

## **Macroeconomic Council**

### **Minutes of the second meeting of the Macroeconomic Council**

*Held 6 April 2017 – 8:30 hrs.-10:30 hrs. – Safnahúsið, Hverfisgata*

The Prime Minister called the meeting to order. He said that the first meeting of the Council had been successful and that the forum was an important one. He also said that discussions had taken place with the Icelandic Federation of Labour (ASÍ) and the Federation of State and Municipal Employees (BSRB) concerning their participation in the Council, in line with the framework agreement in the labour market, but that they had rebuffed those efforts.

#### **The main issues discussed were the following:**

##### Fiscal plan – broad fiscal outlines for the next five years

The Minister of Finance and Economic Affairs explained the Fiscal Strategy Plan for 2018-2022, which was presented before Parliament on 31 March 2017. He said the Plan reflected a tighter fiscal stance than the previous one. Emphasis was placed on reducing debt in 2017, thereby creating the scope to advance important issues. It was important, however, to time public investment projects sensibly – something that applied to all public sector entities. Meetings had been held with local authorities and large State-owned companies such as Landsvirkjun (The National Power Company) and Isavia concerning the timing of investment projects. An important aspect of the Fiscal Strategy Plan was to lower debt, and each year of the plan provided for debt reduction. A large portion of the high-interest US dollar denominated bond had been bought so as to reduce Treasury interest expense in coming years. According to the plan, primary expenditure would increase and interest expense would decrease. It is also planned to make important reforms to the tax system: first, to broaden the value-added tax (VAT) base by shifting accommodation and various other tourism-related services from the lower VAT bracket to the general bracket. The general VAT rate will be lowered to offset this. Also under consideration is the transfer of the tax on overnight stays to the local authorities, but how this should be implemented has yet to be discussed. The Minister considered it appropriate to take recommendations from the Iceland Growth Forum under consideration, regarding simplification of the tax system, and scaling down exemptions. The Minister has discussed equalisation of pension rights across the labour market and other related issues with representatives of employee federations. He mentioned that a committee on the harmonisation of employment terms in the public and private sectors was being appointed, as had been stipulated in the September 2016 agreement on changes to public employees' pension system.

The director of the Icelandic Association of Local Authorities said the new Act on Public Sector Finances was very important for local governments. There had been a change in attitude among municipal authorities, but no less important was the enhanced understanding of local government finances within the Ministry of Finance and Economic Affairs. A sign of this

increased understanding could be seen in the State's contribution to local governments in connection with the equalisation of pension rights. The director said that the local authorities worked in accordance with the fiscal rules laid down in the Local Government Act, which provided them with a guidepost for fiscal management. The municipalities have been streamlining in their operations and have paid down debt, but this is difficult without cutting back on investment. An investment level that is exceeded by depreciation is not sustainable. The director said that the agreement between central and local governments concerning performance targets and municipal debts would be signed later in the day and that the agreement was a part of the Fiscal Strategy Plan. He emphasised the joint understanding of the parties to the agreement that the municipalities had pledged to comply with the fiscal rules laid down in the Local Government Act and the central government bore the brunt of enforcing the Fiscal Plan. The agreement provided for specified joint projects to be undertaken by the parties, including a study of local authorities' sustainability and revenue base. He considered it very important that central and local government authorities work together on these projects and collaborate successfully.

In the discussion of the Fiscal Strategy Plan the Minister of Finance and Economic Affairs said that the general discussion of the revenues side of government finances would probably centre on three things in the months to come: first, the timing of the changes in value-added tax; second, whether and when the general VAT rate should be lowered and whether increased tax revenue should be used instead to fund infrastructure development; and third, whether the savings in interest expense from the Treasury bond buyback should be used for infrastructure development.

The Prime Minister said that this year's increase in state expenditures was much larger than would be sustainable in the long term. He said that while there was much public discussion of the need for increased spending, the issue of whether we could have pursued a more accommodative fiscal policy during the post-crisis period and gone through the crisis years with a different, less onerous focus was hardly discussed. The Prime Minister also said that the Act on Public Finances had already begun to have a significant impact on the whole framework for public finances and policy making. Proposed measures on the state's revenues would be published in the spring, covering a horizon of several years, instead of being presented to the Althing in November for passage by the year-end. It was therefore extremely important that the Fiscal Strategy Plan be published each spring, as is provided for by law, and subjected to thorough discussion.

The labour market – progress of work on developing a new labour market model and wage settlements in 2017

The director of the Confederation of Icelandic Employers had recently returned from a meeting with sister organisations in the Nordic countries, where wage agreements were under discussion. It was clear from that meeting that the situation in Iceland's Nordic neighbours differs greatly from our own. In Sweden, for example, an agreement had recently been reached for a total pay rise of 6.5% over the next three years, and in Norway a similar agreement had been negotiated. These countries consider the capacity of export sectors when they negotiate wages. The director said there was the desire to do the same in Iceland but that efforts had not been successful. The Salek agreement from early 2016 was on ice. All agreed, however, on the need for improved earnings statistics, which the director said were inadequate in Iceland, pointing out that it was to everyone's benefit that decisions be taken based on correct and reliable statistics.

The Prime Minister presented a report from Hallgrímur Snorrason, former director of Iceland Statistics, on earnings statistics in Norway and Iceland. Snorrason presented two proposals for improvements: one, to enlarge the sample used for Statistics Iceland's wage survey, or to discontinue sample-based surveys in favour of collecting data from all employers, in a manner similar to that in Norway. Snorrason's conclusion was that we should adopt the Norwegian approach. It emerged that the Minister of Finance and Economic Affairs has had discussions with Statistics Iceland and the Director of Internal Revenue on their possible participation in the collection and processing of earnings data.

