The Icelandic Economy

Current State, Recent Developments and Future Outlook

ICELAND CHAMBER
OF COMMERCE

The Icelandic Economy:
Current state, Recent Developments and Future Outlook

Editors
Frosti Ólafsson
Björn Brynjúlfur Björnsson
Leifur Þorbergsson

Design
Ásthildur Gunnarsdóttir
Björn Brynjúlfur Björnsson

Photographs
Ófeigur Ö. Ófeigsson

Current Edition
17th edition (July 2014)

Previous Edition
16th edition (July 2013)

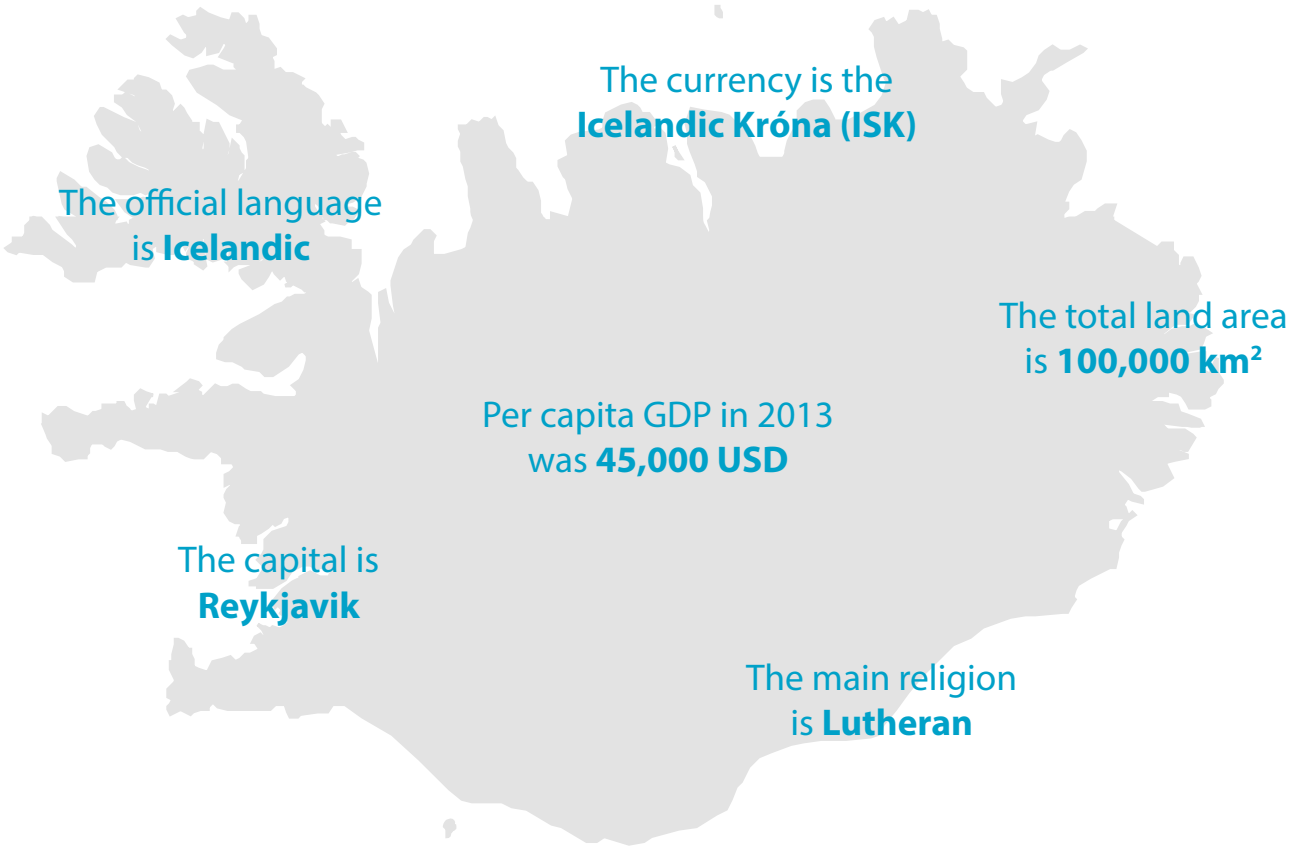
Further information
Slides that accompany the report, previous editions, and a mailing list for updates on future editions are accessible on the Chamber's website, www.chamber.is.

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

Iceland Chamber of Commerce
Kringlan 7
103 Reykjavik
ICELAND
www.chamber.is
Tel. +354 510 7100

Iceland



Did you know?

- The number of tourists visiting Iceland in 2014 is expected to be triple 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 km^2
- 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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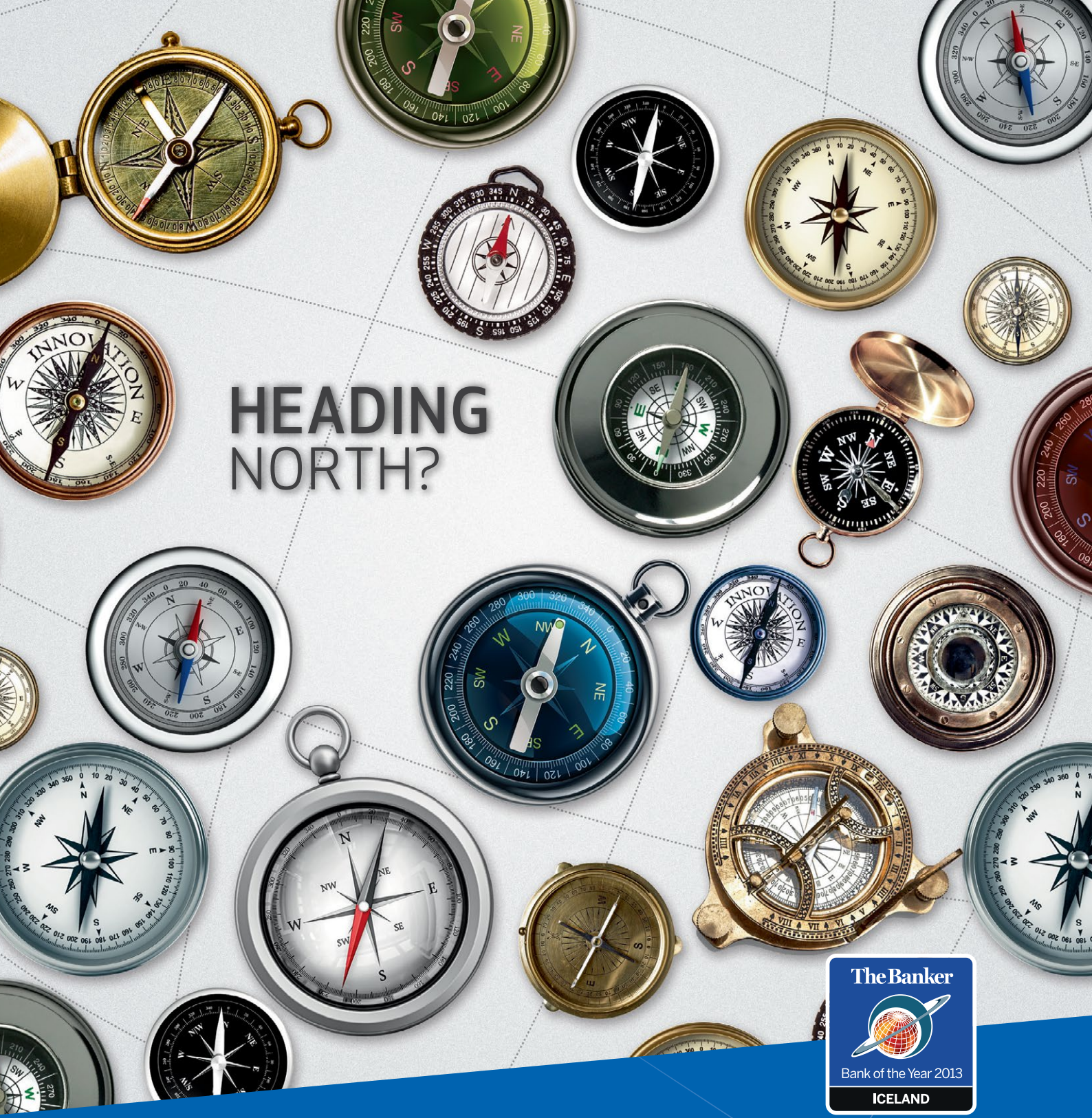

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Contents

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 16 billion USD (1,800 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 325 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

