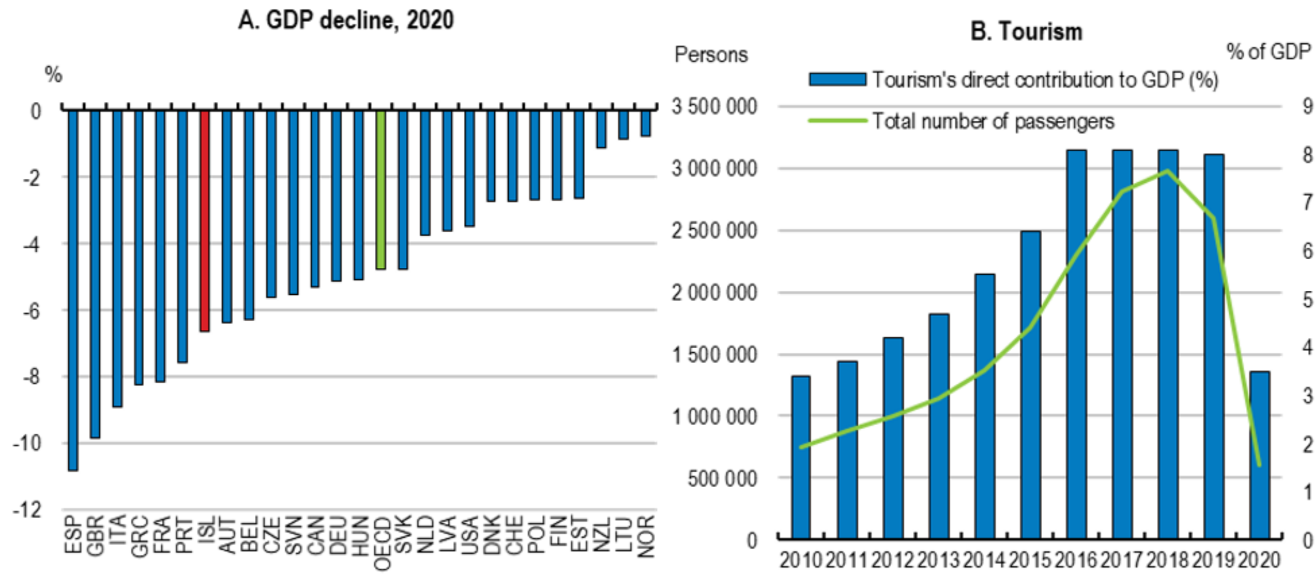
Fostering a resilient recovery and sustainable growth in Iceland

By Hansjörg Blöchliger and Vassiliki Koutsogeorgopoulou, OECD Economics Department

Iceland went through a comparatively mild COVID-19 health crisis. Containment measures were less severe than elsewhere, and all domestic restrictions were lifted at the end of June 2021. Yet the economy suffered a lot. Following lockdowns and travel restrictions worldwide, tourism, Iceland's most important export sector, collapsed with only around a fourth of foreigners arriving in 2020 compared to the previous year. GDP declined by 6.6% in 2020, and unemployment rose to 8%.

Even before the pandemic, other sectors had started to draw level with tourism as growth engines. The pharmaceutical industry continues to develop rapidly, and digital services such as data processing and storage benefit from Iceland's low energy prices and cool and windy climate. Fisheries are climbing up the value chain with fresh seafood and aquaculture rising fast. Innovative carbon capture technologies help reduce carbon emissions and provide export income.

Figure 1. The economy was hard hit as foreign tourism collapsed



Note: Passengers who go through security at Keflavík Airport.
Source: OECD, National Accounts database; and Statistics Iceland.

Macro policy supported households and firms

Like overseas, monetary and fiscal policy cushioned the blow for households and firms. In addition, the government plans to increase spending on infrastructure, digital and green transition, and research and development by around 0.5% points of annual GDP over the next few years, to ensure a healthy and sustainable recovery.

Yet public debt could continue to rise since Iceland, as a small open economy, is highly vulnerable to external shocks. To maintain fiscal space, the government should start consolidating once the recovery is firmly underway. Although Iceland's population is young and active, the government should start addressing disability, pension and long-term care spending.

Structural reform could help boost productivity

Regulation is restrictive, hampering sound competition. Administrative burdens and an extensive licensing and permit system slow the entry of new and innovative firms. Skills gaps are considerable. To boost productivity and diversify the economy, regulation particularly in the tourism and construction sectors should be eased. The quality of education, from primary to tertiary, should be better aligned with the needs of economy and society.

Fostering innovation is crucial for strong economic performance in the digital era

Innovation outcomes remain weak in some critical areas, notably ICT. Despite generous R&D tax incentives, many smaller firms have not been inclined to innovate. Icelandic firms should also be encouraged to step up the adoption of digital technologies, which would help the country make the most of innovation niches. Improving framework conditions and easier access to finance for young innovative firms are important. At the same time, the provision of digital skills needs to be strengthened and knowledge exchange enhanced, through closer business-university collaboration on innovation.

Making climate action more cost-efficient and inclusive

Iceland’s per capita greenhouse gas emissions exceed the OECD average, partly because of emission-intensive aluminium smeltering. The government committed to reduce emissions from their 2005 level by at least 40% by 2030. Iceland’s climate policy should rely on effective carbon pricing, complemented by investment in low-carbon technology and participation in international projects to finance emission reduction in transition and emerging market economies. Revenues from carbon pricing could be redistributed to households and firms.

https://www.oecd.org/economy/iceland-economic-snapshot/