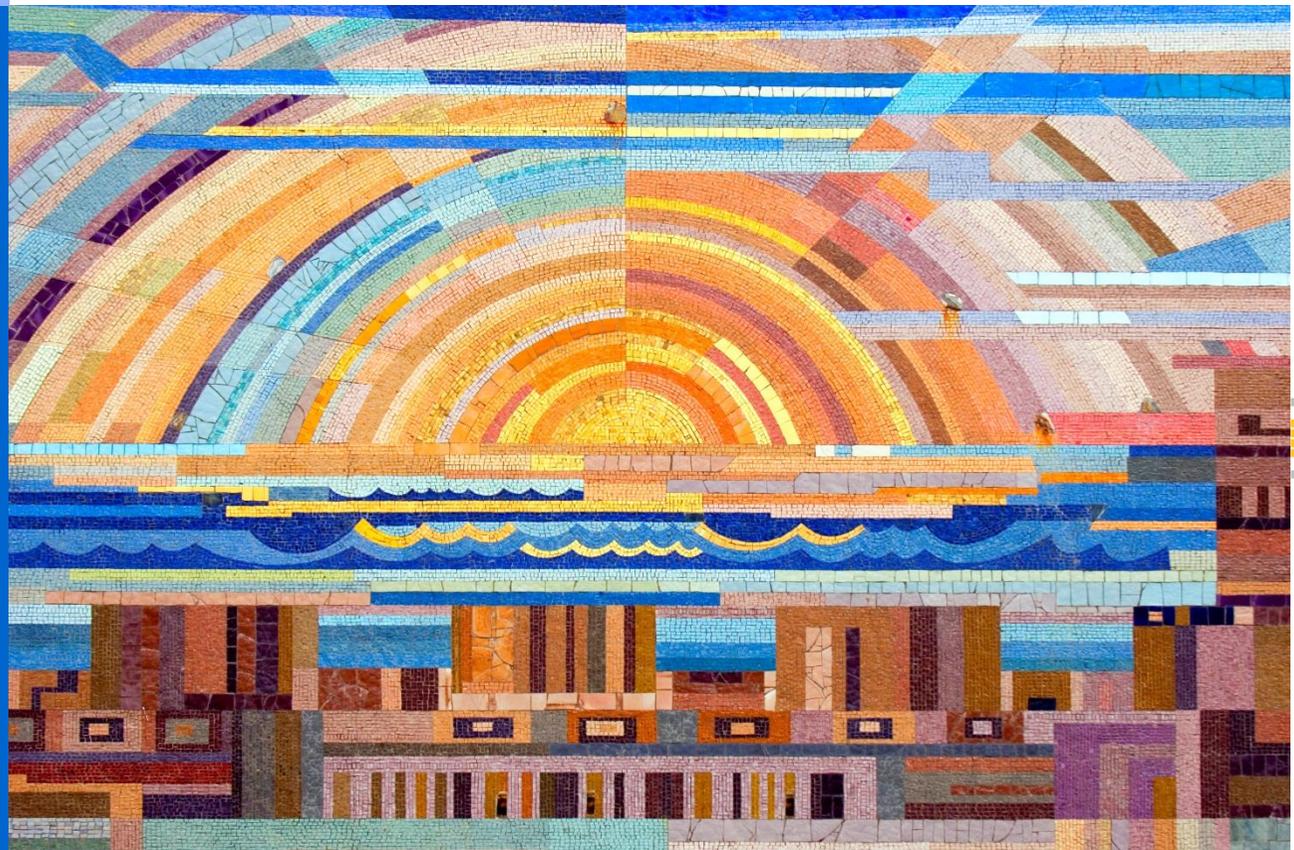
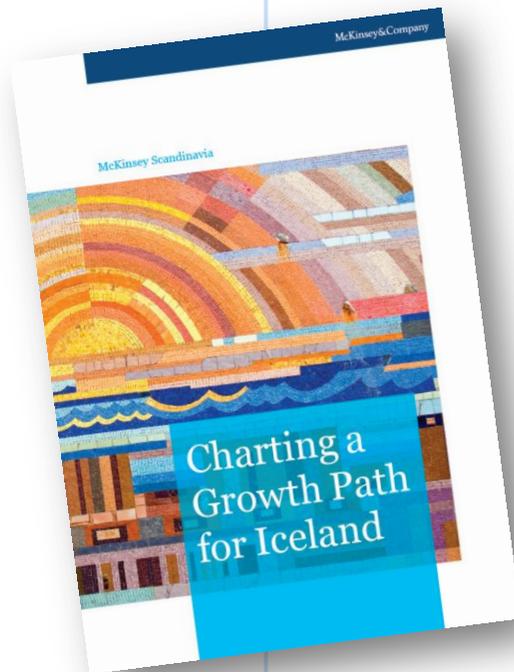


Unlocking Iceland's Growth Potential



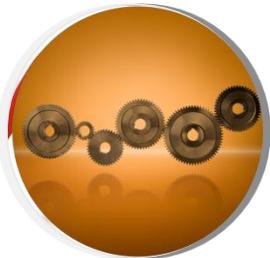
In the report we published on the Icelandic economy 1.5 years ago, the main focus was on productive capacity



Iceland's path towards sustainable economic growth depends on the ability to **increase the productive capacity** of the economy through a **broader portfolio of competitive exporting industries**

The attributes of a successful country are broad

Productivity



Are inputs (for example, capital, labour, natural resources) used efficiently?

Inclusiveness



Is economic growth shared broadly across regions, social groups, genders, and age groups?

Sustainability



Is growth achieved without depleting limited natural resources or accumulating debt?

Resilience



To what extent can the economy mitigate future risks to growth (for example, demographic changes, debt, reliance on too few sectors)?

Connectivity



Can the economy take full advantage of opportunities abroad through the cross-border transfer of goods, services and skills?

