To: Parliamentary Economic Affairs and Trade Committee

From: Gylfi Zoëga, external member, Central Bank of Iceland Monetary Policy Committee

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Re: The work of the Monetary Policy Committee

The economic upswing that started in mid-2010 lost momentum over the course of 2019. Export sectors faced operational challenges in the form of high costs stemming both from domestic wage rises and a strong króna, and the collapse of one of Iceland's airlines in spring 2019 slashed tourist numbers and dampened domestic demand. Economic policy responded to labour market unrest and the reduction in demand for goods and services. Interest rate cuts, tax cuts, and increased Government spending stimulated demand, while tax measures and the Monetary Policy Committee's statement that moderate wage agreements would make interest rate cuts possible helped calm the labour market.

At the beginning of 2020, GDP growth for the year was expected to be relatively weak (1.6% according to *Monetary Bulletin* 2019/4). But a severe, unexpected shock in February affected the economy on both supply and demand sides, and GDP is now estimated to have contracted by 8.5% during the year.

The impact of the pandemic

The COVID-19 pandemic, which arrived in Iceland in February, caused an abrupt, unforeseen contraction in demand, not only for tourism but for services in a large number of related sectors such as restaurant operations. One of the two export sectors that are Iceland's largest by far – one that generated about 8% of GDP in 2019 – suffered colossal revenue losses that lowered employment and output levels nationwide and caused a wave of unemployment and insolvencies in tourism and related sectors. There were supply-side shocks as well, when labour productivity in other sectors declined, as employees could no longer go to work because of the pandemic and customer numbers were restricted in a number of sectors such as wholesale and retail trade – which in turn lowered productivity even further.

This shock was offset by Icelanders' large-scale tourism imports. Not only did significant numbers of tourists visit Iceland in 2019, but Icelanders also travelled abroad in large numbers, spending substantial amounts while overseas (about 200 b.kr., according to figures from Statistics Iceland). In addition, the tourism industry used a sizeable amount of imported inputs, so that value addition in the sector was less than the value of exports. When Icelanders could no longer travel abroad to shop, considerable purchasing power shifted into the domestic economy. Iceland stands out among tourism-intensive economies (those with high tourism-to GDP and tourism-to-employment ratios), in that Icelanders travel abroad much more themselves. As a result, the shock was much milder here than in peer countries. Although the weight of tourism in Iceland was similar to that in the southern part of Europe, the contraction in GDP was smaller. According to figures from the OECD, GDP contracted by 7.5% in Iceland over the first three quarters of 2019, as compared with 11.6% in Spain and 9.5% in Italy. The contraction in Iceland was in line with the eurozone average (7.4%) but much more pronounced than in the other Nordic countries (in Denmark, for example, GDP contracted 3.9%).

When both exported and imported tourism services collapse, the composition of domestic demand changes because Icelanders' consumption patterns differ from those of tourists visiting the country. The result of this is that part of the economy will seize up – i.e., the part that provides services to foreign tourists – while the sectors that sell goods and services to Icelanders will flourish. Unemployment surged in the tourism industry and related sectors during the year, while other parts of the economy saw strong demand and rising purchasing power. [1]

The monetary policy response

Naturally, the pandemic has ravaged segments of the economy that require close physical proximity between employees and customers. This includes a wide range of services. Those industries that can permit employees to work remotely or that do not entail such close physical proximity can continue operating (construction, manufacturing, tradesmen, and importers, for instance). The economy can therefore be split into two parts, one of which sustains a severe shock, while the other is much less affected. Indeed, some companies may even experience an increase in demand.

Under such conditions, monetary policy instruments are applied with the objective of boosting demand in the part of the economy that is less directly affected by the pandemic. These economic policy responses counteract the adverse effects on demand, which can be seen, on the one hand, in the negative impact of unemployment on domestic demand and, on the other, in the increase in domestic saving brought on by uncertainty about the future. As is mentioned above, this is offset by a shift of demand into the domestic economy, when Icelanders can no longer shop abroad and therefore do more business with domestic goods and services providers.

The significant increase in Government spending in 2020 and thus far in 2021, together with automatic fiscal stabilisers (unemployment benefits and reduced tax bases), also help to sustain demand for domestic goods and services.

