

Where do we go from here?

Gylfi Arnbjörnsson

President

The Icelandic Confederation of Labour

Priorities in economic policy-making



- Fiscal adjustment is well under way and important to maintain focus to make the public finances self sustainable, but now we need...
- An aggressive growth and employment strategy to create jobs and income!
 - The government has to initiate transport – and infrastructure projects with of balance sheet financing to jump start growth
 - We need to create investment opportunities in the green sector to enable a transition of the manufacturing sector over to more export oriented growth:
 - Enable and ease investments in green energy by adopting the framework schedule for utilization of hydro and geothermal energy resources
 - Secure a better access to foreign markets, notably in Europe, for fully processed products from our large fishing industry and dairy, meet and green-house industry
 - Use more active labor market policy measures to secure a just transition of the workforce to lift qualifications and competences that are needed

Monetary and exchange rate mechanism is a key factor going forward



- A currency should lay a sound basis for economic and social stability
 - and not be one of the main sources of instability
- Its important that we acknowledge that the krona has played its role as an independent currency and will never be sustainable on a floating basis
 - We have capital controls and restrictions that are counter productive
 - They are in breach of international obligations (both EEA and IMF conventions!) and will effect our terms of trade in near future!
 - The last time we used capital controls it lasted 62 years!
 - The foreign exchange balance is out of proportions
 - The national foreign debt ratio is tolerable (especially since we have a fully funded pension system with appr. 130% of GDP)
 - There is a huge overhang of krona bonds (app. 30% of GDP) in the hands of non-resident investors that are locked inside and others hesitate to come in!
 - There is an even larger pile of domestic savings earning negative real interest rates that are not allowed to invest abroad that wants to exit due to lack of expectations
 - We have next to no currency reserve (its on loan from the IMF and the Nordic countries)



Monetary and exchange rate

- The krona is undervalued by 20-25% compared with long term equilibrium/historical data/profitability of the export sector
 - Inflation is currently high (appr. 6%) mainly due to the devaluation of the krona earlier this year (again!)
 - Export sector „over profitable”, wage drift is picking up in the sector and pressure on the labor market is building up
 - Real income and demand of household sector is low and debt ratios are high
 - Debt ratios of domestic sector is high, output is low and profitability unsustainable
- This is the biggest challenge in stabilizing the economy
 - but too hot to handle for the politicians
- This is a race against time because the real effective value of the krona will appreciate over time,
 - either through nominal changes in the currency market
 - or by way of a wage – inflation spiral
- We have a long experience of similar situations here in Iceland, the question is only which way will get us on track and with what social and economic cost!



The only way out of this mess

- The Icelandic Confederation of Labor proposed both in year 2000 and again in 2008 that Iceland should join the EU and adopt the euro
- We formulated a strategy in October 2008 that would address the problem of having a non-performing currency as an alternative to the currency restrictions
 - a. Apply for a program with the IMF to spear a Nordic backup financing of the sovereign debt and the currency reserve
 - b. Build up a confidence that we will join the EU and adopt the euro a.s.a.p. and commit to that strategy with clear goals on difficult topics
 - c. Negotiate a deal with the IMF and ECB to back-up the pecking of the euro in the recovery process
 - With these steps the confidence of the non-resident holders of glacier bonds and other investors would have been increased and the krona would have appreciated
 - d. Enter the ERM-II corridor and adopt the euro when the Maastricht condition were full filled
 - The Confederation actually offered a two plus three year collective agreement to secure a broad framework for this strategy

How to manage an economy?

