The economic contraction in the wake of the pandemic

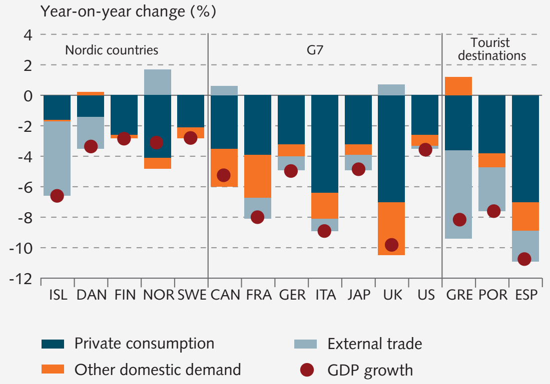
The COVID-19 pandemic that began spreading all over the world in early 2020 has left economic turmoil in its wake, with global GDP contracting by an estimated 3.3% and 4.7% in advanced economies, the largest contraction since the end of World War II. The contraction was greatest in Q2, when a sizeable share of the global economy came temporarily to a halt. The magnitude of the shock varied widely from one country to another, however. Economic activity in Iceland's main trading partner countries declined by an average of 5.2% in 2020, particularly in Spain (10.8%), the UK (9.9%) and Italy (8.9%). The contraction was considerably smaller in the US (3.5%) and the Nordic countries (2.8%, on average). In Iceland, the contraction measured 6.6% last year, and its composition was different from that in most other advanced economies. It need come as no surprise that the difference largely reflects the impact of the pandemic on the tourism industry, which is much more important to the Icelandic economy than to most other advanced economies.

Domestic demand contracted less in Iceland than in most other advanced economies …

As can be seen in Chart 1, the 2020 economic contraction in most advanced economies was due to a steep decline in domestic demand. This is particularly true of private consumption, which contracted by an average of 13.5% year-on-year in Q2, when the first wave of the pandemic struck, and while private consumption shrank markedly in Iceland, too, it contracted less than in most other advanced economies (Charts 1 and 2). The difference may be due to a number of interrelated factors, although presumably, the scope of public health measures imposed by governmental authorities is probably the most important of them. As can be seen in Chart 3, there was a strong correlation between changes in the scope of these measures and developments in household consumption spending in 2020: when more onerous measures were imposed, private consumption contracted between quarters, and when they were relaxed, consumption picked up again. In addition, many firms found their activities disrupted by public health measures, and investment projects and plans were either abandoned or significantly delayed. Therefore, the smaller contraction in domestic demand in Iceland probably reflects in large part the fact that the Icelandic authorities did not need to impose exceedingly stringent and protracted restrictions in order to curb the

Chart 1

Size and composition of 2020 economic contraction[1]

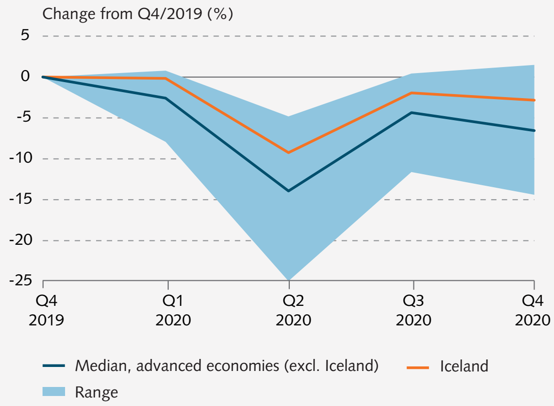


1. The contribution from other domestic demand is the sum of the contributions from public consumption, gross capital formation, and inventory changes, plus possible errors and omissions, as the sum of components may not equal GDP growth because of chain-volume linking in the national accounts. Figures for Norway exclude the production and shipping of oil and gas.

Sources: Norges Bank, OECD, Statistics Iceland.

Chart 2

Developments in private consumption in the wake of the pandemic[1]



1. Seasonally adjusted volume indices.

Source: OECD.

spread of the disease. As a result, the impact on households' willingness and opportunity to spend and on firms' operations was milder than in countries where stricter measures were adopted, such as the UK and many eurozone countries, where curfews were imposed and schools, retail stores, and other services were closed for an extended period. Also important in this context is the extent to which consumption spending is concentrated in contact-intensive sectors and the degree to which it shifted to other spending categories. It is also possible that individuals in Iceland took fewer and less aggressive personal disease-prevention measures because of the relative success in curbing the pandemic (especially in comparison with more densely populated countries that rely more heavily on public transportation). This is supported by traffic data, which, among other things, indicate that after restrictions were eased in summer 2020, appetite for travel rebounded more quickly in Iceland than in many trading partner countries (see Charts 1 and 2 in Appendix 1).

