure 2.15). The Icelandic State Financial Investments (ISFI) controls the state's holdings in Landsbankinn in accordance with the state's ownership policy, but the creditors of the failed banks have no direct influence on the operation of the other two functioning banks (Arion bank and Íslandsbanki).

Iceland's Minister of Finance has recently stated that the government plans to sell up to 30% of its majority stake in Landsbankinn and use the proceeds to reduce public debt, although no official timeline in that regard has been announced.

„The Icelandic banking system underwent a major transformation in 2008, when all three of Iceland's major retail banks collapsed within the space of a week.“

Figure 2.15

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



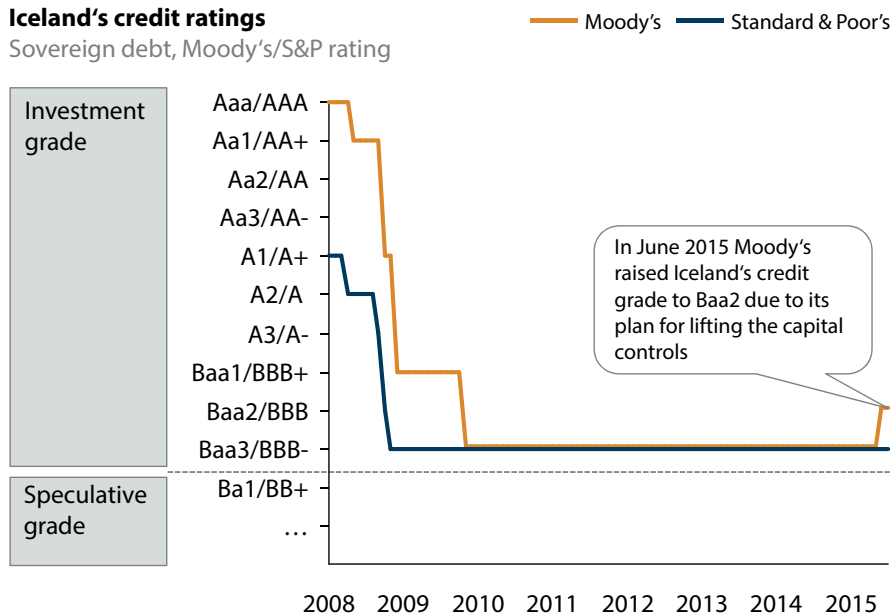
Source: Annual reports

Figure 2.16

Iceland has remained at the bottom of the investment grade credit ratings, but the outlook is now stable instead of negative

Iceland's credit ratings

Sovereign debt, Moody's/S&P rating



Source: Central bank of Iceland

Access to credit

Iceland was hit particularly hard by the global credit crunch, as it had taken advantage of affordable foreign credit in the preceding years, and was heavily reliant on such credit. In early 2007, credit default swap (CDS) spreads on Icelandic government bonds were extremely low, at just 10

basis points. CDS spreads reflect the probability of default, so such a low spread implied a very low probability of the government defaulting on its debt. Additionally, the credit rating agency Moody's gave the sovereign state its highest possible credit rating, AAA, on foreign currency risk,

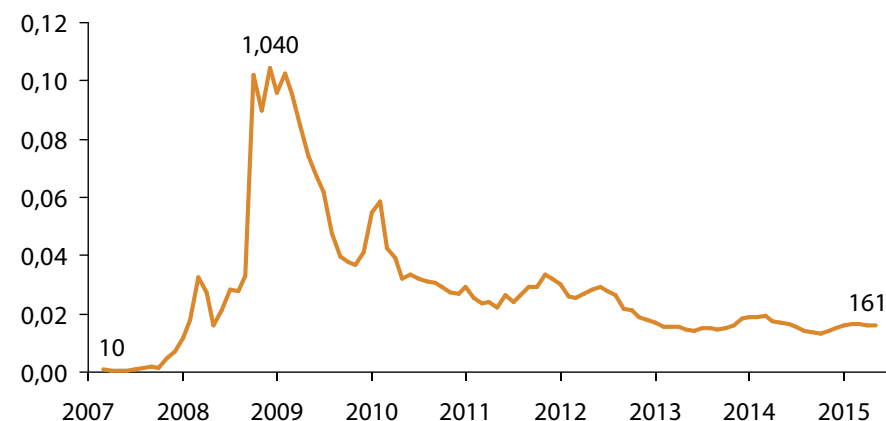
„Iceland was hit particularly hard by the global credit crunch, as it had taken advantage of affordable foreign credit in the preceding years, and was heavily reliant on such credit.“

Figure 2.17

Iceland's risk premium has gradually declined since the financial crisis, improving access to capital for public and private parties

Credit default swap spreads

Icelandic 5Y sovereign debt (basis points)



Source: Central bank of Iceland; Iceland Chamber of Commerce Analysis

reflecting the high confidence in Iceland by foreign investors (Figure 2.16).

