FOR AGENDA

SM/84/251

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November 7, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Iceland - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Iceland. It is proposed to bring this subject to the agenda for discussion on Wednesday, November 28, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Knöbl (ext. (5)8821) or Mr. Hedfors (ext. (5)8830).

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INTERNATIONAL MONETARY FUND

ICELAND

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984 Consultation with Iceland

Approved by L. A. Whittome and Subimal Mookerjee

November 6, 1984

I. Introduction

A staff team consisting of Messrs. Knöbl, Hedfors, Mitra, Ishihara, Gros (EP), with Miss Durand-Jansiac as secretary (all EUR), held consultation discussions with Iceland in Reykjavik between September 6 and 17, 1984. The Icelandic authorities were represented by officials from the Prime Minister's office, the Ministries of Finance, Commerce and the Fisheries, the Central Bank of Iceland, the National Economic Institute and the Institute for Marine Research. The mission also met the Deputy Prime Minister and Minister of the Fisheries, Mr. Halldór Ásgrímsson; and the Governor of the Central Bank of Iceland, Dr. Johannes Nordal. Mr. John Tvedt, Executive Director for Iceland, attended some of the meetings as an observer. Iceland accepted the obligations of Article VIII, Sections 2, 3, and 4, on September 19, 1983. Iceland purchased the equivalent of 49.4 percent of its then quota under the compensatory financing facility in December 1982.

II. Economic Background

Economic developments in Iceland are dominated by the fisheries industry which contributes about 20 percent to GNP. A strong growth in fish catches in the 1970s stimulated an expansion of GNP averaging 4 3/4 percent per annum while keeping the external current account manageable despite two oil price shocks. Full employment was also maintained, though at a cost of a persistently high price inflation that ranged between 30 percent and 60 percent, and was associated with a pervasive system of wage indexation.

However, beginning in 1981, the fish catch at first stagnated and later dropped sharply (Chart 1). An unexpected depletion of the capelin stock in the North Atlantic caused the Icelandic authorities to place a ban on capelin fishing from the end of 1981; the cod catch also fell markedly in 1982 and 1983. In addition serious export marketing difficulties emerged. Quite separately, to dampen price inflation an effort was initiated in 1981 to moderate the depreciation of the exchange rate, and though price inflation did slow down (Chart 2) competitiveness was rapidly lost (Chart 3). As exports faltered domestic demand was given a major boost, through credit expansion that continued to accelerate despite the drop in inflation, and employment was maintained. As a result the external current account, which had been in rough balance in 1980, ran up a deficit averaging 10 percent of GNP in 1982.

Mounting external difficulties forced adjustments in policy. First, to restore competitiveness, the depreciation rate for the krōna was accelerated from the beginning of 1982 to stay ahead of the inflation differential with other countries (Chart 4). Temporary reductions in the degree of wage indexation were also decreed for the second half of the year, causing cost competitiveness to improve even faster than price competitiveness. Real wages began to fall in the final quarter of the year (Chart 5). However, with price inflation now rising rapidly, domestic credit expansion was also stepped up in 1982, thus preserving in real terms the momentum that had been built up during the preceding year (Chart 6). Nominal interest rates remained unchanged and real interest rates fell (Chart 7).

The external current account improved from mid-1982, and was restored to virtual balance by the third quarter of 1983. Though price inflation reached its peak at an annual rate of 130 percent in the second quarter of 1983, the improvement in cost competitiveness had already begun to have a desirable effect on both exports and imports. In addition, while domestic credit expansion had continued very high even in real terms to the end of 1982, the growth of the broad money stock had been slowing down rapidly (Chart 8) as the banking system lost net foreign asset (Chart 9). Also, with inflation approaching its peak the stock of credit as well as money began to decline in real terms, creating very tight financial conditions in the opening months of 1983.

The Government that assumed office in May 1983 succeeded, by the third quarter of 1984, in bringing the year-on-year inflation rate back down to just over 20 percent. It did so by once again stabilizing the nominal effective exchange rate of the krōna following an initial step devaluation of 14 1/2 percent. In addition, it suspended for two years the quarterly wage indexation, which had been fully restored at the beginning of the year, and introduced a statutory wage policy effective until early 1984, that helped to keep the real effective exchange rate intact (Chart 4).

However, the real money stock resumed rising in 1984 reaching rates as high again as two years before (Chart 8). The drop in the rate of price increase was so precipitous that the deceleration in domestic credit expansion did not keep pace with it (Chart 6).

In assessing Iceland's economic position a year ago (SM/83/236, 11/14/83, and Sup. 1, 12/5/83) the staff noted that external adjustment in 1983 had relied largely on a pronounced depreciation of the exchange rate buttressed by incomes policy; but that the stance of financial policies had remained unduly lax and would lead to renewed difficulties on external account. Executive Directors agreed with this assessment, and stressed that the progress in external adjustment in 1984 should be supported by a tightening of financial policies (SUR/83/48, 12/19/83).

In the event, the deficit on external current account has widened again in 1984, returning in the second quarter to the equivalent of some 10 percent of GNP (Chart 3).

III. Recent Developments

The new Government in May 1983 introduced a package of measures aimed at adjusting the external current account, maintaining high employment, and reducing inflation. The 1984 budget adopted as targets balance in the external current account for 1984, and a further deceleration of price increases to an annual rate of less than 10 percent by the end of that year. These targets now appear unlikely to be achieved. Performance to date with respect to each of the three major objectives of policy is considered in this section.

Table. Iceland: Major Economic Indicators

(In percent)

	1981	1982	1983	1984 Official projection
Real GNP (growth rate)	1.6	-1.5	-5.5	-1.2
Consumer prices (changes during period)	59.9	40.9	63.7	15.4 1/
Real earnings (changes in annual average)	3.8	-0.1	-13.6	-4.5
Nominal effective exchange rate (changes during period)	-16.5	-43.0	-34.7	-3.2 2/
Current account balance (in percent of GNP)	-5.1	-10.0	-2.5	-5.2
Adjusted 3/ (in percent of GNP)	-3.4	-7.2	-5.2	-5.0
Unemployment rate	0.5	0.7	1.0	1.3 4/

Source: Data provided by the Icelandic authorities.

1/ The annual rate during the first eight months of 1984.

2/ During the first eight months of 1984.

3/ Adjusted for fluctuations in export stocks and special imports of investment goods.

4/ First half of 1984; not seasonally adjusted.

1. The external balance

The deficit on the external current account fell to SDR 50 million (2 1/2 percent of GNP) in 1983 compared to SDR 232 million (10 percent of GNP) in 1982. The improvement was largely accounted for by the trade account. The effects of the sharp fall in domestic demand and the pronounced gain in competitiveness were enhanced by a number of special factors, notably a significant rundown of export stocks particularly of marine products and aluminum. Nevertheless, even adjusted for these special factors, the improvement in the current account was significant (see Table above).

The external current account deteriorated sharply again in 1984; the deficit for the first half of the year alone amounted to SDR 82 million. The deterioration is traceable to a strong rise in imports related in part to rising domestic demand, and possibly also to exchange rate speculation. While the authorities expect that part of this deterioration will be reversed later in 1984, the current account is still projected to show a deficit for the year of SDR 105 million or some 5 percent of GNP. Imports of goods and services are projected to rise by 11 percent in volume terms, and exports by only 3 1/2 percent despite a rise of 5 percent in the fish catch, and a strong rise in other export production. 1/ The services account is also projected to worsen owing to higher travel expenditures and interest payments on external debt.

The current account deficits of recent years have been largely financed through official borrowing abroad, though borrowing by financial institutions for on-lending to the domestic economy and by private entities has not been insignificant. Gross official reserves rose by SDR 10 million in 1983, but in the first eight months of this year they fell by SDR 26 million to stand at SDR 117 million or close to nine weeks' 1984 merchandise imports. Reserves are expected to be replenished in the final months of the year from the proceeds of fresh foreign borrowing.