To assess Iceland's growth potential, we divided the economy in to three sectors

■ Focus of today

Domestic service sector

Definition

Industries that mostly provide **non-tradable goods and services** for the domestic market

Key challenge

Increase productivity to enable reallocation of labor to export sectors



Resource-based sector

Industries that require **domestic natural resources** as an input for their production

Focus on capturing and maximizing value from limited natural resources



International sector

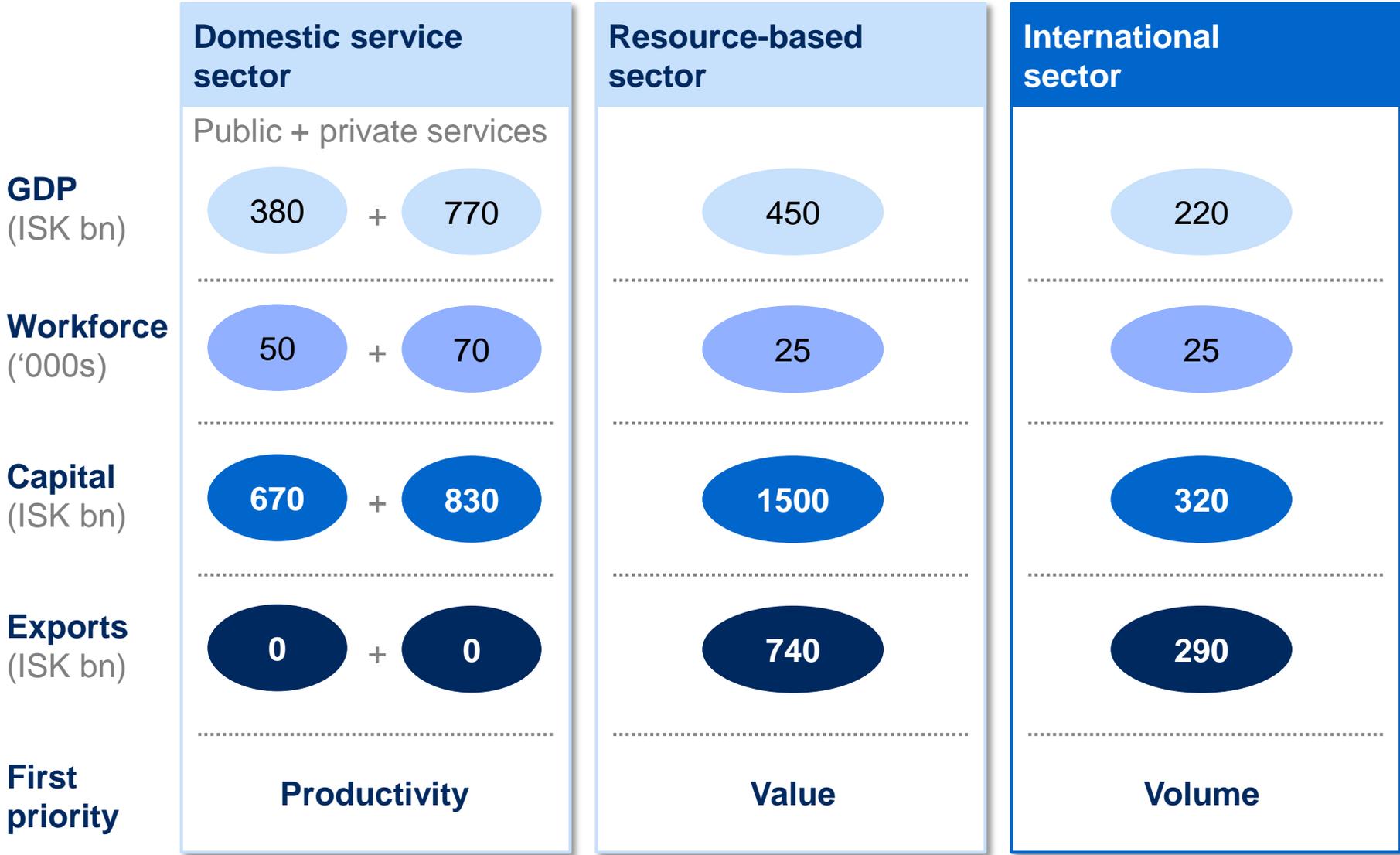
Business that produce **tradable goods and services** that are largely independent of local natural resources

