**Macroeconomic Council**

# Minutes of the first meeting of the Macroeconomic Council

*Held 8 June 2016 — 9:00 hrs. - 11:00 hrs. — Safnahúsið, Hverfisgata*

Names of attendees:

Macroeconomic Council members:
1. Prime Minister (Sigurður Ingi Jóhannsson)
2. Minister of Finance and Economic Affairs (Bjarni Benediktsson)
3. Chairman, Association of Local Authorities (Halldór Halldórsson)
4. Governor, Central Bank of Iceland (Már Guðmundsson)
5. Managing Director, Confederation of Icelandic Employers (Þorsteinn Víglundsson)

Other attendees:
1. Benedikt Árnason, Prime Minister's Office
2. Guðmundur Árnason, Ministry of Finance and Economic Affairs
3. Guðrún Þórdís Guðmundsdóttir, Ministry of Finance and Economic Affairs
4. Karl Björnsson, Union of Local Authorities in Iceland
5. Rannveig Sigurðardóttir, Central Bank of Iceland
6. Þórarinn G. Pétursson, Central Bank of Iceland
7. Hannes G. Sigurðsson, Confederation of Icelandic Employers.

Attachments to the minutes:
1. Agenda of the first meeting
2. Agreement on the role and framework for the Macroeconomic Council
3. Central Bank Governor's slide presentation on monetary policy challenges

The Prime Minister called the meeting to order and recommended that Benedikt Árnason serve as meeting secretary; this was approved. The Prime Minister then reviewed the background to the establishment of the Macroeconomic Council. The social partners first discussed a Macroeconomic Council with the Government in connection with the conclusion of private sector wage settlements in spring 2015. Previously, recommendations from the Consultative Forum for Increased Economic Wellbeing had stated that the interactions between fiscal policy, monetary policy, and the labour market must be improved if attempts at creating conditions favourable for GDP growth were to be successful. In order to facilitate wage settlements, the Government consented on its own behalf to the commencement of preparations for the establishment of the Macroeconomic Council, in a statement published on 28 May 2015.

On 27 October 2015, the social partners concluded among themselves a framework agreement providing for changed procedures in connection with wage negotiations. Article 1 of the framework agreement provides for the establishment of a Macroeconomic Council whose role is to analyse the economic situation and discuss the shared context of fiscal policy, monetary policy, and the labour market in connection with key aspects of current economic policy. In February 2016, the Prime Minister appointed a preparatory group to lay the groundwork for the establishment of the Macroeconomic Council and follow up on the framework agreement.

The establishment of the Council has been delayed because of a disagreement between the Government, on the one hand, and the Icelandic Federation of Labour (ASÍ) and the Federation of State and Municipal Employees (BSRB), on the other, concerning how cooperation between the authorities and the social partners could be improved so as to ensure social stability. In his introductory remarks at the meeting, the Prime Minister emphasised the importance of participation in the Macroeconomic Council by employee federations – not only ASÍ and BSRB, but also the Association of Academics (BHM) and the Icelandic Teachers' Union (KÍ), which are not currently parties to the framework agreement. Other Council members agreed. The Prime Minister considered it important, however, that the Macroeconomic Council begin work immediately, as many demanding issues lay ahead. The Chairman of the Association of Local Authorities proposed that a special forum representing the State, the local authorities, and employee federations be established to discuss social stability. He also drew attention to the fact that there were no women among the founding Macroeconomic Council members but pointed out that this would change when employee federations became members of the Council.

Next, an agreement providing for the role and framework of the Macroeconomic Council was signed, and the parties expressed their satisfaction at the establishment of the Council.

