

A rapid downturn is exposing Iceland's structural weaknesses

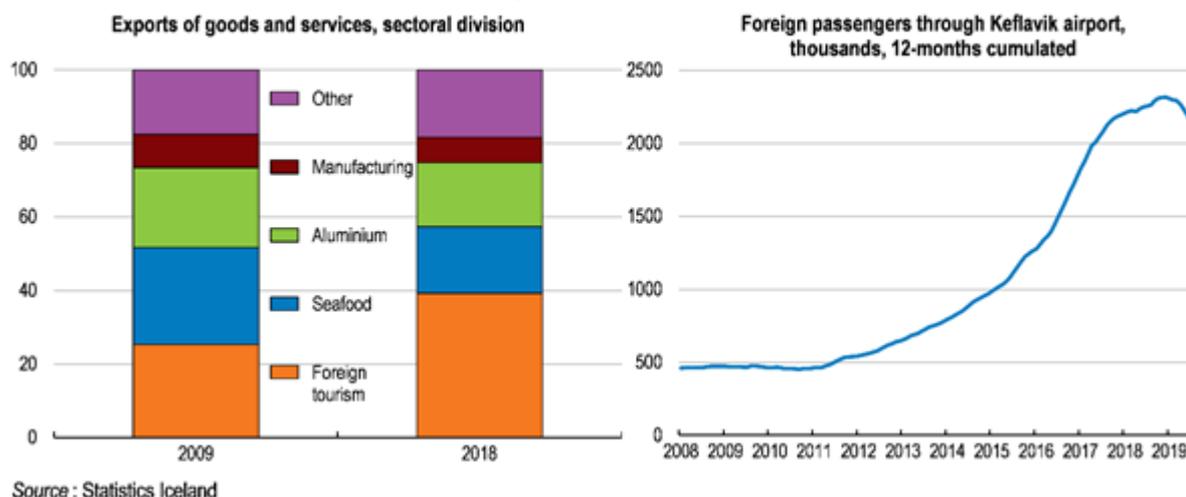
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Over the years Iceland caught up rapidly with the richest OECD economies. Favourable external conditions and good macroeconomic policies helped foster strong growth, low unemployment, low inflation, and sustainable public finances. Iceland is also one of the most inclusive economies in the OECD thanks to high employment, little wage inequality, and a well-targeted social benefit system, suggesting that a performing economy and an egalitarian society can go together.

Yet the country was hit by several export shocks during the first half of 2019, and the economy turned sharply. Revenues from tourism have almost stalled, especially after the Icelandic low-cost airline WOW went bankrupt. Seafood exports also declined as a specific specimen disappeared from the country's fishing grounds. Over the summer, the Central Bank gradually lowered interest rates by 1% percent point to 3.5%. Growth is projected to reach 0.2% in 2019, rebounding to 2.2% in 2020.

Iceland is heavily dependent on tourism, which is stalling

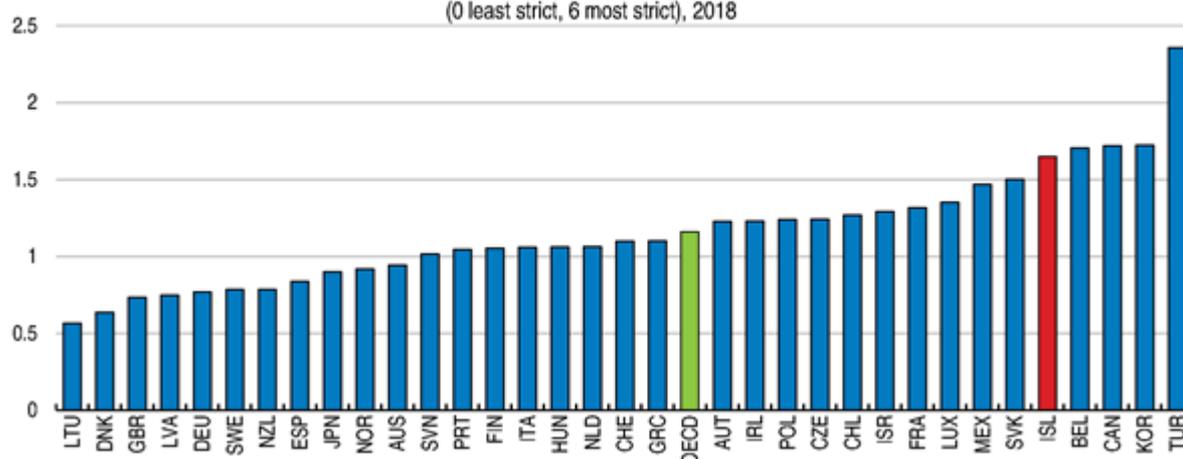
Export sectors relative weights and trend in foreign airport arrivals, 2008-19



The rapid slowdown has exposed Iceland's structural weaknesses. The economy relies heavily on tourism and seafood, which together make up almost 60% of total exports. The gains in competitiveness, achieved after the 2008 financial crisis, have been exhausted by now. Product market regulation is stringent and the administrative burden for start-ups is high, holding back creative young firms. Restrictions to foreign direct investment are among the highest in the OECD, dampening potential productivity gains through more intensive knowledge transfer.

The regulatory burden is high

Barriers to Domestic and Foreign Entry
(0 least strict, 6 most strict), 2018



Source: OECD 2018 PMR database.

The government should set up a comprehensive action plan to open up the economy more, prioritising reforms that foster competition, level the playing field between domestic and foreign firms and attract investment from abroad. In addition,

wages should be linked closely to productivity developments, to maintain competitiveness.

Productivity would also benefit from addressing a decline in student performance and better matching adult skills to the labour market. Iceland has a highly equitable education system and a large share of its workforce is well-educated. Yet it could make education more responsive to labour market needs, to avoid people having the wrong skills or being overqualified. The business sector hardly supports tertiary education. A reform of university funding could help attract more private R&D activities and increase the quality and performance of higher education.

Reference:

OCDE (2019), *OECD Economic Surveys: Iceland 2019*, Éditions OCDE, Paris, <https://doi.org/10.1787/c362e536-en>.