

The Icelandic Economy

2020

Current State,
Recent Developments
and Future Outlook



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Iceland Chamber of Commerce

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ICELAND

The Icelandic Economy

Current State, Recent Developments and Future Outlook
2020 edition

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About the Chamber

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



Table of Contents

	Foreword	6
1	Economic Landscape	7
1.1	Overview of society	7
1.2	Macroeconomic environment	12
1.3	Institutional framework	20
2	Structure of the Economy	29
2.1	The financial sector	29
2.2	Business sectors	38
2.2.1.	The domestic sector	39
2.2.2.	The resource sector	40
2.2.3.	The international sector	46
3	The Impact of COVID-19 on the Icelandic Economy	50
4	Competitiveness Post-COVID-19	61
4.1	Potential infrastructure investments	63
4.2	Getting Iceland out of the COVID-19 crisis	66

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Foreword



This year marks the 23rd edition of **The Icelandic Economy**, which for 12 years has documented recent economic developments and prospects in Iceland. The period has been eventful. Starting from the gruelling times surrounding the financial crisis in 2008, when the unemployment rate peaked at 8%, which evolved into a recovery driven in large by tourism and supported by the devaluation of the Icelandic Króna, financial restructuring and successful policies. In last year's report, that rapid recovery seemed to have reached its mark, with the collapse of WOW air reducing sentiment and increasing the risk of a recession.

Things turned out better than expected, growth in 2019 came in at 1.9% but the outlook for 2020 was nonetheless bleak as slowdown was mounting in most exports and investment. Then, COVID-19 made its appearance and to make a long story short, this year Iceland might face its largest

one-year drop in economic activity in a century. During the strictest public health measures that were put in place, arrivals of tourists virtually stopped but due to Iceland's success in getting the epidemic under control, a rise in sentiment and activity in sectors such as tourism emerged from the end of May. The improvement, however, was short-lived as a second, yet much smaller, wave of the epidemic hit Iceland in late July, forcing the impose of hindering measures at the border of the island.

Recent events highlight that risks and uncertainties will persist as long as the world remains unhealed from the economic and social difficulties caused by the pandemic. In the novel *Independent People*, written by the Icelandic Nobel laureate Halldór Laxness, it says "eventually, all things come to an end, even though we doubt that along the way". It is important, now more than ever, to remember these

words. We will eventually relive a life without COVID-19, here in Iceland as in the rest of the world. The crucial question is how the recovery can be made swift and powerful.

We at the [Iceland Chamber of Commerce](#) believe that Iceland can reach the forefront of major developments in infrastructure, human capital and technology. The nation is highly educated and has a capable workforce which is aware of the current trends that are shaping the new normal. This will speed up our alignment to the future and boost a new growth cycle - based on innovation, sustainable solutions, global connections and cooperation. In that way will we take full advantage of the lessons brought by the current crisis and emerge with a stronger and more dynamic economy – as we have already done before.

Ásta S. Fjeldsted
Managing director
[Iceland Chamber of Commerce](#)

1 Economic Landscape

1.1 Overview of society



What do you know about Iceland?

Key economic indicators

Population:

364,134 (2020)

Inflation:

3.2% (August 2020)

Unemployment:

6.9% (Q2 2020) ¹

GDP per capita:

55,870 USD PPP² (2019)

Central bank policy rate:

1.0% (August 2020)

The currency is **Icelandic Króna (ISK)**

USD 1 = 137.3 ISK (28 August 2020)

General government debt-to-GDP was **37% in 2019**

Current account surplus was **5.9% of GDP in 2019**

¹ Average unemployment rate over the three months in Q2: April, May and June.

² Purchasing Power Parity (PPP) is when statistics such as GDP are adjusted for price differences across countries to make them comparable in real terms.



Interesting facts

The official language is Icelandic and the main religion is Lutheran

Iceland has the most advanced IT infrastructure of any developed nation, according to the UN

Former president Vigdís Finnbogadóttir became the first democratically elected female head of state in 1980

Iceland is a founding member of NATO but does not have any military forces

Iceland's search and rescue services are solely volunteer-run

Iceland's parliament, Althingi, is the oldest operating parliament in the world, founded in 930 AD

A small, open, high-income economy

GDP per capita in 2019

PPP adjusted, USD

Norway	63,633
United States	62,683
Denmark	57,184
Iceland	55,874
Germany	53,815
Sweden	53,205
Canada	49,031
Finland	48,621
United Kingdom	46,699
France	46,184
Italy	42,413
Japan	41,429

Compound annual growth rate

GDP per capita PPP, 1990–2019

Iceland	1.69%
United States	1.52%
Norway	1.49%
Sweden	1.49%
Canada	1.48%
United Kingdom	1.46%
Finland	1.35%
Germany	1.33%
Denmark	1.32%
France	1.07%
Japan	0.89%
Italy	0.49%

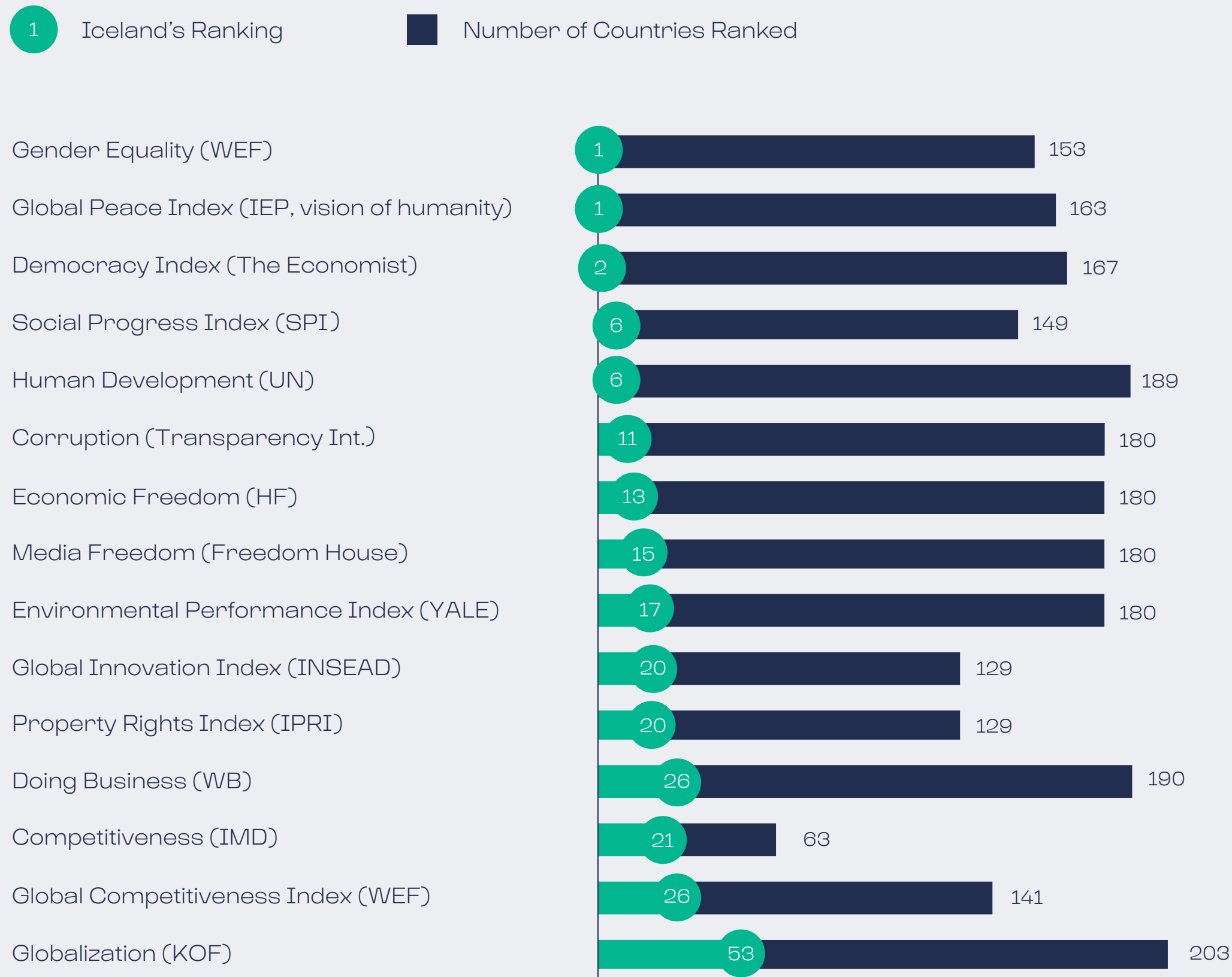
Iceland ranks highly in terms of GDP per capita and has enjoyed a strong growth rate over the past three decades

The Icelandic economy is an open high-income economy combining a free market with a welfare state which is sometimes referred to as The Nordic Model. Although income per capita is high, last year's annual gross domestic product of USD 21.9bn (ISK 2,965bn) makes Iceland's economy the smallest of the OECD.

Overall, Iceland has come a long way since it was one of the least affluent countries in Western Europe in the first half of the 20th century. It has grown fast, albeit in a turbulent manner as price and currency instability were severe problems in the 20th century.

Competitiveness Rankings

Iceland's most recent rank and number of countries ranked¹



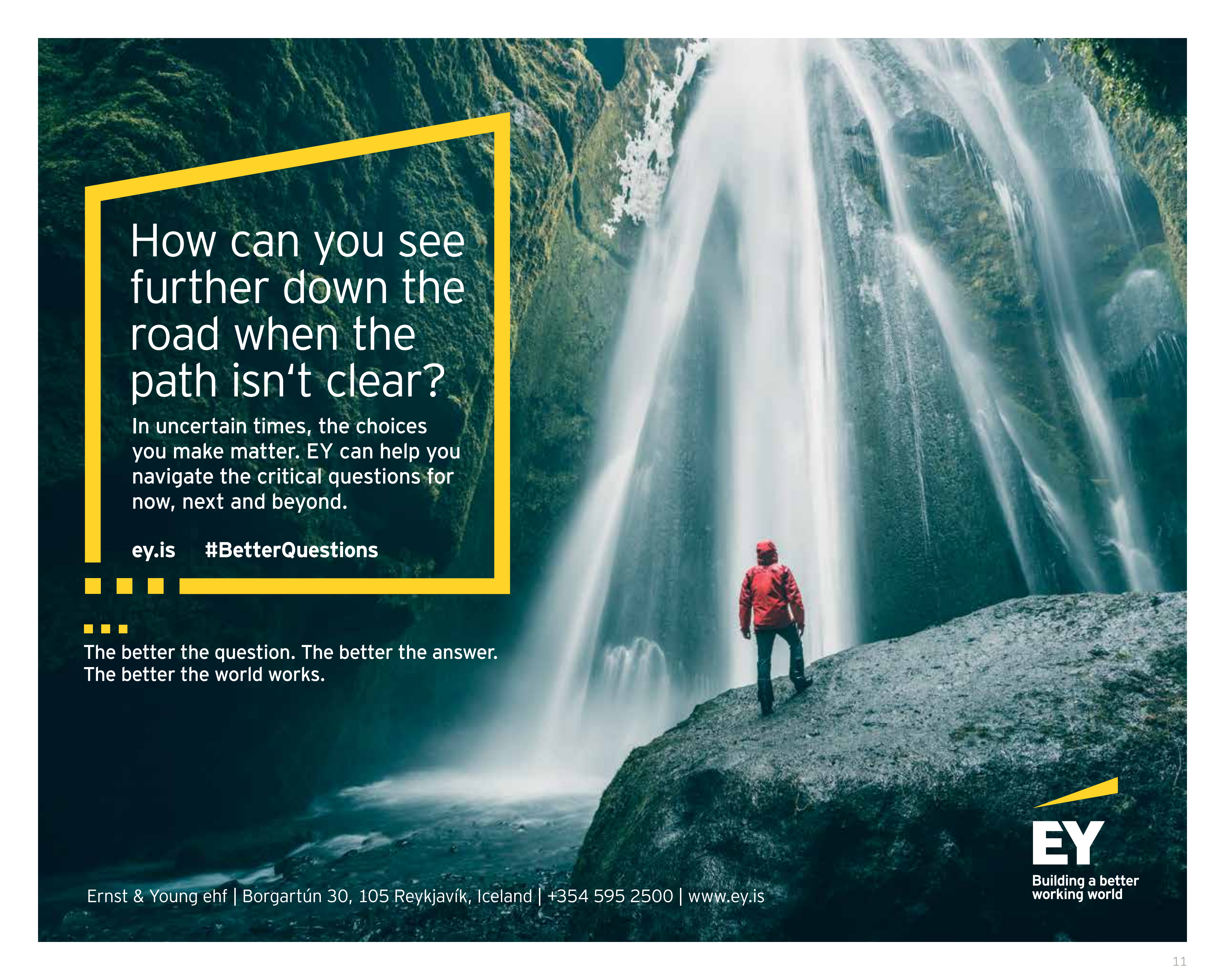
¹ Sources obtained in June 2020.

Among the best

Iceland shows strength in a broad set of competitive indices

Iceland's success as a society can be attributed to factors such as a strong institutional framework, skilled workforce, high degree of economic freedom, sound democracy, strong preference for equity and peace, and low levels of corruption.

Iceland tops cross-country indices for gender equality and peace, and ranks highly in a number of others. High labour force participation rate, the country's openness and economic flexibility are the strong-points of the Icelandic economy. Moreover, Iceland punches above its weight when it comes to competitiveness, overcoming its small size to place 21st out of 63 countries ranked by IMD university in 2020.

A person in a red jacket stands on a large, dark rock in the foreground, looking towards a massive, multi-tiered waterfall cascading down a steep, mossy cliff. The water is white and frothy, creating a misty atmosphere at the base. The surrounding landscape is lush and green.

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1 Economic Landscape

1.2 Macroeconomic environment

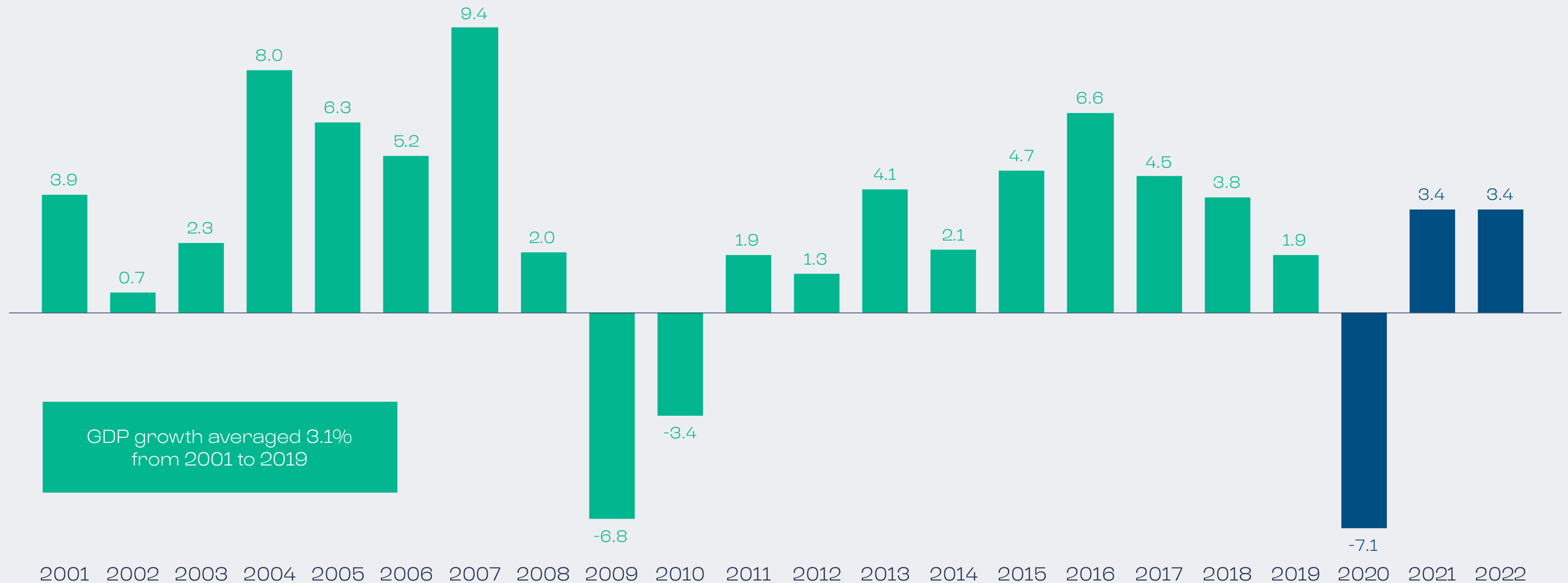


A walk down memory lane

After a decade on the rise, GDP growth will take a hit this year but is expected to bounce back in 2021

Actual Projected

GDP growth, %



Sources: Central Bank of Iceland (Monetary Bulletin 2020/3); Statistics Iceland

2004–2007

A period of large capital inflows, rapid growth in the financial sector and large investments in hydro and aluminium productions.

2008–2010

Iceland was hit especially hard by the financial crisis as it led to high inflation, unemployment and the failure of the banking system.

2011–2018

A tourism-led growth cycle during which the yearly number of foreign visitors increased by 328%.

2020–

The COVID-19 pandemic will severely impact the economy this year but growth is expected to restart in 2021.

A dynamic labour market facing challenges

Iceland has historically kept unemployment low and wage growth high

Iceland has historically maintained low levels of unemployment. The financial crisis was one of the exceptions when the unemployment rate peaked at 8% but in 2015 it had decreased back to below 4%. Notwithstanding the large influx of foreign labour, which substantially expanded the labour force, unemployment had remained low but due to the COVID-19 crisis it has risen swiftly and is forecasted to be a record 8.7% in 2020 and start decreasing in 2021.

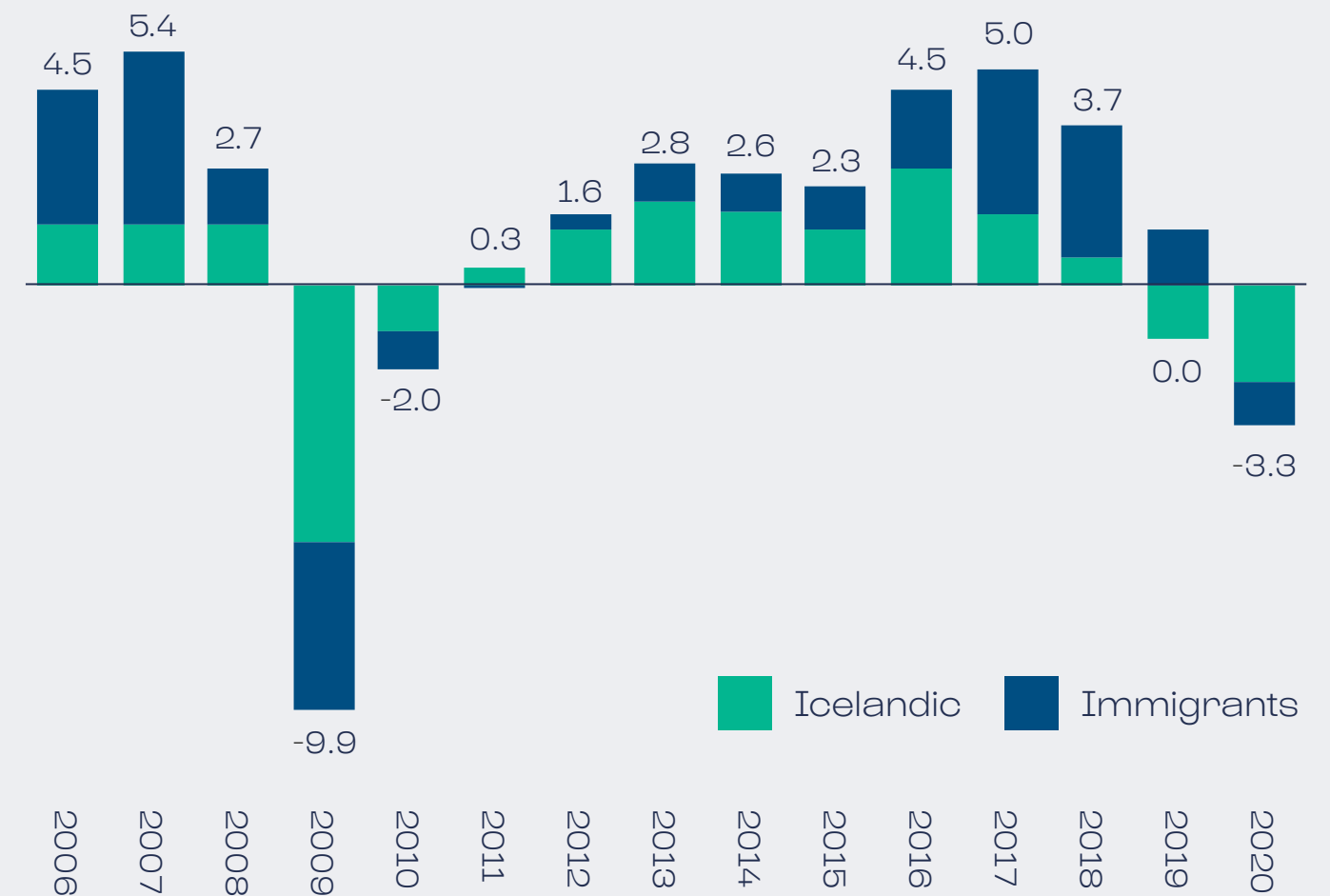
The labour market is highly unionised with collective bargaining agreements covering

approximately 90% of the workforce. In mixture with a strong economic growth, this has led to considerable wage increases in recent years.

Last year, a bargaining round affecting most of the private sector resulted in the signing of the 4-year [Living Standard Agreement](#) which, among other things, links wage hikes to GDP per capita performance. The agreement will go under review this September and with COVID-19 significantly affecting economic performance and the business environment, the agreement will face a big test. Overall, maintaining the recent wage increases while curbing unemployment will be a big challenge for the economy.

Net changes in labour force, unemployment and wage growth

YoY¹ % change

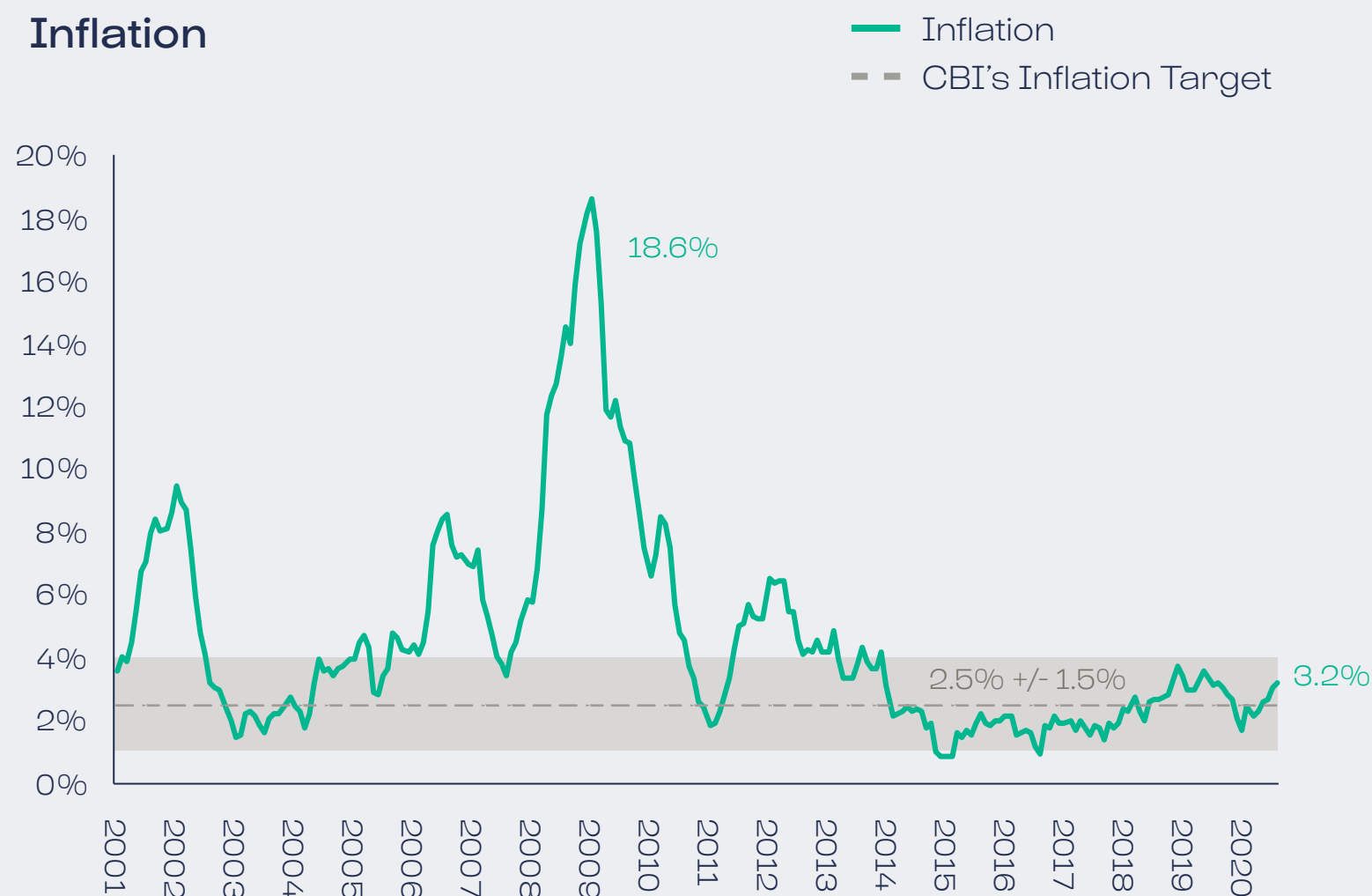


¹ YoY = year on year

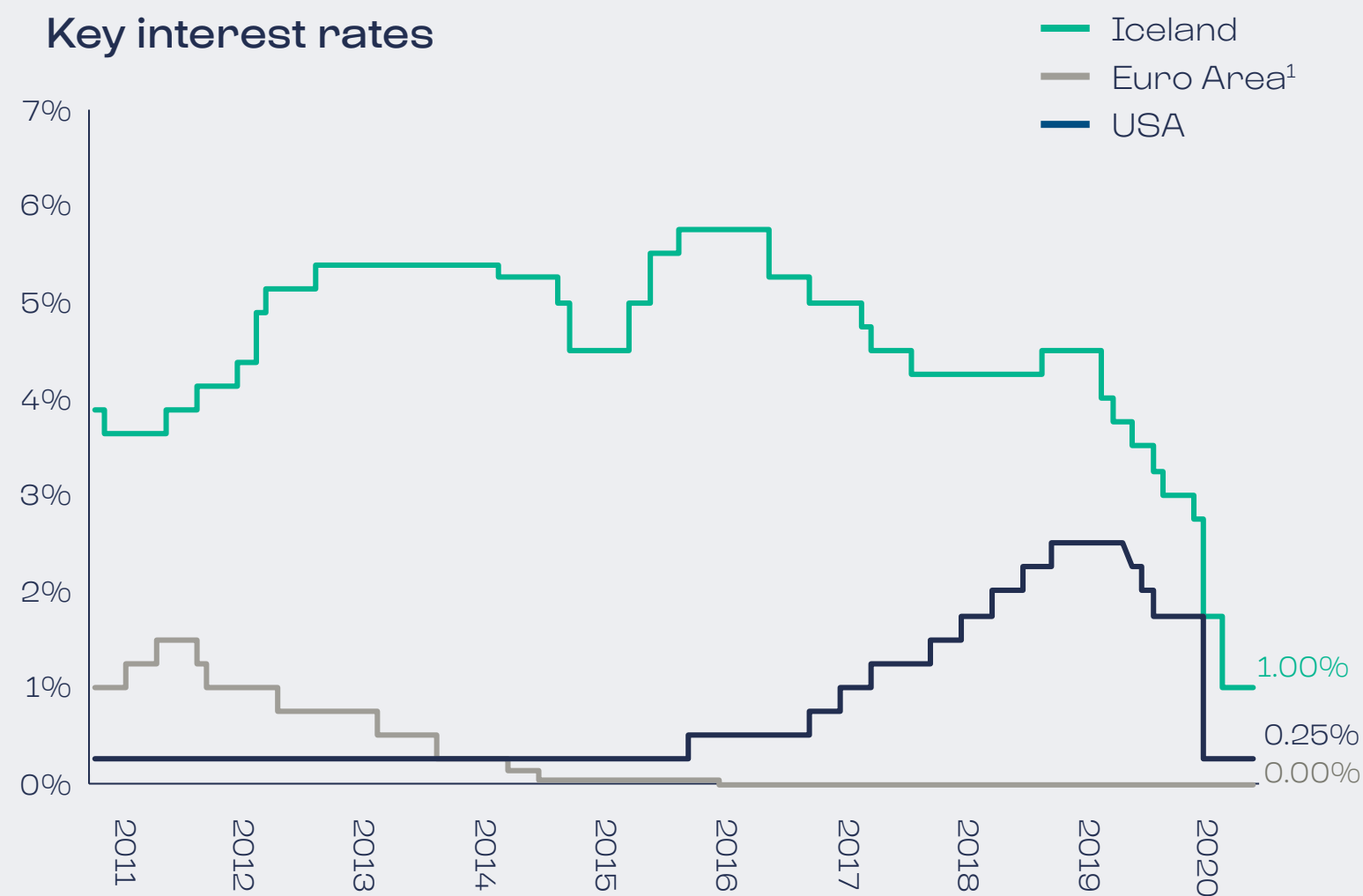
Sources: Central Bank of Iceland (Monetary Bulletin 2020/3); Iceland Chamber of Commerce; Statistics Iceland

Inflation under control and historically low interest rates

Inflation



Key interest rates



1. Rate on main refinancing operations. The deposit facility rate, on the other hand, is currently -0.50%.

Sources: Central Bank of Iceland; European Central Bank; Iceland Chamber of Commerce; Statistics Iceland; The Federal Reserve System

Stable and low inflation and inflation expectations have laid ground for a low interest rate environment

Since March 2001, the Central Bank of Iceland (CBI) main policy objective has been a 2.5% inflation target. Up to 2014, inflation was regularly above the target due to high inflation expectations and unfavourable exchange rate movements which pushed up the imports dependent consumer

price index (CPI). In 2014, a steep fall in oil prices and inflation expectations drove inflation under 1%. Then, continuing low expectations and a vast increase in exports related to tourism - which fuelled a rapid appreciation of the Króna - kept inflation below the target until the second half of 2018. This period of heightened inflows of foreign currency (FX) gave the CBI the ability to grow a substantial FX reserve pile (ISK 1,009bn; 33.9% of GDP) which it

has since then used to stabilise the exchange rate and keep inflation, and its future expectations, near the targeted 2.5%. This has made the CPI less dependent on currency movements, for example in 2018 the Króna depreciated 9% against the EUR but inflation still remained near the target.

