Iceland‘s Industrial Policy - Growth Plan to 2035

BACKGROUND ANALYSIS

Key focus areas and challenges

Stjórnarráð Íslands

Summary

Iceland's GDP growth was strong in international context in 2010-2024. **Per capita GDP growth developed less favourably** and was weaker than in key comparison countries over the same period.

This pattern – strong growth in output coupled with weak growth per capita – stems from the fact that growth in the economy has been **driven substantially by increased labour supply**; i.e., **a surge in population**. This enormous growth has brought with it a range of **social challenges** and **strain on infrastructure**.

Iceland's high standard of living is due in part to **favourable age demographics** and **strong labour participation**.

The composition of exports and of the economy changed radically between 2010 and 2024, primarily because of the boom in tourism and related sectors, plus growth in various innovative sectors.

Many of Iceland's large export industries are subject to **natural constraints on growth**, as they rely on access to limited natural resources.

Capital assets per full-time position equivalent in Iceland have declined. It is essential to remove obstacles and create favorable conditions and **stability for further investment**.

The next growth episode must build on **different pillars than the growth phase of the past 15 years**.

Opportunities lie in **greater productivity** and **more diverse exports**.

To safeguard high living standards and support **continued economic advancement**, it is important to establish an environment that fosters the growth of a **diverse range of high-productivity export industries**.

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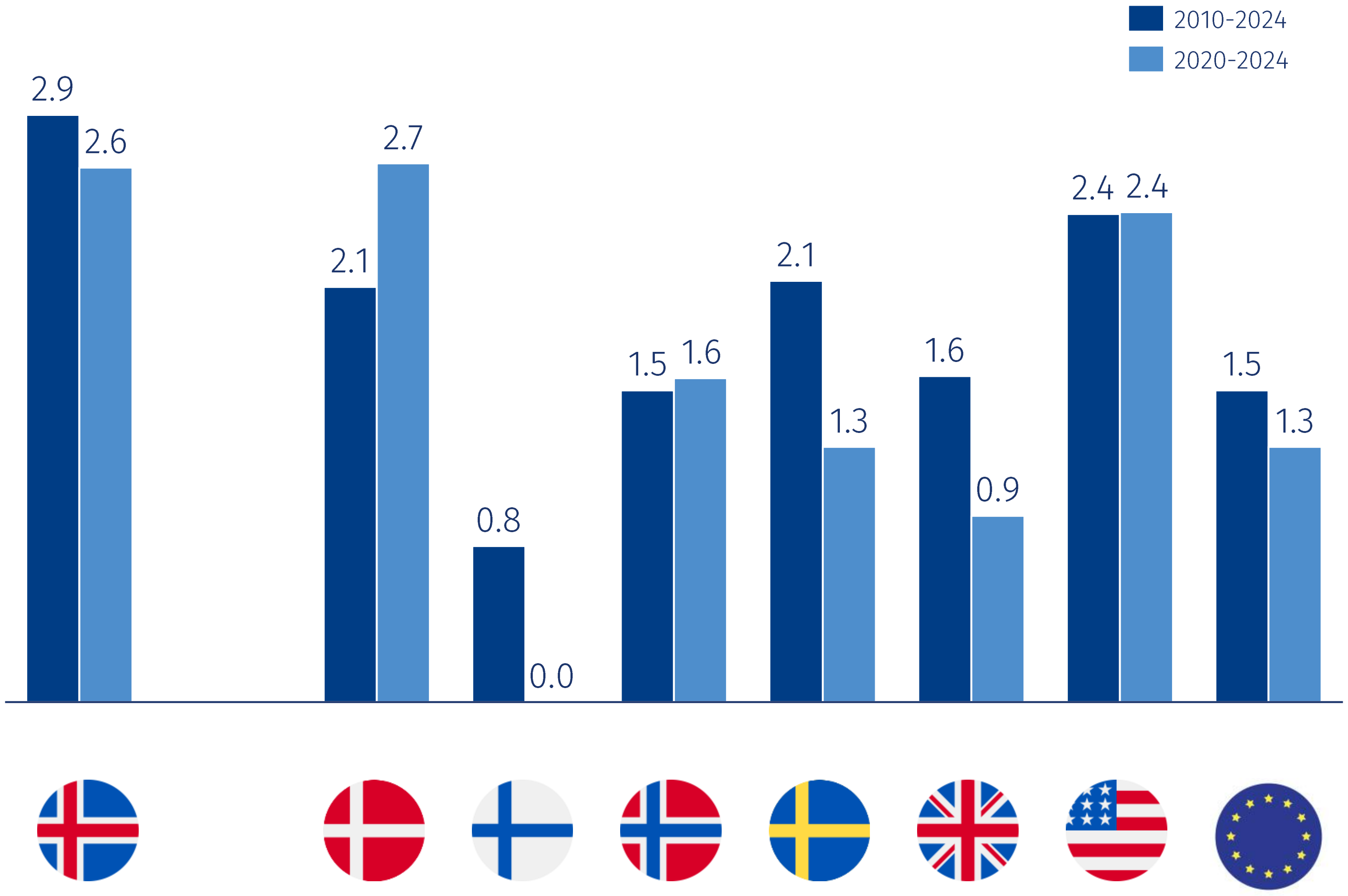
Iceland’s GDP growth has been robust in international context in the last 15 years

Average real GDP growth, % per year



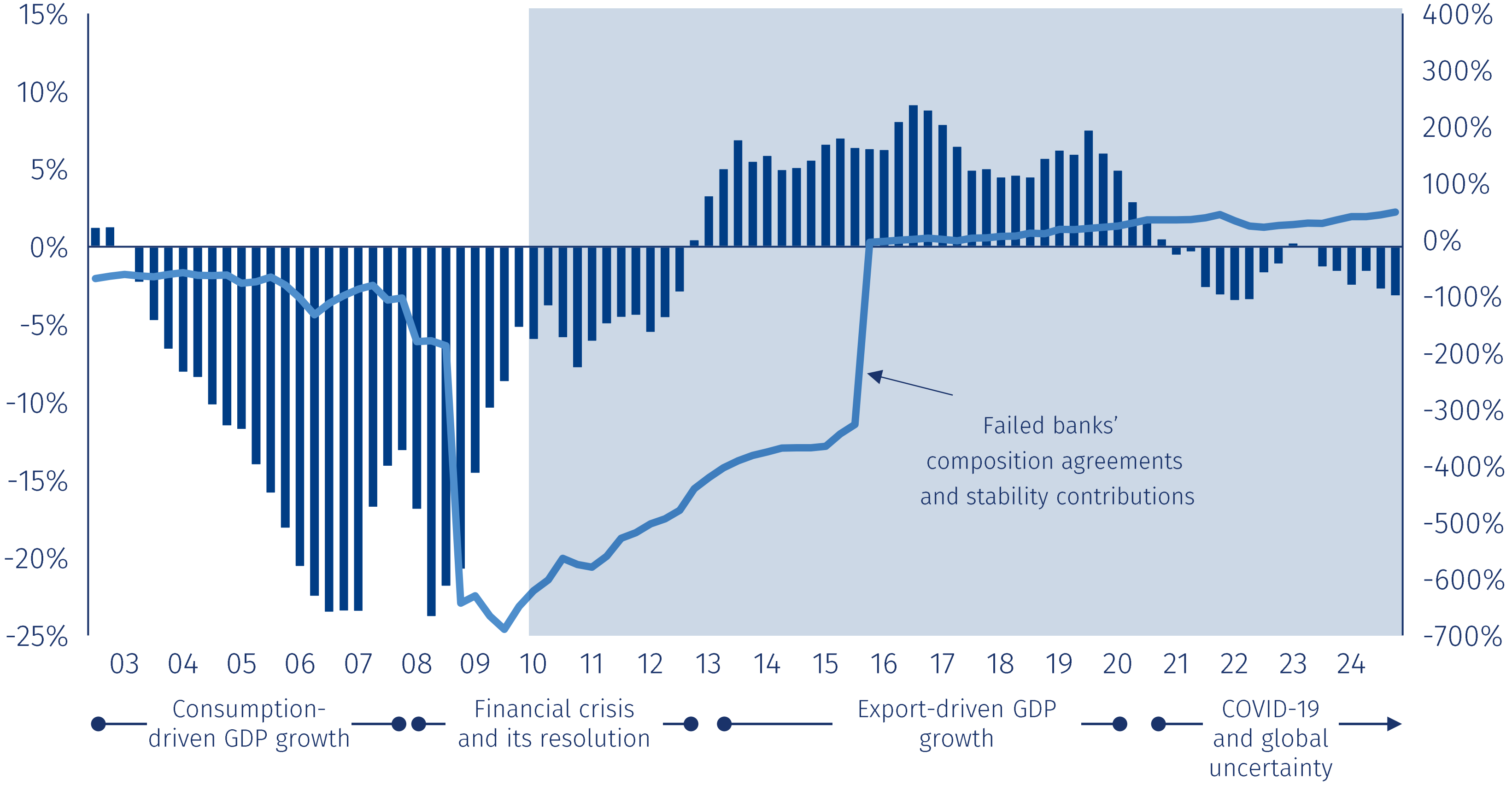
Source: World Bank.

Key economic events in the period 2010-2024

- **Sustainability contributions and capital account liberalisation** thereafter created the foundations for increased investment and improved living standards.
- Favourable **developments in key fish stocks** and **recruitment in mackerel stocks** supported a period of build-up, technological advances, and productivity growth in the fishing industry.
- An unprecedented **surge in foreign visitor numbers** led to vastly increased activity in the tourism industry.
- **The COVID-19 pandemic** caused severe global economic turmoil and major supply chain shocks.
- Financial markets have been in an adjustment phase after the **protracted low-interest-rate phase ended**, with strong inflationary pressures during the latter half of the period.
- The **real exchange rate** of the Icelandic króna **has risen markedly over the period** and is now at a historical high.
- **Geopolitical and trade-related uncertainty** is growing at present.