2. Demand, output, and employment

The level of economic activity was significantly affected in 1983 by a 6 1/2 percent reduction in total marine output, and by the compression of domestic demand. As a result of a 10 percent fall in real disposable incomes, real private consumption declined by 6 percent in 1983 but public consumption is estimated to have risen by 3 percent. A large cut in public investment as well as weaker private investment led to a 13 1/2 percent fall in total fixed investment. Furthermore, the inventory cycle--reflecting chiefly the rundown of export stocks--contributed a negative 4 percentage points to output growth. The main support to economic activity was provided by the improvement in the net foreign balance which contributed 6 percentage points to GNP growth. Despite a

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1/ Exports in 1983 benefited significantly from a drawdown of export stocks; with no change in such stocks in 1984, growth of exports is necessarily below that of export production.

fall in total GNP of 5 1/2 percent, a high level of employment was maintained and the unemployment rate held at 1 percent of the labor force. Real wage flexibility helped, as did relatively easy credit to firms in economic difficulty.

During the consultation discussions of a year ago, the Icelandic representatives indicated that, for 1984, export prospects were not good in view of the limits on the cod catch, and total merchandise exports were therefore forecast to rise by less than 4 percent. The official target of a balanced current account thus implied a renewed compression of imports by means of further cuts in domestic demand. The fall in total GNP was, however, to be limited to around 2 percent. However, by the turn of the year it had come to be thought that the prospects for the cod catch were much worse than was assumed earlier, and the current account objectives was therefore modified to allow for a small deficit.

In the event, domestic demand conditions thus far in 1984 have been considerably more buoyant than proved consistent even with the modified current account target. For the year as a whole, all the demand components are now projected to be stronger than foreseen earlier, with private consumption showing little change and gross fixed investment rising by 3 percent. Stockbuilding is projected to contribute 2 percentage points to domestic demand. Although the data are still incomplete, it appears that considerable wage drift occurred in certain sectors. Investment in the manufacturing and transport sectors has expanded markedly, reflecting stronger demand and improved profitability.

Total domestic demand is now projected to rise by 2 1/2 percent. In contrast to 1983, the net foreign balance is projected to subtract almost 4 percentage points from GNP growth. On balance, GNP is now expected to fall by only 1 percent in 1984 and to rise in the course of the year. The rate of unemployment should remain at about 1 percent of the labor force.

3. Inflation and wage behavior

Against the background of high inflation, that reached a peak of 130 percent at an annual rate during the second quarter of 1983, the recent drop in the rate of price increase is dramatic. The chief measure that brought it about was the stabilization of the nominal effective exchange rate at its post-May 1983 devaluation level, supported by the suspension of wage indexation and the limitation of wage increases to only 8 percent in June, and to 4 percent in October 1983. Exchange rate stability and wage restraint were rapidly reflected in prices. Consumer price inflation decelerated markedly from the third quarter of the year to reach an annualized rate of only 30 percent by year-end.

The improvement in price performance was maintained in the first eight months of 1984, when the annualized rate of inflation averaged about 15 percent, but the low point may already have been reached. The resumption of contractual wage negotiations in early 1984 resulted in fairly moderate settlements, though the increase in wage rates of 14 percent over the 14 months until April 1985 exceeded somewhat the official 10 percent guideline during 1984. However, the agreement also allowed for renegotiations after September 1984, and the trade unions have already invoked this clause to reopen wage bargaining with some extremely high initial bids, supported by strikes in certain sectors including the public sector.

IV. The Policy Discussions

At the time of the consultation discussions in Reykjavik it was already clear that the Icelandic authorities had succeeded in drastically reducing the rate of inflation. However, it was also becoming evident that financial policies contributed to a resurgence in domestic demand, that led to a renewed deterioration in the external current account and to renewed wage pressures. The central issue in the discussions was, therefore, whether this deterioration could be reversed, and further increases in the already heavy foreign debt burden be arrested, without jeopardizing the progress already achieved in reducing price inflation.

1. Exchange rate policy

The dramatic improvement in price performance after May 1983 was achieved mainly by stabilizing the nominal effective exchange rate of the krōna. It was possible to stabilize that exchange rate without loss of competitiveness only because of wage restraint imposed at first by a statutory incomes policy limiting wage increases to 8 percent in June and to 4 percent in October 1983. For 1984 the authorities pre-announced a limit of 5 percent on any effective depreciation of the krōna during the year, in the expectation that greater exchange stability would assist in securing moderate wage settlements even after the statutory limits lapsed in February. They recognized that a stable current account balance would be a necessary precondition for exchange rate stability.

The mission noted that the rate of expansion in the credit aggregates had not declined sufficiently to keep up with the decelerating rate of price increases, and the real stock of money was therefore rising at a rate that would not long be compatible with continued external stability. Indeed, there were already signs that the viability of the current nominal exchange rate was being called in question by the market. The sharp rise in imports and in stockbuilding this year, which was in part of a speculative character, and periods of capital outflows, pointed to a diminished credibility of the exchange rate policy, and underscored the urgency of bringing domestic credit expansion under tighter control.

The Icelandic representatives did not differ with these observations. They indicated that much of the continuing differential in price and cost inflation above that of their trading partners in 1984 was again being offset by exchange rate adjustments. At the end of August 1984 the krōna had been devalued by another 3 percent 1/ on top of the previously announced depreciation limit of 5 percent during 1984. Their present intention was to limit exchange depreciation again to 5 percent during 1985.

However, a major uncertainty stemmed from the wage negotiations currently in progress. The opening wage demands had been very high, and the official pay guidelines already exceeded, not least through wage drift. Real earnings had declined some 20 percent between the second quarters of 1982 and 1984. The authorities intended to review exchange rate policy once the pay negotiations were concluded.

2. Monetary policy

Domestic credit expansion slowed down from 99 percent in the twelve months to August 1983, to 48 percent a year later (Chart 6). The mission emphasized the urgency of reducing credit expansion yet more, if the external position was not to continue to worsen, and also to resist inflationary pressures. In the 1984 credit budget the authorities did adopt a 12 percent target for domestic credit expansion, and a 15 percent target for the rate of growth of M_3. However, developments in 1984 to date suggest that both targets will be overshot by wide margins.

Monetary and credit policy are proving to be the weak spot in the adjustment effort. The judgment that domestic credit expansion remains excessive from the point of view of external adjustment is supported by the continued loss of net foreign assets by the banking system (see Table below). In the 12 months to August 1984 the increase in net domestic assets of the Central Bank contributed 61 1/2 percentage points to the growth of base money, but over the same period the growth of base money itself came to only 35 percent. The rest drained out.

The banks have been accommodated by large overdraft facilities at the Central Bank, and by rediscounting of bills of exchange at privileged rates for the fishing, agricultural, and manufacturing sectors. Also, beginning in 1983, a Treasury deficit has emerged, financed by recourse to Central Bank credit as well as by foreign borrowing. The Icelandic representatives said that borrowing abroad by banks for on-lending to the private sector had also been a problem. They noted that the weak finances of the fishing sector, and the structural difficulties afflicting it, had been an important factor undermining credit restraint.

On the other hand, the authorities had introduced several new credit instruments to promote nonbank financing of the public sector borrowing requirement, notably new savings certificates earning high positive real rates of interest, an SDR-linked bond, and a three-month Treasury bill, but banks as well as nonbanks were free to purchase all of these. The Icelandic representatives drew attention to the announcement in August

1/ At the same time the authorities revised the basket used to calculate their exchange rate index, switching to pure trade weights instead of an average of trade and payments weights used before.

1984 that overdrafts of the banks were to be eliminated over the next six months. It was also intended to discontinue by the autumn of 1985 the rediscounting of bills of exchange by the Central Bank.

Table. Iceland: Monetary Developments

(Increase as percent of money stock 12 months earlier)

	1981	1982	1983	1984 August
Net foreign assets	0.9	-26.8	-30.9	-22.2
Domestic credit	79.3	101.6	122.7	68.7
Broad money (M_3)	70.5	58.1	78.3	36.9

Source: Data supplied by the Icelandic authorities.