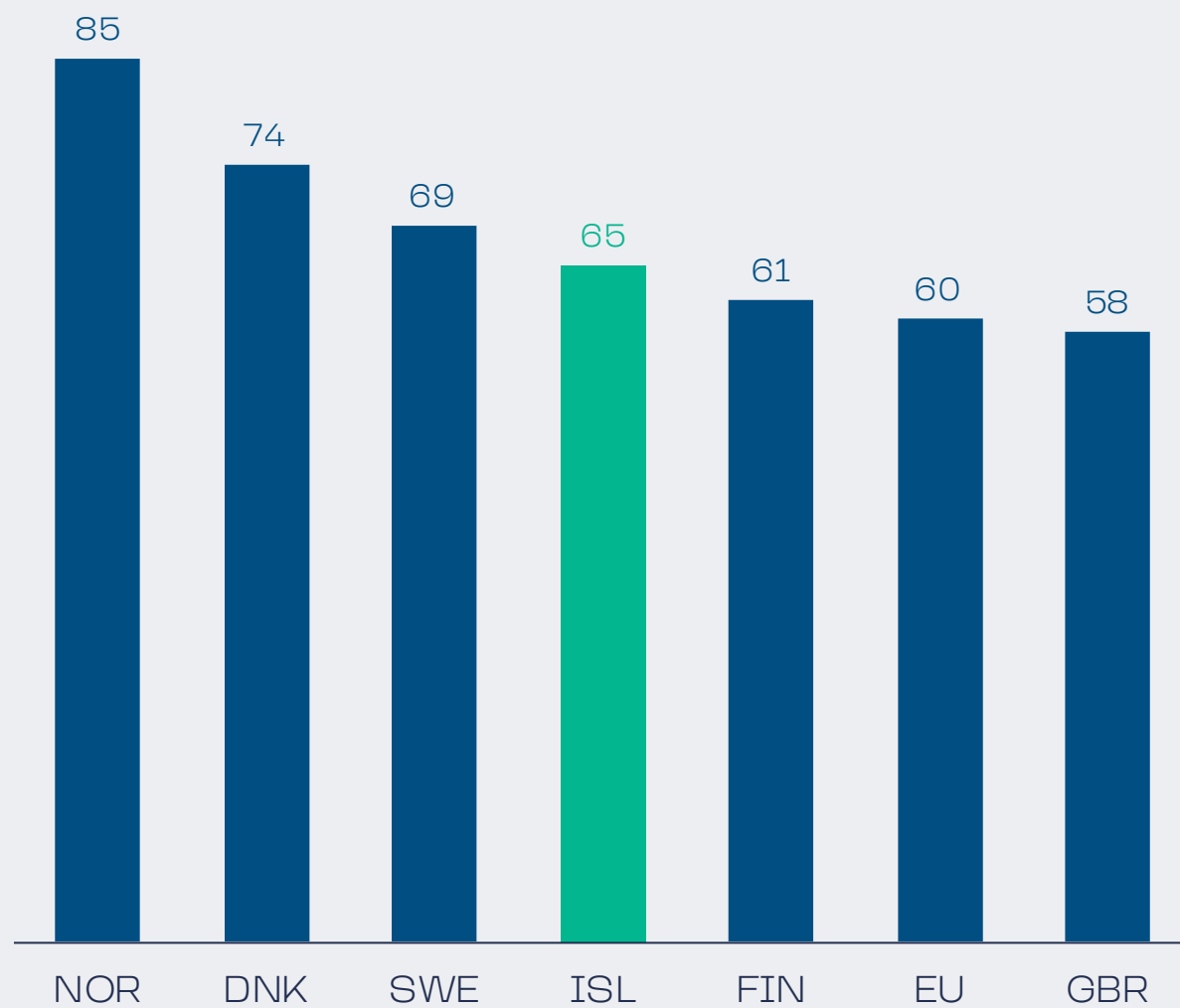
With inflation in tact, the CBI has been able to follow other central banks and lower its policy rate in response to shocks, such as the

collapse of WOW air in 2019 and the COVID-19 crisis. A swift decrease in the first half of 2020 puts interest rates at an all-time low and closer than ever to those in the US and EU. With no significant near-term increases in sight, the Icelandic economy might thus be entering its first ever period of low interest rates.

A note on productivity

GDP per hour worked¹

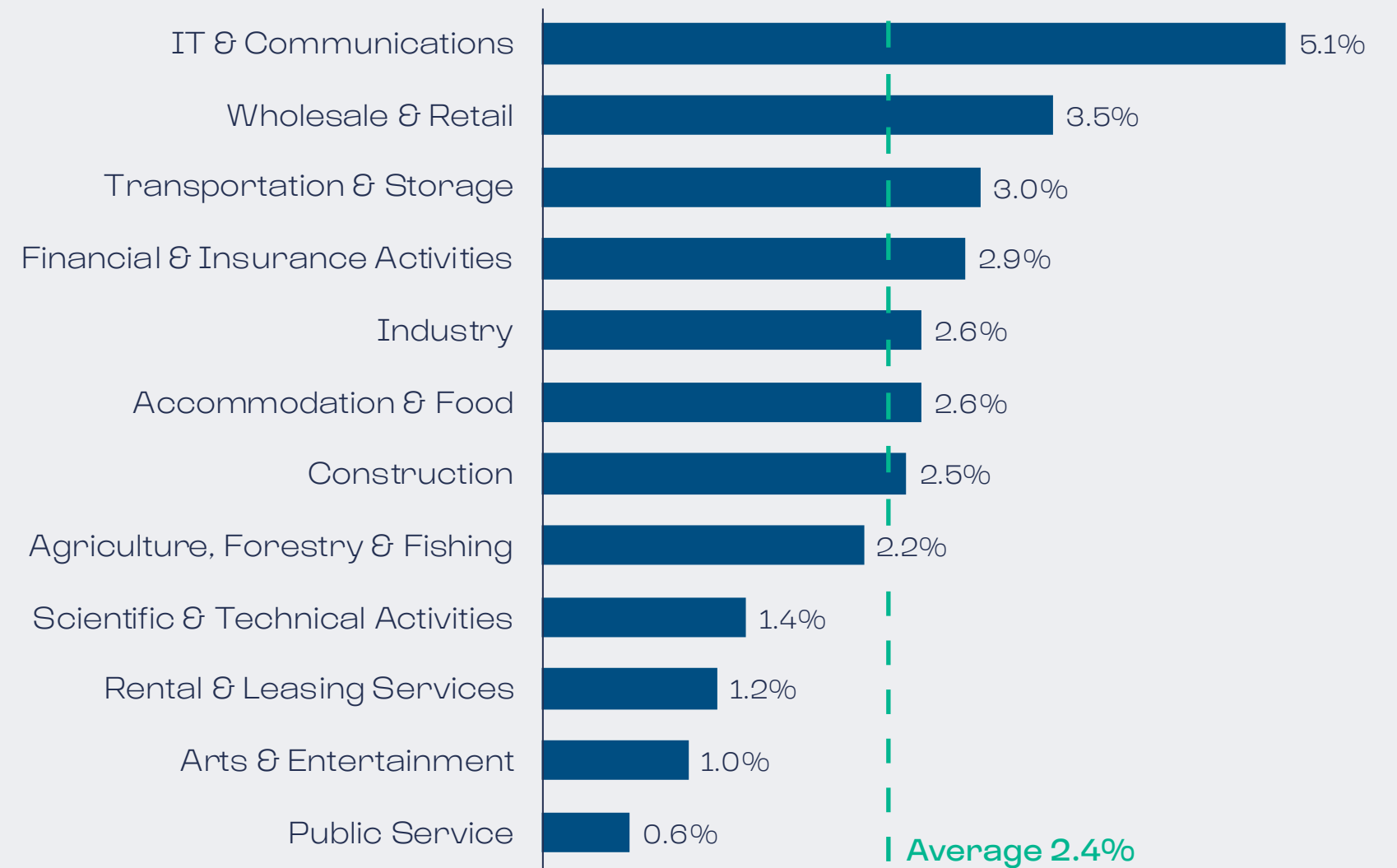
Constant prices (PPP), 2010 USD



¹ 2019 or latest available i.e. NOR, DNK, ISL and EU are 2019 figures but SWE, FIN and GBR are 2018 figures.
Sources: Central Bank of Iceland (CBI); OECD; Statistics Iceland

Productivity changes by industry

Compound annual growth rates, 2008–2019



As for GDP growth, productivity growth is expected to bounce back in 2021

Iceland has experienced a relatively strong productivity growth over the last decade, peaking at a 3.5% increase in GDP per hour worked in 2016. For the first time since 2010, however, productivity growth turned negative in 2019 at -0.6%. The CBI, forecasting zero growth in 2020,

expects productivity growth to resume gradually in 2021.

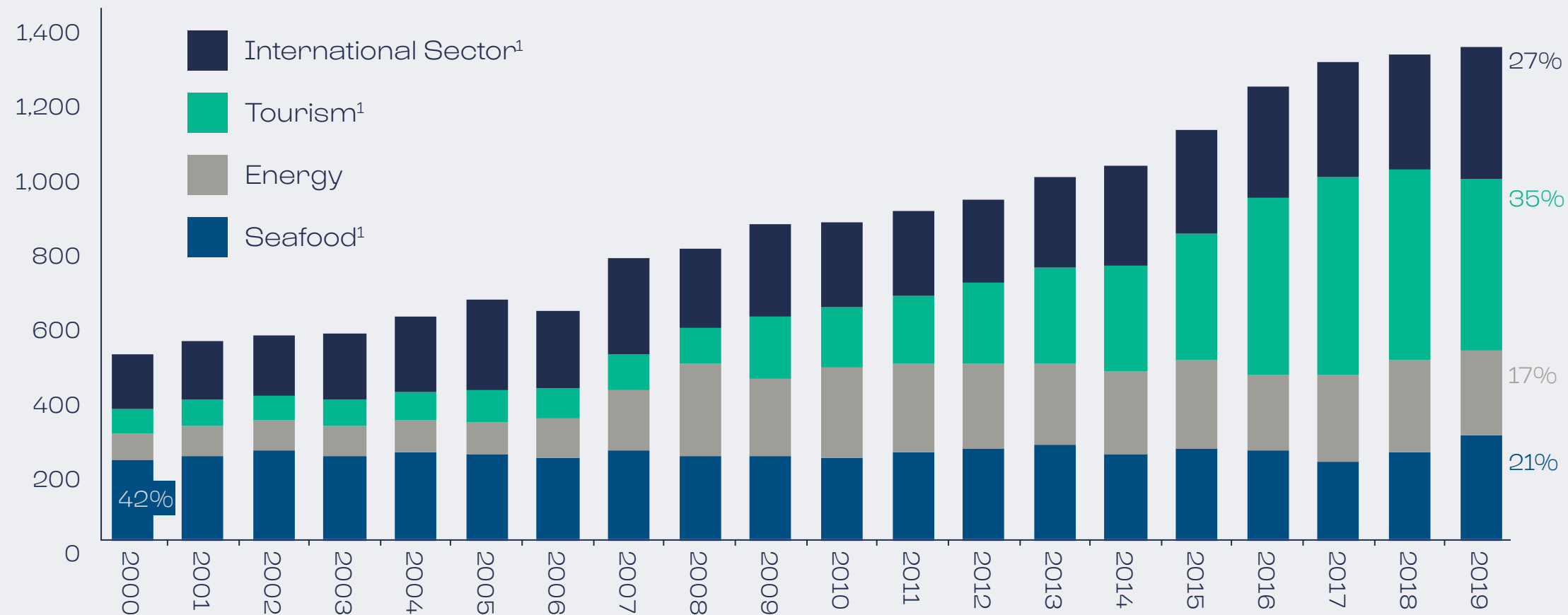
In relative terms, Iceland's GDP per hour worked is slightly above the average European level but slightly below levels in other Nordic countries, with the exception of Finland. On an industry level,

productivity has recently grown most in industries affected by tourism and technological improvements while those lagging behind are rental and leasing activities, arts and entertainment activities and the public sector.

Seeking new export revenues

Tourism fuelled a rapid post-financial crisis recovery – but with the largest export sector hurt, others must step-up

Iceland's exports¹ and exchange rate² developments



After decades of bringing in the bulk of Iceland's exports revenues, seafood no longer holds the crown for Iceland's largest export sector.

The eruption of Eyjafjallajökull in 2010 brought substantial news coverage on Iceland all over the world, which was a turning point that started a decade-long growth in tourist arrivals and amid which tourism weight in total exports went from 19% in 2010 to as high as 42% in 2017.

This period of substantial increase in export revenues brought an appreciation of the Króna, which made Iceland one of the most expensive tourist destinations in the world. Since 2017, tourism activity has decreased and the currency has lost ground, which should help tourism, and other exports, rebound after COVID-19.

However, as the tourism sector suffers a hit that could last for a couple of years, Iceland's valuable natural resources and human capital will play a key role in developing new sustainable export revenues that match the environmental requirements of the future.



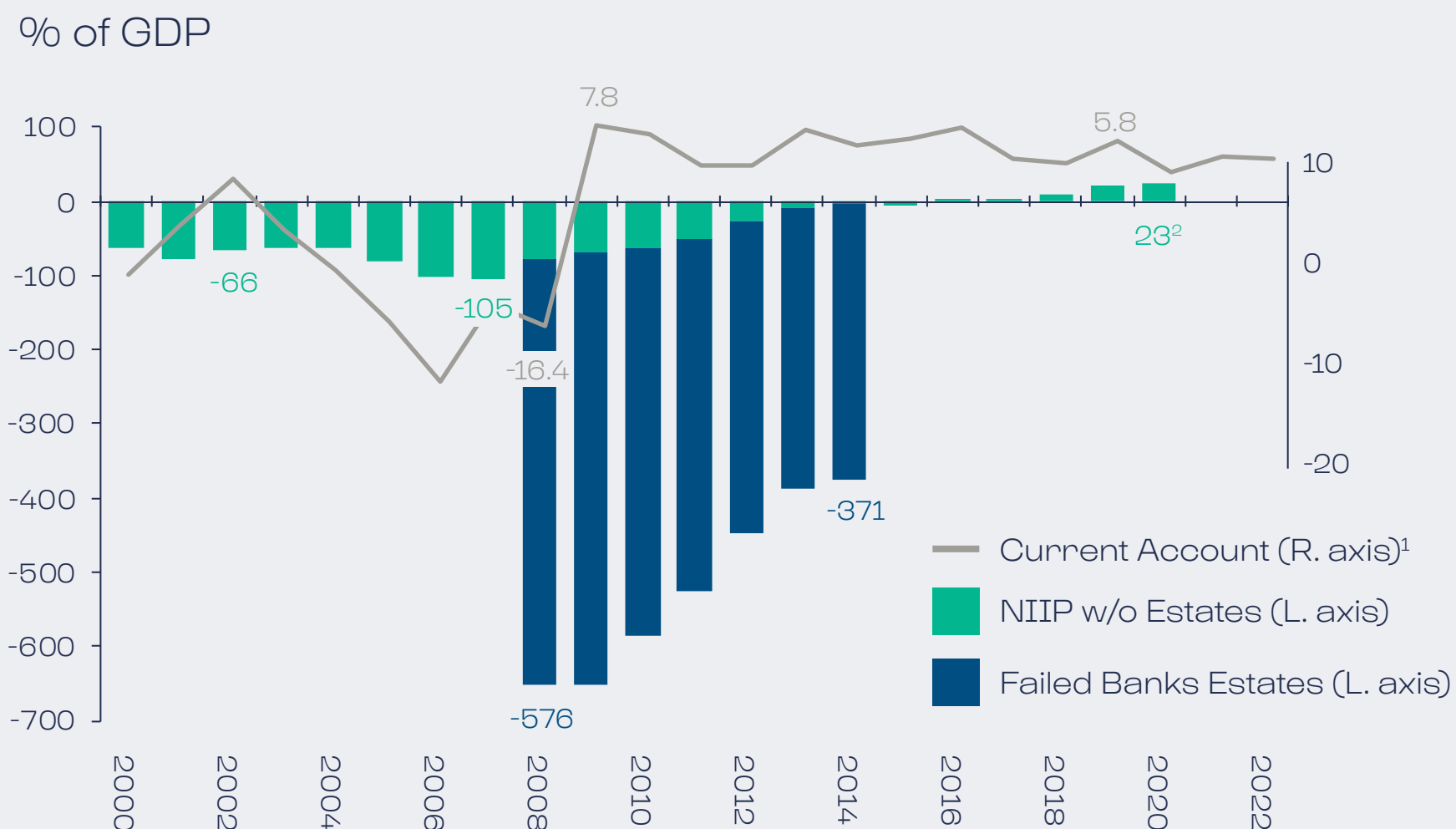
¹ Total exports in real terms by sector, billions ISK. All air transport is included in the tourism sector whereas 50% of passenger transport by air is usually included in the international sector in Chamber analysis. The significant rise in seafood exports in 2019 is largely explained by a 89% year on year increase in aquaculture exports.

² Inversed values, normalised at EURISK's initial value. A higher value indicates a weaker Króna.

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

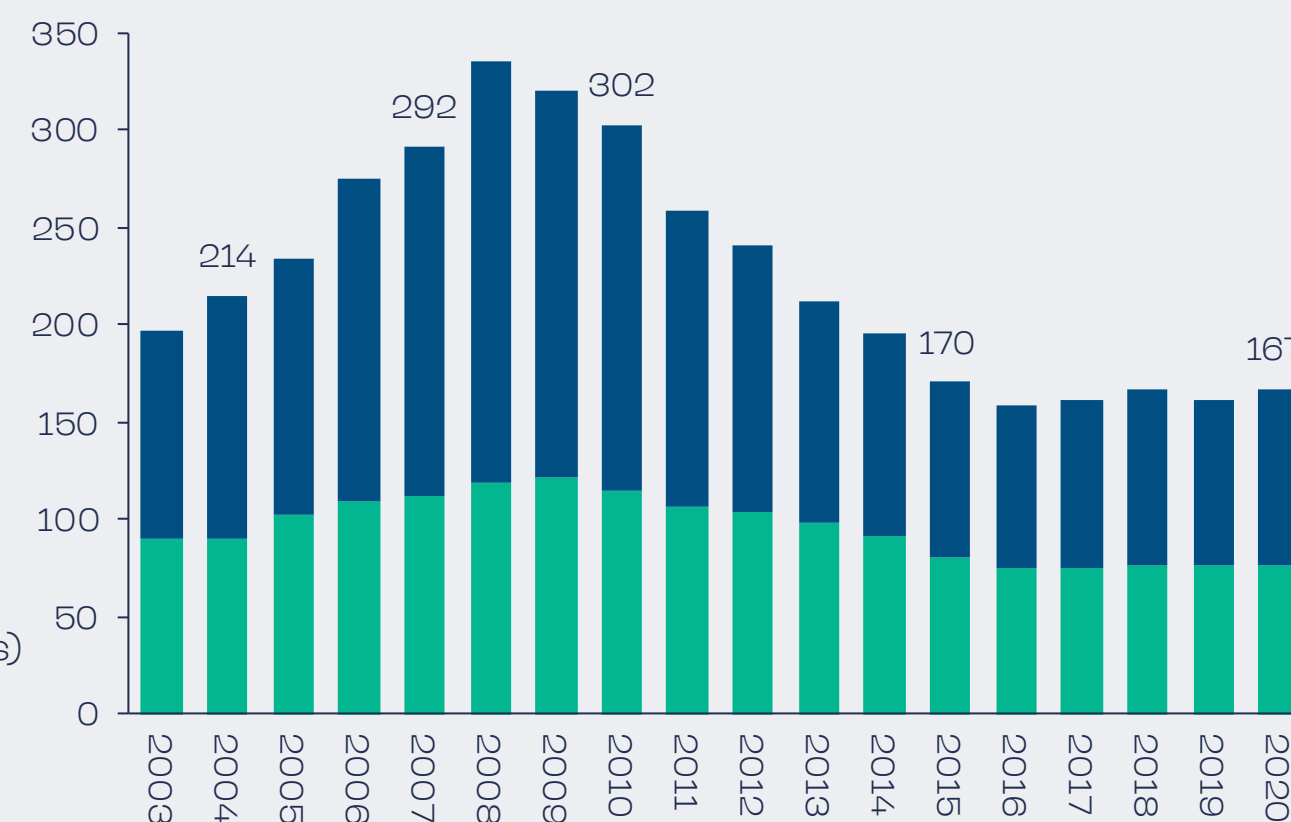
Iceland as a net lender to the world

Iceland net international investment position (NIIP) and current account balance



Corporate and household debt

% of GDP



1 Values for 2020-2022 are forecasted by the Central Bank of Iceland. 2 Data for Q1 2020.

Sources: Central Bank of Iceland (Economic Indicators June 2020 and Monetary Bulletin 2020/3); Iceland Chamber of Commerce; Statistics Iceland

Remarkable reversals in Iceland's external position and debt levels have led to a more sustainable economic model

In the 2008 crisis, the devaluation of the Króna caused a significant improvement in net exports and Iceland's current account turned into a then rarely experienced surplus. Led by the strong tourism-

driven recovery, the surplus has been maintained, helping Iceland transform into a net lender to the rest of the world (positive NIIP). Tourism, other exports and the devaluation played a major role but the key to a transformed NIIP was the stability contributions settlement between the Icelandic government and the failed banks' estates, struck in 2015. The

settlement eliminated the balance of payment risk associated with the estates and allowed the government to reduce external debt (20.6% of GDP in 2013; 9.8% of GDP in July 2020) and improve its credit rating. The private sector, especially corporations, also exploited the upswing to successfully pay down debt but low debt burdens have played a pivotal

role in Iceland's response to the COVID-19 crisis by allowing households, corporations and the government to fund revenue shortfalls with debt (if needed). Going forward, the maintenance of sustainable debt levels will be crucial in stabilising prices, the exchange rate and the overall economy.

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1 Economic Landscape

1.3
Institutional
framework



The grand coalition

Parliamentary parties

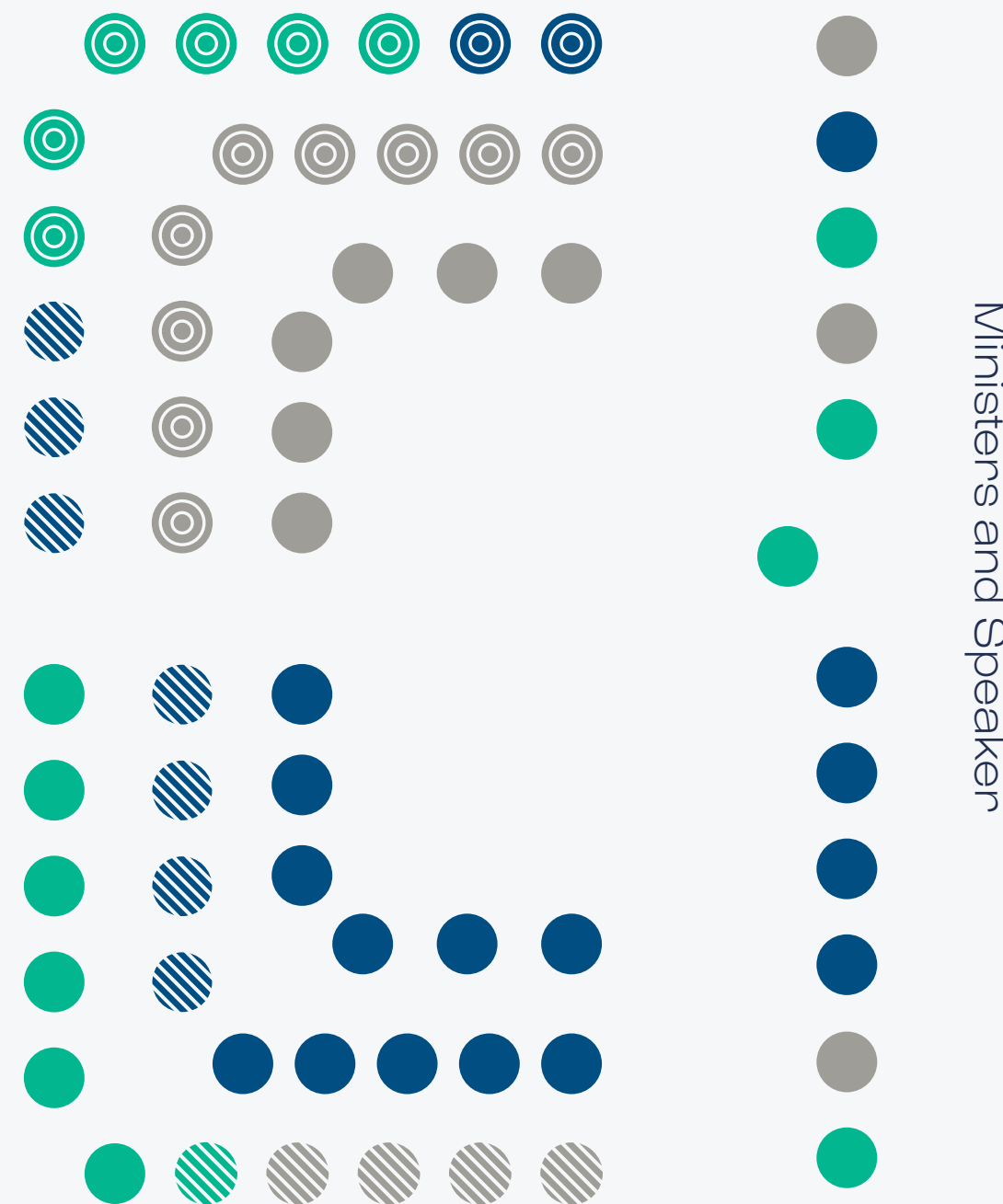
Majority

-  Independence Party
-  Progressive Party
-  Left Green Movement

Minority

-  People's Party
-  Center Party
-  Pirate Party
-  Social Democratic Alliance
-  Liberal Reform Party
-  Independent MP

Members of parliament (MP)



Ministers and Speaker

Oldest parliament in the world

Iceland is a constitutional republic with a multi-party parliamentary system. The current government was formed in November 2017 under the leadership of Prime Minister Katrín Jakobsdóttir (Left Green Movement). The government is a grand coalition in the sense that it spans the political spectrum from left to right. It consists of three of the eight parties that are represented in parliament. At the time of its formation it was the third government to hold power in two years. Regaining political stability was therefore one of the priorities of the governing parties.

The government's agenda stresses social and economic stability in addition to promoting innovation, gender equality and environmental protection. However, the COVID-19 crisis thwarted the governments fiscal and policy plans as from March, most if not all government actions were emergency responses to the public health and economic threats to the country.

Municipalities at a glance

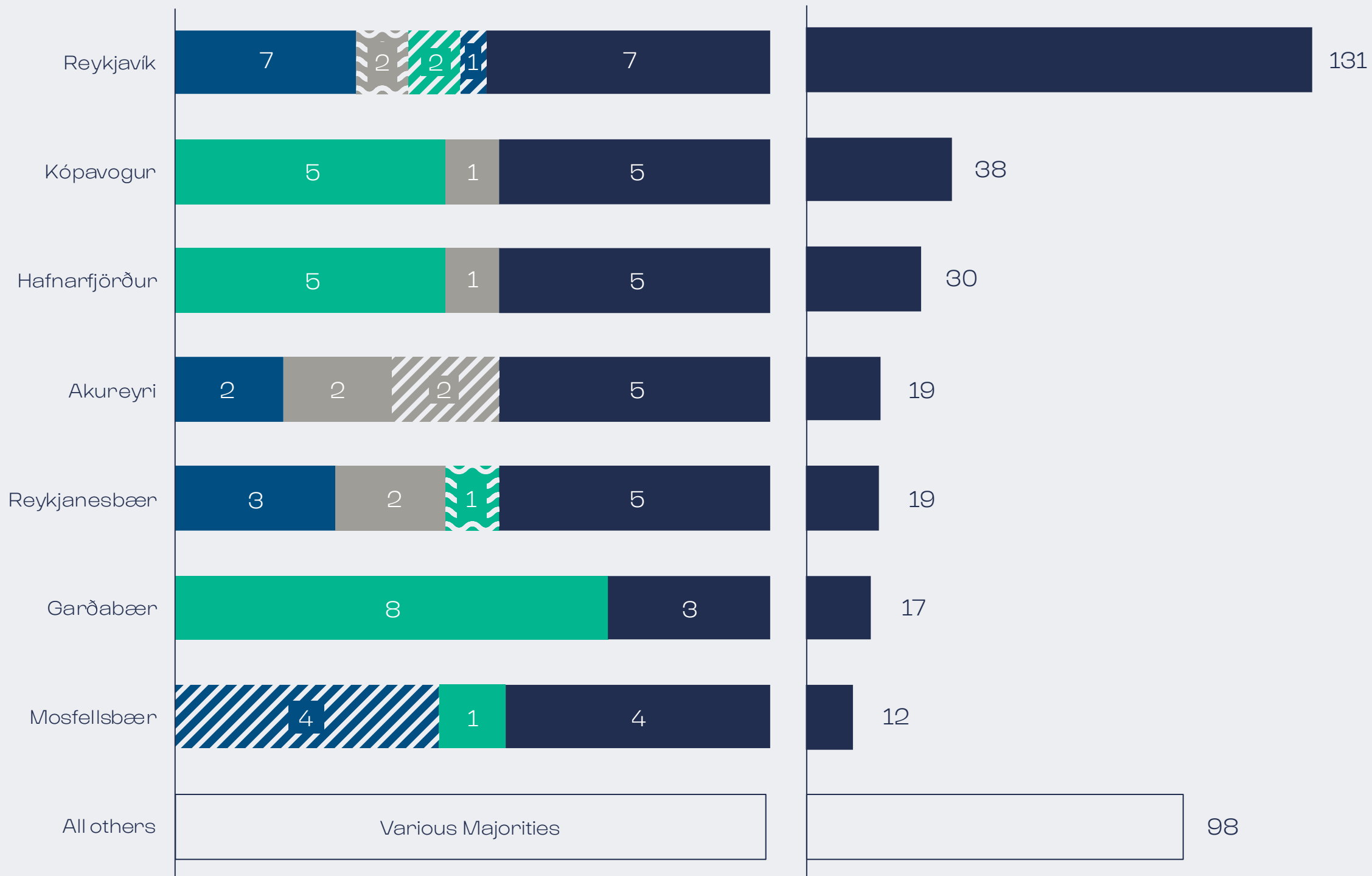
Iceland's municipalities

Majorities in municipal councils and population of municipalities



Council seats by party

Population (thousands)



1 S – Social Democratic Alliance, C – Reform Party, D – Independence Party, P – Pirate Party, V – Left Green Movement, B – Progressive Party, L – L-list, Y – Direct Way.

