



The Icelandic Economy

Current State, Recent Developments and Future Outlook

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About the Chamber

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



Iceland Chamber of Commerce

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Iceland



Did you know?

- The number of tourists visiting Iceland in 2015 is expected to be quintuple 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 member of NATO but does not have any military forces

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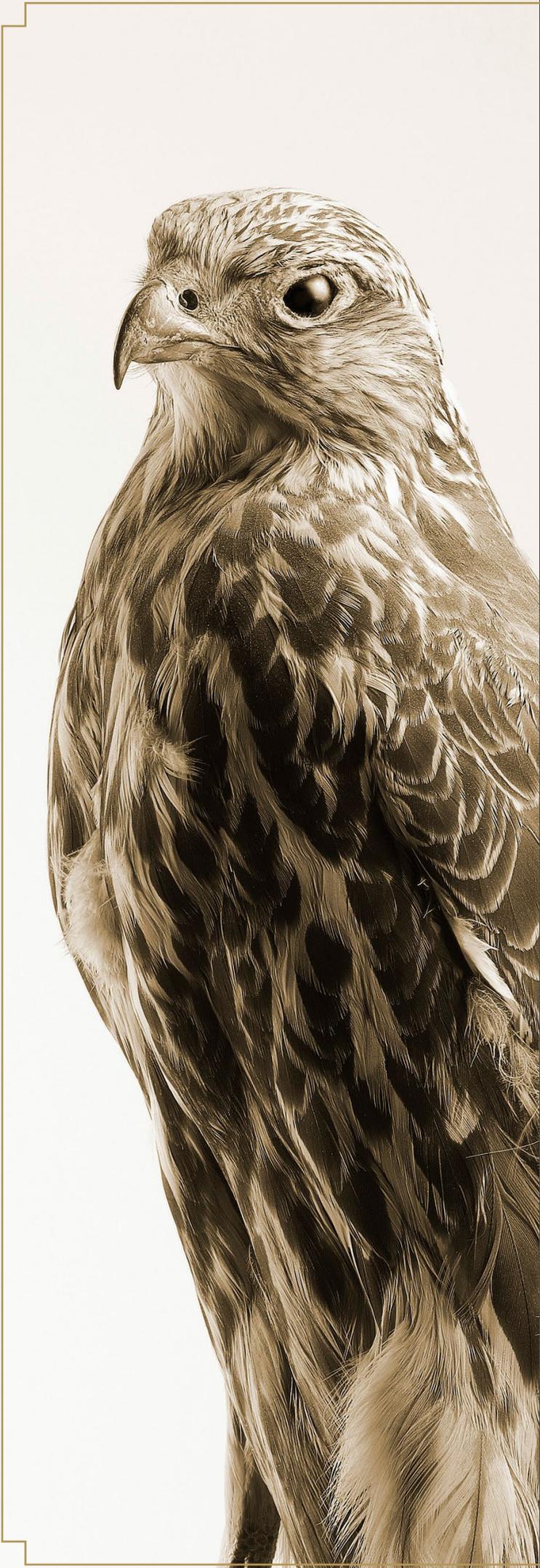
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Foreword

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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Úr Borgarfirði (1933)

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 16.7 billion USD (2,205 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 about 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 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

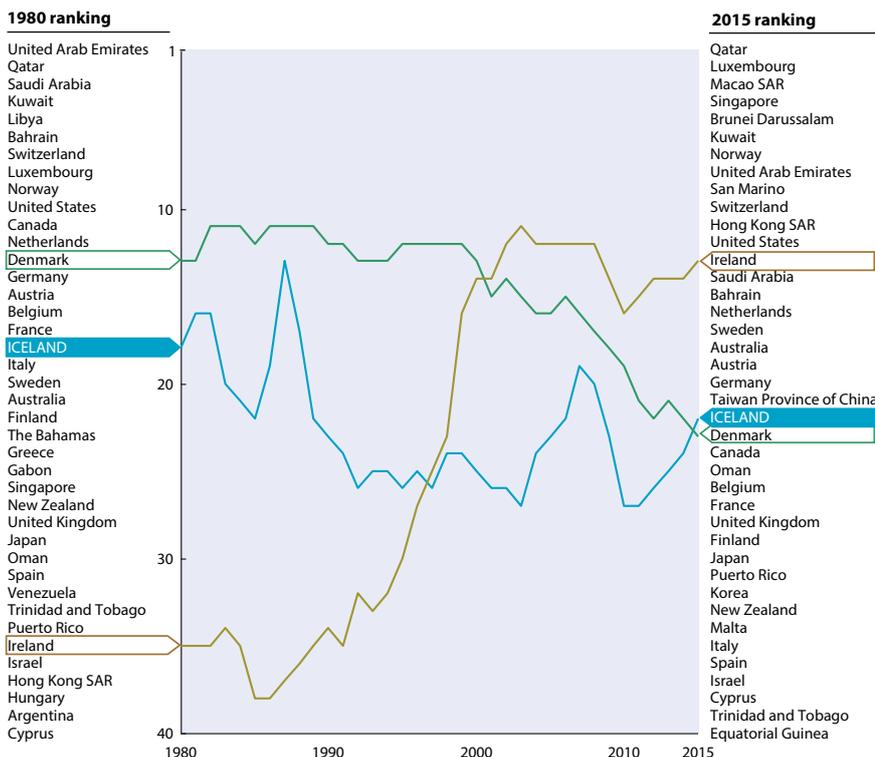
¹ Statistics Iceland, Central Bank of Iceland (ISK/USD = 125,75, average for the year 2015)

Figure 1.1

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

Country rankings

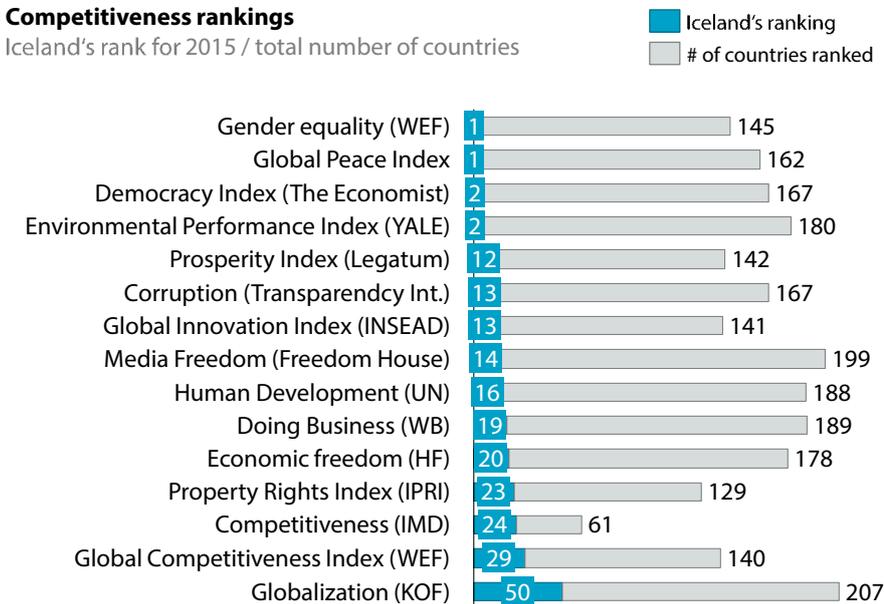
GDP per capita, PPP adjusted



Source: IMF World Economic Outlook; Iceland Chamber of Commerce

Figure 1.2

Iceland ranks highly in numerous competitive indices



Source: Respective websites

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 70% 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.

1.2 Domestic economy

Small open economies are often more volatile than larger economies, as they lack regional diversification². 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,

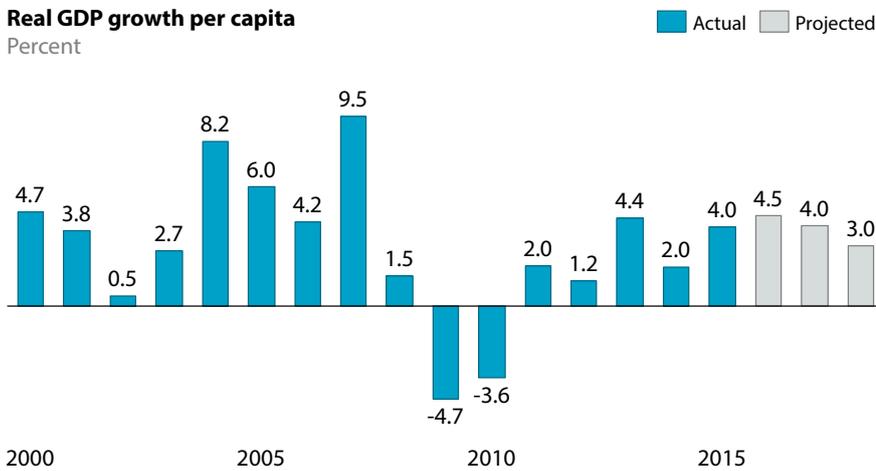
averaging 6.5% in annual growth over a four year period. Conversely, over the two years following the financial crisis, the economy contracted by more than 10% in total, a more severe contraction than that experienced by most other European countries (Figure 1.3).