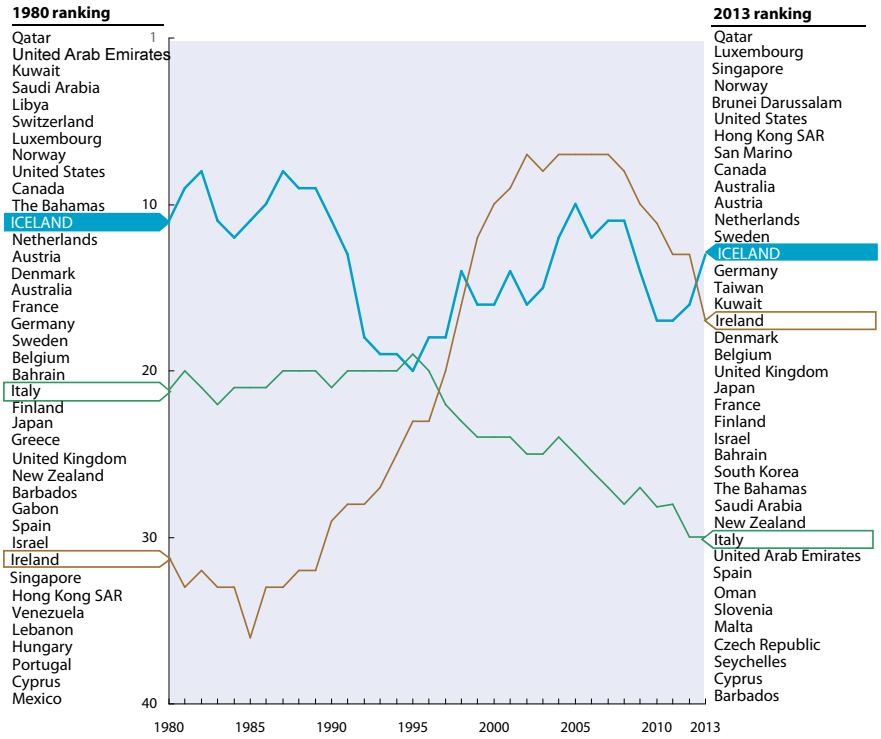
„The Icelandic economy is an open developed economy operating under the Nordic model, combining a free market economy with a welfare state."

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

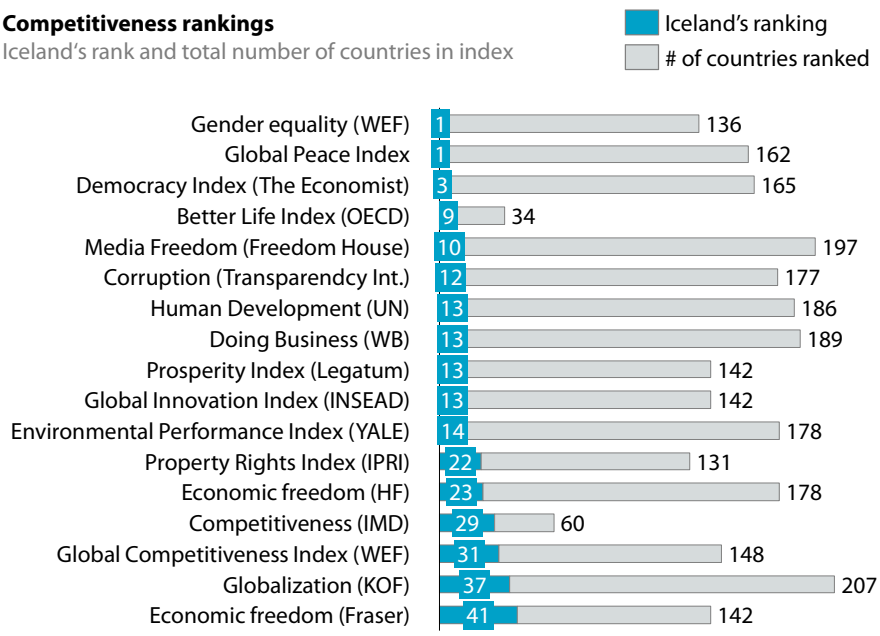


Source: IMF World Economic Outlook; McKinsey & Company

1) Statistics Iceland, Central Bank of Iceland (ISK/USD = 113, June 2nd 2013)

Figure 1.2

Iceland ranks highly in numerous competitive indices



Source: Respective websites

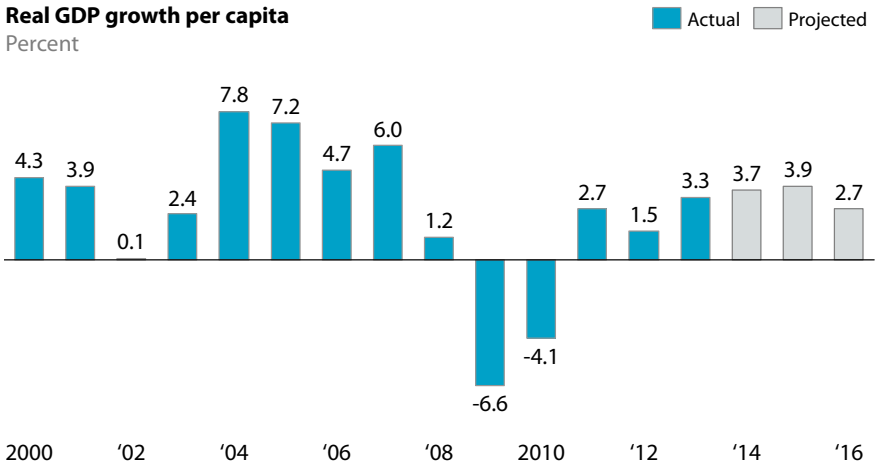
2008, but has risen once more in the previous three years, and regained its pre-crisis position. Iceland is currently ranked 14th globally in terms of GDP per capita.

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 accelerating growth and a positive future outlook



Sources: Statistics Iceland; Central Bank of Iceland (Monetary Bulletin 2014/2)

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.

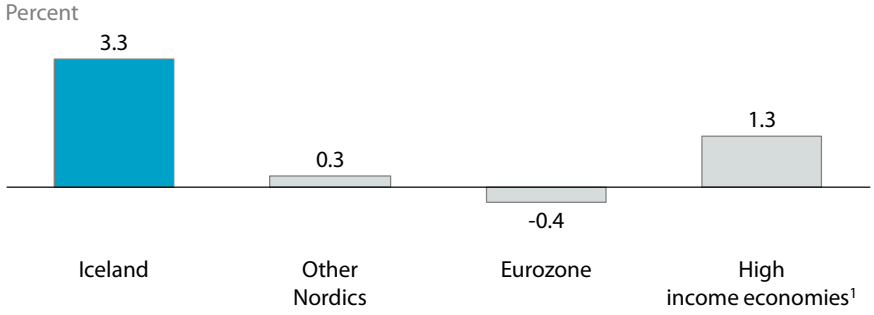
Leading up to the financial crisis in 2008, Iceland was experiencing economic growth almost unparalleled among high income countries, averaging 6.5% in annual growth over a four year period. Conversely, over the two years following the financial crisis, the economy contracted by more than 10% in total, a more severe contraction than that experienced by most other European countries (Figure 1.3).

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

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

Figure 1.4

Iceland experienced robust economic growth in global comparison in 2013



1 A high-income economy is defined by the World Bank as a country with a gross national income per capita above US$12,746 in 2013

Source: World Bank

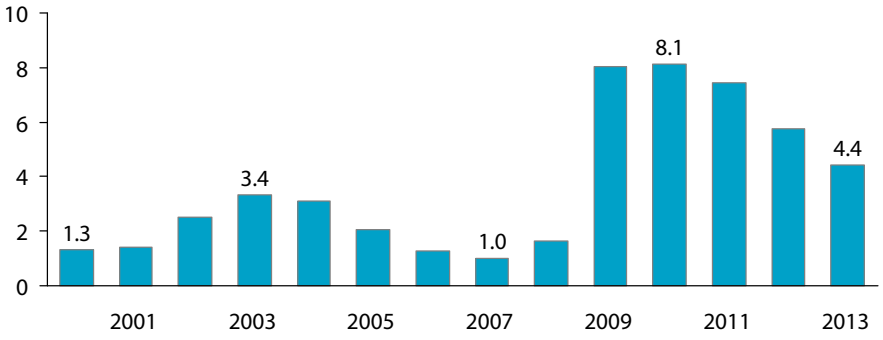
2) Pétursson, Breedon and Rose (2011), http://faculty.haas.berkeley.edu/arose/BPR.pdf

Figure 1.5

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

Unemployment rate

Percent



Source: Statistics Iceland

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

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

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

Figure 1.6

Private debt has gradually declined, especially corporate debt, and is now close to pre-crisis levels

Corporate and household debt

Percent of GDP

Source: Central Bank of Iceland

3) Central Bank of Iceland, Monetary Bulletin (2014/2), http://www.cb.is/library/Skr%C3%A1arsafn---EN/Monetary-Bulletin/2014/May-2014/MB142_Heildarskjal.pdf

tourism infrastructure and real estate projects are taking place.