Over the same period, the current account was in balance and Iceland's external asset position improved greatly

Current account balance (left) and NIIP[1] (right)
Q1/2003–Q4/2024, twelve-month average (% of GDP)



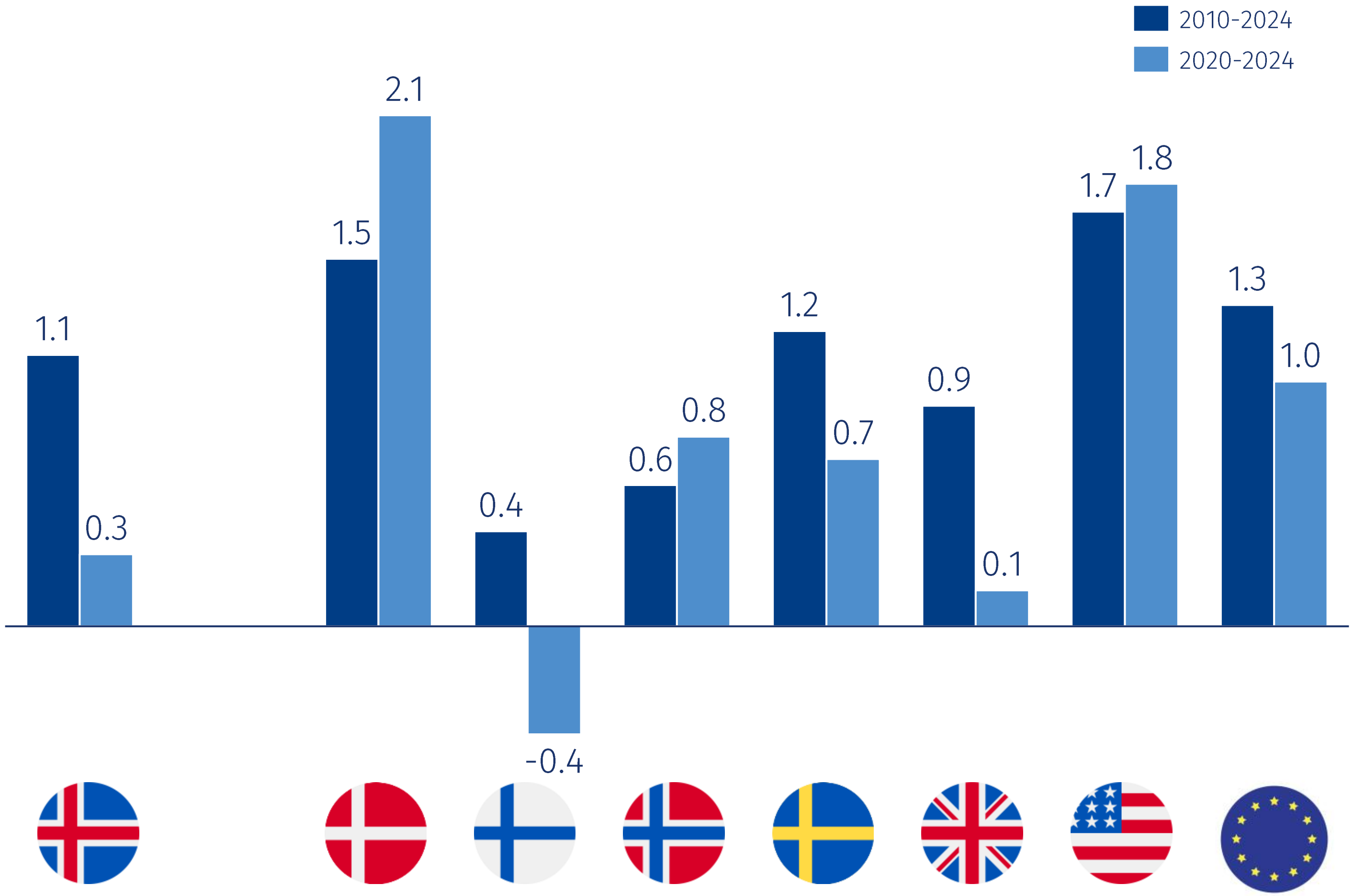
1. Net international investment position (NIIP).

Source: Central Bank of Iceland.

- The domestic economy was **severely imbalanced during the prelude to the 2008 financial crisis**, with hefty current account deficits and debt accumulation.
- The financial crisis **upended Iceland's balance sheet**, as the external debt position was unsustainable.
- A low real exchange rate created **ideal conditions for export-driven output growth** and the necessary scope for investment after 2008.
- Iceland's **net international investment position is now stronger than ever before, with external assets well in excess of external liabilities**, but global trade uncertainty has escalated recently and the current account deficit has widened again.

Per capita GDP growth developed less favourably, however

Average real GDP growth per capita, % per year

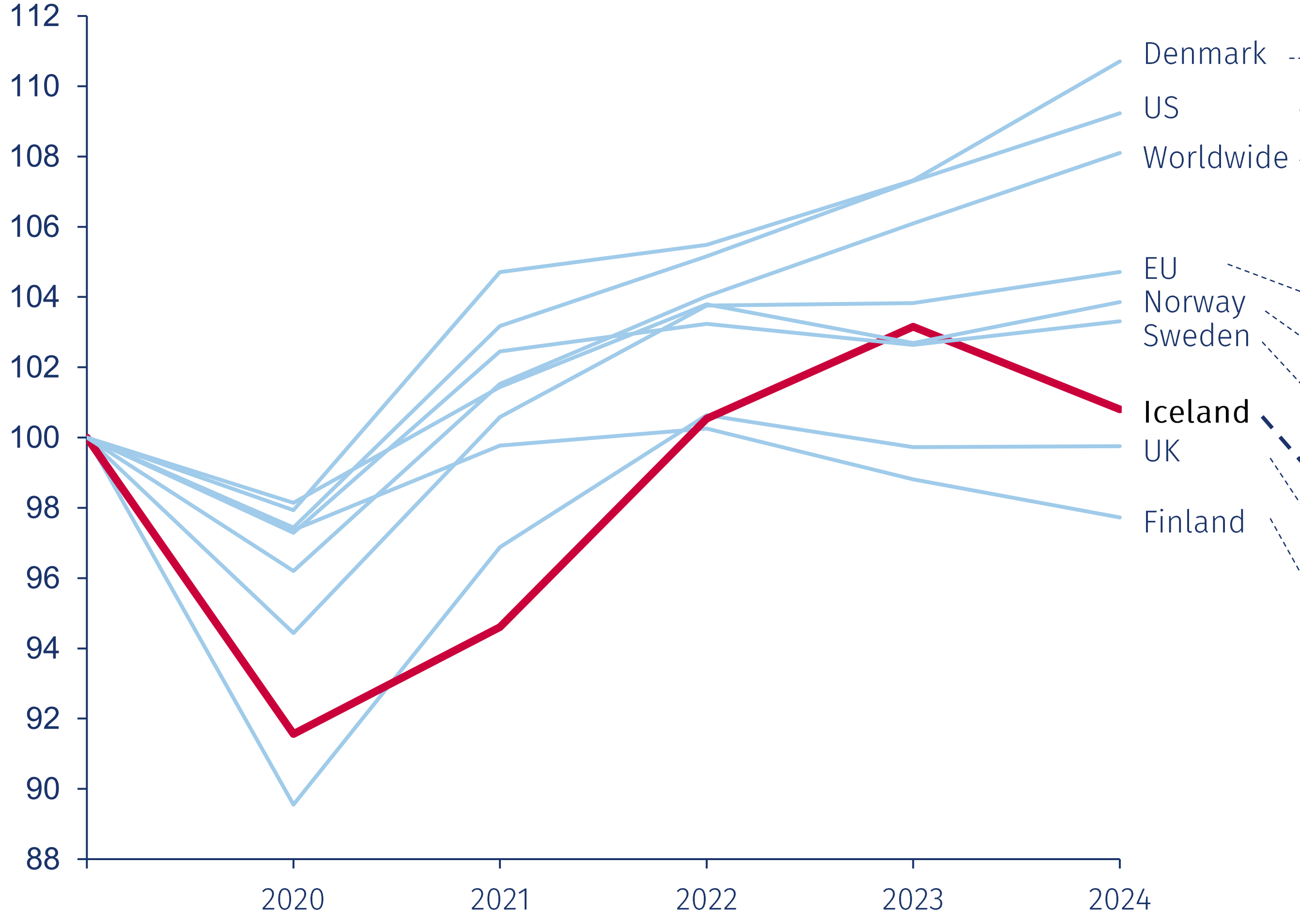


Source: World Bank.

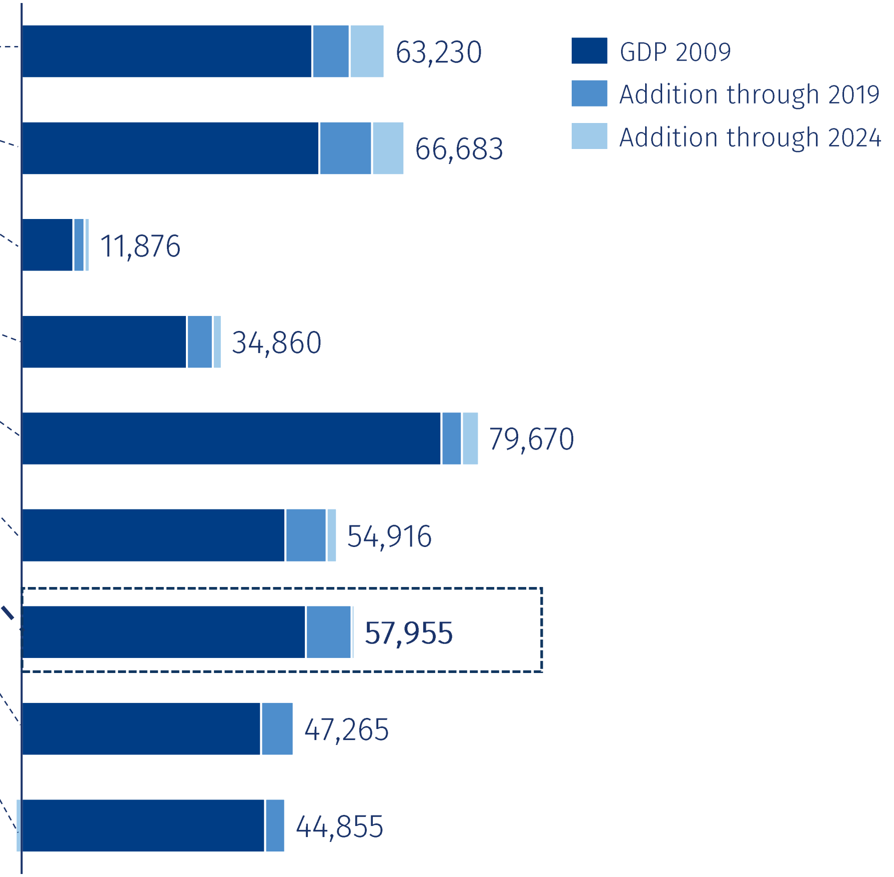
- Iceland stands out sharply in terms of **population growth**, which **measured nearly one-fourth over the period**. Among trading partners, it averaged just under 10%.
- Per capita GDP **increased far more rapidly in 1995-2009, or an average of 2.5% per year**, despite the severely adverse impact of the financial crisis at the end of the period.
- Among advanced economies, per capita GDP growth averaged 1.5% between 2010 and 2024, and 1.3% in 2020-2024. **Iceland is falling behind by this measure**.
- Per capita GDP is the **best measure of average living standards**, and it is vital to turn this trend around so as to ensure that the standard of living continues to improve.