Enable growth and renewal through a globally competitive business environment

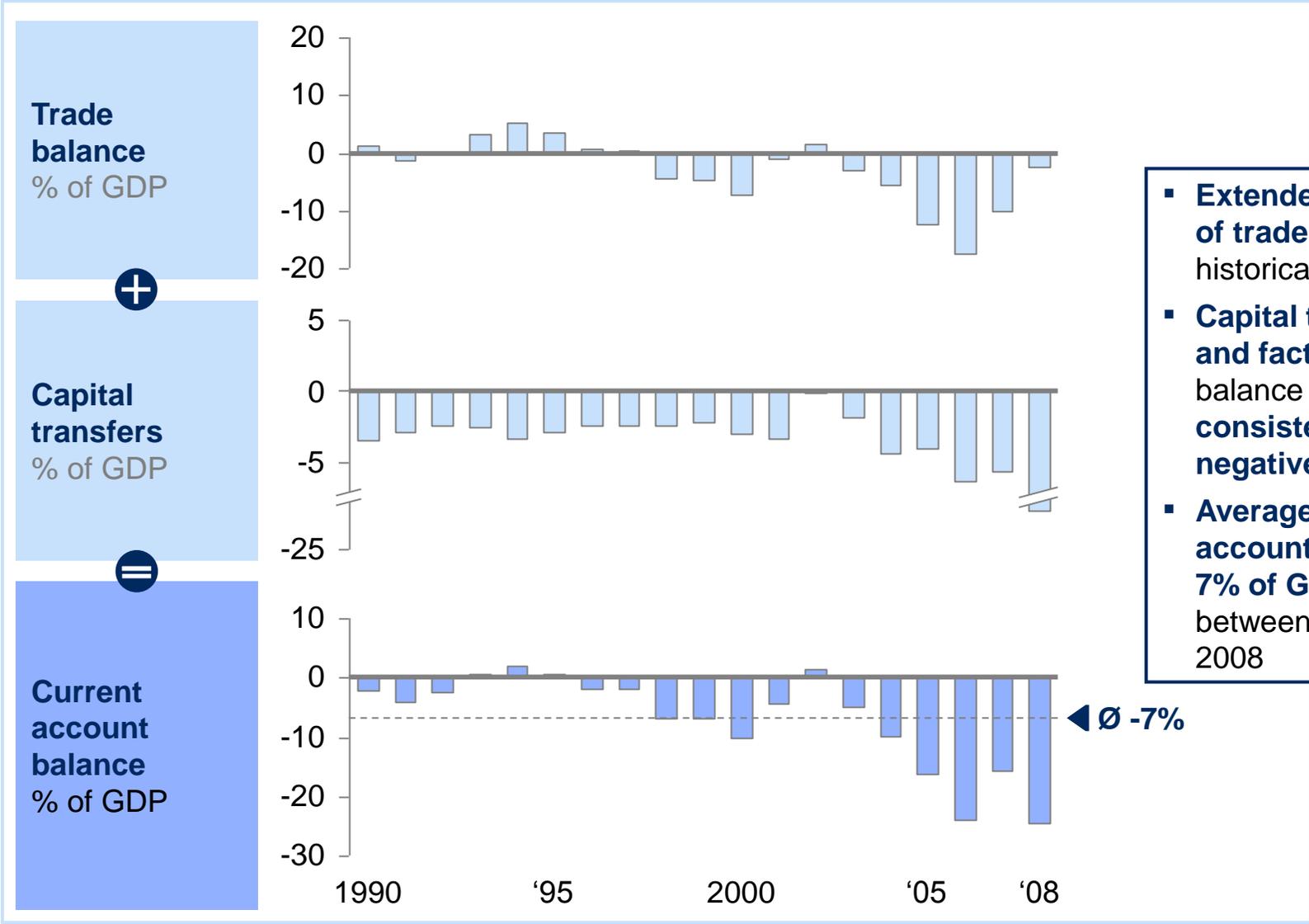


These three sectors are fundamentally different in both size and objectives

■ Focus of today



Historically, Iceland has had a strong tendency to run a current account deficit



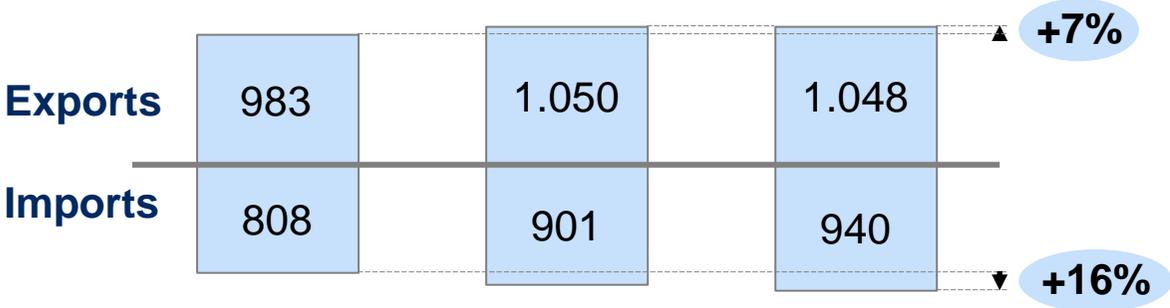
- Extended periods of trade deficits historically
- Capital transfer and factor income balance has been consistently negative
- Average current account deficit of 7% of GDP p.a. between 1990 and 2008

◀ Ø -7%

Weak currency has supported a positive trade balance since the recession, but imports are picking up momentum

Imports are picking up momentum ...

Trade balance components, ISK billions, constant 2013 prices



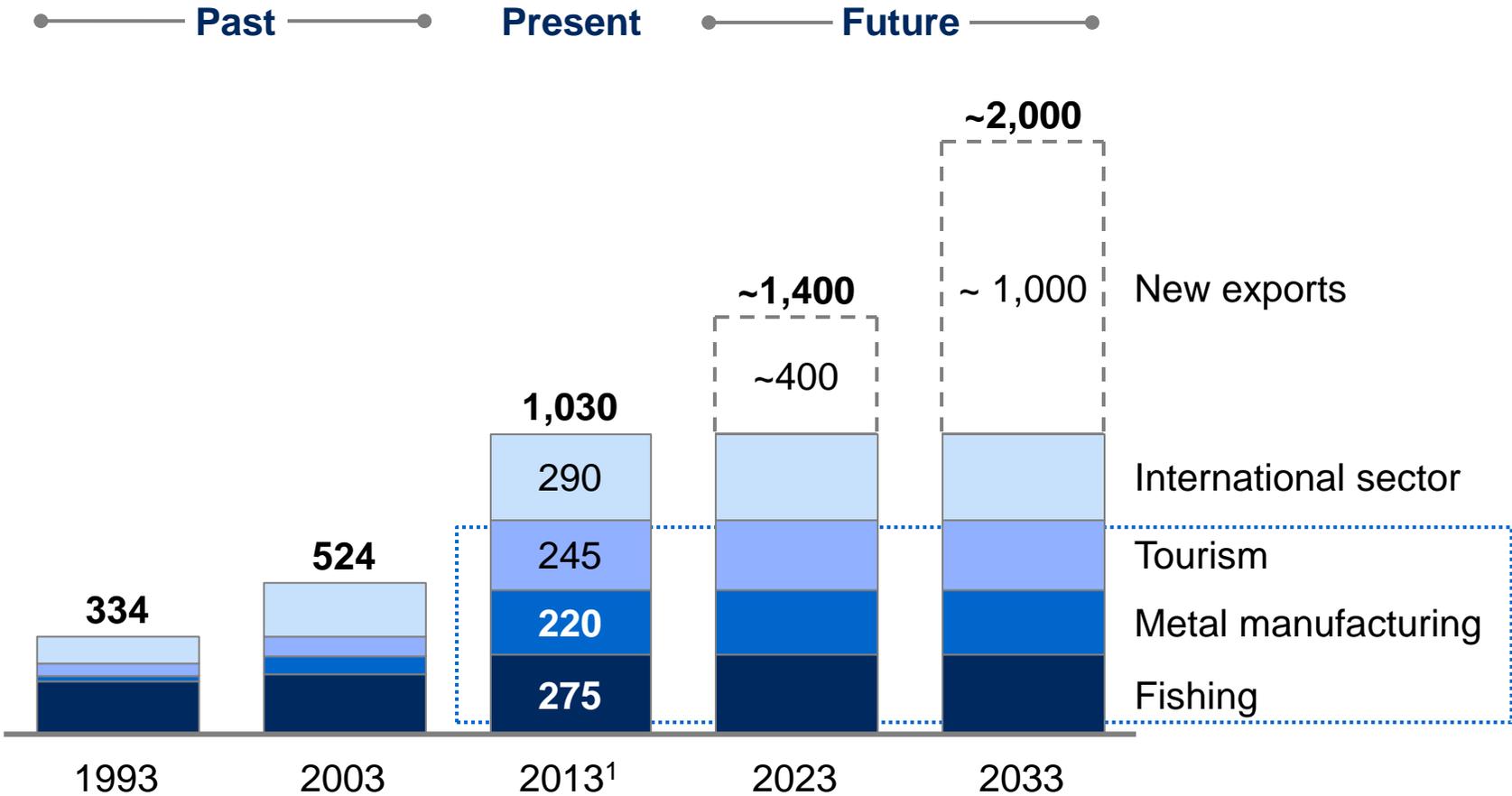
... putting negative pressure on the trade balance