During the latter half of 2007, the CDS spread on Icelandic sovereign debt began to increase, and during the financial crisis in 2008 it suddenly spiked to 1,040 basis points (Figure 2.17). Since then, investors' trust in Iceland has been increasing following a fall in the 5Y sovereign CDS spreads. Recently, CDS spreads have hovered around 170 basis points. Both Moody's and S&P have rated Iceland as having

the lowest Investment grade, (Baa3/BBB-) since late 2009, although Moody's has raised Iceland's credit rating to Baa2 following the outlaid government plans to lift the capital controls in the coming years.

Regardless, Iceland does not have the same access to credit as before. This can be attributed to global factors, such as increased investor risk-aversion, as well as local factors, such as the presence of capital controls, as discussed in Chapter 2.2.

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 capitalisation.

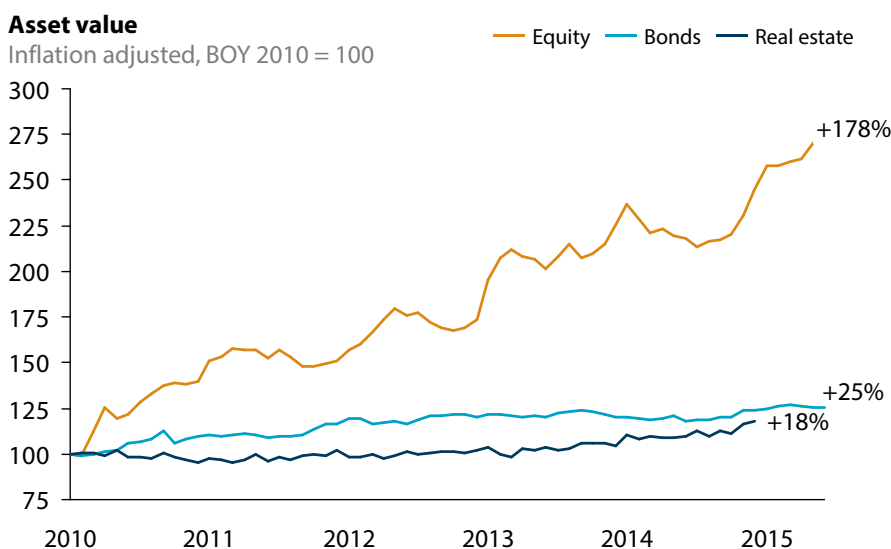
Over the past few years, both the public equity market and the

corporate bond market has been gradually gaining momentum, thus broadening the asset market and making it healthier, bringing it more into line with foreign asset markets. In December 2011, Hagar, Iceland's largest retail company, went public and since then ten additional firms have followed suit and a few more are expected to do so in the near future. The total market capitalisation of the Nasdaq OMX Iceland (including First North, a less regulated listing for smaller firms) has now reached about 840 bn. ISK (just over 40% of Iceland's

„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.“

Figure 2.18

Domestic assets have recovered value over the last few years following significant devaluations during the crisis



Sources: GAM Management; Registers Iceland (Real estate index); Iceland Chamber of Commerce analysis

GDP). The equity market has yielded high returns over the last few years, an annual real return of 21% since the beginning of 2010 (Figure 2.18).

The bond market price development has somewhat followed the progress of the labour market disputes (see Chapter 2.3 for discussion). Early this year inflation was close to an all-time low, market inflation expectations were relatively low in historical terms and economic outlook was stable. However following the labour market disputes the market inflation expectations have increased resulting in lower yields on inflation indexed bonds and higher on non-indexed bonds, causing indexed bonds to rally returning 8% and non-indexed to decrease by 2% in value.

Additionally, a collapse in construction combined with high demographics-driven demand has led to a significant growth in real housing prices. If real estate prices are excluded from the consumer price index, then it has only gained approx. 0.4% since 2013. Real housing prices have therefore increased considerably in 2013 and 2014. The price rise can be partly explained by relatively few new housing projects and partly by domestic institutional investors pursuing yields by investing in housing, as they are incapable of investing abroad due to the capital controls.

