

The Icelandic Economy

Q4 2021

Current State,
Recent Developments
and Future Outlook



Iceland Chamber
of Commerce





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The Icelandic Economy

Current State, Recent Developments and Future Outlook – Q4 2021 edition

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Further information

Previous editions and a mailing list for future editions are accessible on the Chamber's website, www.chamber.is.

About the Chamber

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The Icelandic Economy – Q4 2021

Current State, Recent Developments and Future Outlook

Introduction

Last couple of years have been a rollercoaster for the Icelandic economy. A clear example is that when Icelanders thought they were out of the woods with COVID-19, a new wave hit almost simultaneously as the Q3 version of *The Icelandic Economy* was published.

Luckily, the situation was contained quite fast, and the economy has kept on an upward trajectory. The evidence for that has kept mounting, including declining unemployment, continued tourism recovery and rising domestic demand. For a historical fishing nation, news of a 1% of GDP boost from the upcoming capelin season is very uplifting. Financial markets have also been strong, albeit a bit shaken by rising interest rate and inflation fears.

Iceland is heavily reliant on foreign trade which has had its pros (including rising aluminium prices) and cons (experiencing global supplies shortages). While the impact in Iceland of those developments remain uncertain, political uncertainty has declined after the recent parliamentary election.

Konráð S. Guðjónsson, Chief Economist

Highlights

1 Economic Developments (page 7)

Iceland has sustained a strong economic recovery over the past months with growing domestic demand, tourism and other exports as the pandemic remains contained. The outlook is overall positive with forecasts of strong growth over the next couple of years. Inflation, however, has been a cause for worry and remains at 4.4%, forcing the Central Bank to hike rates as late as 6 October to 1.5%. Hopes are for inflation to slow down to the 2.5% target next year.

Other developments of interest include booming housing and stock markets, relatively stable exchange rate, rapidly declining unemployment rate and 2% of GDP smaller budget deficit than expected in the first half of 2021.

2 Iceland at a Glance (page 20)

Iceland ranks highly on several international indicators. In the IMD's Competitiveness Index it is 21st, behind the other Nordics. Infrastructure and several indicators regarding business efficiency are particular strengths while the country's small size and financial environment lag behind despite improvements in the latter.

3 Institutional Framework (page 26)

Iceland is a parliamentary republic with a large public sector. The Central Bank targets inflation and the financial system is characterised by prominent pension funds.

The government comfortably held its majority in parliamentary election on 25 September. At the time of publication, the three majority parties are in discussion to renew the coalition agreement and a cabinet re-shuffle is expected.



Key facts about Iceland

Key economic indicators

- The currency is the Icelandic Króna (ISK), USD 1 = ISK 129.6, EUR 1 = 150 (11 October 2021)
- Inflation: 4.4% (September 2021)
- Unemployment: 5.1 % (August 2021)
- Central Bank policy rate: 1.5% (October 2021)
- Iceland's gross domestic product (GDP) per capita in 2020 was 55,213 USD PPP (11th highest in the world)
- The current account deficit in 1H/2021 was 3.5% of GDP
- General government gross debt-to-GDP was 80% in 2020, while net debt-to-GDP accounted for 64%
- In 2020 the main exports were seafood (27% of total), aluminium (21%) and tourism (12%)

Interesting facts

- Population is 371,580 (June 2021) spread across 102,775 km² (similar to South Korea)
- The official language is Icelandic, and the capital is Reykjavík
- The former president Vigdís Finnbogadóttir became the first democratically elected female head of state in 1980
- Iceland's search and rescue services are solely volunteer-run
- Iceland was a founding member of NATO but does not have any military forces
- The Icelandic population has been growing rapidly over the last decade (16.4% compared to 2% in the EU)
- Iceland's parliament, Althingi, is the oldest parliament in the world, founded in 930 AD
- 100% of electricity in Iceland is generated from renewable sources

Helpful resources

- [Statistics Iceland](#)
- [Central Bank of Iceland](#)
- [Invest in Iceland](#)
- [Business Iceland](#)
- [Green by Iceland](#)
- Local news: [RÚV](#) and [Iceland Monitor](#)
- [Work in Iceland](#)
- [Reykjavík University](#)
- [Government of Iceland](#)
- [Keldan](#)
- [The OECD Economic Survey of Iceland](#)
- [IMF's 2021 Article IV Consultation](#)
- [Althingi](#)



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**Corporate Finance, Capital Markets
and Wealth Management**



1 Economic Develop- ments

Icelandic Economy
Q4 2021



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Brighter prospects ahead with reinforced short-term indicators

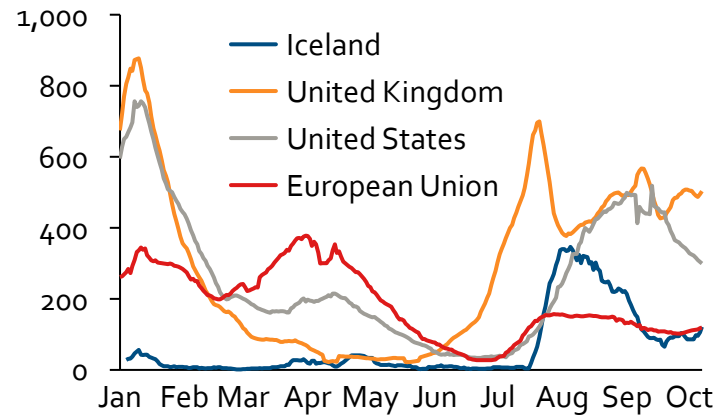
COVID-19 remains contained with gradual lifting of restrictions.

Following eased public health measures and with 88% of the population, 12 years and older fully vaccinated, short-term indicators have been quite promising. Roughly 3% of the population has been diagnosed with Covid-19 and new cases have been steadily declining. As a result, business and consumer sentiments are reaching an all-time high while consumer sentiment had not been poorer for ten years in 2020.

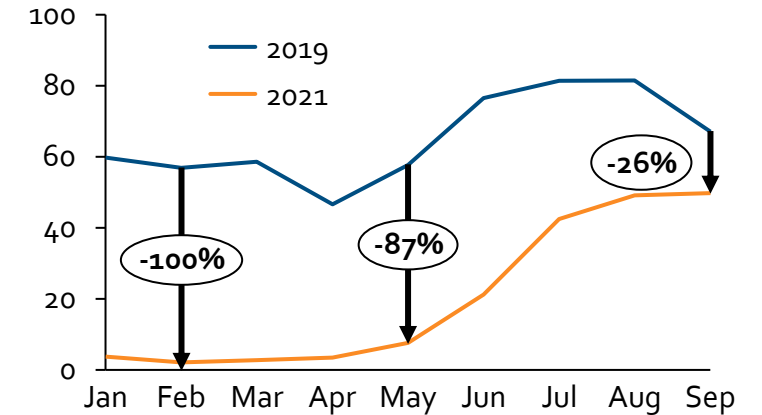
Passenger departures from Keflavik airport are increasing quite rapidly and are expected to increase even further with Play airlines augmented capacity, but the airline advertised 150 new jobs in September. Similar story applies for Icelandair. The Icelandic Tourist Board is forecasting almost two million tourists next year and Isavia, the Keflavik airport operator, is expecting total passengers to reach 2019 levels in 2024.

It is worth adding that both private consumption and payment card turnover have been growing rapidly (page 10). Also, job vacancies and firm's recruit plans (page 15) also indicate that the labour market is recovering.

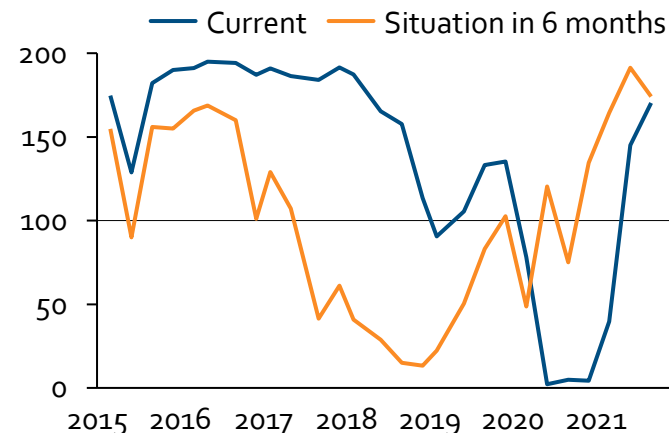
New COVID-19 cases (per million people)¹



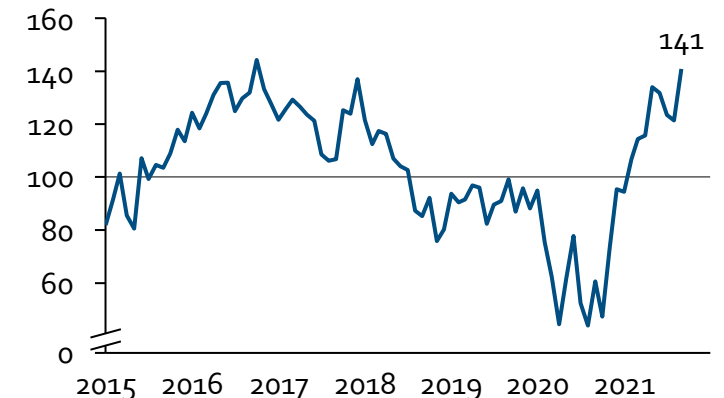
Passenger departures from KEF airport



Business sentiment



Consumer sentiment



Exports in strong tailwind

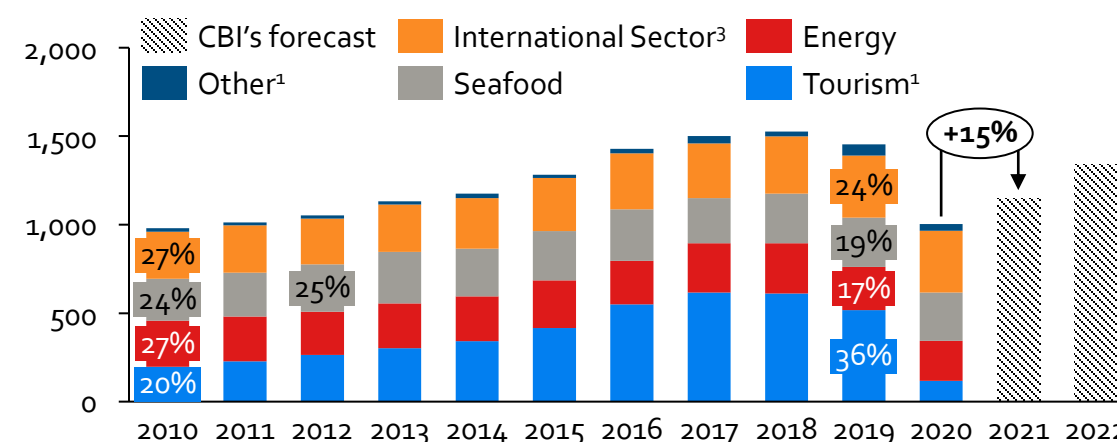
Recovery has been rapid over the past months, but more is required to reach previous levels

Leading up to the pandemic, tourism had become by far the largest export. The sector's growth peaked in 2017 when the tourism exports weighted 42% of the country's total exports. The Covid-19 crisis took its toll on the tourism sector as it accounted for only 12% of total exports in 2020, compared to 36% in 2019. With the largest sector hurt, exports contracted by 30.5% in 2020.