The monetary policy response can be summarised as follows:

- Interest rates were lowered by 100 basis points in two increments in March, then by 75 points in May, and finally, by another 25 points in November. The Central Bank's key interest rate therefore fell from 2.75% in February to 0.75% in November.

- In March, it was decided as well to reduce the supply of one-month term deposits with the Central Bank, which entailed a significant easing of the monetary stance. The commercial banks had been holding substantial liquid assets in these term deposit accounts, at rates above the Central Bank's key rate.

[1] But with the autumn wave of the pandemic in Iceland, demand for various types of domestic services shrank as well. An example of this mismatch can be seen in the impact of the pandemic on actors and other artists.

- The MPC lowered minimum reserve requirements in March and eased deposit institutions' liquidity position, thereby giving them greater scope for increased lending.

- At the end of March, the MPC decided that the Central Bank should begin purchasing Treasury bonds in the secondary market.

The reduction in the Central Bank's key rate has resulted in lower rates for businesses and households. The impact on the economy is multi-faceted. Large-scale refinancing of residential mortgages has bolstered households' disposable income and contributed to increased demand. Lower interest rates have stimulated the property market, with positive effects on both private consumption (the wealth effect) and construction activity. The reduced supply of term deposits with the Central Bank has encouraged the banks to step up their lending activity, and the reduction in reserve requirements increases their lending capacity. The Central Bank's Treasury bond purchases are intended to affect price formation on long-term bonds so as to ensure that the more accommodative monetary stance is transmitted normally to households and businesses.

In the foreign exchange market, the Central Bank has mitigated volatility in the exchange rate of the króna, and since 14 September the Bank has sold foreign currency each business day. This has improved price formation in that market. The daily sales have also raised the exchange rate of the króna, which, in the MPC's opinion, has been below its equilibrium level. Because of the currency sales, the exchange rate has fallen less than it would have otherwise, and it is less likely that a depreciation of the króna will push inflation upwards, which could potentially have called for higher interest rates. This is an example of the application of additional monetary policy instruments, as is described in the report entitled *Monetary policy in Iceland after Capital Controls*, published in 2010.[2]

Developments in inflation

The increased slack in the economy has contributed to lower inflation; however, the depreciation of the króna from H1/2020 until November has pushed imported goods prices higher, resulting in an inflation rate of 3.6% in December (or 4% excluding the housing component of the CPI), as opposed to 2.5% in Q2/2020. Inflation expectations have not risen, however, and businesses' and market agents' expectations are unchanged since mid-2020, notwithstanding the depreciation of the króna and the higher measured inflation rate. The breakeven inflation rate in the bond market is close to the Central Bank's inflation target.

Developments in inflation and inflation expectations suggest that businesses and market agents have greater confidence than before in the Central Bank's monetary policy.

The outlook for coming months

The outlook for the future is highly uncertain at the moment. Developments further ahead will depend in large part on the success of efforts to control the pandemic, both in Iceland and

[2] Central Bank of Iceland *Special Publication* no. 4: Monetary policy in Iceland after Capital Controls (www.sedlabanki.is/library/skaarsafn/serrit/peningastefnan_eftir_hoft.pdf).

elsewhere. Demand could begin to grow slowly over the course of the year, or it could grow rapidly if efforts to inoculate Icelanders are successful and implemented quickly. The large stock of savings accumulated in recent months could finance increased private consumption after the pandemic.

During the post-pandemic period, monetary policy will aim to maintain price stability, as it has hitherto, which could call for interest rate hikes and higher minimum reserve requirements.

Conclusions

The revision of monetary policy following the financial crisis of 2008 has made possible the above-described monetary policy responses to the COVID crisis.

Over the past ten years, restrictions have been imposed on foreign-denominated borrowing by unhedged households and businesses, a special reserve requirement on non-residents' purchases of listed debt securities has largely prevented inflows of volatile capital, and the Central Bank has amassed sizeable international reserves. Monetary policy conduct has involved a wider range of policy instruments than interest rates alone, particularly to include foreign exchange market intervention and the special reserve requirement on non-residents' purchases of listed debt instruments. The foundations were laid a decade ago for this new monetary policy, the fundamental elements of which are described in the Bank's special report *Monetary Policy in Iceland after Capital Controls.*

It is important not to abandon this methodology for monetary policy formulation and conduct in coming years, as it has proven its worth during these challenging times. The lessons of the 2008 financial crisis must not be forgotten.