Just shy of 75% of the population lives in the seven largest municipalities of Iceland

Major revenue sources

- Personal income tax
- Property taxes
- Municipalities equalization fund
- Service fees

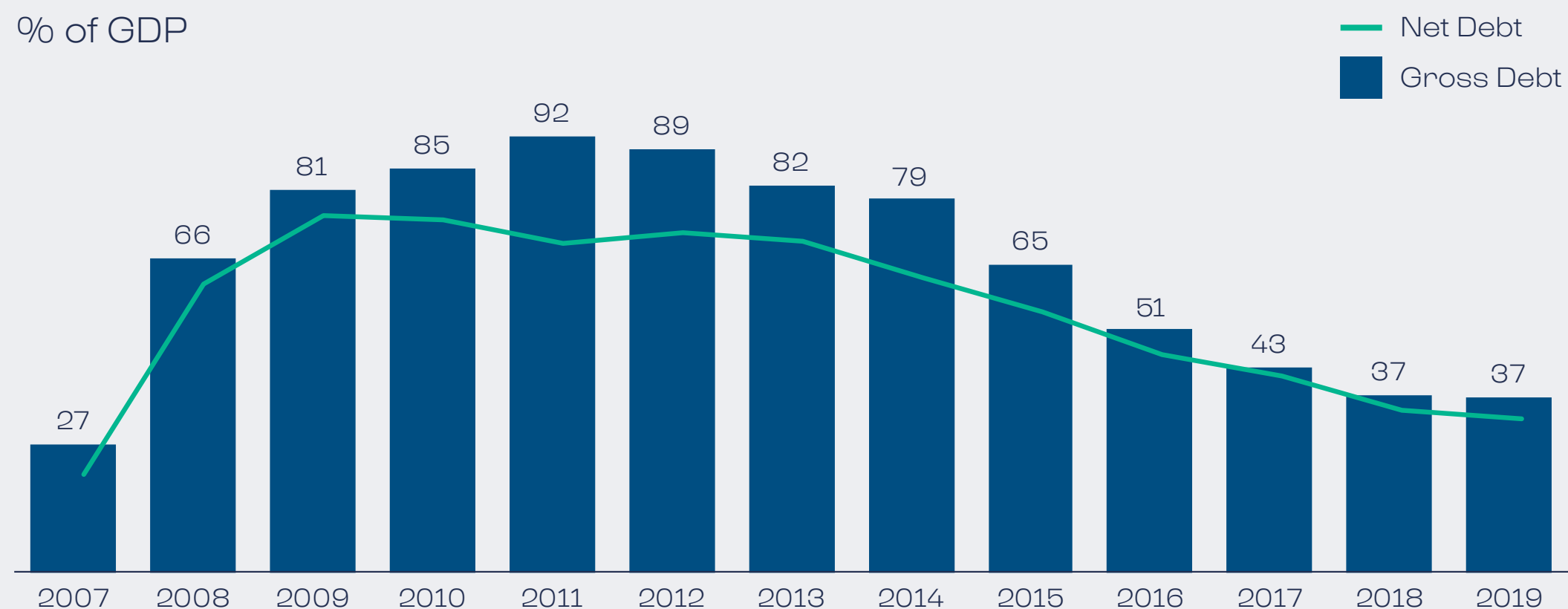
Major operating expenses

- Primary schools
- Kindergartens
- Social services
- Service fees
- Waste management
- Public housing
- General governance
- Public transportation
- Fire protection

The story of declining debt comes to an end

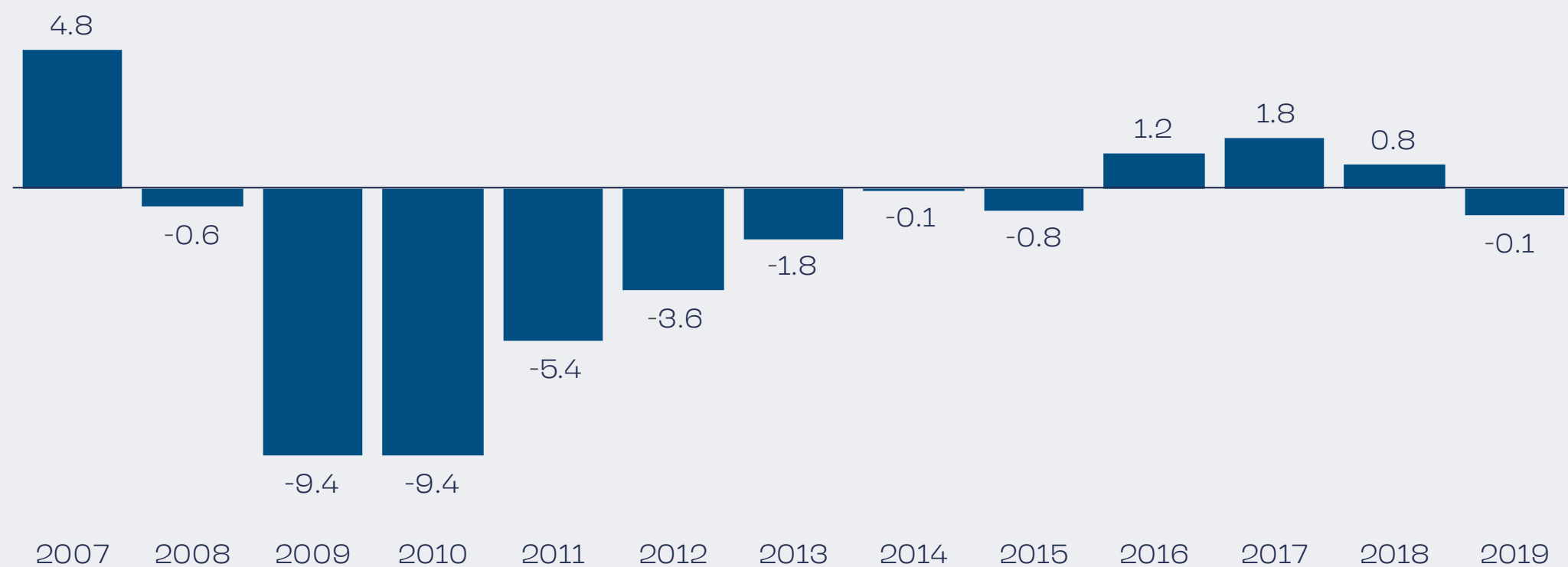
General government debt

% of GDP



General government balance

% of GDP



Sources: Central Bank of Iceland (Economic Indicators June 2020); Iceland Chamber of Commerce

Major fiscal policy changes

General government debt has been declining since gross debt hit a high of 92% of GDP in 2011 but in 2019 gross debt amounted to just 37% of GDP. The large decline is a result of a growing economy but also of prudent fiscal policies. In fact, government finances and fiscal policies have undergone major changes and improvements, mainly due to an act on public finances passed in 2015. The act entails a 5-year fiscal policy statement and fiscal plan, and numerical benchmarks on public debt and surplus/deficit.

As a result, the government has had a surplus balance in three of the last five years. This year however, government measures and cyclical effects will result in a major budget deficit and higher debt level (see chapter 3).

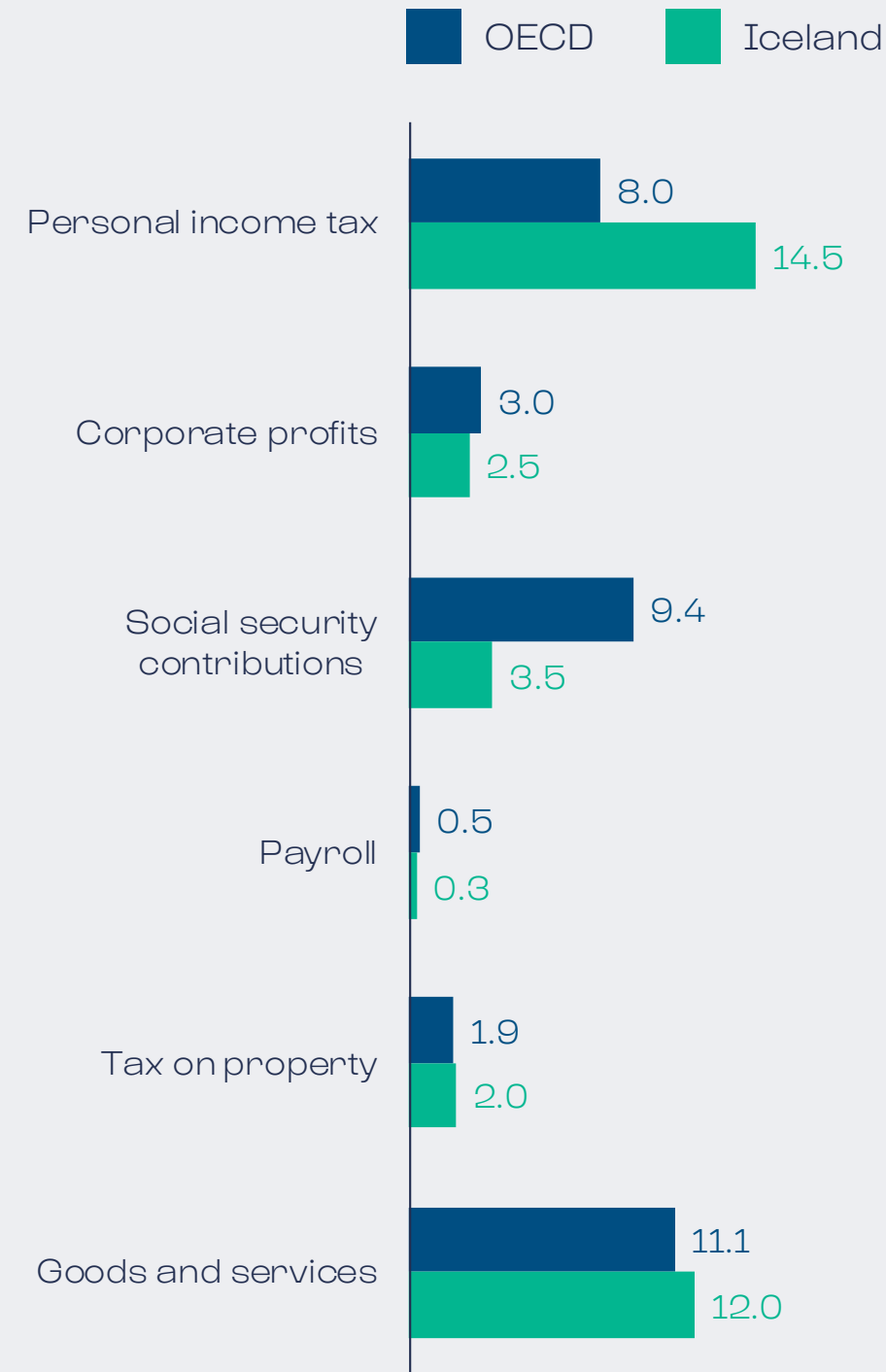
The government's income statement

No defence spending but high income taxes

Iceland's government budget is in many ways similar to other OECD countries. The budget differs in the extent of personal income taxes on the revenue side as they make up 14,5% of GDP in comparison to 8,3% for the OECD as a whole. On the expenditure side the budget represents the fact that Iceland has no military and therefore minimal expenditures on defence issues. However, Iceland spends more than the average OECD nation on culture and education. Furthermore, Iceland has a quasi-private pension system (see [chapter 2.1](#)) which affects the amount of public spending on social protection and revenues from social security relative to other OECD countries.

General government revenues

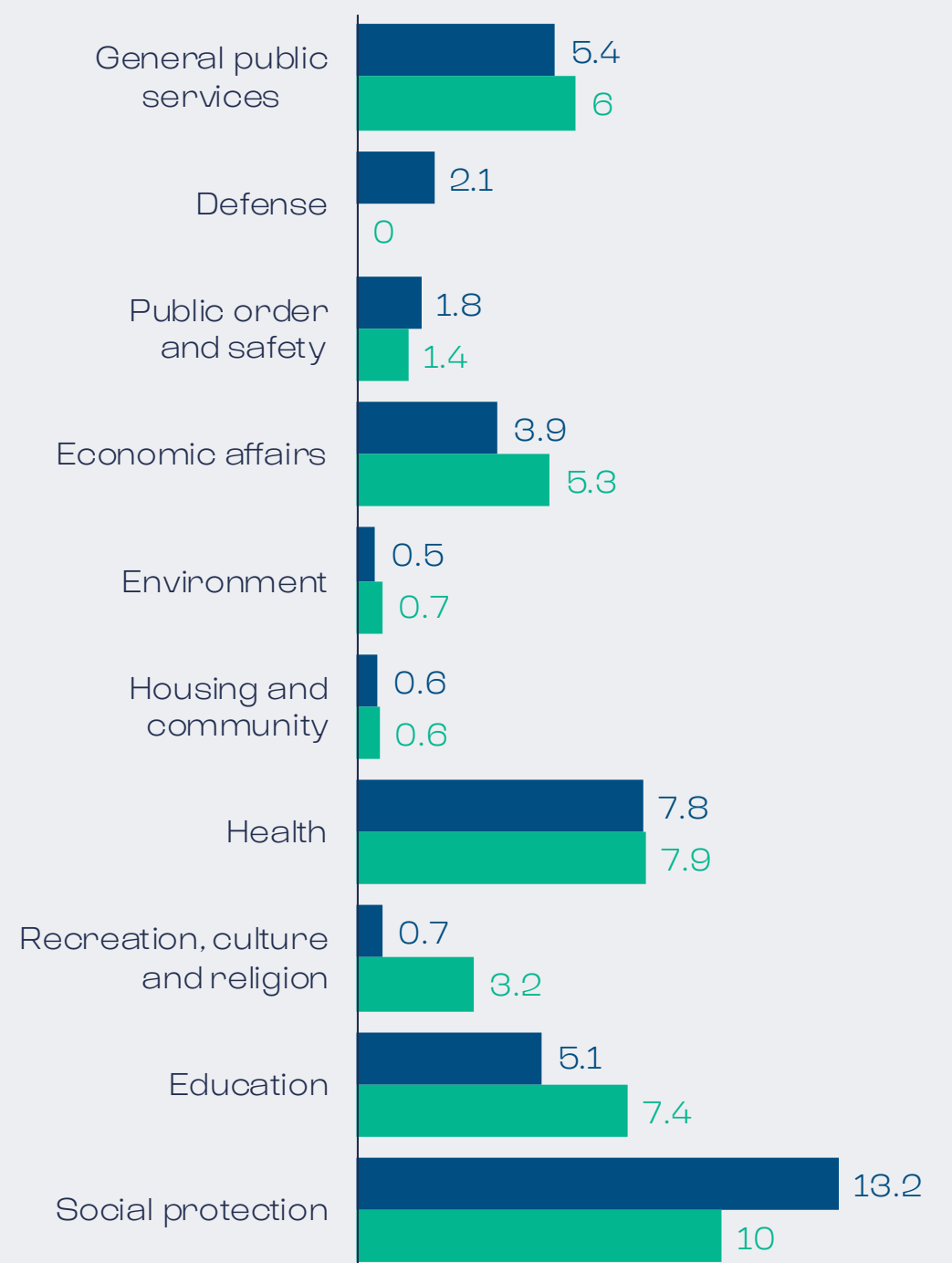
% of GDP, 2018



Sources: OECD

General government expenditures

% of GDP, 2018



The Icelandic tax system

The government's revenues rely heavily on five taxes; VAT, labour income, corporate tax, capital gains and payroll tax

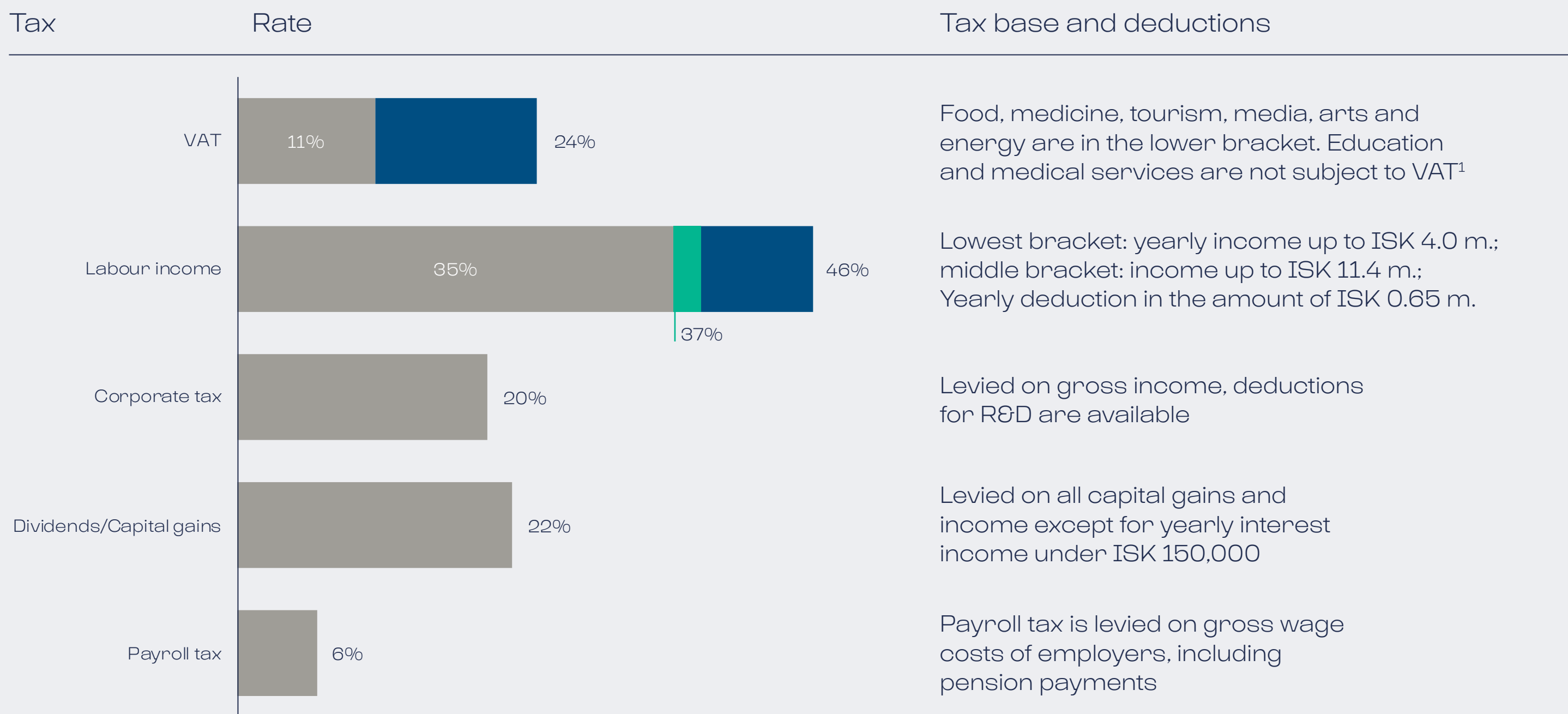
Tax revenues in Iceland amounted ISK 1,213bn in 2019, over one-third of GDP, of which 30% was municipalities' revenue that mostly consists of personal income and tax on property.

Among recent changes in the tax system was the institution of a new lowest bracket for income taxes, which lowered the effective personal income tax rate of all citizens. Also, R&D tax rebates have been increased, the payroll tax has been lowered from 6.60% to 6.35% and the special bank tax (which is levied against debt of financial institutions) of 0.376% will

from the start of 2021 decrease to 0.145%. In the government's COVID-19 response package further short term measures were also included (see chapter 3).

Key taxes in Iceland

Lower Bracket Middle Bracket Higher Bracket

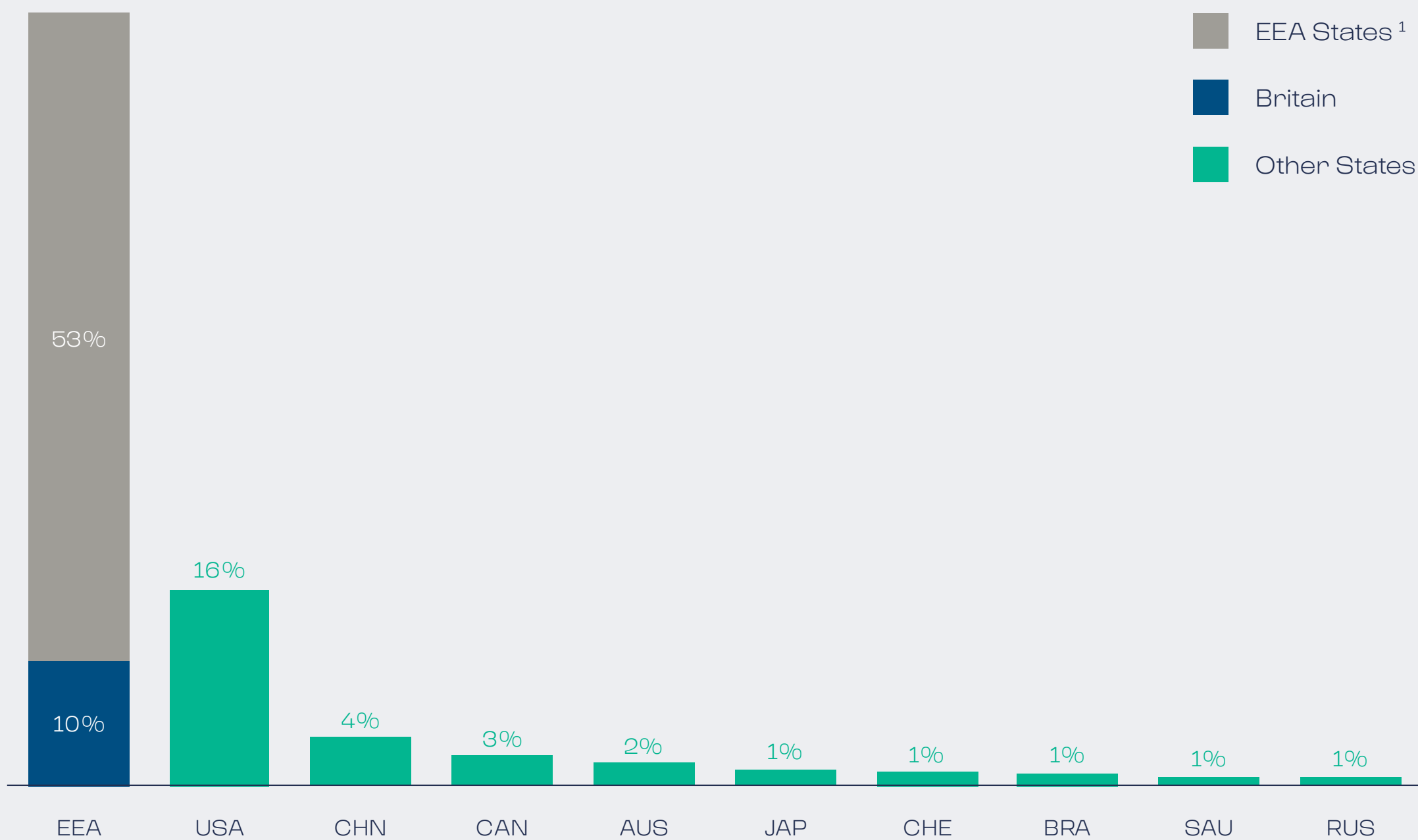


¹ These are examples, not a conclusive list of services and products subject to the lower bracket of VAT.

Strong foreign relations

Iceland's largest trading partners

% of total trade in goods and services, 2018



¹ EEA Countries are EU countries in addition to Iceland, Norway and Liechtenstein.
Sources: Iceland Chamber of Commerce; Statistics Iceland

A large majority of Iceland's trade is with European and the US

Iceland was a founding member of the North Atlantic Treaty in 1949 and has been a member ever since. It has also been a member of the European Free Trade Association (EFTA) since 1970 and entered the European Economic Agreement (EEA) in 1994. Iceland applied for a European Union membership in 2009 but after change of cabinet following the 2013 elections the application was withdrawn. Albeit the EU entrance remains controversial there is an overwhelming support for Iceland's EEA membership. At last, the country is a member of the Schengen area.

In essence, Iceland's membership in these institutions can be seen as the cornerstone of Iceland's foreign policy. That is also reflected in trade relations but Iceland's largest trading partners are by far European countries and the US.

One of the smallest currency areas in the world

A small currency...

Iceland is among the smallest countries in the world to have its own floating currency. The monetary history of Iceland is fraught with high inflation and exchange rate instability. However, over the recent years the CBI has achieved increased stability and short-term exchange volatility has been lower than in prior to 2009.

... with a large cushion

After the financial crisis of 2008 the CBI amassed large reserves of foreign currency while the Króna appreciated. These reserves have been critical in increasing the CBI's credibility and ability to combat excessive short-term fluctuations of the currency. Notably, the ISK depreciation and GDP contraction of the first half of 2020 led reserves, measured as % of GDP, to increase.

¹ FX reserves less CBI's foreign currency liabilities, i.e. FX reserves financed in ISK.

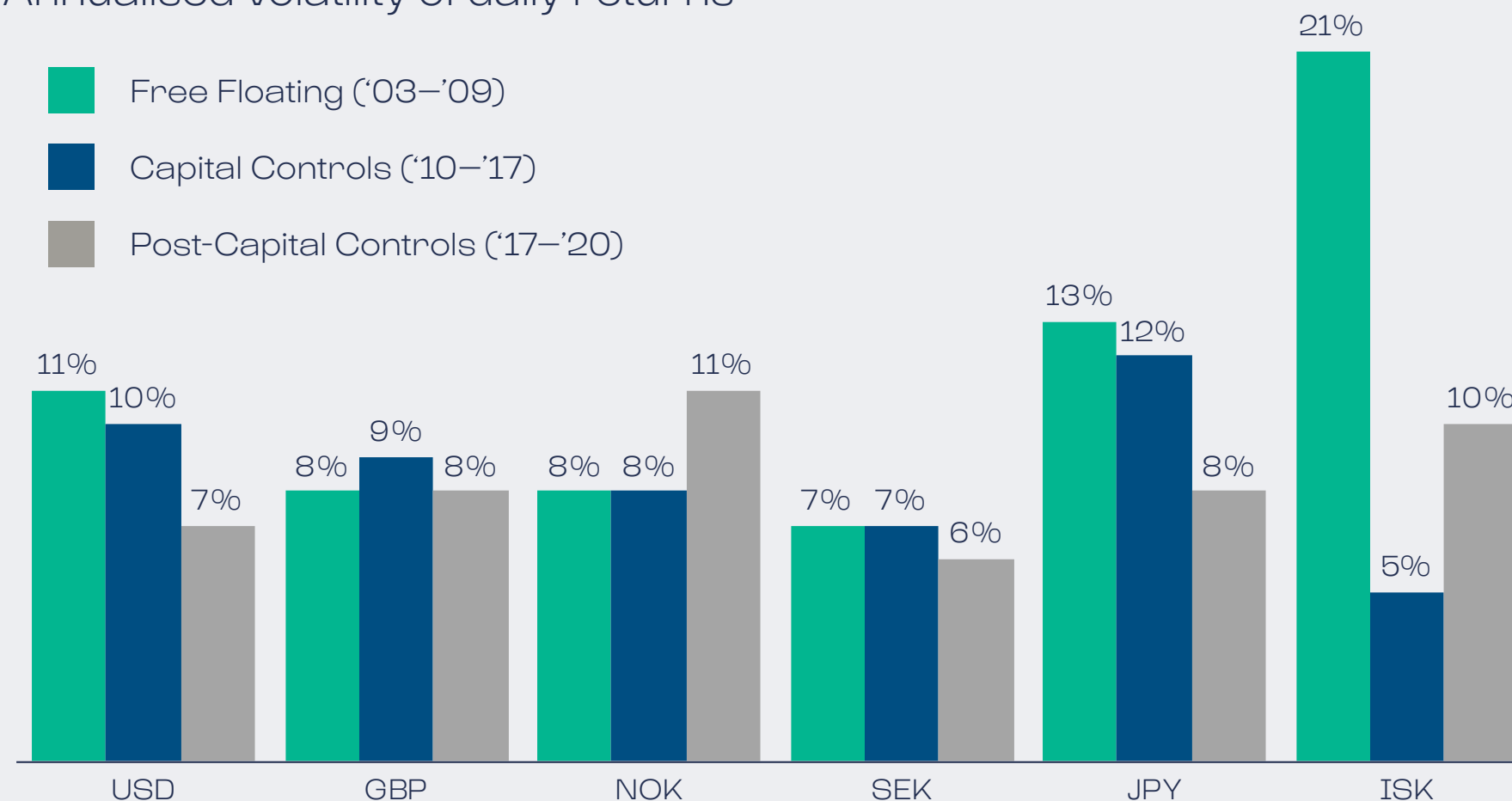
² At the end of June.

Sources: Central Bank of Iceland (CBI); Iceland Chamber of Commerce

Exchange rate fluctuations against the Euro

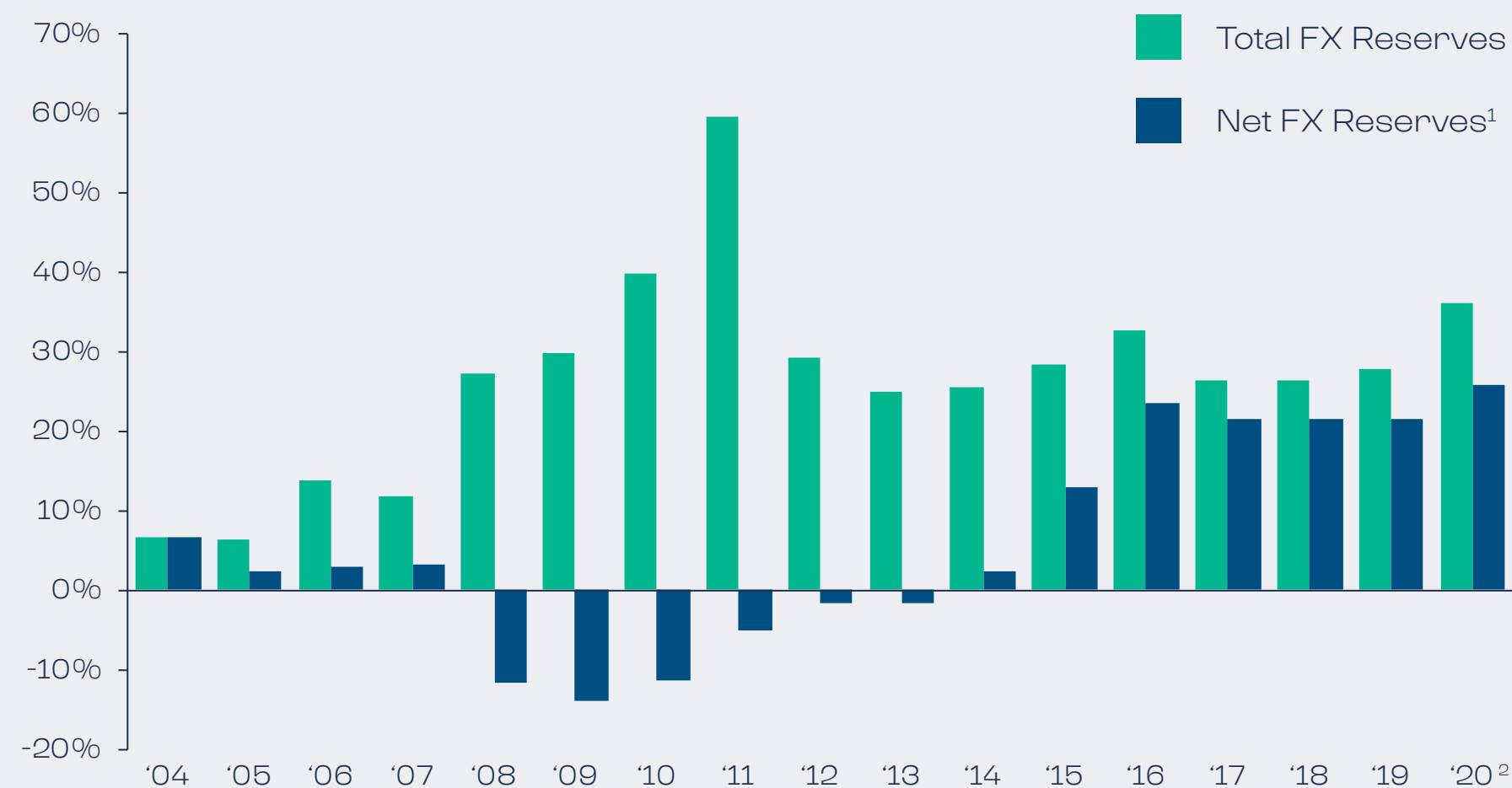
Annualised volatility of daily returns

- Free Floating ('03-'09)
- Capital Controls ('10-'17)
- Post-Capital Controls ('17-'20)



Foreign exchange reserves

% of GDP at year-end



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2 Structure of the Economy

2.1 The financial sector



Stronger banks and improved ratings

part 1/2

A transformed banking system

The Icelandic banking system consists mainly of three universal banks: Arion Bank, Íslandsbanki and Landsbankinn; and the primarily investment bank Kvika. Today, only Arion Bank and Kvika are owned by private investors and publicly listed, with the

government owning Íslandsbanki and 98% of Landsbankinn.

