

13 September 2020



The Economic Impact of the Pandemic and Containment Measures

1st Report of the Working Group
of the Minister of Finance and
Economic Affairs

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1. Introduction

This is the first report of a working group appointed by the Minister of Finance and Economic Affairs on 28 August this year, entrusted with the task of analysing the economic impact of different options for epidemic containment measures. The Minister's letter of appointment required that the analysis take into account, among other things, "the interests of different groups in society and sectors of the economy" and that in addition to short-term effects an assessment be made of the ability of the economy "to make a strong recovery once the epidemic and its effects had passed".¹ The Minister requested the group's first report be delivered by 13 September 2020.

The group's task is in some respects unusually complex, making it possibly difficult to reach definitive conclusions. Only just over six months have passed since the SARS-CoV-2 virus infection was first diagnosed in Iceland. A variety of changes have been made to disease containment measures during this period. Relevant data series are therefore short and for this reason alone it can be difficult to assess the probability distribution of the impact of actions. This becomes even more difficult when the system transmitting the effects to their outcome is subject to change, even in the short term. The public's response to disease containment measures changes as time passes, in part because it is gaining knowledge of the disease, finding out how to accomplish things within the limits of containment measures, and modifying its behaviour over time, both for better and for worse. In addition, when subject to a shock of the magnitude of this epidemic, economic relationships are likely to be more fluid than is usual, making it trickier to assess the economic impact of specific actions.

The problem is that the uncertainty concerning outcomes is not based on a known probability distribution, as is often used for forecasting and optimal control; instead there is uncertainty about the probability distribution itself. However, this is a known problem in various other areas, for example in traditional economic management, especially when the economy has undergone a major shake-up. Then, and in fact often at other times, risk management is applied rather than optimisation, in an attempt to reduce the risk of far-reaching mistakes while at the same time trying to approach an uncertain best outcome. It is important to keep the above caveats in mind when examining the content of this report, as well as in making the relevant decisions. It is also clear that these complications make the work of the working group more time-consuming than otherwise.

¹The letter of appointment is published in an appendix.

The group has held a total of 11 meetings, including meetings with the Chief Epidemiologist, DeCode Genetics, the Icelandic Travel Industry Association (SAF) and biostatisticians at the University of Iceland, with whom an agreement has been made to provide analyses in support of the group's work. In addition, a health economist at the University of Iceland has been consulted, and a closer examination of the overall social cost will be given later in the group's work.² The group has gathered a variety of domestic and foreign material which can be useful for its work. During its brief working period the group has not managed, in tandem with compiling this report, to meet with representatives of those sectors which have been the hardest hit by disease containment measures, with the exception of the tourism industry. The intention is to do so in the continuation of this work. Section 7 of the report gives more details of the group's planned follow-up work.

The report sets a framework for the subject, presents the results of those observations that could be carried out during this brief period and spotlights the economic impact of disease containment. The next section provides an overview of the development of containment measures in Iceland during the COVID epidemic and compares this with other countries. The third section assesses the efficacy of these measures. The focus is particularly on the success of testing at border points, with specific key information obtained through this. The fourth section discusses the economic impact of disease containment measures. An assessment is made of the impact so far in Iceland, both with regard to the economy as a whole and to individual industry sectors. Section five looks to the future as far as the end of 2021, based on different assumptions about the development of containment measures. Section six discusses generally the premises for economic rebound and growth, although a more detailed discussion of this aspect will await the next report. The final section summarizes the results of the material in the report, makes recommendations and explains what follow-up work the working group will undertake.

The working group consists of Ásdís Kristjánsdóttir, Már Guðmundsson and Tómas Brynjólfsson. Benedikt Árnason is working together with the group. Its secretary is Ólafur Heiðar Helgason. The group has been assisted by Analytica.

²See the memorandum from Tinna Laufey Ásgeirsdóttir in an appendix.

2. Conclusions, Recommendations and Next Steps

2.1 Conclusions

Effective disease containment involves short-term sacrifice for long-term benefit. For this reason, individual measures need to be measured by whether the long-term benefits for society outweigh the short-term sacrifices, and assessed in terms of the total societal gain and cost. This assessment is problematic, not least because there is no reliable model of the probability distribution of the effects of disease containment measures. Clearly, however, disease containment can be both too limited and too extensive. Among the most important considerations is not to allow the epidemic to spread out of control, resulting in a situation similar to that in March and April.

International research suggests unequivocally that containment measures significantly reduced the spread of the epidemic during its peak this spring. In Iceland, domestic disease containment measures have for the most part been mild by international comparison, with highly successful results. Extensive testing and contact tracing has enabled and is enabling the collection of a large amount of useful data, which provides better support for decision making based on scientific knowledge than in most if not all other countries.

The economic impact of the pandemic is enormous. In Iceland, the largest contraction this year is in tourism, as short-term economic indicators suggest that the drop in the sector's gross factor income is about 60% in the first nine months of the year compared to the same period last year. Most sectors of the economy have contracted in the first three quarters of this year compared with the same period the previous year. However, this assessment is subject to a great deal of uncertainty.

