ICELAND

Economic growth is projected to remain strong, thanks to continued vibrant tourism activity and strong domestic demand. Positive sentiment and rising asset prices are fuelling residential and business investment. Wages and employment are rising fast. The capital controls introduced during the financial crisis have been lifted.

Currency appreciation and low import prices have kept inflation at bay. Yet, inflationary pressures are mounting due to rising wages and soaring housing prices. The central bank should stand ready to tighten and continue using macro-prudential tools to tackle disruptive short-term capital inflows and moderate tensions in the housing market. Given high growth, a tighter fiscal stance is warranted and could help lower interest rates.

As a small open economy relying on natural resources, Iceland is prone to large terms of trade shocks and boom and bust cycles, but it has an egalitarian society with high levels of health and education spending. The poverty rate is the lowest in the OECD and the gender balance is high. To avoid a recurrence of high economic volatility, policy should act more counter-cyclically, and fiscal, liquidity and capital buffers should be built up further.

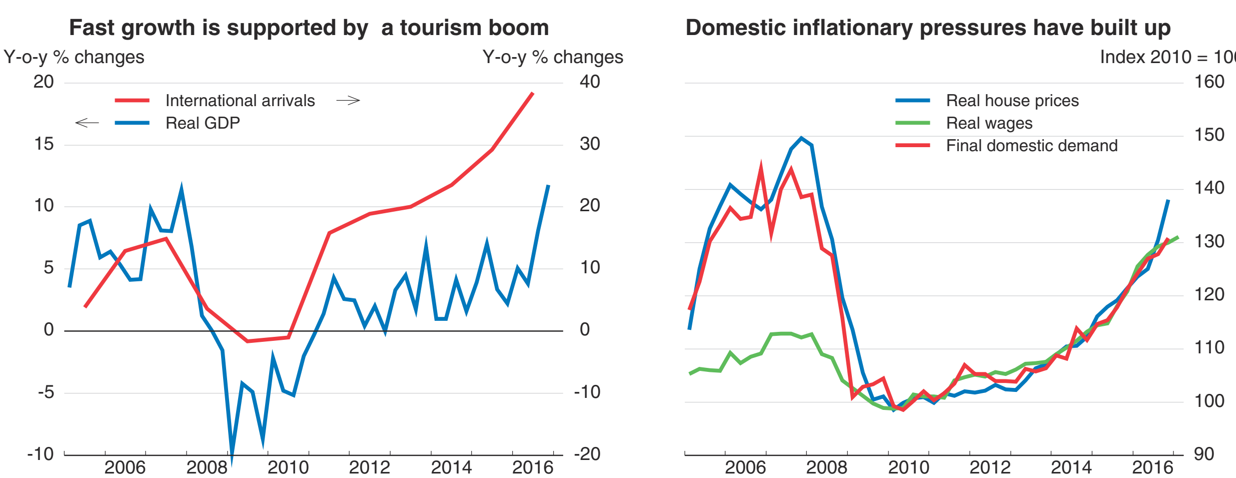
Iceland is the fastest growing OECD economy

GDP growth reached 7.2% in 2016, supported by strong private demand, surging investment, booming tourism and expansionary fiscal policy. Household income continues to benefit from employment growth and steep wage increases. These pay rises exceed productivity growth and will eventually hurt external competitiveness. The unemployment rate has fallen below 3% and many vacancies are being filled by foreign workers. Housing construction, tourism and a number of energy-intensive projects are boosting investment.

Policy should be less expansionary

Inflation has been below the central bank's target of 2.5% for the past three years. Yet, low inflation stems largely from króna appreciation, low inflation abroad and declining

Iceland



Source: OECD Economic Outlook 101 database; Statistics Iceland; and Iceland Tourism Board.

StatLink http://dx.doi.org/10.1787/888933503206

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	4.1	7.2	5.3	2.6
Private consumption	989.7	2.9	4.3	6.9	5.4	3.4
Government consumption	459.2	1.7	1.0	1.5	1.0	1.1
Gross fixed capital formation	296.8	16.0	17.8	22.7	9.2	1.1
Final domestic demand	1 745.8	4.8	6.0	8.7	5.2	2.3
Stockbuilding[1]	- 5.0	-0.9	-0.9	-0.6	0.0	0.0
Total domestic demand	1 740.8	4.0	5.1	8.1	5.2	2.3
Exports of goods and services	1 047.9	3.2	9.2	11.1	6.3	3.5
Imports of goods and services	897.5	9.8	13.5	14.7	5.8	2.6
Net exports[1]	150.4	-2.9	-1.5	-0.8	0.6	0.6
Memorandum items						
GDP deflator	_	4.1	6.0	2.0	1.9	3.2
Consumer price index	_	2.0	1.6	1.7	2.4	3.5
Private consumption deflator	_	2.9	0.8	0.7	0.9	3.1
Unemployment rate	_	4.9	4.0	3.0	2.8	3.0
General government financial balance[2]	_	-0.1	-0.8	17.2	0.9	1.5
General government gross debt[2,3]	_	79.9	73.0	62.3	61.0	59.3
Current account balance[2]	_	4.0	5.5	8.0	5.2	5.6

1. Contributions to changes in real GDP, actual amount in the first column.
2. As a percentage of GDP.
3. Includes unfunded liabilities of government employee pension plans.
Source: OECD Economic Outlook 101 database.

StatLink http://dx.doi.org/10.1787/888933505885

commodity prices. These favourable dynamics could quickly turn if the króna were to depreciate in response to lower export earnings. Moreover, the tight labour market and fast-rising wages and asset prices are generating inflationary pressures. The central bank should stand ready to tighten to defend its inflation target. With capital mobility restored, capital flows could once again become destabilising, therefore the continuation of active use of macro-prudential tools is warranted.

Fiscal trends are favourable: public debt has declined markedly, the budget balance has turned positive and a new fiscal framework has been introduced. Nevertheless, the fiscal stance is overly expansionary due to fast-rising public sector wages and other spending pressures. Public spending needs to be brought under firmer control. With greater spending efficiency in health and education, Icelanders could enjoy the same quality of public services at lower costs.

Labour productivity is low compared to other Nordic countries and productivity growth has declined. Reducing barriers to entry and better enforcing competition policy to prevent an abuse of dominant positions or tacit collusion would boost productivity. The nascent technology sector offers opportunities for future productivity growth, and the government has continued providing support. A rapid growth of tourism has helped greatly in turning around the economy after the crisis, but a comprehensive tourism strategy is needed to help the sector bring high dividends without environmental and societal costs.

Growth will continue

Growth is projected to remain strong in 2017, supported by private consumption, continued tourist arrivals and strong residential investment. Over time, however, investment and exports will slow, as profitability and cost competitiveness are eroded, and the positive impact of the terms of trade will dissipate. Growth will fall closer to trend in 2018. Inflation will rise above target and consumption growth will slow.

Overheating and accelerating inflation are the biggest risks to the outlook. Liberalisation of the capital account raises uncertainty about capital flows. A large króna appreciation could lower growth by causing hardship for exporting businesses and slowing tourism. A weaker króna, on the other hand, would raise growth, but also intensify inflationary pressures. Tensions in the labour market remain. Disruptive strikes could hurt growth and result in unsustainable wage gains. Slower growth in the global economy could have negative consequences for exports, notably tourism. However, geopolitical tensions in other parts of the world could further boost tourism directed towards safe destinations such as Iceland.