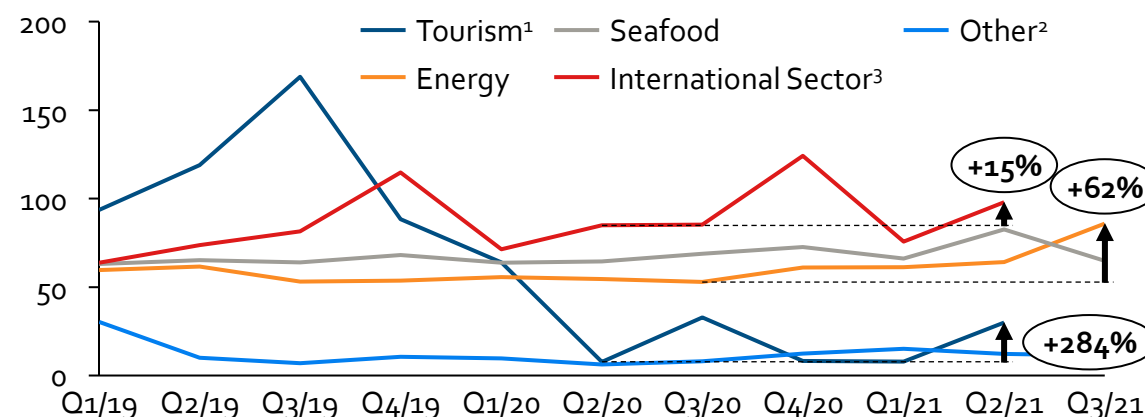
This year the tide has turned, and tourism has grown rapidly since this spring with evidence of a strong third quarter. The sector still remains small compared to before the pandemic and evidence is overall mixed over how fast it will reach previous levels. Seafood exports and exports in the international sector have also been growing relatively fast. In the latter, R&D services and intellectual property have been particularly strong. Iceland's increase of R&D support, including tax credits, is arguably responsible. Soaring aluminium prices have also helped to increase exports from energy intensive industries, primarily aluminium, by 62% nominally in Q3.

The short-term outlook is promising with tourism expected to keep growing rapidly over the next few years. Outlook in other sectors is overall positive and recent news of 20-year high capelin fish-quotas (900.000 tons in total) could increase exports in 2022 by nearly 3%. Forecasters, including Íslandsbanki, are expecting GDP growth to be almost 1% higher in 2022 due to the upcoming capelin fishing season.

Total exports (bn. ISK at 2020 prices and exchange rates)



Quarterly exports (bn. ISK at nominal prices)



Sources: Central Bank of Iceland, Nasdaq, Statistics Iceland.

1. Air transports included. 2. Including agric., ships and airplanes. 3. Exports that are not dependent on Iceland's natural resources.

Strong domestic demand and booming goods imports

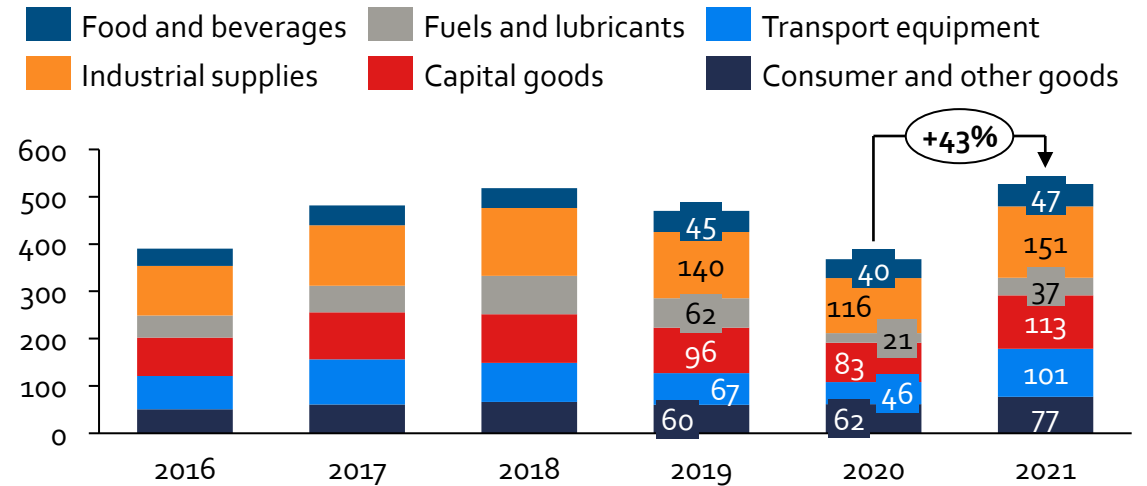
Record goods trade deficits in June and August 2021

While the decline in exports, mostly due to tourism, has been in line with expectations, domestic demand has remained stronger than expected since 2020, particularly driven by private consumption in addition to public and business investment. There is also evidence from imports and construction in initial stages that residential investment is increasing again. Domestic demand recovered faster than many had hoped, and the goods imports have gained more momentum. Imports were relatively modest in late 2020 and early 2021 but kicked off in the spring, resulting in 43% growth YoY in Q2 and Q3. This resulted in Iceland's largest goods trade deficit this century, nominally, in June this year (ISK 48 bn) and the second largest in August (ISK 36 bn). This does not translate in total trade deficit to full extent as the balance on services improved by ISK 23 bn in Q2 2021.

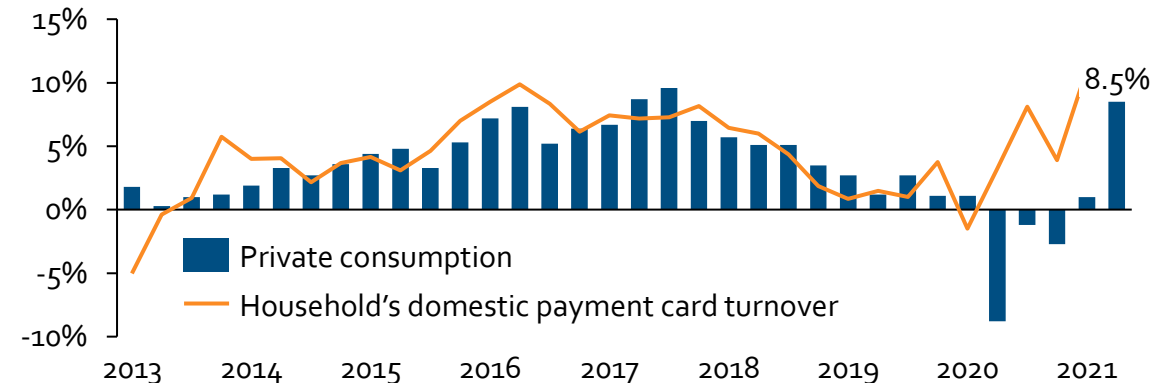
The growth partly comes from large items such as ships, but fast growth is also evident across numerous fields due to demand, such as consumer and capital goods. Compared to 2019, before the pandemic, capital goods imports are 17% higher and consumer goods imports are 29% higher. Rising commodity prices, such as for industrial supplies and fuels, are also important factors, illustrating that the growth is slower in real terms.

Over the past year there has been strong growth in payment card turnover and other high-frequency indicators of economic activity have followed. New motor vehicle registrations have increased, and sentiment has improved as mentioned earlier. In Q2/2021, private consumption increased by 8.5% YoY. The growth is stronger than previously assumed and is now projected to measure 4.2% in 2021 as a whole.

Goods imports from Apr. – Sep. (bn. ISK at constant exchange rates)



Private consumption¹ and payment card turnover (YoY change)



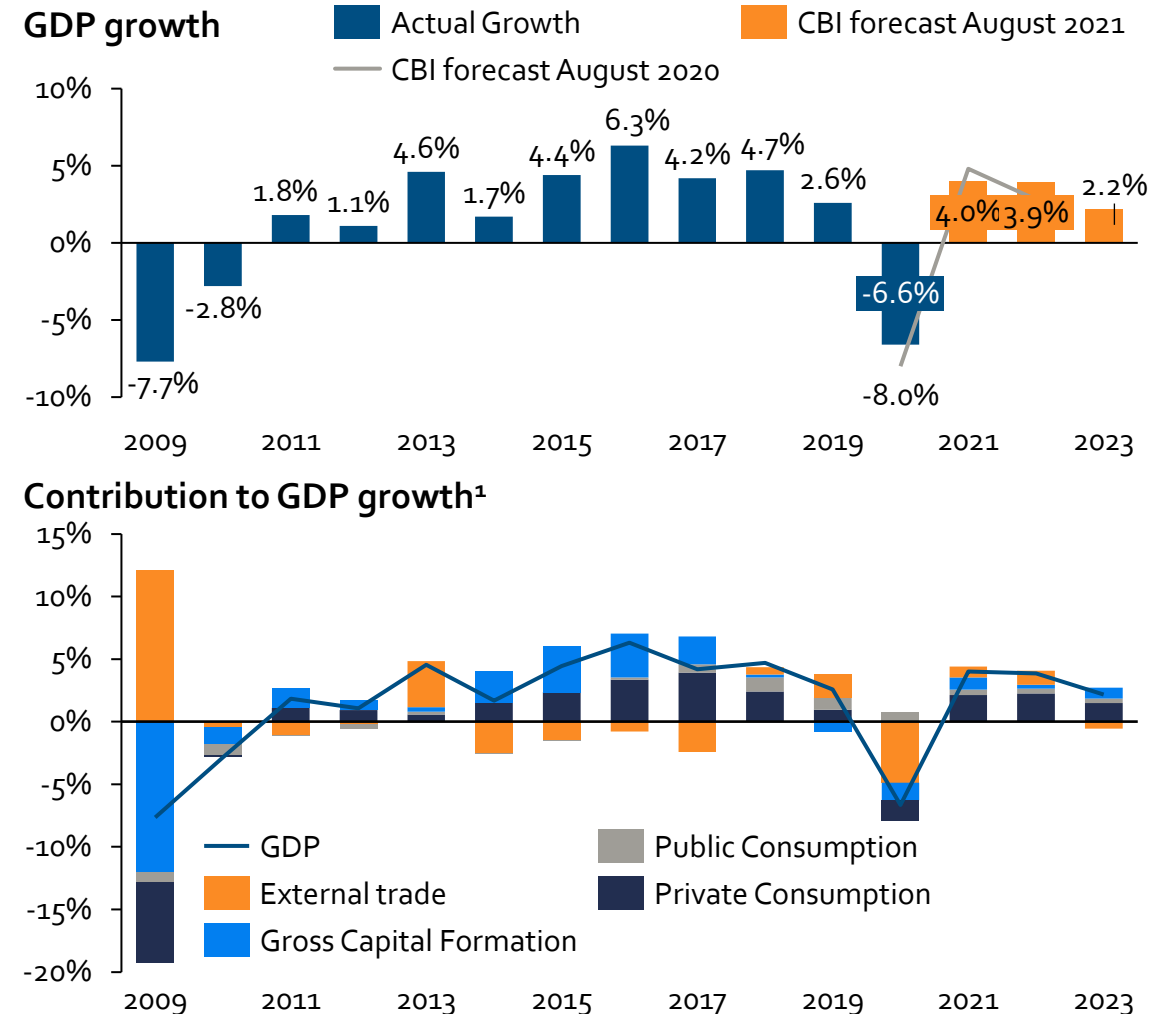
Quick recovery expected to continue in to 2023

Despite one of the steepest recessions in history

All in all, the outlook remains similar as in the Q3 version of this report, and thus better than most feared in 2020. Iceland relies heavily on international tourism and therefore it was expected in 2020 that GDP would contract more than in most other high-income countries. The GDP decreased by 6.6% compared to 6.1% in the EU and 4.7% among the OECD countries. Given other negative impacts on demand and supply and the fact that tourism contributed to 8% of GDP in 2019, Iceland was arguably successful in minimizing negative economic impact of the pandemic.

The CBI's May forecast showed a 3.1% GDP growth in 2021 as a whole, while the August one showed 4% GDP growth. The Central Bank's Monetary Policy Committee, however, had expected a stronger first half of 2021 but states it does not affect the outlook for the year overall. It should also be reminded that a boost in capelin fishing quotas as expected to increase growth further in 2022, by even 1 percentage point. Effects of COVID-19, domestically and abroad, as well as supply frictions globally will largely determine the path of the economy over the next 1-2 years.