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 their lowest level since 2005. However, even after this significant six year deleveraging period, the private sector remains relatively indebted by international standards. The average among OECD countries is 220% of GDP, compared to 247% of GDP in Iceland.

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 has been reduced annually to adapt to this new situation. The government is now, for the first time since the crisis, expected to achieve a surplus in the budget for 2014.

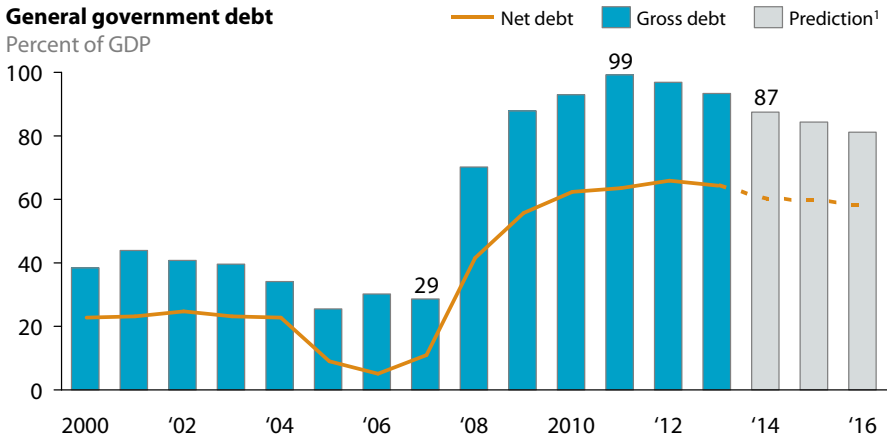
Current government debt is rather high, approx. 90% of GDP, only trailing the PIIGS-countries[5] and Belgium in Europe. The comparison with European countries is more favourable to Iceland when net debt is examined, the U.K. and France both exceeding Iceland.

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).

„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: Ministry of Finance; Central Bank of Iceland (Monetary Bulletin 2014/2)

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

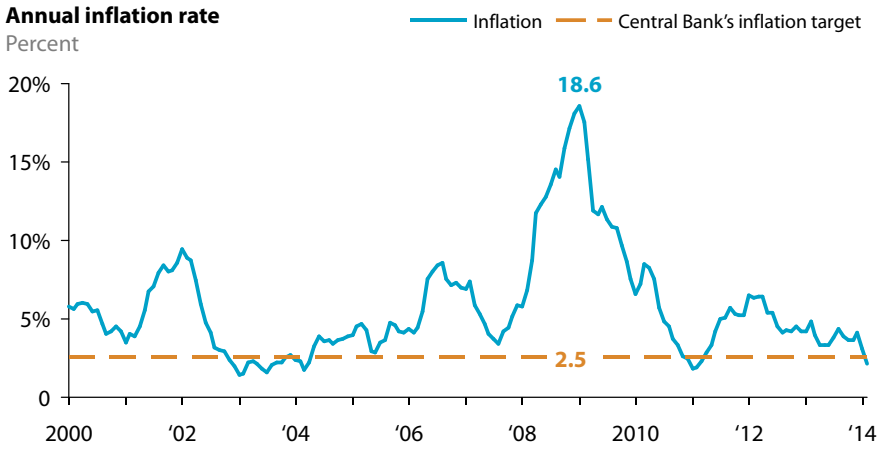
One of the characteristics of the Icelandic economy is the volatile currency and the high impact of exchange rate fluctuations on inflation. When the Icelandic Krona weakens, import prices of foreign goods and services rise, causing inflation. In 2008 and the beginning of 2009, this effect was particularly pronounced. During this period, the value of the Krona sank 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.

It is expected that inflation will again rise in 2015, as private consumption and investment picks up, and strong economic growth continues. This projection can be seen both in the Central Bank's predictions 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 rise in 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

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 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 balance[6] was highly negative (i.e. imports far exceeded exports), leading 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.

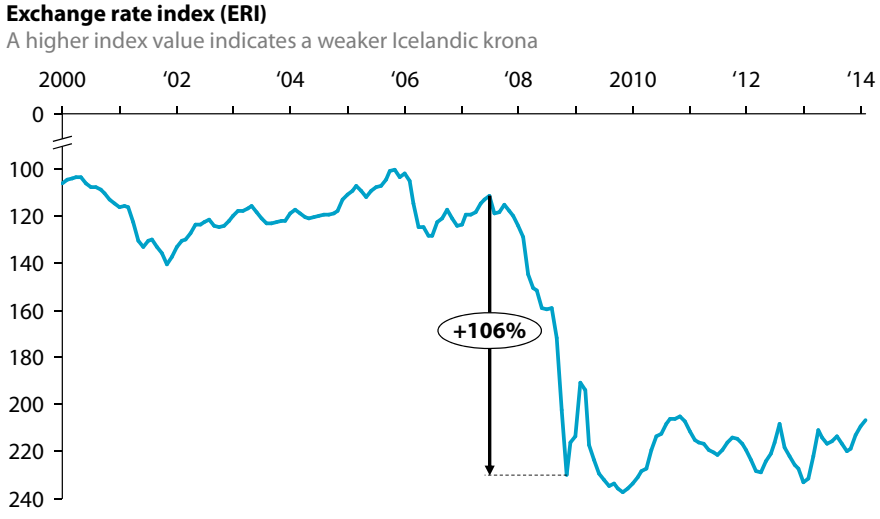
In 2013, exports of goods and services amounted to about 60% of Iceland's GDP and there was a surplus in the balance of trade in goods and services of about 7%. In the five years following the financial crisis (2009-2013) there has been a total balance of trade surplus of 37% of one year's GDP, which 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 current account surplus has averaged about 1% 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 (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

„The small size of the domestic economy makes Iceland highly dependent on international trade."

Figure 1.9

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

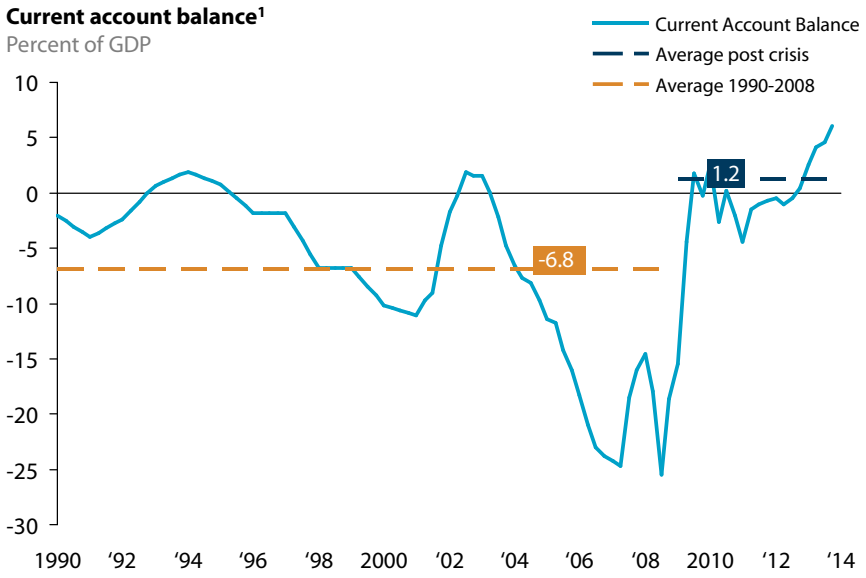


Source: Central Bank of Iceland

6) Balance of international trade in goods and services

Figure 1.10

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



1 Seasonally adjusted, trailing 12 month average

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

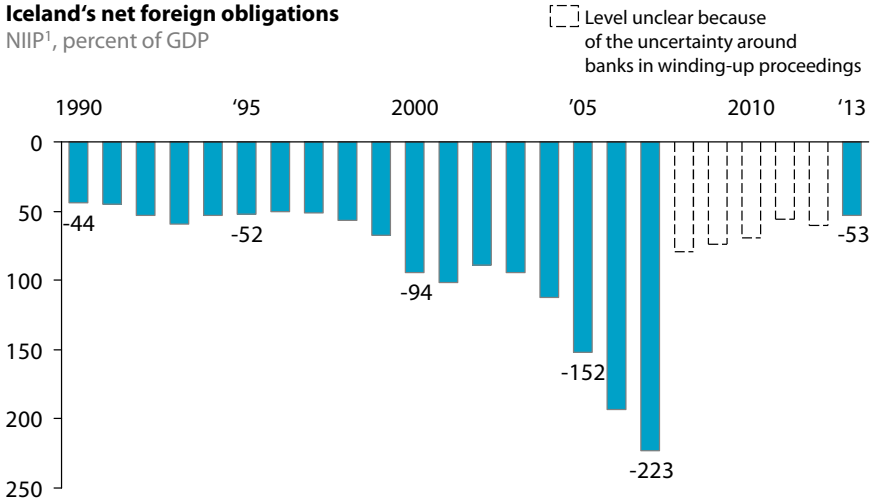
1.11). After a restructuring of the banking system in the aftermath of the financial crisis and years of current account surplus, the position has gradually been becoming healthier – but is still considerably negative by international standards.