The trend is bleaker for the past five years, but per capita GDP is still strong in international context

Per capita GDP 2020-2024
beginning of 2019 = 100

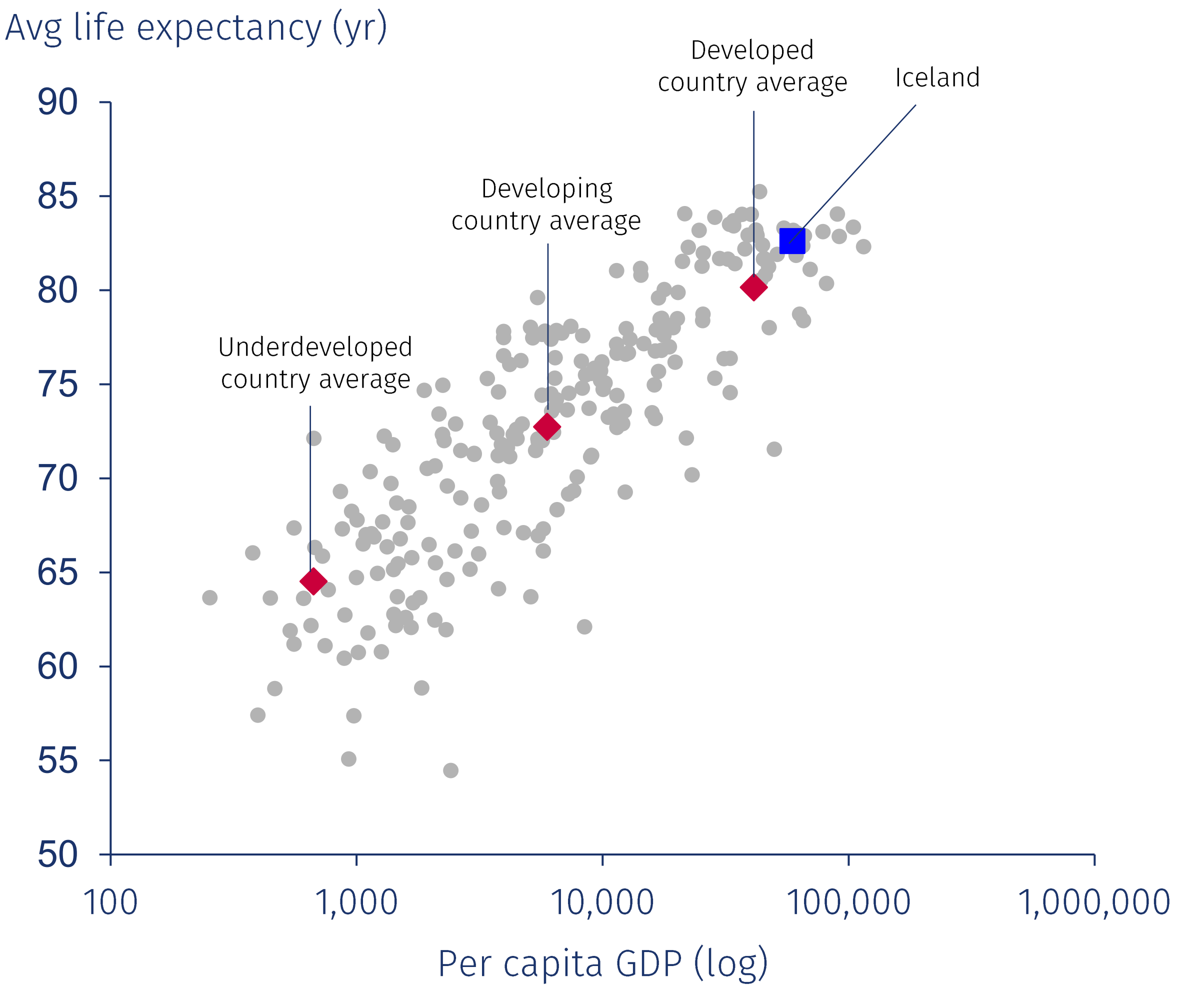


Per capita GDP 2024
USD at constant 2015 prices



Despite certain limitations, per capita GDP is the best measure of economic prosperity

Correlation between per capita GDP and average life expectancy at birth



Why use per capita GDP?

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- Strong correlation with important quality-of-life metrics; i.e., health, educational level, and democracy
- Easy to measure
- Comparability over time and between countries
- Well suited to government target-setting and policy formulation

Key limitations of per capita GDP

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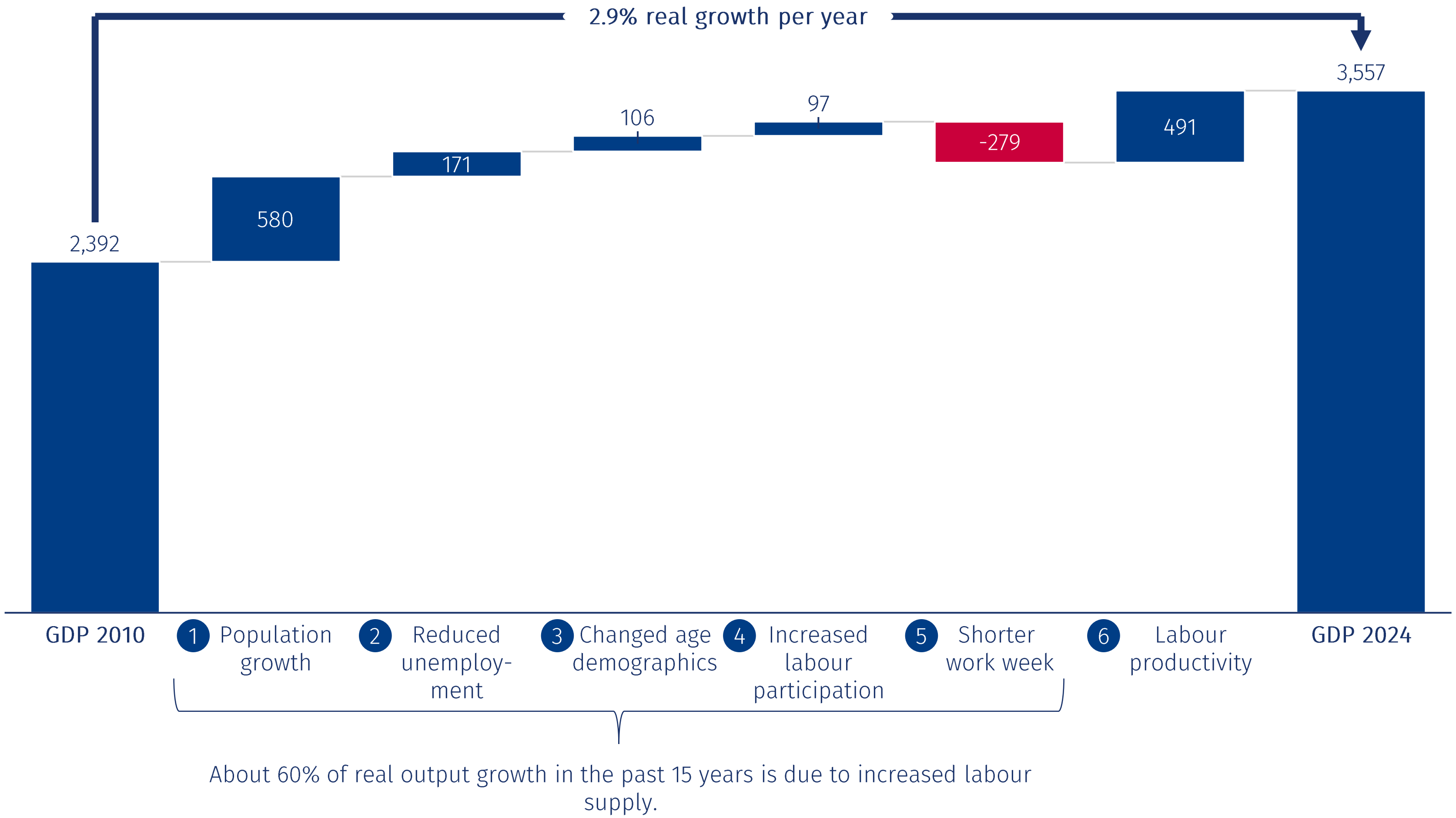
- Does not capture income distribution within the economy or the contribution of unpaid labour
- Does not capture environmental and sustainability factors
- Measures only the funding allocated to public services, not the quality of services provided

Source: World Bank

A large share of GDP growth for the period is due to growth in the labour force

Contribution to GDP growth 2010-2024, ISK bn (constant prices = 2020)

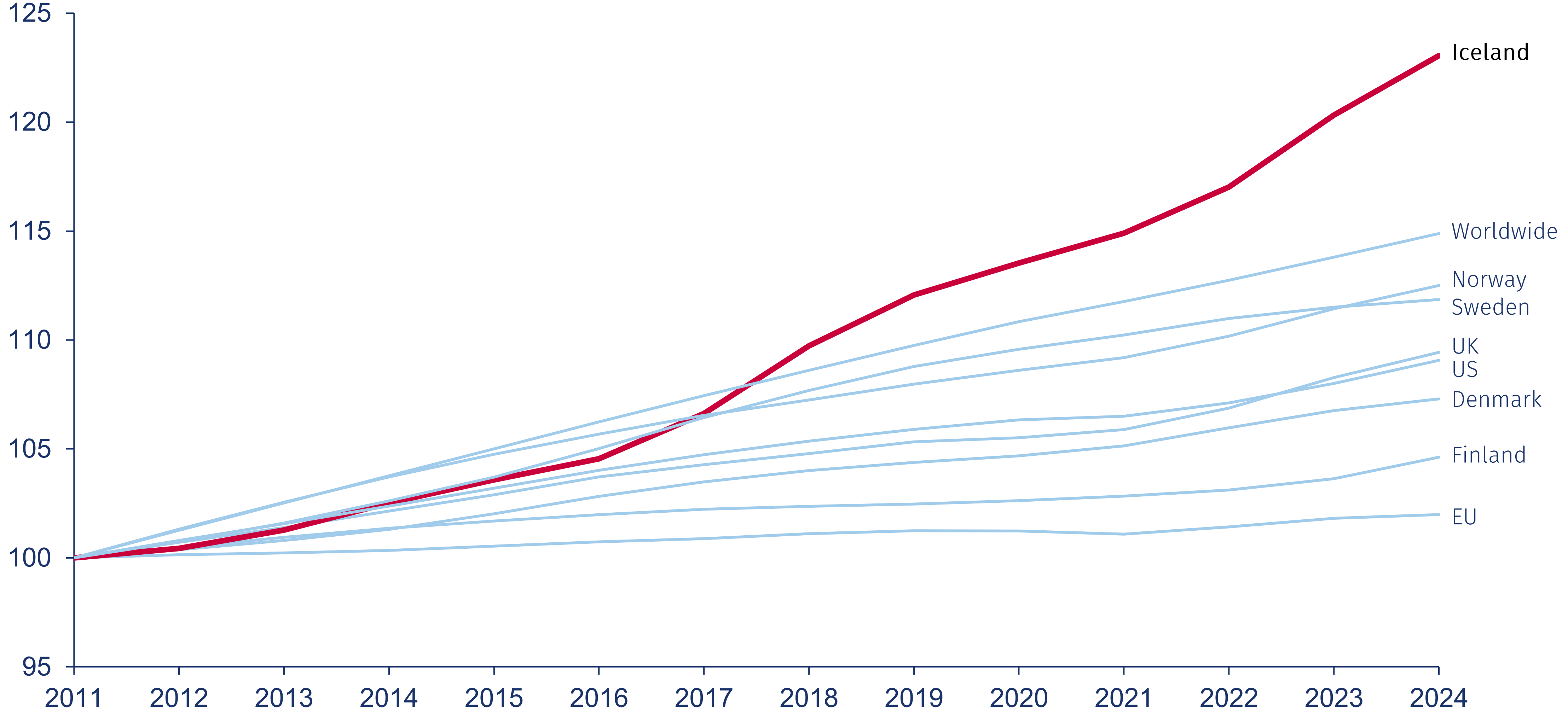


Source: Statistics Iceland.

1. **Iceland's population grew by ~75,000, or 24.2%, during the period.** Foreign nationals accounted for two-thirds of the increase.
2. **Unemployment fell from 8.3% of the labour force to 3.4%.** This is equivalent to the creation of 11,600 jobs.
3. The share of **inhabitants aged 16-74 rose from 71.2% to 73.7%,** increasing the supply of working persons.
4. **The labour participation rate rose from 79.6% to 82.2%,** as persons outside the labour market increased more slowly in number than those in the market.
5. **Average working hours per week fell by ~8.3% during the period**, from 39.6 to 36.3. This has reduced the labour supply.
6. About 40% of real output growth in the past 15 years is due to increased labour productivity. **Without the increase in the labour force, GDP growth would have averaged 1.1% for the period**, which is in line with the increase in per capita GDP.