The composition of the growth will be largely driven by private consumption, investment (gross capital formation) in 2021 to 2023 and finally external trade. The trade is arguably most uncertain and will depend on developments previously mentioned, most importantly tourism recovery.



Stock prices and turnover have increased rapidly

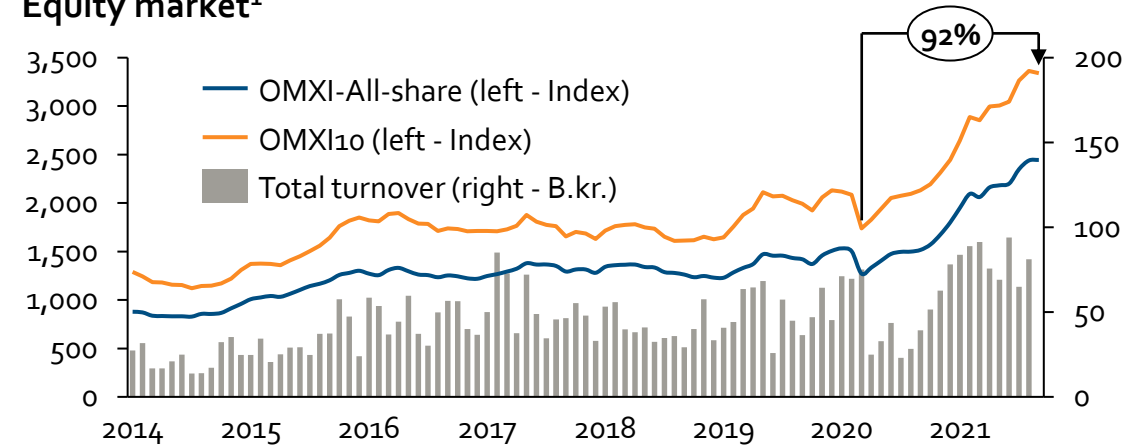
Since March 2020, the OMXI10 index has risen by 108%

After a brief shock once the pandemic hit, there has been a steep rise in asset prices overall including and most notably in the domestic stock market where both prices and turnover have risen significantly. Shortage of interest-bearing investment options with lowered interest rates and higher inflation, and therefore, negative real interest rates on deposit accounts has increased investors' risk appetite significantly.

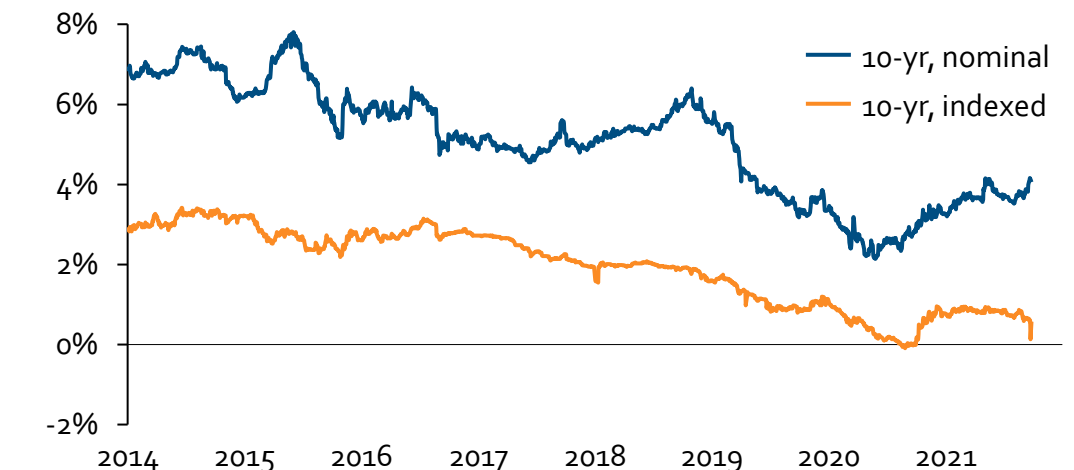
Historically, share prices are currently high and have risen by 62% in the past 12 months. The OMXI10 Index has recently been hitting new peaks since the financial crises and the deviation of the stock price from long-term trend is at its widest since the crises. In September, the index had risen by 92% from its trough in March 2020, partly due to increased interest of retail and institutional investors. The Icelandic shareholder group has grown enormously and is four times bigger than it was at the end of 2019. Approximately 10% of Icelanders now own listed shares. As a result, trading volume has increased by 186% YoY in September. Major part of listed equities is owned by the pension funds, or 40%. Around 27% are owned by financial institutions, investment funds and UCITS funds and 9% are owned by other firms. Individuals own around 5%.

In recent months, the bond market has been relatively quieter than the stock market, with 38% less turnover for the first eight months of 2021 than over the same period in 2020. In the past few weeks, yields on nominal Treasury bonds have risen, especially on short maturities. Yields on long-term nominal bonds have also risen significantly along with increased uncertainty. On the other hand, yields on consumer price index linked Treasury bonds have fallen, amid inflation fears.

Equity market¹



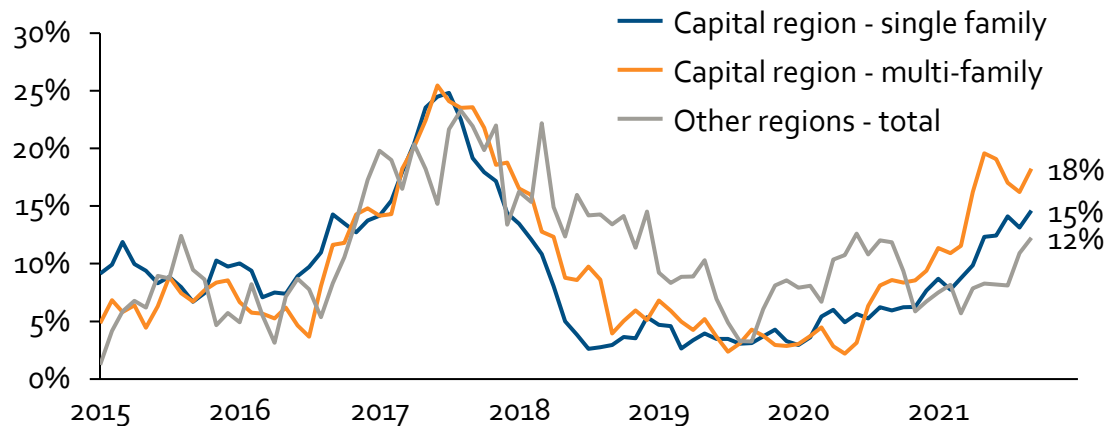
Government bond yields²



Booming housing market

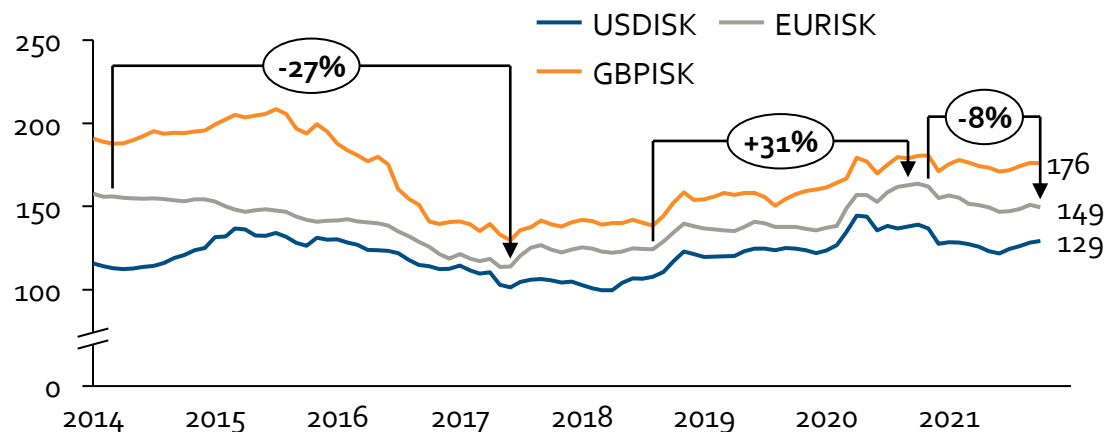
The Króna has remained relatively steady in 2021

Residential housing prices (YoY change)



Accommodative monetary policy with lower interest rates (page 17) has not only boosted stock markets, most notably also the housing market. Prices have soared due to rising demand, particularly for single-family homes, which rose by 18% YoY in the capital region in September. There is also evidence that more construction is needed in the coming years, putting more pressure on prices. Such price increases are a global phenomenon with people having more to spend on housing, and valuing space more than before the pandemic. Housing prices in the capital region rose 8% more than wages in August YoY and the same applies to disposable income. Considering the large decline in mortgage rates, such price increases, on top on large price increases over the past decade, are in line with fundamentals. That is assuming that interest rates will be permanently lower than historically, which evidence suggests is the case.

Monthly exchange rate of the Króna (ISK)



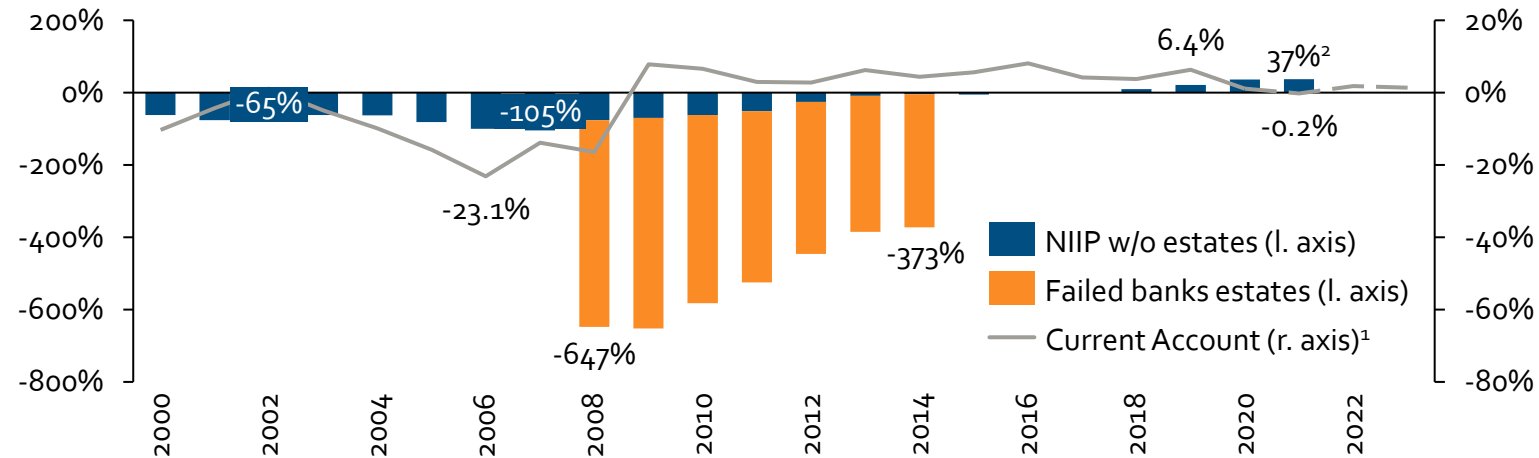
In 2014 to 2017 the Króna appreciated fast after lifting of capital controls and due to a boom in tourism. In hindsight the exchange rate overshot and in the next few years the Króna depreciated, culminating once the pandemic hit. As covered in the latest edition of the *Icelandic Economy*, the exchange rate had appreciated modestly since late 2020. Forecasters were expecting a further appreciation, despite fundamentals not showing clear evidence of a stronger ISK and relative prices and wages (adjusted for productivity) being historically high. Since then (July 2021) it has depreciated again by almost 2% against major currencies, largely due to strong import growth and net capital outflows. The recent news of a 20 year record capelin fishing season in 2022 have supported a slight appreciation and such news will continue to determine the path of the exchange rate.