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

„A key challenge for Iceland is to increase its exports in order to maintain current account surplus“

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

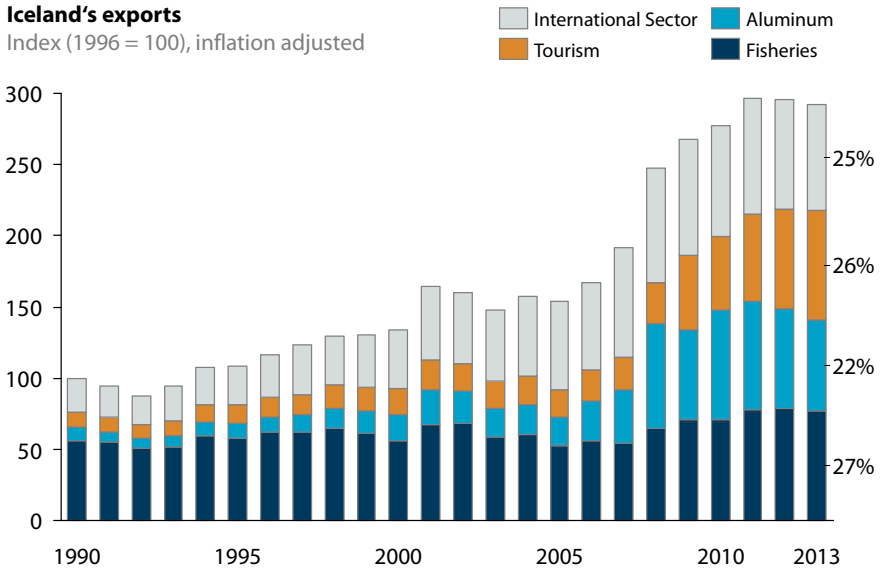


1 Net International Investment Position

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

relatively stable, as the industry is limited by the quantity it can fish, 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 negotiations[7], 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.

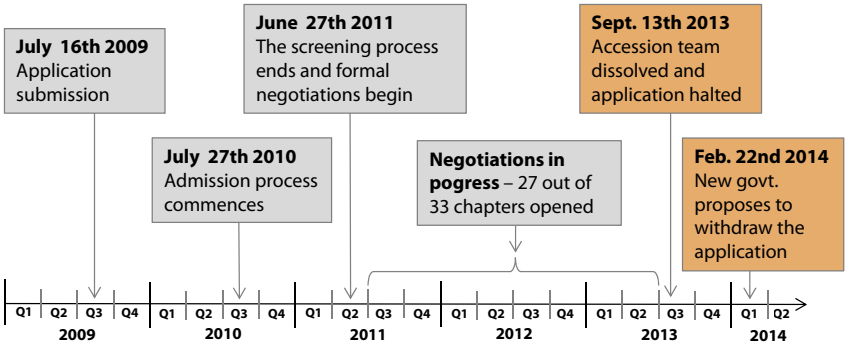
The new Government, formed after the election in 2013, made it clear in its coalition agreement that the membership application would remain suspended, pending a referendum on the question of whether or not to continue. In February 2014, a government bill proposing a formal withdrawal of the membership 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 prior to Alþingi's summer recess.

„Iceland submitted an application for a membership of the European Union (EU) in July 2009"

Figure 2.2

Iceland's application to the EU was halted in 2013, but a proposal to withdraw the application has met with resistance

Iceland's negotiations with the European Union
Timeline

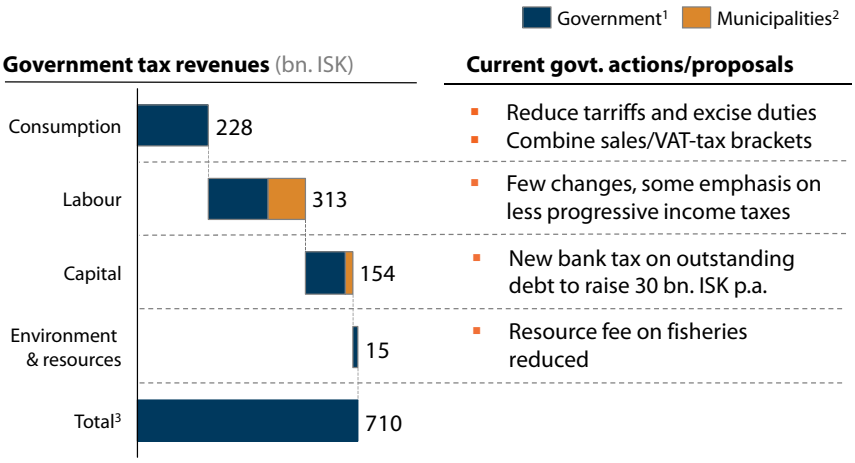


Source: Iceland Chamber of Commerce

7) 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

Figure 2.3

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



1 Central Government 2014 draft budget
2 2012 data for Municipalities
3 On top of this the general government gets 53bn. ISK in other revenues, mostly from public services, capital gains and dividend payments

Sources: Iceland Chamber of Commerce, Statistics Iceland

Tax and fiscal policy

The new government also emphasised fiscal prudence and a reduction of public debt. The fiscal deficit is projected to be eliminated for the first time since the financial crisis, and new legislation pertaining to public finance reform has been passed. The minister of Finance has recently advocated selling part of its stake in Landsbankinn, Iceland's largest bank, in order to further reduce public debt.

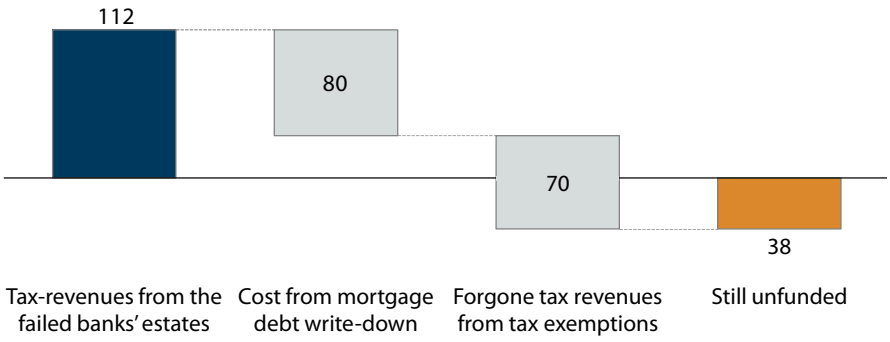
The tax system has been altered somewhat, and more changes have been proposed (Figure 2.3). To date, the key changes include an extension of and an increase to a financial institutions tax, a reduction in a resource fee on fisheries, and a small reduction in income taxes. The most significant planned change lies in reforms of consumption taxes, with the aim of reducing tariffs and excise duties, and reducing VAT tax bracket disparity.

„The fiscal deficit is projected to be eliminated for the first time since the financial crisis"

Figure 2.4

The government unveiled its plan to allocate 150 bn. ISK to a mortgage debt relief plan – most of it is funded by a new tax on the failed banks' estates

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 estimates

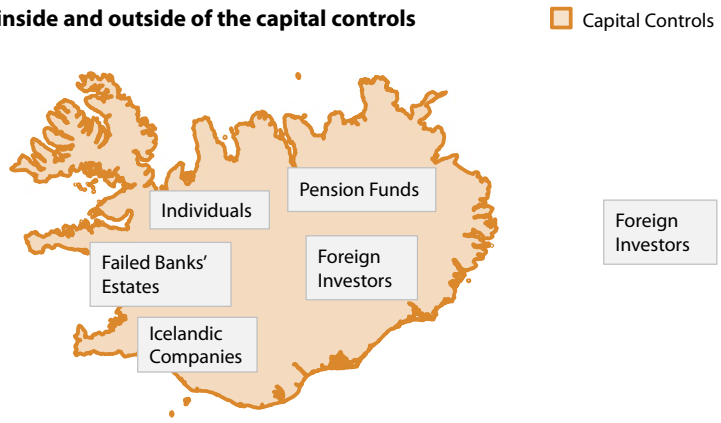
A tax on financial institutions has been extended to the estates of the failed Icelandic banks, raising significant new revenues. The additional funds will be earmarked to fund a new mortgage relief programme, beginning in 2014 (Figure 2.4). The programme is comprised of two components. The first component 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 of the 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.