During the last few years, Iceland has experienced a robust economic recovery, higher than its neighbouring countries or high-income countries in general (Figure 1.4). This growth has derived from a sustainable source - the

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

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 2016/2); Iceland Chamber of Commerce

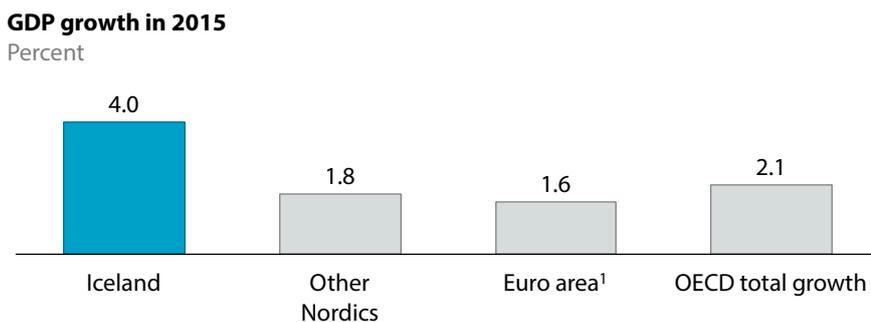
export sector - and been driven mostly by the fast growing tourist industry. The growth in 2015 was no exception as export growth was the main driver, along with strong contributions from business investment and private consumption. The Central Bank of Iceland predicts that growth will continue and even accelerate over the next few years, with declining but positive contribution from domestic consumption and investment but increasing input from net trade.³

Labour market recovery has followed suit. Unemployment rose from 1% in 2007 to 8% 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

³ Central Bank of Iceland, Monetary Bulletin (2016/2), <http://www.sedlabanki.is/library/Skraarsafn/Peningamal/2016/Mai-2016/Heildarskjal.pdf>

Figure 1.4

Iceland’s growth rate in 2015 was especially strong in global comparison



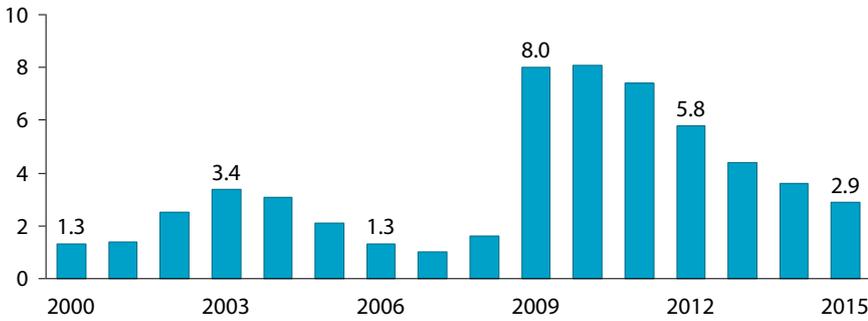
¹ The OECD time series used had 15 euro area countries: Austria, Belgium, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovak Republic, Slovenia and Spain

Source: OECD statistics; Iceland Chamber of Commerce

Figure 1.5

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

Unemployment rate
Percent, yearly average



Source: The Directorate of Labour

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

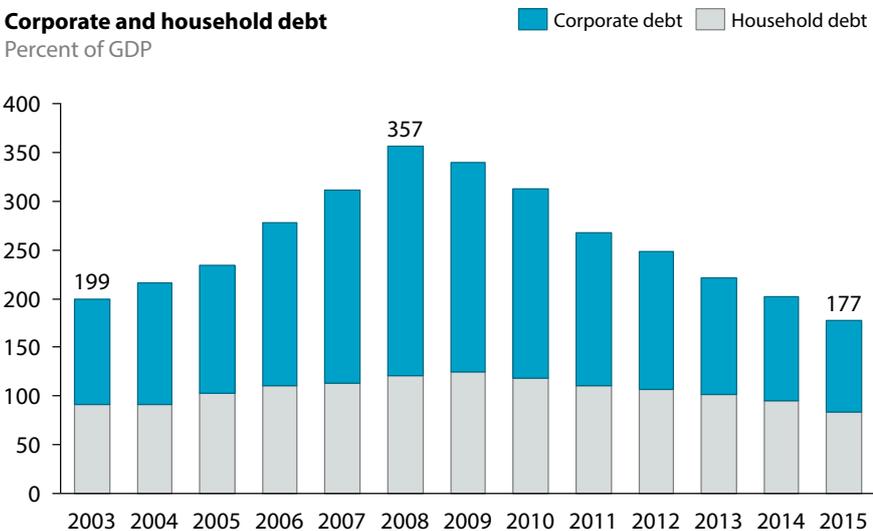
in Q3 2008, firms and households have been deleveraging. Debt levels, especially corporate debt, have declined rapidly and are now at lower levels than in 2003.

Iceland's public debt used to be low by international standards but rose in almost a single leap in the aftermath of the financial crisis in 2008 (Figure 1.7). The government then had to recapitalize both the Central Bank and the big banks, a cost which the

Figure 1.6

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

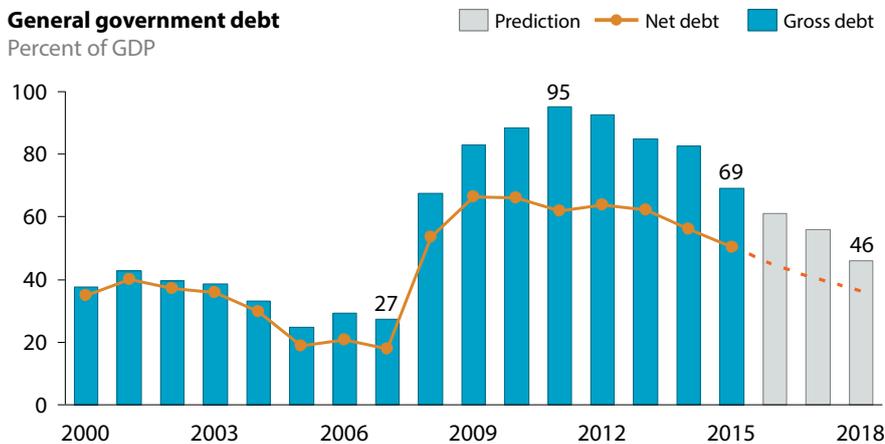
Corporate and household debt
Percent of GDP



Source: Central Bank of Iceland (Monetary Bulletin 2016/2)

Figure 1.7

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



1 Central Bank of Iceland's prediction

Sources: Central Bank of Iceland

IMF estimates at around 34% of GDP.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. Following this, some austerity measures were undertaken and public expenditures were reduced. The government achieved a budget surplus in 2014 - the first time since the financial collapse. Recently, public debt levels have gone down again as the government is running a surplus and has sold some of the assets acquired as a result of the financial crisis.

Current government debt is approximately 69% of GDP which is a significant improvement from 2014 when it was around 82% of GDP. The government debt level in Iceland has thus fallen rapidly and is for example below the level in Germany and the Netherlands.⁵

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.

