To: Parliamentary Economic Affairs and Trade Committee

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

17 January 2020

Re: The work of the Monetary Policy Committee

The economic upswing that began in summer 2010 came to an end in 2019. GDP is now estimated to have contracted by 0.2% during the year. In particular, the cause of the contraction can be traced to reduced activity in the tourism sector following airline WOW Air's collapse, which has had a ripple effect across many parts of the broader economy. Reduced imports have mitigated the impact on GDP, however.

Causes of the contraction

A high domestic cost level is of the main reasons for the downturn in tourism in Iceland, as it complicates airline operations and makes Iceland an expensive destination for travellers. Average wages (real wages) are now the highest in the OECD (see Chart 1). A high wage level cuts into export sector competitiveness, and Iceland's ratio of wage costs (wages and related expenses) to value creation is third-highest in the OECD, topped only by Switzerland and Denmark (see Chart 2). The real exchange rate — i.e., the relative price level — is also historically high. According to figures from Statistics Iceland, the ratio of wages to operating revenues in the tourism sector peaked in 2018, the most recent measurement.[1,2] See Table 1 below.

Economic policy response

During the spring, economic policy had to respond to reduced demand for goods and services, which stemmed mainly from the contraction in tourist numbers, yet it also had to take into consideration labour market unrest, strikes, and potential wage hikes. It can

[1] The wage share was 24.1% in passenger transport by air in 2018, as opposed to 16.2% in 2003 and 12.4% in 2013. In guesthouse operations, it was 35.7% in 2018, up from 32.3% in 2013, and in restaurant operations it is now 39.7%, up from 33.5% in 2011.

[2] I.e., since measurements were introduced in 2003.

be said that the demand side of the economy produced the shock that lowered GDP, while the supply side could have given rise to sizeable pay increases that could have complicated economic policy. The demand shock called for interest rate cuts to stimulate GDP, but large pay rises on the supply side would have boosted inflation, calling for higher interest rates. It would have taken very little to tip the scales in an unfavourable direction requiring a tighter monetary policy response to rising inflation during a time of declining demand. Because of intervention by the authorities, which entailed tax measures and a declaration that moderate wage agreements would make it possible to lower interest rates, the social partners negotiated modest pay increases. This enabled the MPC to stimulate demand with policy rate cuts instead of raising rates to stem the tide of rising inflation.

The Central Bank's key rate has fallen by 150 basis points since the March 2019 wage agreements. By the same token, the Government and Parliament have decided to boost demand this year with tax cuts and spending increases amounting to a combined 0.5% of year-2020 GDP.

With monetary and fiscal policies pulling together, the authorities have managed to mitigate the economic downturn. GDP is estimated to have shrunk by only 0.2% in 2019 and is expected to turn positive again in 2021.

Inflation

Efforts to keep inflation at target have been successful. Inflation averaged 2.5% in Q4/2019 and measured 2.0% in December, and it is expected to remain close to the target. This extends the episode of near-target inflation to six years. Inflation expectations have fallen by most measures and are also close to target.