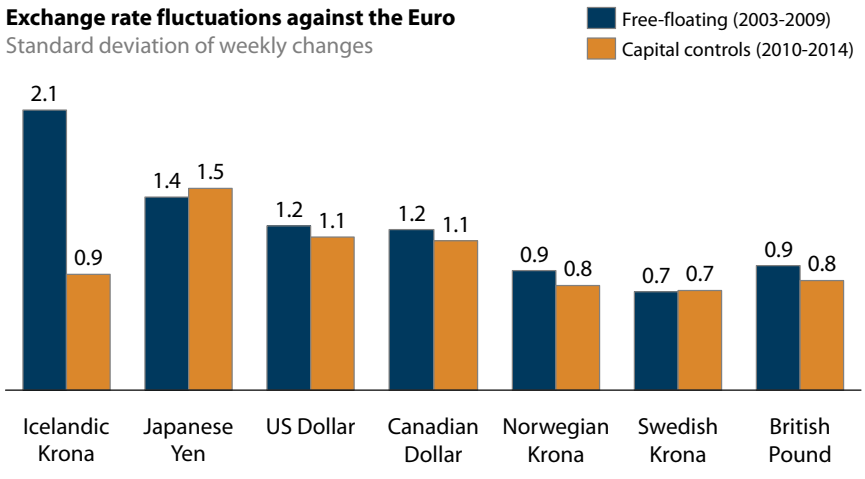
The capital controls remain in place and affect multiple parties (Figure 2.5). The controls have been tightened a number of times since they were first imposed, almost six years ago. For example, in March 2012, the estates of the failed domestic banks were forbidden to transfer payments to creditors abroad. Also, in June 2014, individuals were forbidden to allocate their pension savings to insurance companies abroad.

„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



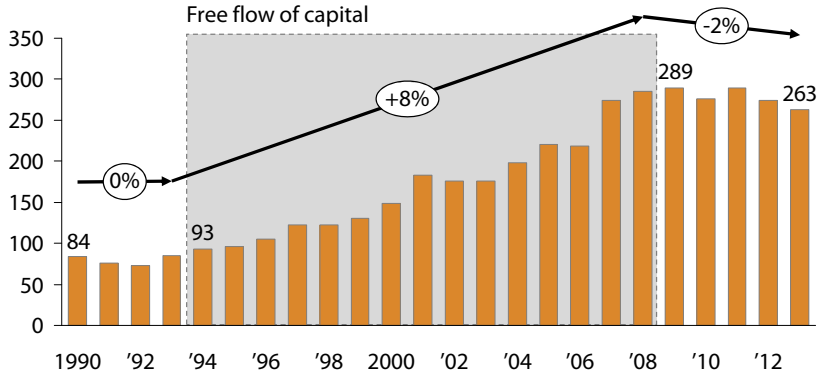
Sources: Central Bank of Iceland; Iceland Chamber of Commerce analysis

Figure 2.7

The adverse effects of the capital controls are most visible in the international sector; such exports have only grown 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 estimates

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

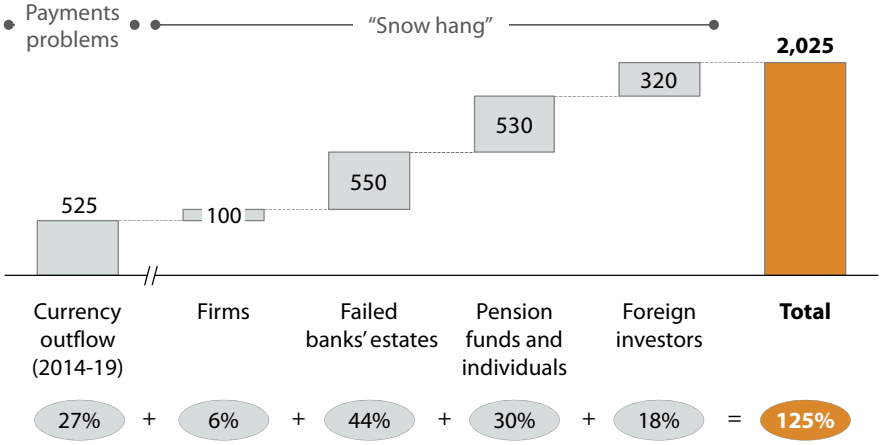
„The largest economic cost is in the form of a slower growth of globally competitive firms."

Figure 2.8

Iceland's shortage of foreign currency combined with the risk of capital flight makes it difficult to lift the capital controls

Iceland's Currency Needs

ISK billions / % of GDP



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

(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 shrunk by 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 overinvestment 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 estimates that Iceland's shortage of currency could at worst amount to 125% of GDP. To bridge this gap, domestic parties will need access to foreign credit to finance these potential outflows.

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

2.3 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 which 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 2.9). 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 – 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 increased demand. This lag can be partially attributed to the high seasonality of tourism (Figure 2.10). Peak demand during the summer and lower demand in the winter reduces the utilisation and productivity of tourism-related investment such as hotels. However, over the last three years, tourism in Iceland has been becoming less seasonal, increasing the return on tourism-related investment.

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 responded to this by charging visitors a fee, but there have been disputes as to the legality of such actions. The Ministry of Industry has been working towards resolving these issues and establishing a framework where visitor flow can be managed, whether by visitors' fees or other measures.

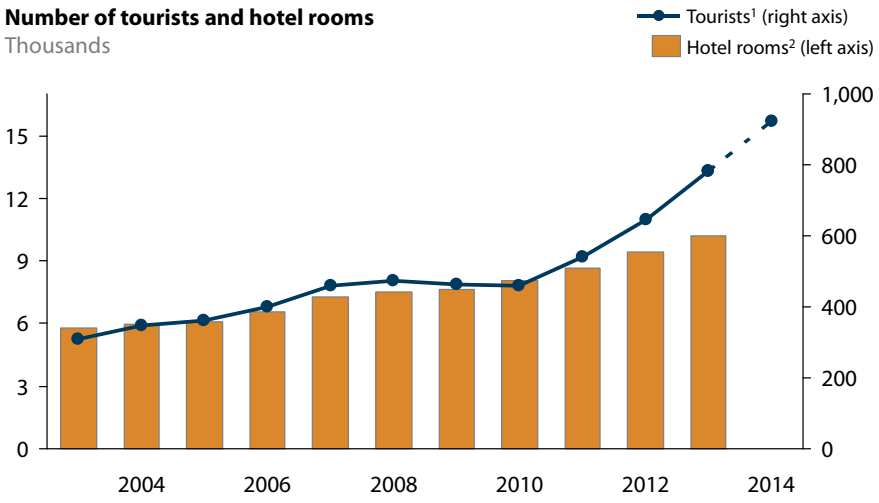
„The largest recession remedy for the Icelandic economy has been a booming tourism sector."

Silicon plants

Four large foreign investment projects are likely to be realised in the immediate future, due to the planned

Figure 2.9

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

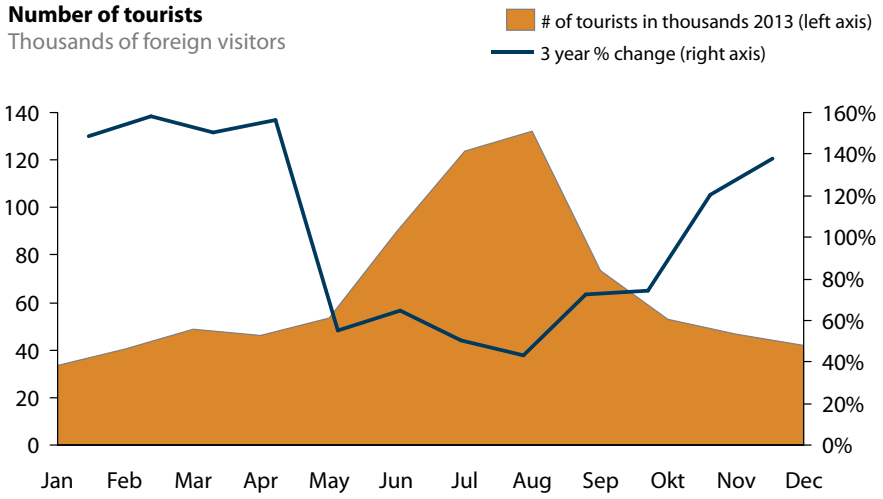


1 The figure for 2014 is an estimate by the Economic Research department of Landsbanki
2 Yearly average

Sources: Statistics Iceland; Icelandic Tourist Board; Landsbanki; Iceland Chamber of Commerce

Figure 2.10

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



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 (8.3% of GDP), almost equivalent to the total business investment in 2013 (Figure 2.11). This would also strengthen the export sector by increasing its volume and making it more diversified.

