



Economic Performance

Lessons from the past and a guide for the future

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Analysis of economic performance

- Capital and labour: The raw ingredients in economic development
- However, increased productivity and advances are the key factors behind economic growth
- Industrial policy objectives
- How has the development of investment and labor been in different sectors?
- How has productivity evolved?
- Has the macroeconomic environment offered increased productivity and growth?
- What are the next steps?



Industrial policy objectives 1990 - 2008

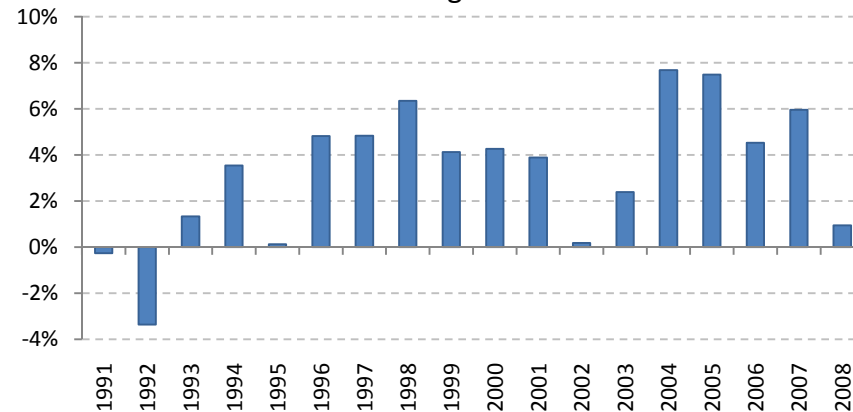
- Industrial policy in the two decades prior to the banking crisis has been characterised by very clear objectives
 - Strengthens the fisheries sector by a system of freely tradable fishing quotas
 - Build up of a second pillar for export revenue by harnessing unused energy potential. This has led to major investment projects in aluminium and energy sectors
 - Support for a rapid growth of financial services sector
 - Strong support for the tourist sector
- This policy has been driven and supported by
 - Global liberalisation trend with a strong political backup in Iceland
 - A consensus among social partners



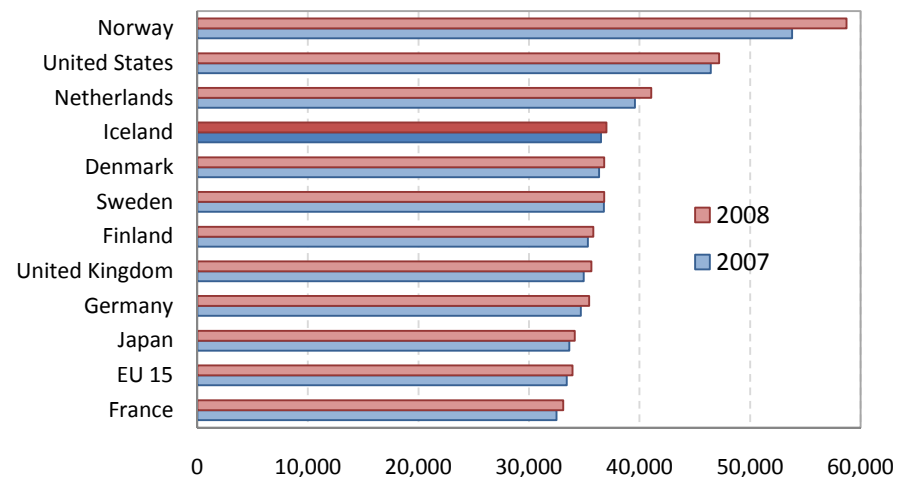
Economic performance 1990 - 2008

- Measured by real GDP growth
Iceland was doing exceptionally well
- GDP per capita on a PPP adjusted basis in 2008 was on the top of the list
- The fiscal position was also exceptionally good with close to zero net public debt
- The unemployment rate was among the lowest in the world and labour participation rates were very high