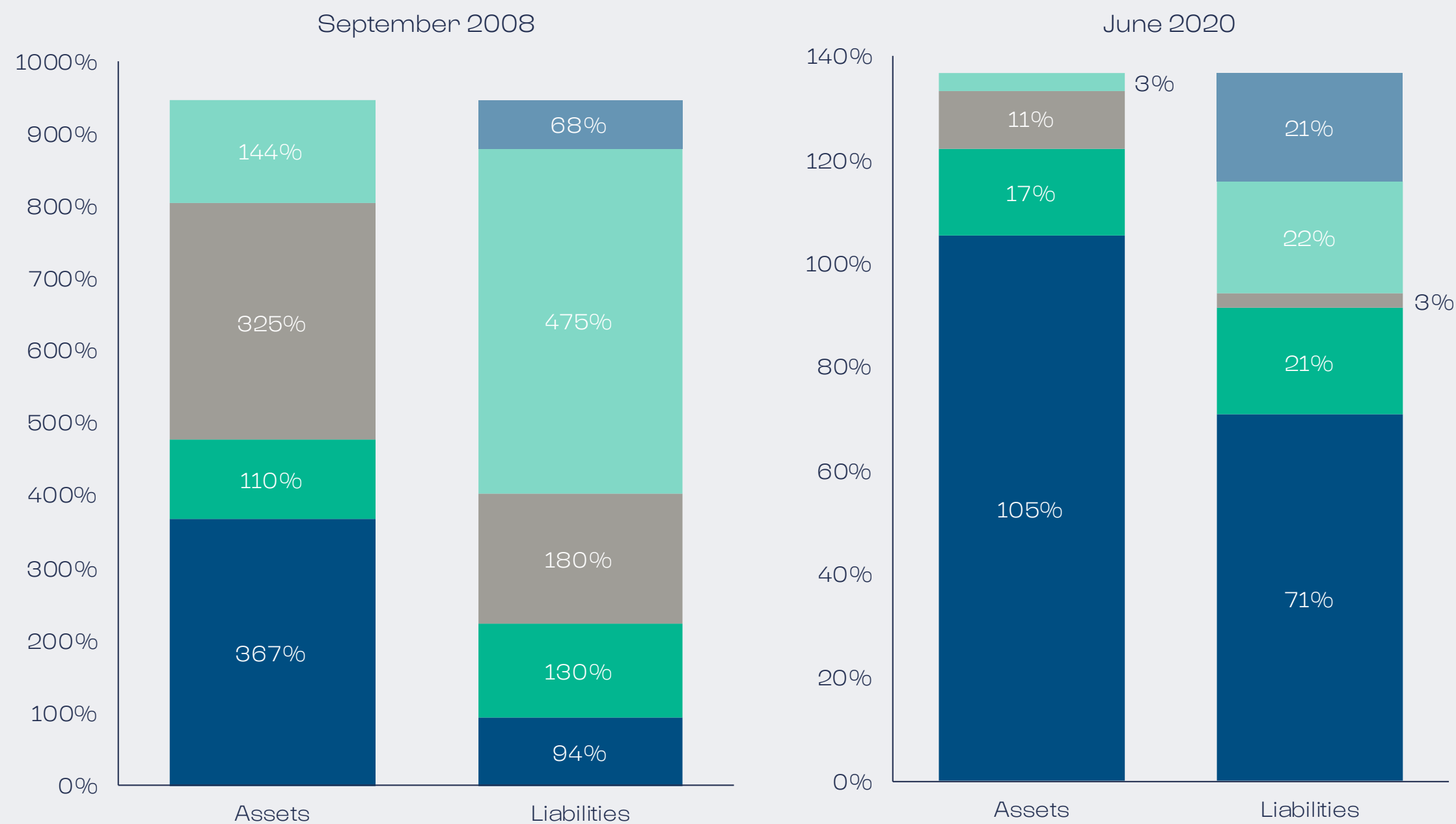
The banks balance sheets have changed enormously over the past decade as they have reduced their foreign operations and become more equity and deposit

funded. In this electoral term, the government was aiming to reduce its bank holdings in order to increase efficiency and competitiveness in the banking system but those plans had to be put on hold due to COVID-19.

Aggregated deposit-taking bank's balance sheet¹

% of GDP

- Domestic Lending/Deposits
- Other Domestic
- Foreign Lending/Deposits
- Other Foreign
- Equity



¹ Arion Bank, Íslandsbanki, Kvika, Landsbankinn, savings banks and their predecessors. Assets and liabilities are classified by location, not currency. Sources: Central Bank of Iceland; Iceland Chamber of Commerce

Stronger banks and improved ratings

part 2/2

More trust has led to lower yields

The abolishment of capital controls, strong economic growth and the improved external position of the economy have played a major role in improving Iceland's credit rating (since mid-2015 the

rating has improved from BBB- to A). The indicators driving this positive development include the strong institutional focus on avoiding vulnerabilities that led to the 2008 banking crisis and

strong government and household finances. As a result, the government's internal and external financing terms have seldom been better.

Icelandic government bond yields (ISK denominated)



1 Interest rate differential between Icelandic and German government bonds, of the same maturity, at the time of issuance of Icelandic government **EUR** bonds. Sources: Iceland Chamber of Commerce; lanamal.is; worldgovernmentbonds.com

Iceland has become more open to foreign investments

part 1/2

The Icelandic stock market

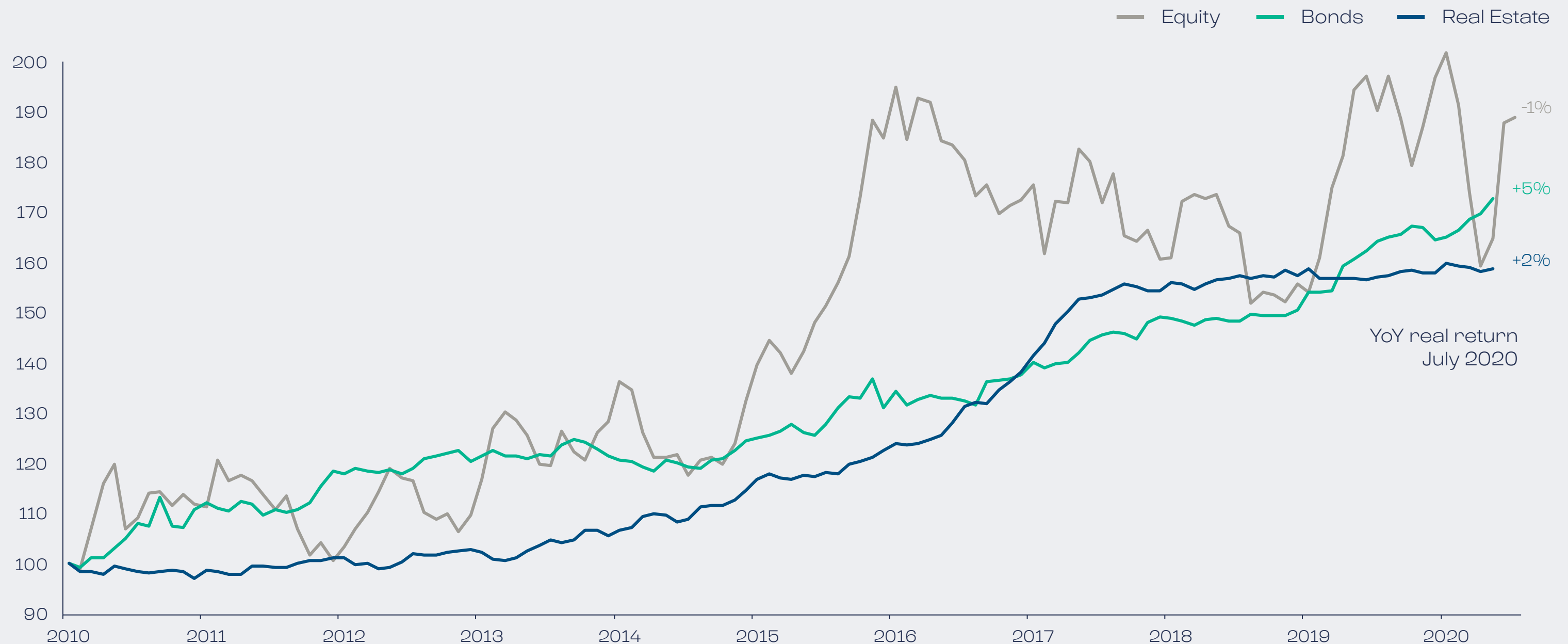
Twenty-three firms are listed on the Icelandic stock exchange (total mkt cap ISK 1,221bn; 41% of GDP). General public ownership decreased significantly after the financial crisis (4% in 2017; 11-17% in 2002-2007) and pension funds now own 48% of the listed shares with the rest split between mutual

funds and private investors. After sliding for nearly 3 years, the market had been rising before the COVID-19 fear struck in March. The uptick was driven mainly by decreasing interest rates and gains by Marel, the largest listed company. Since the March-slump, a wave of optimism and the

inclusion of MSCI Iceland Index in the MSCI Frontier Markets has fuelled a quick rebound. Declining rates have also benefitted bond prices which have increased notably since rates started descending in 2016.

Asset values

Indices, inflation adjusted, Jan. 2010=100



Sources: Iceland Chamber of Commerce; Nasdaq Iceland; Registers Iceland; Statistics Iceland

Iceland has become more open to foreign investments

part 2/2

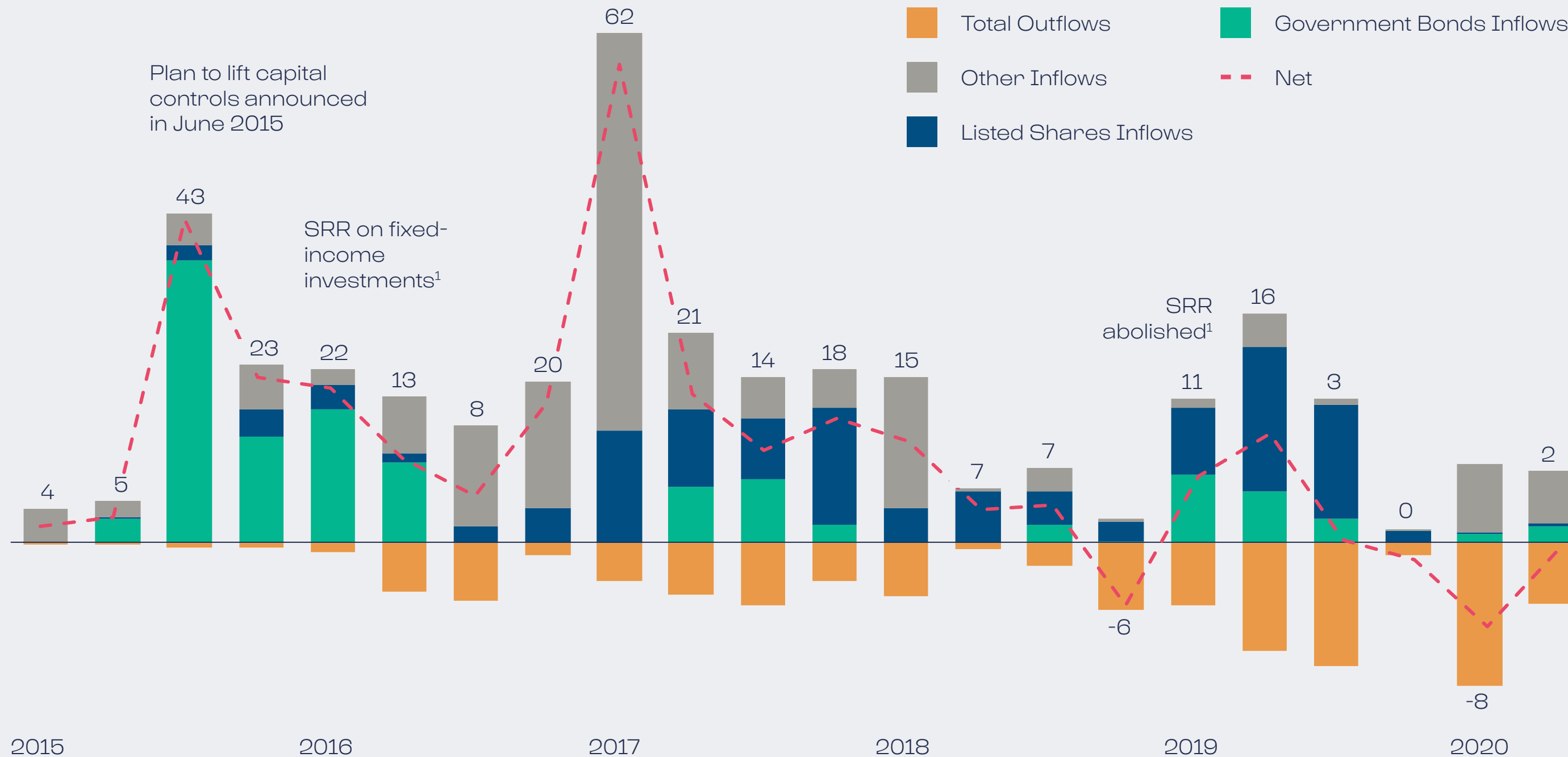
Wanted: inflow of foreign capital

Foreign investment in Iceland picked up when plans for lifting capital controls were announced but then a new capital flow instrument (SRR)¹ imposed in 2016 hampered inflows into government bonds, leaving foreign holdings at

13.5% in June 2020. After the sale of shares of Arion Bank to foreign investors in early 2017, a rise in outflows has weighted on net new investments. Last year, a significant step to re-attract foreign investment to Iceland was taken

with the abolishment of the SRR. Consequently, foreign investors can exploit a range of return-yielding opportunities without having to worry about their capital getting trapped in the CBI.

Quarterly new investment in billions ISK



1 SRR = special reserve requirement.

Sources: Iceland Chamber of Commerce; Central Bank of Iceland (CBI); Statistics Iceland

One of the best funded pension systems in the world

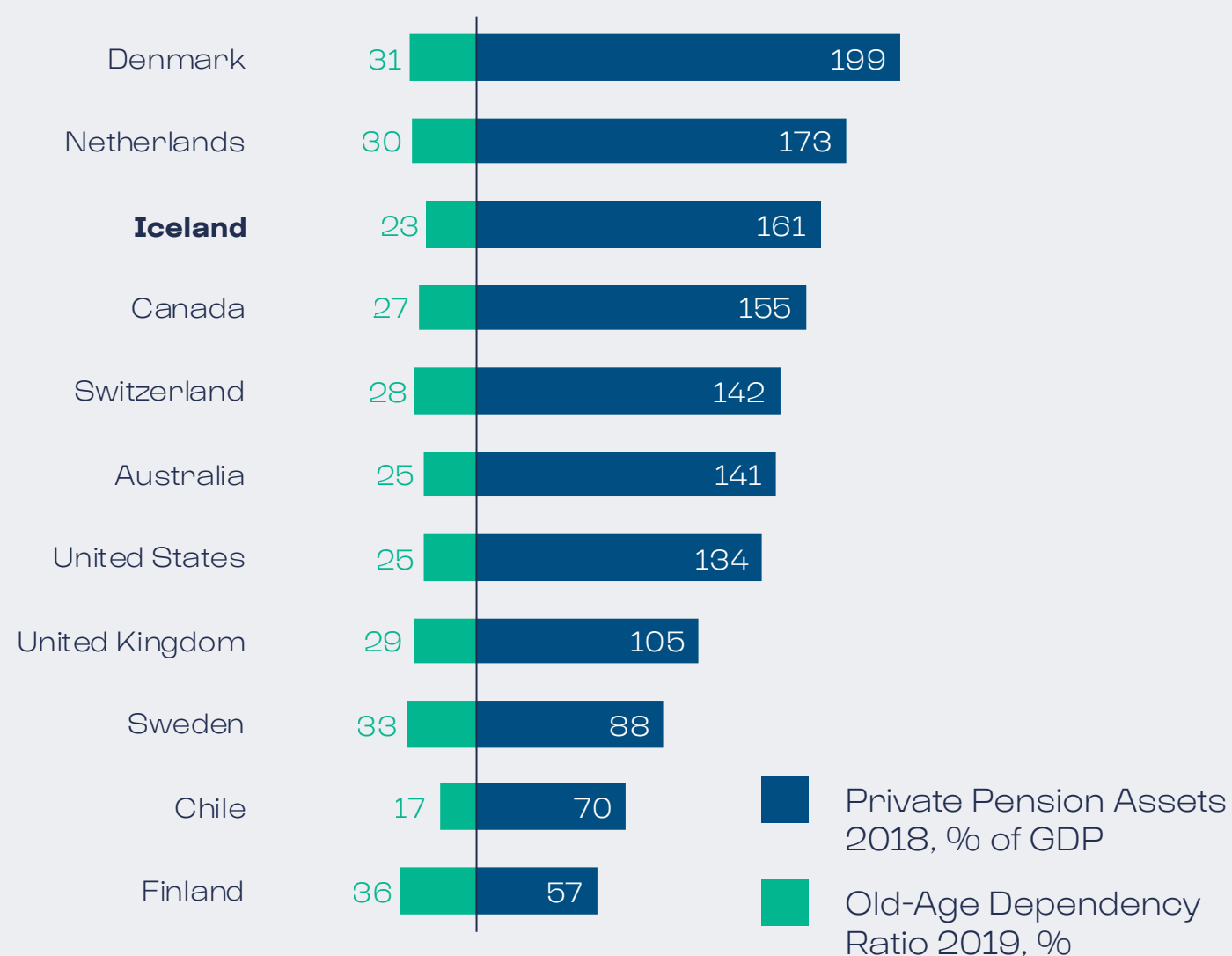
With a young population, the Icelandic pension fund system is expected to continue growing

The Icelandic pension fund system relies mostly on mandatory savings, making it fully-funded, rather than pay-as-you-go. The system consists of 28 funds where the three largest funds hold approximately half of all assets. The pension funds played a key role in kickstarting the economy

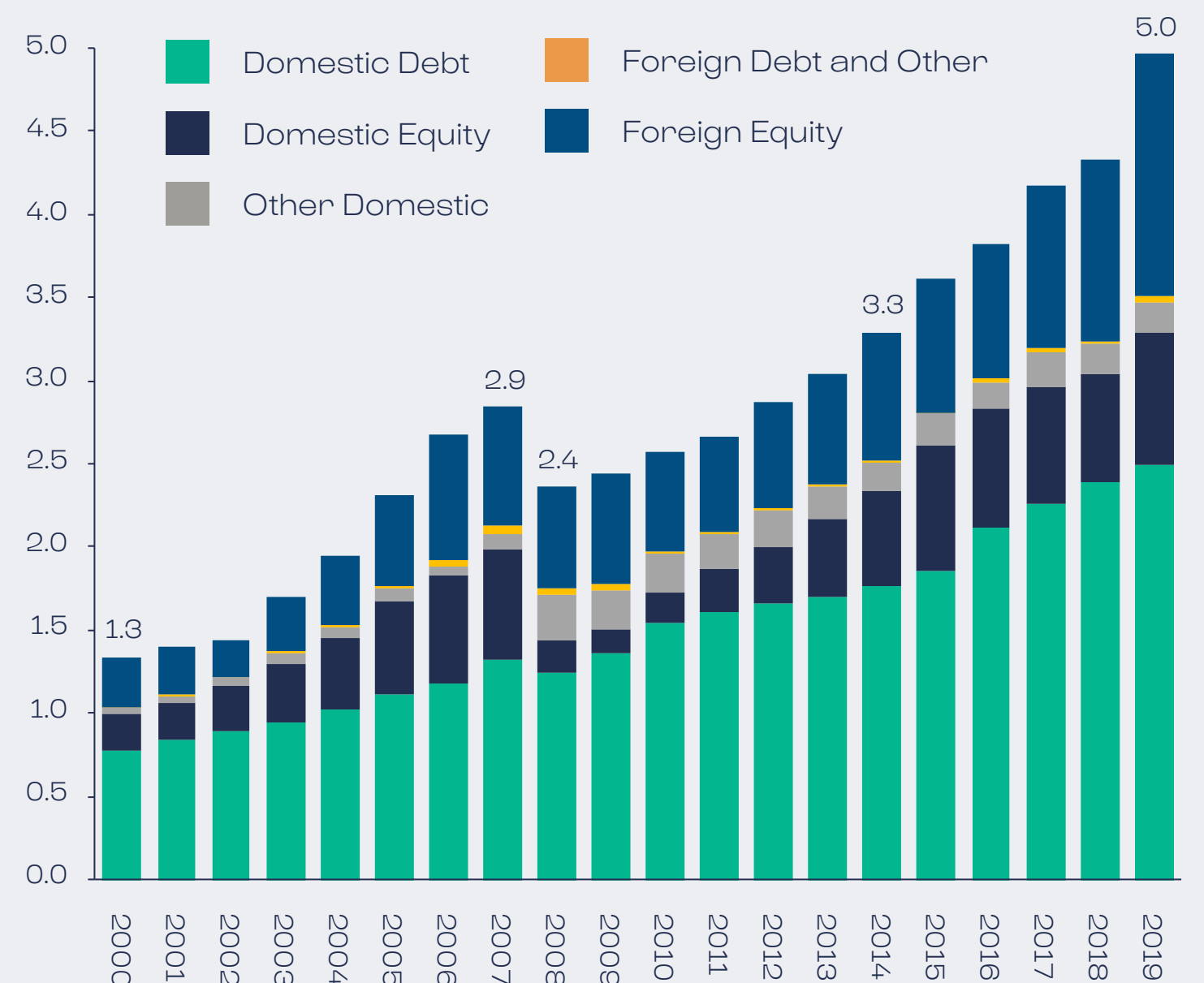
during the restructuring of many businesses after the financial crisis, and they remain prominent in most business sectors. After free capital outflows were allowed in March 2017, the pension funds were able to diversify their portfolios abroad. The CBI estimates that the pension funds invested ISK 120bn (4% of GDP) abroad in 2019. Despite having few investment options while restricted to the local economy, the funds

have good historical returns on investments. From 2010-2015 the real average return was 5.7%, beating the OECD average of 3.6%, and in 2019 returns averaged 12%, substantially above the 3.5% discount rate of pension benefits. However, maintaining returns of 3.5% or higher in a low interest rate environment remains a big challenge for the funds.

Pension statistics



Pension funds' total assets in billions ISK at 2019 prices



Sources: Central Bank of Iceland (CBI); Iceland Chamber of Commerce; OECD Global Pension Statistics; World Bank; Statistics Iceland

The Icelandic housing market – where demand dominates supply

House prices have in real terms reached historical heights and supply is yet to catch up with demand

Over the last decade housing prices have risen significantly, especially over the period 2015-2017 when demand pressures (rising incomes, booming tourism and population growth) once again conquered supply which has been lagging far behind housing demand since 2011 as

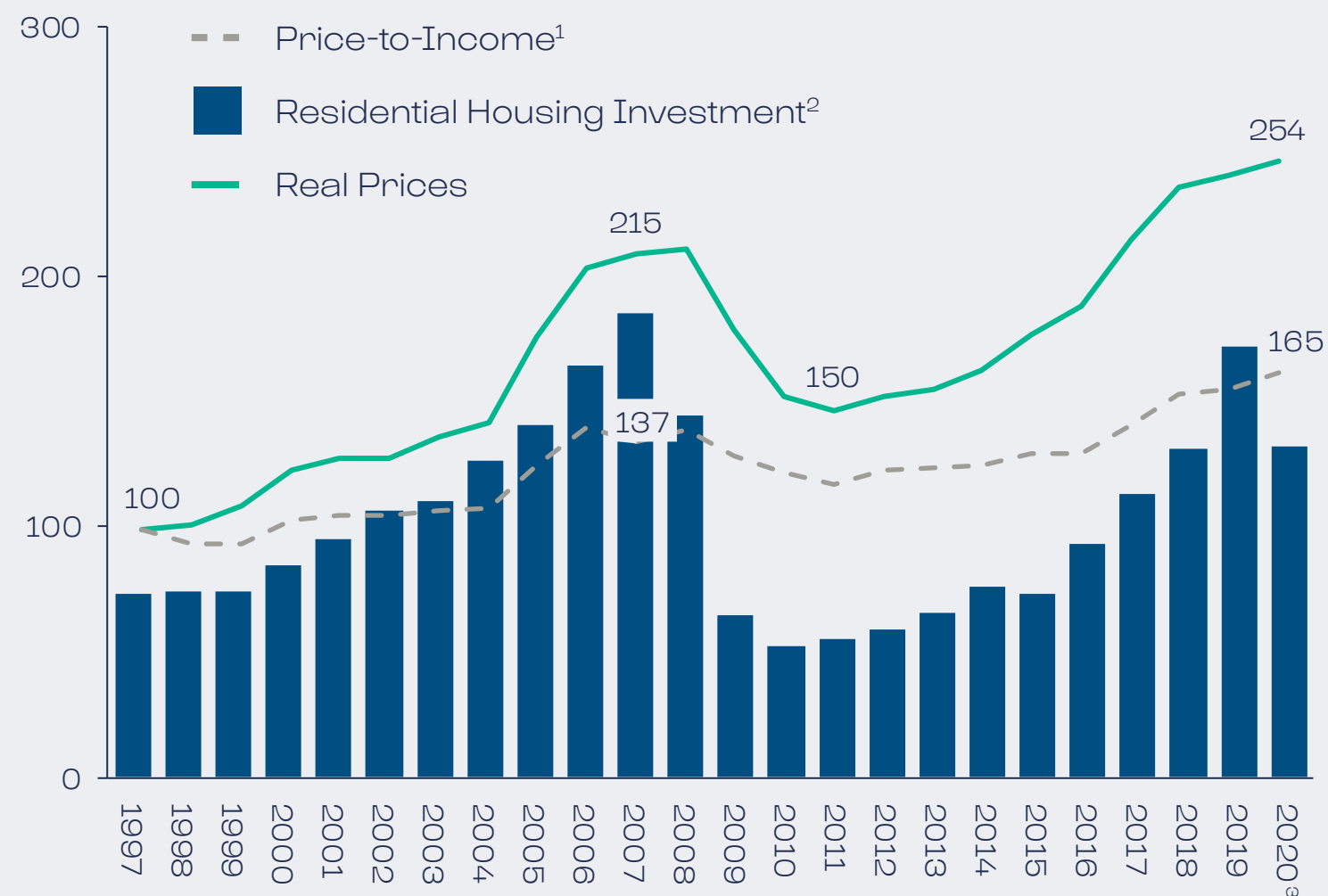
the continuous excess growth of population over housing units shows.

The price surges peaked in May 2017 when the year-on-year increases in Greater Reykjavík reached 24%. Since then the market has levelled off with the economy cooling down and more new housing entering the market. In combination, the rise in unemployment and collapse in tourism, including Airbnb rentals,

are weighing against price hikes. However, mortgage interest rates have fallen rapidly which should, other things being equal, lead to a stronger demand and higher prices. Regardless of short- and medium-term price fluctuations, the relatively young age of the population will continue to increase demand over the next decades (population growth will be 13% over the next 20 years according to Statistics Iceland).

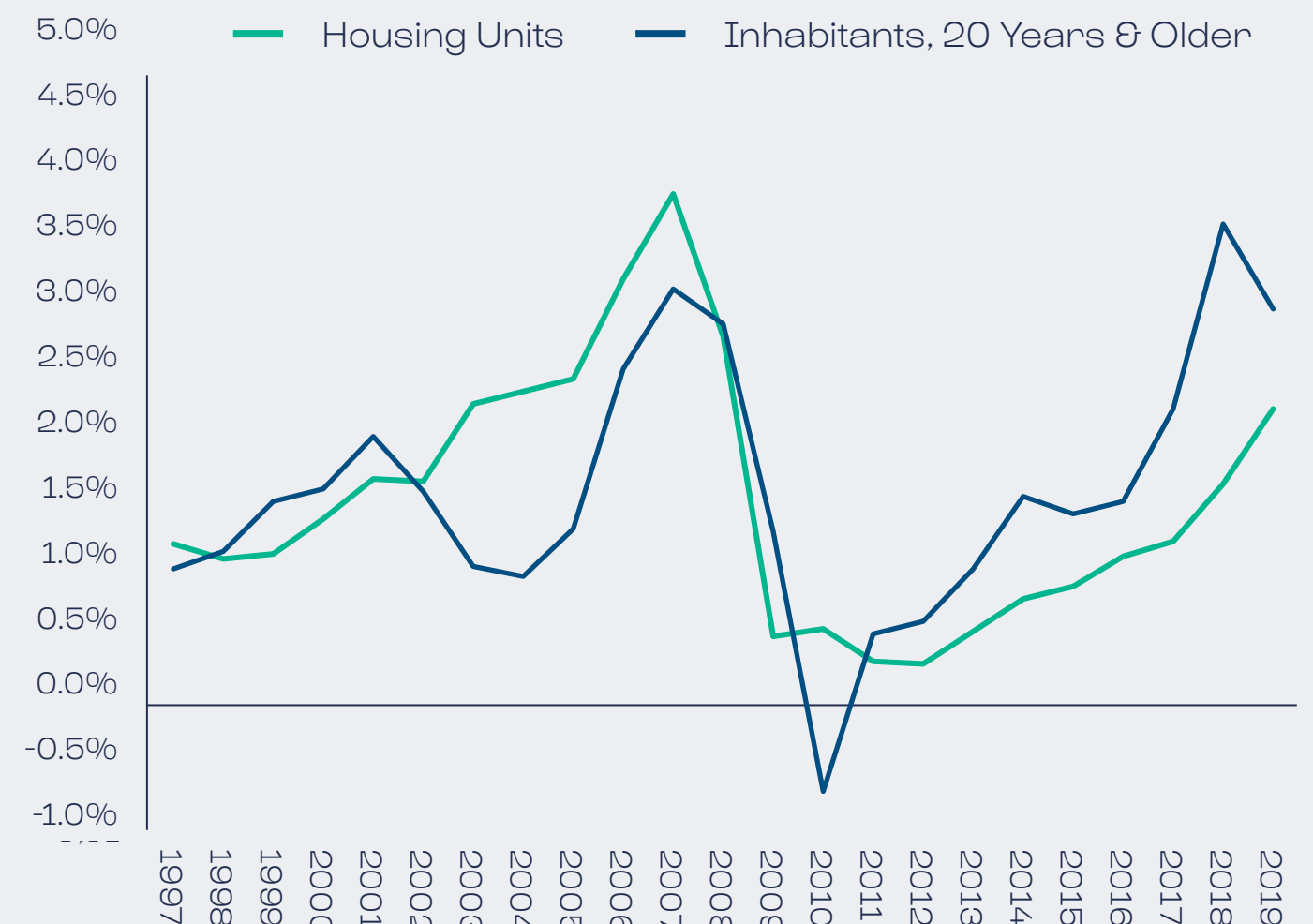
Housing prices and investment

Indices (Jan. 97=100) until May 2020 and billions ISK



Population and housing growth

YoY % change



1 Housing prices/disposable income per capita. 2 Billions ISK at 2020 prices. 3 CPI and housing prices for July 2020, investment and income based on CBI's forecast. Sources: Central Bank of Iceland (CBI) (Monetary Bulletin 2020/2); Registers Iceland; Iceland Chamber of Commerce; Statistics Iceland



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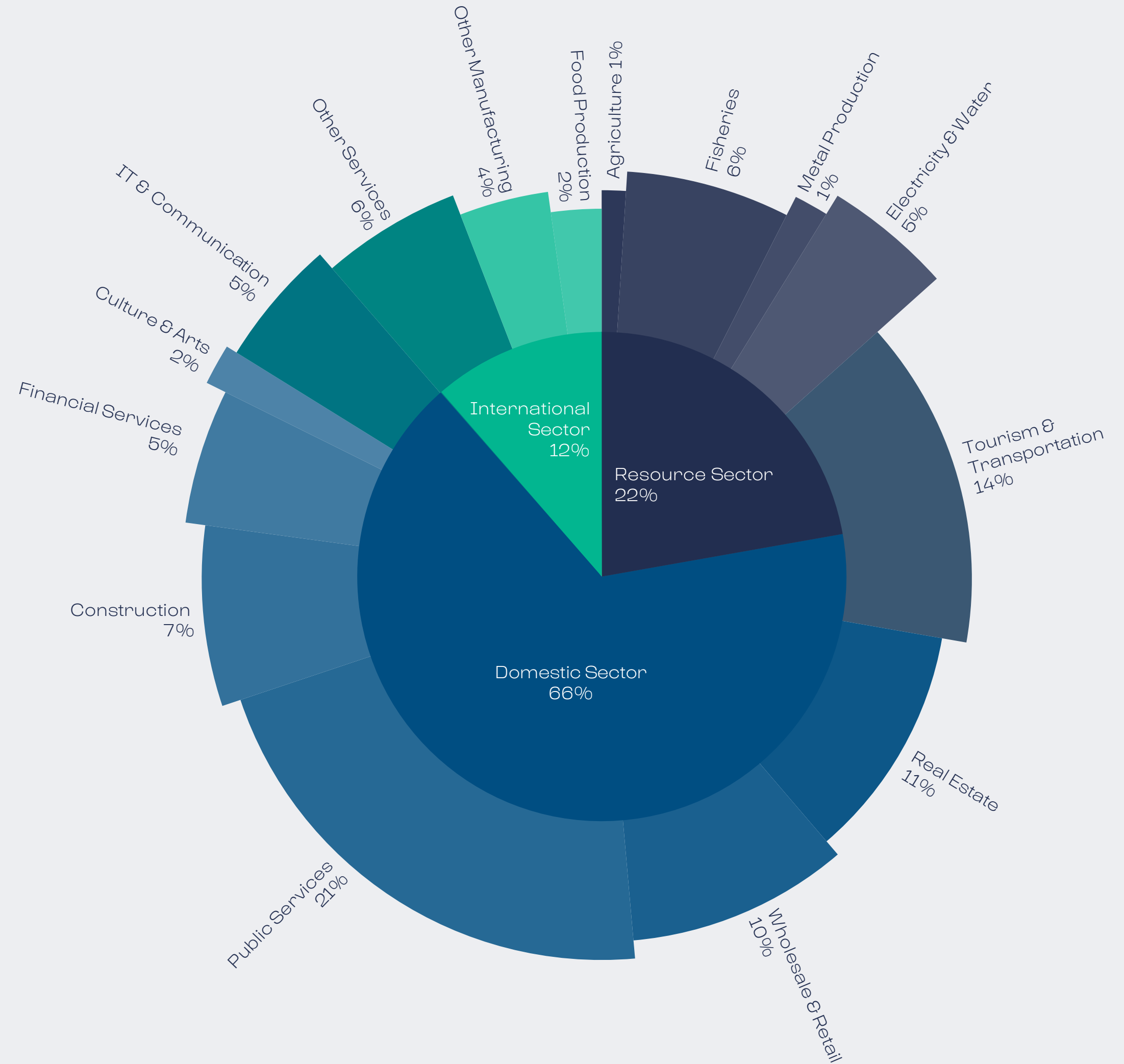
arionbanki.is