- Following the collapse of the ISK trade balance **converted from deficit to surplus**
- This was driven to a large extent by significant **reduction in imports** (measured in foreign currency)
- As import momentum picks up, **it is critical that exports grow in parallel** to continue on a sustainable growth track

Exports need to increase by one trillion ISK in the next 20 years to support sustainable GDP per capita growth of 3% p.a.

Total exports, constant 2013 prices; ISK billions



¹ As only Q1-Q3 export values are available, Q4 is estimated using an average of seasonality factors for 2010-12

The scarcity of natural resources means that half of these new exports needs to come from the international sector

Scenario

Key assumptions

Limited resource growth

- Tourism growth slows down and average spending is unchanged
- Power generation grows but energy prices remain low
- Fishing is unchanged

Moderate resource growth

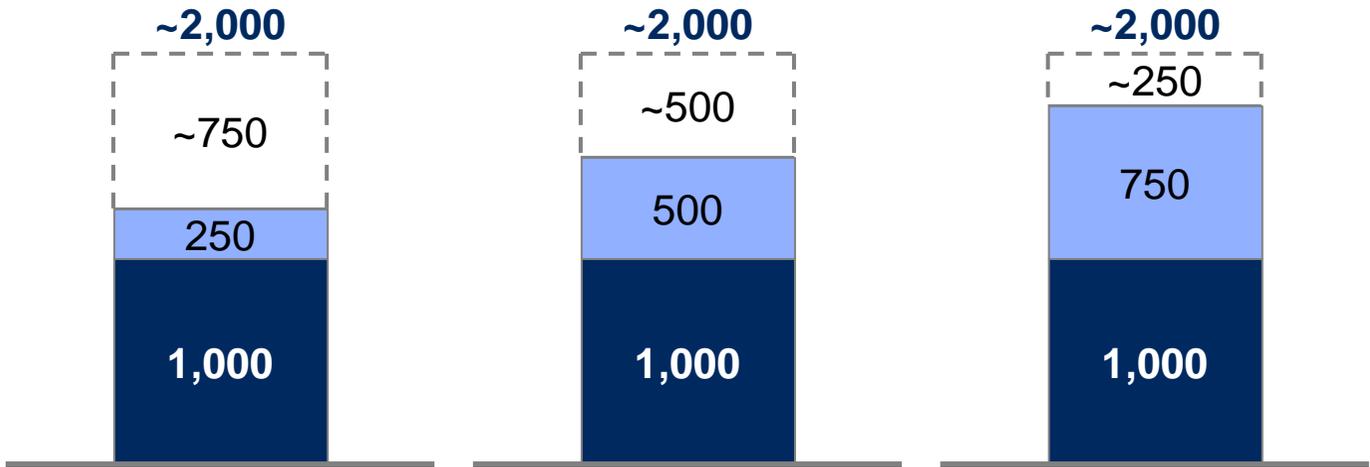
- Moderate growth in tourism volume and average spending
- Power generation increases and energy prices rise modestly
- Modest value increases in fishing

High resource growth

- Tourism grows fast and spending increases
- Power generation integrated with other markets through interconnector
- Fishing value increases