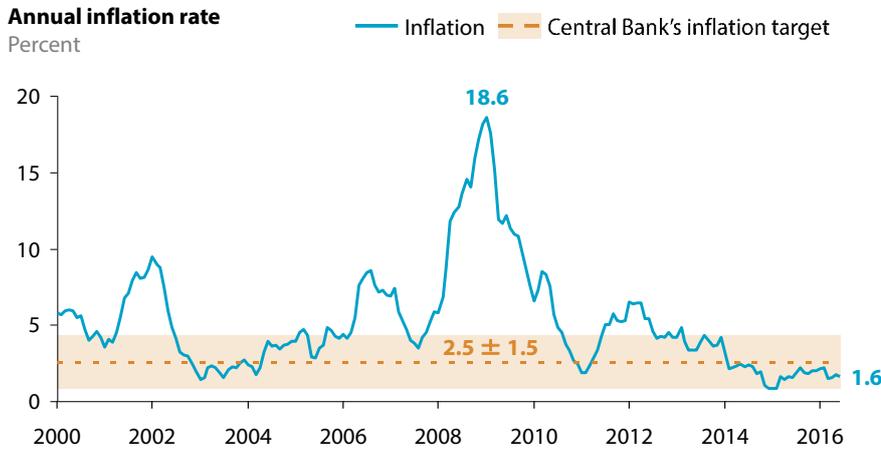
Inflation has remained below the inflation rate target the first half of 2016 and is not expected to rise above the Central Bank's target this year. Despite significant nominal wage increases, inflation has not followed as the Central Bank expected, and the bank's inflation forecast through the year 2018 is within its target range.

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

5 International Monetary Fund (2016). World Economic Outlook, April 2016.

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 range



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

1.3 International relations

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

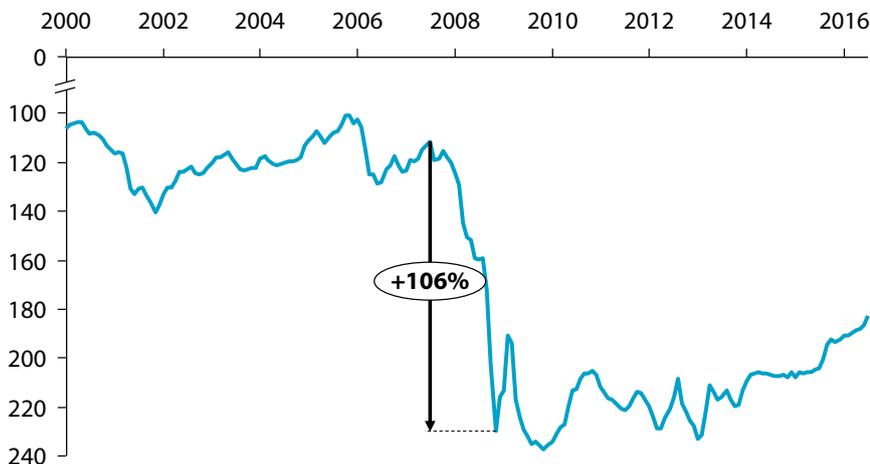
Prior to the financial crisis, Iceland's trade balance⁶ was highly negative (i.e. imports far exceeded exports), which led to a build-up of record-high levels of external debt. This trade deficit was in large part caused by a strong exchange rate of the Icelandic krona, which lowered prices of foreign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

Figure 1.9

After years of high exchange rates the Icelandic krona devaluated dramatically during the financial crisis but has been strengthening recently

Exchange rate index (ERI)

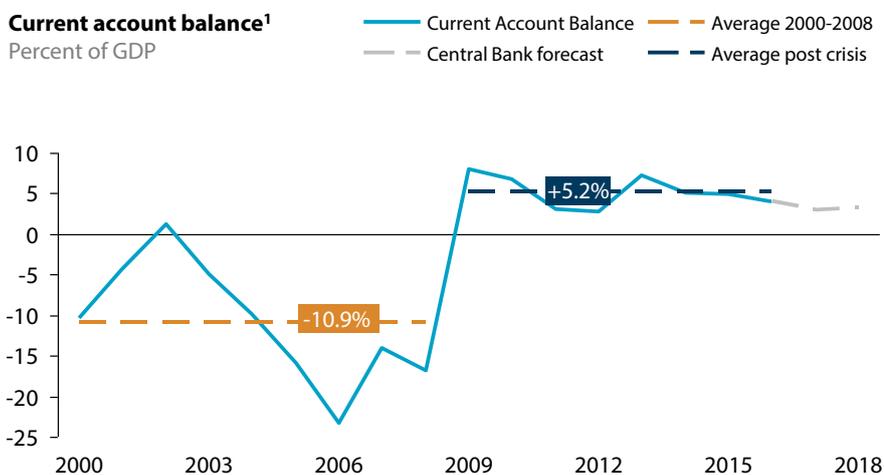
A higher index value indicates a weaker Icelandic krona



Source: Central Bank of Iceland

Figure 1.10

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



¹ Underlying current account, excludes the effects of the failed banks' estates

Sources: Central Bank of Iceland; Iceland Chamber of Commerce

This caused the trade deficit to revert to a surplus, as many foreign goods became too expensive to import, and revenues from exports increased. Consequently, the króna has now begun to strengthen again.

In 2015, exports of goods and services amounted to about 50% of Iceland's GDP and there was a surplus in the balance of trade in goods and services of about 7%. In the six years following the financial crisis (2009-2015) there has been a total balance of trade surplus of 54% 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 5,2% 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).

⁷ Excludes the effects of the failed bank's estates

The reason the current account surplus has not been as large as the trade surplus is Iceland's negative net international investment position (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 before the crisis (Figure 1.11). After a restructuring of the banking system in the aftermath of the financial crisis and years of current account surplus, the position gradually became less negative.

Today the NIIP is the most favourable it has been in decades and comparable to that in the United Kingdom and France.⁸ The main driver of the improvement in 2015 was a settlement of the failed banks' estates which eliminated the balance of payment risk associated with the estates. That procedure in itself reduced NIIP by a fifth of GDP.

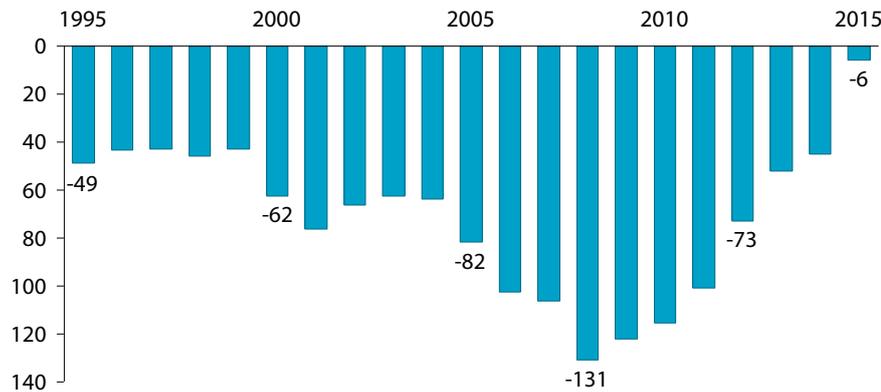
⁸ Central Bank of Iceland (2016). Financial Stability 2016/1. <http://www.cb.is/publications/publications/publication/2016/04/20/Financial-Stability-2016-1-published/>

Figure 1.11

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

Iceland's net foreign obligations

NIIP¹, percent of GDP



¹ Net International Investment Position

Source: Central Bank of Iceland; Iceland Chamber of Commerce

A key challenge for Iceland is to increase its exports in order to maintain current account surplus and strong sustainable growth. Two decades ago the country was heavily dependent on fishing, with more than half of exports originating from the fishing industry (Figure 1.12).

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

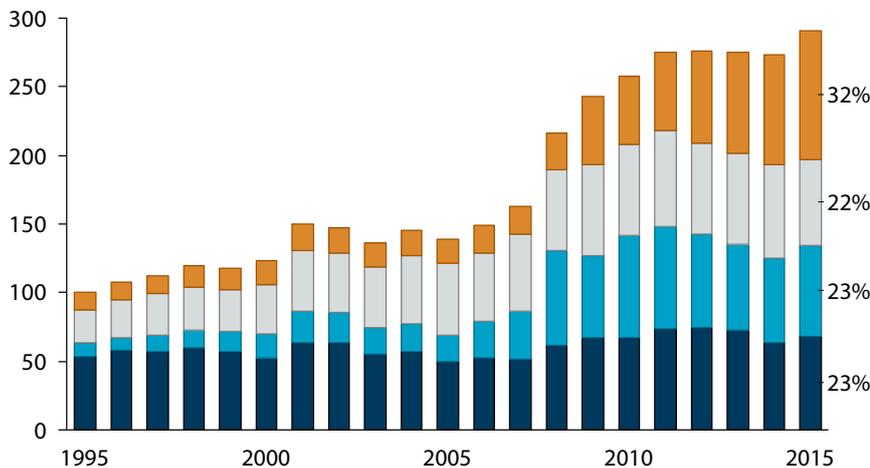
Figure 1.12

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

Iceland's exports¹

Index (1995 = 100), inflation adjusted

Tourism (orange), Aluminium and silicon (light blue), International Sector (grey), Fisheries (dark blue)



¹ As agriculture is heavily subsidised and only a small fraction of total exports, it is dropped from this analysis

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 which now makes up a third of Iceland's total export. Overall, Iceland's exports of goods and services have grown rapidly and become more diversified over the last two decades.