External position historically strong

Net capital outflows in since 2020 despite rising asset prices

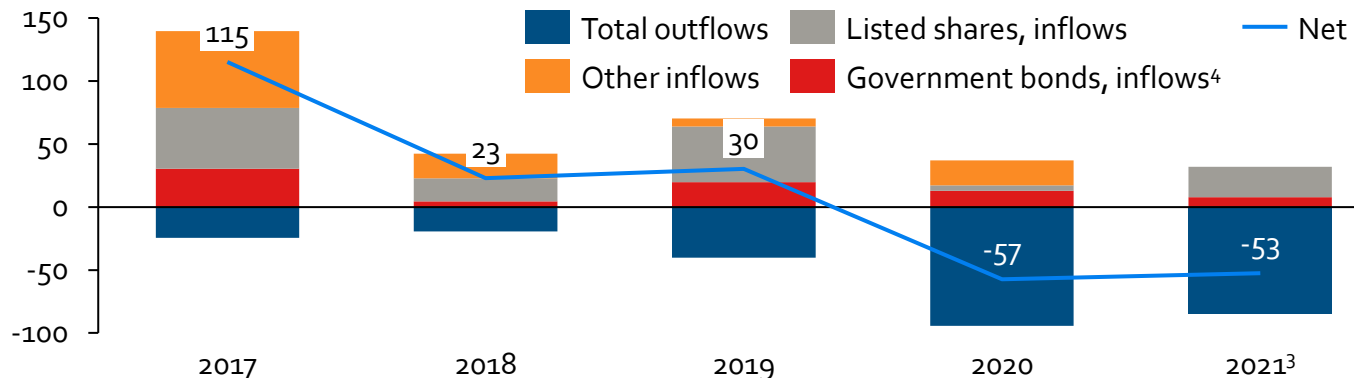
Net international investment position (NIIP) and current account balance (% of GDP)



For the past few years, Iceland has maintained a current account surplus due to a strong tourism-driven economy, which has helped Iceland transform to a net lender to the rest of the world (positive NIIP). However, due to the Covid-19 crisis, the country's current account surplus shrank from 6.4% of GDP in 2019 to only 1% of GDP in 2020, which was one of the largest contractions among the OECD countries.

Despite the pandemic, Iceland's net international investment position was 37% of GDP at the end of Q2/2021. With modest current account surplus ahead, the outlook is very stable.

Capital flows due to registered new investment (bn. ISK)



In 2020, Iceland's foreign direct investment (FDI) outward position was 36% of GDP, which is somewhat lower than the OECD average, which is 58%. Inflows of foreign investment have overall been disappointing since the onset of the pandemic. Recent IPO's have however shifted the trend since early this year. With rapid recovery of the economy and favourable developments in capital markets, investment opportunities are abundant.



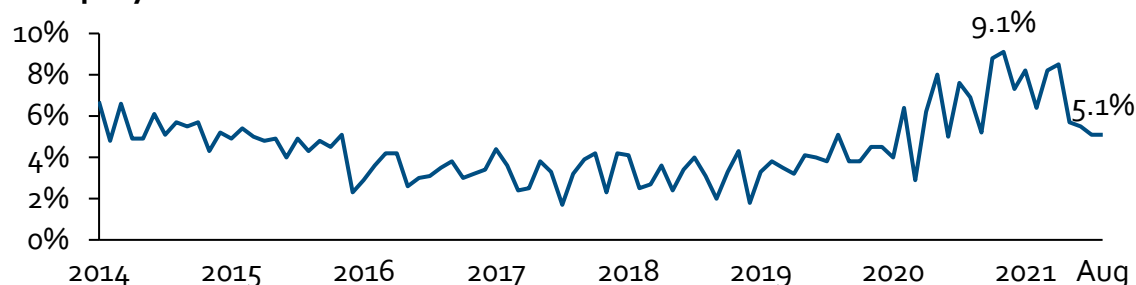
Sources: Central Bank of Iceland, OECD.

1. CBI's forecast after 2020. 2. Q2/2021. 3. Year to date. 4. Including special reserve accounts.

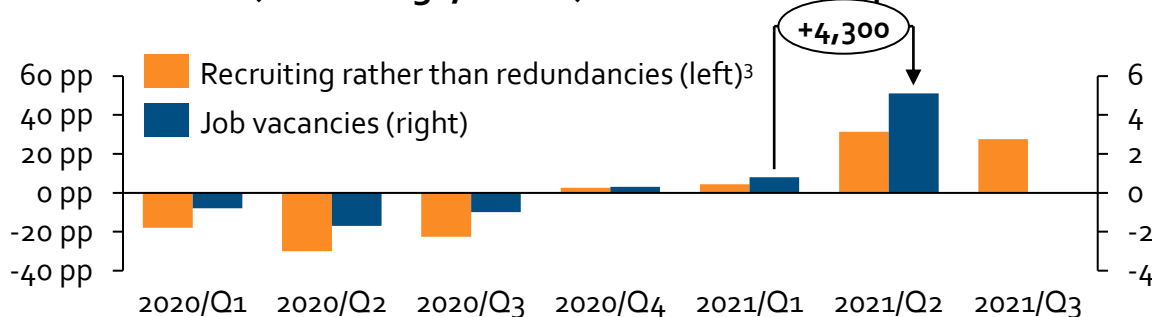
Unemployment is projected to decline faster than previously assumed

Unemployment measured 5.1% in August, 4 percentage points below its peak in November 2020 (9.1%)

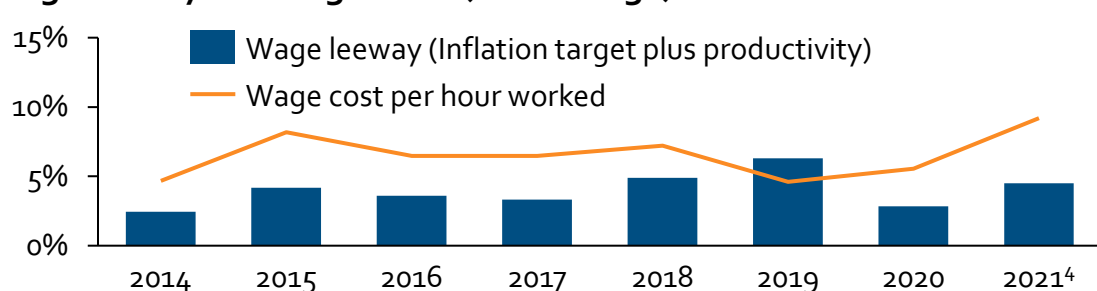
Unemployment rate¹



Job vacancies² (YoY change, thous.) and firms' recruit plans



Wage leeway and wage costs (YoY change)



The labour market situation in Iceland has improved significantly since the pandemic struck. In August, the unemployment rate was 5.1% and short-term indicators, such as registered unemployment, are hinting a more rapid recovery than anticipated, measuring 5% in September, only 0.4 pp higher than before the pandemic. In 2021, the unemployment rate is assumed to be 6.5% and then gradually decrease to 5% in 2023.

The pandemic brought on a sharp contraction in the tourism industry, the largest export sector in Iceland, where nearly half of jobs were lost by end of 2020. Moreover, the labour participation rate fell significantly in the wake of the pandemic, reaching a historical low in Q2/2020. However, the rate increased by nearly 1 percentage point (pp) between quarters in Q2/2021, bringing the rate back to pre-pandemic levels. Job vacancies have also increased significantly and are estimated at 7,600 in Q2, or 4,300 more than in Q1. Surveys also indicate a marked increase in firms' recruitment plans where 35% of firms are interested in hiring, while 7% are planning redundancies. Therefore, the share of companies planning to recruit net of share planning redundancies is positive by 28 pp.

The Icelandic labour market is highly unionised with collective bargaining agreements covering roughly 90% of the workforce, which is one of the highest ratios globally. That, along with strong economic growth, has led to a substantial increase in wages in recent years. In addition, two contractual wage rises have taken place since the pandemic hit Iceland. As a result, wages have risen, with the public sector leading with 18% increase. As wages have risen, they have diverged from labour productivity which declined by 1.8% YoY in 2020, making it the largest drop since 1999.

Sources: Central Bank of Iceland, Gallup, Statistics Iceland.

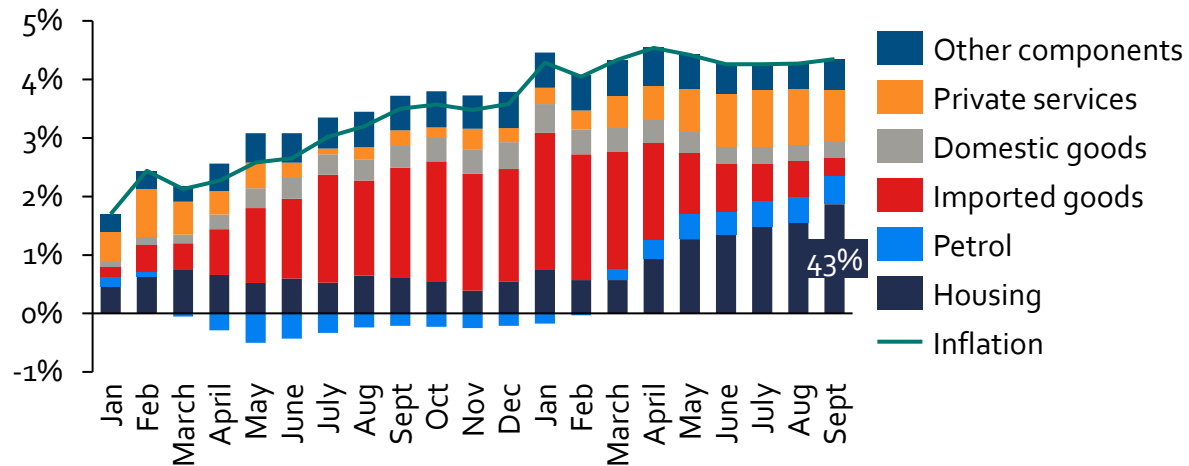
1. LFS, seasonally adjusted monthly data. 2. According to Statistics Iceland company survey. 3. Share of companies planning to recruit net of share planning redundancies in the coming 6 months according to Gallup survey of Iceland's 400 largest companies. CBI's Seasonally adjusted data. 4. Productive growth is expected to be 2% in the CBI's August forecast.



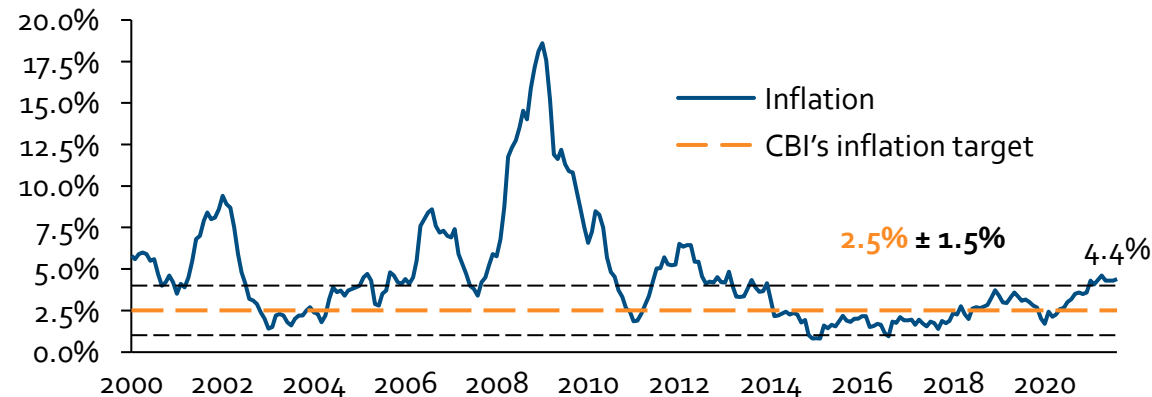
Inflation has proven higher and more persistent than anticipated

The inflation spurt is in mainly due to increase in domestic demand as public health measures has eased

Components of inflation (CPI)



Inflation and inflation target



Inflation has been higher and more persistent than previously expected, and above the CBI's deviation threshold since January 2021. In April 2021, inflation reached 4.6% which is the highest rate since early 2013. Inflation measured 4.3% in Q3/2021 and 4.4% in September. Inflation excluding housing measured only 2.9% in September. According to the Central Bank's forecast in August, 4.2% inflation is expected in 2021 as a whole, aligning with the target in Q3/2022 and measuring 2.8% in 2022.