2 Structure of the Economy

2.2 Business sectors

Composition of the Icelandic economy in 2019

% of GDP



Sources: Iceland Chamber of Commerce; Statistics Iceland

2.2.1 The domestic sector

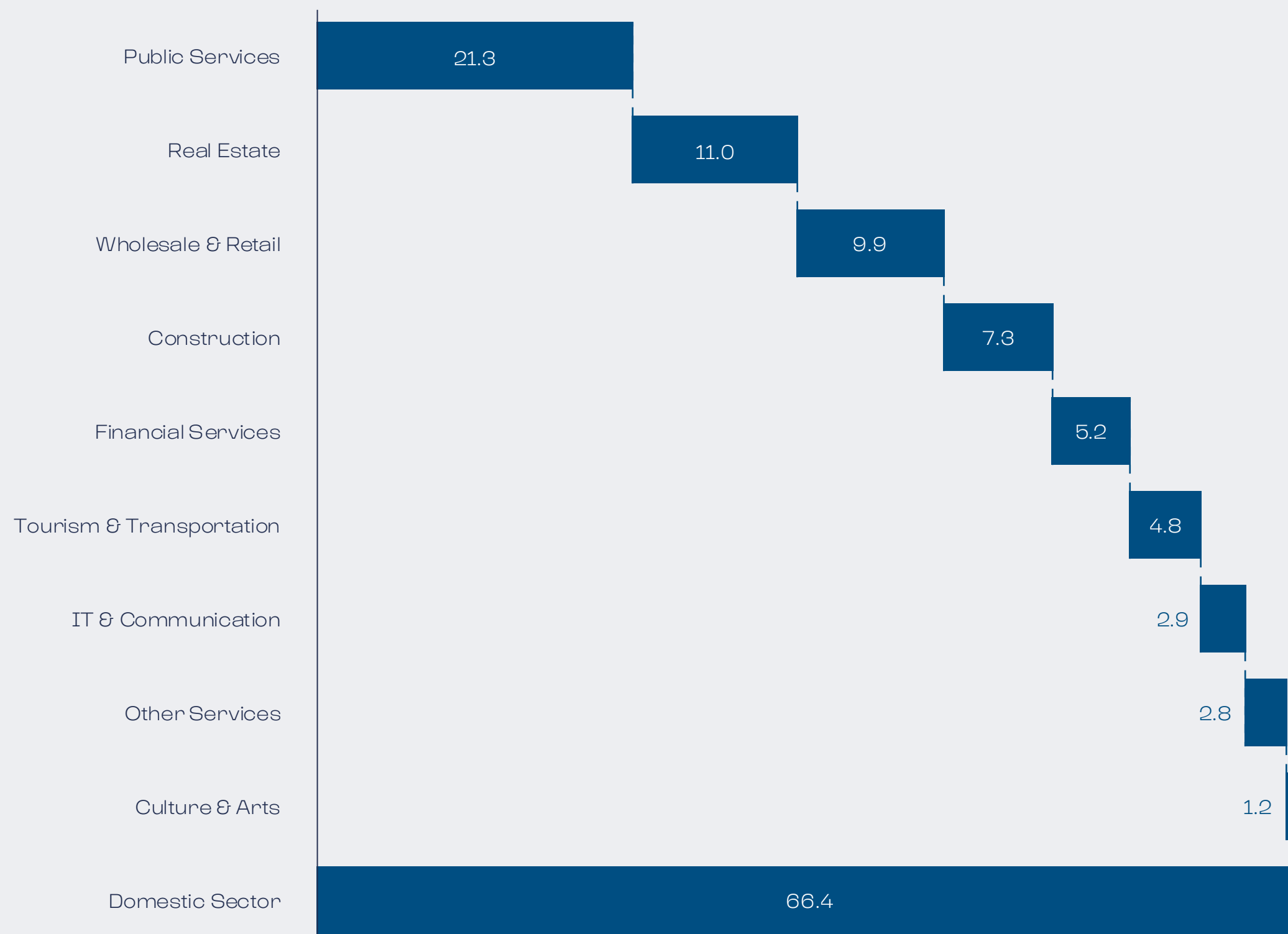
The development of the domestic sector is vital to the Icelandic economy

Iceland's domestic sector consists of industries that mostly provide non-tradeable goods and services for the domestic market. This includes, wholesale and retail, real estate, construction, arts and entertainment, public services, the domestic components of information and communication, tourism and logistics and lastly, business and financial services. In general, these industries are mature and face demands which are strongly linked to the business cycle.

As such, increased productivity is the key challenge for the domestic sector which has lagged behind other sectors in recent years. Notably, now that international trade is depressed due to COVID-19, activity in the domestic sector is more important than ever in regards to sustaining the standard of living. In fact, the inward shift of Icelanders demand for foreign goods and services creates a rare output-increasing opportunity for the sector.

Industries of the domestic sector

% of GDP, 2019

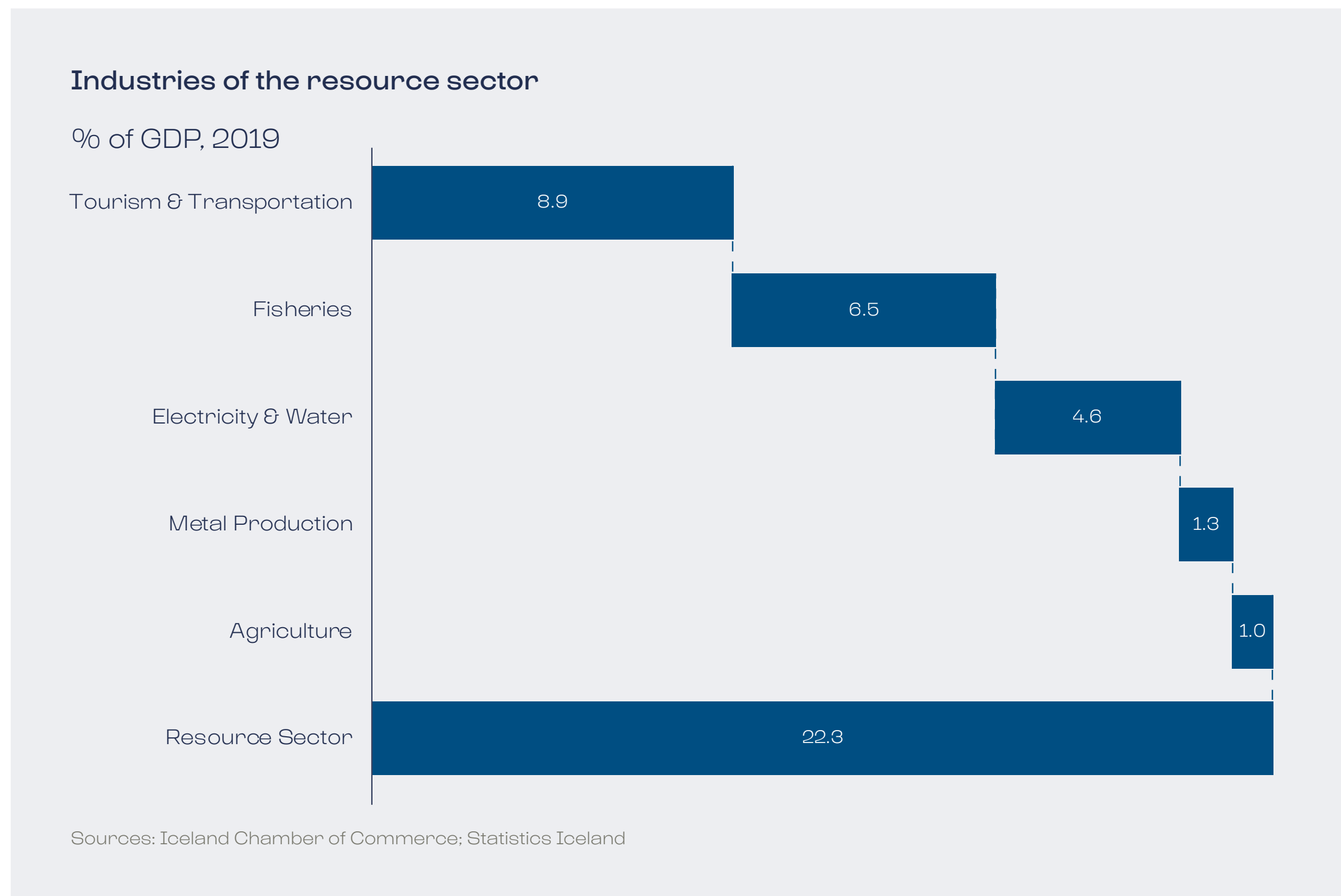


Sources: Iceland Chamber of Commerce; Statistics Iceland

2.2.2 The resource sector

The backbone of Icelandic exports

Iceland is endowed with abundant natural resources, which the country's rise from poverty since the early 20th century has been built on. Industries based on those resources, the resource sector, constitute 22% of Iceland's GDP and roughly 73% of exports. The exact definition of resource-based sectors is open to interpretation as most economic activity is reliant on natural resources to a certain extent. The definition in this report is based on the reliance of industries on Iceland's natural resources. The resource sector consists of three main sectors; tourism, which is by far the largest, the seafood industry and energy intensive industries, of which aluminium production is the largest.



Agriculture

Agriculture was historically the most important source of livelihood in Iceland but accounted for only 1% of GDP and 0.6% of exports in 2019. The industry,

however, remains protected and subsidised by the government. The main products are livestock (sheep, cattle, poultry and pigs) but also crops grown in geothermally

heated greenhouses, for instance. Recently, efforts have been made to increase exports of agricultural products such as skyr, a yoghurt like dairy product, and lamb meat.

The tourism industry

With the pandemic paralysing international travel, tourism is facing unprecedented challenges and uncertainties

Iceland's unique and largely unspoiled nature is a key reason for the success of tourism in the recent decade. Tourism is mostly concentrated around the southern and western part of Iceland with 81%¹ of overnight stays in those

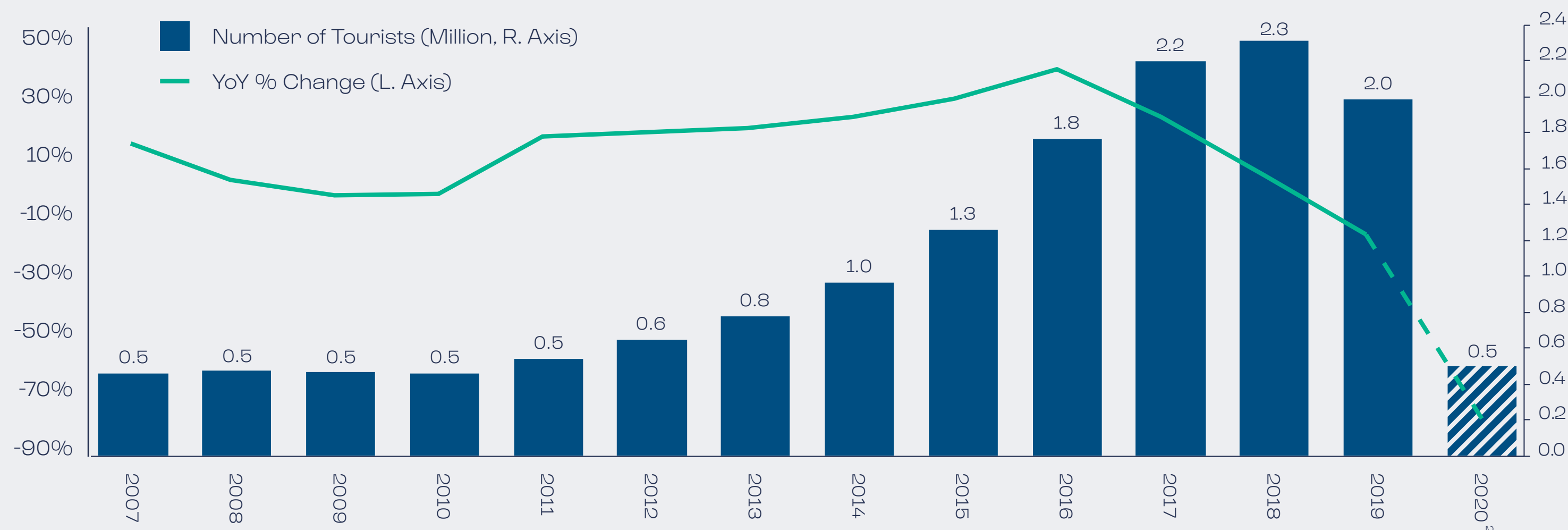
regions which include various popular tourist attractions. Visitors come from both sides of the Atlantic with the greatest number coming from the US (23.4% of total), followed by the UK (9.7%) and Germany (6.7%)¹. Tourism has been the main driver of Iceland's recent rapid economic growth but the number of tourists three folded after a surge in arrivals that started in 2011 and peaked in

2018. After COVID-19 the sector short-term outlook looks dim and analysts forecast a 60-75% decrease in tourist arrivals in 2020. The government is seeking ways to revive the sector and has granted ISK 1.5bn to Promote Iceland which will lead a promoting campaign that aims to re-attract tourists to Iceland as quickly as possible. The country reopened on June 15 and tourist arrivals were

exceeding expectations, leading Iceland to be mentioned as the perfect post-COVID destination thanks to its success in handling the virus, its disperse population density, its good infrastructure and its generally safe environment. Now, however, the new strict measures at the island's border (see chapter 3) have reduced enthusiasm and arrivals of tourists.

Keflavik airport passengers

Total and % change



1 2019 figures. 2 Based on a 75% decrease scenario. Sources: Central Bank of Iceland; Iceland Chamber of Commerce; Icelandic Tourist Board

The tourism industry - hoping for a quick recovery

part 1/2

Why a weaker Króna could help tourism and other exports recover after the COVID-19 crisis

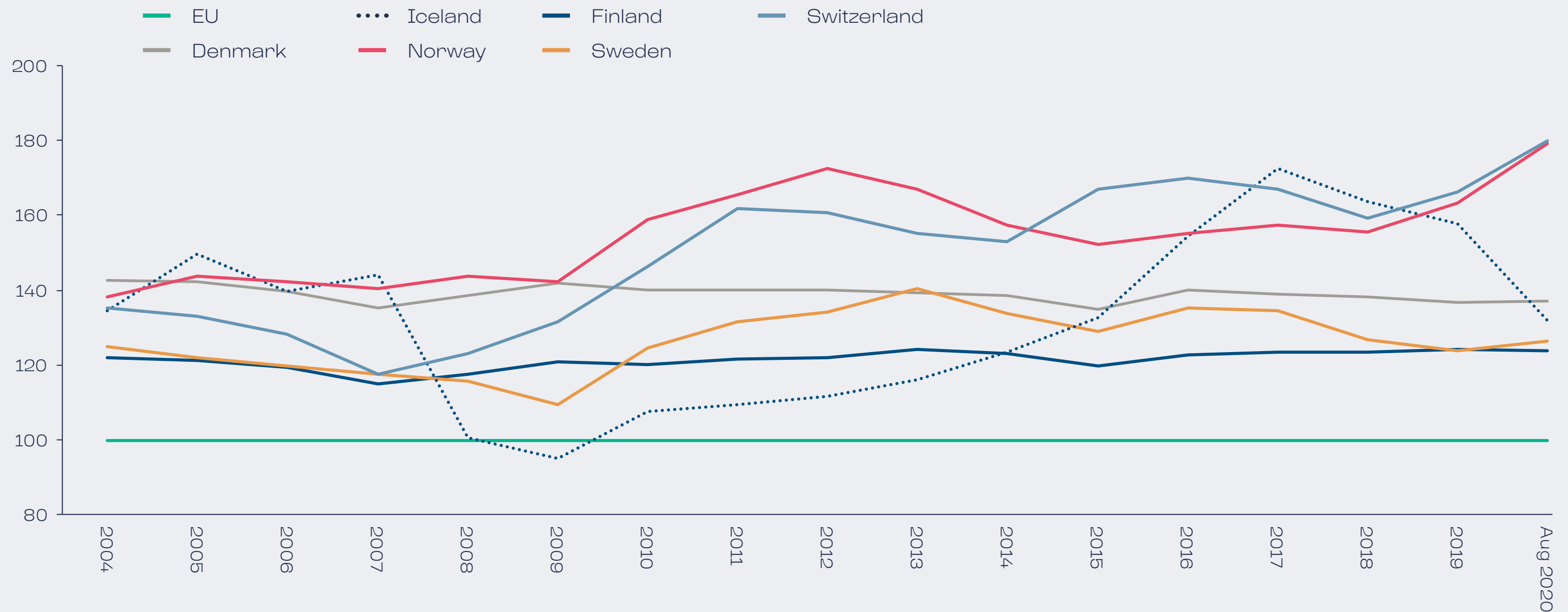
This year's decline in foreign visitors is a large shock to the economy and the tourism sector. The number of visitors is expected to reach levels last seen in 2010, when Iceland was the cheapest of

the Nordic countries, which made it an attractive holiday destination for people of various income brackets. As tourism in Iceland expanded, the situation reversed as an appreciating exchange rate, a world class hotel occupancy rate and pricey accommodations reduced the pool of income brackets that could easily afford a

trip to Iceland. In fact, growth in card turnover per tourist slowed in the period 2017-2018 as visitors sought less expensive ways to enjoy the island ([graph in part 2/2](#)).

Relative consumer prices

Indices, European Union=100



Sources: Central Bank of Iceland; Eurostat; Iceland Chamber of Commerce; Statistics Iceland

The tourism industry - hoping for a quick recovery

part 2/2

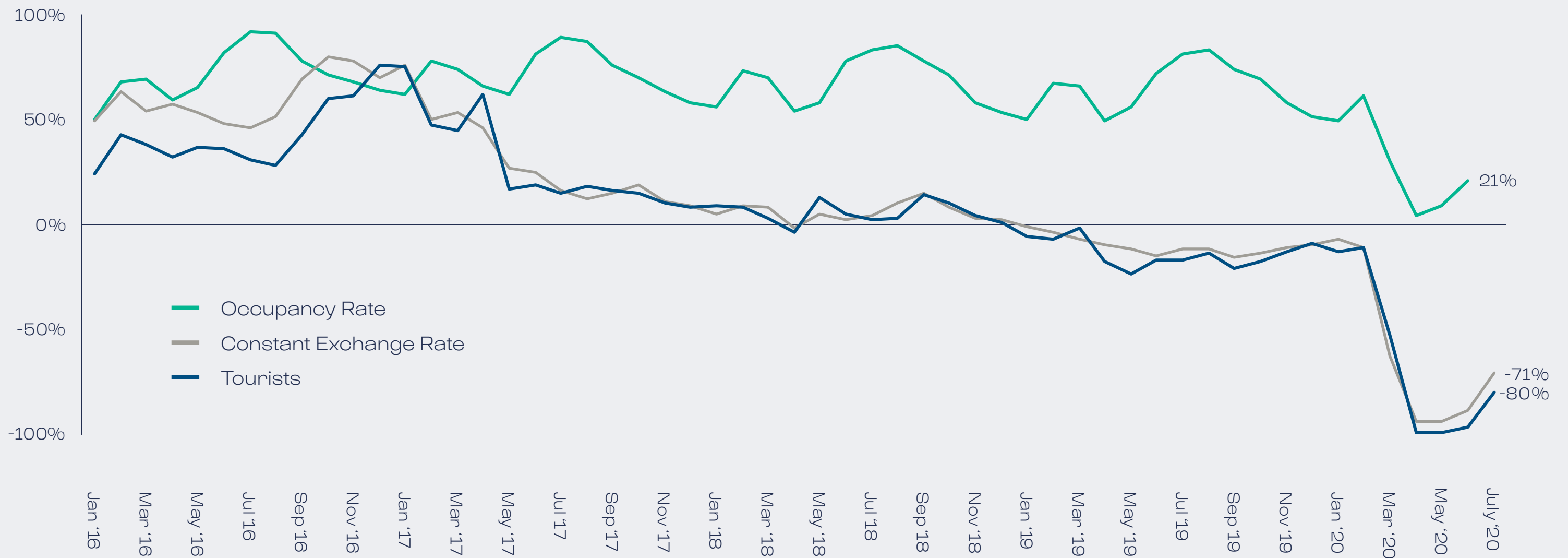
Then, in 2019, the bankruptcy of WOW air (which carried 36% of passengers who travelled through Keflavik airport in 2018) put downward pressure on the Króna and the number of tourists. This had a positive effect on spending per tourist throughout 2019 but since the pandemic struck in late

March 2020 the numbers have collapsed. However, the sector's infrastructure is ready for a mass return of tourists and a positive indicator is Iceland becoming cheaper. Hopefully that will bring the same uprising as in 2010-2017, although the possibility of an enduring fear of travelling means it

could be risky business for the economy to continue relying massively on tourism to deliver growth and value in the coming years.

Tourists, foreign card turnover and hotel occupancy rate

YoY % change



Sources: Centre for Retail Studies; Iceland Chamber of Commerce; Statistics Iceland

The productive Icelandic seafood industry

The seafood industry at a glance

Before 2006, seafood accounted for over half of exported goods but now that has decreased to 21%. The Icelandic fisheries management is based on “individual transferable quotas” (ITQ) which aim to protect and ensure sustainable fisheries while maximising the economic value of the scarce resource. Fishing quotas can be bought and sold in the market, with the ITQ system incentivising companies to plan and invest with a long-term perspective. The Icelandic fishing industry is internationally renowned for its

adherence to a sustainable fisheries policy, resulting in strong fish stocks. Additionally, it is experiencing rapid technological advances and labour productivity has outgrown other industries, with a 3% average growth. In fact, recently, the fishing fleet and other equipment were largely renewed, making investment climb to a record high in 2017. The UK remains the most important market (15% share) followed by France (11% share), Spain, Norway and the US (all three with a 9-10% share).

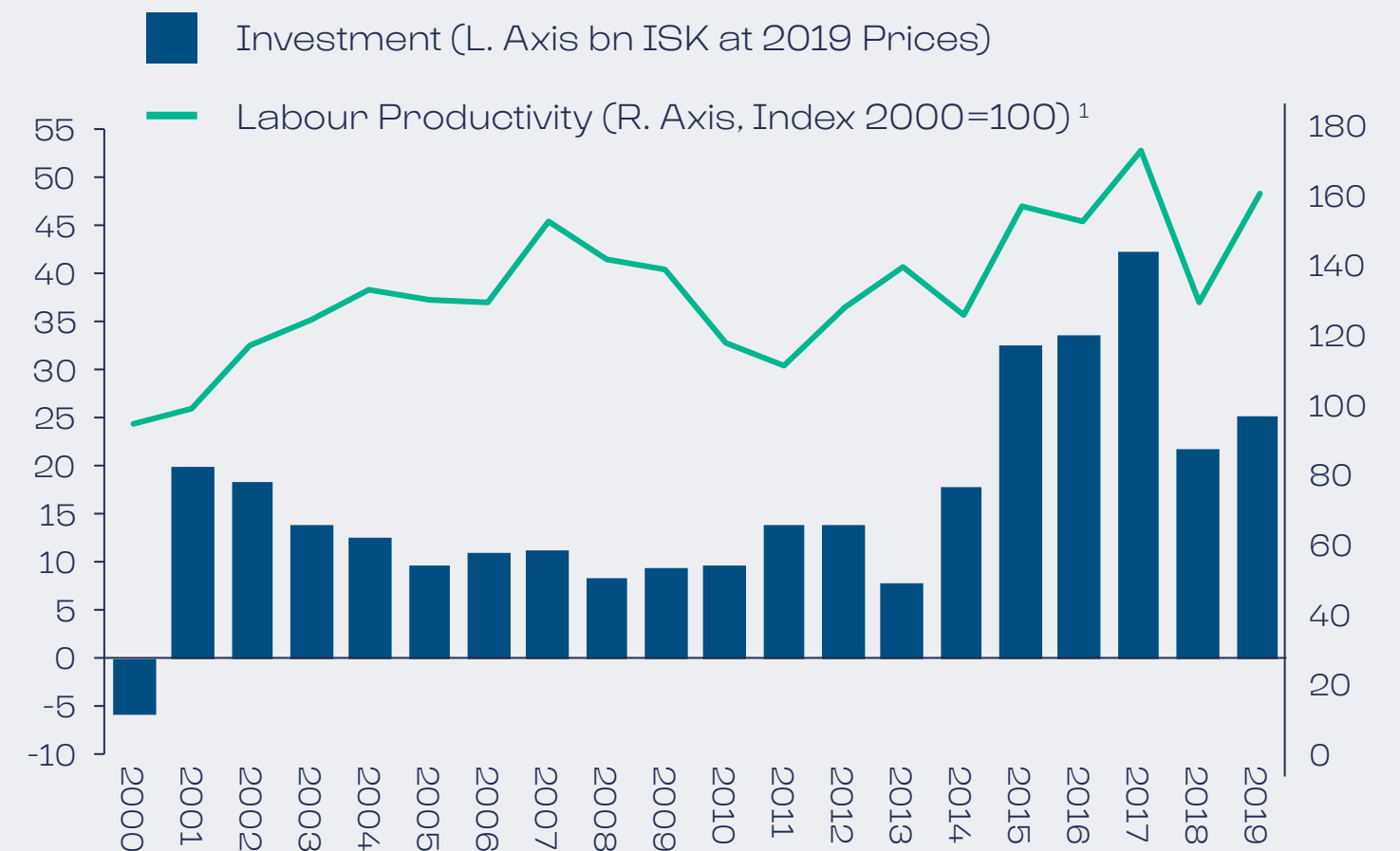
The rise of aquaculture

Foreign direct investment (FDI) has been a key factor in the rise of aquaculture and largely explains a total of ISK 15.3bn FDI in agri- and aquaculture in the period of 2013-2018. However, aquaculture remains small compared to the catch of wild fish stock and only accounts for about 2% of total exports. In 2019 around 27,000

tons of farmed fish were produced, which is 20,000 tons greater than in 2013. Growth has continued in 2020 which is on track to become the biggest year in history. The plan is to continue the expansion of open-cage salmon farming in the coming years, both in the Westfjords and Eastfjords.

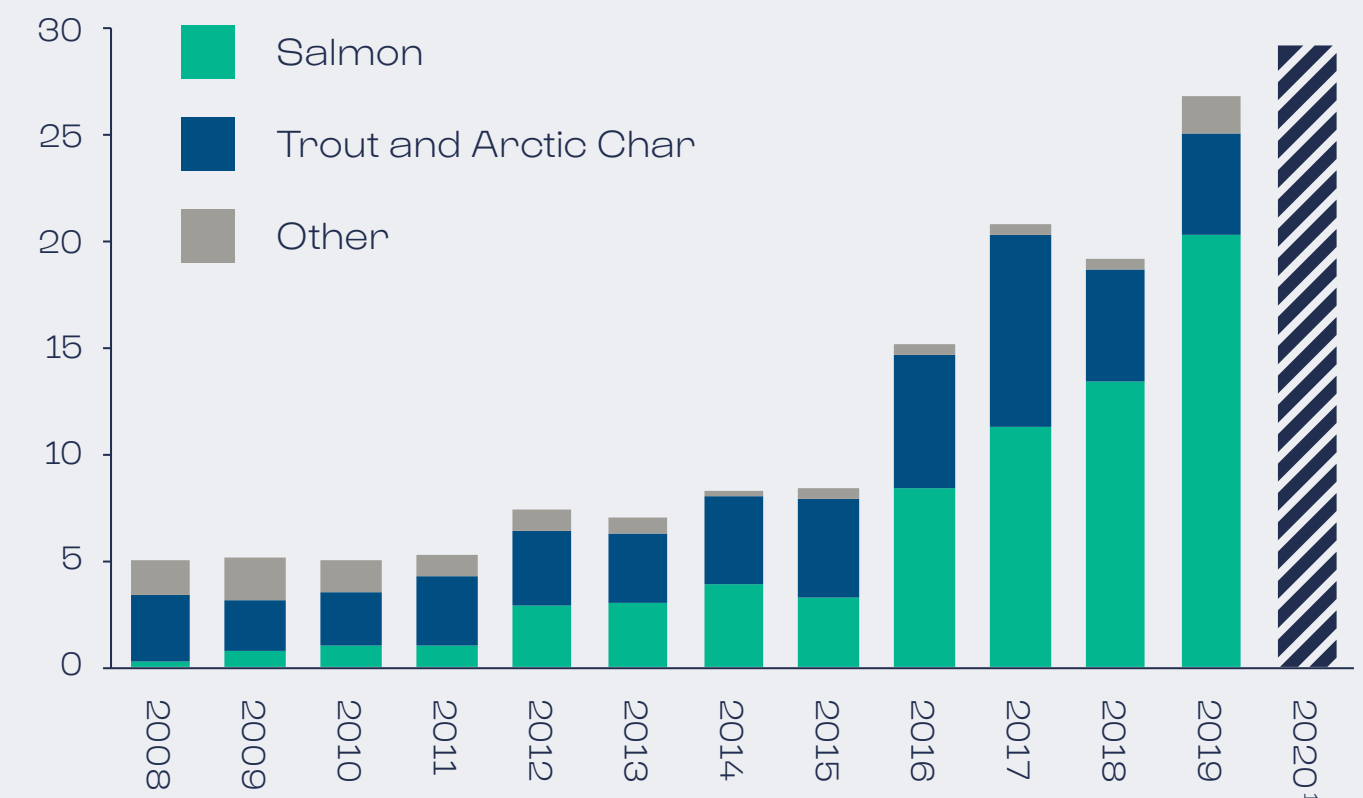
Seafood (including aquaculture)

Investment and productivity



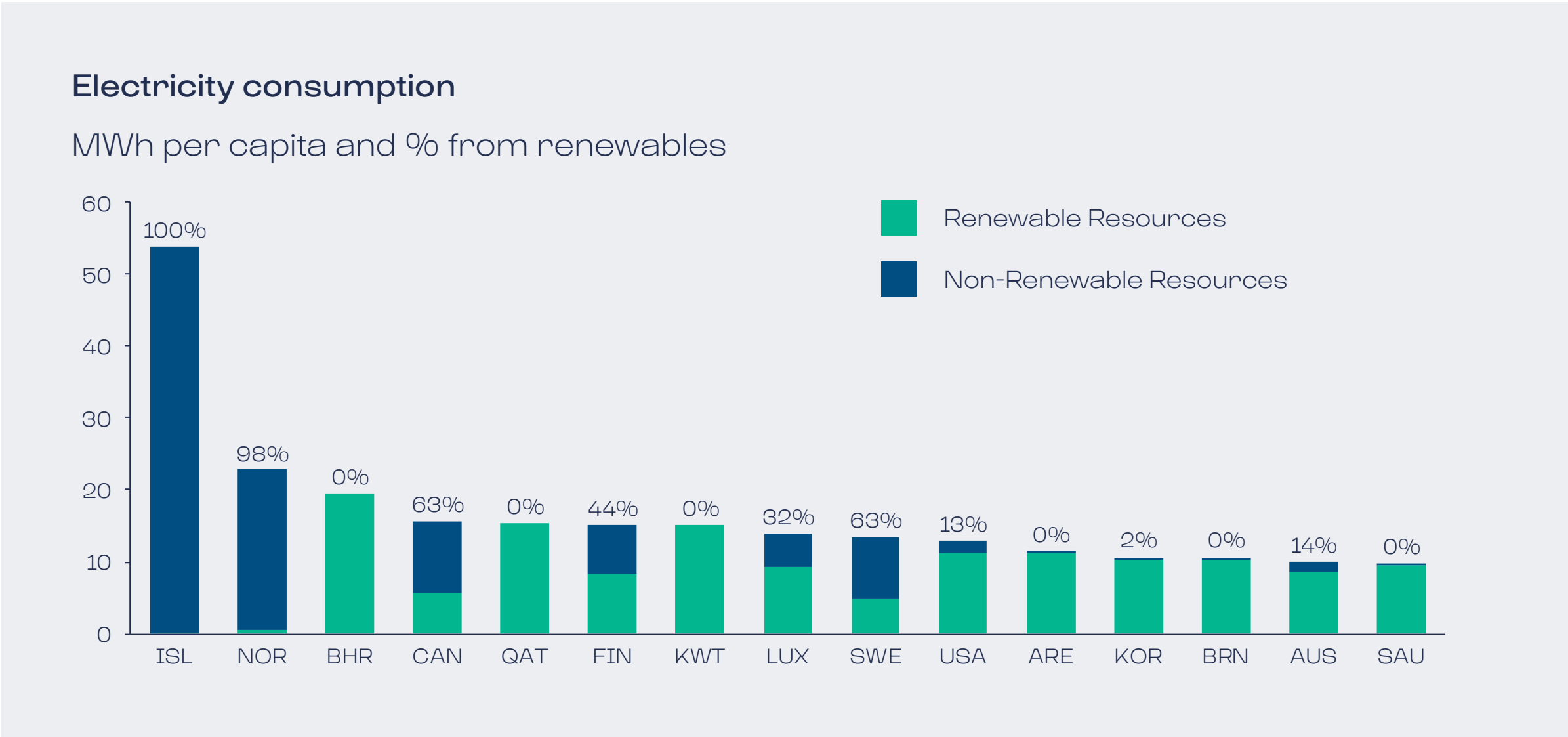
Aquaculture production

Thousand tons



¹ Projection of total production based on year on year growth in January-June 2020. Sources: Iceland Chamber of Commerce; Statistics Iceland

Iceland, the land of fire, ice... and energy



Iceland is located between two tectonic plates, placing it in an excellent position to harness geothermal power. It also has great highlands, glaciers and abundant precipitation. As a result, it produces renewable energy at low costs but 73% of Iceland's electricity is produced from hydro-power, while geothermal power accounts for 27%. Not only does this make Iceland the biggest per capita renewable energy producer in the world but also the largest per capita total energy producer. Energy intensive industries (the main three listed here below) consume 77% of all produced electricity and contribute 17% to total exports where aluminium is by far the largest contributor.

