

The COVID-19 pandemic and government measures to curb the spread of the disease have caused the global economic outlook to change radically in a short period of time (see Box 1). Many companies have scaled down operations significantly, and both domestic and foreign demand have all but collapsed. In addition, domestic and international financial markets have been highly volatile. The economic contraction has been unusually sharp and sudden, but a rebound is expected to begin in H2. The chief task of macroeconomic policy is to mitigate the economic impact of the pandemic to the extent possible and support households and businesses through the most difficult period. The aim of such mitigation is to minimise the probability of permanent damage to households and businesses, thereby maximising the strength of the economic recovery once the pandemic recedes.

## Monetary policy measures

Since the pandemic struck, the Central Bank of Iceland has taken a wide range of actions to ease the monetary stance and boost financial system liquidity, in order to shore up demand, support increased access to credit, and preserve financial system stability. In this way, the Bank attempts to achieve its set objectives; i.e., to ease the economic contraction so that inflation can be held at target and financial stability can be ensured.

### Central Bank cuts interest rates by 1 percentage point

The Central Bank Monetary Policy Committee (MPC) lowered the Bank's key interest rate by 0.5 percentage points at two consecutive meetings, on 11 March and again on 18 March, bringing the key rate to 1.75% (Chart 1). Even before these reductions, the key rate was at its lowest ever. The objective of the rate cuts was to ease the monetary stance in response to the worsening economic outlook, which stemmed from the spread of the virus and the negative economic impact of public health measures taken in Iceland and abroad to curb the spread of the disease.

### Liquidity boost

In order to stimulate demand even further, the Bank adopted wide-ranging measures aimed at easing financial institutions' access to liquidity, thereby facilitating lending to households and businesses.

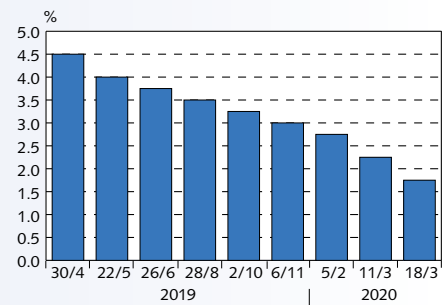
On 11 March, the MPC announced changes to minimum reserve requirements; i.e., the amount deposit institutions must hold with the Central Bank as liquid assets. Minimum reserve requirements fall into two categories: average reserve maintenance and a fixed reserve requirement. The average reserve maintenance requirement – the requirement that deposit institutions hold in reserve a specified percentage of their liquid assets, on average, over any given reserve maintenance period – was lowered from 1% of short-term funding to 0% (Chart 2). Although the fixed reserve requirement – the portion of liquid assets that deposit institutions must hold in reserve at all times – remained unchanged, its treatment under the Rules on Liquidity Coverage Ratio (LCR) was changed. With this, credit institutions' LCR increased, even though the fixed reserve requirement was unchanged. As a result of these changes in reserve requirements, deposit institutions' liquidity position was strengthened by approximately 40 b.kr.

On 18 March, the Bank's Financial Stability Committee (FSC) announced that financial institutions' capital requirements would be eased so as to bolster their lending capacity and their ability to restructure distressed households' and businesses' debt. The counter-

## Box 2

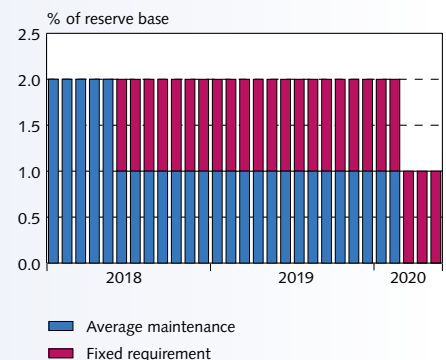
### Macroeconomic policy measures in response to the COVID-19 pandemic

Chart 1  
Central Bank of Iceland key interest rate<sup>1</sup>  
April 2019 - May 2020



1. The Central Bank's key interest rate is the rate on seven-day term deposits.  
Source: Central Bank of Iceland.

Chart 2  
Minimum reserve requirements<sup>1</sup>  
1 January 2018 - 15 May 2020



1. A financial institution's minimum reserve requirement is a percentage of its reserve base, which includes deposits and its own bond issues with a maturity of up to two years.  
Source: Central Bank of Iceland.