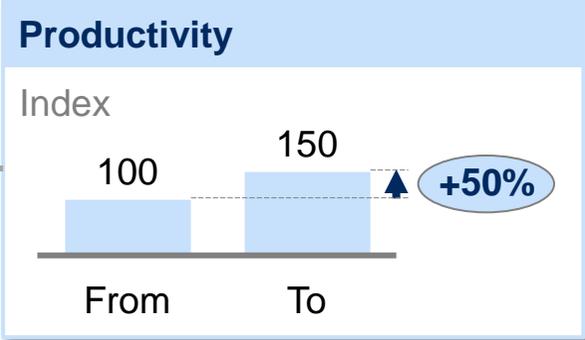
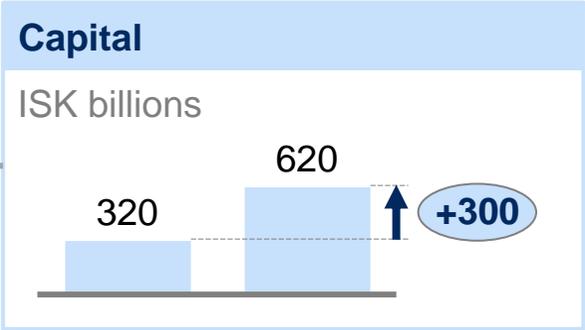
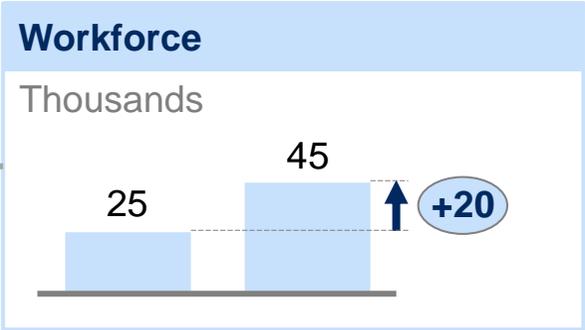
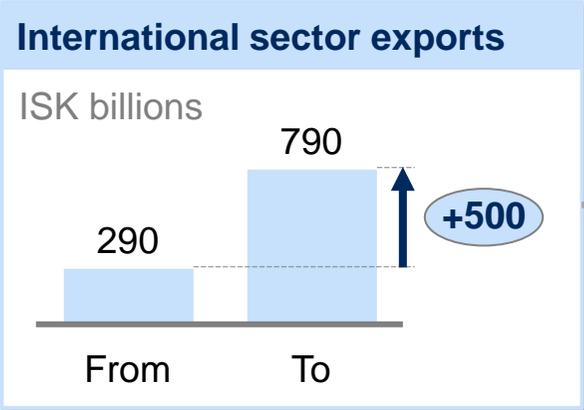
Resulting exports
ISK billions (2033)

- ▭ New international sector exports
- ▭ New resource sector exports
- ▭ Current exports



Back-of-the-envelope calculations reveal that this implies a major increase for the international sector in workforce, investment and productivity

Exports growth decomposition, assumes moderate growth scenario for resource sector¹



¹ The decomposition of exports growth is based on the Cobb-Douglas production function, where exports are the product of capital input, labor input and total factor productivity, with the output elasticity of capital input assumed to be 0.33

To put the size of this challenge in perspective

An increase of 20,000 employees in the international sector is equivalent to...

40 × 

50 × 

80 × 

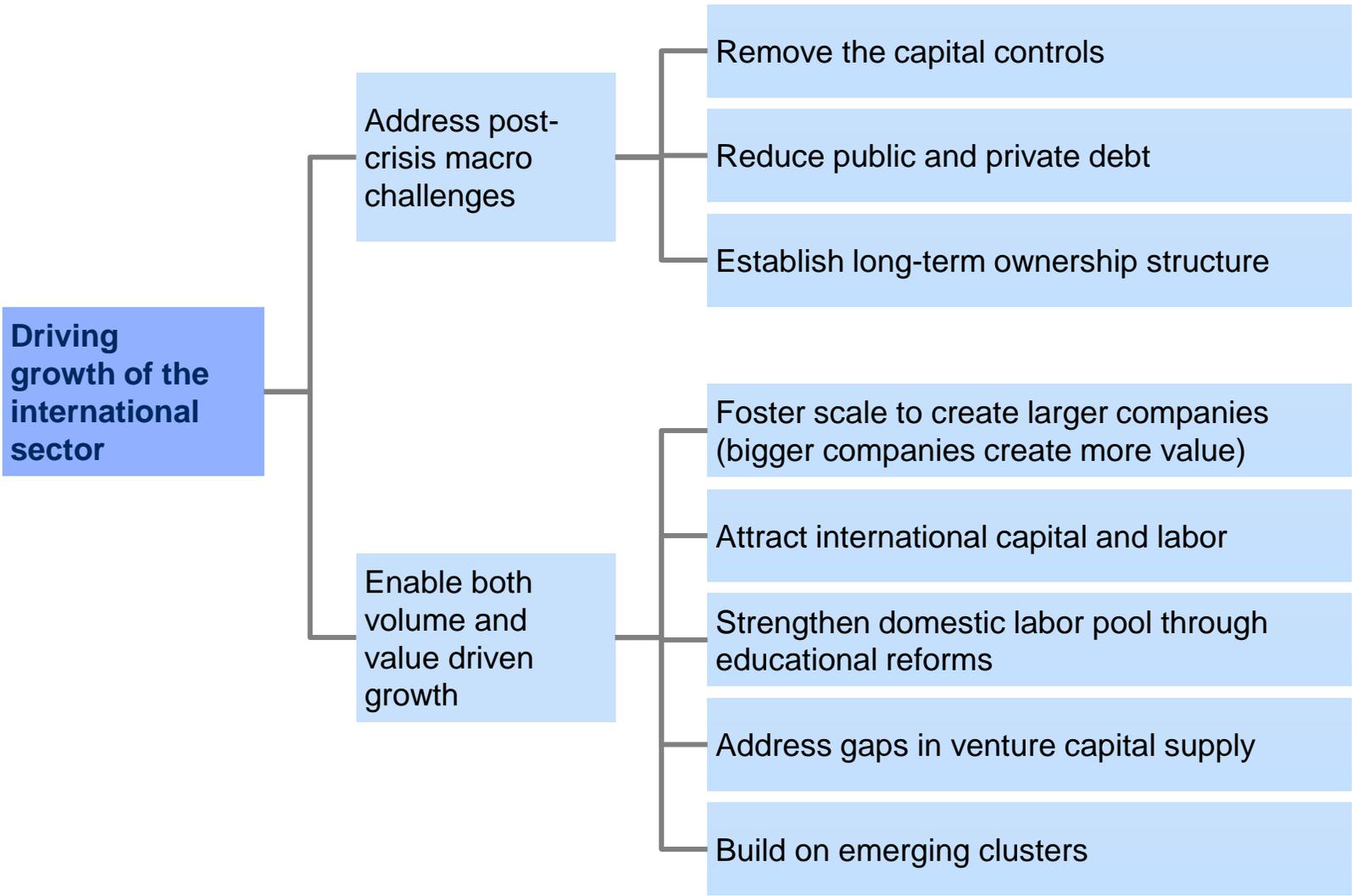
320 × 

To achieve such a major transformation, you need a holistic approach

Step	Description	
1 Get the facts on the table	<ul style="list-style-type: none">▪ Understand the economic situation and the levers that can be used for improvement	
2 Set the goal	<ul style="list-style-type: none">▪ Set a realistic target, understand the implications and communicate the vision	
3 Develop a plan	<ul style="list-style-type: none">▪ Set up and prioritize an action plan with impact-prioritized initiatives	
4 Implement the changes	<ul style="list-style-type: none">▪ Drive the change over a long time period across different administrations	