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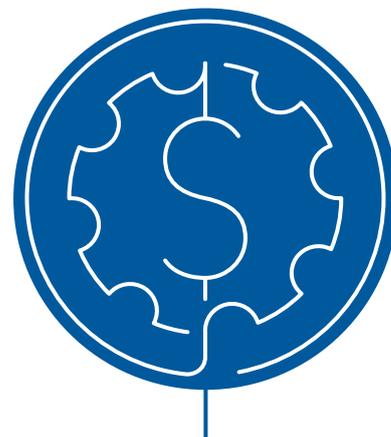
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Vetrarkvöld í Hafnarfirði (1932)

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.

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 negotiations¹, 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.²

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

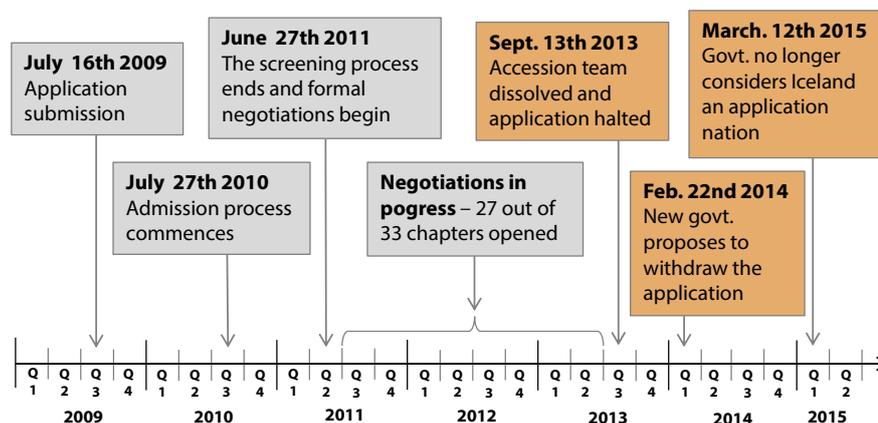
² See http://europa.eu/about-eu/countries/index_en.htm

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

Tax and fiscal policy

The current 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, and the surplus was sustained in 2015. In addition new legislation pertaining to public finance reform has passed. In addition the minister of finance has advocated selling a large share of the government's stake in the banking system in order to further reduce public debt.

The tax system has been altered somewhat, and additional changes

have been proposed. To date, key 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 2.3). 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.

Figure 2.3

The Icelandic tax system relies heavily on consumption and labor income

Key taxes in Iceland

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

¹ Consumption taxes 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

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

Election year

As a response to public distrust following the “Panama papers”, a data leak exposing multiple tax havens around the world, Iceland’s Prime Minister, Sigmundur Davíð Gunnlaugsson, resigned and the government sped up elections from 2017 to autumn 2016. Replacing him as Prime Minister was Sigurður Ingi Jóhannsson, former minister of fisheries and agriculture. The upcoming elections will most likely bring a change in government as the current

government’s approval rating has been low (Figure 2.4).

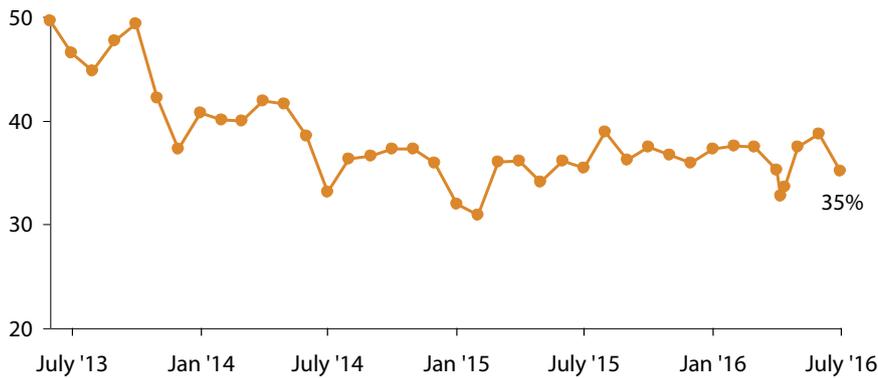
In addition to the upcoming parliamentary elections, presidential elections were held in 2016. The winner of the election was Guðni Th. Jóhannesson with 39% of the votes. Prior to Mr. Jóhannesson being elected, Iceland had the same president since the year 1996, Ólafur Ragnar Grímsson.

Figure 2.4

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

Government approval rating

Percent



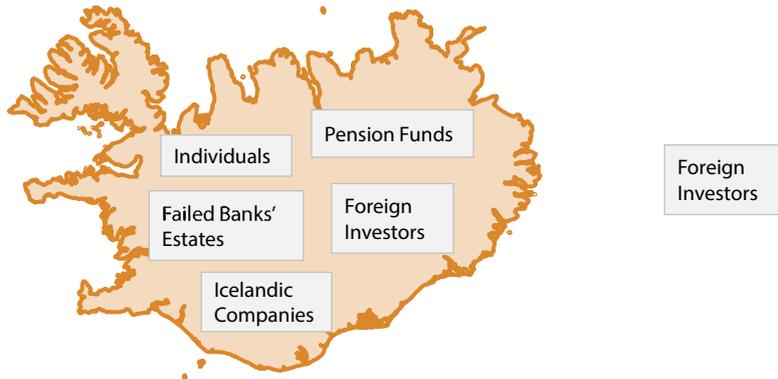
Source: Gallup; Datamarket; Iceland Chamber of Commerce

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 and affected multiple parties (Figure 2.5). Only financial outflows are limited under the controls; financial inflows as well as trade in goods and services is still permitted.

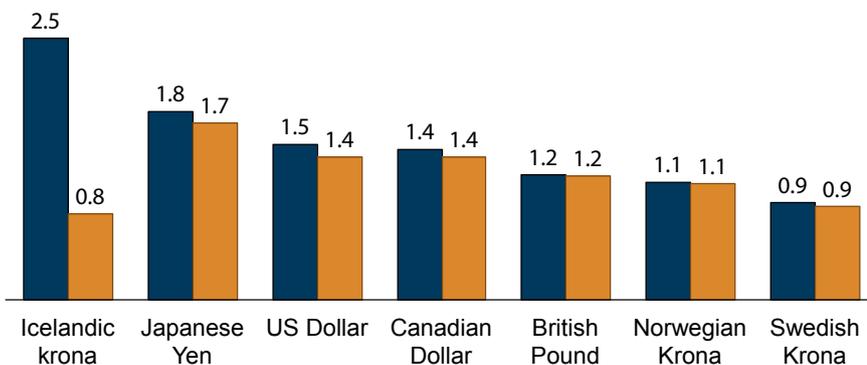
Figure 2.6

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 (03-'09)
Capital controls (2010-2016)¹



¹ From 1st of January 2010 till 12th of July 2016

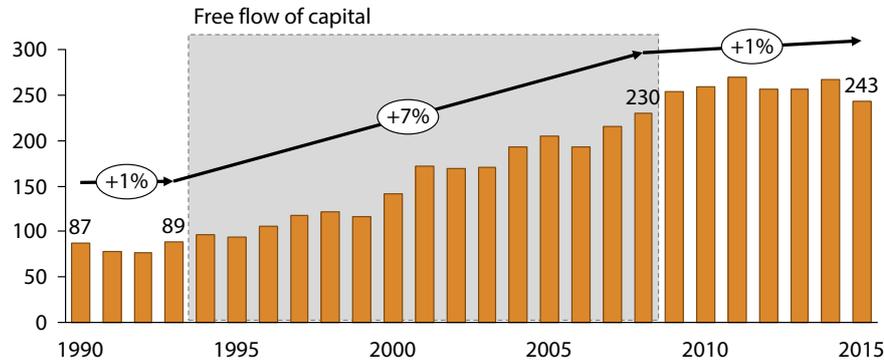
Sources: Central Bank of Iceland; Iceland Chamber of Commerce

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)



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

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 is inflation-linked, a volatile exchange rate could have resulted in

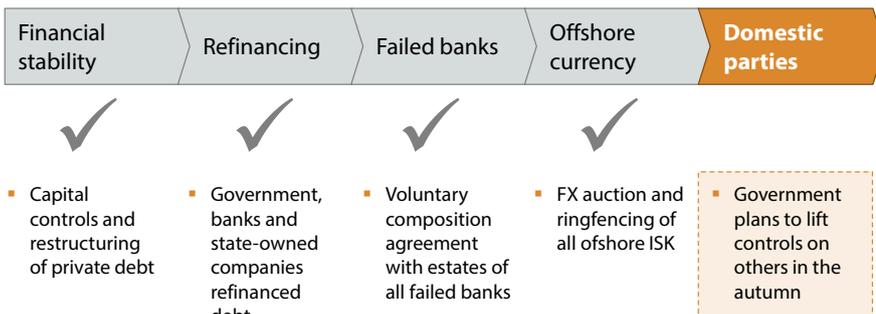
unforeseeable fluctuations in debt levels.