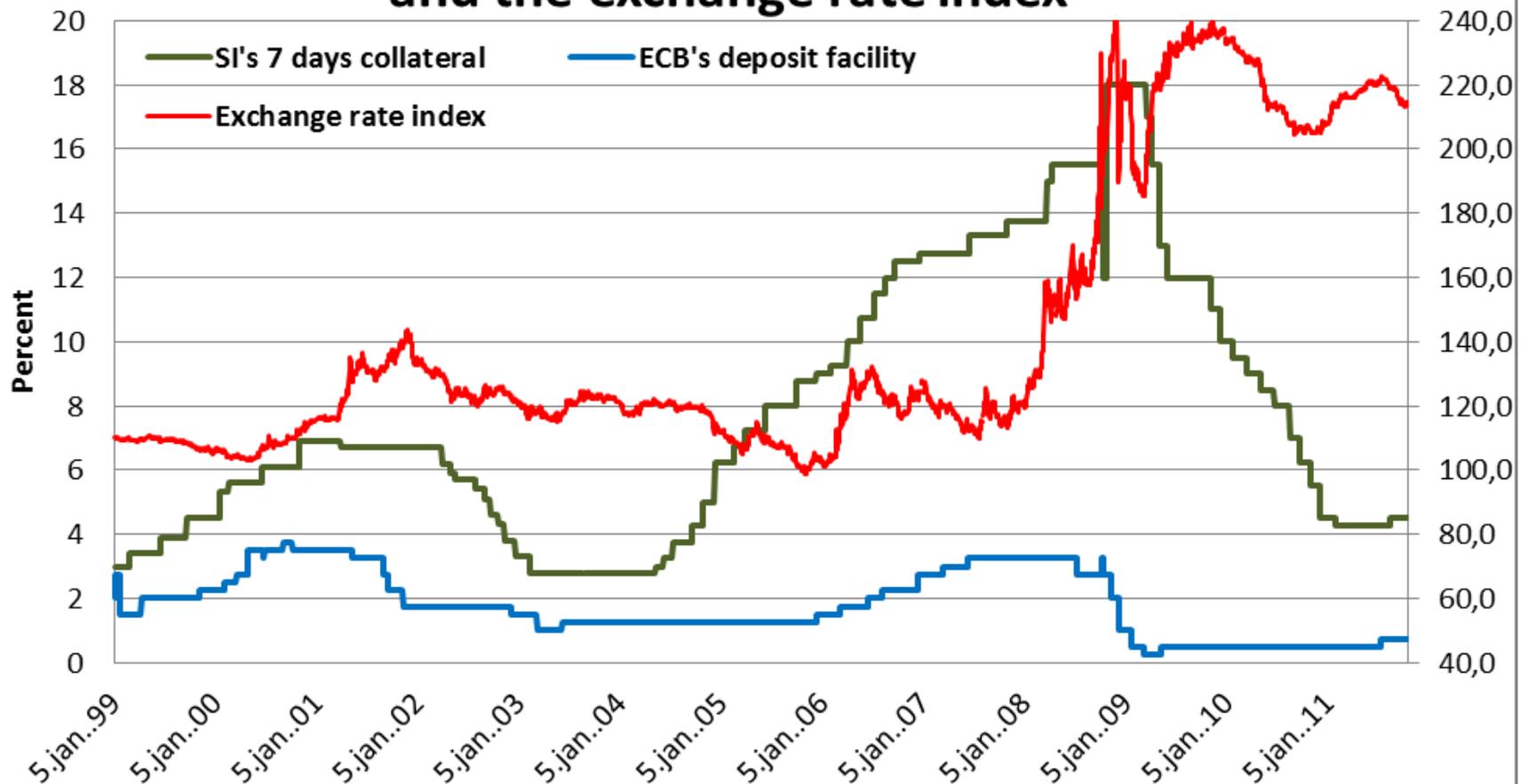


- Obviously there will be conflicts of interest and the need to mitigate them – hence it is important to create a dialogue between the political sphere and the social partners
- Globally politicians talk about „economic governance” instead of „economic policy making”, they create G6, G7 and G20 to underline their role but consequently neglect the social dialogue
- Long tradition for tripartite negotiations here in Iceland but each actor has to follow the same long term goal of preserving and maintaining a stable economy regardless of short term popularity!
 - Companies and workers that are in an open economy are exposed to global impact and competition that set clear restrictions for „irresponsible” behavior. A