1. GET THE FACTS ON THE TABLE

The McKinsey report gives a good understanding of the situation and challenges in the international sector



The key message: If Iceland wants to follow a strong, sustainable growth path it will need to grow its exports dramatically



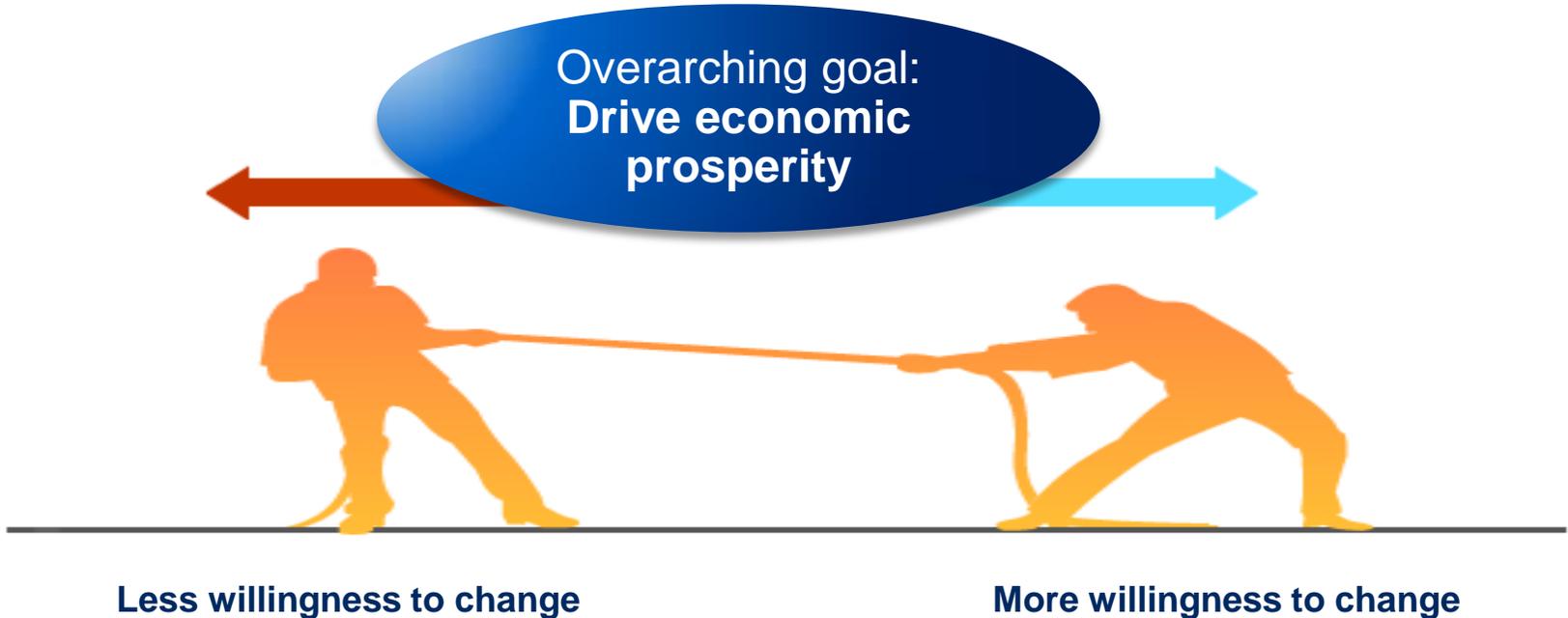
GDP growth per capita p.a.



In exports within 20 years

2. SET THE GOAL

Setting the goal and a time frame



Option A: Sluggish growth

- 1% GDP growth p.a., leading to doubling exports within 70 years
- The growth would be **slower than neighboring countries**, but require **limited structural changes**

Option B: Moderate growth

- 3% GDP growth p.a., leading to doubling of exports within 25 years
- The growth would be **similar to neighboring countries** and require **significant reform in key areas**

Option C: Robust growth

- 4% GDP growth p.a. (3% per capita), leading to doubling of exports within 18 years
- Catch up with **neighboring countries**, and require **major reform in most areas**

3. DEVELOP THE PLAN

Additionally, you should keep this in mind, given your unique characteristics

Focus on the right industries

For Iceland low unemployment, limited labor supply and high GDP levels make it imperative be selective in choosing where to grow