Meanwhile, although interest rates had progressively been reduced between September 1983 and January 1984, they had come down less rapidly than the rate of inflation, and were now positive in real terms. From August 1984, the authorities had permitted a significantly greater role to market forces in interest rate determination. The earlier system of interest rates prescribed by the Central Bank was replaced by one permitting banks to propose interest rate changes, although the Central Bank reserved the right of refusal. The criteria by which the Central Bank will allow or reject proposals have not yet been determined.

The Icelandic representatives hoped that, with higher real interest rates credit expansion could be more effectively controlled. They also stated that firm limits on external borrowing by banks would be applied. The mission thought that the adequacy of current interest rate levels would depend on whether credit expansion would cease to press on the exchanges. They noted that the authorities had on a number of occasions refused tender bids at the Treasury bill auction to keep interest rates from rising. Indeed, the stock of outstanding bills had fallen in August and again in September. Moreover, there had recently been a net redemption of savings certificates rather than net sales.

A flaw in the recent liberalization measures had been that interest rates on rediscounts of bills of exchange and on overdrafts at the Central Bank had not been raised. Accordingly, there had been a renewed widening in the interest rate differential between these and other forms of lending. More generally the mission stressed that the selectivity of credit control through the preferential treatment of certain sectors had complicated the task of monetary management, and hoped it would not be allowed to undermine monetary restraint in future.

3. The emergence of a fiscal deficit

In 1983 a deficit equivalent to almost 3 percent of GNP emerged in the Treasury budget 1/ largely because domestic expenditure and imports--the main determinants of tax revenue--fell sharply. The net borrowing requirement of the Central Government as a whole 2/ was considerably larger. Central Government deficits have been increasingly financed by external borrowing, although in 1983 the deficit of the Treasury proper was largely financed by recourse to the Central Bank.

The authorities considered it important to support their macroeconomic objectives for 1984 by a tightened fiscal policy stance. In the original budget for 1984, the authorities aimed at a sharply reduced deficit in the Treasury accounts principally through measures of expenditure restraint; the expenditure to GNP ratio was targeted to fall by 3 1/2 points to 27 1/2 percent.

In early 1984, it became evident that some expenditure estimates had been unrealistic. In addition various welfare benefits were raised in an attempt to modify wage demands. In May, following some expenditure cuts and the shifting of various spending items onto other public entities, the Government decided to accept a deficit of ISK 1 billion (1 1/2 percent of GNP) and to finance it mainly through additional foreign borrowing. This represented a significant relaxation of the fiscal stance from earlier plans. Subsequent developments have shown revenues to be much more buoyant than expected, especially receipts of import duties, owing to a more buoyant economy than earlier projected. Thus, the latest (August) estimates indicate that the deficit may be held back to ISK 70 million (0.1 percent of GNP) in 1984.

The mission recalled that in the consultation discussions a year ago the Icelandic authorities had viewed a balanced Treasury budget as important, and had emphasized that a strict ceiling on foreign borrowing was crucial. It noted that the improvement now expected in 1984 reflected mainly a more buoyant tax base, as domestic demand and imports were much stronger than expected, rather than a tightening in fiscal policy. Indeed, given the sizable financing requirement of public investment and other entities outside the Treasury budget, a strong case could be made for a surplus on the Treasury accounts if external and internal balance is to be achieved and sustained.

1/ The Treasury budget comprises the finances of the Central Government proper. It excludes a large number of central government agencies, funds, and enterprises, responsible inter alia for the main part of government capital expenditure.

2/ No consolidated measure of the borrowing requirement of the Central Government is available. The authorities intend to compile consolidated accounts for the Central Government on an experimental basis in 1985. A consolidated account for the total public sector lies further in the future.

Table. Iceland: Treasury Finances

(In percent of GNP)

	1981	1982	1983	1984 Voted budget	1984 Forecast	1985 Preliminary budget estimates
Revenue	29.2	30.7	28.5	27.0	29.0	28.5
Expenditure	29.6	30.1	31.3	27.6	29.1	29.1
Balance	-0.4	0.6	-2.8	-0.6	-0.1	-0.6

Source: Data supplied by the Icelandic authorities.

The Icelandic representatives stated that the decline in real incomes in 1983 had made the task of fiscal consolidation difficult. Although a case could be made for a surplus in the Treasury budget, it had proved very difficult in practice to curb expenditures as planned. Furthermore, despite Iceland's low tax ratio on international comparisons, there was a political commitment to cut income taxes. The authorities intended to phase out expenditures on agricultural subsidies over time, especially on exports, to perhaps eliminate all consumer subsidies, and reduce outlays on student loans. The Government was also committed to a reduction of the size of the public sector, partly through privatization of public enterprises.

The budget for 1985 was to be presented to Parliament in mid-October. The Icelandic representatives indicated that a small deficit of about ISK 500 million (1/2 percent of GNP) was envisaged for the Treasury budget. Expenditure would remain at about 29 percent of GNP. The budget would reflect the first year's effects of a three-year program of reducing income tax rates, such that by the end of that period most incomes would be exempt from central government taxation, though they would still be subject to local government income taxes. The reform was to be financed by an increase in indirect taxes, either by a widening of the tax base, or an increase in rates, or a combination of the two. The authorities intended to introduce VAT from January 1986, to be levied on a wider range of goods and services than the present sales tax.

The mission observed that an accurate assessment of the overall fiscal stance was rendered difficult by the absence of consolidated public sector accounts and the prevalence of shifts into and out of the Treasury budget. Nevertheless, it seemed clear that the financing requirements of the Treasury, investment and credit budgets, were difficult to reconcile with external balance. Moreover, they put strains on the task of monetary management.

4. The external debt

The mission noted that the external debt burden on the economy was becoming onerous. The authorities projected net external debt to rise to 59 percent of GNP by end-1984, and net long-term external debt alone to 62 percent of GNP, giving rise to a debt service burden equivalent to 23 percent of exports of goods and nonfactor services.

The assumptions and results of two illustrative medium-term debt case studies prepared by the staff are shown in Appendix I. These projections show that in the absence of an intensified adjustment effort, the debt burden could rise to 68 percent of GNP by 1990, with a debt service ratio of 33 percent. If domestic demand is held flat in 1985 and 1986 and then permitted to expand at a rate less than that of Iceland's trading partners, the current account would come close to balance by 1986; at the end of the 1980s net external debt would have declined to 43 percent of GNP, while the debt service ratio would still stand at 26 percent.

Although the maturity profile of Iceland's debt is well structured, the authorities consider the present debt burden to be unsustainable in the long run, and they intend to reduce it. Iceland has not encountered difficulties in contracting foreign debt. However, the abandonment of the target of a balanced current account in 1984 and, indeed, the continuation of a large deficit into 1985, give grounds for concern particularly as new debt is increasingly being used to sustain consumption.

The mission stressed that, although Iceland continues to enjoy an excellent credit rating at present, the lack of visible progress toward external adjustment could be seen as evidence of an unduly complacent economic management. The Icelandic representatives contended that the sharp fall in incomes and consumption in 1983 could not be repeated, so that new net external borrowing had to be resorted to for the time being. They hoped that marine catches and exports would rise over the medium term, although the outlook for the cod catch over the next few years was not thought to be good.

5. Trade policies

The Icelandic trading system has remained open consistent with the rules for competition under GATT. Iceland's exports and export receipts have, however, been damaged by protectionist measures and the trade and payments practices of certain other countries. The authorities stressed that the subsidies offered on a large scale to fishing interests, particularly in Canada and Norway, had an adverse impact on the most significant activity in Iceland. They stated that fish prices in international markets had been depressed as a result of such practices. The important

Nigerian market for stockfish remained virtually closed and Nigeria was in arrears over payments. Portugal had of late imposed a discriminatory tariff on salt fish which was the subject of negotiations.

V. Economic Outlook

The Icelandic authorities have not as yet prepared detailed forecasts for 1985. The outcome of the current wage negotiations and the policy response to it will have an important bearing on developments. The Icelandic representatives stated that a continued deceleration in inflation remained an important objective. They believed that, with continued growth in domestic demand and some improvement in the real foreign balance, GNP could rise by about 2 percent. The current account deficit was projected at about 4 percent of GNP, only a little less than in 1984. It was an important objective not to permit the rate of unemployment to rise from its present level of approximately 1 percent of the labor force.

