ICELAND

Economic growth is strong with continued expansion in tourism, robust private consumption and favourable terms of trade. Steep wage gains, employment expansion and large investments are fuelling domestic demand. The capital controls introduced during the financial crisis are being lifted.

Currency appreciation and low import prices have kept inflation low. Inflationary pressures from wage increases and uncertainty with respect to the lifting of capital controls nevertheless call for a tight monetary stance. Moreover, the central bank should continue using its macro-prudential toolkit to tackle potentially large short-term capital inflows that might follow the lifting of capital controls. Reformed wage bargaining could prevent a future wage-price spiral while improved competition and reduced barriers to entry would boost productivity.

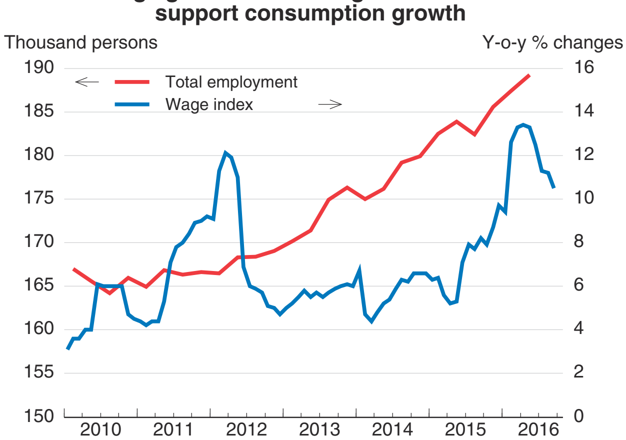
Iceland has considerably improved its fiscal position, reduced its net public debt and introduced a new budget law. Given the position of the economy, fiscal expansion would be unwise. But resources could be redeployed to health, pensions, and public infrastructure. Doing so would make growth more socially inclusive.

Economic growth is strong

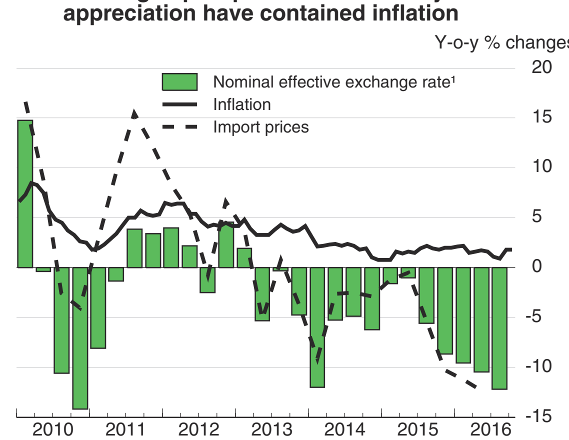
The economy is booming, supported by strong consumer spending and investment, a surge in tourism and fiscal easing. Household income continues to benefit from the strengthening labour market and double-digit wage increases. These pay rises far exceed productivity growth and will affect competitiveness as well as put pressure on inflation. Employment growth has been robust and the unemployment rate has fallen below 3%. The tourism boom continues and is supporting construction. In addition, a number of energy-intensive projects are boosting business investment.

Iceland

Wage gains and a strong labour market support consumption growth



Falling import prices and currency appreciation have contained inflation



1. A decrease denotes an appreciation.

Source: OECD Economic Outlook 100 database; and Statistics Iceland.

StatLink http://dx.doi.org/10.1787/888933437672

Iceland: **Demand, output and prices**

	2013	2014	2015	2016	2017	2018
	Current prices ISK billion	Percentage changes, volume (2005 prices)				
GDP at market prices	1 891.2	1.9	4.2	4.7	4.1	2.5
Private consumption	989.7	2.9	4.3	7.2	4.2	3.0
Government consumption	459.2	1.7	1.0	1.1	1.1	1.1
Gross fixed capital formation	296.8	16.0	18.3	18.1	7.7	0.8
Final domestic demand	1 745.7	4.8	6.3	7.9	4.2	2.0
Stockbuilding[1]	- 5.0	-0.9	-1.0	-0.7	0.0	0.0
Total domestic demand	1 740.8	4.0	5.2	7.2	4.2	2.0
Exports of goods and services	1 047.9	3.2	9.2	6.2	3.9	3.6
Imports of goods and services	897.5	9.8	13.5	13.8	4.4	2.6
Net exports[1]	150.4	-2.9	-1.5	-3.0	0.0	0.6
Memorandum items						
GDP deflator	_	4.1	5.9	3.4	3.1	3.8
Consumer price index	_	2.0	1.6	1.7	2.9	3.8
Private consumption deflator	_	2.9	0.7	1.5	2.9	3.8
Unemployment rate	_	4.9	4.0	3.1	3.1	3.2
General government financial balance[2]	_	-0.1	-0.8	16.6	0.5	0.5
General government gross debt[2]	_	83.1	73.8	64.4	63.6	56.0
General government net debt[2]	_	25.8	24.2	5.7	4.8	4.0
Current account balance[2]	_	4.0	5.1	3.5	2.3	2.9

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP. Includes unfunded liabilities of government employee pension plans, which amounted to about 25% of GDP in 2012.

Source: OECD Economic Outlook 100 database.

StatLink http://dx.doi.org/10.1787/888933439077

Macroeconomic policies need to tighten

Inflation has remained below the central bank's target of 2½ per cent, reflecting currency appreciation and the fall in import prices. However, considerable inflationary pressure has built up, as reflected in very large wage increases. The central bank needs to keep a tight stance if it is to achieve low and stable inflation. The uncertainties surrounding the final steps in liberalisation of the capital account pose further monetary and financial policy challenges for the central bank. The projections assume that it will raise short-term interest rates. Given the projected high interest rate differential with the rest of the world, macro-prudential tools need to be used to reign in potential unstable short-term debt capital inflows as controls are relaxed.

Past fiscal tightening, much lower net public debt and consequently a lower interest burden have significantly improved the budgetary position. Substantial windfall receipts of around 17% of GDP in 2016 from agreements with the estates of the failed banks will be used to reduce public debt significantly. A fiscal surplus is projected through 2018, but the stance may have to be tightened further to contain demand pressures.

Rapid growth of tourism has buoyed the Icelandic economy in recent years, diversified the output mix, and provided jobs, though many with low skills. However, it is also putting pressure on infrastructure and the environment. A recent breakdown in negotiations between social partners indicates that Iceland needs to revamp its wage bargaining framework in order to prevent a future wage-price spiral that undermines competitiveness. Reducing barriers to entry and better enforcing competition policy to prevent abuse of dominant positions or tacit collusion would boost productivity.

The economy will continue to grow with risks of overheating

Sustained investment and private consumption will support robust growth in 2017. Moderation in investment, end of the positive terms-of-trade shock and inflation pressures will gradually erode demand, and growth will slow in 2018 to more sustainable levels. The unemployment rate will stabilise at a low level.

Overheating and accelerating inflation are the biggest risks to the outlook. Possible future wage increases can fuel this further. Liberalisation of the capital account raises uncertainty about capital flows, while at the same time the relatively high interest rates could cause large capital inflows and strong appreciation of the Krona, hurting the economy. Slower growth in the global economy, and in particular more negative effects of Brexit than assumed, could have negative consequences for exports, notably tourism.