The population surged during the period, especially in the last eight years

Population growth, beginning of 2011 = 100

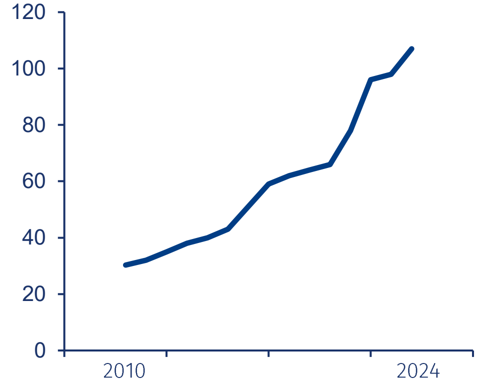


Source: World Bank and Statistics Iceland.

Population-driven output growth has put significant strain on public services and all key social infrastructure

Housing market

House price index

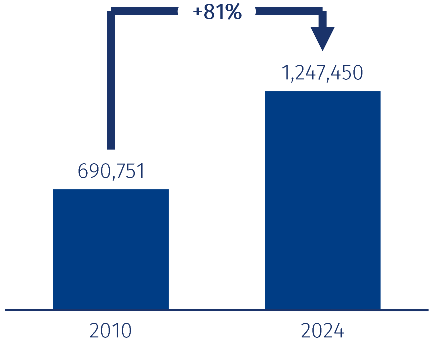


Population growth and short-term rentals to tourists have caused a surge in demand for housing.

Real house prices have more than doubled in the past 15 years. Nominal prices have more than trebled.

Transportation infrastructure

Road traffic, Hwy 1 (thousands of km driven)

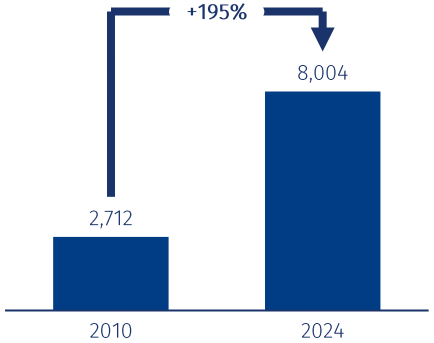


Population growth and the tourism boom have put substantial strain on transportation infrastructure.

Traffic on Highway 1 grew 80% over the period.

Educational system

Students of foreign nationality

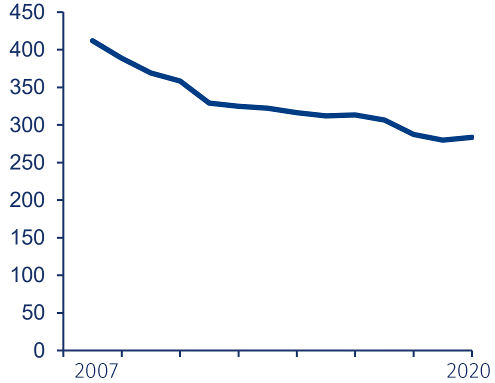


Alongside the increase in inhabitants of foreign nationality, student demographics in pre-schools and primary schools have changed, with the attendant strain.

The number of **foreign nationals of pre-school and primary school age trebled during the period.**

Healthcare system

Hospital beds per 100,000 inhabitants

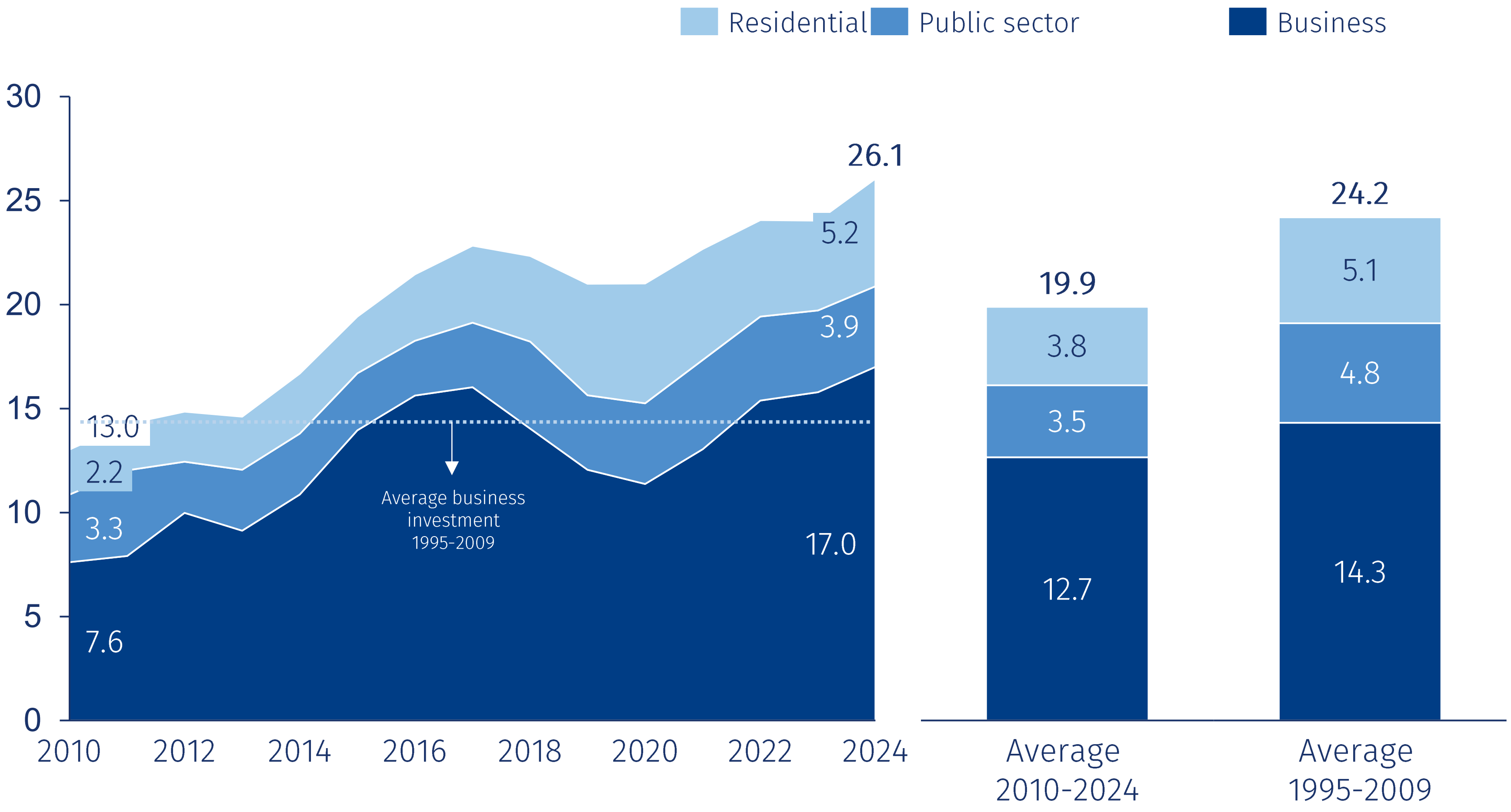


Population growth and the tourism boom have greatly increased demand for healthcare services.

The number of hospital beds per 100,000 inhabitants has **fallen nearly 30% from its peak.**

The investment ratio was below its historical average during the period but has picked up in the recent term

Investment 2010-2024, % of GDP

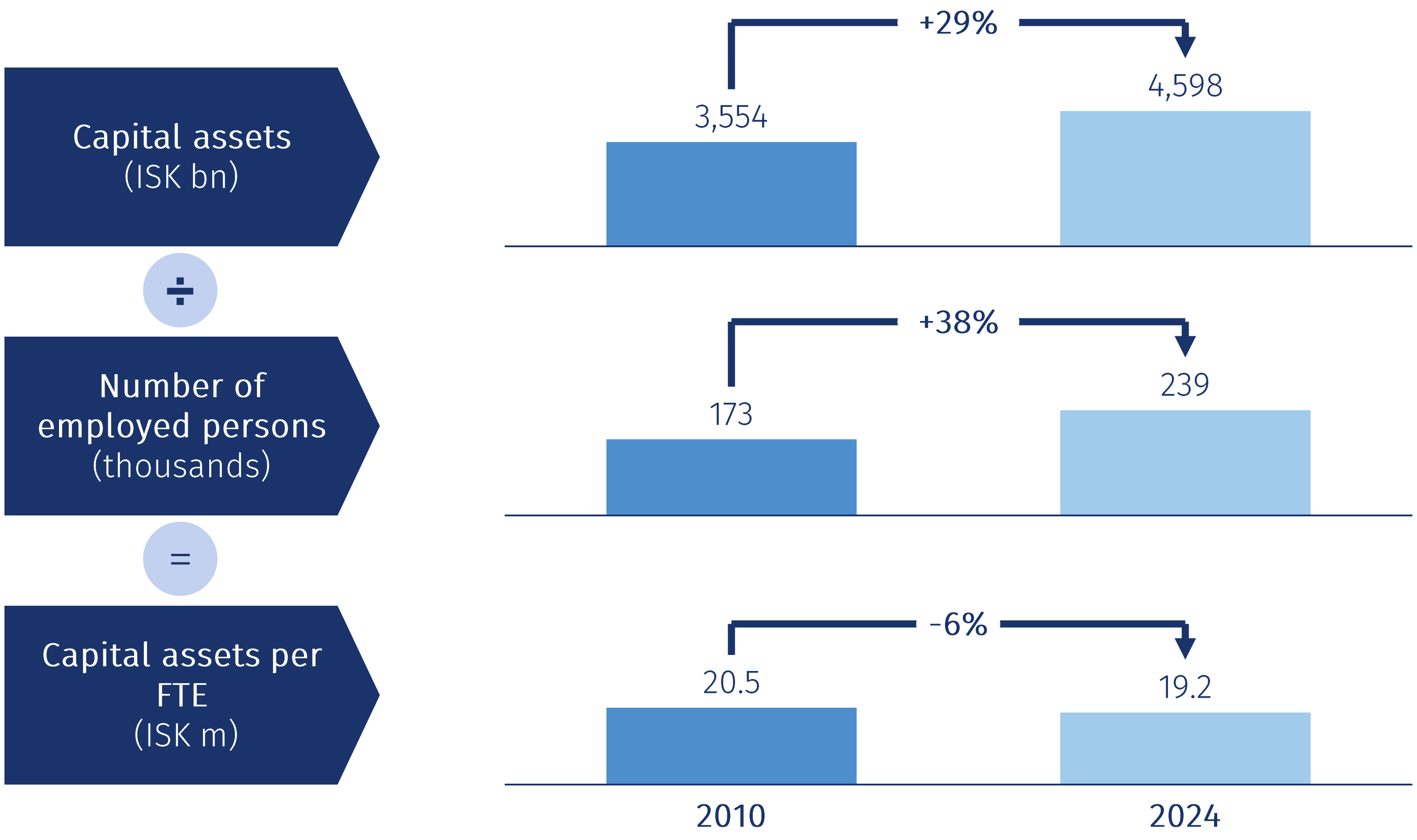


Source: Statistics Iceland.

- The economy **emerged from the financial crisis in debt**, and scope for investment was therefore limited in the first half of the period.
- The turnaround in Iceland's NIIP, the liberalisation of capital controls, and greater confidence in the economy's long-term prospects led to an **increase in investment in the latter half of the period**.
- Key classes of investment were **below their historical average** for the period as a whole, however.
- It can therefore be assumed that there is **still significant pent-up investment need** in all key categories.
- This must also be considered in light of the larger **population** and labour force during the period.
- Despite high interest rates, the investment-to-GDP ratio is **now very high in historical terms**, as well as in international context.