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

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



Source: Iceland Chamber of Commerce

the capital controls, their operations have shrunk by grown by only 2% 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 (6.7% 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, though proven difficult, will soon be a completed task, as the major obstacles have been dealt with (Figure 2.8). Most recent developments have been the voluntary composition agreement with the creditors of the failed banks' estates, which was finalised in the

beginning of 2016, and an offshore króna auction which went through in June.

After the controls were introduced in order to prevent financial outflows, fears persisted about large amount of capital seeking a rapid exit as soon as they were lifted. Large outflows could then significantly weaken the exchange rate and thus threaten economic stability.

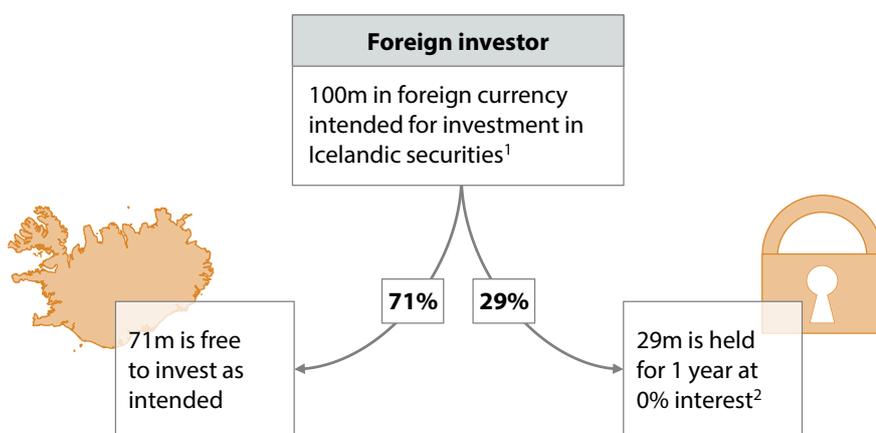
However, strong economic growth in Iceland and strengthening of the Króna along with low growth in the international economy have increased concern of foreign currency inflow rather than outflow. To stem against the possible risk of excess appreciation of the króna, the Central Bank has imposed a new capital flow instrument (Figure 2.9). The measure consists of a reserve requirement for new foreign currency inflows that are for investment in liquid Icelandic securities.

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

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

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, 22% p.a. on average from 2010 to 2015. Last year over 1.2 million tourists visited Iceland and in 2016, the number of tourists visiting Iceland is expected to exceed 1.6 million – a growth of almost 30%. 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 attractions around the country are suffering from congestion and littering. Some landowners have

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 2016 is an estimate by Íslandsbanki

2 Yearly average

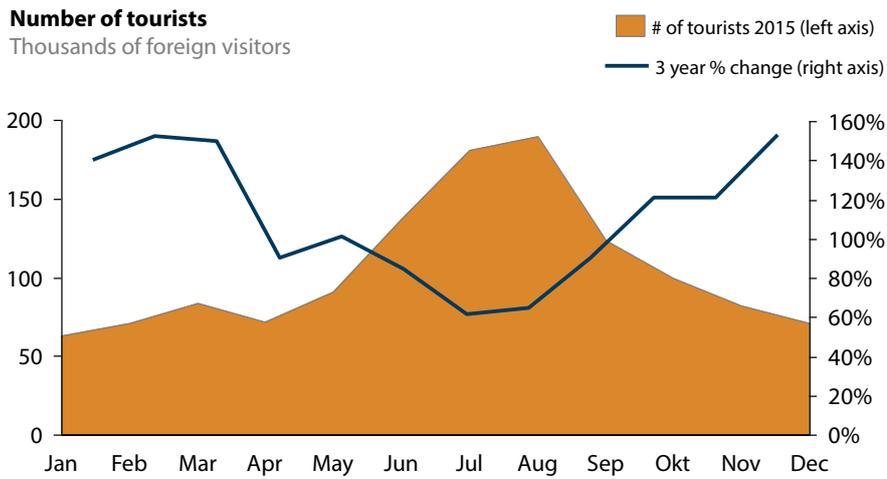
Sources: Statistics Iceland; Icelandic Tourist Board; Íslandsbanki (Report on the Icelandic Tourism); Iceland Chamber of Commerce analysis

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 but little progress has been made.

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

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 207 bn. ISK (9.4% of GDP)³, three quarters of total business investment in 2015 (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 three of the proposed projects: United Silicon, PCC and Thorsil. The construction of United Silicon's and PCC's plants has begun while Thorsil and Silicor still haven't finalised their funding. The latter two are expected to make their final investment decision within the next year.

In May 2015, United Silicon began construction of a 22,000 ton metallurgical grade silicon metal production plant in Helguvík near Reykjanesbær. The investment is about 12 bn. ISK and 200 people will be employed during the construction of the plant, which is expected to start production in the third quarter of 2016.

The construction of PCC BakkiSilicon's 33,000 ton metallurgical grade silicon metal production plant started last year. Total investment of the project will be 40 bn. ISK and planned commission is in 2018. The plant will be located at Bakki near Húsavík in the northeast part of Iceland.

Thorsil and Landsvirkjun signed a power purchase agreement in May for the supply of electricity for Thorsil's silicon metal production plant, subject to certain conditions.⁴ The plant is to be constructed in Helguvík near Reykjanesbær. The investment is about 35 bn. ISK and the plant could produce 54,000 tons per year upon

³ Viðskiptablaðið (2016) See: <http://www.vb.is/frettir/verd-kisilmalmi-snarlaekkar/124948/?q=Orkum%C3%A1ll>

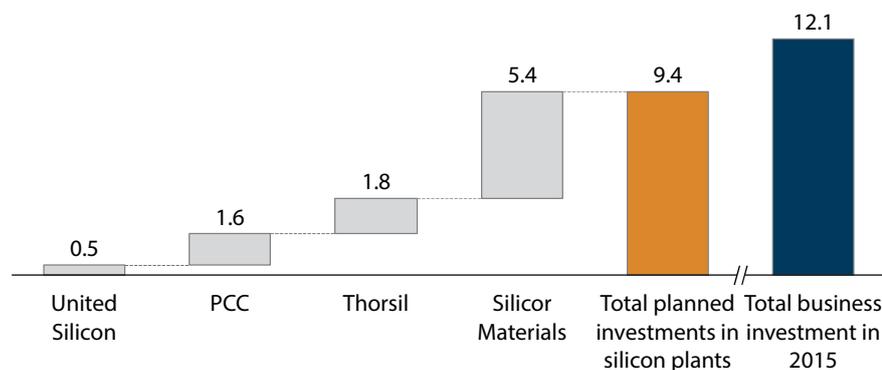
⁴ Landsvirkjun (2016) See: <http://www.landsvirkjun.com/company/mediacentre/news/news-read/landsvirkjun-and-thorsil-sign-power-purchase-agreement>

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

completion. Roughly 300 people will be employed during the construction phase, and 130 people once production is underway. Construction is expected to take about two years and production should begin in 2018.

Silicor Materials have signed a contract to build a solar silicon plant at Grundartangi Port in the west of Iceland, an investment of 120 bn. ISK. The plant is expected to produce up

to 19,000 tons of solar silicon annually. Construction was supposed to begin last year but there have been setbacks regarding financing and finalising energy agreements. Of the necessary 85 MW needed, 40 MW has been negotiated with ON Power while 45 MW are still needed. The company nevertheless plans to start the construction phase in the latter half of this year and it is expected to take about three years.