The main drivers of rising inflation during 2021 are related to increasing domestic demand. There has been a significant rise in house prices as well as prices on private services, fuelled by increased demand for various services once public health measures were eased. Additionally, the slack in the domestic economy has narrowed faster than previously assumed. During the last quarter, housing costs, primarily for owner occupied housing, was the main driver of inflation, accounting for 43% of inflation in September. The capital region house price index rose by 16.4% YoY in August and the deviation of housing prices from the long-term trend is now around 14%, the highest since 2008. Those increases are expected to slow down over the next months, at least partly owing to implementation of macroprudential tools in the housing market (page 13).

Another major factor that plays a part in rising inflation, and inflation uncertainty, are rising global commodity prices and shipping costs as well as more persistent cost pressures stemming from Covid-19-related supply chain disruptions.



The Central Bank continues to raise its key interest rate

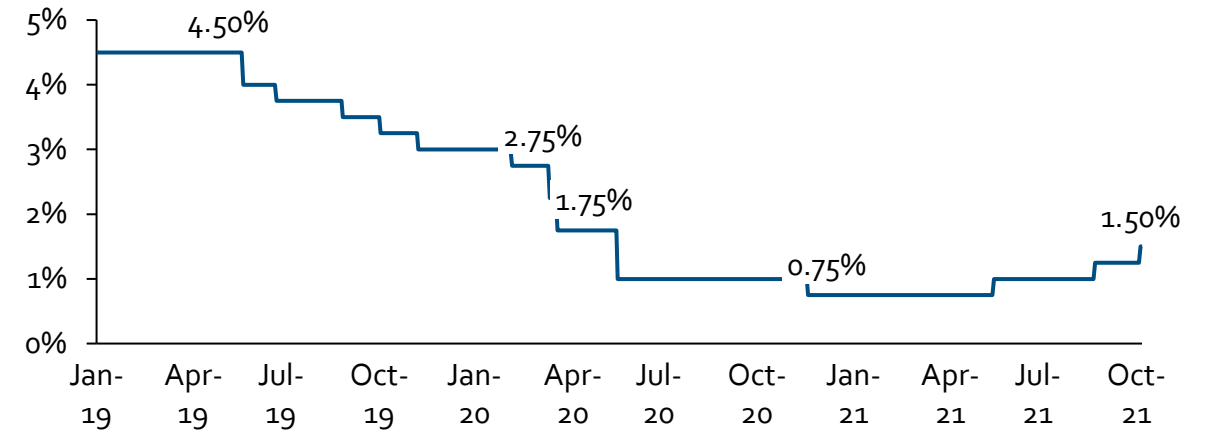
Inflation expectations are inching up

The Central Bank of Iceland took a range of actions and played an active role in mitigating the effects of the pandemic. The Bank lowered interest rates, increased access to capital for domestic financial institutions, mitigated exchange rate volatility by using the international reserves, and took a part in secondary market purchases of Treasury bonds.

This year, the tide has shifted quickly, and the Bank has started to raise rates and most forecasters are expecting further rate hikes. The main reasons for raising rates are higher and more persistent inflation than previously assumed, amid strong economic recovery. The Bank's concerns are that higher global inflation, the inflationary impact of supply chain disruptions and rising domestic wages, will cause inflation to remain high and inflation expectations to rise even further. Inflation expectations began to rise significantly in the beginning of 2021. Market agents and corporate executives expect inflation to measure 3% in one year's time and households 4%. Expectations five years ahead also rose slightly in the last survey where market agents and corporate executives expect 3% inflation and households 3.5%, seemingly causing the Bank a concern.

Additionally, the Bank has responded to rapid price increase in the residential housing market, over 13% YoY in August overall, by lowering the maximum loan-to-value ratio on mortgages from 85% to 80%, apart from first-time buyers. In late September, the Bank added rules on maximum debt service-to-income ratios, 40% for first-time buyers, 35% for others. Moreover, the CBI has decided to increase the countercyclical capital buffer on banks from 0% to 2%. The Bank argues that rapid rise in asset price and increased household debt has already raised cyclical systemic risk to pre-pandemic level.

CBI Key interest rate



25 August 2021

Key rate increased from 1% to 1.25%

Inflation was more persistent than previously projected, and it was prospected that it would take longer time to bring inflation back to target.



29 September 2021

Rules set on maximum DSTI ratios, 40% for first-time buyers, 35% for others. CCyB increased from 0% to 2%

Household debt has increased as house prices have risen. Asset prices have increased as well.



6 October 2021

Key rate increased from 1.25% to 1.5%

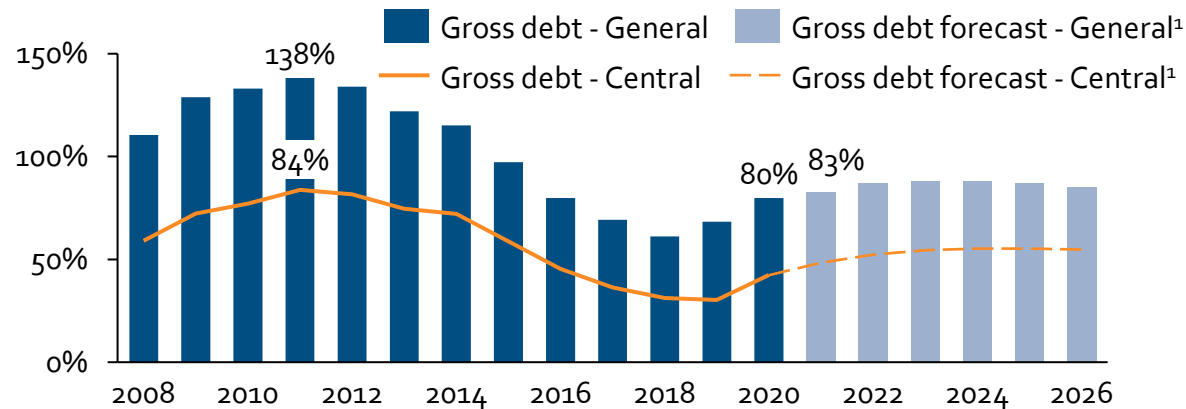
Inflation rose to 4.4% in September and inflation expectations seem to have started to rise again. There are also indications of continued strong domestic economic recovery.



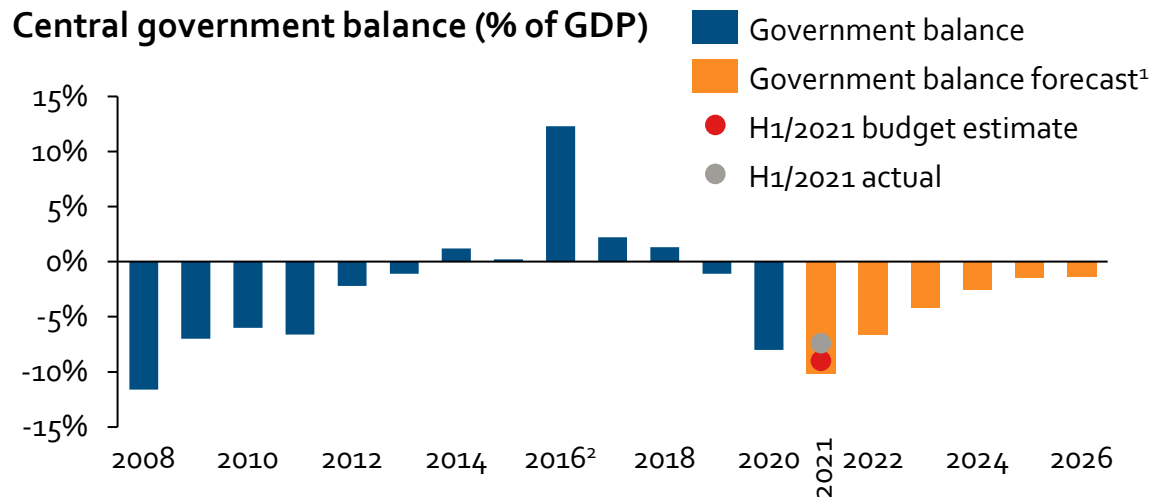
Central government deficit in H1/2021 ISK 27 bn smaller than expected

Starting from low debt levels has helped to counter the recession with generous fiscal support

General and central government debt (% of GDP)



Central government balance (% of GDP)



Until 2019, both general and central government debt had declined after peaking in 2011 with general government debt peaking at 138% of GDP and central government at 84% of GDP. However, the pandemic quickly shifted that trend. Last year's gross debt was 80% of GDP, which is relatively higher than previous years. The decline in general and central government debt before the pandemic can largely be explained by a rapidly growing economy and the stability contributions from the failed bank estates. Prudent fiscal policy and surpluses have also been important. The fiscal policy framework has furthermore improved due to an Act on Public Finances passed in 2015. This act entails a 5-year fiscal policy statement along with a fiscal strategy plan, as well as numerical benchmarks on public debt and surplus/deficit, and an independent Fiscal Council.

This year, the general government debt is expected to remain similar to last year, or 83% of GDP. The forecast shows that for the next five years, the general government debt will be 87% of GDP on average. The government measures, and cyclical effects due to Covid-19, have resulted in a large central government deficit, or 8% of GDP in 2020, in tandem with higher debt level. The central government deficit is forecasted to be larger in 2021 (10.2% of GDP) and then improve. That might however be already happening as the deficit in the first six months of 2021 was ISK 27 bn smaller than expected, measuring 7.4% of GDP instead of 9% of GDP. The improvement in the central government balance is explained by stronger revenue growth than previously assumed, which is largely driven by a rapid recovery in the economy, which has exceeded expectations since the budget was approved in December 2020.



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2

Iceland at a Glance

Icelandic Economy
Q4 2021



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Among the best

Iceland punches above its weight on several indicators

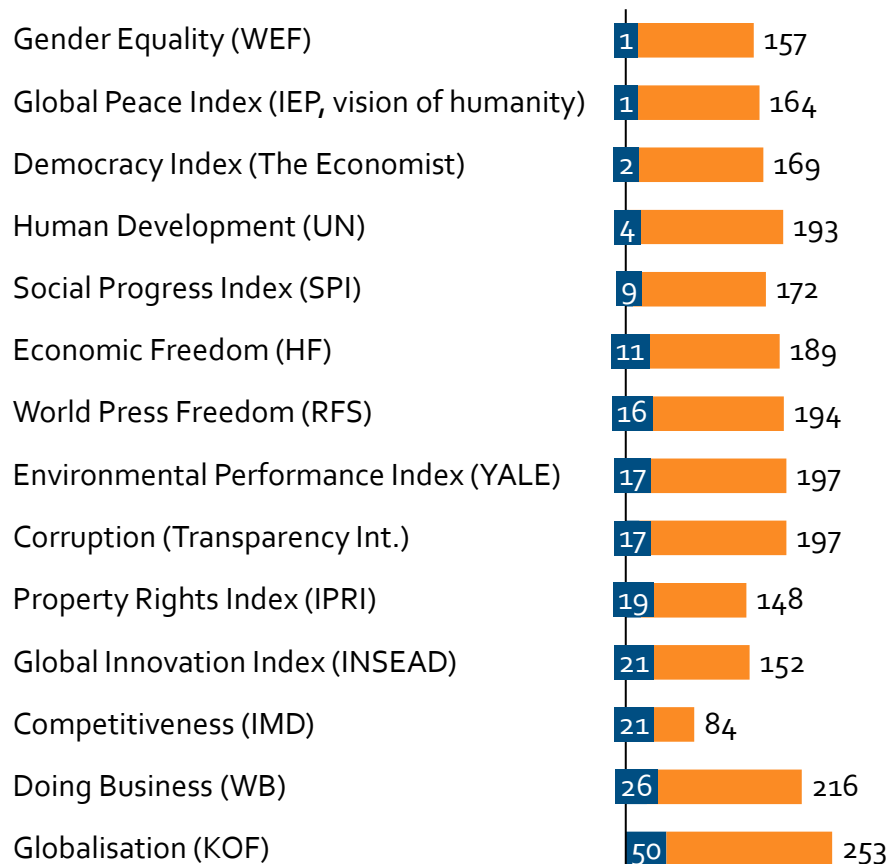
The Icelandic economy is an open high-income economy that combines a free market with a welfare state which is sometimes referred to as the Nordic Model. Iceland's income per capita is high (USD 55,213 in 2020), while being the smallest economy among the OECD countries in terms of total GDP.