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

Labour market

The Managing Director of the Confederation of Icelandic Employers discussed the work being done on a new labour market model based on a Nordic blueprint, known as the Collaborative Committee on Wage Information and Economic Premises for Wage Settlements (Icelandic: Samstarfsnefnd um launaupplýsingar og efnahagsforsendur kjarasamninga, SALEK). The point of departure for this work is that the competitive position of export sectors creates the scope for wages in collective bargaining agreements. He said the work was well underway and that he considered it promising. Even though progress was being made, however, there were roadblocks ahead, such as the equalisation of pension rights between the public and private sectors, which was an important part of the SALEK work and the framework agreement of October 2015. The aim was to deepen understanding of the importance of a new model, thereby providing greater cohesiveness among the social partners.

The Minister of Finance and Economic Affairs said that the unstable Icelandic labour market model was characterised by persistent and built-in competition about whether better standards of living were provided to the public by the labour market, through wage agreements, or by government authorities, through statutory amendments. The labour market also affected the legislative process and budgetary allocations through demands made in connection with wage settlements. He said that prioritising social welfare services was the role of politicians and not the labour market, but that politicians must also withstand the temptation to involve themselves in private sector labour market issues. He was of the view that the Icelandic model had led to wage increases well in excess of productivity growth and had thereby prevented reductions in interest rates.

Members of the Macroeconomic Council agreed on the importance of the SALEK agreement and on the importance of success in the planned modifications to the labour market model. It was pointed out that, in spite of large wage increases in the recent term, many factors had contributed to keeping inflation at or below target for more than two years, among them reduced oil prices, low global inflation, increased product prices, and tighter monetary policy. Although many things had gone well, it would be imprudent to assume that the favourable developments that had helped contain inflation would continue to do so in the future.

## Public sector finances

The Minister of Finance and Economic Affairs and the Chairman of the Association of Local Authorities discussed the state of public sector finances. The Minister of Finance and Economic Affairs said that the fiscal outlook had improved in the recent term and that the targeted 30% debt ratio provided for in the Act on Public Finances was within reach. The five-year fiscal strategy plan described plans for increased primary expenditure at constant prices at the State and local levels, alongside reduced interest expense and improved performance. The Chairman of the Association of Local Authorities said the municipalities' situation had been difficult, particularly due to costly wage settlements, but was now improving. Increased cyclical revenues were beginning to flow in, but it was important to give consideration to income distribution between the State and the municipalities. Cooperation between State and local authorities concerning economic and labour market issues had been greatly increased, as it was important that the two bodies integrate their activities and link them to the business cycle.

In the discussion of public sector finances, it emerged that demands for substantially increased expenditures – well in excess of the five-year fiscal strategy plan – posed difficulties for the authorities. The threshold was set too high. If efforts to dampen expectations of vastly increased spending were unsuccessful, an inflation spiral of the type so well known in Icelandic economic history would ensue. The Managing Director of the Confederation of Icelandic Employers was of the view that the time was ripe to consolidate in State operations, as expenditures were very high in international context and the labour market situation was good. State finances amplified the expansion in the economy under current conditions, which was extremely unfortunate. The Prime Minister and the Minister of Finance and Economic Affairs pointed out Iceland's positive primary balance in comparison with other countries. The Governor of the Central Bank said, however, that the fiscal stance had eased somewhat in terms of the cyclically adjusted primary balance.

The Chairman of the Association of Local Authorities noted that the State and municipal investment level had been low for many years, which was undesirable, and that there was a significant pent-up need for investment in social infrastructure. It emerged in discussion, however, that the public sector had limited scope for increased investment, in spite of a favourable economic outlook. The increased scope had been used primarily for wage increases and social insurance benefits; therefore, there was limited latitude for other operational expenditures and investment. It was pointed out that, in general, there appeared to be limited understanding of the fact that it was impossible to increase wages by dozens of percentage points and increase investment substantially at the same time.