Real GDP growth 1991 - 2008

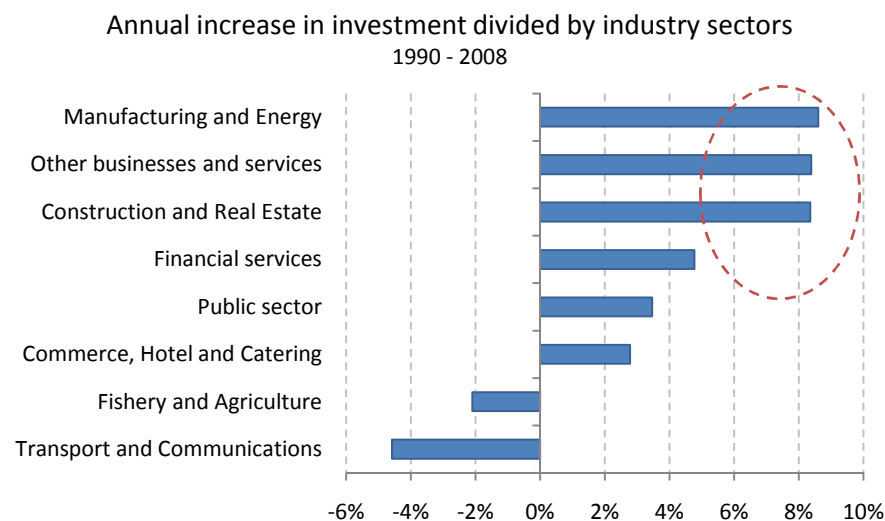


GDP per Capital (USD PPP adjusted)



Investments 1990 - 2008

- During the last two decades investment has boomed in certain sectors
 - Manufacturing and energy
 - Huge buildup of smelter capacity
 - Nine times more aluminium export than in 1990
 - Large energy project
 - Construction and real estate
 - Easy credit in the real estate market
 - Spillover effect from the energy sector
 - Financial services and other services
 - Tremendous growth in the banking sector
 - Too big for the economy and unsustainable in the long-term
 - Other business and services
- Other sectors have contracted:
 - Fisheries and agriculture
 - Transport and communications