Chart 3  
10-year Government-guaranteed bond yields<sup>1</sup>  
1 January 2018 - 15 May 2020



1. Based on the zero-coupon yield curve, estimated with the Nelson-Siegel method, using money market interest rates and Government-guaranteed bonds.  
Source: Central Bank of Iceland.

cyclical capital buffer – the special capital buffer that had been built up in recent years so as to bolster financial institutions' resilience – was lowered from 2% to 0% and will remain there for at least two years. All else being equal, this measure should give credit institutions additional scope to expand their loan portfolios by 12.5%, or 350 b.kr.

On 27 March, the Central Bank announced that it would tighten financial institutions' access to one-month term deposits with the Bank. These deposits have been one of financial institutions' main avenues for investing króna-denominated liquid assets and complying with liquidity requirements, as Treasury bonds have been in short supply. The commercial banks have held a large share of their liquid assets in these accounts, and interest rates on them have been somewhat above the Central Bank's key rate. Reducing the supply of term deposits in this manner forces the banks to find other uses for this excess liquidity; i.e., hold it in current accounts or seven-day term deposits or, alternatively, to use it to buy Treasury bonds or increase other assets, such as loans.

On 8 April, in order to ensure that deposit institutions have access to adequate liquidity, the FSC and the MPC introduced a special temporary collateralised lending facility and an expanded list of eligible collateral. This measure was designed primarily to guarantee smaller deposit institutions sufficient access to liquidity while the pandemic is ongoing.

### Secondary market purchases of Treasury bonds

On 23 March, the MPC announced that the Bank would begin buying Treasury bonds in the secondary market. The purpose was to ensure even further that the more accommodative monetary stance would be transmitted normally to households and businesses. It was announced that the Bank will purchase bonds for up to 150 b.kr., or about 5% of GDP. Further details on the purchases were announced on 22 April, and in early May the Bank began buying Treasury bonds. The Bank announced that it will purchase bonds for up to 20 b.kr. in Q2.

This measure is particularly important under the current circumstances, where it is foreseen that the Treasury will need to borrow significant amounts via Treasury bond issuance in order to finance pandemic response measures. Because of this, there was a risk that the increased Treasury bond supply would push market rates upwards, thereby disrupting the transmission of the more accommodative monetary stance to the long end of the yield curve. The impact of these Central Bank measures could be seen immediately after the MPC's 23 March announcement, with long-term interest rates falling by 0.37 percentage points (Chart 3).

### Other Central Bank measures

The Central Bank had announced previously that, effective 1 April 2020, deposit institutions would be the only institutions authorised to hold deposits with the Central Bank. This forced the deposits of other financial institutions and Government institutions into the financial system, thereby strengthening deposit institutions' liquidity and supporting monetary policy transmission.

The Bank has also intervened in the foreign exchange market in recent months in order to mitigate excess exchange rate volatility. Furthermore, the Bank has urged the pension funds to reduce the amount of foreign currency they purchase to finance foreign investments until the economic situation normalises. Moreover, the Central Bank has obtained access to the US Federal Reserve's temporary repurchase agreement facility, which grants the Bank access

to US dollar liquidity against collateral in US Treasury securities from the Bank's international reserves. Finally, the Bank has instructed the boards of financial institutions to refrain from using their improved liquidity position and reduced capital requirements to pay dividends.

## Fiscal policy measures

The main objectives of the Government's fiscal policy measures have been, on the one hand, to mitigate the shock suffered by those households and businesses that are most vulnerable to the impact of the pandemic and, on the other hand, to protect jobs and companies during the pandemic and support a strong economic recovery when it recedes.

### Policy measures and their scope

In March and April, the Government introduced over twenty measures aimed at softening the economic blow from the pandemic. The scope of these measures is estimated at nearly 352 b.kr., or around 11.9% of year-2019 GDP. The measures that directly affect the fiscal budget amount to 4.2% of GDP, which is similar to the measures announced in Norway and Denmark (Chart 4).

From an economic perspective, the measures centre mainly on two areas: reducing distressed households' and businesses' income losses and supporting economic activity during a steep contraction in private sector demand. Also introduced were special measures aimed at improving the position of students and protecting individuals with delicate health or difficult social circumstances (Table 1).