The main factors of the country's success as a society can be attributed to factors such as skilled workforce, strong institutional framework, high degree of economic freedom, great preference for equality and peace as well as low level of corruption. Iceland has remained at the top of WEF's gender equality index since 2009. It has also held its place as the most peaceful country in the world since 2008. As for the other indicators, Iceland ranks highly.

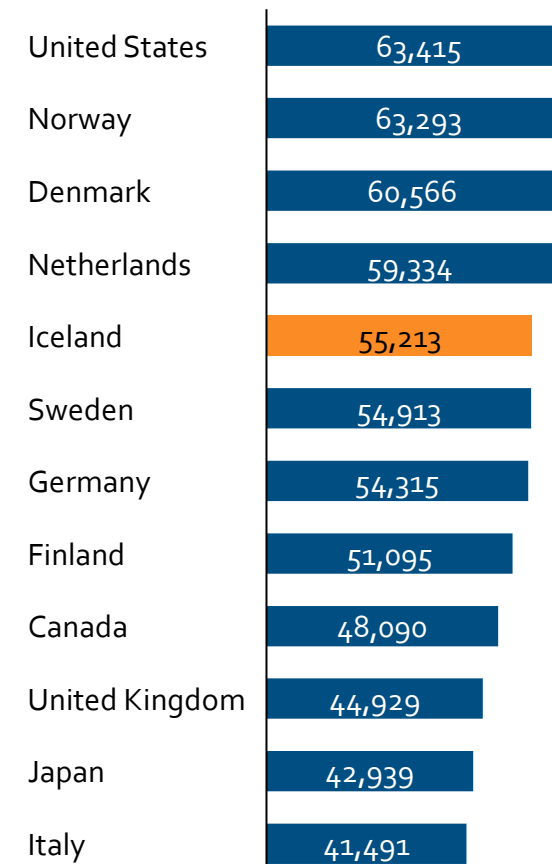
Despite its small size, Iceland punches above its weight in competitiveness, as it ranked 21st out of 63 countries in IMD World Competitiveness Ranking in 2021 (page 22). Iceland also does relatively well on other indicators but still with room for improvement, particularly on globalisation.

Ranking on international indicators¹

■ Iceland's ranking ■ Number of countries ranked



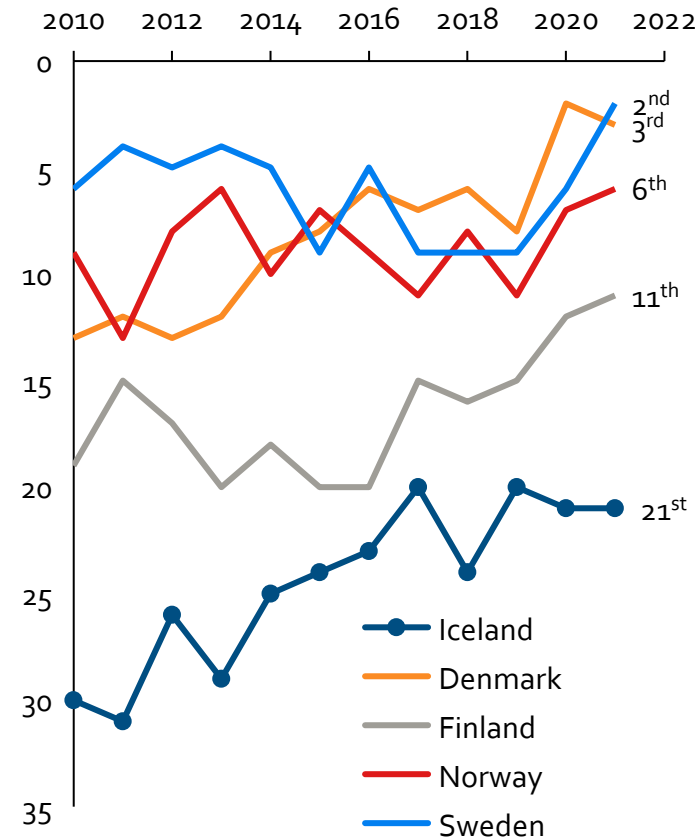
GDP per capita in 2020 (USD PPP adjusted)



Iceland ranks among the top third countries in competitiveness

Iceland jumps from 17th to 9th place in infrastructure, mainly due to improved support for R&D

Nordics - ranking in IMD competitiveness

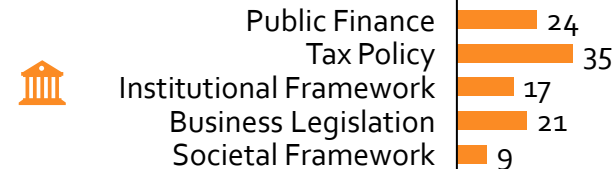


Iceland - ranking on IMD sub-factors

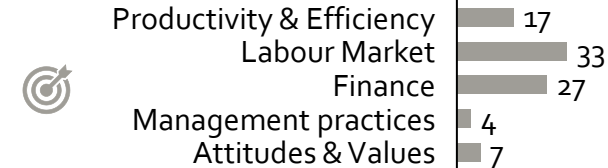
Economic Performance (55th)



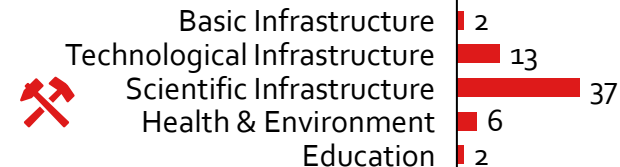
Government Efficiency (17th)



Business Efficiency (14th)



Infrastructure (9th)



The IMD Business School has ranked countries by competitiveness since 1989 and for over a decade the ICoC has been their partner in Iceland. This year, 64 high- and middle-income countries were ranked, and Iceland ranked 21st, as it did in 2020.

Considering the small size of the economy, which affects ranked economic performance, and the pandemic, there are several reasons for optimism. Iceland has jumped from 17th to 9th place in infrastructure, largely due to higher R&D expenditure of firms and improved government support for R&D.

There are also notable improvements relating to finance where Iceland improved by five places, for instance due to more effective monetary policy, lower interest rates, stronger stock market and more access to financing.

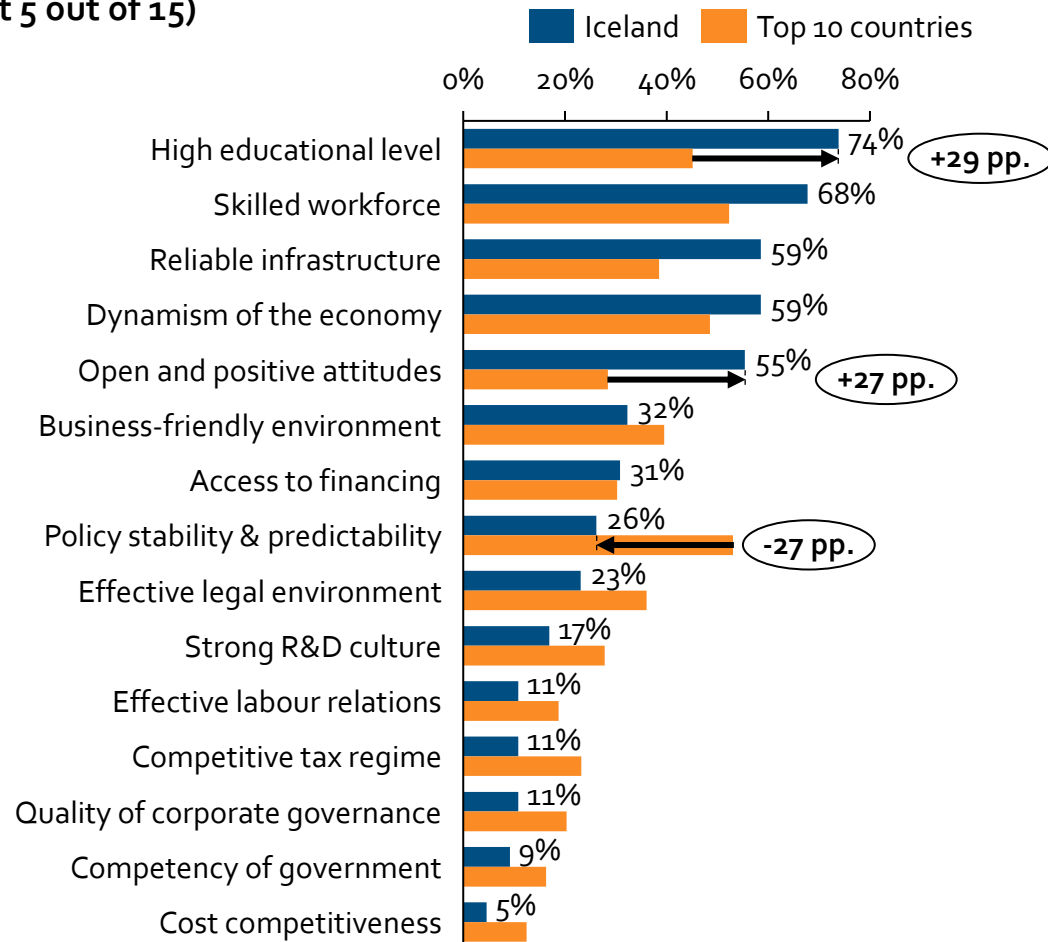
[Click here](#) for a detailed report on Iceland's competitiveness.



Executives' views shed light on strengths and weaknesses

Outstanding educational level and infrastructure while policy stability is lacking

Key attractiveness indicators for executives (Survey respondents select 5 out of 15)



The IMD Competitiveness ranking is 1/3 based on a survey among executives in the respective countries. In Iceland the survey is conducted in cooperation with the Iceland Chamber of Commerce. Among other things, executives are supposed to name five out of 15 factors which are particularly attractive for their economy. This section of the survey provides valuable insights into countries' relative strengths and weaknesses.

Iceland scores highly in education and skilled workforce, which is unsurprising since Iceland scores highly on many educational indicators, such as being 4th of the 64 countries in the survey on THE's University Education Index. Iceland also has a reliable infrastructure and a dynamic, albeit fluctuating, economy. Respondents also rate open and positive attitudes highly, particularly when compared to the 10 most competitive countries.