Businesses’ financial assets per FTE shrank 6% over the period

Developments in businesses’ financial assets 2010-2024

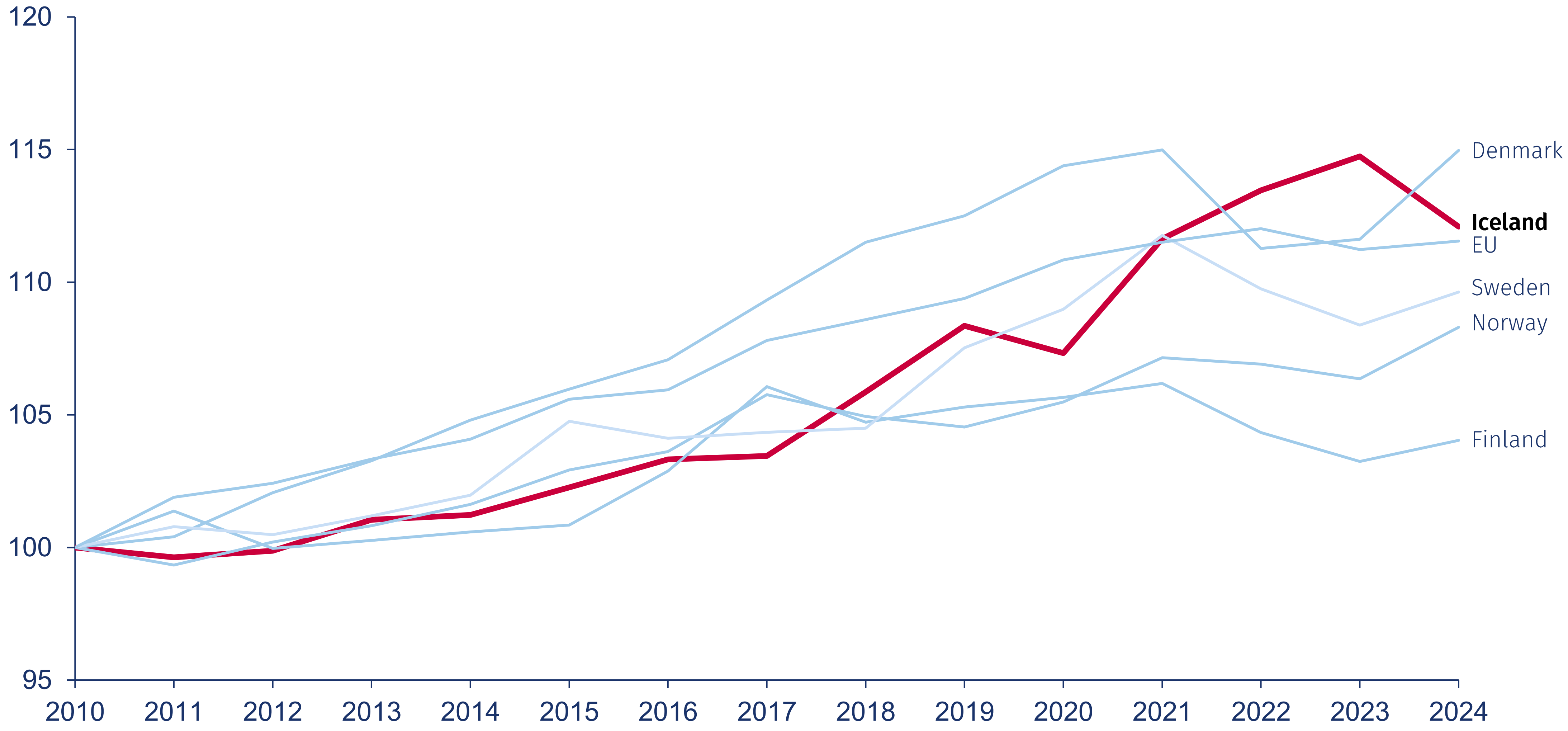


Source: Statistics Iceland.

- Although the investment level was high enough to build up businesses’ financial assets, **the number of working persons grew faster.**
- As a result, there is currently **6% less capital underlying each full-time position equivalent (FTE)** than there was at the beginning of the period.
- An increase in financial assets is also **distributed unevenly across sectors** (see p. 20).
- There is a strong cause-and-effect relationship between **capital per FTE and labour productivity**.
- It is important to **maintain strong investment** in the years ahead.

Labour productivity in Iceland developed broadly as in comparison countries during the period

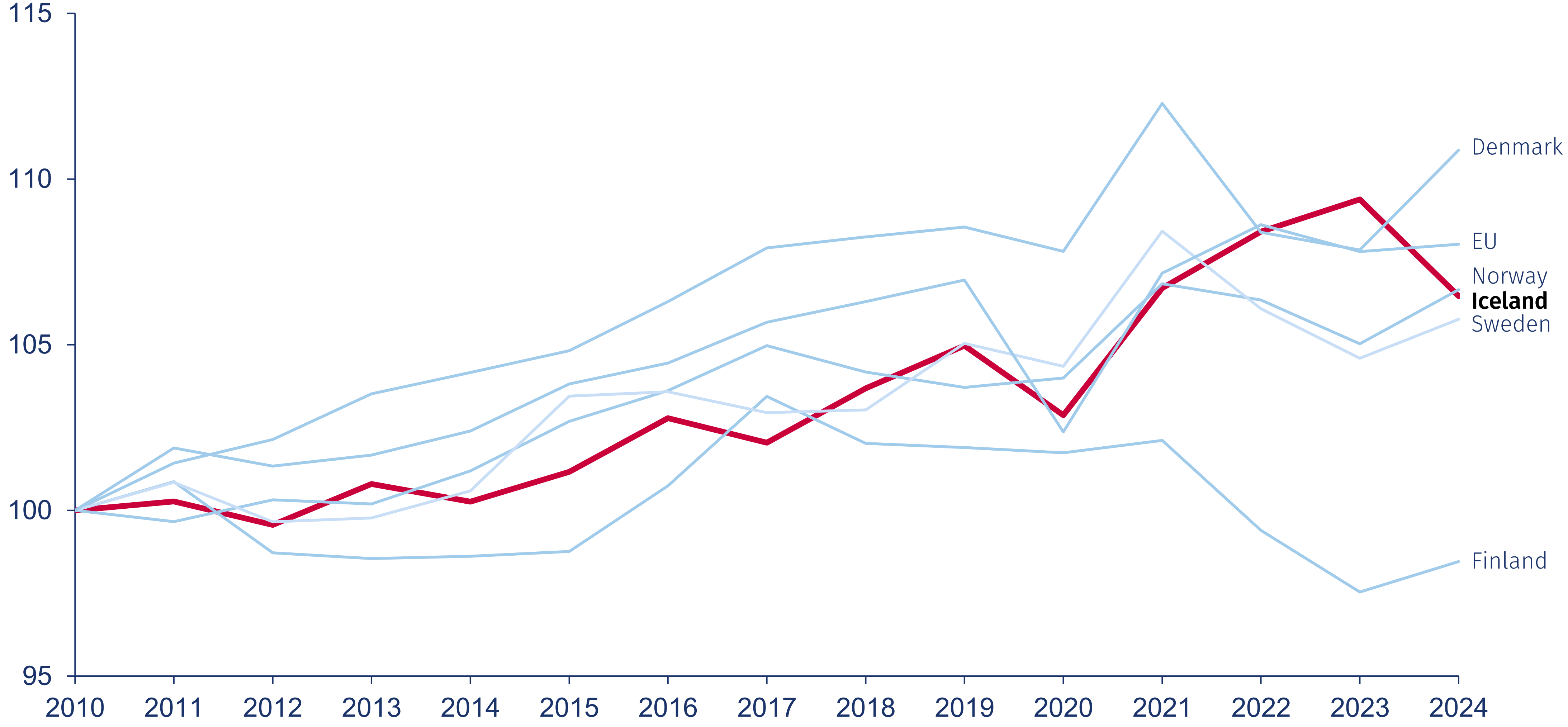
Developments in gross value added **per hour worked** 2010-2024, 2010 = 100



Source: World Bank and Statistics Iceland.

Labour productivity in Iceland developed broadly as in comparison countries during the period

Developments in gross value added **per employee** 2010-2024, 2010 = 100



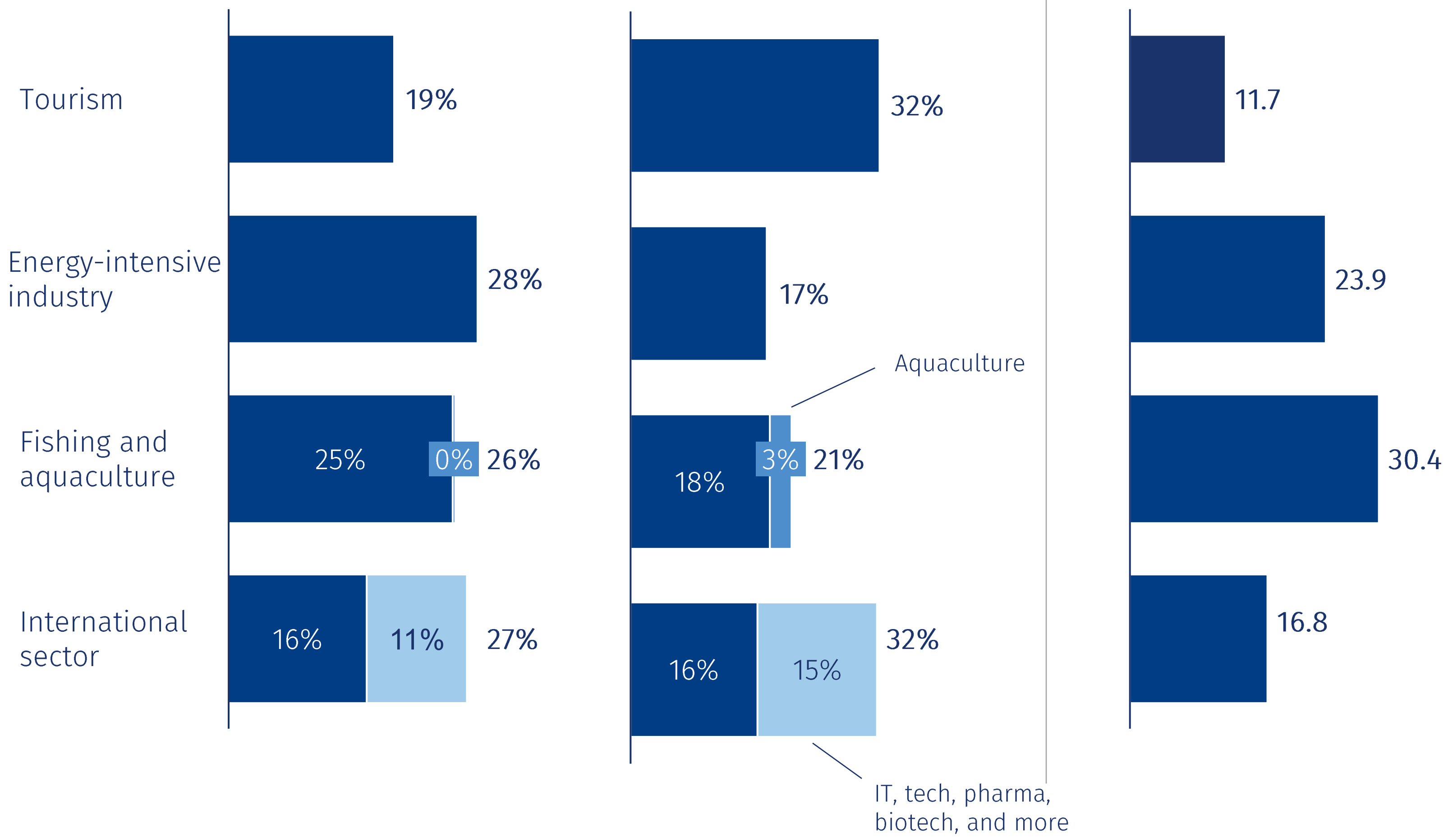
Source: World Bank and Statistics Iceland.