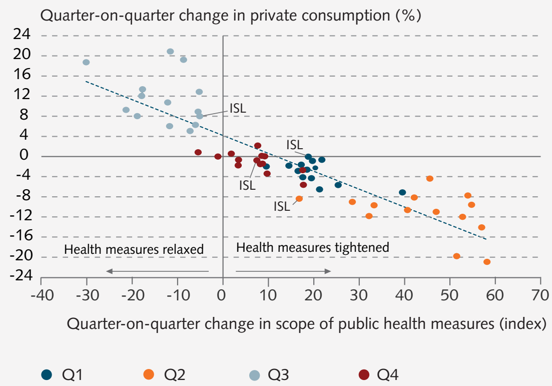
… but the contraction in exports was the largest in the OECD, and the main driver of the economic contraction

The main reason economic activity in Iceland contracted as much as it did in 2020 was the steep decline in exports. This is particularly the case for tourism-related exports, as international passenger flights have been severely limited since the pandemic struck, owing to tight travel restrictions and border closures all over the world. Pandemic-related restrictions on international travel were felt more in Iceland than in most other advanced economies, as the weight of tourism in the domestic economy was about double the OECD average before the COVID crisis (Chart 4).

Iceland's tourism exports contracted by 76% in 2020, and total services exports fell by 51%. The pandemic also triggered contractions in other export sectors. Exports of goods and services shrank by over 30% during the year, about three times the OECD average (Chart 5). Other tourism-dependent countries such as Greece, Spain, and Portugal also suffered severe export shocks. Even though imports also contracted more in Iceland than elsewhere in the OECD, or by 22%, the contribution of net trade to output growth was negative by nearly 5 percentage points. Therefore, about ¾ of Iceland's economic contraction in 2020 was due to a negative contribution of external trade. The composition of the contraction in GDP was therefore different in Iceland than in most other advanced economies but similar to that in countries that rely heavily on tourism (Chart 1). ■

Chart 3

Private consumption and scope of public health measures 2020[1]

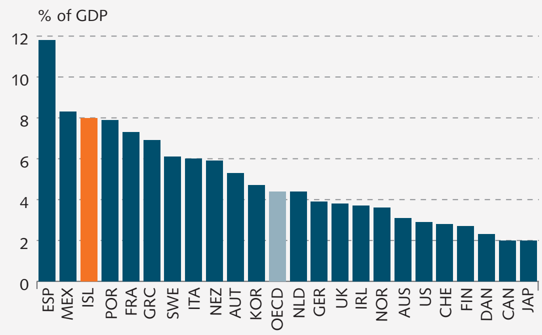


1. The countries are the US, the UK, Denmark, Finland, France, Iceland, Italy, Japan, Norway, Spain, Switzerland, Sweden, and Germany. Scope of public health measures weights together various measures of the extent of government restrictions in order to curb the spread of COVID-19.

Sources: OECD, Oxford COVID-19 Government Response Tracker.

Chart 4

Weight of tourism in GDP in selected OECD countries[1]

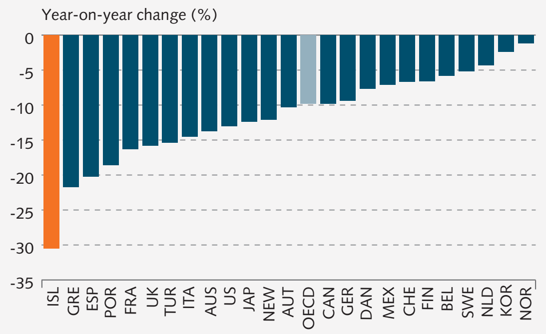


1. Weight of tourism in GDP in 2019, or previous years if 2019 data are not available. Weight in total gross value added instead of GDP for Canada, Denmark, Finland, Germany, Greece, Italy, Mexico, Netherlands, New Zealand, Portugal, Switzerland, United Kingdom and the United States. Data for South Korea and Spain includes indirect effects of tourism.

Sources: OECD, Statistics Iceland.

Chart 5

Exports in 2020 in selected OECD countries[1]



1. Seasonally adjusted volume indices for exports of goods and services.

Source: OECD.