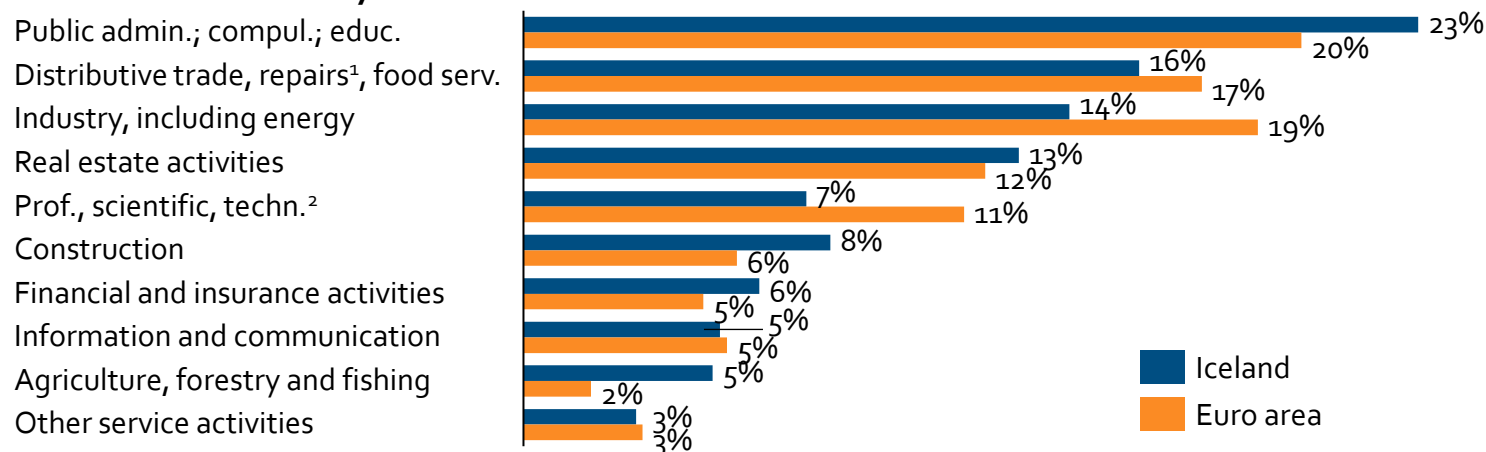
However, Iceland is admittedly not very cost competitive, and few executives point to government competency, corporate governance, tax regime and labour relations as strengths. It should be noted that relatively few executives in the 10 most competitive countries select these indicators. Only 11% mention corporate governance, but that has been improving in the rankings. The ICoC has contributed to [guidelines that were updated this year](#), hopefully moving corporate governance further in the right direction. Furthermore, there are large opportunities for improvement in labour market relations.



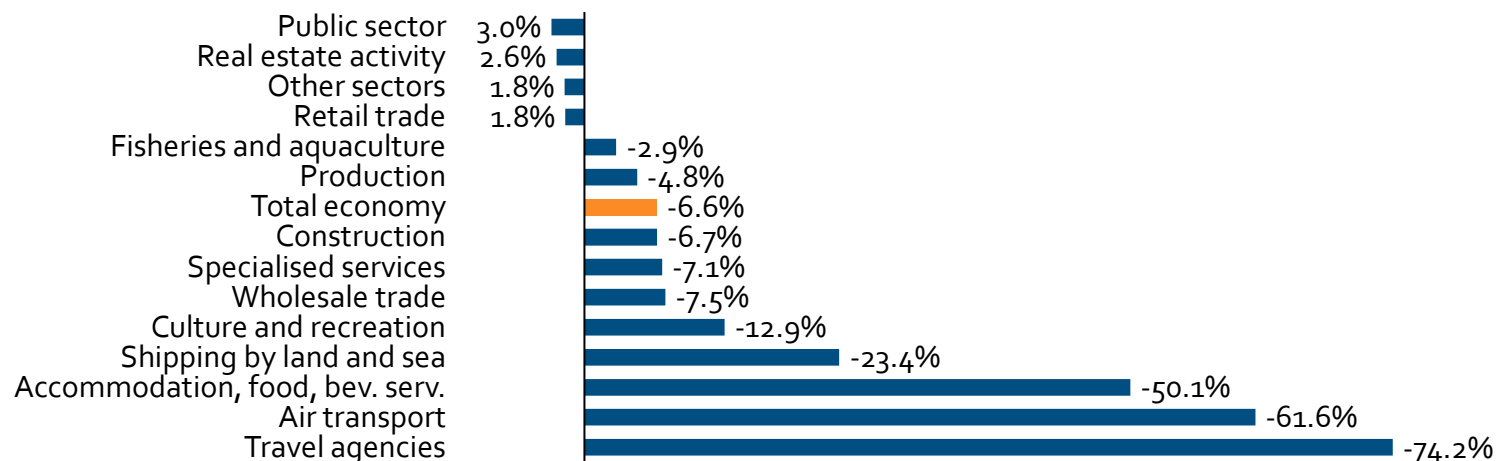
Composition of the economy differs somewhat from Europe

Tourism sector driven economy faced challenges last year

Contribution to GDP by industries in 2020



Contraction in GFI³ by sector in 2020 (YoY change)



Although Iceland is a developed high-income economy its composition differs somewhat from the Euro area, the largest trading partner. The public sector is larger, highlighting high government spending in Iceland. Construction is also larger, largely due to much faster population increase. However, industry and various services are relatively smaller in Iceland. It should be noted that tourism related sectors are larger in most years, particularly in Iceland since tourism is a relatively large sector.

Since 2010, the tourism sector has grown rapidly, with a 328% yearly increase in foreign visitors until 2019. In 2011, the tourism sector constituted 3.7% of GDP while it accounted for 8% of GDP in 2019. In the wake of the pandemic, GDP growth took a hit last year. Activities related to travel bookings, air transport, accom. and restaurants decreased by 50-75% from 2019. This led to a contraction in the tourism sector by 3.9% of GDP in 2020.

In total, GDP contracted by 6.6% in 2020. The downturn was not limited to tourism and related sectors, as other sectors also contracted noticeably. On the other hand, output increased in some sectors, including retail sales, but the largest contribution was a 3% growth in the public sector.



Sources: Central Bank of Iceland, OECD, Statistics Iceland.

1. Transport; accommodation. 2. Admin., support serv. activities. 3. Gross factor income. The difference between GDP and GFI is that indirect taxes are not included in GFI, whereas manufacturing subsidies are included.



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3 Institutional Framework

Icelandic Economy
Q4 2021



Iceland Chamber
of Commerce



Political and judicial structure

Government held majority in parliamentary election in late September 2021

1. Legislative and executive

Iceland is a constitutional republic with a multi-party parliamentary system. The parliament forms a cabinet which exercises the executive power. Katrín Jakobsdóttir (Left Green Movement), is the current prime minister. The 63 members of parliament are elected for a four-year term from six different constituencies.

The president, currently Guðni Th. Jóhannesson, is the head of state and is elected by a popular vote every four years. The president confirms bills of legislation by signing them and sometimes plays an active role in the formation of the government. If the president refuses to sign a bill it goes to a referendum, which has only happened on three occasions (2004, 2010 and 2011).

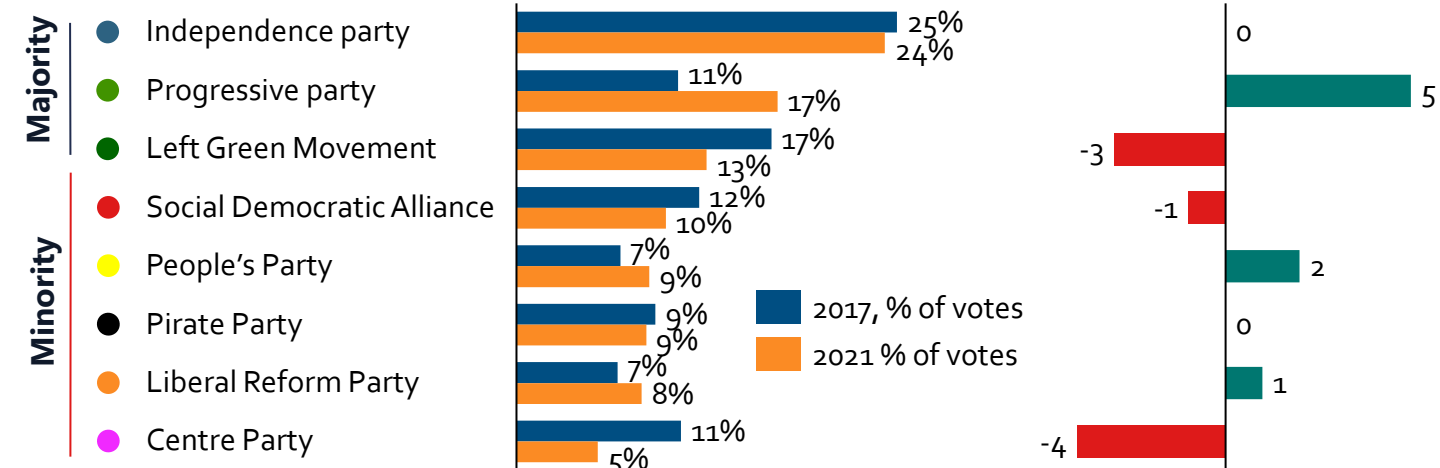
2. Local governments

Local governments are responsible for variety of services, including education up to lower secondary level, some welfare and local infrastructure. There are 69 local governments in Iceland, spending 14.4% of GDP in 2020.

3. Judicial

The judicial power is divided into three levels: District courts, Court of appeal and the Supreme court.

Icelandic parliamentary election¹



Government held majority in parliamentary election

Icelanders voted in a general election for parliament on 25 September. The left-centre-right government held its majority and currently has 37 out of 63 MPs. At the time of publication, the three parties were in discussion to renew the coalition agreement and for a cabinet re-shuffle. It should be noted that the election in the Northwest constituency has been challenged and is under review. The Northwest is the smallest constituency and regardless of how it will be settled it is unlikely to significantly change the overall results.

The election can be interpreted as a shift to the centre. Left parties, such as the Left Green Movement and the Social Democratic Alliance lost seats, while Socialists didn't pass the 5% threshold to earn MPs. Of the right leaning parties, the Centre Party (right leaning despite the name) had a major loss while the Independence Party, although it held all its seats, lost a small share of votes. The rather centrally located Progressive, Liberal Reform and People's Parties all gained seats.

The tax system in Iceland relies heavily on labour income and consumption


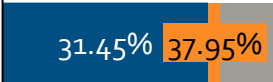



Tax revenues 32.4 % of GDP in H1/2021

Tax revenues in Iceland amounted to ISK 454.4 bn in H1/2021, which is 32.46% of GDP, similar to 1H/2020. Taxes on personal and corporate income are the largest source of revenue for the general government and are estimated to have brought 43.9% of the government revenues in H1/2021.

Among recent changes in the tax system were the reduced labour income tax rate for low-income earners in 2021 from 35.04% to 31.45% and increased rate for middle-income earners from 37.19% to 37.95%. Moreover, yearly deduction decreased from ISK 0.65 m. to ISK 0.61 m. In addition, the income tax threshold of dividend/capital gains was increased from ISK 150,000 to 300,000 and the payroll tax has been lowered from 6.35% to 6.10%. In 2021, the special bank tax, which is levied against the debt of financial institutions, decreased from 0.376% to 0.145%.

In terms of revenues/GDP, Iceland is near the OECD average on most taxes. The main difference is in terms of personal income tax, where Iceland is 6.6% of GDP higher. In contrast, social security contributions are low, mainly due to large quasi-private pension system.