Pharmaceutical

Two international privately-owned pharmaceutical sister companies, Alvogen and Alvotech, have plans to invest 75 bn. ISK in Iceland over the course of the next few years.⁵ Approximately 8 bn. will be used to construct the companies' headquarters adjacent to The University of Iceland whereas most of the investment will be in research and development. The centre is already in use and houses Alvogen's international offices and Alvotech's facilities for the development and production of biotechnologically

based pharmaceuticals. It's anticipated that roughly 200-300 people will be employed by the companies in Iceland.

However, Allergan, which acquired Actavis – Iceland's then biggest pharmaceutical company – in 2014 announced its plan in 2015 to gradually shut down its plant in Iceland as a consequence of the companies' merger deal.⁶ The procedure is to be finalised by mid-2017.

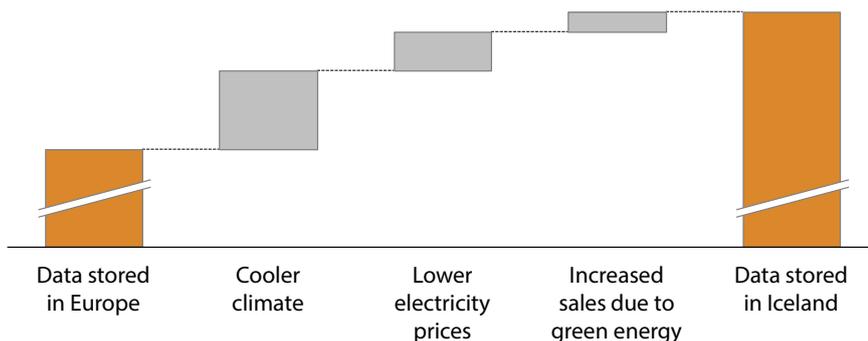
⁵ Morgunblaðið (2015). See: http://www.mbl.is/frettir/innlent/2015/10/19/75_milljarda_fjarfesting/

⁶ Morgunblaðið (2015). See: http://www.mbl.is/vidskipti/frettir/2015/06/29/hluti_actavis_flytur_fra_islandi_5/

Figure 2.13

Favorable climate in addition to affordable and renewable energy makes Iceland an attractive location for data centers

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



Source: Iceland Chamber of Commerce

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

Data centres

The data centre industry is a rapidly emerging industry in Iceland. Multiple data centres have been constructed in recent years and total investment for the last 6 years has been estimated at around 20 bn. ISK.⁷ Iceland’s cold

temperate climate, low electricity prices and renewable energy production has made it an attractive location for such operations (Figure 2.13).

7 Viðskiptablaðið (2015. See: [http://www.vb.is/fret-](http://www.vb.is/fret-tir/20-milljardum-fjarfest-i-gagnaver/116620/)

[tir/20-milljardum-fjarfest-i-gagnaver/116620/](http://www.vb.is/fret-tir/20-milljardum-fjarfest-i-gagnaver/116620/)

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.

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. However, as a fulfilment of the stability condition the government imposed on the creditors of the failed banks' estates June 2015,

the Treasury acquired all share capital in Íslandsbanki at the turn of the year 2016.

Since the emergency legislation, 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 and Íslandsbanki, but the creditors of the failed banks have no direct influence on the operation of Arion bank.

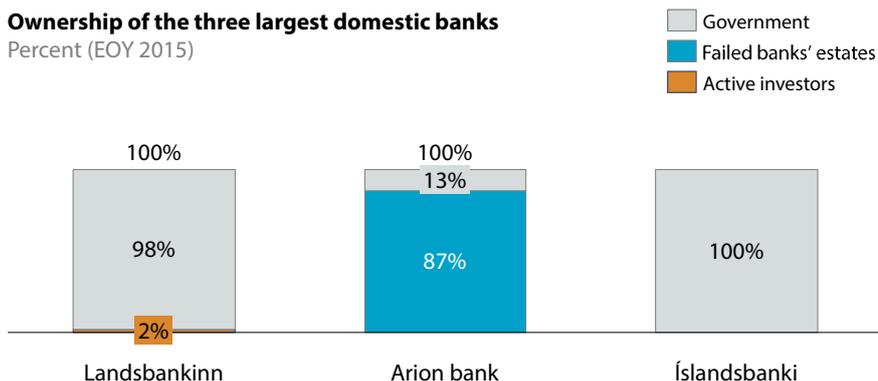
There is much debate whether the government should be a shareholder in the Icelandic banking system in the long run, and how big the stake should be. Iceland's Minister of Finance stated that the government plans to sell up to 30% of its majority stake in Landsbankinn during his term and use the proceeds to reduce public

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)



Source: Annual reports

debt. However, with no established timeline and upcoming elections this

year it will most likely be up to a new government to decide.

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. Driving the affordable credit was high credit rating from the international credit agencies. In that regard, Moody's had the sovereign state at the highest possible credit rating, Aaa, on foreign currency risk in 2002, reflecting the high confidence in Iceland by foreign investors. The agency then affirmed that rating in March of 2008 – though with a negative outlook (Figure 2.16).

As the crisis hit the credit rating of the Icelandic sovereign plummeted into the lowest investment grade, whether it was Moody's or Standard and Poor's (S&P). The credit rating agency Fitch went a step further and downgraded the Icelandic economy into BB+, or speculative grade in 2010. Since then, investors' trust in Iceland has been increasing. Both Moody's

and S&P had rated Iceland as having the lowest Investment grade, (Baa3/BBB-) until the summer of 2015, when Moody's and S&P raised Iceland's credit rating to Baa2 and BBB respectively, following the government plans to lift the capital controls in the coming years. In January of 2016 S&P raised Iceland's rating to Baa1 and Moody's seems to be following suit, as it has placed the rating on review for upgrade with key conditions being continued debt sustainability and effective containment of the external vulnerabilities following lifting of the capital controls.

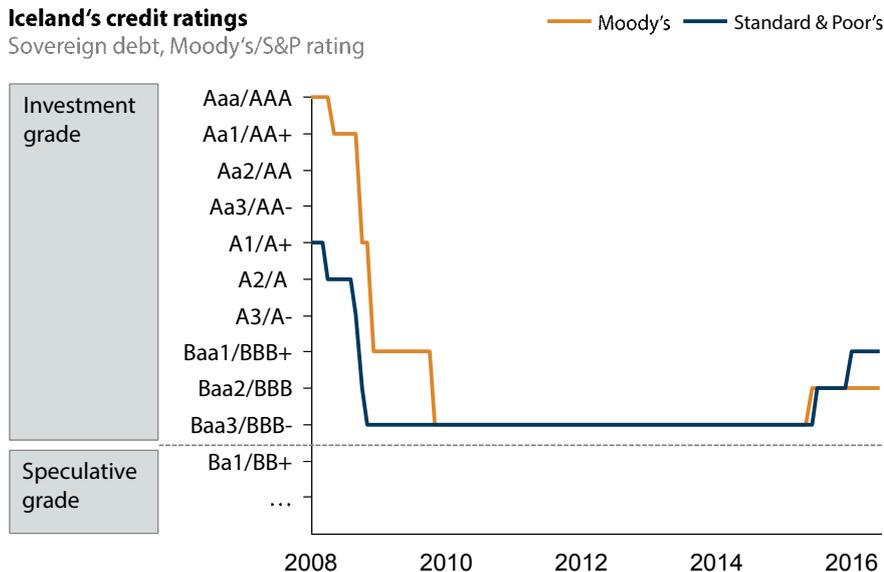
Regardless, Iceland still does not have the same access to credit as before. This can be attributed to global factors, such as increased investor risk-aversion, as well as local factors, such as the presence of capital controls, as discussed in Chapter 2.2.

Figure 2.16

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

Iceland's credit ratings

Sovereign debt, Moody's/S&P rating



Source: Central bank of Iceland

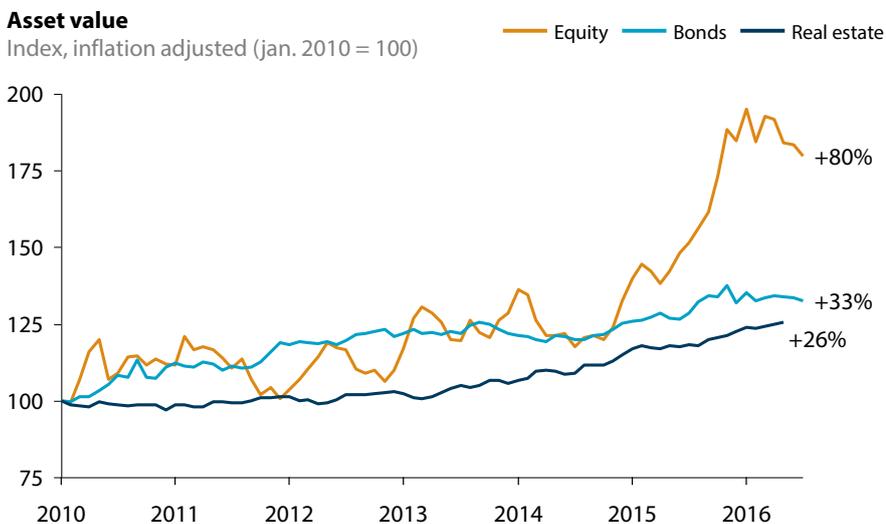
Asset markets

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 950 bn. ISK (just over 40% of Iceland's GDP). The equity market has yielded high returns over the last few years, an annual real return of 9.4% since the beginning of 2010 (Figure 2.17).