The Icelandic representatives emphasized that these conjectures depended on wage settlements turning out moderate. The mission inquired as to the policy response should wages exceed the present guidelines. The Icelandic representatives indicated that policy still had to be determined; much depended on the extent to which the exchange rate would be moved. The mission emphasized the urgency of adopting firm financial policies and of not waiting until 1986 before initiating additional restraint.

The Icelandic authorities noted that, over the medium term, the structural adjustment problems of the economy would need to be addressed. The decline in the fish catch rendered a significant part of the fishing fleet redundant. The severe overcapacity in the fishing sector, and its associated financial difficulties, have cast a shadow over the economy as a whole and have made the task of monetary management increasingly difficult. The authorities have begun to address these weaknesses through two new steps taken in 1984. First, the previous ad hoc overall catch limits were replaced by quotas on the permissible catch for various species of fish by each boat; such quotas are marketable under certain conditions. Second, the authorities intend to encourage consolidation of the debt of the boatowners and link this in part to the retirement of fishing vessels. In this way, they hope that the problems of low rates of capacity utilization in this capital-intensive sector can be tackled.

The Icelandic representatives agreed that the subdued outlook over the medium term for fish catches underscored the need for diversification of the output and export base of the economy. The most promising prospects are to be found in energy-intensive projects that utilize Iceland's abundant resources of hydroelectric and geothermal energy, and the authorities have initiated negotiations on foreign investment in this area. It was also understood to be important to maintain an adequate competitive position, such that the desired shift of resources into new activities in the traded goods and services sector could be achieved.

VI. Staff Appraisal

As a result of determined measures in May 1983, the inflation rate was brought down sharply from 130 percent at an annual rate in mid-1983, to 15 percent a year later. Unemployment held at 1 percent of the labor force, despite a significant drop in GNP, as real wages fell by 13 1/2 percent in 1983. Nevertheless, the earlier improvement in the external current account, between the third quarters of 1982 and 1983, has since been reversed.

The Icelandic authorities are to be commended for the striking reduction in price inflation, but it seems that the low point on inflation may also have been reached. The staff would emphasize the importance of restoring the momentum of external adjustment by sharply tightening financial policies and regret that the authorities, on the other hand, appear reconciled to external deficits on current account as high as 5 percent of GNP in 1984, and only slightly less in 1985.

In the view of the staff, it is necessary for Iceland soon to stabilize, and eventually to reduce, its heavy external debt and debt service burdens. To this end the external adjustment effort should be renewed in 1985, with the aim of obtaining a balanced external current account, and of maintaining that position for a number of years. A further important objective would be to safeguard the low rate of price inflation. The authorities agree on the inflation objective, but believe that the achievement of external balance can be postponed.

Monetary policy has continued to be largely accommodating despite earlier intentions of restraint. To be sure, recent measures have already led to a significant rise in real interest rates, and the authorities intend to severely limit accommodation extended by the Central Bank and to place constraints on foreign borrowing by the banks. The staff is not certain that domestic credit expansion will be adequately controlled by these measures. It notes with concern the authorities' reluctance to accept the interest rates that would be required to achieve the planned sales of debt instruments. The selectivity of credit control and the prevalence of preferential rates of interest also make restraint difficult.

As regards fiscal policy the staff notes that in 1984 expenditures were significantly higher than had been envisaged in the original budget. Moreover, the budget plans for 1985 envisage a further large borrowing requirement for the public sector as a whole. If this occurs it is likely again to undermine monetary policy, especially if foreign borrowing is not constrained, and if attempts to raise nonbank financing of the public sector remain less successful than anticipated. The staff believes that in these circumstances the Treasury accounts--which are only a part of the public sector--should be moved into surplus. If curbing expenditures continues to be difficult, then there is a case for raising the tax burden. A widening of the base for indirect taxation preparatory to the introduction of VAT in 1986 offers one promising avenue.

The staff recognizes the contribution that a relatively stable nominal exchange rate has made to the counter-inflationary effort. It is clear, however, that exchange rate stability has been inadequately supported by financial restraint. The rapid rate of credit expansion that has been allowed to persist thus far in 1984, is incompatible with continued stability of the exchange rate. The behavior of imports and of stockbuilding are indirect pointers to this fact, and underscore the urgency of bringing domestic credit expansion under control. The situation will need to be reviewed once the present wage negotiations are concluded. It is highly important for pay settlements to be moderate, if high employment is to be consistent with low inflation and external equilibrium.

The performance of the economy over a longer time horizon depends also on how successfully the structural difficulties of the fishing sector can be dealt with. A shrinking of that sector appears to be inevitable. There is, more broadly, a need to strengthen the supply performance of the Icelandic economy: the subdued outlook over the medium term for the fish catches lends a degree of urgency to this task. The authorities' reaction has been to initiate negotiations with international companies for an expansion of energy-based industries. Iceland's political stability, its free access to the European market, and its educated work force are factors making investment in Iceland attractive. But these advantages need to be supported by the maintenance of an adequate competitive position in order to achieve the desired shift of resources into the traded goods and services sectors.

The staff welcomes Iceland's adherence to the principles of free trade, and its intention to reduce agricultural subsidies, despite its balance of payments difficulties. It notes with regret the trade and payments practices of some of Iceland's competitors that have been detrimental for Iceland's exports and export receipts.

It is recommended that the next Article IV consultation with Iceland be held on the standard 12-month cycle.

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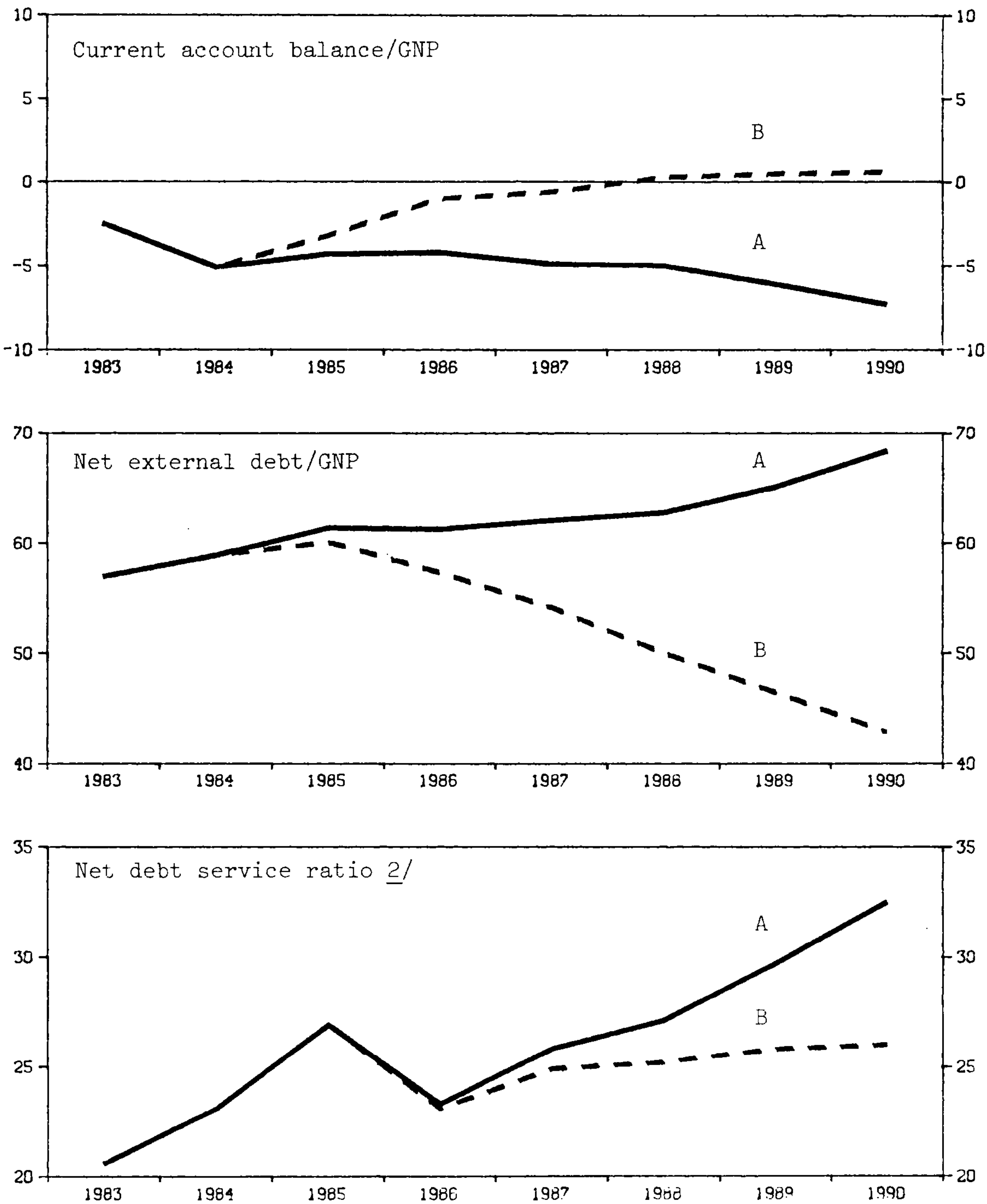
ILLUSTRATIVE DEBT PROJECTIONS 1/