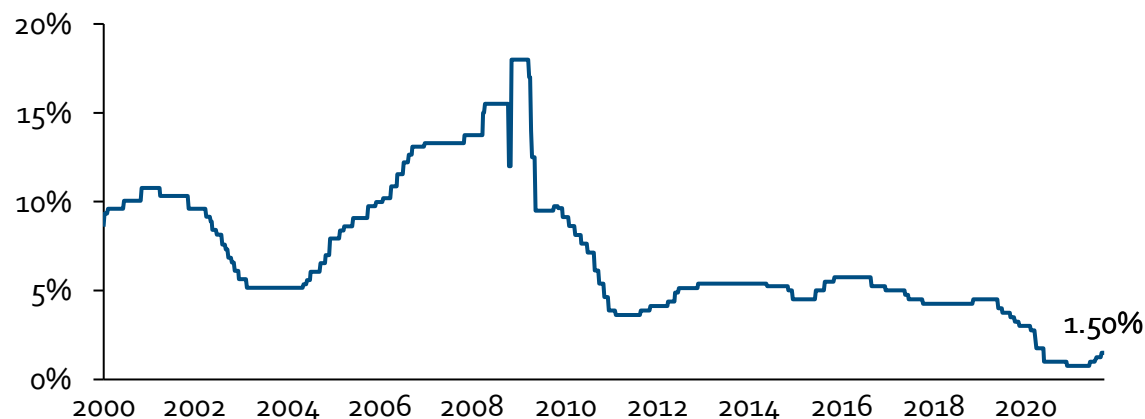
Key taxes in Iceland

	Lower bracket	Middle bracket	Higher bracket	
Tax	Rate	Tax base and deductions		
VAT	 11%24%	<ul style="list-style-type: none">Food, medicine, tourism, media, arts and energy are in the lower bracket. Education and medical services are not subject to VAT¹		
Labour income	 31.45%37.95%46.25%	<ul style="list-style-type: none">Lowest bracket - yearly income up to ISK 4.2 m.Middle bracket - income up to ISK 11.8 m.Yearly deduction in the amount of ISK 0.61 m.		
Corporate tax	 20%	<ul style="list-style-type: none">Levied on gross income, deductions for R&D are available		
Dividends / capital gains	 22%	<ul style="list-style-type: none">Levied on all capital gains and income except for yearly interest income under ISK 300,000		
Payroll tax	 6.1%	<ul style="list-style-type: none">Payroll tax is levied on gross wage costs of employers, including pension payments		

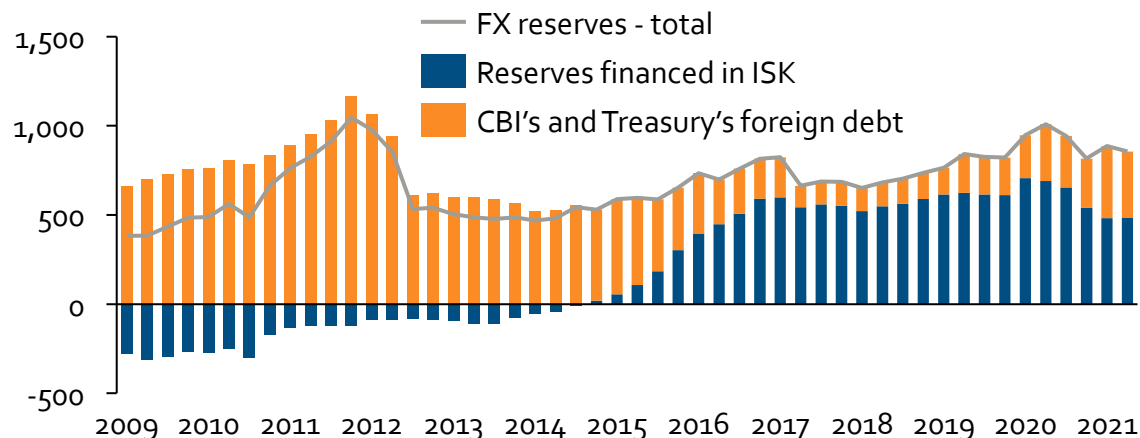
Monetary policy framework centered around inflation targeting

The Central Bank merged with the Financial Supervisory Authority in 2020

CBI key interest rate



Central Bank of Iceland foreign exchange reserves (bn. ISK)



The Central Bank of Iceland (CBI) is an independent institution, operating under the Prime Minister and owned by the State. The main objective of the CBI is to promote price and financial stability along with keeping secure financial activities. In 2001, the Bank converted from an exchange rate targeting policy to an inflation target policy, defined as a 12-month inflation rate, at 2.5% with a deviation band of 1.5%.

The Prime Minister appoints the Governor and three Deputy Governors for a term of five years. Deputy Governors manage matters relating to monetary policy, financial stability and financial supervision. Decisions on the application of the CBI's monetary policy instruments are taken by the Monetary Policy Committee (MPC), which consists of five individuals, while the decisions on the application of the Bank's financial stability policy instruments are taken by the Financial Stability Committee (FSN), consisting of seven individuals. Following a new bill on the Central Bank, it merged with the Financial Supervisory Authority in January 2020 and therefore financial supervision is now part of the Bank's role. The Financial Supervision Committee makes decisions entrusted to the Financial Supervisory Authority by law or governmental directives.

The Bank collaborates with many foreign institutions, for example The European Central Bank and the Organization for Economic Co-operation and Development (OECD). The Bank is also a shareholder in the Bank for International Settlements (BIS) in Switzerland and representative at the International Monetary Fund (IMF).



Sound financial system with relatively large private pension funds

Credit growth is modest, overall

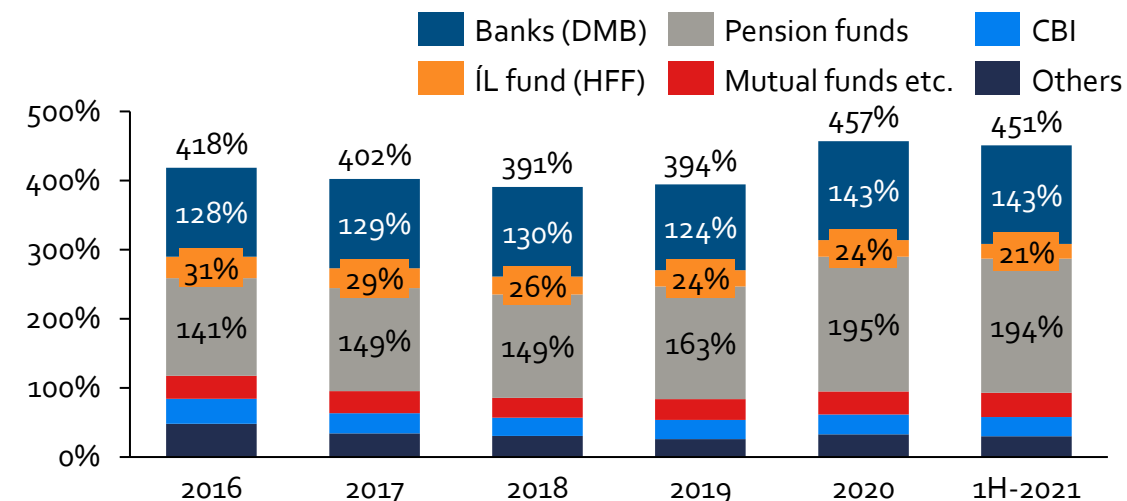
The Icelandic banking system mainly consists of three universal banks: Arion Bank, Íslandsbanki and Landsbankinn; and the primarily investment bank, Kvika, along with a few smaller savings banks and financial institutions. Until recently, Arion Bank and Kvika were the only ones owned by private investors and publicly listed. In June this year, Íslandsbanki joined them when the government sold 35% of its stake, making Landsbankinn the only one not publicly listed. Depending on the outcome of aforementioned government formation, more stakes in the state owned banks might be up for sale. The three banks are strong in many ways, their liquidity and capital are well above regulatory minimums, and they have ready access to liquidity in both ISK and foreign currencies.

The size of the financial system was 451% of GDP at the end of June 2021. Recent changes in the assets of the financial system are largely due to changes in GDP and movements of the exchange rate, highlighting modest growth. The banks' assets account for nearly a third (143% of GDP) while the pension funds assets accounted for 43% of total assets (194% of GDP).

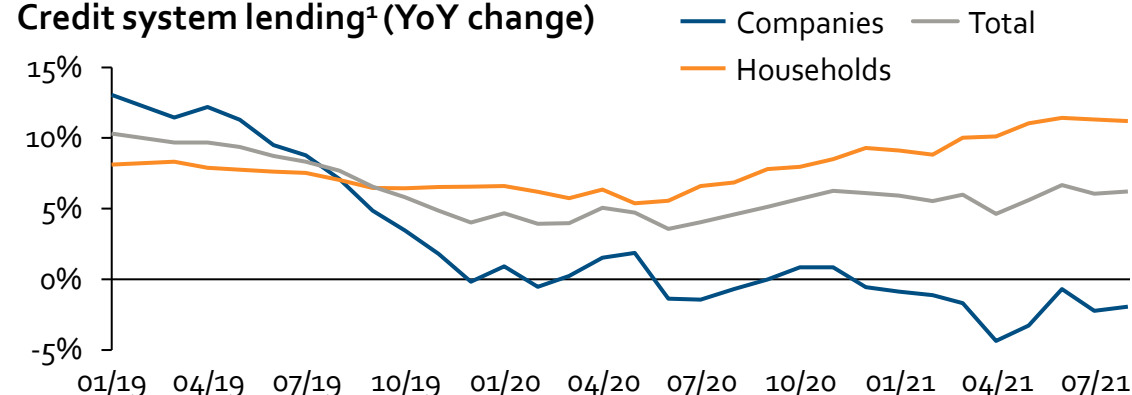
In 2019, the private pension assets accounted for 168% of GDP, one of the highest in the world. In 2020, the assets grew rapidly and the system is expected to continue growing in the next few decades since the population is relatively young and premiums are close to 10% of GDP.

Credit system lending grew by 5.2% YoY in 2020, where the growth was driven by household lending while corporate growth stood still. The growth in household lending is mainly due to increased mortgage lending along with lively housing market. Meanwhile, companies' lending has decreased.

Financial system assets (% of GDP)



Credit system lending¹ (YoY change)



Source: Central Bank of Iceland.

1. Domestic lending. Credit stock adjusted for reclassification and effect of debt relief measures. Excluding loans to deposit institute, failed financial institutes, and the government. 2. Deposit money banks.



The Iceland Chamber of Commerce

About the Chamber

The Iceland Chamber of Commerce (ICoC) is a nongovernmental organisation based on voluntary participation with the mission of improving the environment of businesses in Iceland and to enhance economic prosperity. The ICoC has been diligent in its mission, celebrating its centennial anniversary in 2017.

ICoC Bilateral Chambers

The ICoC operates 15 bilateral Chambers, both directly and in collaboration with others. An important role of the bilateral Chambers is strengthening the relationship with other organisations as well as cooperating in several ways with embassies and consulates on promoting Icelandic businesses abroad.

Joining the ICoC

Membership to the ICoC grants companies an opportunity to influence its strategy and to promote their interests in a robust forum. The issues that the ICoC deal with relate both to the business community, as well as to specific interests of individual member companies. Anyone interested in joining the Chamber should please contact mottaka@vi.is.

Operations

Safeguarding of interests: The ICoC works in the interests of anyone conducting business and is a powerful tool for the business community in its work towards improving the business environment and enhancing productivity.

A representative towards the authorities: The ICoC strives for positive changes to laws, regulations and other influencing factors concerning the business community. It reviews all major legislative bills that concern the business community and provides comments, in collaboration with members, which are presented to the relevant parliamentary committees.

Annual business forum: The ICoC annual Business Forum is the largest event in the Icelandic business community. The Forum is attended by members, politicians, government officials and others interested in the Icelandic business community.

Corporate governance: The ICoC publishes guidelines for corporate governance, in collaboration with the Confederation of Icelandic Employers and Nasdaq OMX Iceland. The latest edition is available [here](#).

Legal counsel and arbitration: The ICoC General Counsel supervises various projects for members, free of charge. The Counsel assists members with matters such as the import and export of goods and specific laws or regulations concerning the business environment. The ICoC also operates an independent arbitration institute, the Nordic Arbitration Centre. Its purpose is to provide companies and individuals with alternative means to the judiciary to resolve commercial disputes in a secure manner. The arbitration process and the Arbitral Tribunal final awards are strictly confidential.

A backbone for business education: The ICoC is an active advocate of technology and business education. The ICoC owns and operates Reykjavik University (RU) and is involved in the Commercial College of Iceland (CCol). RU is an international university and is Iceland's largest private university with around 3,000 students. The CCol is an upper secondary school with over 1,000 students.





Iceland Chamber of Commerce

The Icelandic Economy – Q4 2021

Current State, Recent Developments and Future Outlook