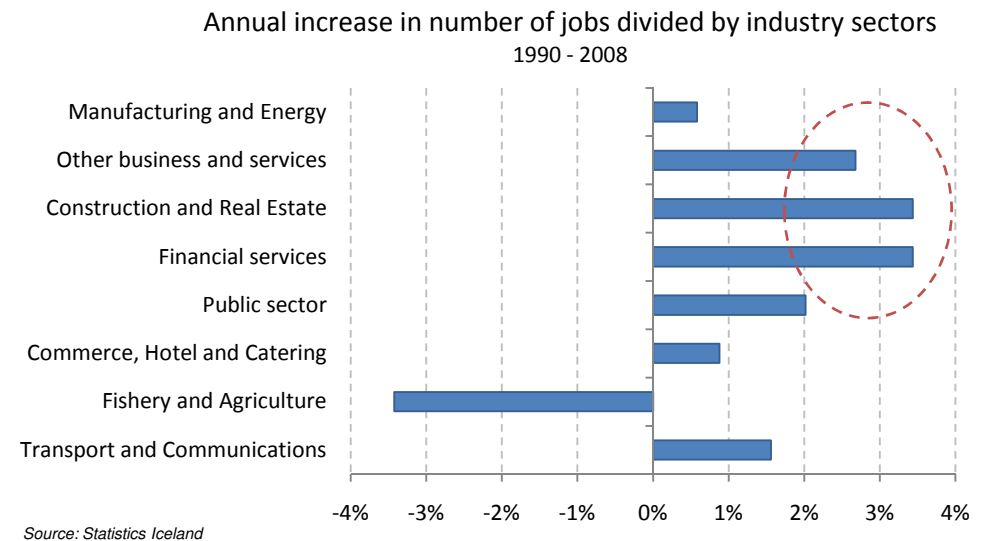


Source: Statistics Iceland



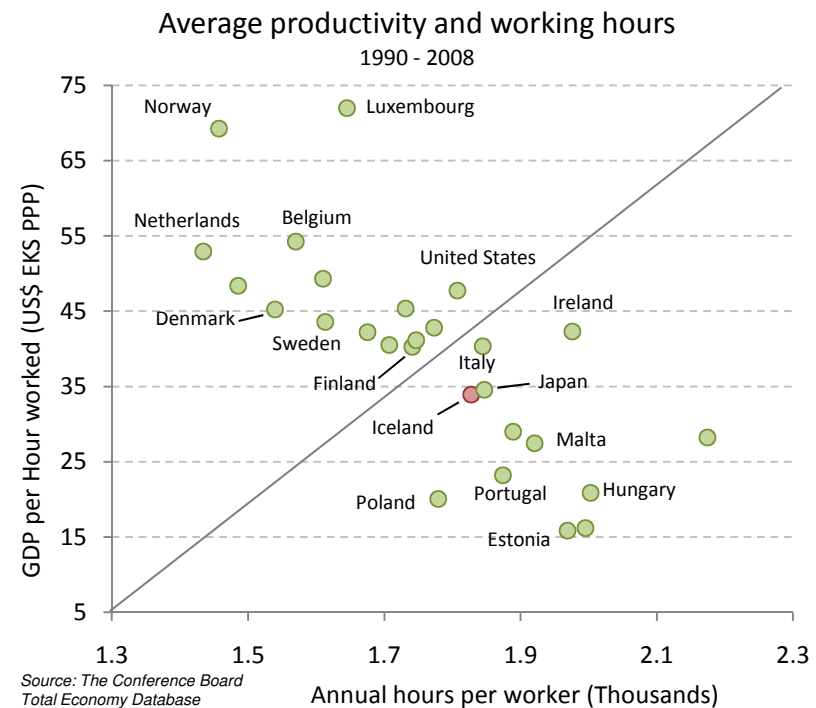
Labour development 1990 - 2008

- Jobs have mainly been created in the service-related (labour intensive) sectors:
 - Financial services
 - Other businesses and services
 - Commerce, hotel and catering
- The manufacturing and energy sectors on the other hand are capital intensive with high technology content. Therefore job creation is moderate
- Fisheries and agriculture has been shrinking



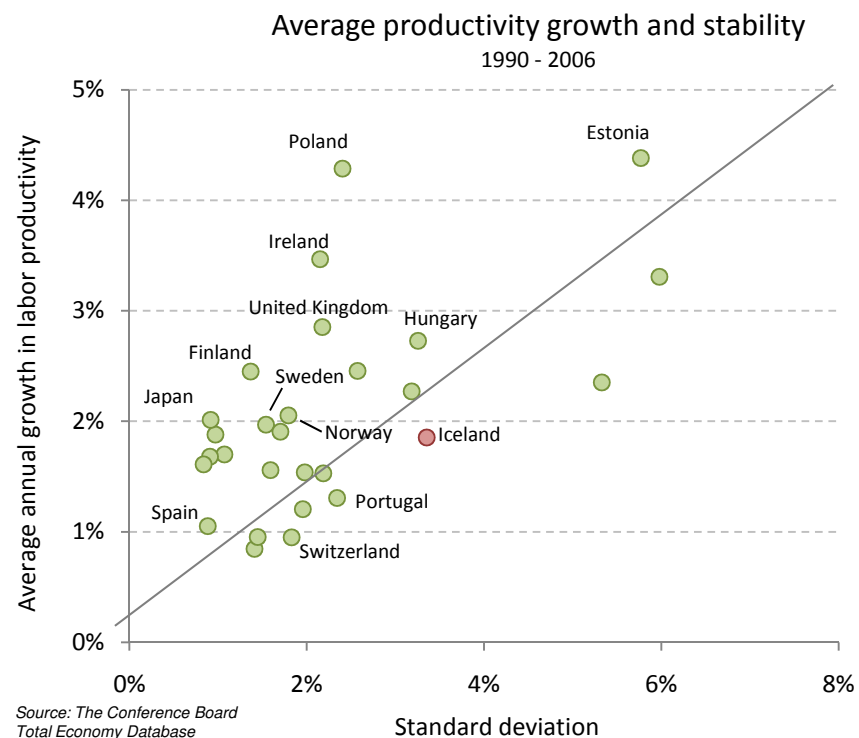
Productivity 1990 - 2008

- Having looked at capital and labour in different sectors, how has productivity in Iceland evolved?
- Iceland has not been among high-productivity countries in Europe
 - Such as Norway, Luxembourg, Netherlands, Belgium, Denmark, Sweden, Finland
- Annual working hours per worker is also quite high
 - Similar to Japan, Italy, Poland and Portugal
- To be able to increase production and reduce working hours at the same time, Iceland needs to increase productivity