(In percent)



Source: Staff estimates.

1/ A- growth of domestic demand at 1 percent in 1985 and 3 percent during 1986-90.

B- growth of domestic demand at zero percent in 1985-86 and 2 percent during 1987-90.

2/ In percent of goods and nonfactor services.

Iceland: Illustrative Medium-Term Debt Projection 1/

	1984	1985	1986	1987	1988	1989	1990
Current account (in percent of GNP)	-5.2	-4.3	-4.2	-4.9	-5.0	-6.1	-7.3
Total external debt, net 2/ (in percent of GNP)	58.9	61.4	61.3	62.1	62.8	65.1	68.4
Debt service ratio, net 3/	23.1	26.9	23.3	25.8	27.1	29.7	32.5

Source: Staff estimates.

1/ Corresponding to "moderate" demand management in Iceland, Case A (see note below). Developments under Case B (slower growth of domestic demand) are illustrated in the Chart.

2/ Net medium- and long-term debt and net short-term debt including official reserves.

3/ Net interest payments plus amortization on medium- and long-term debt, in percent of exports of goods and nonfactor services.

Note: The illustrative medium-term debt projections have been based on the following main assumptions. Output of industrial countries is assumed to grow at 3 1/2 percent in 1985 and at 3 percent per annum during 1986-90, and their GDP deflator at 4 1/2 percent throughout the period. The price of oil expressed in U.S. dollars is assumed to remain unchanged in 1985, and thereafter to remain unchanged in real terms. Interest rates on long-term debt are assumed to decline gradually from 13 percent in 1985 to 10 percent in 1990. The relative competitive position of the economy is assumed unchanged from its current position. Consistent with assumptions regarding the long run sustainable level of the fish catch, the volume of marine exports is assumed to rise by 2 percent per annum before leveling off during 1989-90.

Given the above environmental assumptions, two scenarios are postulated for domestic demand. In the first scenario, Case A, after rising by about 1 percent in 1985 on the basis of the latest official assumptions, domestic demand is assumed to rise at the same rate as in industrial countries, i.e., 3 percent per annum. In the second scenario, Case B, a more restrictive demand management is assumed consistent with moving the current account close to balance from 1986; domestic demand would be held flat in 1985-86, and be permitted to rise one percentage point less than abroad during 1987-90.

The simulation results are very sensitive to the underlying assumptions. Against the base run of Case A, interest rates 1 percentage point higher than assumed during 1985-90 would raise the ratio of net debt to GNP by 3 percentage points and the net debt service ratio by 2 percentage points in 1990. A 10 percent lower income elasticity of import demand than the original estimate of 1.5 would lower the ratios by 3 and 0.5 percentage points, respectively, in 1990. If marine exports would remain flat at the 1984 level, the ratios would rise by 10 and 3 percentage points, respectively, in 1990.

Fund Relations with Iceland

(As of end-August 1984; in millions of SDRs)

I. Membership status

(a) Date of membership: December 1945.

(b) Status: Article VIII from September 19, 1983.

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 59.6 million

(b) Total Fund holdings of krónur: SDR 77.1 million (129.3 percent of quota)

(c) Fund credit: SDR 21.5 million, or 36.1 percent of quota (all of which under CFF)

(d) Reserve tranche position: SDR 4.0 million

(e) Current operational budget: not applicable

(f) Lending to the Fund: none

III. Stand-by or extended arrangements and special facilities

Iceland purchased SDR 21.5 million (49.4 percent of its then quota) under the compensatory financing facility in December 1982.

IV. SDR Department

(a) Net cumulative allocation: SDR 16.4 million.

(b) Holdings: SDR 0.12 million or 0.7 percent of net cumulative allocation of SDR 16.4 million as of September 25, 1984

(c) Current designation plan: not applicable.

V. Administered accounts

Not applicable.

VI. Overdue obligations to the Fund

None.

B. Nonfinancial Relations

VII. Exchange rate arrangments

Iceland does not maintain exchange margins. There is no organized foreign exchange market in Iceland, and official buying and selling rates for the U.S. dollar, the principal trading and reserve currency, are quoted by the Central Bank of Iceland. The effective exchange rate depreciated by 35 percent during 1983 and by a further 3 percent during the first seven months of 1984. On August 31, 1984 the basket used to calculate the effective exchange rate was adjusted and the krőna was depreciated by 3 percent. On September 26, the official market rates were ISK 33.48 buying and ISK 33.57 selling per US$1. There are now no multiple currency practices or exchange restrictions.

VIII. Last Article IV consultation

Discussions for the 1983 Article IV consultation were held in Reykjavik during the period September 8-19, 1983. The Staff Report (SM/83/236, 11/14/83 and Supplement 1, 12/5/83) was discussed by the Executive Board on December 9, 1983 (EBM/83/171).

Iceland - Basic Data

Area: 103,100 square kilometers
Population: (December 1983) 258,175
GNP in 1983: ISK 53,004 million; per capita SDR 8,400

	1980	1981	1982	1983	1984 1/
Demand and supply	(Volume changes in percent)				
Private consumption	1.0	5.0	2.0	-6.0	--
Public consumption	4.0	5.0	3.8	3.0	--
Gross fixed investment	9.4	2.1	-1.5	-13.6	2.8
Final domestic demand	3.5	4.2	1.3	-6.8	0.6
Changes in stocks 2/	0.8	0.4	1.4	-4.2	2.1
Total domestic demand	4.2	4.6	2.6	-18.5	2.7
Exports of goods and services	2.7	1.9	-9.0	9.0	3.7
Imports of goods and services	3.6	8.6	0.8	-4.7	10.8
Gross national product	3.9	1.6	-1.5	-5.5	-1.2
Gross national income 3/	2.7	1.9	-1.8	-3.7	-0.4
Volume of marine production	10.5	1.5	-12.7	-6.6	5.0
Labor market	(Annual averages)				
Unemployment, number of persons	331	406	770	1,184	1,363 4/
Unemployment, as percent of labor force	0.3	0.5	0.7	1.0	1.3 4/
Incomes and prices (averages)	(Changes in percent)				
Hourly wage rates	50.9	49.5	50.3	49.4	17
Cost of living index	58.5	50.9	51.0	84.3	29
Real disposable income	1.7	7.0	2.2	-10.3	-3
Raw whitefish prices 5/	39.3	41.8	75.0	60.7	18.8
Terms of trade	-3.4	1.0	-1.5	3.7	1.5
Balance of payments	(In millions of SDRs)				
					(1st half)
Exports, f.o.b.	714	767	622	700	348
Imports, f.o.b.	-690	-790	-760	-683	-370
Trade balance	24	-23	-138	17	-22
Net services and transfers	-78	-100	-94	-67	-60
Current balance	-54	-123	-232	-50	-82
Direct investment	13	46	33	1	1
Long-term borrowing, net	104	125	174	109	21
Short-term capital, net	-23	1	-61	-66	19
Balance on capital account	94	171	147	44	41

1/ Official estimate of September 1984.
2/ Change as percent of previous year's GNP.
3/ GNP adjusted for changes in terms of trade.
4/ Average for January-June.
5/ Change during the year. The figure for 1984 refers to the change from January to August.