The composition of exports has changed markedly, with tourism taking the lead, although intellectual property has gained ground as well

Composition of exports 2010, % of total

Composition of exports 2024, % of total

Labour productivity, ISK m



Constraints on growth

Constrained by infrastructure and destinations

Energy constrained by harnessing options

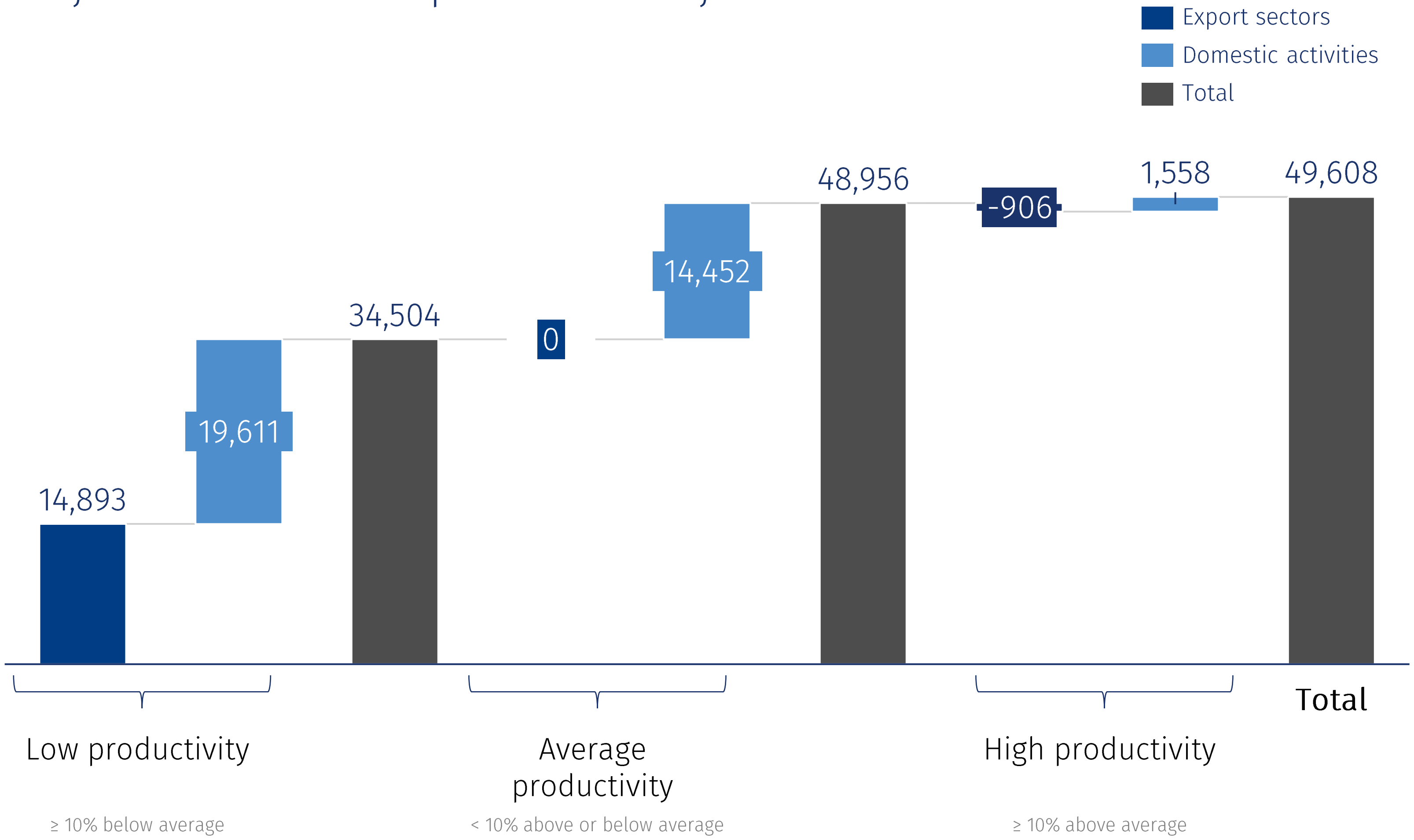
Constrained by fish stocks and fish farming sites

Few if any natural constraints on growth

Source: Statistics Iceland.

Only 1% of net private sector jobs created in the past 15 years are in high-productivity sectors

Net job creation and composition of new jobs 2010-2024

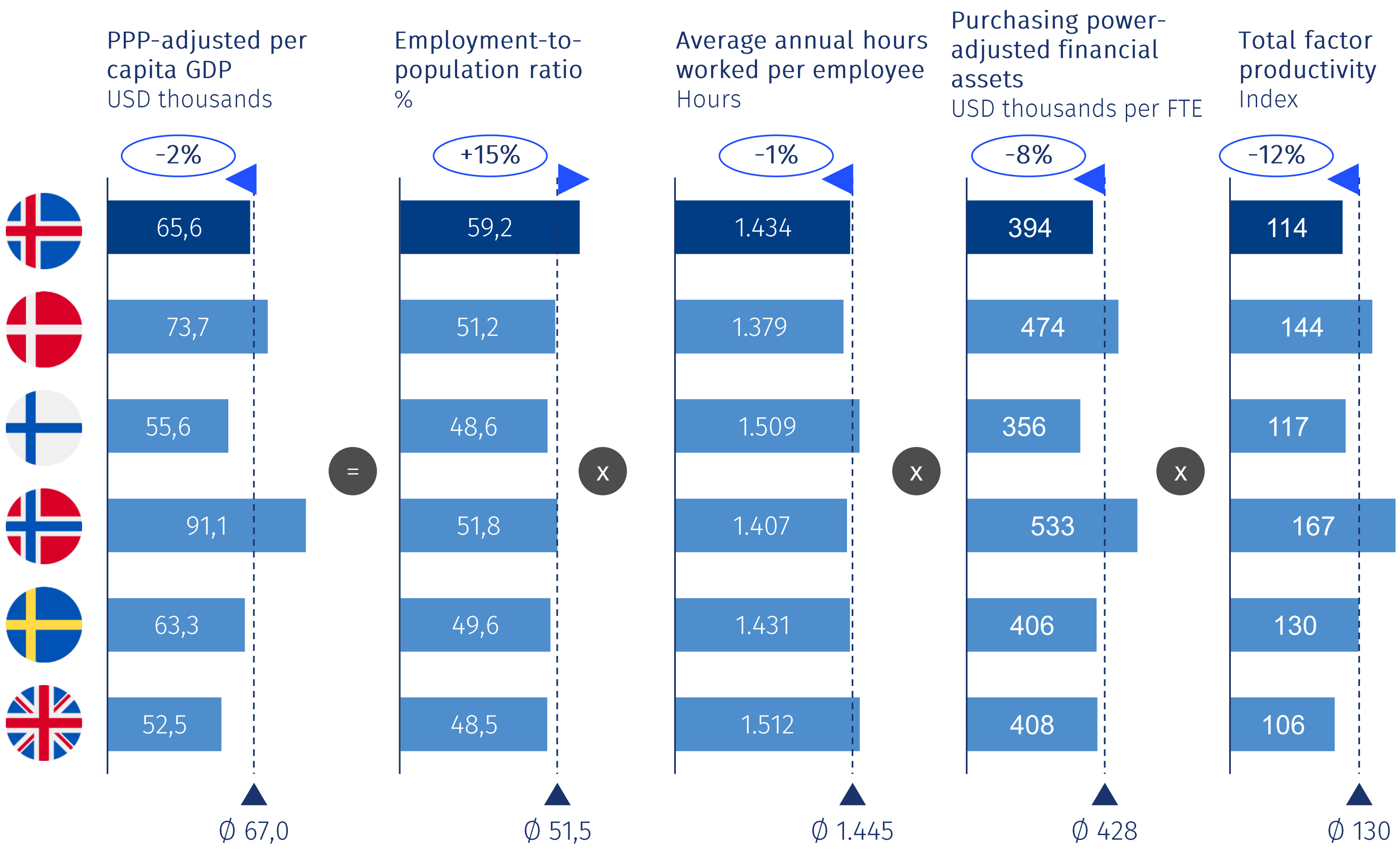


Source: Statistics Iceland.

- The composition of the economy changed markedly over the period, **led by growth in tourism**.
- The vast majority of **jobs created are in tourism or domestic services,** which have benefited from brisk economic activity.
- Net job growth in sectors with labour productivity at least **10% above the economy's average has been negligible**.This reflects, among other things, the sizeable drop in employee numbers in the fishing industry, where productivity growth was substantial during the period.
- In other words, the **percentage of sectors characterised by relatively low productivity grew rapidly** during the period.

Iceland's high labour participation rate offsets a weaker capital base and lower total factor productivity

Comparative contribution of production factors to purchasing power-adjusted per capita GDP 2024*