Know what you stand for

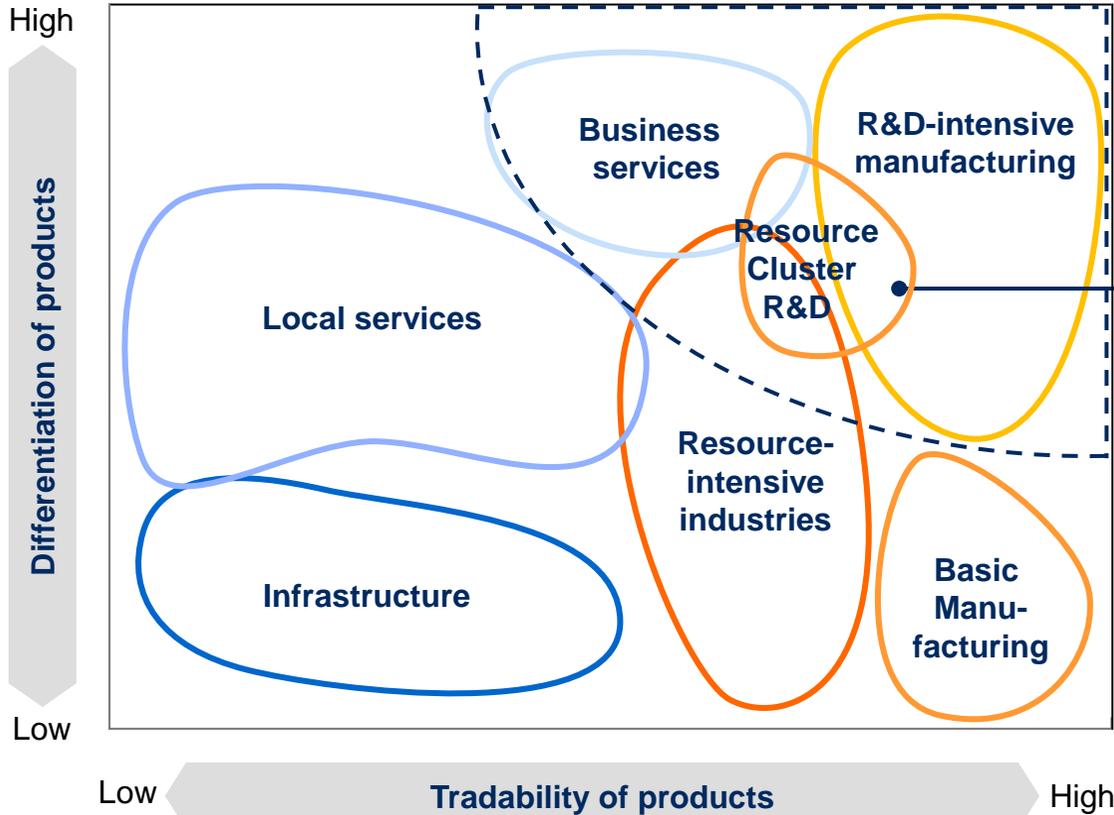
Larger nations can have different regions specializing in different things, but Iceland it too small to scale in many sectors

3. DEVELOP THE PLAN

Given the need to grow exports, you should focus on sectors with high product differentiation and tradability

Focus on the right industries

Industries with tradable and differentiated products offer the greatest opportunity



- Industries with highly tradable and differentiated goods have **desirable characteristics for Iceland**
- **Clustering** toward resource industries e.g. Fishing, Energy and Tourism/Health to picky bag on scale on talent and small home market
- They require significant **intellectual capital** and are easily **scalable**, but demand **little physical transport**

Being a small nation with a single city, you need to retain the critical mass required for global competitiveness

Know what you stand for

Holland has many cities where each has a cluster of companies around a core competency

Rank		Pop	Core competency
1	Amsterdam	808,032	Business service and tourism
2	Rotterdam	616,042	Port and global trade
3	The Hague	508,634	City for world law
4	Utrecht	326,516	-
5	Eindhoven	220,836	Electronics (Former HQ Philips)
6	Tilburg	209,788	-
7	Groningen	198,123	-
8	Almere	195,845	-
9	Breda	179,823	-
10	Nijmegen	167,613	Cancer institute
	Wageningen	37,000	Agrifood leader

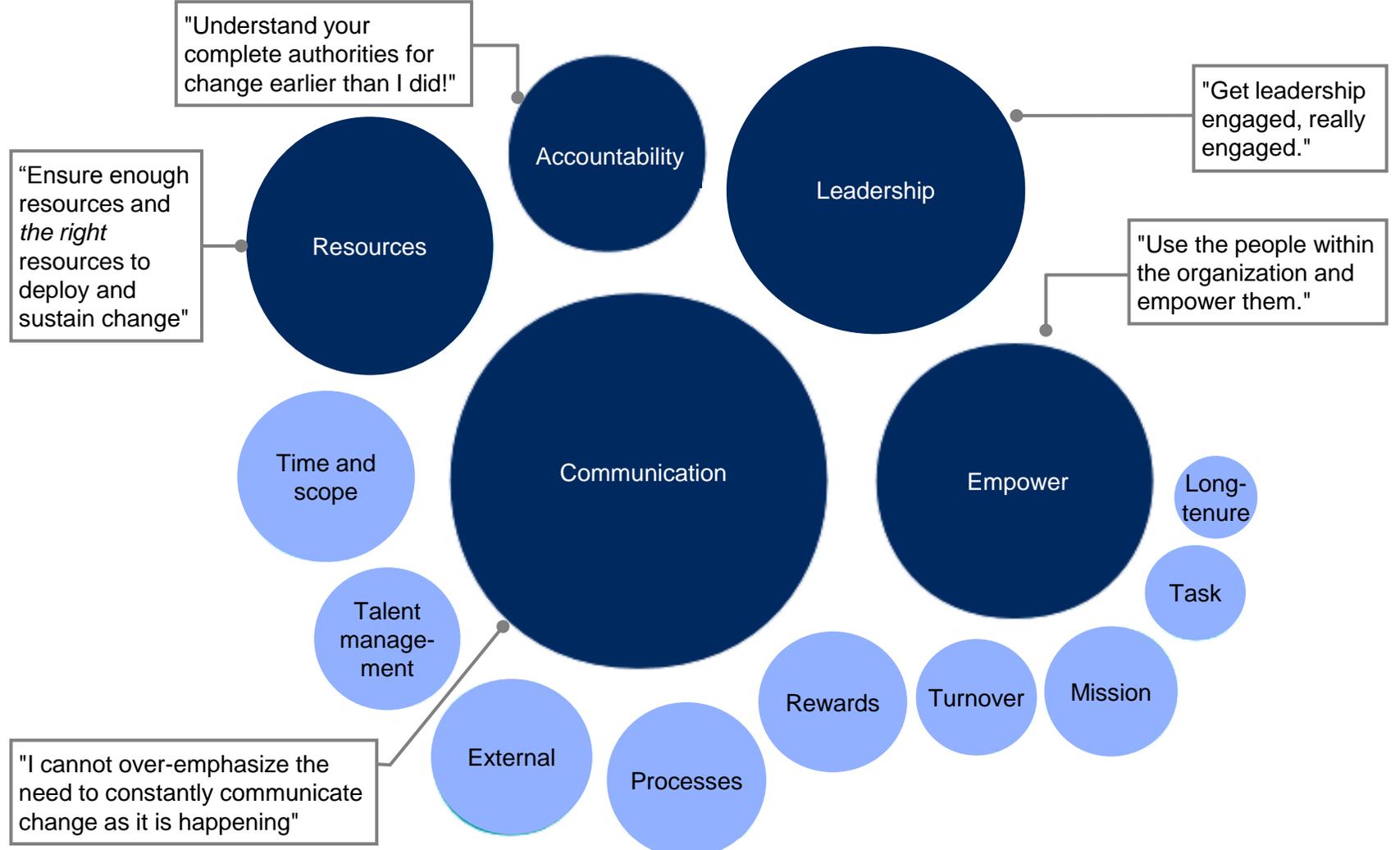
And Iceland needs to follow a similar strategy