	1980	1981	1982	1983	1984 1/
	(In millions of SDRs)				
Current balance (in percent) of GNP	-2.5	-5.1	-10.2	-2.5	-5.2
External long-term debt, gross (SDR millions; end-period)	736	890	1,083	1,210	1,360
External long-term debt, gross (in percent of GNP)	34.4	36.6	48.0	60.6	62.3
Debt service ratio	14.1	16.4	21.2	20.6	23.1
Foreign reserves and liabilities	(SDR millions; end-period)				
Gross official reserves	138	199	133	144	117 2/
Gross official liabilities	-24	-27	-52	-53	-56 2/
Of which: to IMF	(-15)	(-6)	(-22)	(-22)	(-22) 2/
Total net reserves	124	180	92	87	20 2/
Public sector	(ISK millions)				
Central Government revenue	3,681	5,993	9,577	15,100	19,500
Central Government expenditure	3,766	6,075	9,379	16,598	19,570
Balance	-85	-82	198	-1,498	-70
Net financial transactions with domestic nonbanks	147	267	-32	238	-551
Net recourse to Central Bank, foreign borrowing, and cash balances	-62	-185	-166	1,260	621
Balance before financial transactions in percent of GNP	-0.6	-0.4	0.6	-2.8	-0.1
Monetary survey	(Change in percent during the year)				
Foreign assets, net 3/	1.0	0.9	-26.8	-30.9	-15.6 4/
Domestic assets, net 3/	75.1	79.3	101.6	122.7	46.0 4/
Broad money (M3)	65.4	70.5	58.1	78.3	19.6 4/
Exchange rate					
ISK per SDR, period average	6.24	8.52	13.64	26.60	30.89 5/
ISK per SDR, end-period	7.96	9.51	18.34	30.02	31.40 5/
Change in effective rate 6/					
Average	-26.1	-23.9	-32.3	-45.4	-16.1 5/
End of period	-30.7	-17.1	-42.8	-34.7	-3.2 5/

1/ Official estimate of September 1984, and staff estimates.
2/ End-August (preliminary).
3/ Change as percent of M3 at the beginning of period.
4/ Annual rate January-August 1984.
5/ January-August.
6/ Trade-weighted average according to staff calculations.

Iceland - Statistical Issues

1. Coverage, Currentness, and Reporting Data in IFS

		Latest data in October 1984 IFS
Real Sector	- National accounts	1983
	- Prices	May 1984
	- Production	May 1984
	- Employment	n.a.
	- Earnings	Q3 1983
Government Finance	- Deficit/Surplus	1982
	- Financing	1982
	- Debt	1982
Monetary Accounts	- Central Bank	July 1984
	- Deposit Money Banks	July 1984
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	July 1984
	- Merchandise Trade: Prices	1983
	- Balance of Payments	Q4 1983
	- International Reserves	August 1984
	- Exchange Rates	August 1984

During the past year, the reporting of data for inclusion in the IFS has been timely.

2. Outstanding Statistical Issues

Government Finance

No monthly data have been reported to IFS, annual data correspond to the government finance statistics data published in the GFS Yearbook.

Monetary Accounts

The sectorization of the Central Bank's accounts in IFS has been questioned by the IFS correspondent especially with regard to definition of central government. This problem can only be resolved through a detailed review of the accounts of the Government, the investment credit funds, and the monetary institutions.

Balance of Payments

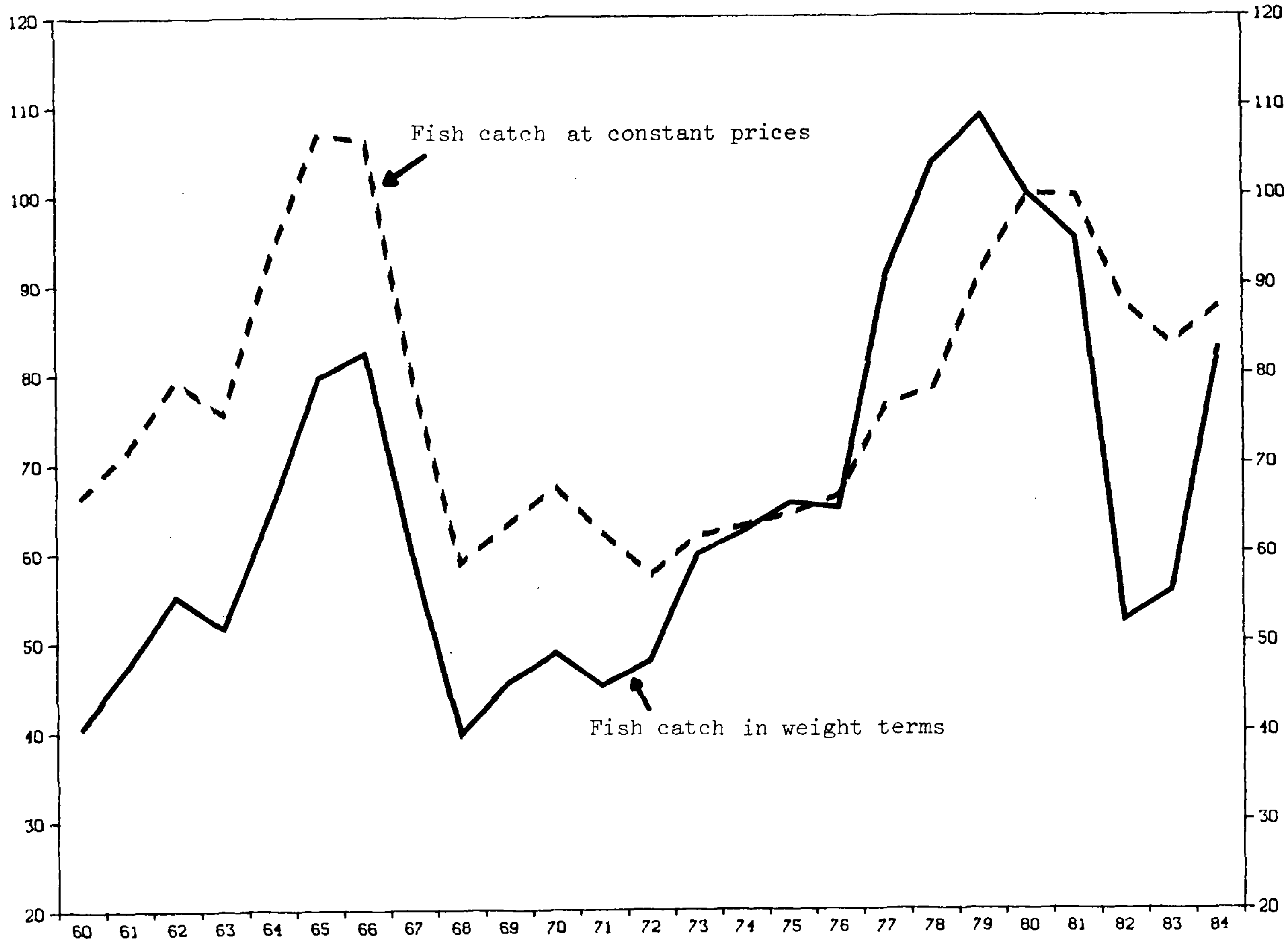
The need to establish a data base comprising stock data is currently being discussed with the IFS correspondent.

CHART 1 1/

ICELAND

FISH CATCH

(1980 = 100)



Sources: National Economic Institute, The Icelandic Economy; and data provided by the Icelandic authorities.

1/ The data for 1984 are official estimates in September 1984.