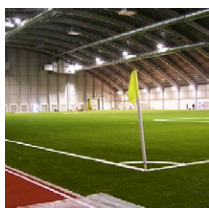
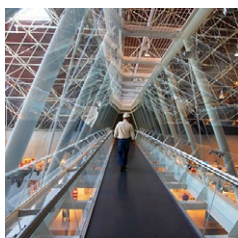
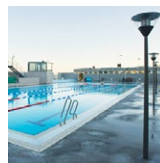
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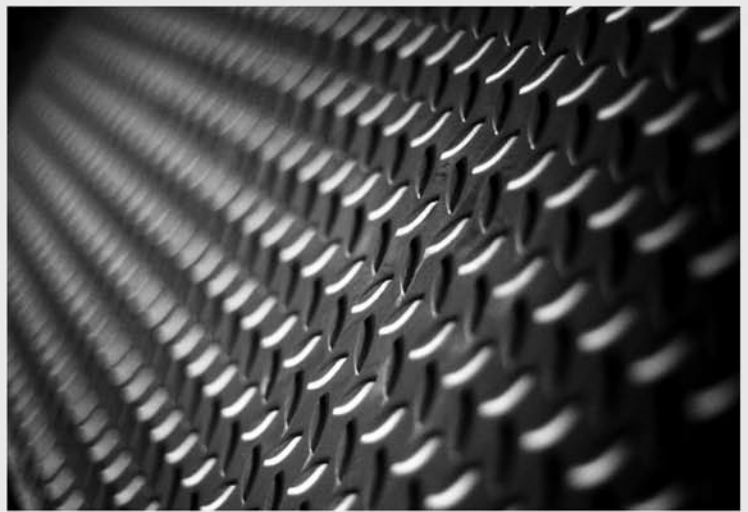
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3 Future Prospects

3.1 Overview

Iceland has largely recovered from the financial crisis. Growth has been robust recently and is projected to continue to be so for the next few years. 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, how Iceland will service and refinance

its external obligations, and secondly, whether Iceland will be able to realise economic growth in the longer term through an increase in productivity and exports.

3.2 External Obligations

Iceland currently has a negative net international investment position of 45% of GDP (Figure 3.1), in line with many Western-European countries. In recent years a large portion of Iceland's foreign obligations have been in the form of debt with low

maturity, causing an outflow of capital. However the problem has been somewhat mitigated. In July 2014 the Government refinanced 700 million euros' worth of foreign debt by issuing a euro denominated bond at the most favourable rate since the

„Iceland currently has a negative net international investment position of 45% of GDP (Figure 3.1), in line with many Western-European countries.“

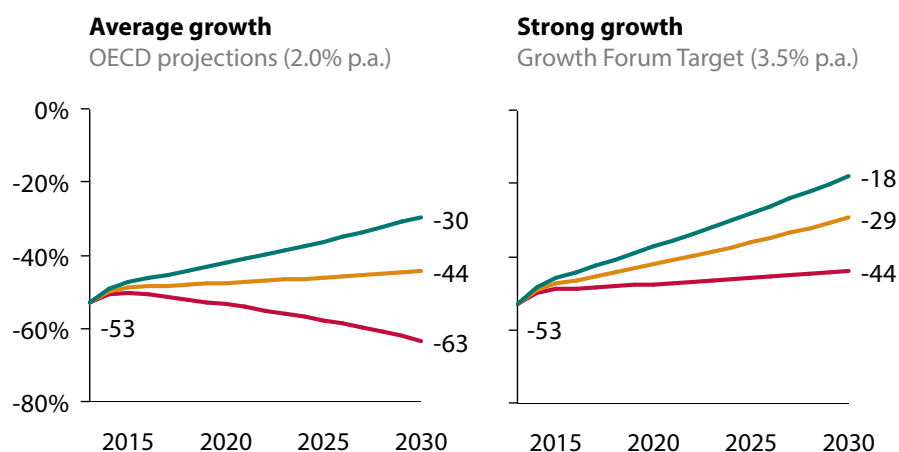
Figure 3.1

The trajectory for Iceland's net external obligations will be determined by its access to foreign credit and GDP growth over the longer term

Iceland's net external obligations

Net International Investment Position (% of GDP)

- Unfavourable rate (7.5%)
- Unchanged rate (5.0%)
- Favourable rate (2.5%)