Figure 2.17

Domestic assets have gained significant value in the last few years



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



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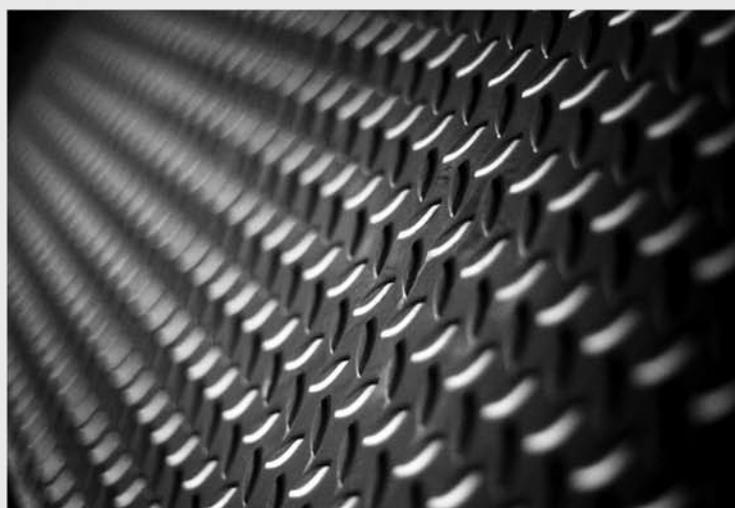
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Sérfræðipekking á fjölbreyttum þörfum fyrirtækja

Landsbankinn býður fyrirtækjum alhliða lausnir fyrir fjármál þeirra. Hjá okkur starfa tugir sérfræðinga um land allt sem sérhæfa sig í þjónustu við fyrirtæki í öllum helstu greinum atvinnulífsins.





Kiðá í Húsafellsskógi (1953)

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 the Icelandic economy will fare following lifting of the capital controls in conjunction with domestic cost pressure stemming from high wage growth and an appreciating króna, and secondly, whether Iceland will be able to realise economic growth in the longer term through an increase in productivity and exports.

3.2 Economic Growth

In 2012, the management consulting firm McKinsey & Company published a report titled "Charting a Growth Path for Iceland", where Iceland's long term growth prospects and key challenges were assessed. The report has had a

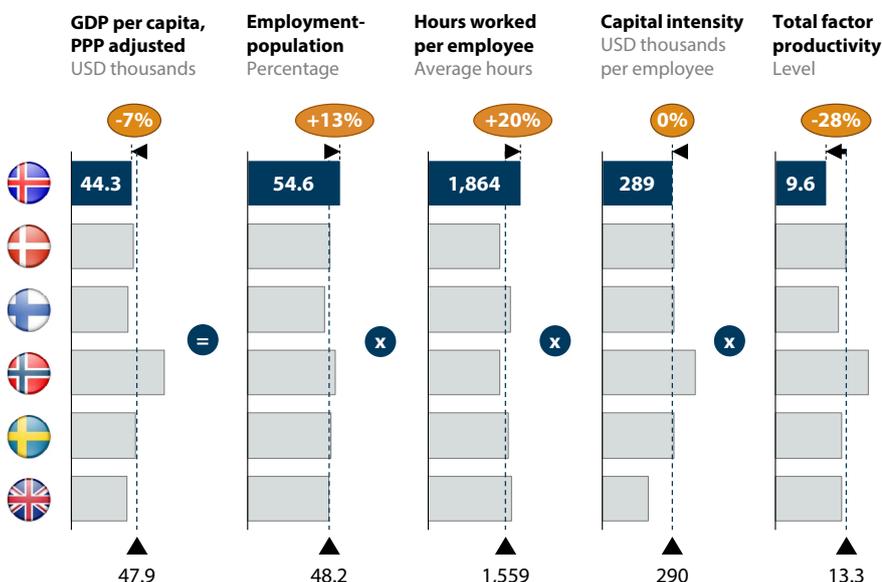
significant impact on public debate in Iceland and provided insights to the future prospects of the Icelandic economy. One of the key messages of the McKinsey report concerns the

Figure 3.1

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

Iceland's GDP composition

Figures for 2014



Source: Iceland Chamber of Commerce analysis

composition of Iceland's production compared to neighbouring countries. Iceland's production is characterised by high labour contributions, both through high employment and high average hours worked per employee (Figure 3.1). Additionally, capital intensity is at a similar level as elsewhere. However, Iceland's weakness is low productivity, resulting in a lower production per inhabitant overall than in neighbouring countries. In order for Iceland to reach

the same (or higher) income level as its neighbours, productivity - being the most fundamental component of long-term sustainable economic growth - must improve.

This decomposition of Iceland's production is a useful framework to assess Iceland's economic performance and future prospects. Here each of the three main components is explored further: labour, capital and productivity.

3.2.1 Labour

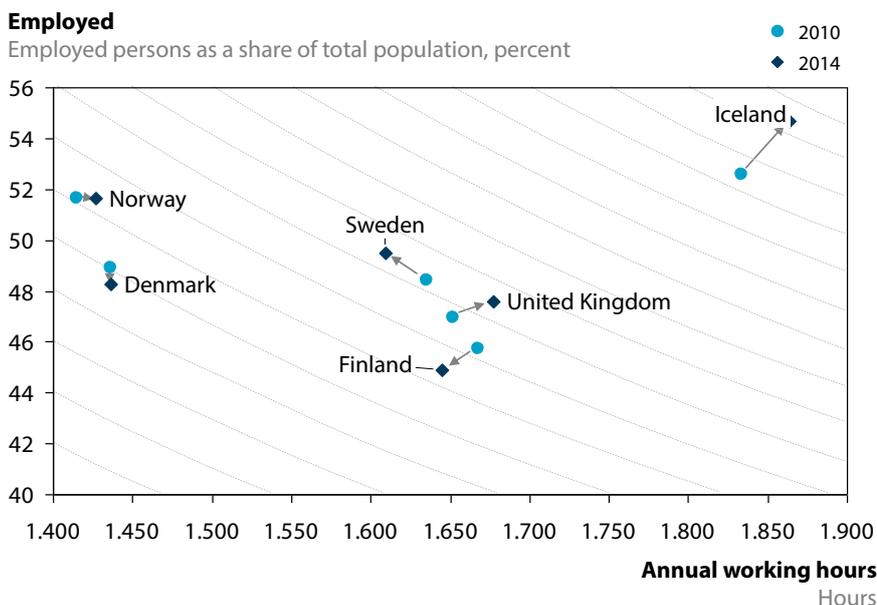
Labour utilisation is higher in Iceland than in neighbouring countries, in terms of both the employment ratio and hours worked per employee (Figure 3.2). This results in significantly higher labour contributions than in any neighbouring country. Furthermore, Iceland's labour market has been strengthening even more in the last few years, as employment has further increased and hours worked gone slightly up.

The implications of this, however, are that Iceland's future growth will not come from increased employment or a greater number of working hours. Thus, Iceland needs to look for improvements when it comes to capital and investment on one hand, and productivity levels on the other hand.

Figure 3.2

The Icelandic workforce's contribution compared to that of neighbour countries is even more than when the McKinsey report was published

Work effort of Icelandic and neighbour countries' labour



Sources: IMF; OECD; Iceland Chamber of Commerce

3.2.1 Capital

In the years after the financial crisis, investment levels in Iceland were significantly lower than in neighbouring countries and have just started to pick up in recent years (Figure 3.3). Capital controls and possible overinvestment prior to the crisis were potentially significant factors in that regard. This lack of investment has resulted in a gradual decrease in the capital available to each employee in Iceland over the last eight years. As shown in Figure 3.1 previously, capital intensity in Iceland is now at a similar level as in other countries.