drop in competitiveness due to high wage increases hits us hard in terms of unemployment and drop in income
 - Politicians do not have the same external „watchdog” to maintain their course and the temptation to be the good guy - to be Santa Klaus – to secure reelection is sometimes overwhelming as we saw here in Iceland f.ex. in 1998-2000 and again in 2003-2007 with devastating results
 - Joining the EU and committing to goals of the Growth and Stability Pact and the surveillance and rules of the EcoFin is of importance to at least raise the threshold of populism and demagogy!

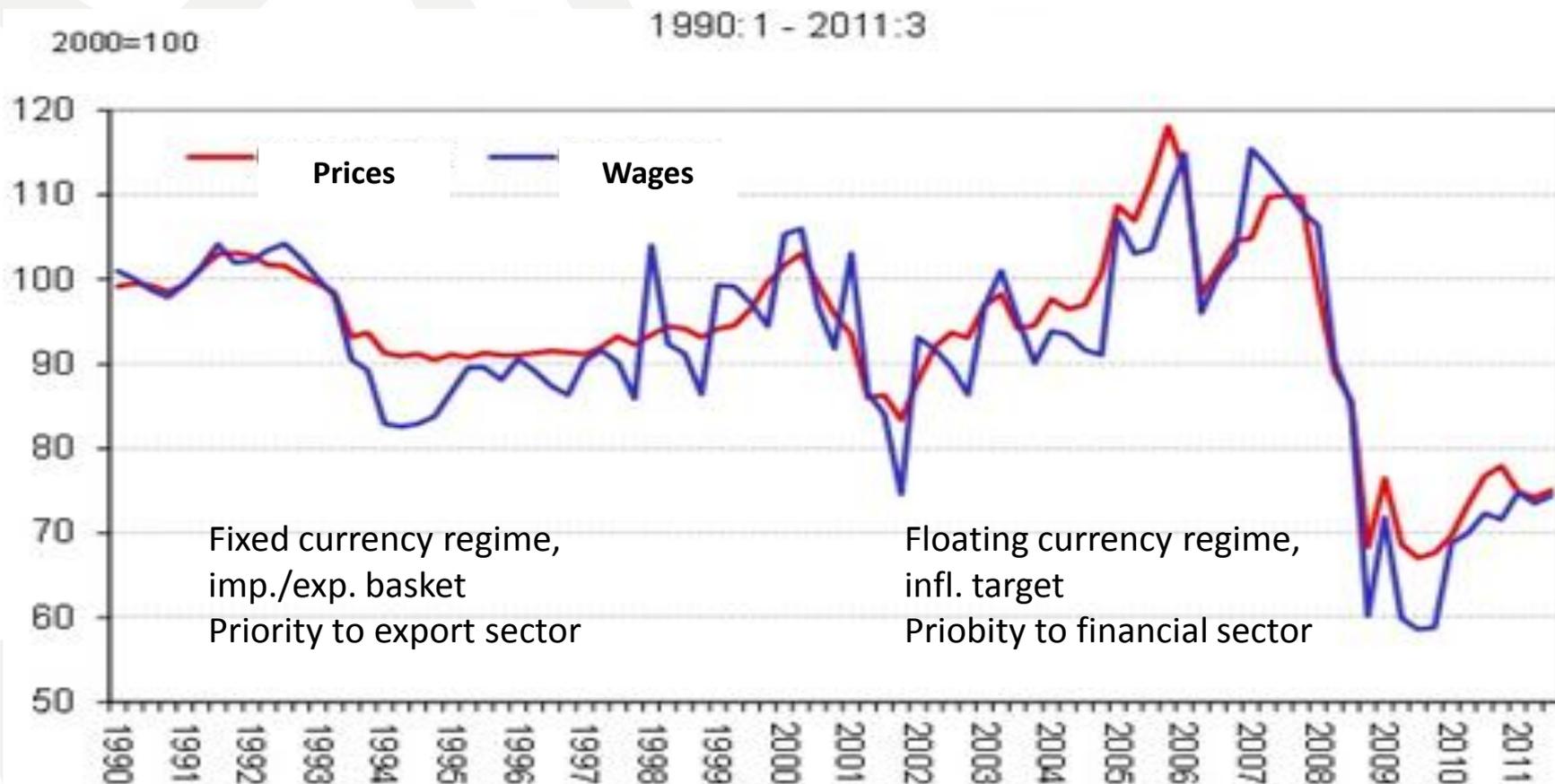
SI created a large interest differential and encourage carry trading so that foreign capital soured into the economy