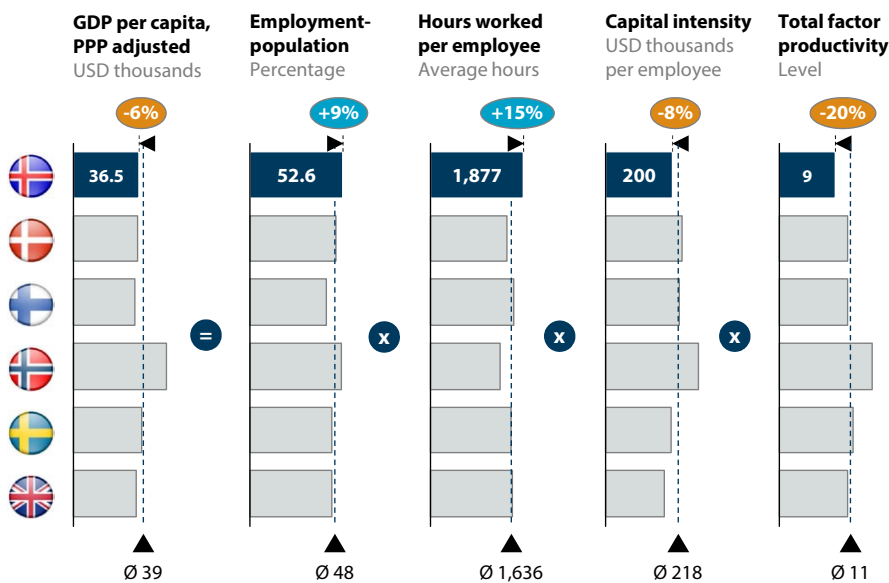
Sources: OECD; Iceland Growth Forum; Central Bank of Iceland; ICoC estimates

Figure 3.2

Iceland has a strong labour market compared to peers, but investment and productivity levels are lagging behind

Iceland's GDP composition

Figures for 2010



Source: McKinsey & Company

financial crisis.¹⁴ There was over-demand for the issue, which indicates a positive development for Iceland in regards to international capital markets. In addition Landsbankinn, Iceland's largest retail bank, negotiated an increase in maturity of a

large part of its foreign debt, relieving some pressure from debt repayments. Additionally, a strong economic growth scenario further helps in improving this position.

3.3 Economic Growth

In 2013, McKinsey & Company published a report titled "Charting a Growth Path for Iceland", in order to assess Iceland's long term growth prospects and key challenges. The report has had a significant impact on public debate in Iceland and provided insights to the current challenges facing the economy, as well as its future prospects.

One of the key messages of the McKinsey report concerns the composition of Iceland's GDP (Figure 3.2). Labour utilisation is higher in Iceland than in neighbouring countries, in terms of both the employment ratio and hours worked

per employee. However, capital intensity (i.e. the amount of capital per employee) and productivity levels (output per unit of input) are lower. In order for Iceland to reach the same (or higher) income level as its neighbours, these two factors must improve. Increased investment is required to build up more capital and bridge the capital intensity gap. Most importantly, however, productivity - being the most fundamental component of long-term sustainable economic growth - will need to improve through public sector reform, along with increased market openness and private sector competition.

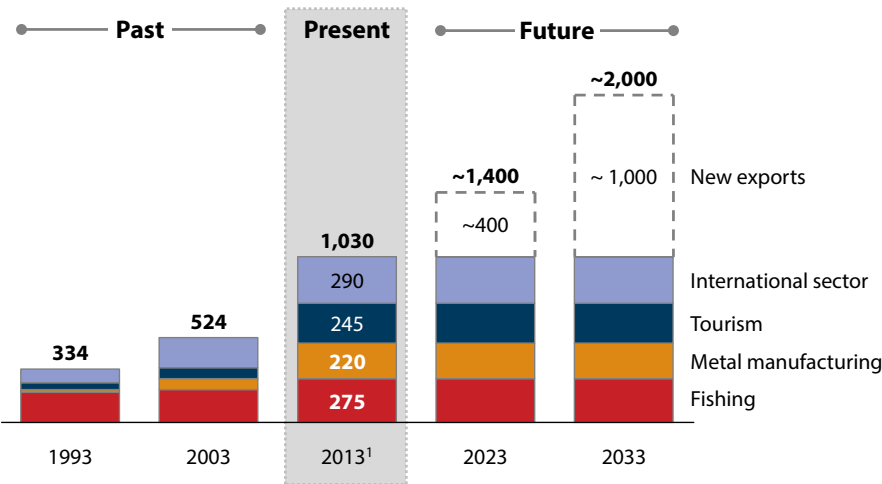
„Labour utilisation is higher in Iceland than in neighbouring countries, in terms of both the employment ratio and hours worked per employee.“

¹⁴ See <http://www.lanamal.is/GetAsset.ashx?id=5665> (in Icelandic)