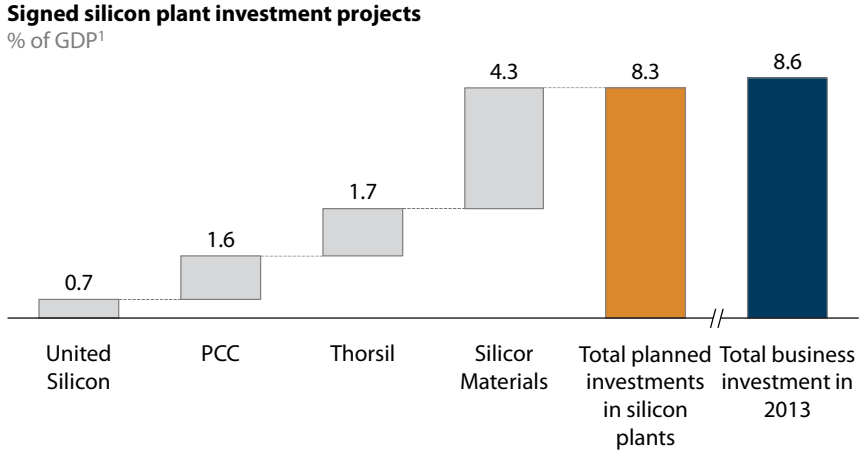
Investment agreements and a power purchase agreement (PPA) have been signed by the Government and Landsvirkjun, Iceland's biggest energy company, with three out of four of these proposed projects (all but Silicor Materials), and construction has begun in some cases.

In May of this year, United Silicon began construction of a 20,000 ton metallurgical grade silicon metal production plant in Helguvík near

„The total value of the four planned investments is about 150 bn. ISK (8.3% of GDP), almost equivalent to the total business investment in 2013."

Figure 2.11

Four large silicon plant investment project agreements have been signed recently, which will create a new energy-intensive industry



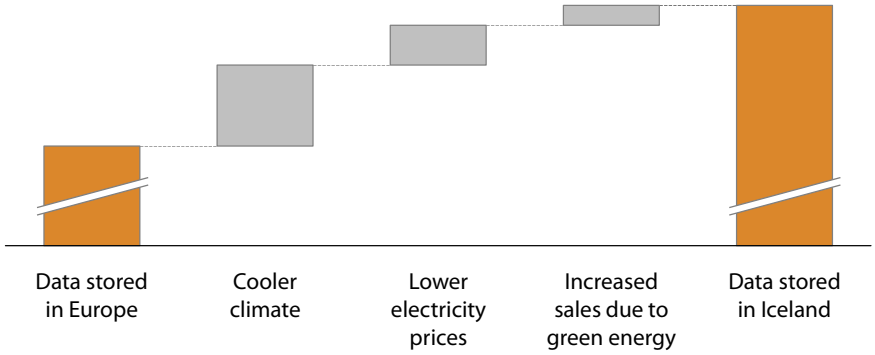
1 United Silicon, PCC and Thorsil have signed both investment agreements with the government and power purchase agreements with Landsvirkjun. Silicor Materials has signed a terms of a contract agreement with the government but has not yet signed a power purchase agreement with a power provider.

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

Figure 2.12

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

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 ton 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.

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.[8] 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.

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 2.12).

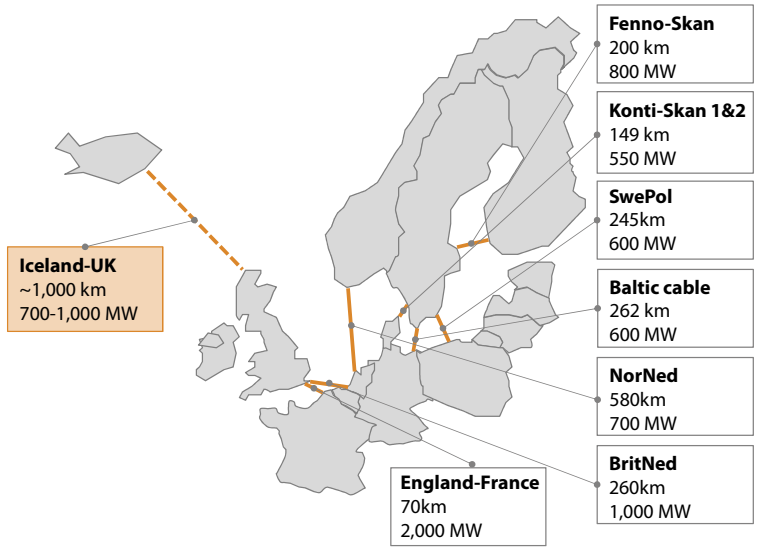
„The data centre industry is a rapidly emerging industry in Iceland."

8) http://english.hi.is/frettir/alvogen_and_uoi_science_park_collaborate

Figure 2.13

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

Interconnector

The Icelandic and British authorities are currently exploring the possibility of constructing an electrical interconnector between the two countries (Figure 2.13). 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, in some cases, a waste of energy. 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.

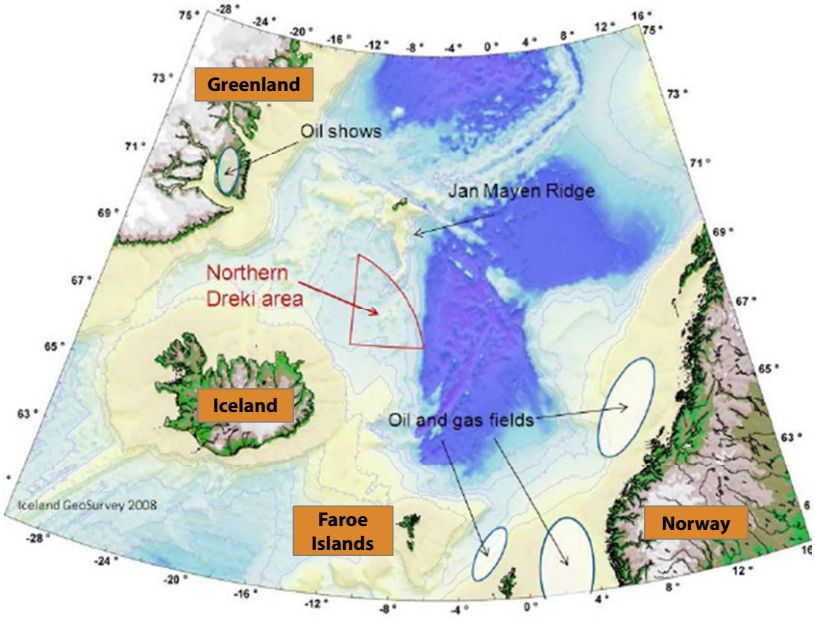
An interconnector between Iceland and the UK would be one of the longest in the world and would require a significant investment. Landsvirkjun, Iceland's largest power generator, is currently examining the engineering and financial aspects of construction to assess its viability.

„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

Iceland shares a ridge with Norway near Jan Mayen which has the potential to yield a large amount of oil and gas

Dreki area is the part of the ridge that falls within Iceland's jurisdiction



Source: Iceland GeoSurvey

Oil

The Jan Mayen Ridge, located between Iceland and Norway, is thought to contain hydrocarbon accumulations (Figure 2.14). The Dreki (i.e. dragon) area is that part of the ridge lying within Iceland's jurisdiction. A report from the Icelandic Ministry of Industries and Innovation[9] suggests that the area may potentially yield up to 2 billion barrels of oil equivalents (BOE) of hydrocarbons, 0.8 billion BOEs of oil and 1.2 billion BOEs of gas. At market prices this amounts to 233 bn. USD in revenues, or approximately 14 times Iceland's GDP.[10] Thus, a successful oil production industry in the Dreki area could dramatically increase Iceland's exports.

Iceland has issued three permits for oil and gas exploration in the Dreki area. The Icelandic share of these permits is held by the privately owned firm Eykon Energy. This has three international partners, one for each permit: Faroe Petroleum, ITHACA Energy, and China National Offshore Oil Corporation (CNOOC).

Eykon plans to conduct ultrasound exploration in 2014. The company hopes to start drilling for oil in 2017 and to start production by 2021. This will depend on the results of the exploration efforts and whether hydrocarbons are present in sufficient quantities for profitable extraction.

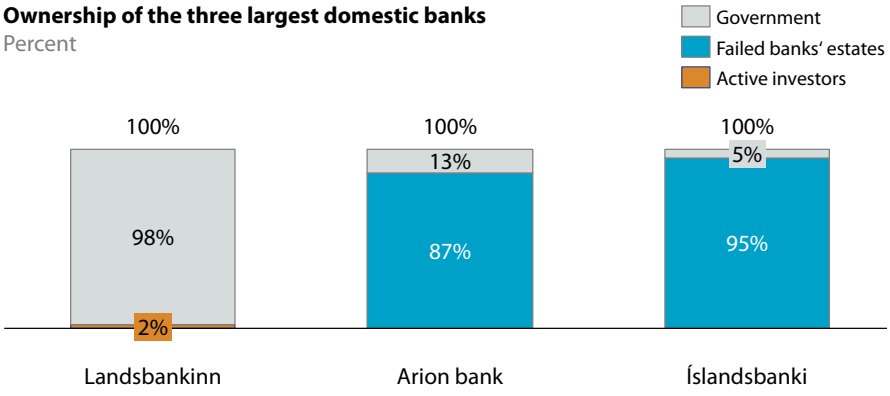
„A successful oil production industry in the Dreki area could dramatically increase Iceland's exports."