The domestic portion of private consumption and consumption of foreign tourists have changed greatly during the epidemic, which can be linked to different periods in its development and in disease containment. It appears, for instance, that the contraction in private final consumption during the seven-week period of the restrictions on public gatherings this spring resulted in a drop of ISK 9-14 billion in GDP, while increased consumption in the seven weeks immediately following their relaxation led to an increase in GDP of ISK 9-14 billion. Similarly, the country's income from tourism increased by ISK 11-13 billion during the period of more lenient border control measures in June and July, compared with a situation where measures had not been relaxed. The loss to the economy due to lower exports of travel services following stricter border restrictions in August could amount to around ISK 13-20 billion by year-end, based on certain assumptions.

The working group had an assessment made of the impact of travel opening up again after the middle of next year, instead of in the second quarter of the year, as the macroeconomic forecast assumes. The result is, other things being equal, that the increase in GDP in 2021 would be over one percentage point less, unemployment would be 1.5 percentage points higher and foreign trade would increase by 3-5% from that of 2020, compared with 17-19% in Statistics Iceland's forecast. However, the effect of major economic shocks is especially uncertain, as economic models assume that macroeconomic relationships will remain unaltered.

If the uncertainty drags on for a lengthy period, it can have a serious and long-lasting effect. Governments play a key role in mitigating damage, for example, by spreading the effects of the shock, creating conditions to fully utilise the factors of production when conditions improve, protecting the relationship between employers and employees, safeguarding business relationships and ensuring that important expertise and experience are not lost while the situation prevails.

It is important that actions also take care not to impede the inevitable adjustment of the economy to changes that are likely to take place regardless of the short-term effects of the epidemic and disease containment. Not all enterprises can be saved, but it is important to help viable companies keep afloat during unprecedented circumstances. The banking system must continue to play a key role in assessing corporate viability.

2.2 Recommendations

Given the above conclusions, the working group's recommendations are as follows:

1. The government's objectives in its disease containment measures are more diverse now than simply to keep the epidemic within the limits of the healthcare system's capacity. To achieve the widest possible consensus on the objectives of disease control, as was the case this spring, they need to be explained better.
2. Uncertainty is high concerning the development of the epidemic, both domestically and abroad. It is therefore impossible to provide predictability with regard to the authorities' disease containment measures with high certainty, but it would be beneficial if the government would increase this as much as possible, both vis-à-vis external and internal disease containment. Repeated modifications to disease containment may be necessary but are unfortunate, as they increase uncertainty. Increased predictability, as far as possible, makes it easier for both enterprises and individuals to make plans for responding to changed actions.
3. While domestic restrictions have been relaxed, external containment measures are still strict. An examination should be made of whether

other external disease containment measures are possible without this posing too great a risk for the development of the epidemic in Iceland. The government and the tourism industry should have a conversation on this question.

4. Tourism is the industry most affected by the epidemic and related disease containment. Given that tourism will be important for the economy's rebound, providing support to the industry in one way or another should be carefully considered, to maintain experience, expertise and business relationships while this situation lasts.

2.3 Next steps

In this report, the framing of the working group's task is based on the mapping that the group has managed to accomplish during the short period it has been allocated. Important analytical work in connection with this task, however, is still in progress and other efforts are commencing. If the Minister's approval is forthcoming, the working group is prepared to continue analysing the economic impact of the epidemic and related disease containment measures. In this connection, the group envisages four tasks in particular:

1. To complete an analysis of the economic impact on individual sectors. This involves, firstly, an assessment of the development of the factor income of individual sectors, based on relevant high-frequency data, and secondly, conversations with representatives of those sectors most affected by the epidemic and disease containment measures arising from it. With regard to the former, the aim is to obtain an impact assessment as close as possible in time. The group has held a meeting with representatives of the tourism industry and could hold more in continuation. It is interested in having discussions with representatives of other sectors, with the aim of mapping the economic impact as accurately as possible.
2. An agreement has been made with a statistical team at the University of Iceland to plot scenarios for the development of the epidemic, based on different implementations of disease containment. The aim is to link these results to the economic developments and in so doing obtain a better assessment of the impact of disease containment on them.
3. A cost-benefit analysis of disease containment measures will be made, taking into account as many factors as possible which affect social welfare (see further the memo from Tinna Laufey Ásgeirsdóttir, professor of health economics).
4. Analyse the impact of possible disease containment measures on the balance of payments.
5. Take a closer look at the preconditions for an economic turnaround and economic recovery that were given somewhat lower priority during the preparation of this report.

6. Assist the government as requested regarding follow-up on the recommendations set out above.

The working group considers it most appropriate to submit shorter reports on these individual aspects, depending on the topic and material, rather than an overarching report of the type presented here, which was necessary to provide an initial framework for the undertaking. This will help ensure the government gets results as soon as possible which will be more useful in policy-making.