## Monetary policy

The Governor of the Central Bank discussed the recent progress made in monetary policy and the main challenges that lay ahead. He pointed out that progress in monetary policy could be seen in inflation expectations, which had fallen and were more firmly anchored than had previously been the case. He added that this had played a role in keeping inflation under control in the wake of large wage increases. National saving was also more than before relative to the current business cycle position, which helped to deliver a surplus on external trade. The challenges facing monetary policy were significant, however. Liberalisation of the capital controls was one such challenge. Furthermore, interest rates were much higher in Iceland than in most other economies, as Iceland was at a different point in its business cycle. The increased slack in fiscal policy also contributed to higher interest rates in Iceland than would otherwise be needed. The Governor presented the alternative scenario published in the May 2016 issue of *Monetary Bulletin*, which indicated that because of increased fiscal slack in 2015 and 2016, the Bank's interest rates were about ½ a percentage point higher than they would have been under fiscal-neutral conditions. He said the interest rate differential between Iceland and other countries created the risk of carry trade-related capital inflows, and that such inflows had disturbed the monetary policy transmission mechanism in the latter half of 2015. With new capital flow management measures, however, it should be possible to affect the composition of capital flows to and from Iceland, thereby making it more possible to apply interest rates to dampen demand if necessary.

During the discussion of this item, Council members discussed the conditions under which interest rates in Iceland could be lowered. It was also pointed out that the interest rate tool was less effective than generally admitted because of price indexation. The Governor said that interest rates could be reduced if inflation expectations were in line with the inflation target, as in most industrialised countries, and if the labour market and fiscal policy supported monetary policy. This did not change the fact, however, that conditions in Iceland were quite different than they were elsewhere: GDP growth was robust, a positive output gap had opened up, and full employment had been achieved. The Governor considered it necessary to show patience; many things were going very well, and important changes were being implemented. It would be a favour to no one to lower interest rates prematurely. Discussion turned to whether it was possible to apply other monetary policy instruments such as, for instance, minimum reserve requirements. It was pointed out that it was certainly possible to use tools other than interest rates, but that using reserve requirements actually represented raising banks' interest rates and market interest rates in a different way; i.e., by affecting the money multiplier and interest rate spreads. The problem was, however, that the effectiveness of this tool is not as well documented as the effectiveness of interest rates and that, furthermore, reserve requirements extend only to a portion of the credit market. This was not to say, however, that reserve requirements should not be used together with other tools; in fact, this had been done last winter.

There was also some discussion of productivity growth, which had been weak in Iceland in recent years. Discussion turned to whether measurements of productivity were flawed, particularly in view of the fact that firms had been streamlining to cover increased wage costs. It was also mentioned that the explanation for weak productivity growth in recent years could lie in the growth of tourism, a labour-intensive industry. The productivity level of tourism was considered lower than that in sectors such as industry and fishing. It was mentioned that, in spite of signs of increased productivity in all areas, more rapid growth in tourism than in other sectors could cut into overall productivity. Underlying productivity growth could therefore be underestimated. Those present at the meeting agreed that if productivity could be increased in Iceland, all aspects of economic policy would be easier to manage. For instance, firms would be able to respond more easily to wage increases. Reference was made to the alternative scenario in *Monetary Bulletin* 2015/4, which showed how, other things being equal, more rapid productivity growth contributed to stronger GDP growth and lower inflation. Interest rates could therefore be lower, real wages higher, and the fiscal surplus larger. Council members agreed that studying ways to promote increased productivity growth was an interesting idea.

<u>Increased formalisation does not automatically change attitudes</u>

Council members agreed that the Macroeconomic Council was one step of many that have been taken in recent years to enhance discipline and stability in economic policy. In this context, mention was also made of the Act on Public Finances, increased cooperation between State and local authorities, the Financial Stability Council, and the SALEK agreement in the labour market. Increased consultation and formalisation of interactions among key parties involved in major decisions concerning the development of the economy were necessary, but they were not sufficient in and of themselves. Attendees agreed that it was the joint task of Macroeconomic Council members to prevent the economy from overheating.

Scenarios for the next meeting

Discussions among Macroeconomic Council members revealed an interest in preparing scenarios showing the economic impact of wage rises and increased public spending on interest rates in advance of the Council's next meeting.

The meeting was adjourned at 11:00 hrs.