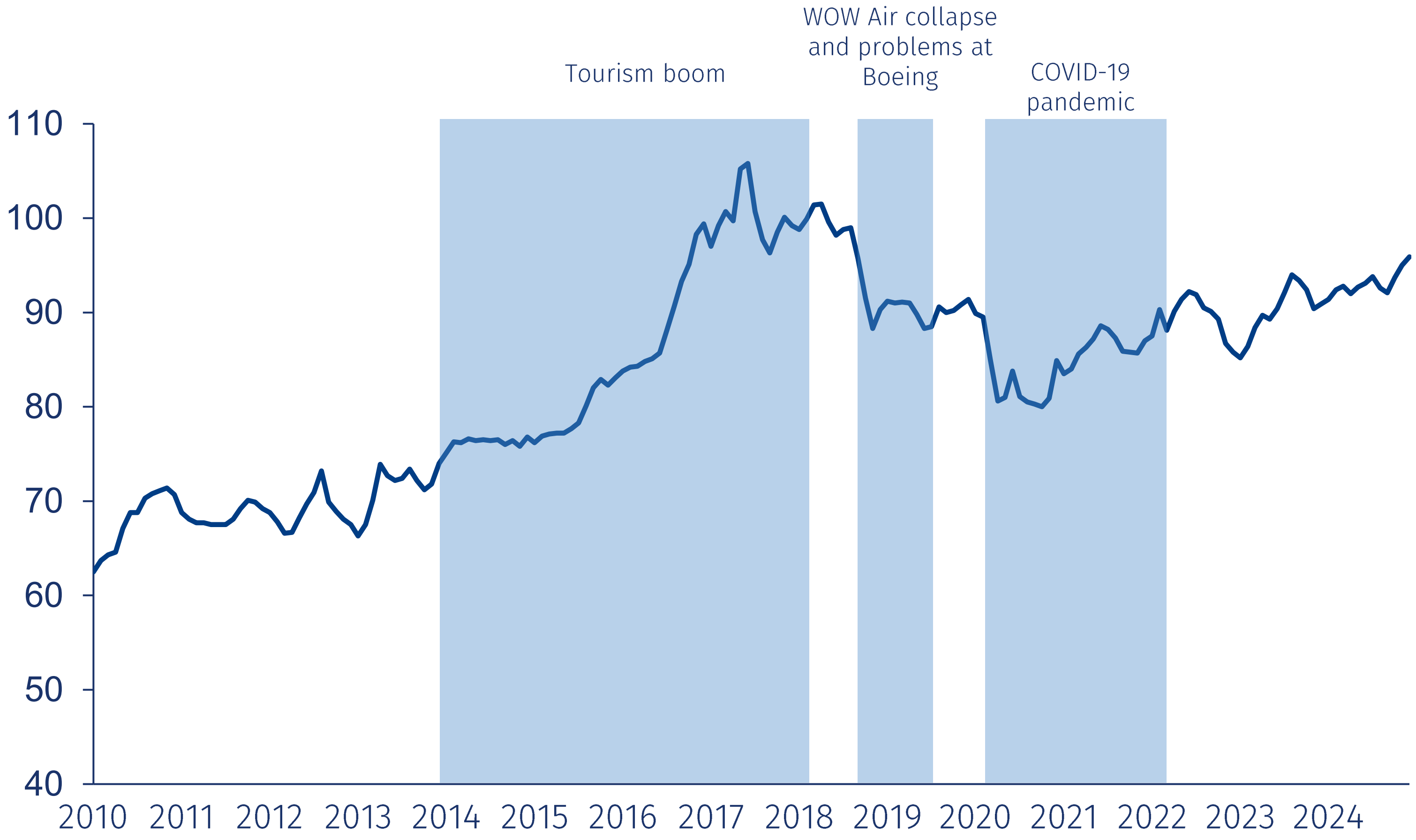
- Iceland is **well positioned in relative terms as regards per capita GDP**, surpassed only by Norway and Denmark.
- Iceland **benefits from strong labour participation and favourable age demographics**. With 60% of the population employed, it is far ahead of peer countries, while average hours worked per employee are on a par with those countries.
- On the other hand, **purchasing power-adjusted financial assets are somewhat below average**; i.e., each employee has less capital to support the contribution to GDP.
- Labour and capital appear to be less effectively used in Iceland, as **total factor productivity is 12% below the comparison country average**. This metric indicates how high per capita GDP would be if all countries had the same input of labour and capital.

Sources: Eurostat, Nordic and British statistical bureaus, OECD, World Bank.

*For Sweden and the UK, financial assets are calculated from 2023 data, as more recent figures were not available.

The real exchange rate has been high and volatile, posing challenges for the export sector

Real exchange rate movements 2010-2024, index = 100, 2005

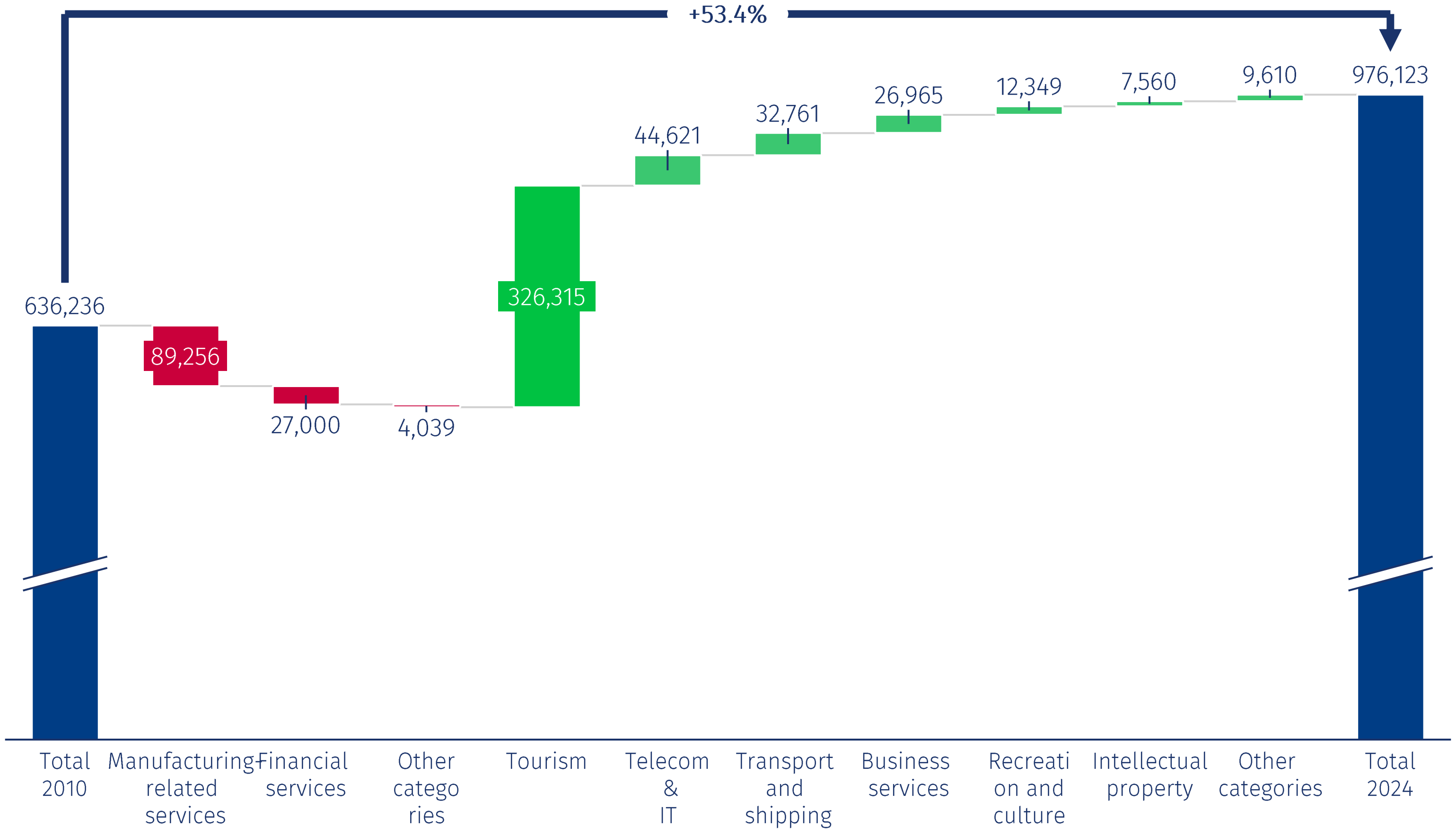


Source: Central Bank of Iceland.

- The real exchange rate was at a **historical low** in the wake of the financial crisis.
- Tourism **grew by leaps and bounds** in 2014-2018. External conditions were also positive for other key export sectors at the time.
- The real exchange rate **sagged following a setback in tourism** (2019) and slid further with the onset of the COVID-19 pandemic (2020).
- The recent episode of high inflation and pay increases without a nominal depreciation of the ISK has pushed the **real exchange rate close to an all-time high**.
- Under such circumstances, there is the risk that **sectors without access to natural resources will be weakened**. The high real exchange rate could crowd out important sources of export growth.

Tourism stands head-and-shoulders above other sectors in terms of growth in services exports

Change in composition of **services exports** 2010-2024, ISK m

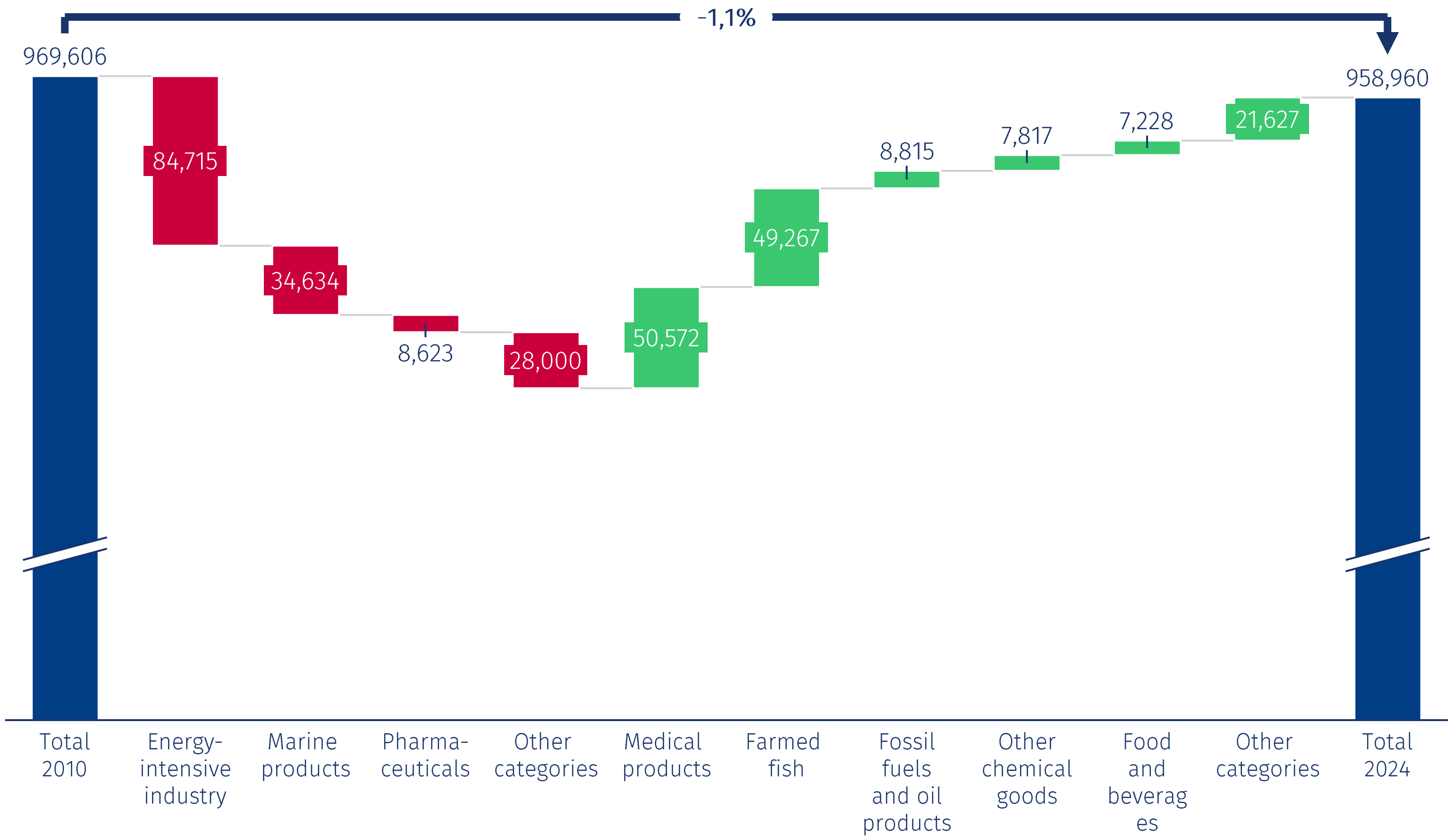


Source: Statistics Iceland.

- **Tourism-generated export revenues more than trebled** in real terms during the period, far outpacing other services exports.
- Intellectual property-related export revenues grew strongly over the same period, particularly in data centres and IT-related sectors.
- The contraction in manufacturing-related services is due to **changes in accounting methods** in connection with aluminium production in Iceland.
- The financial system has continued to **scale down overseas activities** in the years since the financial crisis.