Central banks key interest rates and the exchange rate index



Real effective exchange rate





Why a flexible currency does not work for a small open economy

- 40% of the CPI is imported goods
 - hence a devaluation is transformed into an inflation immediately
- Volatility of exchange rate policy systematically raises the base rate by 3-4%
 - currently SI is at 4,5% compared with ECB's 0,75%
- Willingness and dedication to the devaluation therapy means that banks take a risk premium towards unexpected inflation,
 - here the premium has been 1-3% historically on nominal loans
- Debt ratio for households was 236% of DPI in 2010, that means that 1% in interest rate equals 2,4% in net income.
 - On an average mortgage loan compared with euro zone the burden was 12% of net income on average the last 10 years, but currently the burden is 20% of a new loan for an average apartment!



Why a flexible currency dos not work ...

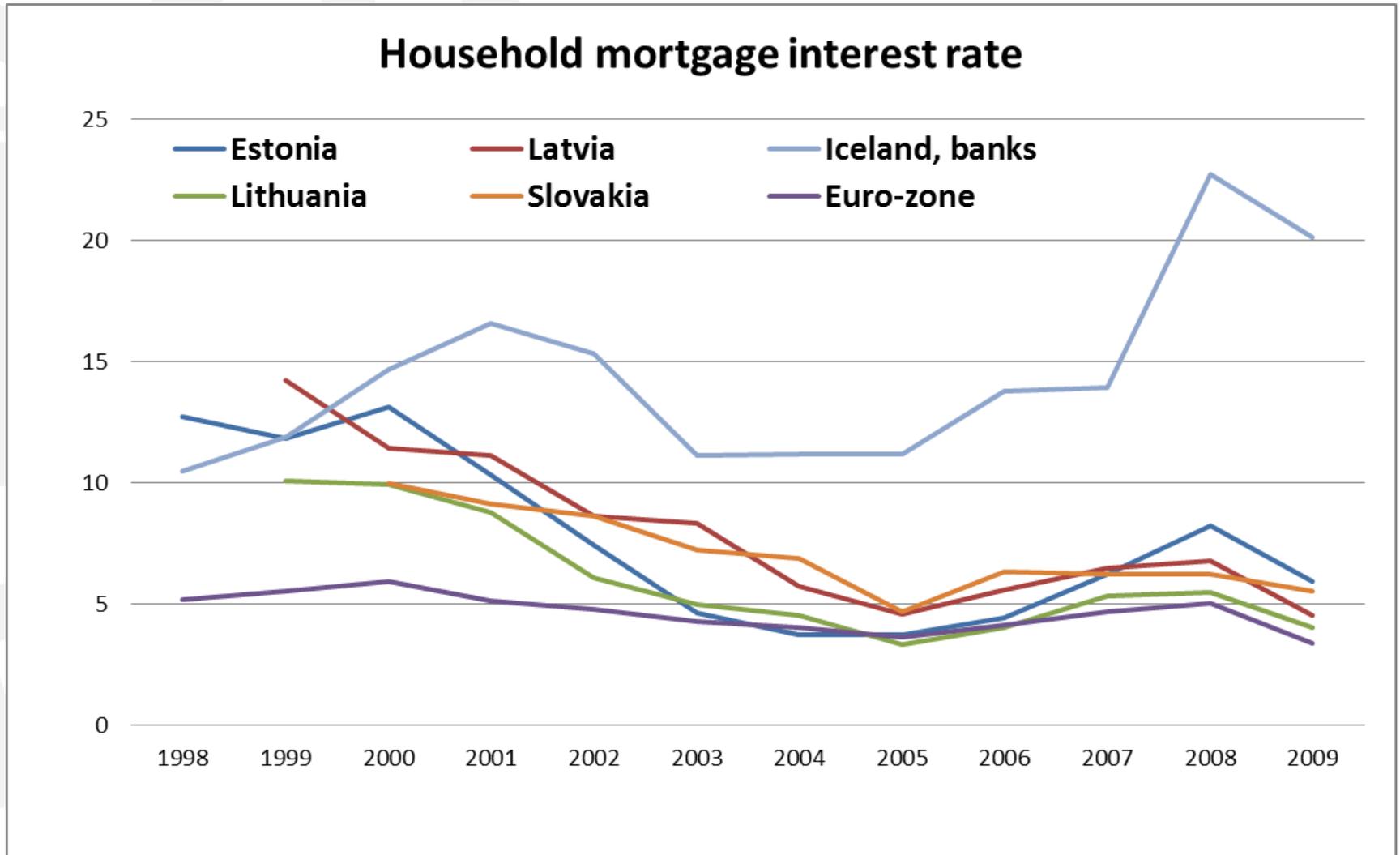
- Very few investment opportunities has the profitability to cover this 4-7% risk premium,
 - therefor the companies financed there investments and operations with foreign loans with enormous FX exposure!
- If every country solves its productivity problem with devaluations of their currency to „beggar thy neighbor” there wont be any gain in the relative comparative advantage, but a lot of inflation and/or stagflation!
 - That was the lesson of the seventies, took us most of the eighties to solve it, the nineties to enjoy it and the first decennial of the 21st century to spoil it!