**Table 1 Fiscal policy measures in response to COVID-19**

Measure	Scope (b.kr.)
Government-guaranteed bridge loans to businesses <sup>1</sup>	70.0
Support loans <sup>1</sup>	40.0
Deferral of tax payments <sup>1</sup>	75.0
Corporate income tax netting <sup>1</sup>	13.0
Closure subsidies <sup>3</sup>	2.5
Expedited reduction of bank tax <sup>2</sup>	11.0
Deferral of payments of import levies and cancellation of customs processing fees <sup>1, 2</sup>	13.6
Part-time employment option <sup>3</sup>	38.0
Wage payments during termination notice period <sup>3</sup>	25.0
Wage payments in quarantine <sup>3</sup>	1.0
Supplemental child benefit <sup>3</sup>	3.0
Additional authorisation for third-pillar pension withdrawal <sup>4</sup>	10.0
Special tourism-centred measures <sup>2, 3</sup>	4.6
Special support for media, local governments, and front-line workers <sup>3</sup>	4.7
Innovation and R&D <sup>2, 3</sup>	5.2
Student jobs initiative and artists' stipends <sup>3</sup>	2.5
Measures for students and vulnerable groups <sup>3</sup>	4.7
Increased VAT reimbursement for property construction and maintenance <sup>2</sup>	8.0
Special investment initiative <sup>3</sup>	20.0

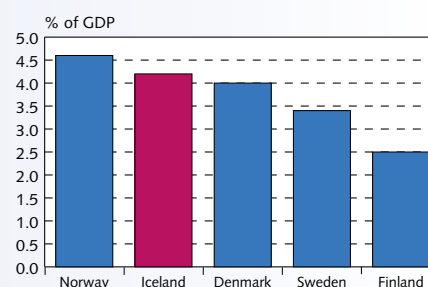
1. Affects firms' balance sheets and cash flow statements. 2. Entails reduced Treasury revenues 3. Entails increased Treasury expenditures 4. Increases households' cash balances for consumption spending.

Sources: Government of Iceland, Central Bank of Iceland.

### Firms helped to withstand temporary revenue losses

One of the broadest aspects of the Government assistance lies in measures to support companies through a period of substantially reduced revenues stemming from the pandemic and the actions taken

**Chart 4**  
Pandemic response – international comparison of fiscal measures<sup>1</sup>



1. Only those measures that directly affect the national treasury's profit and loss account are included.

Sources: Government of Iceland, International Monetary Fund, Central Bank of Iceland.

in an attempt to hinder the spread of the disease. The Treasury will guarantee up to 70% of bridge loans to companies deemed viable. The amount of the Treasury guarantee is up to 50 b.kr., and the impact of the measures on firms' balance sheets and cash flow is estimated at 70 b.kr.

As a further measure to counteract smaller companies' liquidity problems, the State will also grant support loans of up to 40 m.kr. per company, for a minimum term of thirty months. The first 10 m.kr. will be guaranteed in full by the State, as will 85% of the loan amount over and above that. Loans of up to 10 m.kr. will bear interest equivalent to the Central Bank key rate, but for loans beyond that, the lender is allowed to charge a moderate credit risk premium. An estimated 40 b.kr. will be loaned in this manner, and both support loans and bridge loans will be processed through the commercial banks.

Firms experiencing operational difficulties will also be authorised to defer up to three payments of pay-as-you-earn tax (PAYE) and payroll tax until 2021. This measure will improve companies' liquidity by an estimated 75 b.kr. Another measure designed to improve companies' liquidity by a further 13 b.kr. is a new authorisation to carry year-2020 operating losses back to offset 2019 profits, thereby lowering their income tax payments.

Businesses that were forced to close for public health reasons will be eligible for closure subsidies of up to 2.4 m.kr. per company, to compensate for a portion of lost revenue and help them to cover fixed costs during the closure period. The scope of these closure subsidies is estimated at 2.5 b.kr.

In addition, a reduction of 11 b.kr. in the tax on financial institutions has been expedited, customs processing fees are cancelled through year-end 2020, and payment due dates for import levies have been deferred by four months. The Treasury will relinquish a total of 13.6 b.kr. in revenues because of these changes in fees and levies.