9) http://www.os.is/media/utbod2009/Umhverfisskyrsla_2007.pdf

10) Using current spot prices for Brent oil ($111 on 30 June 2014)

Figure 2.15

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



Source: Annual reports

2.4 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.

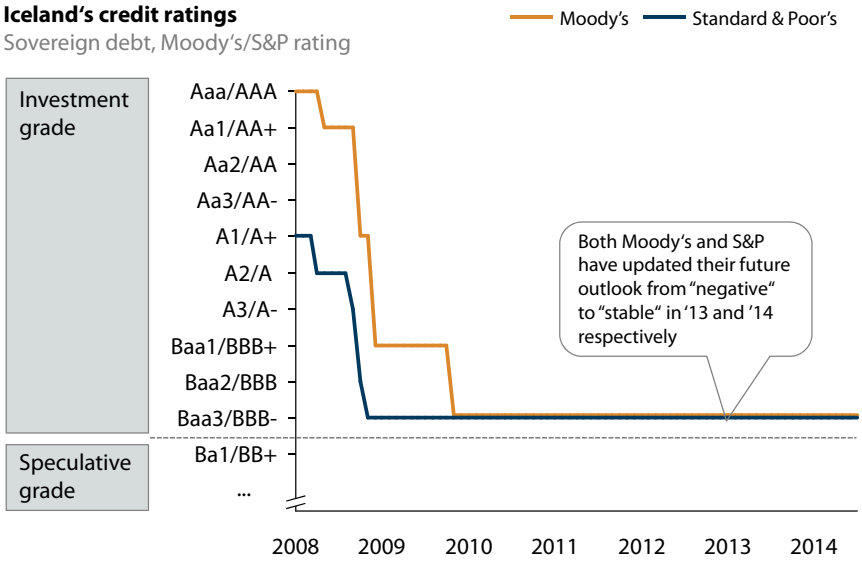
Access to credit

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 prices (CDS) on Icelandic government bonds were extremely low, at just 10 basis points. CDS prices reflect the probability of default, so such a low price

„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 2.16

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



Source: Central bank of Iceland

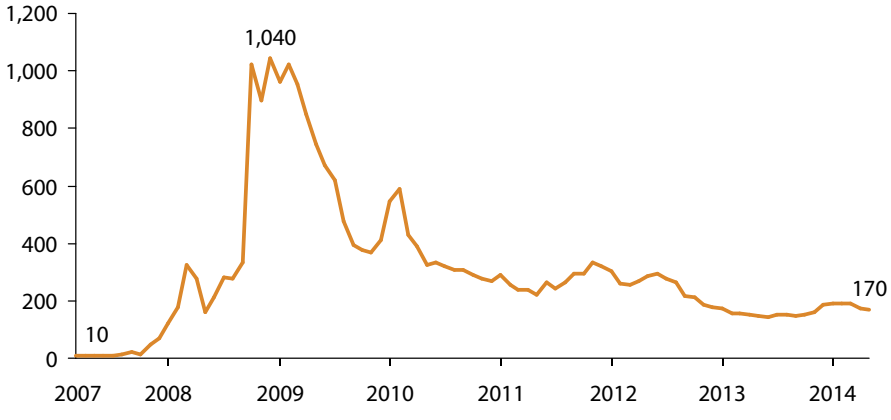
implied a very low probability of the government defaulting on its debt. Additionally, the credit rating agency Moody's gave the sovereign state its highest possible credit rating, AAA, on foreign currency risk, reflecting the high confidence in Iceland by foreign investors (Figure 2.16).

During the latter half of 2007, the CDS price 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 as the CDS prices have been sinking. Recently, CDS prices have hovered around 170 basis points. Both Moody's and S&P rate Iceland as having the lowest Investment grade, (bba3/BBB-), although they have both revised their future outlook projections from "negative" to "stable" in 2013 and 2014, respectively. Regardless, Iceland does not have the same access to credit as

„Both Moody's and S&P rate Iceland as having the lowest Investment grade, (bba3/BBB-)."

Figure 2.17

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



Source: Central bank of Iceland

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 bonds and the real estate market had significant market capitalisation.

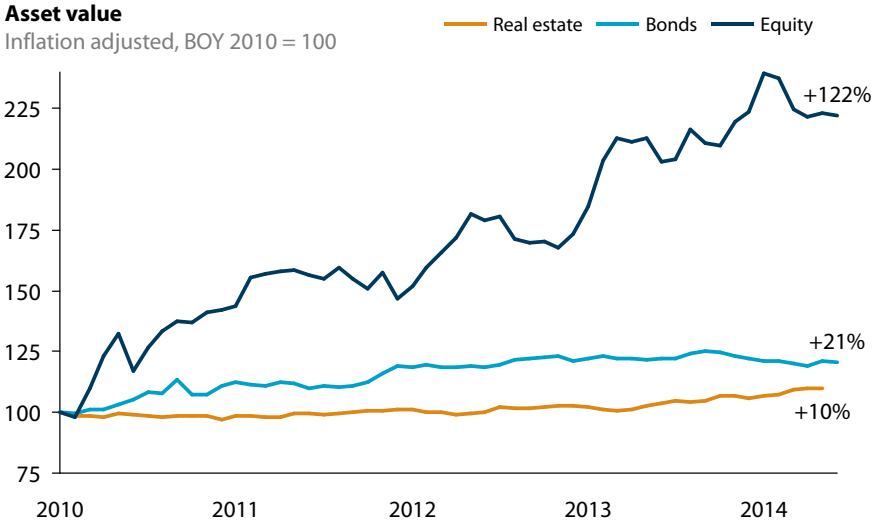
Over the past few years, both the public equity market and the corporate bond market have been gradually gaining momentum, thus broadening the asset market and making it healthier and bringing it more into line with asset markets in other countries. In December 2011, Hagar, Iceland's largest retail company, went public and since then eight more companies 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 600 bn. ISK (a third of Iceland's GDP), an increase of 120 bn. in the last 12 months.

The equity market has yielded high returns over the last few years with total aggregated real returns of about 120% since the beginning of 2010 (Figure 2.18). However, 2014 has not been in line with that trend, as prices have declined by 7% in real terms since the beginning of the year. Bond market prices have also decreased over the last few months with negative real returns. Conversely, the real estate market has recently been yielding high returns. Housing prices have been appreciating about 10% in real terms over the last 12 months, following three years of relative price stability. Many domestic institutional investors have been moving into real estate investments to pursue yields, as they are incapable of investing abroad due to the capital controls.

„Over the past few years, both the public equity market and the corporate bond market have been gradually gaining momentum."

Figure 2.18

Domestic assets have appreciated in value over the last few years, especially equities, which collapsed in value during the crisis



Sources: GAM Management (Government Bond Index, Equity Index); Registers Iceland (Real estate index); Iceland Chamber of Commerce analysis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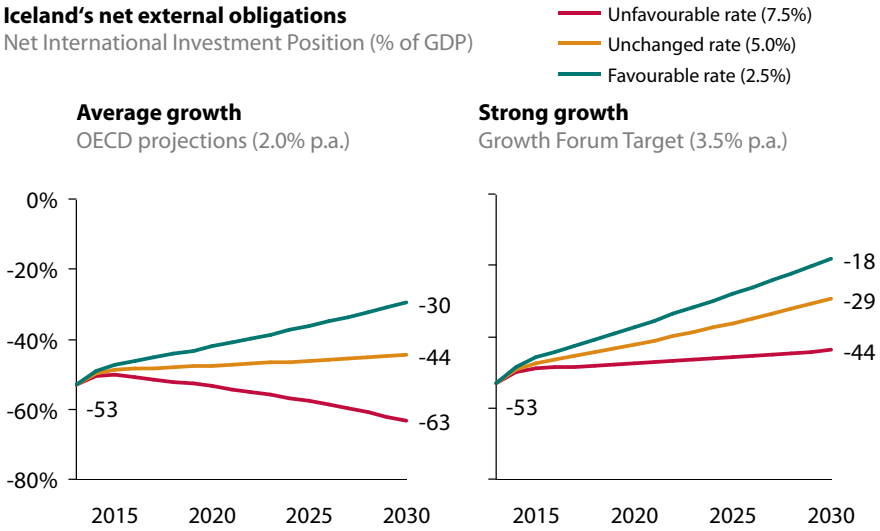
3 Future Prospects

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



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

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 53% of GDP (Figure 3.1), in line with many Western-European countries. However, a large portion of Iceland's foreign obligations is in the form of debt with low maturity, scheduled for repayment within the next few years. Thus, the development of Iceland's debt levels will largely depend on the interest rates agreed upon when domestic parties refinance their debt. If favourable rates are achieved, this position could improve rapidly. Additionally, a strong economic growth scenario further helps in improving this position.