Goods exports contracted in real terms over the period, mainly because of a higher real exchange rate

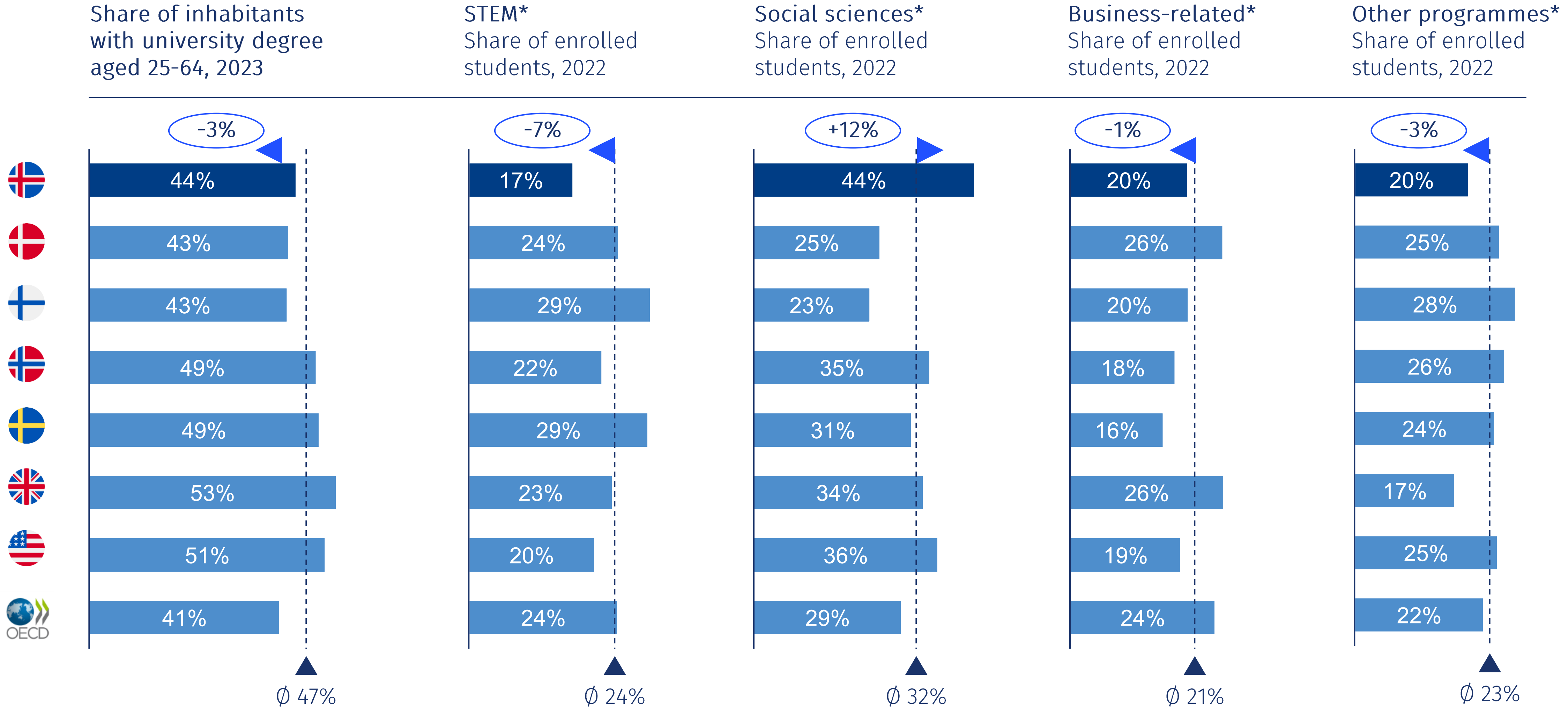
Change in composition of **goods exports** 2010-2024, ISK m



Source: Statistics Iceland.

- Increased **salmon farming and medial product sales** have somewhat offset the contraction in **energy-intensive industry and marine products**.
- The contraction in export revenues from the energy-intensive and fishing industries is **due mainly to the appreciation of the króna and changes in terms of trade**. Production volumes increased somewhat over the period.
- Sea-based fish farming has already surged, and large land-based aquaculture products will boost exports even further in coming years.
- **Various innovative sector have also grown** in terms of goods exports.

Iceland's ratio of university-educated persons is on a par with comparison countries, but enrolment in STEM programmes is low

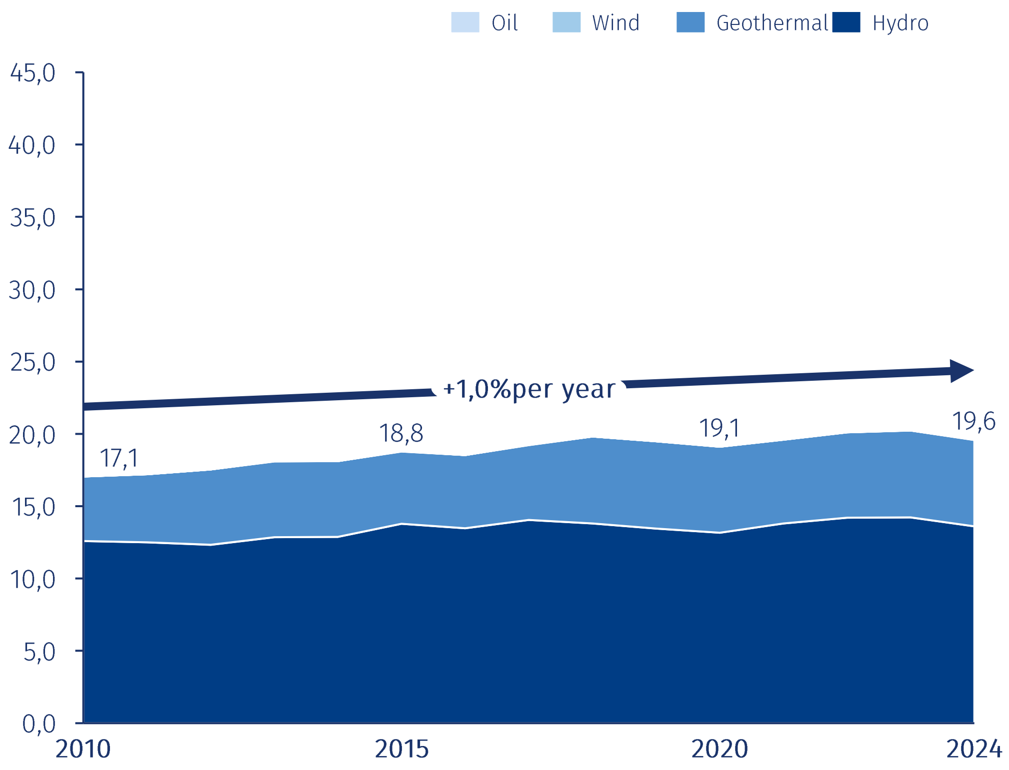


Source: OECD.

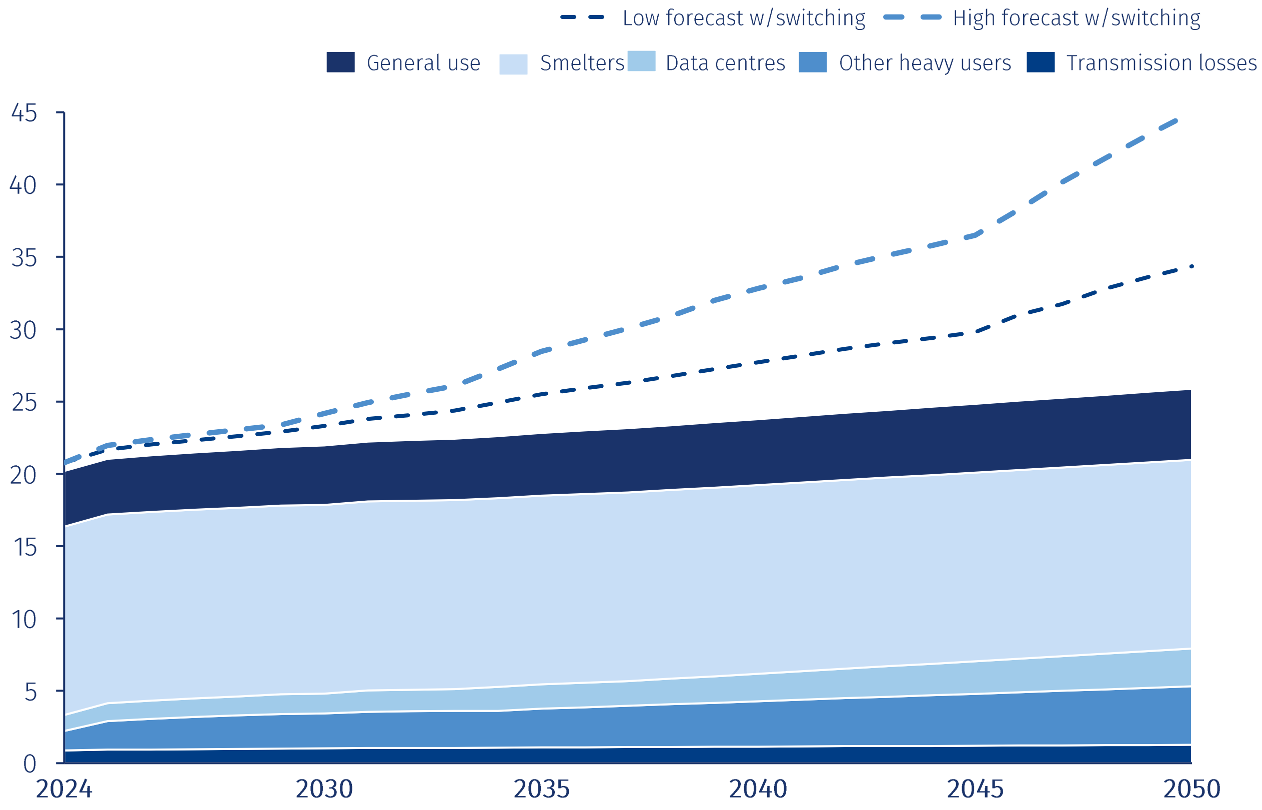
*STEM refers to science, technology, engineering, and mathematics. Social sciences include education, arts, and social studies. Business-related programmes include business administration, economics, and law. Health sciences and natural sciences are largest among other programmes.

Energy production grew slowly over the period and could impede further commercial development and energy transition

Electricity use 2010-2024, TWh per year



Landsnet* forecast: developments in demand 2024-2050, TWh per year



Source: Landsnet and National Energy Authority.
*Landsnet is a company responsible for the transmission and distribution of electricity in Iceland.

To support robust, sustainable GDP growth, priorities in some areas of commercial development need to change

	2010 – 2024	2025 – 2035
GDP growth	The economy was growing rapidly, yet real GDP growth per capita was below European and US averages.	Strong priority must be given to boosting per capita GDP.
Labour force	Strong job creation was limited almost entirely to low-productivity sectors. Labour productivity growth has slowed.	An effort must be made to increase the share of jobs in high-productivity sectors. Job growth alone is not an independent goal.
Capital	Investment has not kept pace with the rise in FTEs; therefore, capital has not supported productivity growth satisfactorily.	It is important to maintain a high investment level throughout the business cycle so as to increase capital per FTE.
Exports	Export growth has been relatively homogeneous, and concentrated in sectors with low productivity and natural constraints on growth.	Broad-based export growth underpinned by high-productivity sectors not subject to natural growth constraints.