### **Mitigating households' income losses**

The Government will also guarantee that workers receive income in spite of a temporary reduction in working hours. First, the Treasury will pay income-linked unemployment benefits proportional to the reduction in employment percentage if the employer must scale down operations because of pandemic response measures. Through 30 June 2020, workers must be employed at least 25% to qualify for the measure, and from 1 July through 31 August they must be employed at least 50%. The measure is set to expire on 1 September. For those covered by this measure, the sum of labour income and unemployment benefits may not exceed 90% of the worker's average total monthly wages, and may never exceed 700,000 kr. per month. For jobs that pay 400,000 kr. per month or less for a 100% position, full monthly wages are guaranteed. Although an assessment has yet to be finalised, the cost of this measure is expected to total about 38 b.kr.

Second, firms will be given the opportunity to apply for Government support to cover a portion of wage costs during employees' termination notice period. This support will take the form of a payment not to exceed 633,000 kr. per month for up to three months. It is limited to those companies that have suffered at least a 75% loss in revenue and envision continued revenue losses at least through end-2020. It is estimated that up to one-fourth of companies have suffered such losses. The Government support will be capped at 85%, and the measure is available from 1 May through 30 September 2020. The estimated cost to the Treasury for this measure is 25

b.kr. Third, the Treasury will reimburse employers for wages paid to workers in quarantine and will pay self-employed individuals 80% of their 2019 income, up to 633,000 kr. per month. The estimated cost to the Treasury for this measure is 1 b.kr.

#### **Incentives for increased economic activity**

The Government measures also include other incentives to support economic activities and mitigate the adverse impact of the pandemic on the domestic economy. Families with children will be paid a special supplemental child benefit, at an estimated total cost of 3 b.kr. Furthermore, the authorisation for early withdrawal of third-pillar pension savings has been expanded, and the Government's estimates assume that the scope of this measure will be 10 b.kr., some 4 b.kr. of which will revert to the Government in the form of income tax. These measures increase households' cash balances for consumption spending.

#### **Special support for tourism**

In order to provide special support to domestic tourism operators, the bed-night tax has been cancelled through end-2021, and payment due dates for the first three months of the year have been deferred until February 2022. The Treasury also plans to allocate 1.5 b.kr. to the issuance of special gift certificates to all adults in Iceland, which can be used to pay for domestic tourism, and another 1.5 b.kr. will be allocated to a dedicated marketing campaign advertising Iceland as a tourist destination. The total scope of these special tourism support measures is estimated at 4.6 b.kr.

#### **Other support measures**

It has been decided to provide special support to privately operated news media companies totalling up to 350 m.kr., in partial compensation for revenue losses. There are also plans to support the municipalities that have suffered most from the pandemic response measures, the Suðurnes peninsula in particular. In addition, investment by local governments will be supported with an expansion of the "Back to Work" initiative, and the Real Estate Fund of the Local Authorities' Equalisation Fund will be authorised to grant subsidies to municipalities. Healthcare employees and others fighting COVID-19 on the front lines will receive special wage bonuses totalling 1 b.kr. These measures together total 4.7 b.kr. Incentives for research and development (R&D) will also be strengthened and financing for innovation expanded. The estimated cost to the Treasury for this measure is 5.2 b.kr.

Other measures will be taken to address various groups' special needs due to the pandemic and its repercussions. The Government will offer up to 3,000 new summer jobs for students. It has also been decided to increase the number of artists receiving Government stipends by up to 40%. The estimated cost to the Treasury for this measure is 2.5 b.kr. Funding is also being allocated to new measures intended to strengthen job-seekers' skills. Moreover, funding will be dedicated to new social and mental health measures to protect vulnerable groups. The estimated cost to the Treasury for these measures is 4.7 b.kr.

#### **Increase in investment funding and incentives**

The "Back to Work" initiative will be expanded so that value-added tax (VAT) on labour for property construction, maintenance, and renovation will be reimbursed at a rate of 100%, up from the previous 60%. VAT on labour for car repairs will be reimbursed as well. With this programme, which will remain in effect through the year-end, the Treasury will relinquish about 8 b.kr. in revenues.

Finally, the Government has decided to expedite large-scale investment projects and increase total planned public investment by 20 b.kr. relative to the previous plan. Chief among these projects are investments in construction of traffic structures and other infrastructure. In addition, Government-owned companies will expedite investments totalling roughly 10 b.kr.