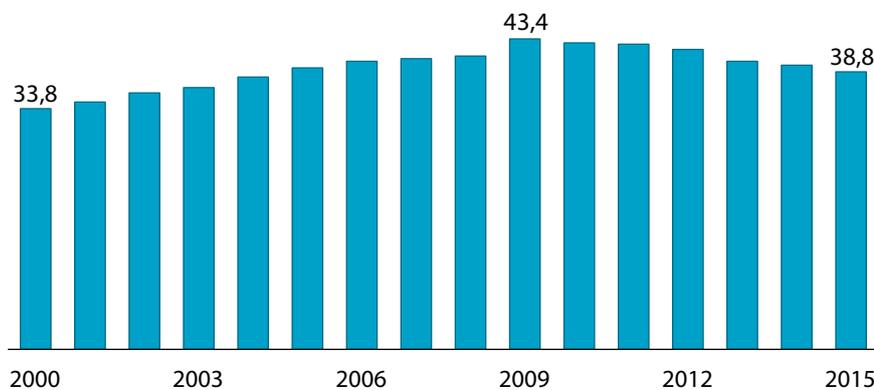
However, Iceland's rural nature and the need for capital-intensive power generation from hydro and geothermal sources implies that the capital intensity should be somewhat higher than elsewhere. Thus, a significant opportunity lies in increasing investment levels in order to increase the level of capital employed for each worker. This in turn would also increase labour productivity, enabling workers to reap higher hourly salaries or enjoy more leisure time than they do today – both ways to increased prosperity.

Figure 3.3

Capital per employer has contracted in recent years

Capital intensity

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



Sources: Statistics Iceland; Iceland Chamber of Commerce

3.2.1 Productivity

Iceland's Achilles heel is productivity. Figure 3.4 shows that most industries in Iceland are lagging neighbouring countries significantly when it comes to productivity. The implication of this is that most workers create less value for every hour worked compared to workers in other countries. Thus, Icelanders need to work harder to

achieve the same standard of living as inhabitants in other countries.

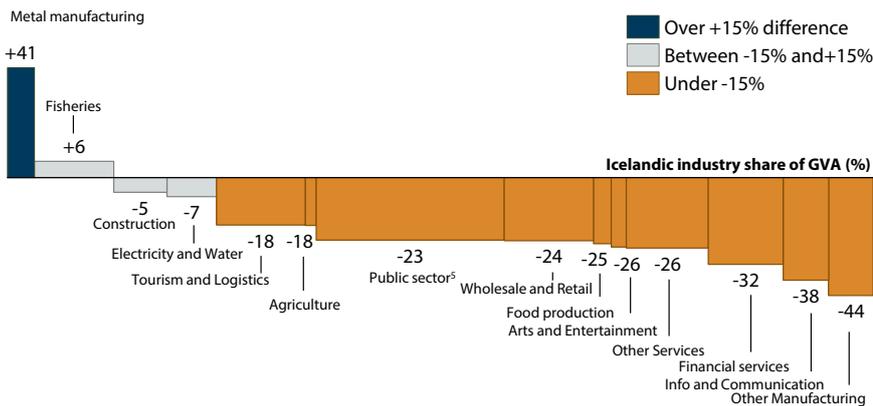
Efforts to improve living standards in Iceland are thus highly dependent on increasing productivity. The good news is that such a significant productivity gap should provide opportunities for such increases.

Figure 3.4

There is a big labour productivity gap between most Icelandic industries and its neighbour countries' counterparts

Labour productivity

Relative comparison of labour productivity in various industries between the Nordic countries (2014)^{1,2,3,4}



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 2009-2013

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 its operating cost, not its quality

Sources: Respective countries' statistic bureaus; OECD; McKinsey & Company (2012); Iceland Chamber of Commerce

3.3 Sustainability

Additionally, Iceland will face a challenge in making sure that future growth is sustainable. Leading up to the 2008 financial crisis, economic growth had been largely fuelled by a negative trade balance and build-up of external debt. This led to instability and made the recession particularly deep for Icelanders. Another lesson to be learned from this experience, according to McKinsey, is to aim for a growth of exports at least equal to the growth of the economy as a whole. If that condition is satisfied, exports will support a balance in international trade and ensure that the growth is sustainable, but not borrowed from abroad.

Three quarters of Iceland's exports today are based on the utilisation of natural resources (fish, renewable energy, and natural tourist attractions)

(Figure 3.5). 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, 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.

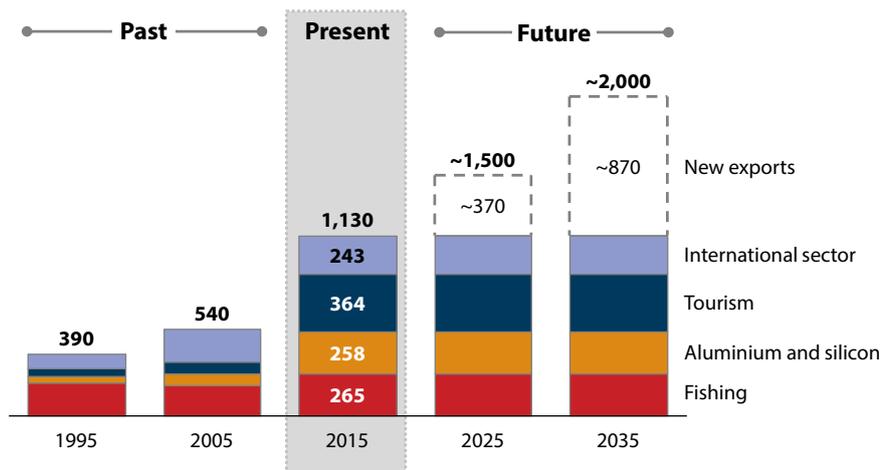
Concluding from the insights detailed above, McKinsey provided three key recommendations, one for each sector

Figure 3.5

Exports need to increase by around 870 billion ISK in the next 20 years to support a sustainable GDP per capita growth of 2.9% p.a.

Iceland's exports

Total exports, ISK billions (2015 prices)¹



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

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

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



Source: McKinsey & Company

of the economy (Figure 3.6). 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 3.7) 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.

Figure 3.7

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

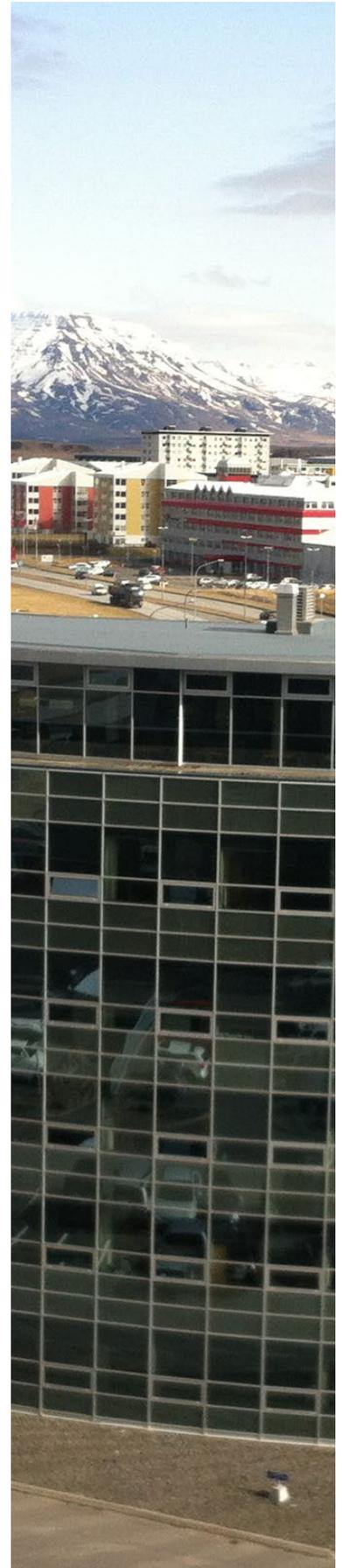
The Chamber has taken the initiative in publishing guidelines for corporate governance, in collaboration with the Confederation of Icelandic Employers and Nasdaq OMX Iceland. The guidelines were first issued in 2004, and have since been updated and published several times. The fifth and latest edition 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 logo and main entrance of Reykjavik University.



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

Joining the Iceland Chamber of Commerce

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

Iceland Chamber of Commerce bilateral Chambers





Úr Húsafellsskógi (1937)