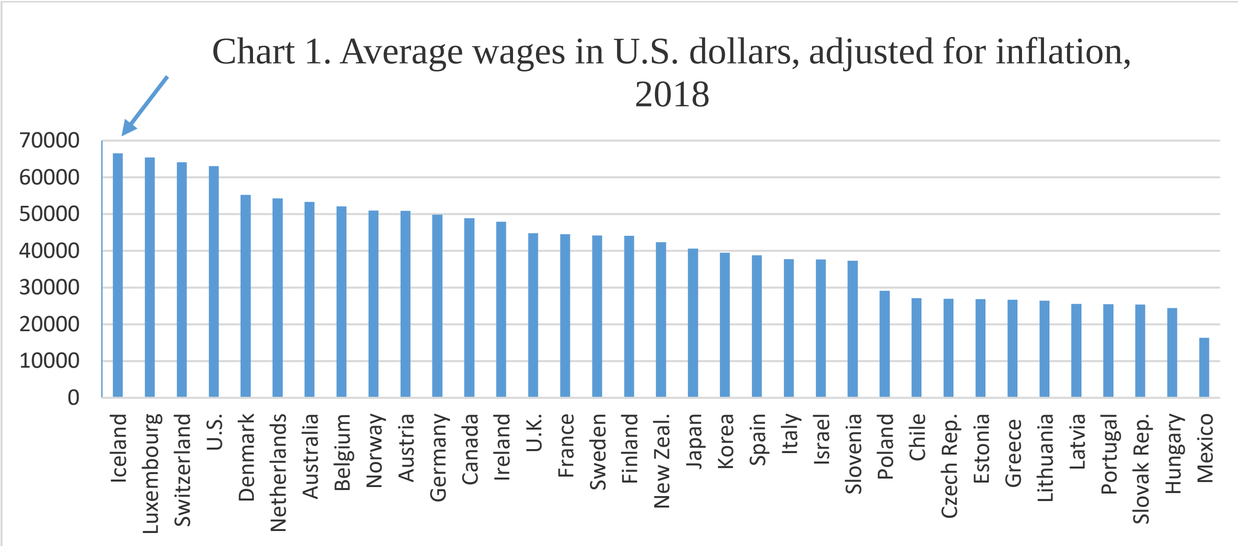
The key to this strong performance is the use of a wider range of monetary policy instruments. These are Central Bank interest rates, foreign exchange market intervention, and the special reserve requirement (SRR) on foreign investors' investment in listed bonds. The SRR enables the MPC to keep interest rates in Iceland higher than those in trading partner countries, the (real) interest rate level is determined with the aim of keeping demand and output close to capacity so as to prevent inflationary pressures from building up, and foreign exchange market intervention prevents the exchange rate from spiralling.

Future prospects

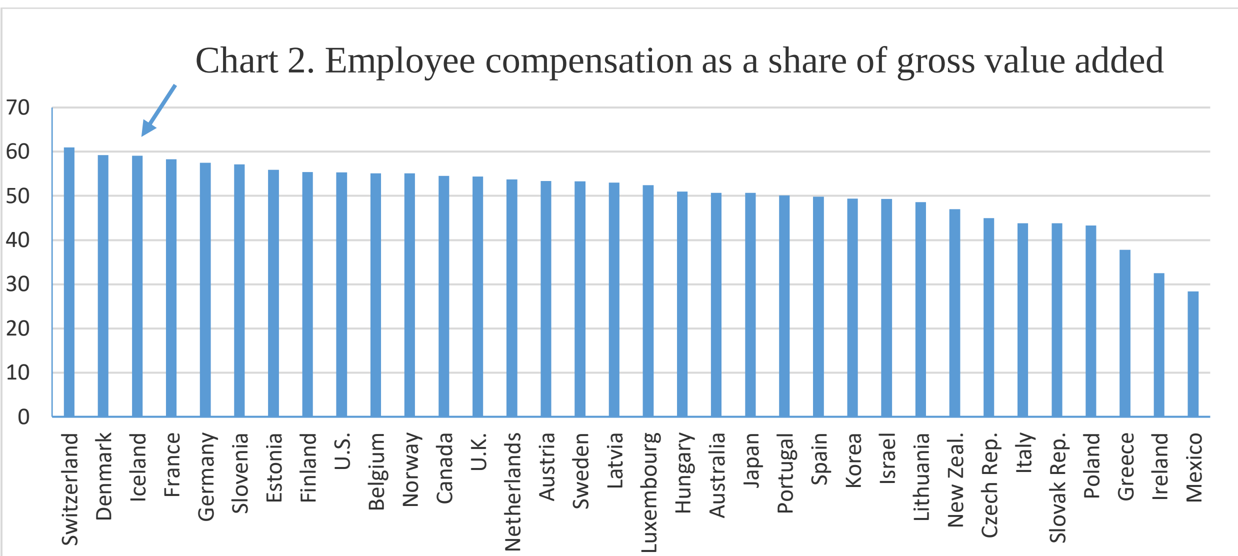
Although wage-earners' conditions improved this spring with moderate wage rises and tax reforms, real wages in Iceland are nevertheless very high compared with those in trading partner countries, as Chart 1 indicates. High-income countries face constraints on GDP growth. The ratio of profit to national income is lower, and the incentive to invest is weaker. Companies in competitive sectors are in a difficult competitive position. Export companies' earnings will decline, and importers will experience competition from online merchants and overseas shopping excursions. Under these conditions, firms try to boost their earnings by streamlining. In the coming term, Icelandic firms will attempt to lower costs, including by using increased technology, which cuts into job numbers, and by expatriating jobs that do not require local knowledge. Both of these will reduce employment, and GDP growth could be stifled in the meantime.