Figure 3.3

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

Iceland's exports
Total exports, ISK billions (2013 prices)



1 As only Q1-Q3 export values are available, Q4 is estimated using an average of seasonality factors for 2010-12
Source: McKinsey & Company

Additionally, Iceland will face a challenge in increasing its exports in the coming years (Figure 3.3). Three quarters of Iceland's exports today are based on the utilisation of natural resources (fish, renewable energy, and natural tourist attractions). These

resources are limited in volume, so long term, export growth will eventually need to derive from non-resource based industries. This may be in the form of knowledge or manufacturing exports. Currently this sector, i.e. the international sector,

„Natural resources are limited in volume, so long term, export growth will eventually need to derive from non-resource based industries.“

Figure 3.4

McKinsey & Company divided the economy into three distinct segments, with a different focus for each in order to support Iceland's growth trajectory

Domestic service sector	Resource-based sector	International sector
Definition		
Industries that mostly provide non-tradable goods and services for the domestic market	Industries that require domestic natural resources as an input for their production	Businesses that produce tradable goods and services independently of local natural resources
Key focus		
<i>Increase productivity to enable reallocation of labor to export sectors</i>	<i>Focus on capturing and maximizing value from limited natural resources</i>	<i>Enable growth and renewal through a globally competitive business environment</i>

Source: McKinsey & Company

accounts for a quarter 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 is crucial. As the international sector is not dependent on natural resources and Iceland is small in global comparison, its growth potential is essentially unlimited.

In summary, McKinsey provides three key recommendations, one for each sector of the economy (Figure 3.4). Firstly, for the domestic service sector, the focus should be on increasing productivity, which will enable labour to move to export sectors. Secondly, for the resource-based sector, the focus should be on capturing more

value from limited natural resources. Lastly, for the international sector, growth should be enabled through a globally competitive business environment.

Following the publication of the McKinsey report, the Iceland Growth Forum was established (Figure 3.5) 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. Additionally, the Forum established a secretariat which created proposals for public policy reform. Many of the proposals are currently being implemented, with the aim of supporting Iceland's long term growth prospects.

„Following the publication of the McKinsey report, the Iceland Growth Forum was established in order to develop further its policy recommendations.“

Figure 3.5

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

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.

Operations of the Chamber

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

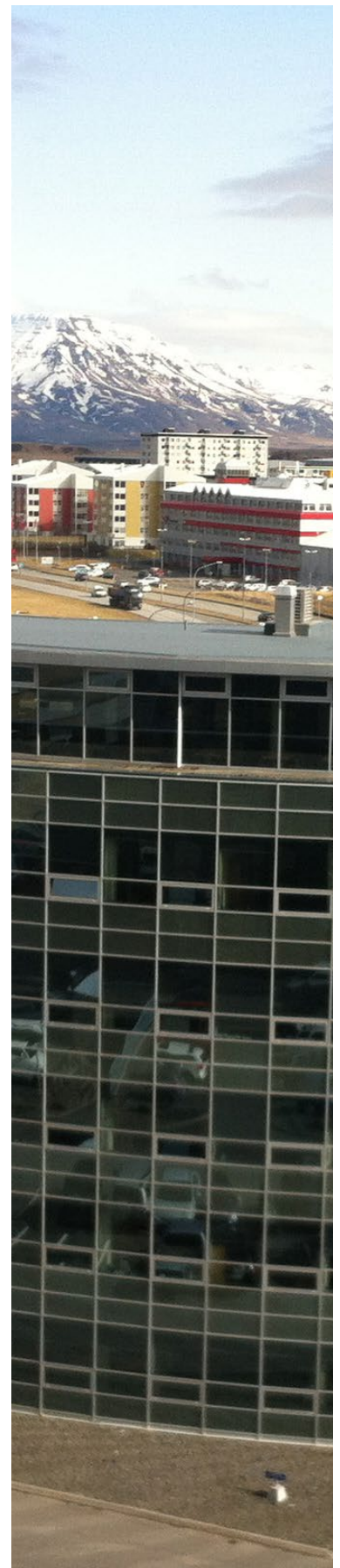
The Chamber has taken the initiative in publishing guidelines for corporate governance, in collaboration with the Confederation of Icelandic Employers and Nasdaq OMX Iceland. The guidelines were first issued in 2004, and have since been updated and published several times. The fifth and latest edition 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 prior to and 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 upon the business environment of its members.



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.

The logo and main building of the Commercial College of Iceland.



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 about 3,000 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.

The logo and main entrance of Reykjavik University.



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





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