Aluminium

Three large aluminium plants (Alcoa Fjarðaál, Norðurál, and ISAL) are situated in Iceland. They accounted for over 15% of Iceland's total exports in 2019 and over 1% of global aluminium production. Aluminium production has coincided with the power generation and grid investments of Landsvirkjun (the national power company and producer of 71% of Iceland's electricity). This year the world price of aluminium has collapsed, forcing the plants to reduce their output. ISAL has been most severely affected and has the operation of its plant in Straumsvík under review.

Silicon

Silicon plants have been among the largest investments in Iceland in recent years. Three plants have been built although only Elkem's ferrosilicon is currently operating. In 2017 the Environmental Agency of Iceland shut down United Silicon after receiving complaints regarding its operation and in June 2020 PCC Bakki had to shut down temporarily due to a sharp decrease in the world price of silicon. There have been plans to expand the sector, including an other plant, but after recent developments those plans are on hold.

Data centres

The data centre industry is a new and rapidly growing industry in Iceland which has benefitted from the growing global demand for data storage and the recent boom in cryptocurrencies. Iceland's cold climate, affordable energy prices and fruitful renewable energy production make it an attractive location for such operations. Multiple data centres have been constructed in recent years and further growth is anticipated as the National Energy Authority expects the sector energy use to increase 18% from 2020 to 2022.

Sources: Iceland Chamber of Commerce; World Bank

2.2.3 The international sector

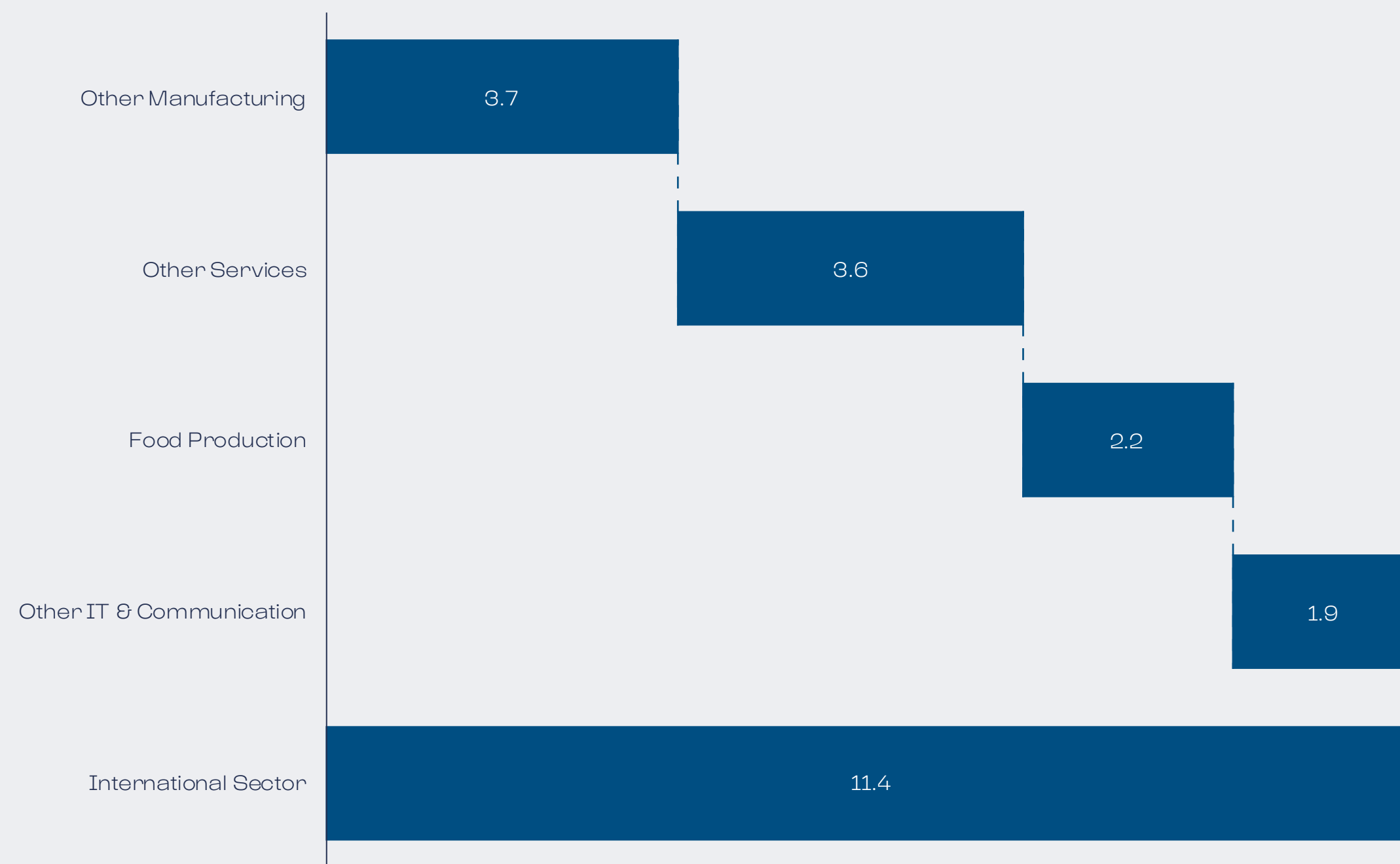
Shaping the future

The international sector consists of businesses that produce tradable goods and services that are independent of natural resources and compete in an international environment. These industries rely more on intellectual property and technology. In 2019 the international sector produced 12% of GDP.

The growth of the international sector has been on the agenda since the financial crisis and its importance was highlighted in a 2012 report by McKinsey & Co which set out a long-term growth path for Iceland. The report highlighted the importance of maintaining an external economic balance and to achieve it, export growth needs to at least match the long term growth of the economy. If the economy grows at 3% p.a. that necessarily entails an 80% increase in exports which amounts to around ISK 1,000bn over the span of 20 years. This policy objective has since been dubbed the “1,000 billion challenge.”

Industries of the international sector

% of GDP, 2019



Sources: Statistics Iceland; Iceland Chamber of Commerce

Deepening the talent pool

To foster the international sector, talent needs to be harvested

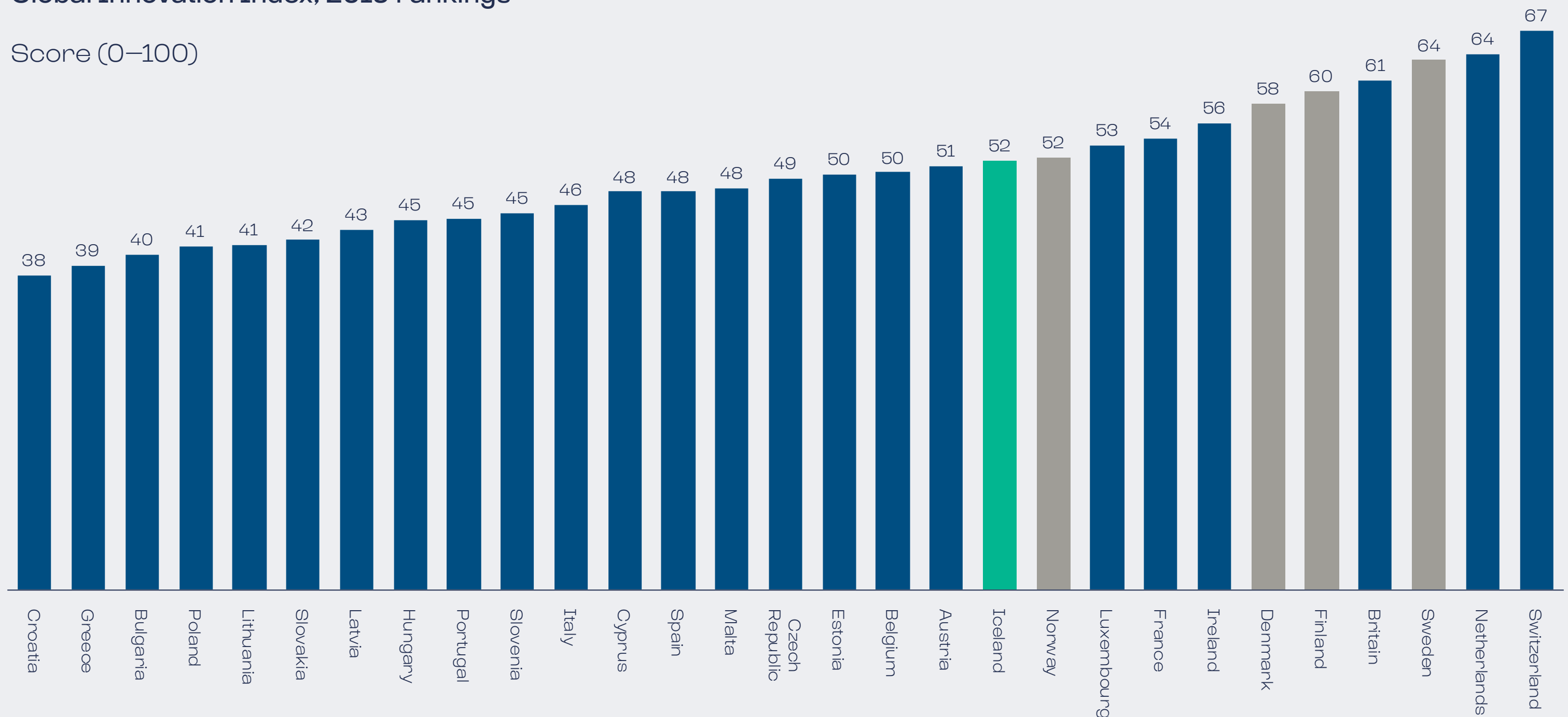
Being independent from Iceland's natural resources means the international sector is not bounded by the same constraints as the resource sector, making its growth potential unlimited. When unlocking this growth innovation will play a crucial part but Iceland was the 20th most innovative

country in the world in 2019, ahead of many large European countries but still behind its Nordic neighbours. Improvements can be made and a key challenge will be to deepen the talent pool that the sector has access to. The challenge can be approached from two sides, by attracting foreign talent to the country and by improving education levels. Steps have already been taken with tax

breaks and expedited work visa arrangements for foreign specialists, and by increasing the number of university graduates, which has tripled since 2000. Continuing along this path will ease the way for value-adding innovations as companies can exploit greater access to talented people, regardless of their nationality.

Global Innovation Index, 2019 rankings

Score (0–100)



Sources: INSEAD – Global Innovation Index 2019

Enhancing innovation

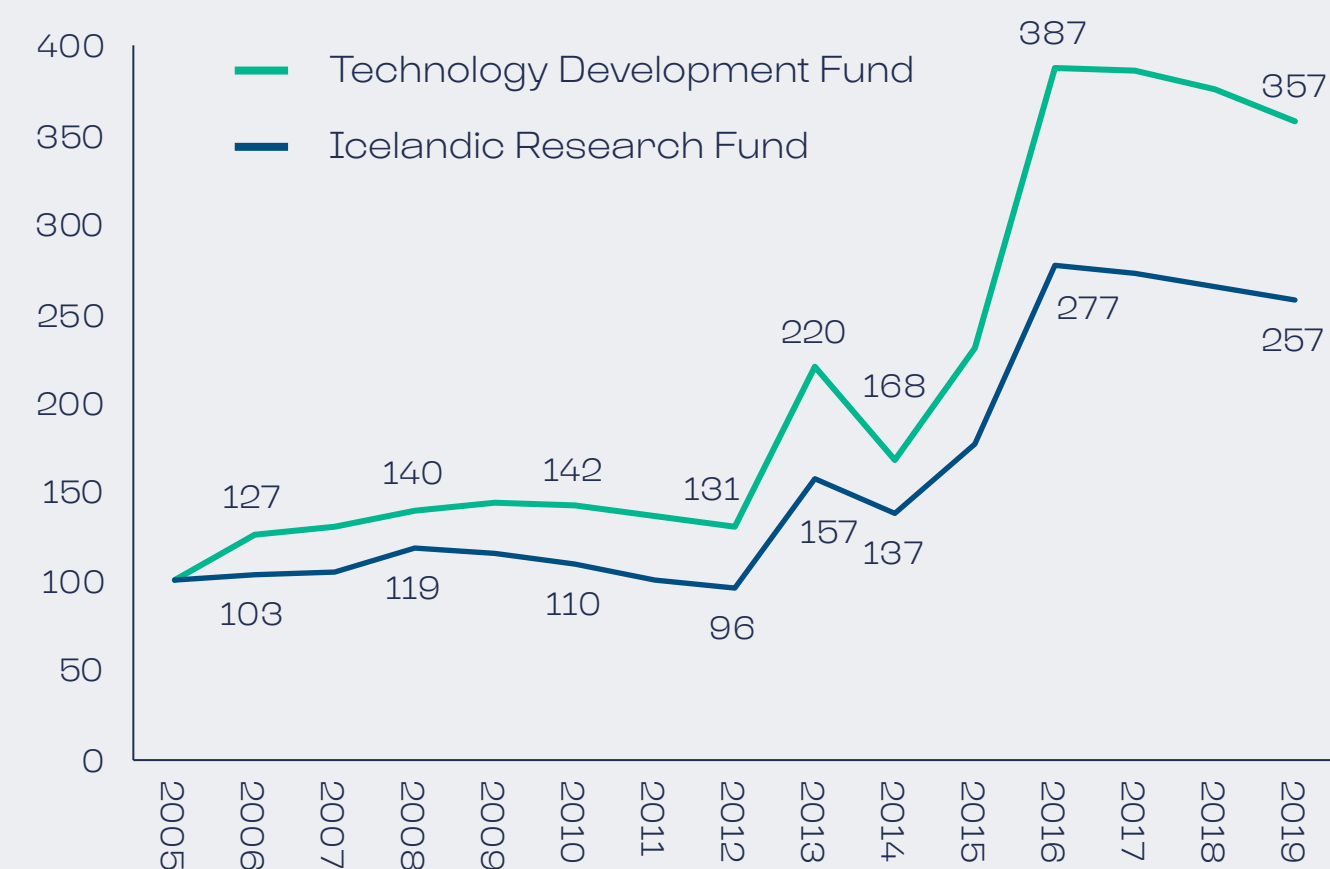
Iceland is on the right way in terms of improving the entrepreneurial environment

In November 2019 the government presented a 10-year strategy called “The innovative Iceland” which is supposed to make innovation imbedded in the Icelandic society and make Iceland the ideal country to establish, and run, competitive multinational companies. As a result, the government has introduced a few new incentives to foster innovation in addition to expanding existing ones. One of those was to substantially increase contributions to the two main funds that provide grants for research and technological developments but since 2005, the Technology Development Funds budget has increased more than three-fold and that of the Icelandic Research Fund by more than two-fold. Another one was to allow companies to claim tax rebates for part of their expenditures towards

research and development (R&D). Since the policy was established in 2010 it has been expanded and as of 2020 allows for 25% rebates for large companies (more than 250 employees) and 35% rebates for smaller companies. Rebates can be claimed for R&D expenses up to ISK 1.1bn. The policy has incentivised a widespread increase in R&D spending by the private sector and universities with expenditures increasing 96% and 46%, respectively, over the period 2013-2018. While the measure has boosted Iceland’s competitiveness in terms of feasibility of conducting R&D projects within the country, more needs to be done if Iceland is to be at the top in terms of incentivising R&D spending. In fact, rebate percentages and caps are still higher in many industrialized countries such as Australia, Ireland and Canada. Ultimately, the goal with incentivising innovation is to improve Iceland’s competitiveness (see more in chapter 4).

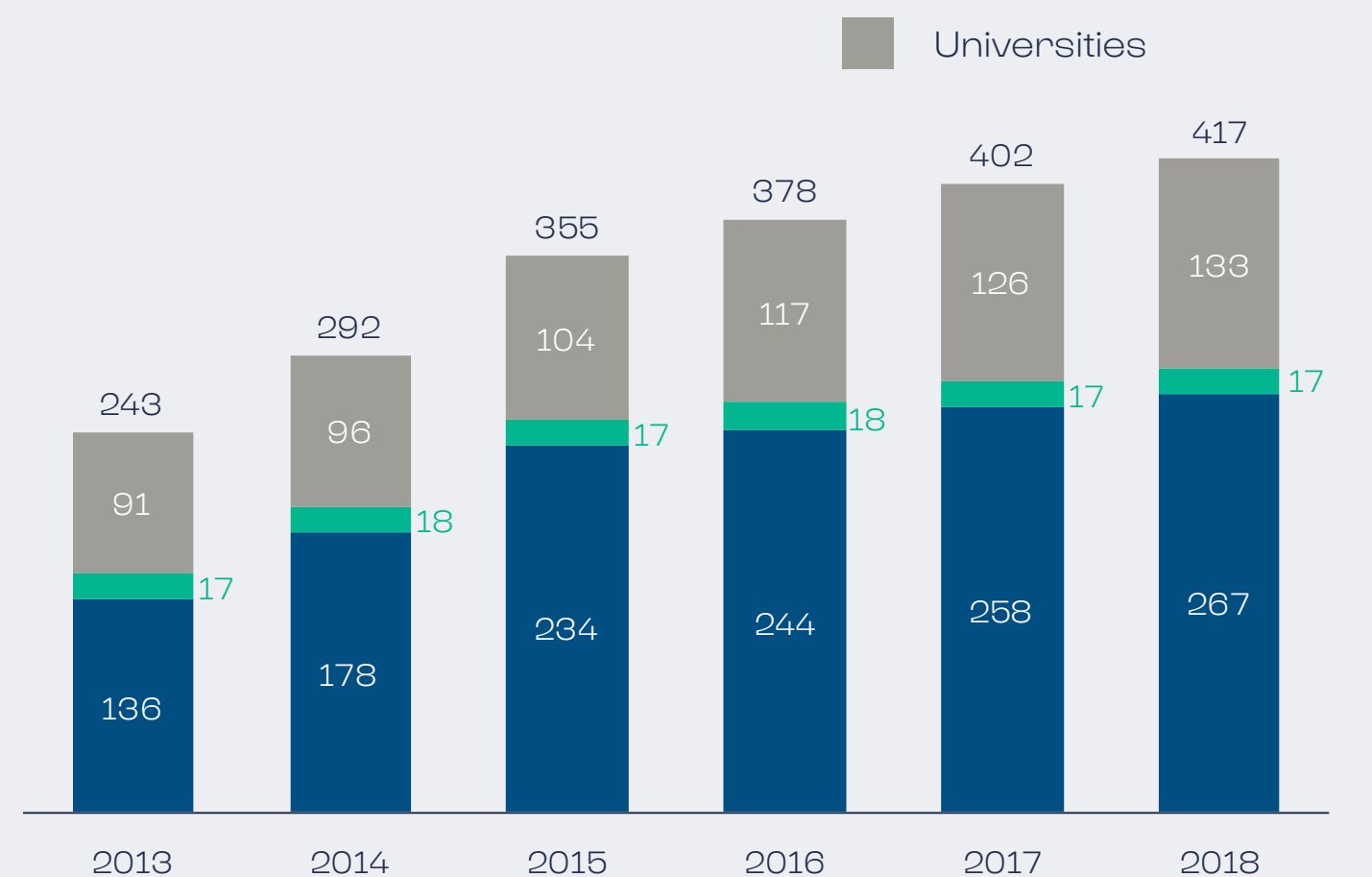
Government contributions to R&D grants

Real prices, index 2005=100



R&D expenditure by sector

Million USD (PPP)



Sources: Iceland Chamber of Commerce; Statistics Iceland



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3 The Impact of COVID-19 on the Icelandic Economy



The Icelandic economy has been heavily affected by COVID-19, especially given its dependence on tourism and other export sectors. As mentioned in chapter 1.2, a recent economic transformation has helped the economy cope with the epidemic as low private debt levels and strong public finances have given companies, households and the government ammunition and confidence to tackle the consequences of the virus.

Overall, it seems that crisis-responses of governments in both Europe and the USA have changed since 2008. Now, the reaction is to inject significant amounts of public money into companies, financial

markets and households. As such, the austerity policies of 2008 have been replaced by Keynesian actions and the hope is they will prove more successful in getting the world economy back on track in the shortest time-frame possible.

As per the Icelandic outlook, a lot of predictions have been made recently and all are rather bleak. It is undoubted that this year will be difficult, particularly this fall when unemployment is expected to reach 10%, but the rigorous regime of testing and tracing that was put in place at the onset of the epidemic lifted sentiment and for a time being the virus was virtually

eliminated. During that period, business activity notably increased as ban of gatherings were lifted and the country reopened to tourists.

Specifically, from 15 June onwards, visitors from Schengen countries had the option of being tested on arrival, instead of spending 14 days in quarantine. Overall, the regime worked quite well as the majority of cases were diagnosed at the border. Yet, the nature of the virus is so that the handful of cases who sneaked through started a second wave in late July. The upswing in economic activity was therefore short-lived. Now a ban of gatherings of more than 200

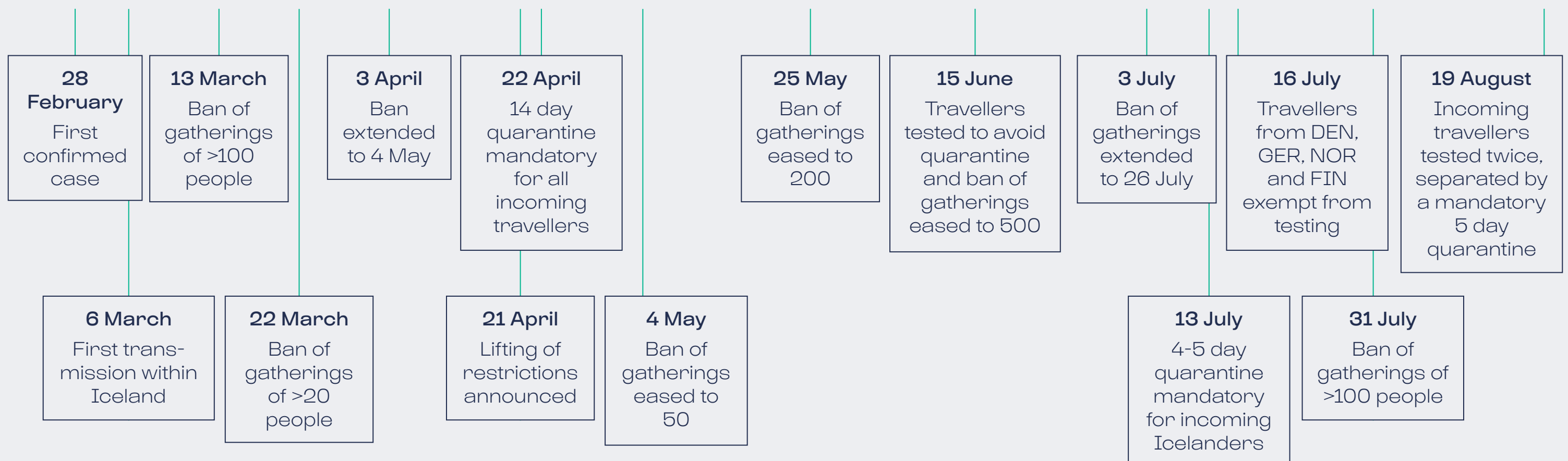
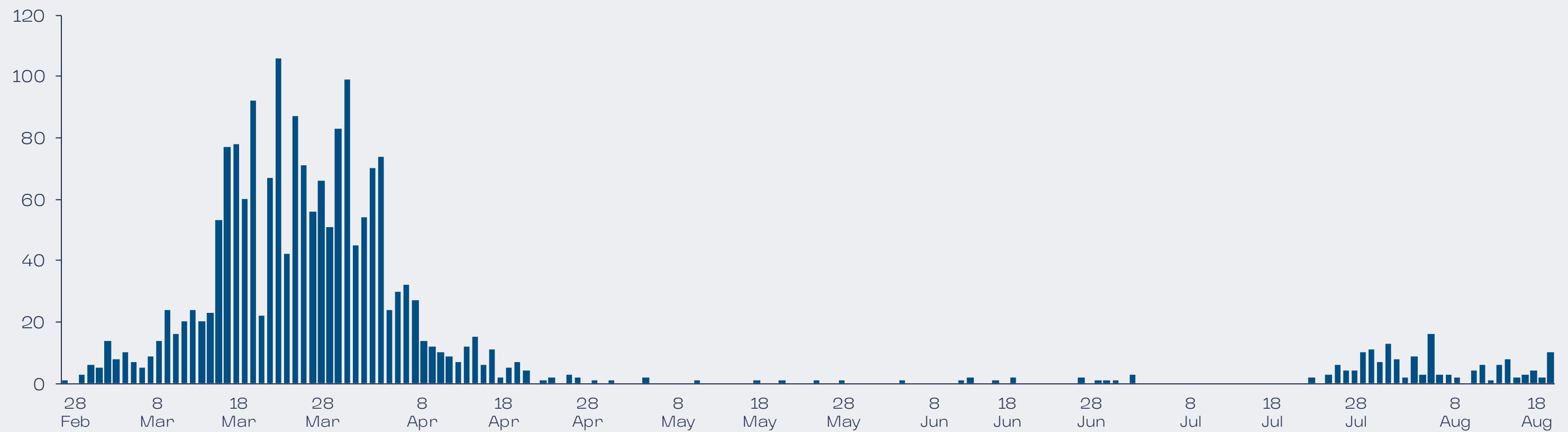
people has been reinstated and all incoming travellers must either undergo two tests, separated by a 5 day quarantine, or quarantine for 14 days. However, the procedures are frequently reviewed and hopefully it won't be long until less severe border restrictions are put in place.

Notwithstanding the recent setbacks Iceland emerged as one of the victors from the fight against the first wave of COVID-19. This chapter documents that fight and how it has affected economic activity in the past months.

The fight against COVID-19 in Iceland

COVID-19 emerged fast in Iceland but disappeared even faster due to successful social distancing policies - a second smaller wave started in July

Number of domestic infections



Source: Covid.is

First impact: ↑ Unemployment ↓ Economic Activity

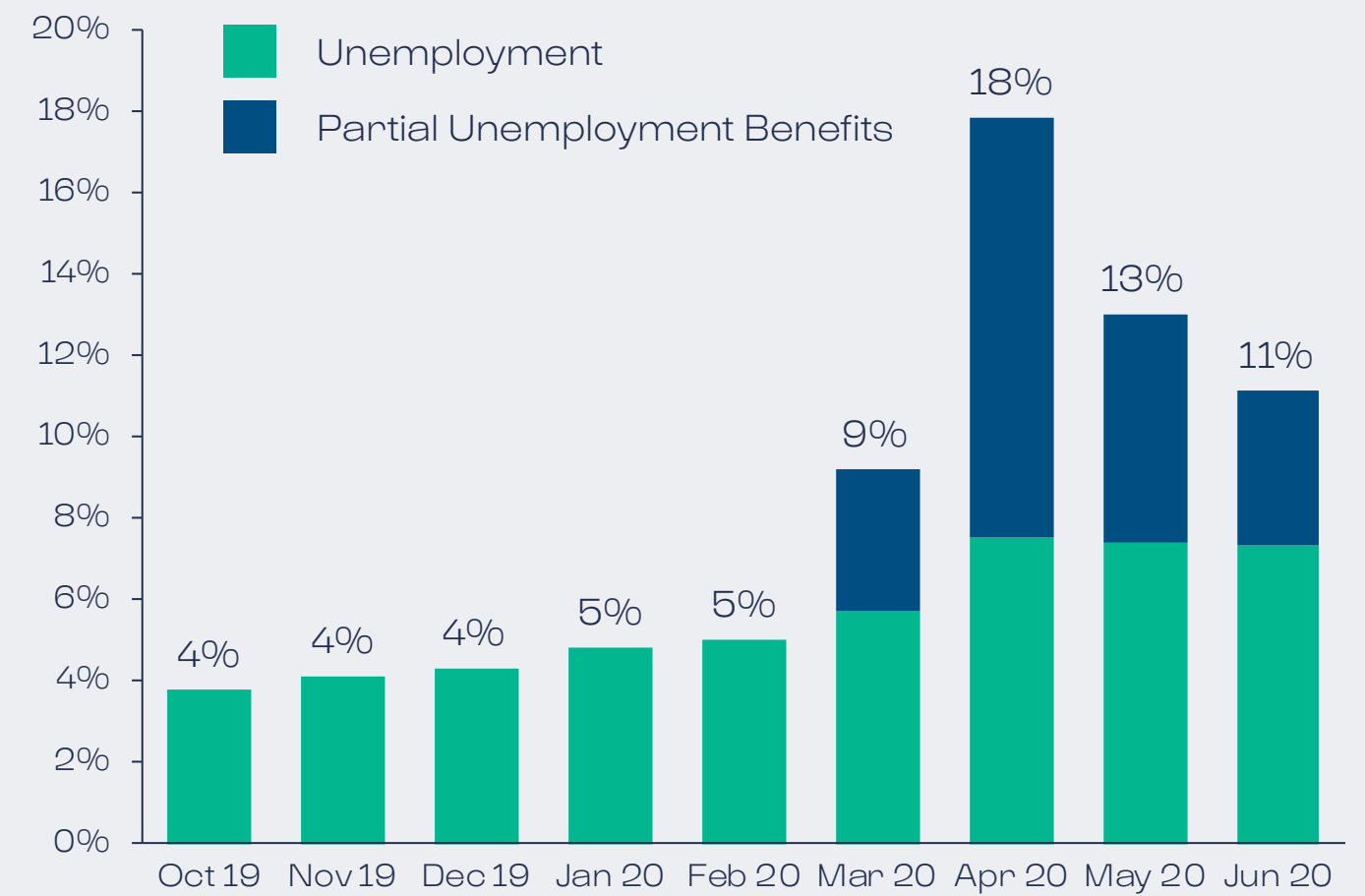
Like in most countries COVID-19 had a fast and large impact on the economy

Rising uncertainties and restrictions on travel and social gatherings were a major blow to the Icelandic economy.