The current situation is not dissimilar to that in the early 1990s, when firms were forced to adjust to a higher interest rate level. Interest rates are now low in comparison with the 1990s, although much higher than in the two decades preceding, yet wage costs are high. These circumstances also require and adjustment, with some firms discontinuing operation and others undergoing reorganisation, with technology replacing human capital, and with jobs moving out of the country.

The period ahead will probably be characterised by modest inflation and weak GDP growth, but with growing productivity in firms that streamline in order to cut costs. Unemployment will then rise slowly. Monetary policy and fiscal policy have made an effort to ease the contraction, but longer-term GDP growth will depend on private sector initiative.



Source: OECD (www.oecd.org)



Source: OECD (www.oecd.org)

Table 1. Wages and related expenses, current-year price level, in b.kr.										
				Wage share, % of operating revenues						
	2003	2005	2007	2009	2011	2013	2015	2016	2017	2018
Passenger transport by air	16.2%	15.2%	18.7%	11.9%	12.7%	12.4%	14.1%	16.4%	19.2%	24.1%
Guest accommodation operations, total	29.8%	29.2%	31.3%	28.7%	31.8%	32.3%	34.2%	30.6%	35.2%	35.7%
Hotels and guesthouses, with restaurant services	31.5%	31.2%	33.8%	30.1%	33.1%	34.4%	36.9%	36.2%	38.9%	37.9%
Hotels and guesthouses, w/o restaurant services	20.7%	18.8%	19.6%	23.9%	26.1%	23.7%	26.8%	20.6%	24.6%	29.0%
Vacation homes, campgrounds, etc.	21.9%	20.4%	20.9%	18.9%	21.4%	24.3%	21.7%	16.2%	21.6%	24.4%
Refreshment sales and services	31.9%	31.0%	31.3%	30.9%	33.1%	34.1%	36.0%	34.9%	38.8%	39.4%
Restaurants	31.7%	30.8%	31.5%	31.1%	33.5%	34.4%	36.3%	35.1%	38.8%	39.7%
Pubs, cafés, and dance halls, etc.	32.8%	31.9%	31.9%	27.1%	29.9%	30.0%	32.8%	32.6%	38.7%	37.1%
Cross-border and coastal passenger transport by ship	37.6%	38.0%	33.8%	21.2%	25.0%	32.4%	33.4%	35.5%	41.5%	39.3%
Other passenger transport on land / long-distance coaches	32.5%	35.2%	37.7%	28.0%	32.1%	29.5%	33.4%	37.2%	40.5%	39.3%
Taxi operations	35.8%	34.4%	33.3%	29.1%	27.6%	27.5%	28.6%	28.2%	31.4%	32.3%
Car rental	31.3%	34.2%	35.6%	24.7%	14.3%	14.2%	14.3%	18.6%	22.2%	23.4%
Recreational and athletic equipment rental										
Travel agencies, tour operators	13.9%	15.1%	14.7%	10.6%	11.6%	12.8%	16.7%	17.8%	21.7%	22.1%
Travel agencies	12.2%	12.3%	10.9%	7.5%	8.0%	8.7%	13.2%	16.2%	17.5%	16.1%
Tour operators	23.1%	26.5%	28.2%	21.0%	23.7%	25.1%	24.8%	28.4%	30.6%	32.5%
Total, several tourism sectors	21.2%	20.8%	23.4%	17.2%	18.1%	18.6%	21.5%	23.1%	26.7%	28.7%

Source: Statistics Iceland.