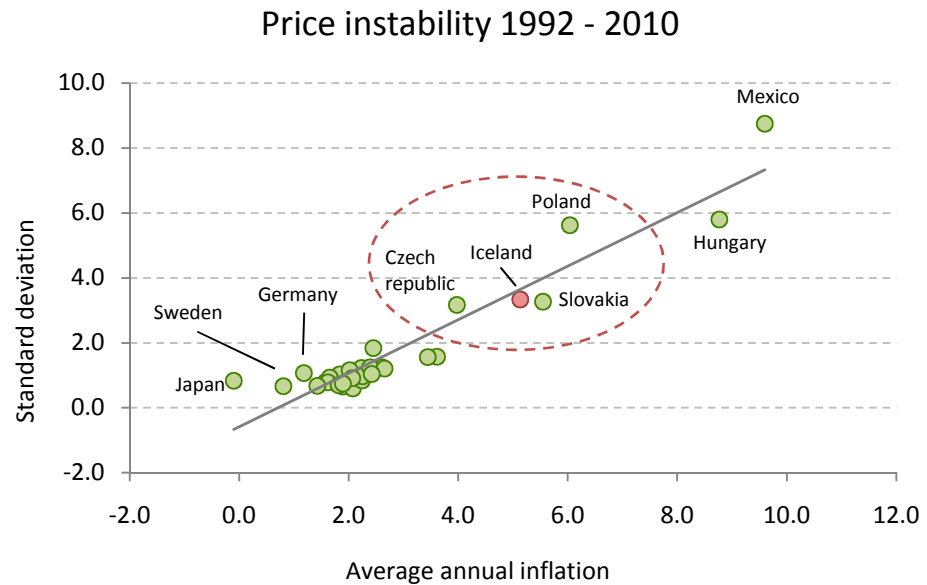
Productivity growth 1990 - 2008

- Annual average growth of labour productivity during 1990 – 2008 is slightly below other Western-European countries
- Also the growth has been volatile in Iceland the last two decades, which is reflected in high standard deviation of productivity growth
- In general a catch-up effect seems to emerge where the fast-growing countries in Europe are those with low productivity:
 - Poland, Estonia, Hungary



Macroeconomic environment: Inflation

- Price instability
 - Persistent inflation
- The Icelandic krona is highly volatile “carry-trade” currency with strong spill over effect to domestic prices
- Inflation-targeting as a monetary policy model has not been very successful

