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Effects of Exchange Rate Volatility on Tourist Flows into Iceland

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Abstract

This paper examines the effect of Exchange Rate Volatility (ERV) for Iceland, on tourist arrivals exports during the period of first quarter of 1990 to fourth quarter of 2014. It is claimed by some researchers that exchange rate volatility causes a reduction on tourist arrivals. Empirical researchers often utilize the standard deviation of the moving average of the logarithm of the exchange rate as a measure of exchange rate fluctuation. In this study, a new measure for measuring volatility is proposed. The empirical methodology used relies upon the theory of cointegration, error correction representation of the exchange rate volatility measures using the Autoregressive Distributed Lags (ARDL) modeling to cointegration. Overall, our findings suggest that there is a negative effect of volatility to tourists' arrivals for Iceland.

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Keywords: Exchange Rate Volatility; tourism; Iceland; ARDL

1. Introduction

During the past decades many empirical researchers have attempted to model different sample countries' tourist flows. The fundamental aspect of this estimation has been the determination of a set of variables which will allow for the creation of more accurate models. As a result the selected variables often vary among sample countries since

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there are often fundamental differences among sample countries. Despite the differences among studies, our investigation will focus on one variable often overlooked in the literature. This variable is exchange rate volatility. The main argument of empirical researchers is that high exchange rate fluctuation can effect tour operations causing them to shift their business from a country with high exchange fluctuation to a country with low exchange rate fluctuation. Although the effect of exchange rate volatility has to some extent incorporated in empirical models through the utilisation of variables such as relative prices less attention has been given to measures of fluctuation of exchange rates among countries in tourism estimation models. The purpose of this paper is to explore the relationship between tourist flows and exchange rate volatility for Iceland.

The structure of the paper is as follows: Section 2, provides an overview of the relevant literature, Section 3, justifies the choice of the specific model and the choice of the variables. In section 4, data description and methodology issues are analysed. Section 5, presents our results and finally, Section 6, contains concluding remarks and analyses the policy implications of our findings**.**

2. Literature Review:

Although there has been some difference among selected variables determining exchange rates our investigation has uncovered a set of commonly utilized determinant variables. These variables are: a) the real effective exchange rate; b) the relative prices between destination and origin and c) the income, approximated by the GDP in PPS of set or major countries of tourists origin.

Empirical studies that investigate the impact of tourism have found that the devaluation of exchange rate at the country of destination attracts tourist flows while an exchange rate revaluation reduces tourism outflows (see e.g. among others Agiomirgianakis (2012); Garin-Munoz (2000) and Patsouratis, et. al. (2005)) adopting what Artus (1970) has suggested, namely, that travelers are more aware of exchange rates that they use and they are using them as proxy for the cost of living abroad. Researchers often suggest that the origin country income affects positively the inclination of people to travel. The cost of living at a destination relative to an origin, given by relative consumer prices between destination and origin is negatively related to tourism inflows (see, among others, Dwyer et al.2010 page 63-64). Transportation costs which is actually part of the overall cost of traveling to a destination, is negatively related in tourist flows see e.g. Agiomirgianakis (2012).

Some researchers have shed, some light into the effect of exchange rate volatility to tourist flows for example Patsouratis (2005) who shows that exchange rate fluctuations may be identified as the sole factor determining tourist flows, as the case of German tourism inflows in Greece. Fewer, however studies focus rather on the exchange rate volatility such as Webber (2001), Chang et al (2009), Yap (2012), Santana Gallego (2010). In a seminal paper by Webber (2001), the volatility of exchange rate is identified as a significant determinant of the long run tourism demand since in some cases exchange rate volatility might also be associated with political instability or social unrest in the destination country deterring tourists from this destination. In some cases according to Webber exchanger rate volatility may lead tourists to abandon the idea of travelling to a particular country in 40% of cases.

Recent studies such as Chiang et al (2009) initiated a further analysis into the effects of volatility of exchange