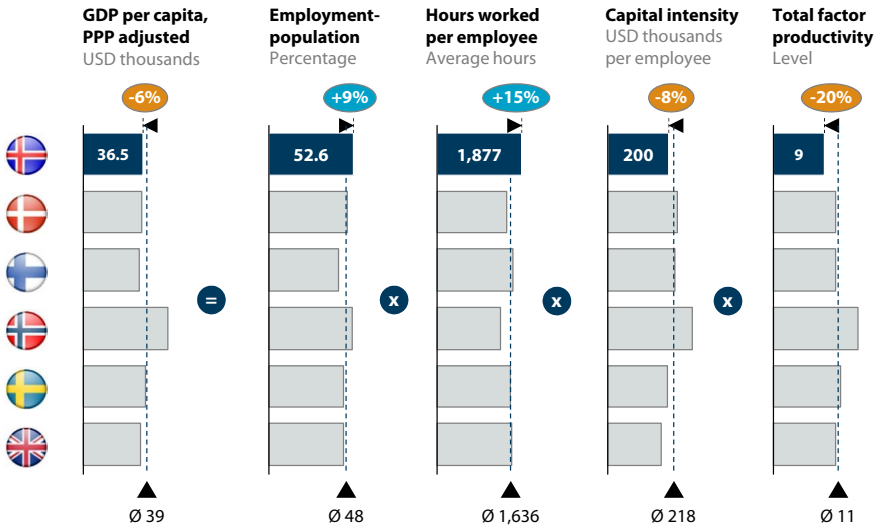
„The development of Iceland's debt levels will largely depend on the interest rates agreed upon when domestic parties refinance their debt."

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

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

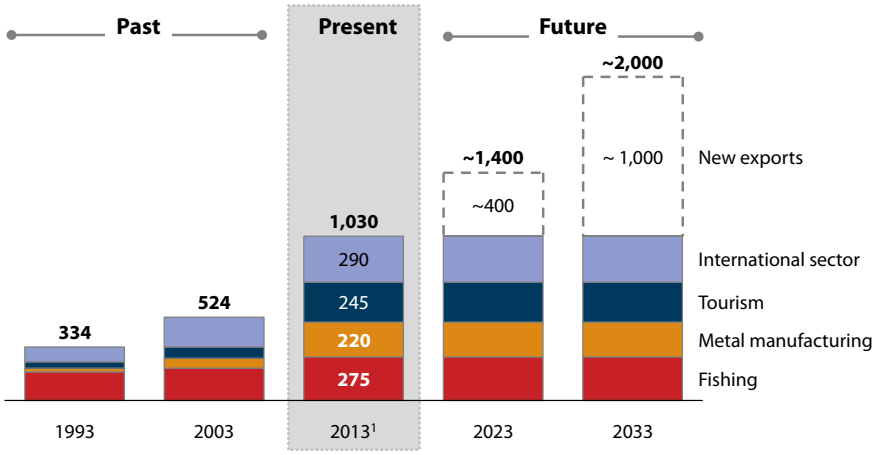
„One of the key messages of the McKinsey report concerns the composition of Iceland's GDP."

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)

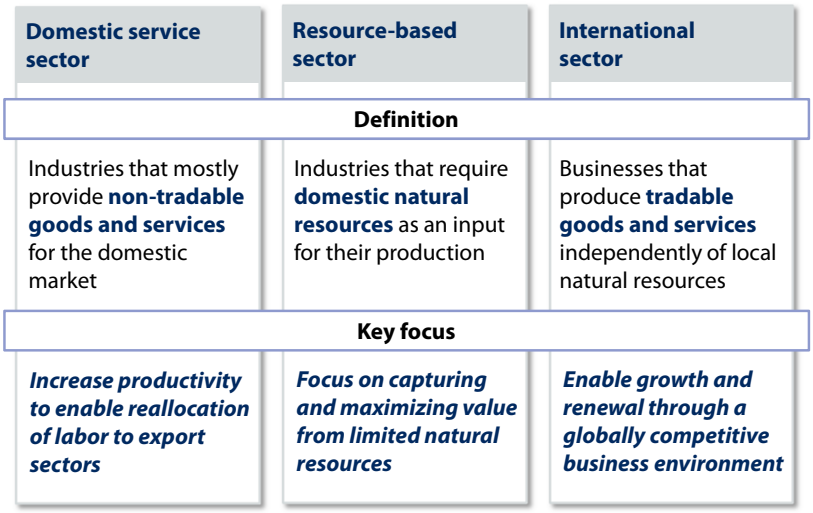


1 As only Q1-Q3 export values are available, Q4 is estimated using an average of seasonality factors for 2010-12

Source: McKinsey & Company

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



Source: McKinsey & Company

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.

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, 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.

„Productivity - being the most fundamental component of long-term sustainable economic growth - will need to improve."

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

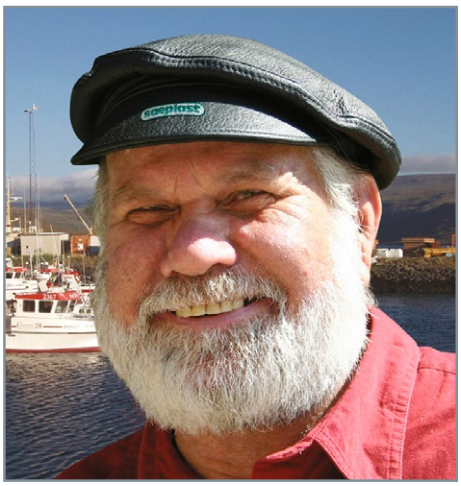
Following the publication of the McKinsey report, the Iceland Growth Forum was established (Figure 3.5) in order to develop further its policy recommendations. The forum's aim was also to increase alignment and facilitate cooperation between key stakeholders in the economy.

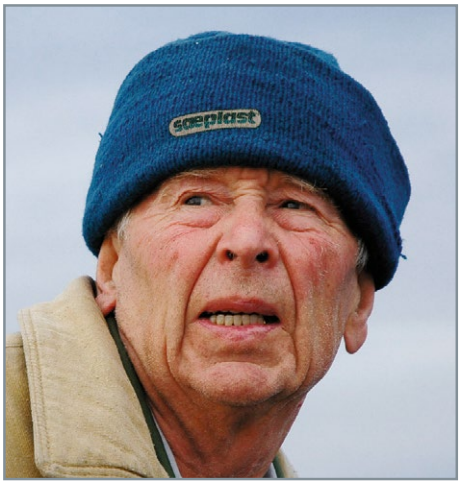
Additionally, the Forum established a secretariat which created proposals for public policy reform. Many of the proposals are currently being implemented, with the aim of supporting Iceland's long term growth prospects.

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

Fishermen Don't Listen to Nonsense





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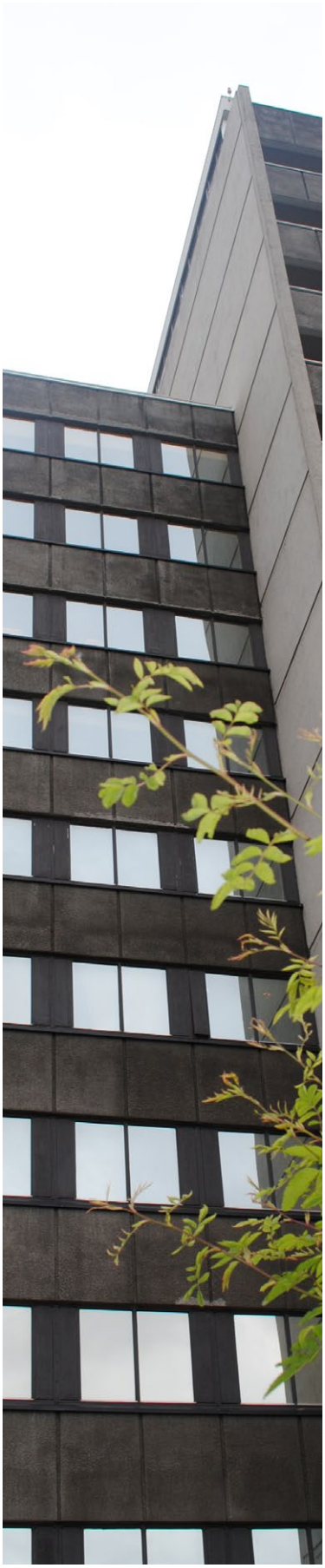
About the Iceland Chamber of Commerce

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 to increase economic prosperity.



Operations of the Chamber

General 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.

The Chamber's 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 fourth and latest edition was issued in March 2012.

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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