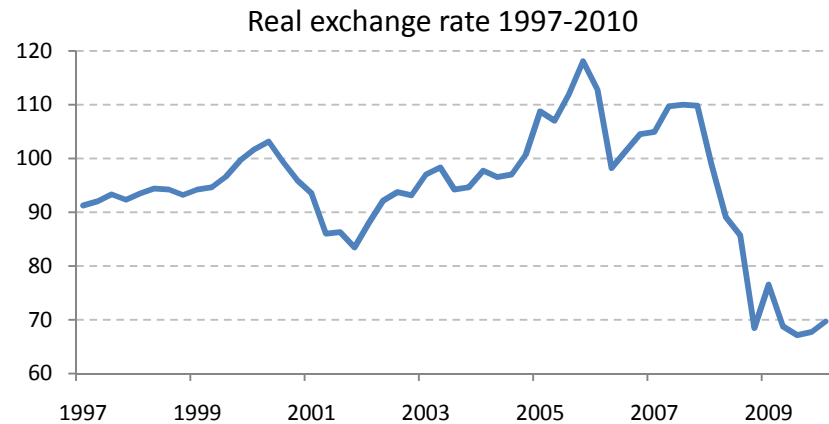


Source: OECD

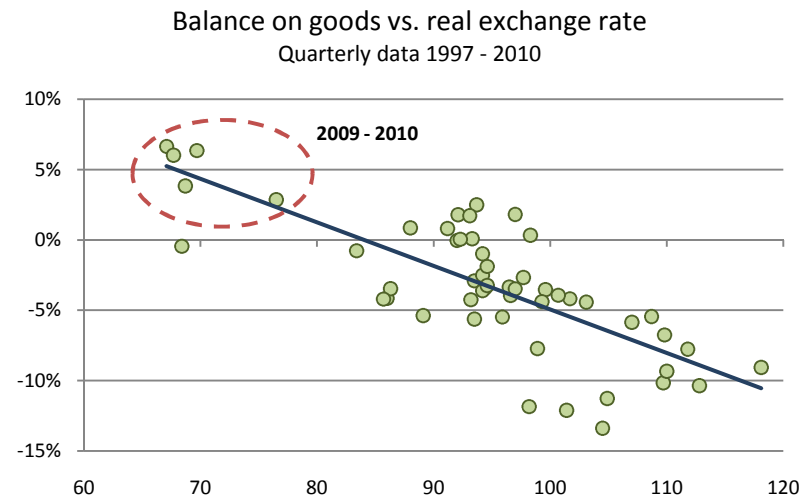


Macroeconomic environment: Real exchange rate

- The real exchange rate has fluctuated
 - Has indirect impact on domestic prices
 - Increases uncertainty in the business environment
- The current account deficit has been in correlation with the real exchange rate
- Currently the low real exchange rate improves the competitiveness of the export sector
 - After a decade of strong real exchange rate



Source: Central Bank of Iceland

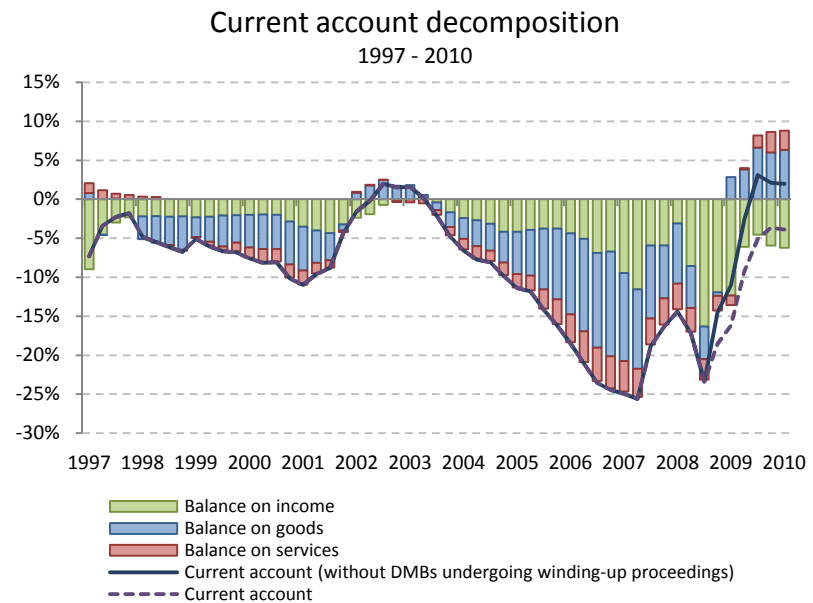


Source: Central Bank of Iceland



Macroeconomic environment: Current account deficit

- Continuous current account deficit in 1997-2001 and 2003 – 2009
- The current account deficit can be explained by:
 - Strong real exchange rate
 - increased purchasing power leading to higher volume of imported goods and higher consumption
 - created difficult conditions for the export sectors
 - High investment in energy and construction sectors
 - Low savings rate



Lessons for the future

- It is not sufficient to have abundant sources of growth. Sustainability of high living standards is just as important
- Stable macroeconomic environment is a pre-condition for sustaining success
- Policies should also focus on supportive infrastructure in order to enhance productivity
- Macro, micro and social policies need to work hand in hand
- Sector specific policies are less important