City	Pop	Core competency
Reykjavik	120,000	?

Iceland could create a **cluster** in the capital around one of the current **core competencies**. This could for example be **fishing-related** products and services, **renewable energy**, **pharmaceuticals** and medical products, or **digital technologies**

4. IMPLEMENT THE CHANGES

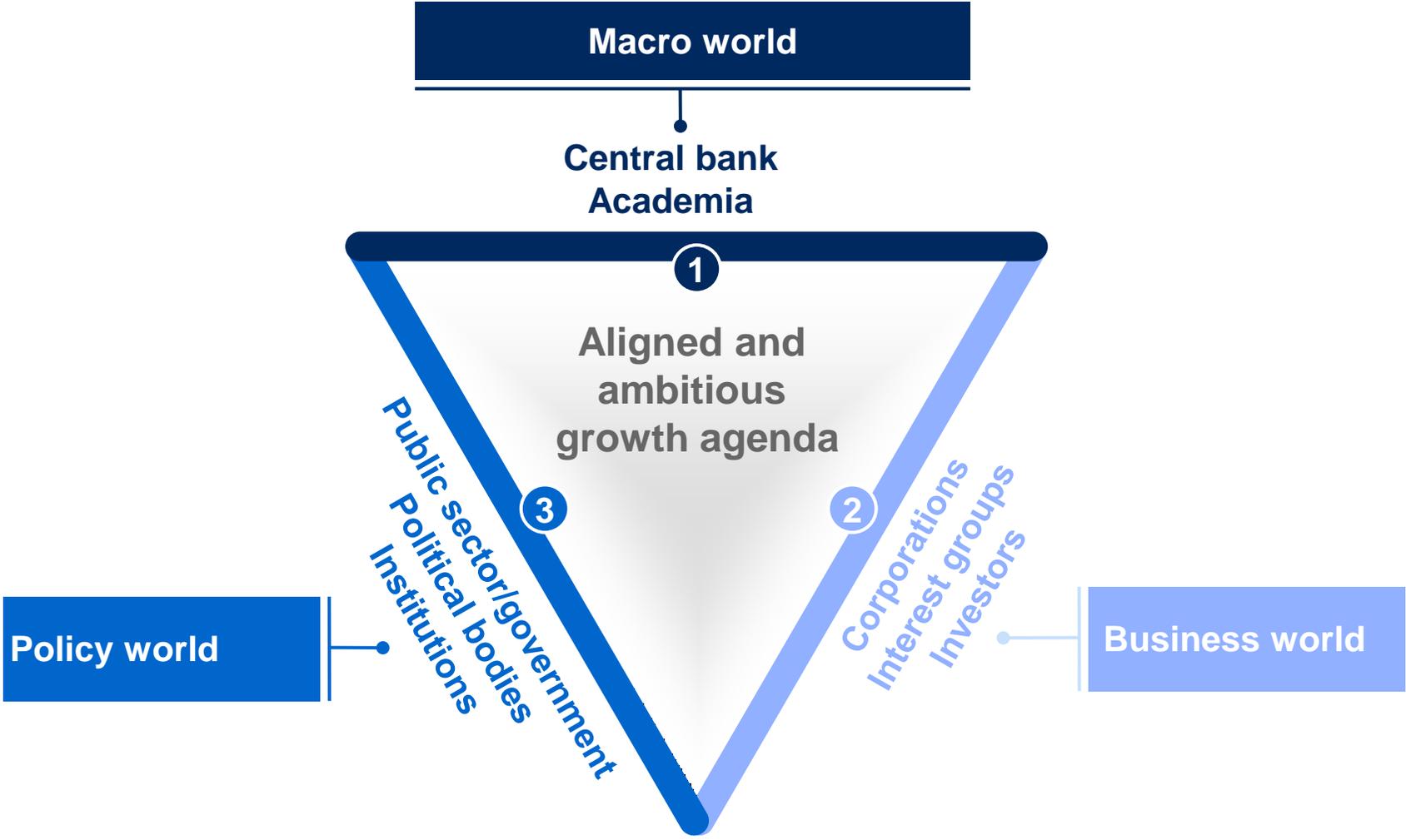
4 Five change actions are most frequently cited when government leaders talk about their transformations



Note: Bubble size is defined by frequency of theme mentioned ● Theme ties in with identified action ● Other theme

4. IMPLEMENT THE CHANGES

4 A credible growth plan for Iceland requires alignment and cooperation between key stakeholders



From my understanding this is where you currently stand in the overall change process

Step	Description	Iceland's progress
1 Get the facts on the table	Understand the economic situation and the levers that can be used for improvement	
2 Set the goal	Align on a target across a wide range of stakeholders while keeping the implications in mind	
3 Develop a plan	Set up and prioritize an action plan with impact-prioritized initiatives	
4 Implement the changes	Drive the change over a long time period across different administrations	

Unlocking Iceland's Growth Potential