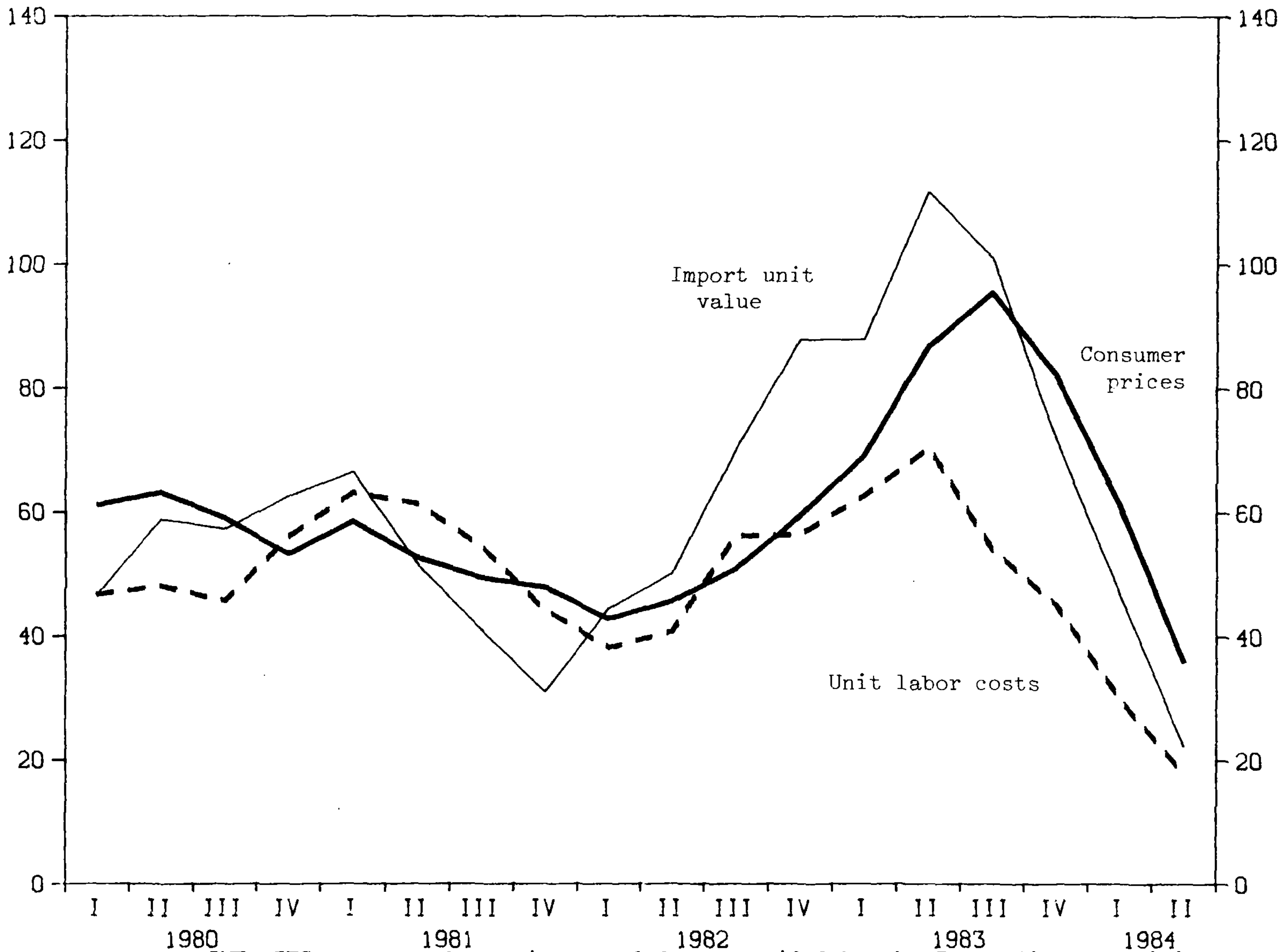
[illegible]

CHART 2

ICELAND

CONSUMER PRICES, UNIT LABOR COSTS, AND IMPORT UNIT VALUES 1/

(In domestic currency; percent changes year-on-year)



Sources: IMF, IFS, staff calculations; and data provided by the Icelandic authorities.

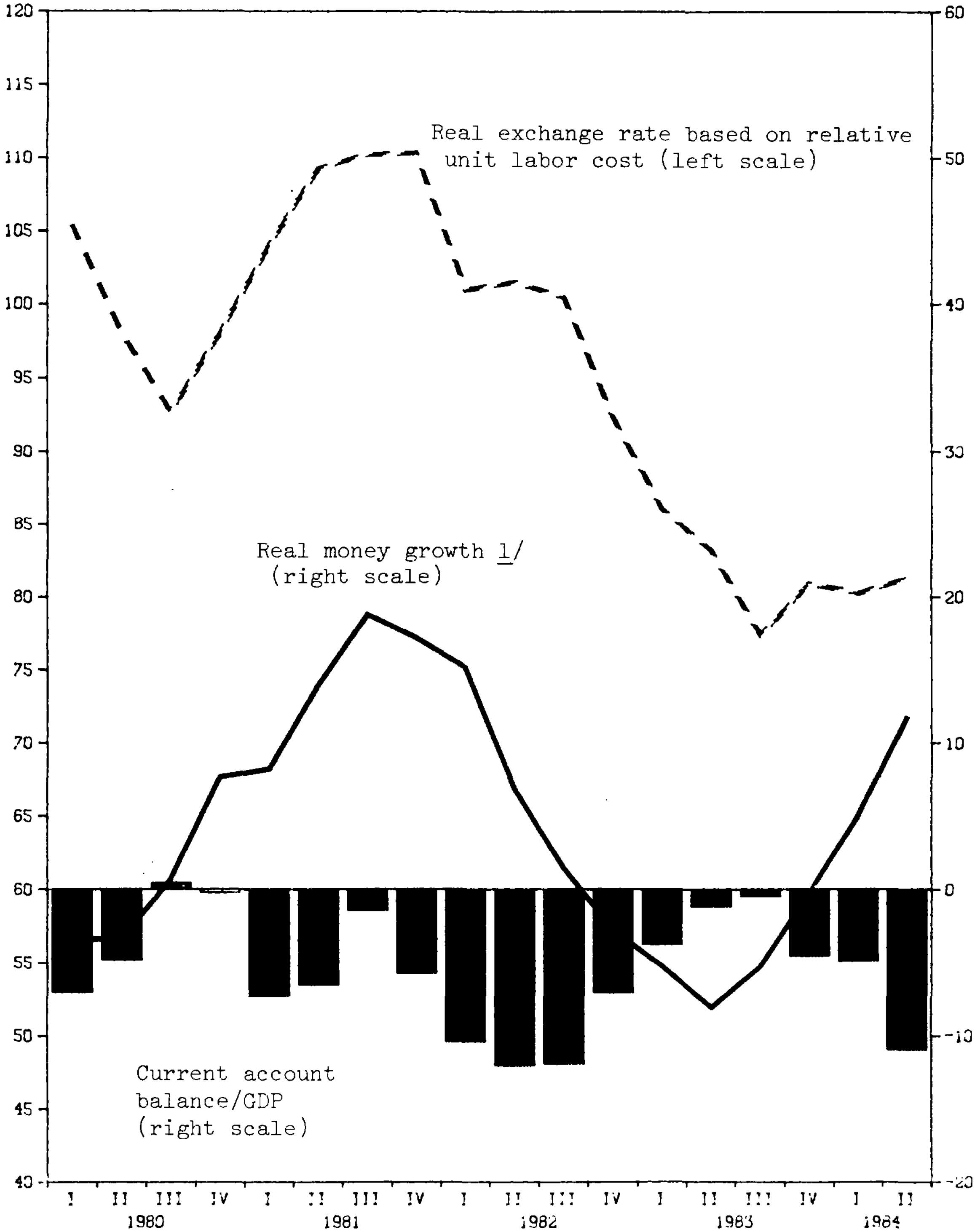
1/ Weighted export unit values of partner countries. Import unit values for Iceland are available only on an annual basis.

CHART 3

ICELAND

REAL EXCHANGE RATE, REAL MONEY GROWTH AND
CURRENT ACCOUNT BALANCE

(Quarterly)



Source: Staff estimates.