Unemployment (including partial unemployment benefits for part-time workers, [see next page](#)), jumped to over 10% in just two months, domestic card turnover took a massive hit and foreign card turnover (mainly tourists) became virtually non-existent. Lockdown was never imposed which undoubtedly mitigated the negative economic effects compared to many other countries.

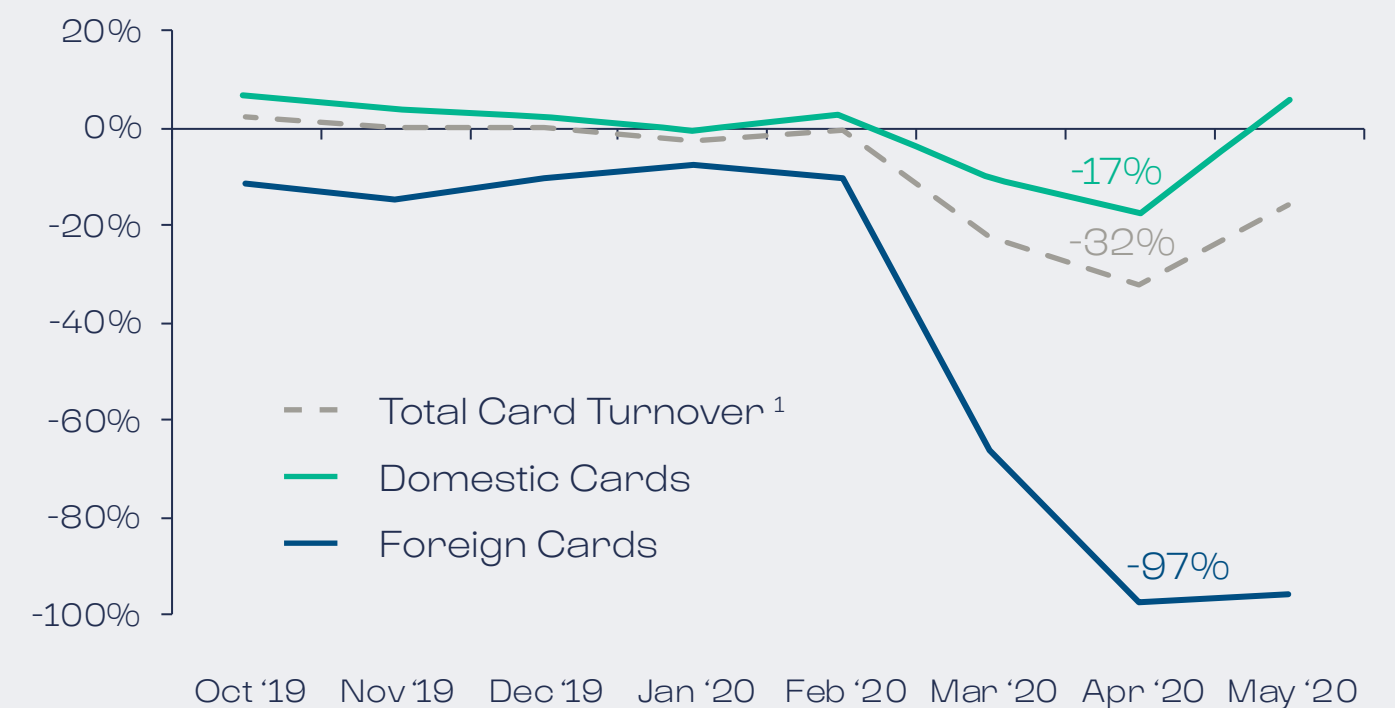
Nonetheless, the restrictions put several businesses under extreme pressure as they had little or no revenue, and nobody knew for how long. As such, several institutions, including municipalities and credit institutions, put measures in place to help companies and households weather the storm. However, the largest measures were put in place by the government and the CBI.

Registered unemployment



Payment card turnover in Iceland

YoY % change



¹ Domestic card and foreign card turnover in Iceland.
 Sources: Directorate of Labour; Central Bank of Iceland (CBI)

The government's fiscal response was quick and effective

Timeline of key fiscal policy measures

10 March

Action plan announced

Several broadly defined policy actions, including:

- Extended deadlines for taxes and other public charges
- Temporary reliefs for tourism businesses
- Marketing campaign for tourism
- Tax reductions accelerated and increased benefits
- Infrastructure projects
- Cooperation with the Icelandic Financial Services Association

21 March

First response package

Key policy actions:

- Execution of earlier policy announced, actions elaborated such as tax deferrals
- Payment of up to 75% of salary for part time workers
- State-backed bridge loans for businesses
- Access to third pillar pension savings
- Refund of VAT for construction projects
- Lowering of bank tax accelerated

21 April

Second response package

Several and broader measures, including:

- Reimbursement caps and ratios for R&D increased
- Subsidies for closed businesses
- Support loans for SMEs
- 2020 losses allowed to offset 2019 income tax
- Special measures concerning violence, mental health, students and other social support

28 April

Further policy measures

- Option for support of part-time workers extended to 31/8 and reduced to 50%¹
- Simpler rules on financial restructuring put in place
- Companies suffering at least a 75% loss of revenue can receive support to cover costs over notice period

Scope of actions is 12% of GDP, of which 4% directly affects the fiscal budget (similar to Denmark and Norway)

Deficit is projected to be -10.4% of GDP in 2020, resulting in a 36.8% debt-to-GDP level²

¹ On August 25, the government extended the furlough scheme to 31/10 and increased the months of payed wage related unemployment benefits from 3 to 6.

² Central government deficit and net debt figures. General government deficit is projected to be -11.6% of GDP and net debt-to-GDP 43.6%.

Source: Government.is

Unparalleled monetary policy measures

Timeline of key CBI measures¹

11 March Rate cut by 50 bp

Main rate cut from 2.75% to 2.25%

Deposit institutions' reserve requirement lowered from 1% to 0%

18 March Another 50 bp rate cut

Main rate cut to 1.75%.

Asgeir Jonsson, governor of CBI: "We're just getting started"

23 March QE announced

Treasury bond purchases

Implemented in beginning of May with a cap of ISK 150bn

8 April Temporary credit facility

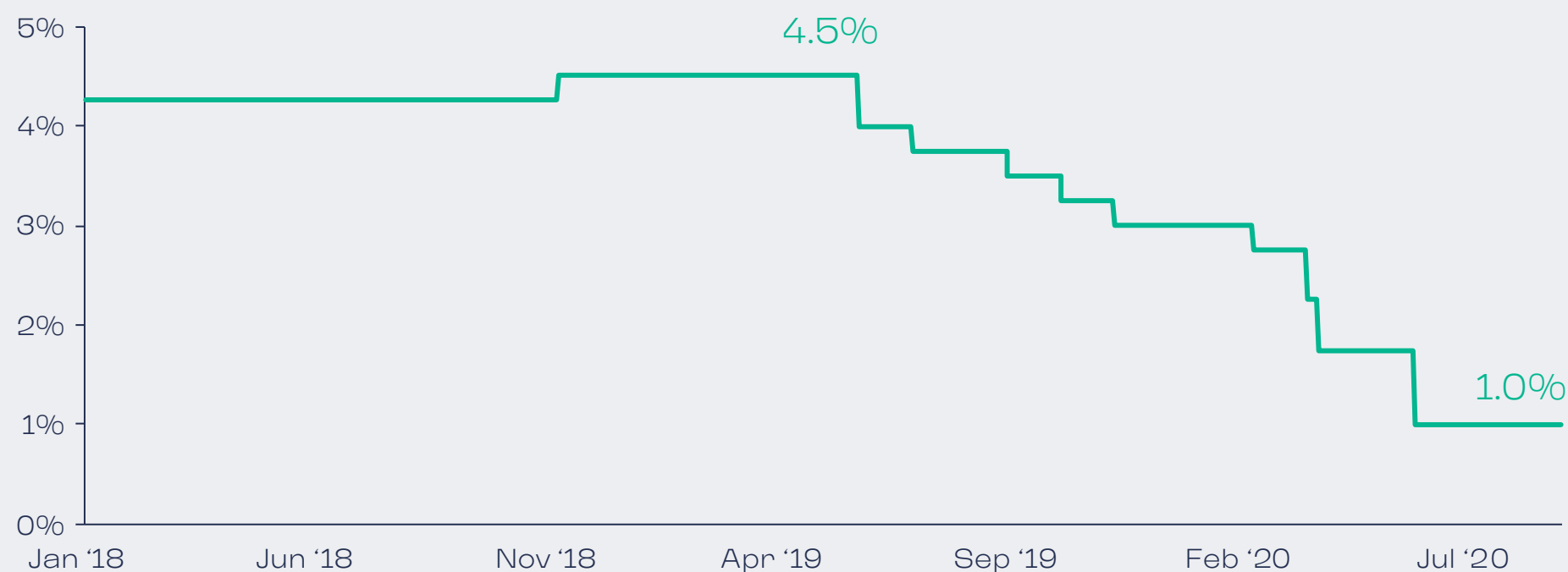
In the form of collateralised loans, with a temporary expansion of the list of securities eligible as collateral

20 May 75 bp. rate cut

Main rate cut to 1%

CBI stops offering one-month term deposits

CBI Key Interest Rate



Other CBI Measures

Intervention in the FX market to prevent excess exchange rate volatility

Consulting with pension funds to suspend FX purchases for 6 months

Facilitating bridge and support loans on behalf of the government

Reducing the countercyclical capital buffer from 2% to 0%

¹ Decided by the Monetary Policy Committee and the Financial Stability Committee of the CBI.
Source: Central Bank of Iceland (CBI)

A quick partial rebound

Success in fighting the first wave supported a strong rebound this summer

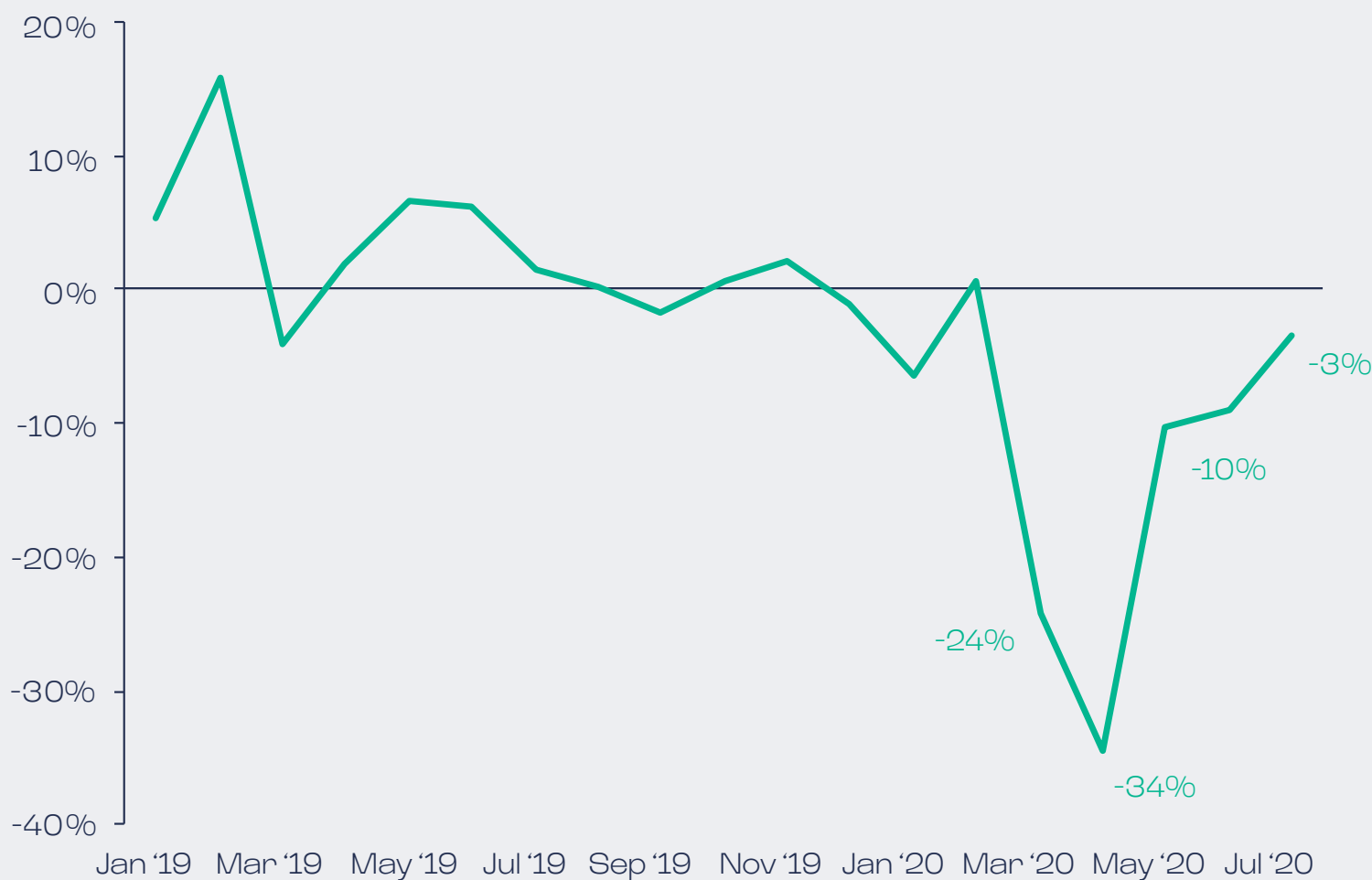
With the rapid decline in COVID-19 cases it was possible to lift restrictions on gatherings in the beginning of May and by mid-June the limit had been lifted from 20 to 500. Along with people seemingly relieved, this helped the local economy to rebound quickly, which is reflected in road traffic bouncing back in May and consumer confidence approaching pre-pandemic levels in June.

Nevertheless, the rebound was only partial as Iceland's dependence on tourism (8.9% of GDP in 2019) is the third highest among OECD countries. Tourism activity was almost none from mid-March to mid-June but Icelanders, who couldn't travel abroad and so decided to travel domestically, helped cushion the hit.

The virus also shifted the composition of domestic demand, causing certain business areas to experience large rise in sales. Those include outdoor retailers, home improvement stores and jacuzzi vendors, not to mention the spike in residential housing transactions.

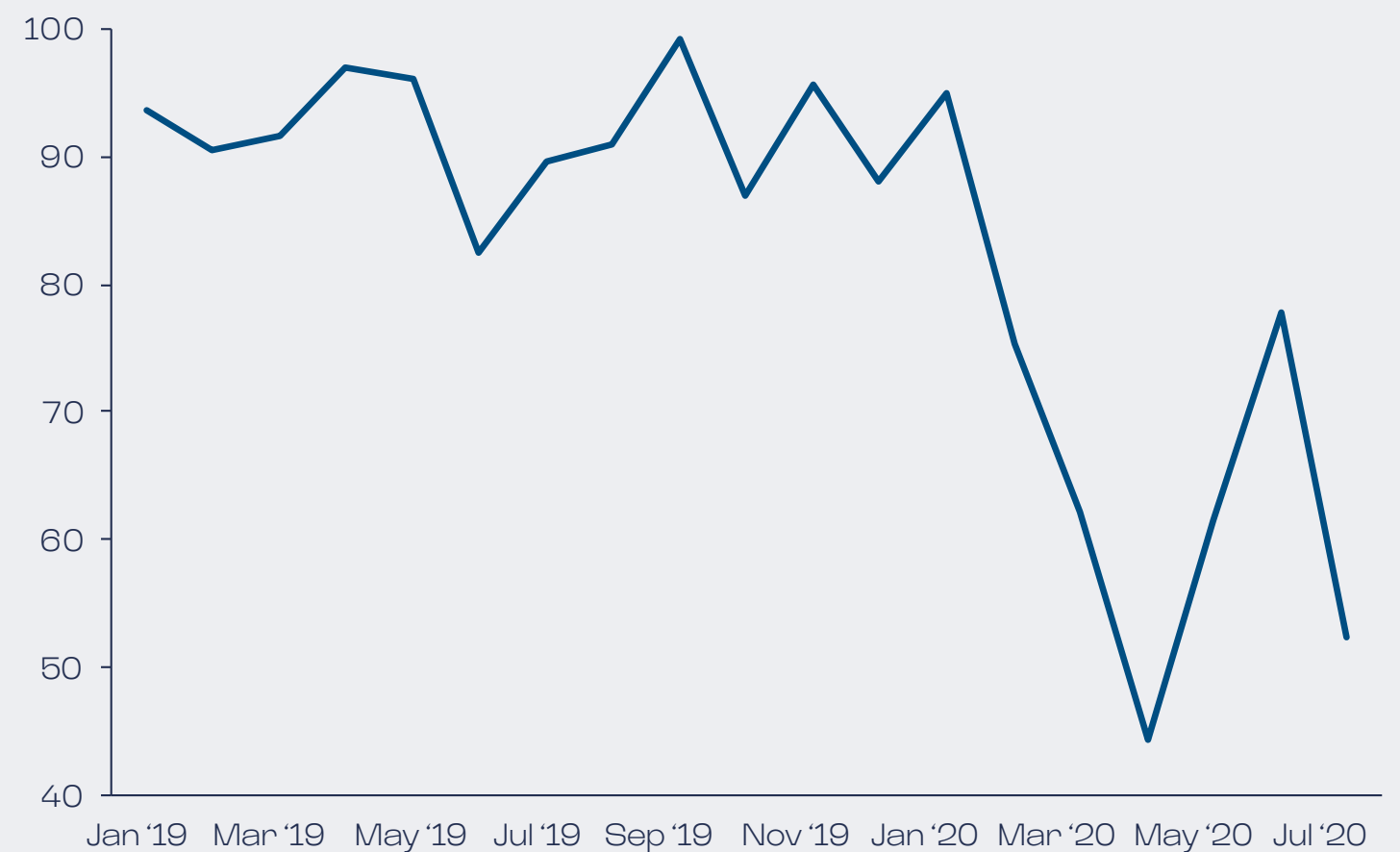
Average daily traffic on the ring road¹

YoY % change



Consumer Confidence Index

Index value of 100 implies equal number of positive and negative answers



1 116 counters on route one which goes around Iceland, connecting Reykjavík with several towns and villages.
Source: Gallup; the Icelandic Road and Coastal Administration

Border screening was a game changer – for a moment

Double border screening postpones the recovery of tourism

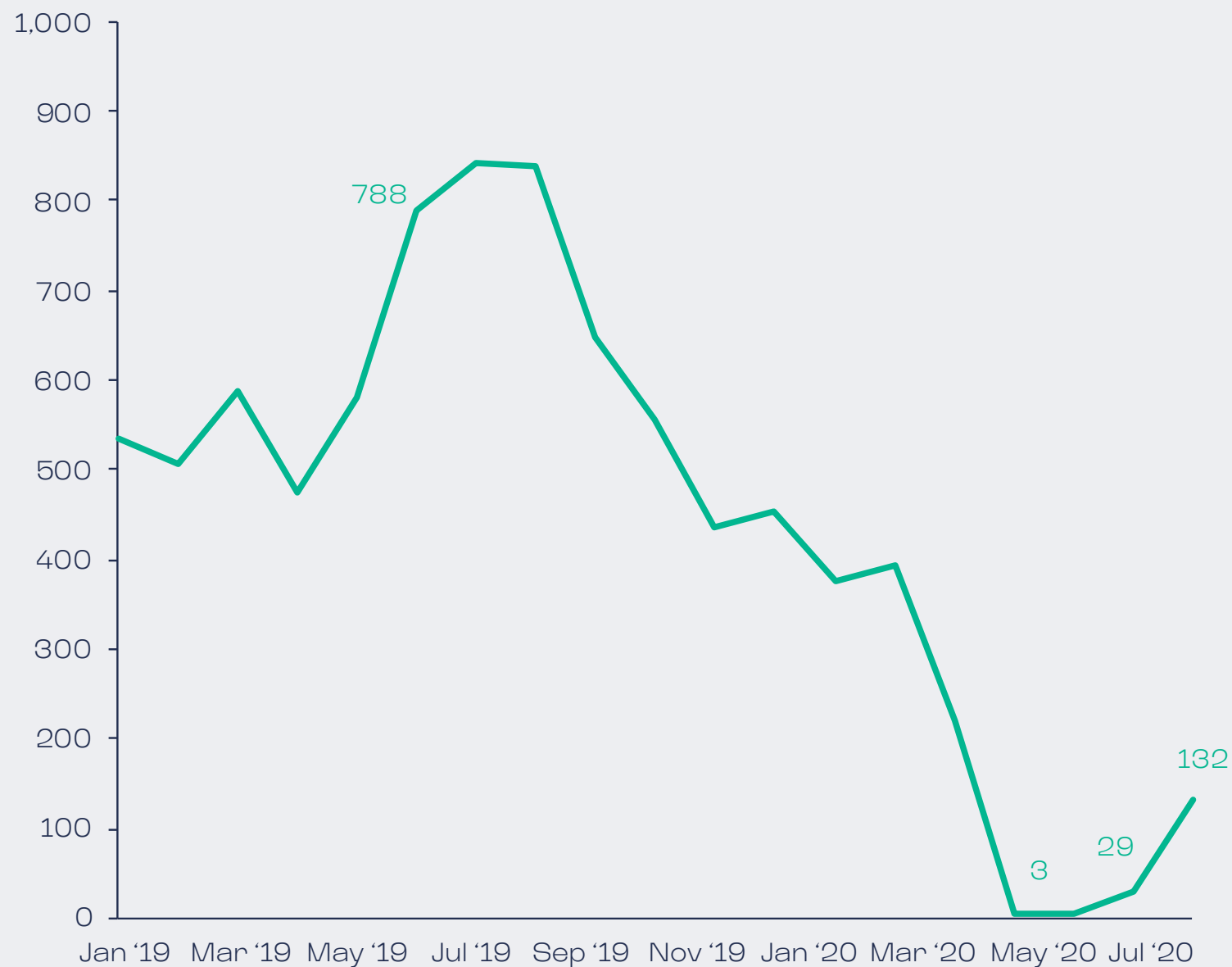
After it started to lift restrictions on public gatherings in May, the government announced, from 15 June, that incoming visitors could choose to be tested at the airport and avoid a 14 day quarantine if their test was negative. Home-

coming Icelanders who chose to be tested, however, needed to take two tests, separated by 4-5 days of crowd avoidance. This paved the way for international flights to resume, the number of departures per day went from less than 5 to 12 on 15 June. Since then airlines had slowly been increasing capacity and the outlook for the tourism sector was

brightening up. Now, however, the new restrictions have put the rebound on hold. Looking ahead, the Icelandic infrastructure, in tourism and other industries, is ready for activity to pick up but, when that will be depends, unfortunately, on the virus's development, in Iceland and other countries.

Passengers at Keflavik airport

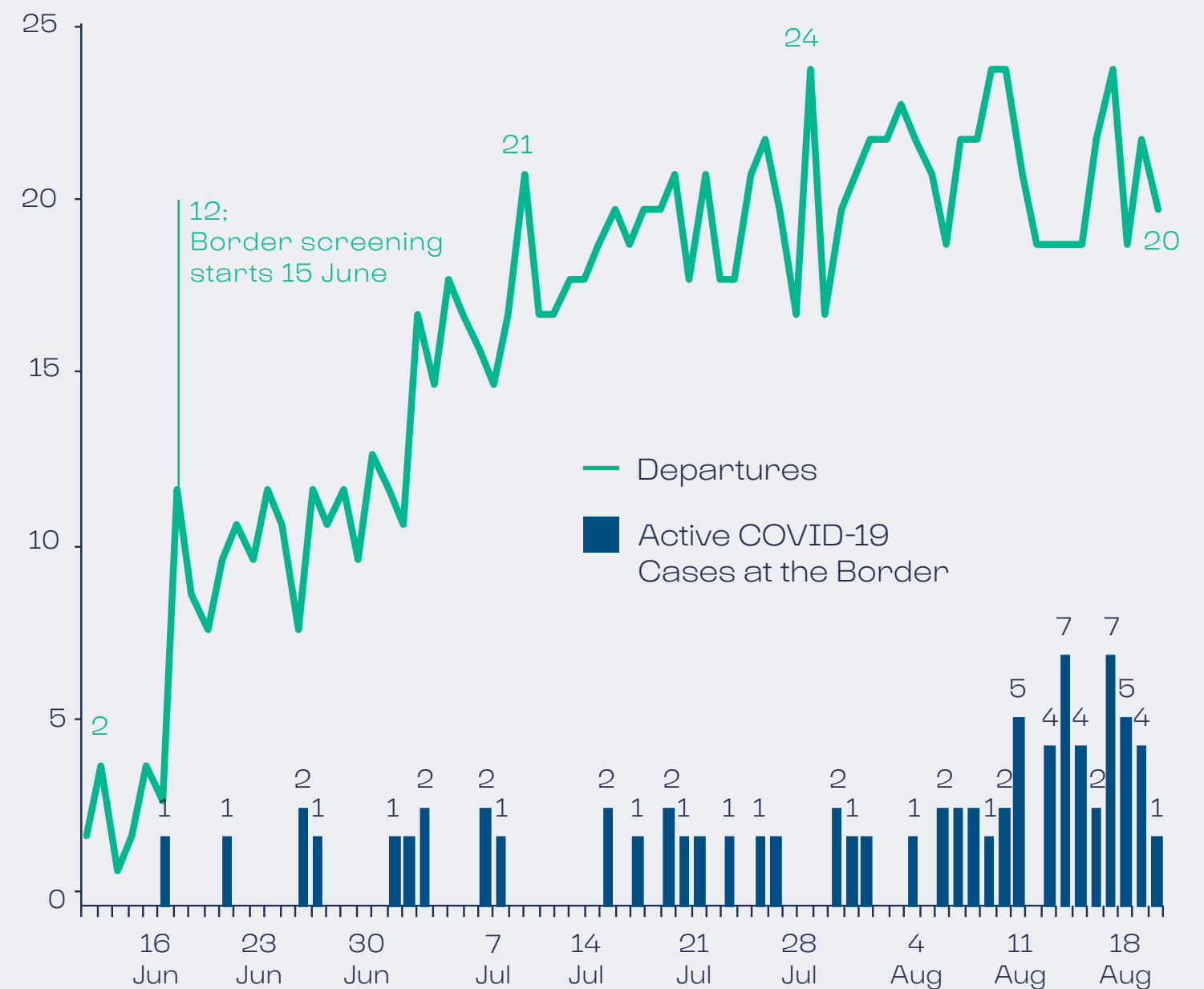
Thousands per month



Sources: Isavia; Flightradar24

Number of departures and active cases found at Keflavik airport

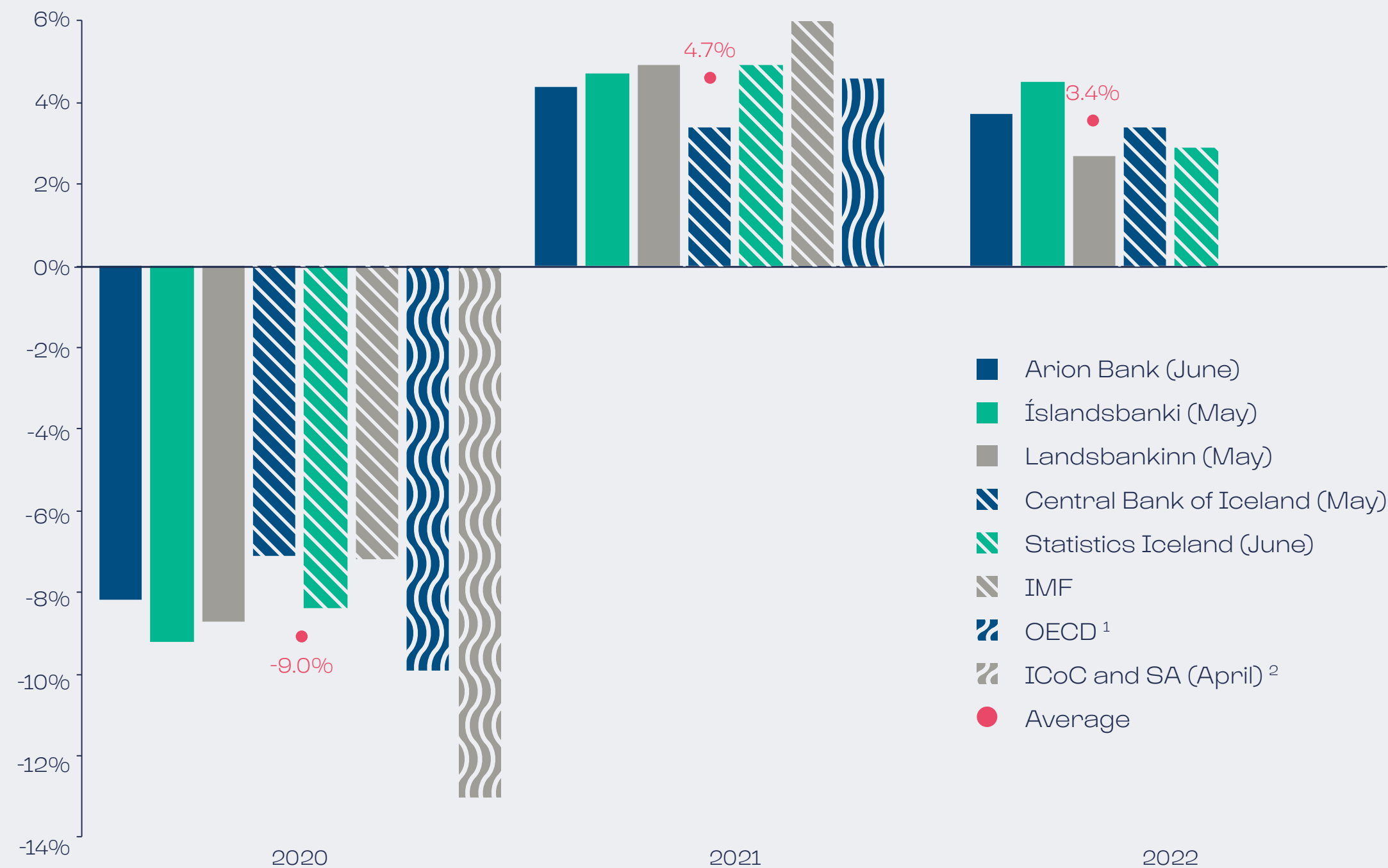
Daily in 2020



Short-term outlook depends entirely on the virus

Economic outlook for Iceland

GDP growth forecasts and scenarios



¹ Single-hit scenario. ² Base case.
Sources: Institutions' websites

The resurface of COVID-19 in Iceland is big bump in the road to recovery

Most institutions are forecasting a GDP decline of 7-10% this year. The hit to tourism, and to a lesser extent other exports, is the main culprit although domestic demand, including private consumption and investment, will also decline considerably. On the upside these projections did not expect domestic consumption to be as resilient as it has been over the summer, highlighted by the 19% YoY growth of domestic payment card turnover in July. That will help mitigate some of the negative effects.