Is adopting the euro a quick fix and will life then become beautiful?

- No, of course not
- any form of fixed exchange rate mechanism demands disciplined economic policy making and a responsible and flexible labor market
 - We have a bad experience of both flexible currency policy and of the floating mechanism with a inflationary target
 - We can not support a fixed exchange rate mechanism on our own, hence adopting the euro!
- Lower and stable interest rates are crucial to be able to develop this economy into a more diversified knowledge based high tech economy
- F.ex. for the households, going from Icelandic interest rates – with all its risk premiums for uncertainty of the currency – over to euro-zone interest rate is a positive move!

EU's small MS enjoyed a drastic fall in mortgage rate – while we went from bad to worse!



Iceland has a flexible labor market and I dare say that we are responsible!

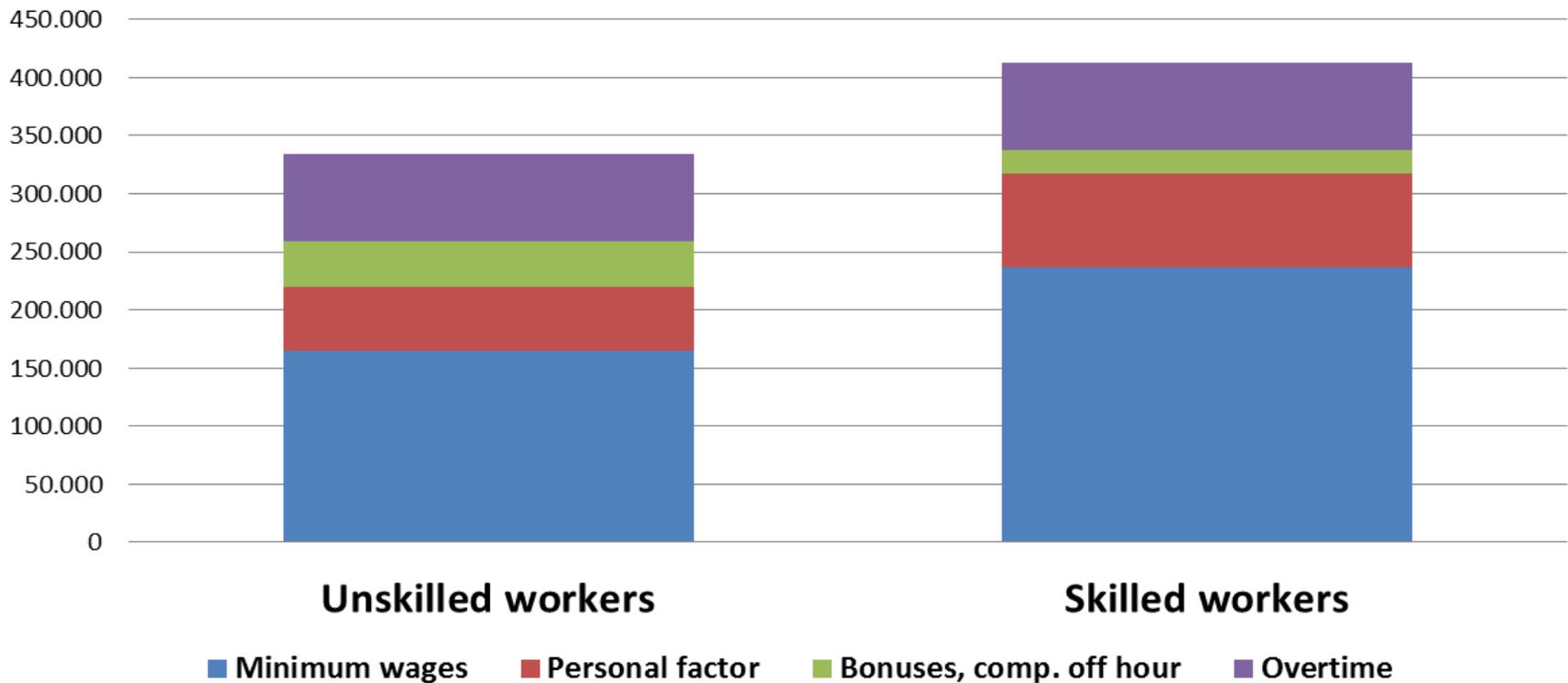


- Well organized labor market, with high participation rates in trade unions and employer organizations
 - 85-86% of the work force in organized
 - 50-55% of the companies are organized plus collective agreements with many single companies
- Long history of social dialogue and broad acceptance for semi-central negotiations during crises-management in recessions
- Flexible wage formation with generally applicable minimum wages with high coverage rate
- Widespread welfare-system on the labor market as an integral part of our flexicurity-system