The Minister of Finance and Economic Affairs also took up the issue of the labour market situation and the negotiations ahead, as about one-third of state employees' wage agreements will expire in 2017. He said that wage increases had been large in 2016 and that, in line with the framework agreement, more modest changes were expected this year. Under current discussion is wage drift guarantee, which was part of the framework agreement, although opinion on the subject is divided.

The director of the Icelandic Association of Local Authorities was of the opinion that the recently established public sector pay committee represented an important step towards harmonising wage policy and that this forum was growing stronger. He also considered it important to ensure that wage drift guarantee would be effective; otherwise, the need for large pay increases would accumulate in various public sector groups where wage drift is limited in comparison with the private sector.

The director of the Confederation of Icelandic Employers said that the Confederation had doubts about whether parts of the framework agreement could apply while other parts did not. Pension rights and wage drift guarantee would continue to be under discussion. He said that this year the Confederation had 15 expired wage agreements affecting some 1,700 employees. The unions gave little consideration to the framework agreement and made wage demands in excess of those provided for in the agreement. The Confederation, as well as the public sector, was obliged to take the framework agreement into account. Notwithstanding the unprecedented rise in real wages in the recent past, wage demands had not subsided. Actually, real wage growth that could have been deemed appropriate over a decade had been achieved in a single year. The labour market would now have to be sensible in its approach if the situation were not to be

derailed. The increase in real wages had been achieved because of the appreciation of the króna, favourable terms of trade, and low imported inflation. These were extraordinary circumstances. If this progress were to be preserved, the parties must observe caution. He emphasised that the State and the local governments must abide by the signed framework agreement in upcoming negotiations because it was clear what would happen if the agreement were not followed: we would repeat the mistakes of the past.

### The economic situation – successes and challenges for monetary policy

The Governor of the Central Bank discussed the economic situation and challenges facing monetary policy conduct. He said the chief problem of economic policy at present was that the domestic economy's capacity was being tested as regards factor utilisation, even though potential output had increased because of importation of labour. He emphasised that the situation differed from the pre-crisis period in many ways, in that there now was a current account surplus and the domestic economy was not driven by a credit boom. Nevertheless, there was the risk of overheating. Wages and domestic prices are being pressured upward, as can be seen in the labour market and real estate market, although this had been offset by the appreciation of the króna and low global inflation. Unemployment was low and labour participation back to its pre-crisis peak. He said that overall policy easing was therefore not appropriate. With tight monetary policy in the recent past, price stability had been preserved and inflation expectations had been anchored more firmly. The recent fiscal easing called for a tighter monetary stance than would be needed if the fiscal stance was tighter. Labour market agreements based on the Nordic model would also help. He pointed out that, to simplify, monetary policy worked through two channels: interest rates and the exchange rate. Monetary tightening via the interest rate channel affected the non-tradable sector more strongly, and monetary tightening via the exchange rate channel – appreciation of the króna – affected the tradable sector more. The Governor pointed out that 85% of inflows to the foreign exchange market in 2016 stemmed from the current account surplus and transactions between residents. Capital inflows related to new investment in the domestic bond market had subsided greatly, however, after the Central Bank activated its capital flow management measure last summer.

The Minister for the Environment and Natural Resources brought up ways to address the problems faced by individual groups – such as young people in the housing market – without exacerbating the tension in the economy. The Governor said that the problem in the housing market was due in large part to insufficient supply and that stimulative measures on the demand side of the housing market would therefore push prices upwards unless offset by increased supply. He said that it was important for stability, however, that house prices not rise too high before supply can be increased. Lower interest rates would result in higher house prices, all else being equal.

The Prime Minister concluded the meeting by stating that the discussions had been useful and stressed the importance that all pull together because the situation was complex.

The next meeting of the Macroeconomic Council is scheduled for autumn 2017.

### **Names of attendees:**

Macroeconomic Council members:

1. Prime Minister (Bjarni Benediktsson)
2. Minister of Finance and Economic Affairs (Benedikt Jóhannesson)
3. Minister for the Environment and Natural Resources (Björt Ólafsdóttir)
4. Chairman of the Icelandic Association of Local Authorities (Karl Björnsson as substitute for Halldór Halldórsson)
5. Governor of the Central Bank of Iceland (Már Guðmundsson)
6. Director of the Confederation of Icelandic Employers (Halldór Benjamín Þorbergsson)

Other attendees:

1. Ragnhildur Arnljótsdóttir, Prime Minister's Office
2. Benedikt Árnason, Prime Minister's Office
3. Sigrún Ólafsdóttir, Prime Minister's Office
4. Guðmundur Árnason, Ministry of Finance and Economic Affairs
5. Anna Borgþórsdóttir Olsen, Ministry of Finance and Economic Affairs
6. Sigurður Snævarr, Icelandic Association of Local Authorities
7. Rannveig Sigurðardóttir, Central Bank of Iceland
8. Þórarinn G. Pétursson, Central Bank of Iceland
9. Hannes G. Sigurðsson, Confederation of Icelandic Employers.

### **Accompanying documents:**

1. Agenda of the second meeting of the Council
2. Minister of Finance and Economic Affairs' slide presentation on the fiscal plan
3. Central Bank Governor's slide presentation on the economic situation and challenges facing to monetary policy conduct
4. Governor's speech at the Annual Meeting of the Central Bank of Iceland, 30 March 2017
5. Hallgrímur Snorrason's slide presentation on wage statistics in Norway and Iceland
6. Hallgrímur Snorrason's report on wage statistics in Norway and Iceland