Regarding the next couple of years, most expected the rebound to start in the second half of 2020 and peak in 2021, at a 5% GDP growth, when exports and consumption would be back at their pre-crisis levels. The new rise in COVID-19 cases puts those rebound projections under question as ongoing restrictions, domestically and at the border, could weigh heavily on economic sentiment over the next 12 months.

What is on the horizon?

Large uncertainties that mostly hinge on the virus and its effects

The main uncertainties regarding Iceland's economic outlook over the medium term are in many ways similar to what numerous other countries are experiencing. Moreover, should the fight against the virus prolong, the outlook could easily deteriorate. That said, Iceland has been comparatively successful in fighting the epidemic and hopefully it will remain that

way. In fact, if the virus is contained, and tourism recovers relatively quickly, it could have a knock-on effect in supporting investment and the various sectors of the economy. Additionally, a transformed economy, with lower debt levels and a strong external position, provides a precious cushion for policy makers should the outlook deteriorate. For example, FX reserves at 168% of IMF's reserve adequacy metric

(100-150% is considered sufficient)¹ will help stabilise capital flows and support the Króna.

Overall, the Icelandic economy is better shaped to overcome a crisis than it has been in the past. The medium term outlook will therefore largely depend on external developments. Should those be of favour, there is reason to be optimistic about the economic prospect of coming years.

↑ Factors that could improve the outlook

- ↗ Success in keeping a lid on the epidemic in Iceland
- ↗ An early vaccine or treatment against COVID-19
- ↗ Tourism bouncing back faster than anticipated due to looser border restrictions
- ↗ Low interest rates, positive sentiment etc. enhancing private investment and consumption
- ↗ Reopening of Iceland's silicon metal plants
- ↗ Export growth originating from the international sector
- ↗ Productivity boost to cover rising wages and help reduce unemployment

¹ Central Bank of Iceland (Financial Stability 2020/1)

↓ Factors that could deteriorate the outlook

- ↘ Prolonged second wave of the epidemic resulting in stricter restrictions
- ↘ Long-lasting fight against the virus
- ↘ Tourism not bouncing back significantly over the next couple of years
- ↘ Depressed investment levels
- ↘ Further business closures and the virus's knock-on effects on various businesses
- ↘ Capital flight and depreciating Króna leading to an inflation hike
- ↘ Rising wage costs sustaining unemployment

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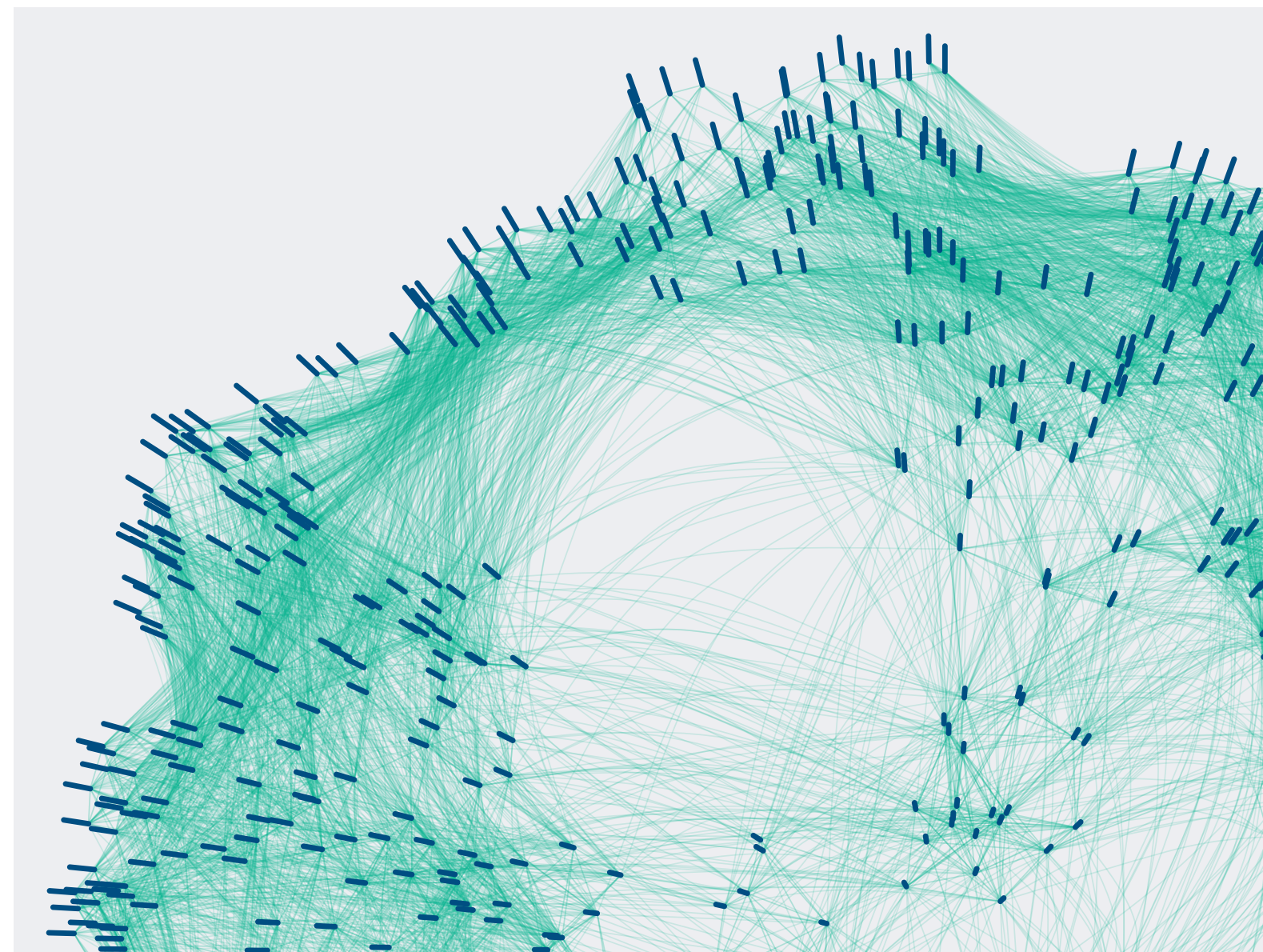


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4

Competitiveness Post-COVID-19



Future progress and living standards will be determined by how prepared people in Iceland are to face the number of disruptive trends that are now shaping the future of the global economy, such as digitisation, climate change, ageing populations and ever changing global connections. That will have a major say in whether Iceland will be able to realise economic growth over the longer term through increases in productivity and exports. It goes without saying that COVID-19 has affected those trends. Although the pandemic was hard, if not impossible, to anticipate, it has questioned the resilience of many economic

models and will probably affect their competitiveness at the global level. The Icelandic model is one of those, as its small domestic sector means the greatest value-adding opportunities appear mostly from goods and services that can be exported.

Global trade has faced a big test this year and it is still unknown when, how, and to what extent, it will bounce back. Attracting interest in Icelandic business opportunities after COVID-19 hinges therefore largely on Iceland's competitiveness, specifically in factors concerning domestic and foreign investment. In its latest World

Competitiveness Yearbook for 2020, IMD outlines high cost of capital, low investment incentives, insufficient access to venture capital and limited public-private partnerships as some of the domestic weaknesses of the Icelandic economy. It is fair to expect the improvement of these factors correlates strongly with the improvement of some of the external weaknesses outlined, such as lack of foreign direct investment, international experience and foreign highly-skilled personnel.

Iceland has much to offer when it comes to investment opportunities

and ranks amongst the most competitive economies in the world when it comes to factors concerning employment levels, creation of firms, use of digital tools and technologies, economic flexibility, skilled labour, finance skills, and renewable energy. This chapter elaborates on those strengths and opportunities, first by discussing how competitiveness can be improved and then by presenting potential infrastructure projects, and other more dynamic opportunities, which could benefit from the partaking of private parties, foreign and domestic, and could have a large impact on future economic growth.

Making Iceland more competitive

Increased awareness of the importance of FDI¹ and innovation is bearing results

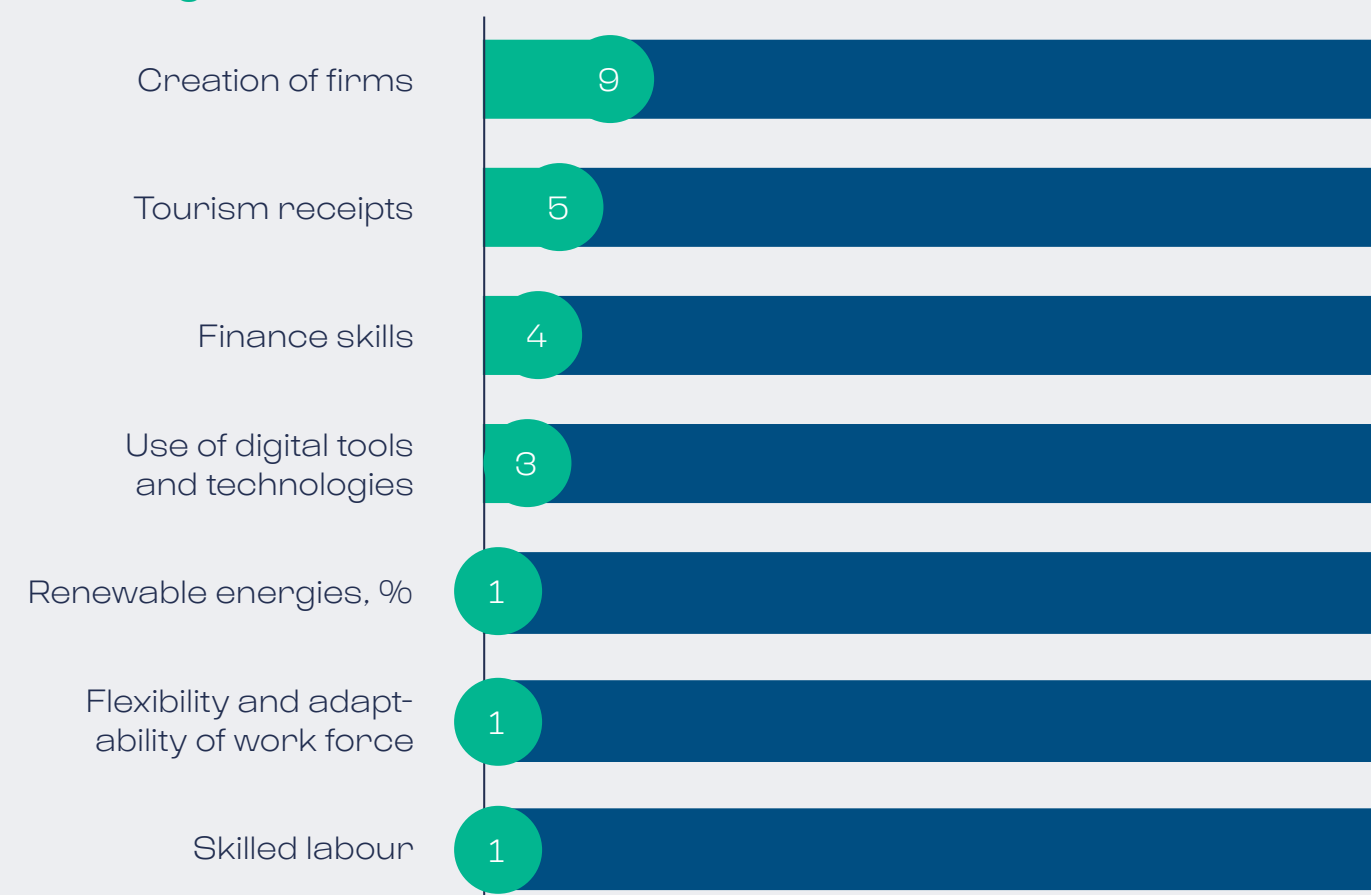
Increased awareness of the subdued inflow of foreign investments to Iceland in recent year has incentivised policy makers to put in place measures that aim to arouse this important determinant of economic prosperity. The need for action is urgent as the aforementioned IMD competitiveness report proves by ranking Iceland low in some factors that critically affect investment decisions. As already discussed, important steps have been taken to attract highly skilled foreign labour (chapter 2.2.3) and it is hoped that will bring more international experience to the country. Also touched on is the decrease of interest rates (chapter 1.2) which could become a game-changer in paving the way for investment levels to increase. In regards to innovation and access to venture capital then as mentioned in chapter 2.2.3 the government has increased its contributions to innovation funds and improved Iceland's R&D environment. The strategy "The

innovative Iceland", presented in chapter 2.2.3, has also started to bear fruit but recently the government approved the establishment of the ISK 7.65bn publicly-owned venture capital fund "Kría". Its purpose is to increase liquidity and activity in the venture capital sector by investing in other, privately-owned, venture funds. By improving access to venture capital, Kría will quicken the foundation of new export revenues and hopefully bring more foreign capital, and expertise, to the country.

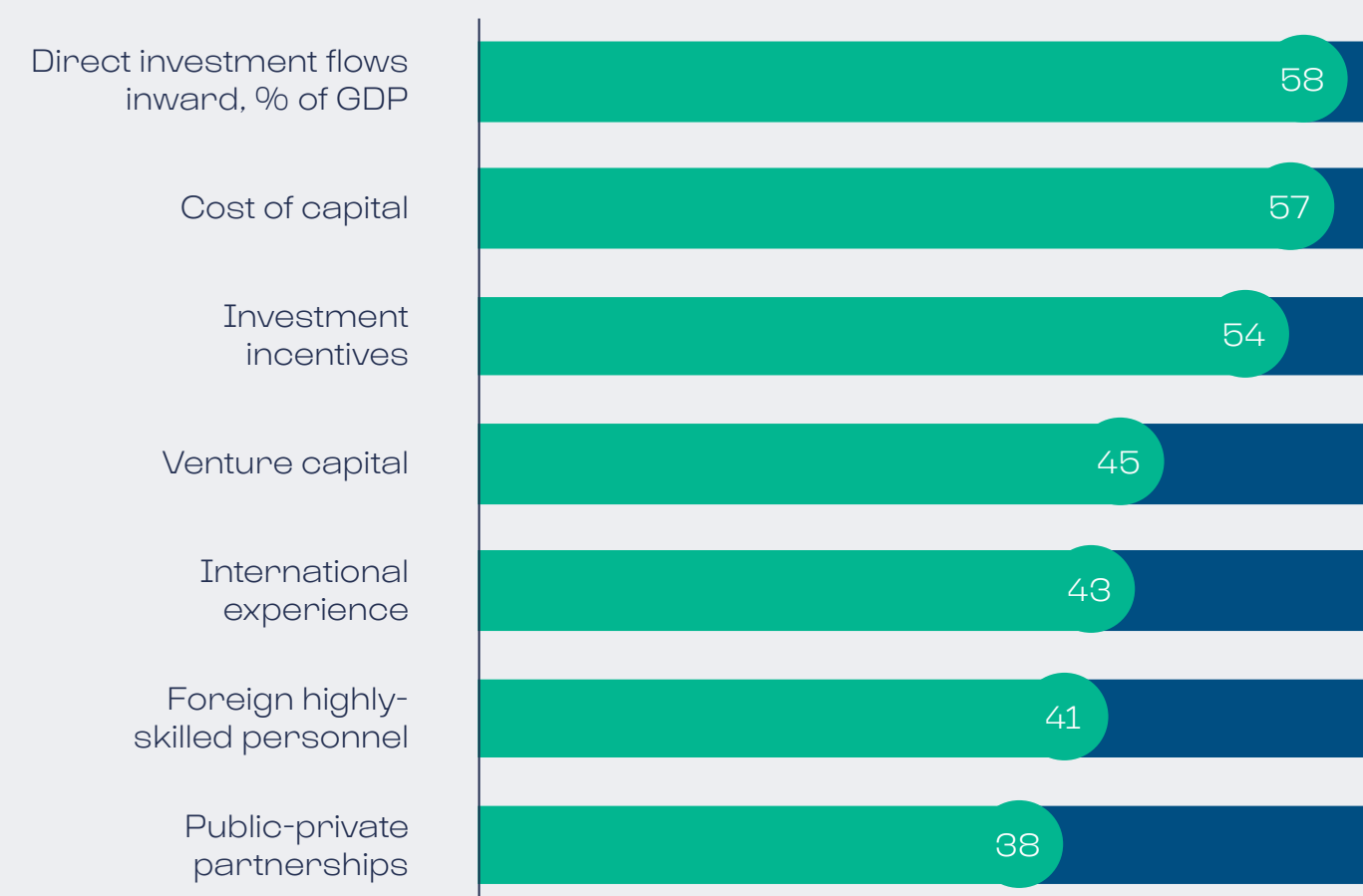
Strengths and weaknesses of The Icelandic Economy

● Iceland's Ranking
■ Countries Below Iceland

Strengths



Weaknesses



¹ Foreign direct investment
Source: IMD

4.1 Potential infrastructure investments

Calls for new infrastructure investments have been apparent in recent years. The reasons are threefold. First, efficient and reliant infrastructure is key for increased productivity and future prosperity. Second, investment was limited in the years after the financial crisis,

and after de-leveraging Iceland is in a healthy state to catch up. Finally, Iceland's population is growing. Consequently, this sub-chapter presents some potential infrastructure projects that have been a significant topic of debate in recent years and could have a

large impact on the economy. The projects are neither complete nor ranked in any way and should only be taken as a list of examples. Profitability and viability are furthermore debated in many cases, often on the grounds of environmental concerns.

Power industry investments

Interconnector to the UK

The possibility of constructing an electrical interconnector between Iceland and the UK has been explored in recent years. Except for generating new export revenues for Iceland, the connector could strengthen electricity supply security in the countries. A report from 2016 estimated the total cost at ISK 800bn (27% of Iceland's 2019 GDP)¹. The project has been stranded due to political opposition and, probably, declining costs of renewable energy. However, in its latest comment, Landsvirkjun announced it was still keen on the project.²

Wind power

In recent years, the option of wind power has been tested with promising results. Landsvirkjun has plans of building a 200 MW wind farm near Búrfell Power Station but no dates have yet been set. Other companies and private investors have also shown interest in constructing wind farms and some pilot projects have been initiated. Iceland can be very windy and is mostly powered by hydropower, making wind power an interesting option.

Power generation shortage?

In 2019, the power transmission system ("the grid") operator Landsnet published a report with projections on power generation and consumption³. According to the report, the probability of power shortage in 2022 is over a threshold value. It goes without saying that power generation might therefore need to increase, and/or consumption decrease/grow slower. With a growing population and electrification of the car fleet, this might become a challenge that demands other investments in power generation and in the grid.

The grid

While sufficiency of power generation is up to argue, investment in the grid has without doubt lagged behind. In a report by The Federation of Icelandic Industries on Icelandic infrastructure, the grid is stated as one of the key weaknesses, as connections between some regions are insufficient⁴. Therefore, electricity supply security is a concern and hinders optimal operation of power stations. The report estimates that an ISK 70bn investment is needed in the grid. Nevertheless, the outlook is good and Landsnet aims to take on 26 new maintenance, and investment, projects during the next 4 years.⁵

1 Information from Landsvirkjun: <https://www.landsvirkjun.com/researchdevelopment/research/submarinecablotoeurope>

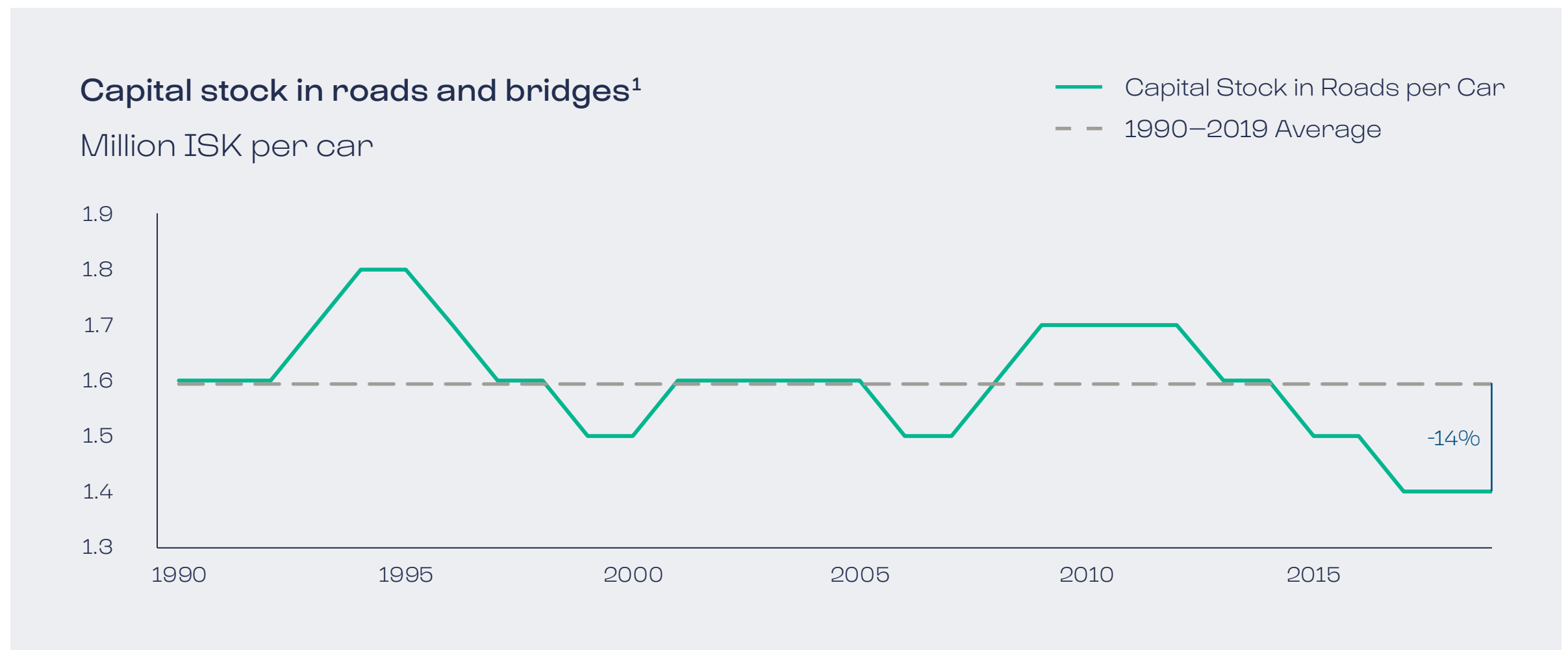
2 Visir.is, an online newspaper: <http://www.visir.is/g/2018180229216>

3 Landsvirkjun's report "Afl- og orkujöfnuður 2019-2023" can be found here: <https://www.landsnet.is/um-okkur/utgafa-og-samskipti/kynningarnit-og-skyrslur/>

4 The Federation of Icelandic Industries: https://www.si.is/media/_eplica-uppsetning/Innvidir-a-Islandi_skyrsla2017.pdf

5 Information from Landsnet: <https://www.landsnet.is/um-okkur/utgafa-og-samskipti/kerfisaaetlun/framkvaemdaaetlun-2021-2023/framkvaemdaaetlun-2021-2023/>

Transportation related investments



Roads

There is a substantial lack of road maintenance, as well as new roads, bridges and tunnels, around Iceland. According to the capital stock in roads and bridges per vehicle there is need for investments up to ISK 68bn to maintain the long run average. As the government (the owner of almost all road infrastructure) is constrained by fiscal responsibility, public-private partnership (PPP) projects, which so far have been uncommon in Iceland, could be a driver of those investments. In fact, in its fiscal response measures to COVID-19 the government pledged to spend ISK 8.3bn in road and infrastructure projects in 2020 and some of whom will be PPP projects.

Finnafjord port project²

New Arctic shipping lanes create opportunities to better connect cargo from Asia to Europe and North-America but Iceland's location puts it in a key position to embrace them. Last year a company was formed to pursue studies into the possible development of a new international port and industrial zone at Finna fjordur in northeast Iceland. The signing of an MoU with the Icelandic government puts the development officially on the radar of national infrastructure. However, many things remain unclear as the size and complexity of the project are extremely large.

Airports

After COVID-19, future projections of passenger activity at Keflavik airport are outdated. However, further investment in the airport's infrastructure will be needed when tourism rebounds (since 2010 the airport's expansion has been 30% and passenger growth 400%) the only question is when that will be. A new international airport between Reykjavik and Keflavik, in Hvassahraun, has also been considered in recent years. However, it is a large investment and many questions remain unanswered - the future of flight demand amongst them.

Reykjavik City Line

A hot topic of debate in recent years has been the "Borgarlína" or Reykjavik City Line in Greater Reykjavik. The City Line is a proposed bus rapid transit system (BRT) with a cost estimate of over ISK 70bn. A significant step towards the City Line's implementation was taken in June this year when the government passed laws that allow establishments of public entities that can direct large transportation projects such as the City Line. The first phase of the project is now underway and construction of bus lanes will start in 2021.

¹ Sources: Statistics Iceland; Iceland Chamber of Commerce. ² For more information on the project visit <https://www.efla.is/leit?q=Finnafjord>

New opportunities

Data centres and food production

COVID-19 and the necessary change to cleaner ways of production has made industries' flexibility and adaptability to changes a criterion investors must consider. Iceland has quite a few of these dynamic industries which pertain to sustainability and clean energy. For example, as [chapter 2.2.2](#) outlined, Icelandic based data centres are already exploiting one of the world's most reliable

power infrastructure for free cooling. Production of food is also something that could be looked at as a future opportunity. Iceland has a lot of advantages when it comes to producing food as focus on quality and sustainability makes food products easier to sell nowadays. To this regard, aquaculture is a fast-growing industry ([chapter 2.2.2](#)) but algae culture is another promising field

as Iceland's pure environment, availability of clean water and extensive offer of land are great advantages to this kind of culture. Lastly, improving Iceland's fishing industry spin-offs, both in terms of production technology and products based on excellent fish caught in the North Atlantic waters, could yield valuable results as demand from abroad has been plenty ¹.

Transition to carbon neutrality

Appetite for green investments, such as stocks and green bonds of environmentally aware corporations or green government bonds, is growing. In fact the CEO of Black Rock, the largest asset management company in the world, wrote in January 2020 "Climate change has become a defining factor in companies' long-term prospects ... and I believe we are on the edge of a fundamental reshaping of finance" ².

If global capital starts flowing increasingly towards environmentally-improving solutions, demand for investing in Iceland could improve substantially. The government recently released a new ambitious climate action plan that will, if followed from end to end, reduce CO₂ emission by 35 percent by 2030, which equals more than a 1-million-metric-ton reduction of CO₂. Overall, the probability of finding return yielding

opportunities that fulfil the environmental-improving criterion will be greater in locations where supply of natural resources is plenty, the labour force is highly skilled, the infrastructure is top of the art and the use of technology is at the forefront. As Iceland checks in all these boxes it should be worthwhile for investors to look at the opportunities it offers.

¹ For example, Marel, Iceland's largest company, has become one of the world-leading companies in developing fish, and livestock, production technologies.

² Larry Fink's, Chairman and CEO of Black Rock, annual letter in 2020: <https://www.blackrock.com/corporate/investor-relations/larry-fink-ceo-letter>

4.2 Getting Iceland out of the COVID-19 crisis

Leveraging Iceland's strengths in a broader perspective will yield great returns

This report has covered the most important aspects of the Icelandic economy and highlighted its competency going forward. Building on the strengths and improving on the weaknesses outlined in this chapter will with no

doubt matter a great deal for the future prospect of the economy. However, under current circumstances such focus is short-sighted since what is of utmost importance is understanding how the pandemic will shape a renewed global economy and how that can be exploited to recover as rapidly as possible from the current crisis.

On that thought, the Chamber presents five strengths that could prove vital for continuing the improvement of standards of living in Iceland. The list is not exhaustive but provides a solid ground from which ways to deliver value in the post-COVID-19 world can be found.

Some key areas of competitiveness in a post-COVID-19 world

Strength	Why?	Illustrative Example
Conditions for accelerated digitisation	People in Iceland possess the qualities, such as high skill levels, flexibility and positive attitudes towards technology, for adapting well to accelerated digitisation.	Iceland ranks 1st in digital/technological skills in the IMD Competitiveness Ranking
Strategic location	Iceland's location between America and Europe will remain a unique strength when global trade and travel recuperates.	 <p>A diagram showing a map of Iceland in the center. To the left is the word 'America' with a left-pointing arrow, and to the right is the word 'Europe' with a right-pointing arrow.</p>
Sparse population	The pandemic could make less populous places more attractive for residence and travel. Iceland is set to be at the forefront of capturing such trends.	Iceland is the 190th least densely populated country in the world (population/km ² = 3.6)
Strong and flexible education system	The highly praised Icelandic education system will play a key role in ensuring long-term competitiveness. The flexibility it has shown during the pandemic is promising.	Iceland ranks 3rd in the IMD University Education Index
Strong society and safety nets	Iceland's world-class social and welfare system will be essential in protecting people during the crisis, which afterwards should help them get quickly back on their feet.	Iceland ranks 3rd in OCED Better Life Index

¹ Country score calculated by IMD from Times Higher Education university ranking. Sources: Iceland Chamber of Commerce

Looking beyond the COVID-19 crisis

Focus on key challenges

Looking beyond COVID-19, the Icelandic economy is greatly affected by global disruptive trends and challenges that go beyond traditional economic policy. The Four Lenses of Disruptive Trends tie together current challenges and provide policy makers and business sectors a perspective through which to analyse actions for further economic improvements.

Foremost, how the Icelandic society embraces technological changes will determine productivity growth and service improvements across sectors. Leadership, entrepreneurship and educational matters will then be of great importance to the international sector and growth of knowledge in the economy. In addition, the shift to sustainable solutions is inevitable and Iceland's resources provide a competitive

advantage which must be exploited. At last, making the most of these changes will require maintaining valuable global connections, and establishing of new ones.

Should the economy succeed in these transitions, it would be among the vanguards in regards to infrastructure, human capital, technological innovation and sustainable economic growth.

The Four Focus Lenses of Disruptive Trends in Iceland

Digitisation

Embrace technological changes to drive productivity improvements across sectors

Improve services and achieve cost efficiency through digitization

Use big data insights to connect with customers and transform operations

Regeneration

Support and grow knowledge driven export sectors of the Icelandic economy

Ensuring that all generation's talents match the need of the society

Determining how business leaders can navigate through present challenges

Environmental sustainability

Maximize value creation of Icelandic resource industries

Protect nature with focus on productivity and sustainability

Leverage Iceland's unique situations to fight climate change

Global connections

Boost global position of Iceland as the country to base and do business in

Safeguarding Iceland's position in the EEA and openness to trade

Focus on business development in new markets



The Icelandic Chamber of Commerce

About the Chamber

The Iceland Chamber of Commerce (ICoC) is a non-governmental organisation based on voluntary participation of companies and individuals with the mission of improving the operating

environment of businesses in Iceland and to enhance economic prosperity. The ICoC has been diligent in its mission, celebrating its centennial anniversary in 2017.

Operations of the Chamber

Safeguarding of interests

The ICoC works in the interests of everyone 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 and most attended 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

Since 2004, The ICoC has published guidelines for corporate governance, in collaboration with the Confederation of Icelandic Employers and Nasdaq OMX Iceland. The latest edition is available online here: <http://www.corporategovernance.is/>

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, employee/employer relations and specific laws or regulations concerning or impacting the business environment of its members. The ICoC also operates an independent arbitration institute, called 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 and timely 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 technological and business education. Globalisation, 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 (CCoI)

The CCoI is a three-year secondary school which has over one thousand students. Its main objective is to promote the competitiveness of Icelandic businesses, both domestically and internationally, by providing education in general and business education at the secondary and lower tertiary level.

Reykjavik University (RU)

RU is an international university and is Iceland's largest private university with about 3,000 students. The university's focus is on research, excellence in teaching, entrepreneurship, law, technological development, and co-operation with the business community. The university's stated objective is to educate students to become leaders in business, technology, and society.

Joining the 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 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. Anyone interested in joining the Chamber should please send an e-mail to mottaka@vi.is

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 similar organisations in their respective countries. They also cooperate in several ways with embassies and consulates on promoting Icelandic businesses abroad.



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