Almost half of monthly earnings are variable with in a short time



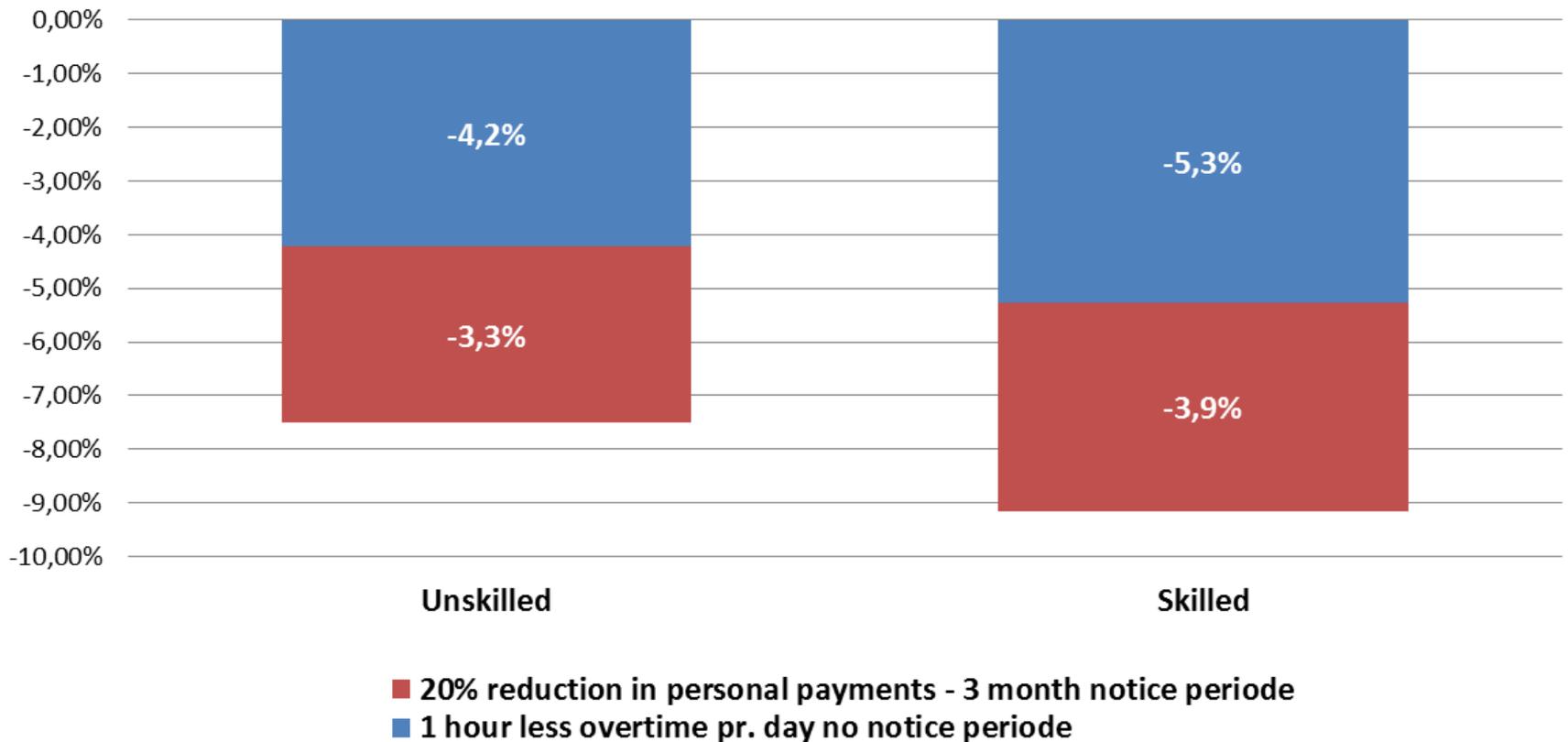
Composition of monthly earnings in 2010



The adjustability in terms of wage cost and manning is high

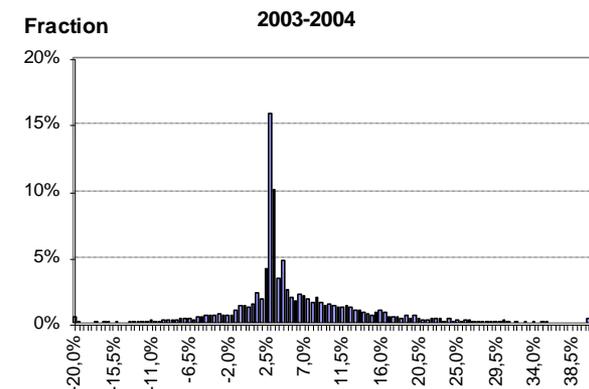
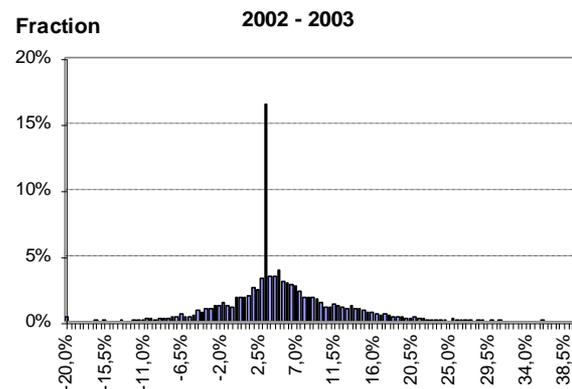
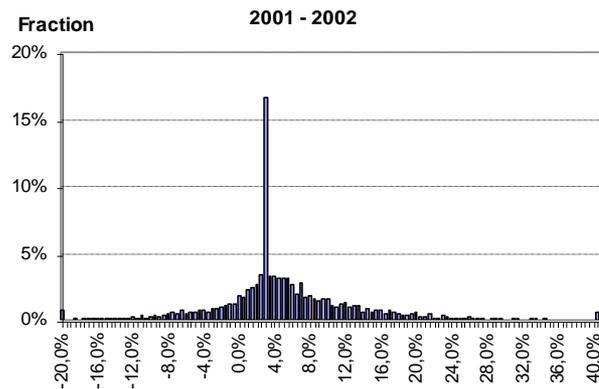
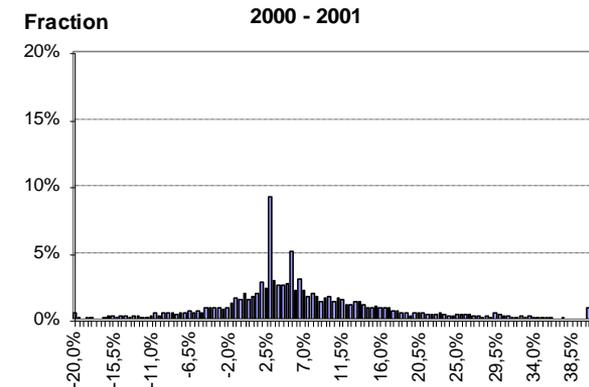
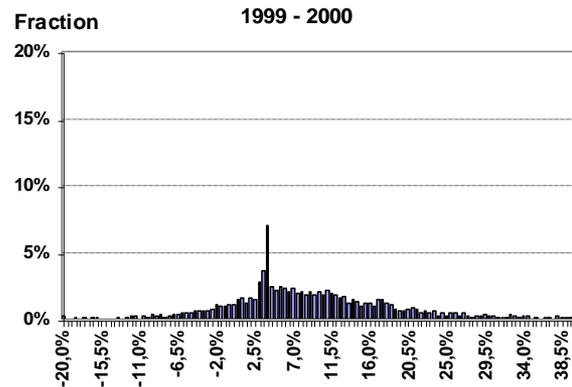
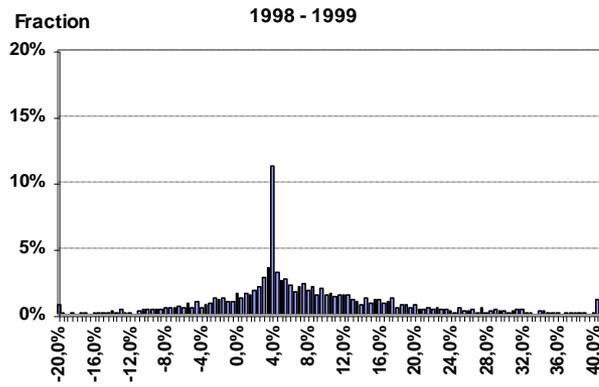


Flexibility of the average hourly wages is high





Average-hourly wages change





What is the message?

- Focus on a fiscal and monetary policy that supports a competitive economy in the long run
- Instead of using the currency policy as a quick fix for irresponsible behavior of financial markets and bad policy making by politicians!