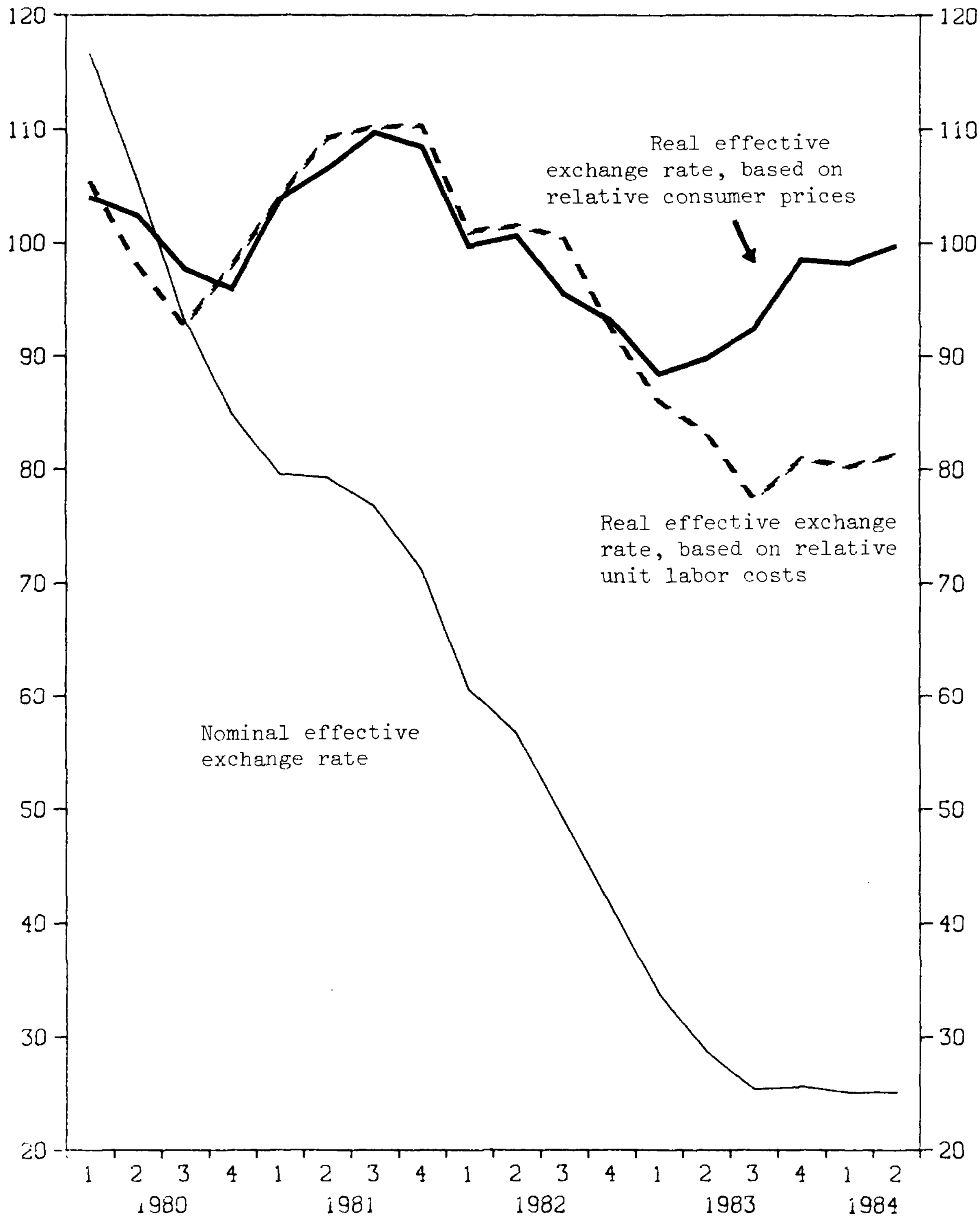
1/ Percentage change in quarterly average over 12-month period.

CHART 4

ICELAND

EFFECTIVE EXCHANGE RATES

(Index 1980 = 100)



Source: Staff calculations.

CHART 5

ICELAND

WAGES AND PRICES

(Quarterly averages; percent changes year-on-year)

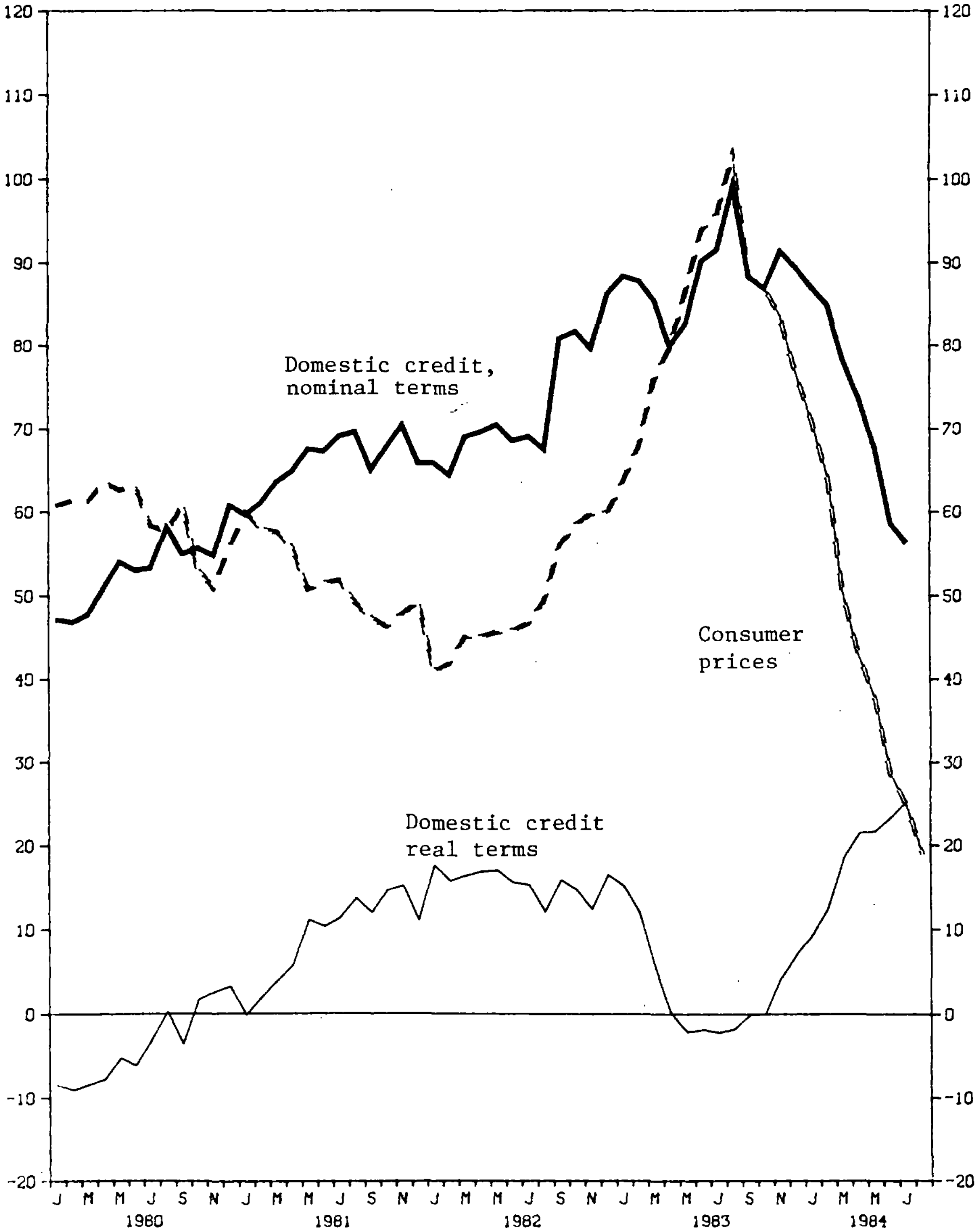
Sources: Data provided by the Icelandic authorities; and staff estimates.

CHART 6

ICELAND

DOMESTIC CREDIT EXPANSION

(Percent changes; year-on-year)



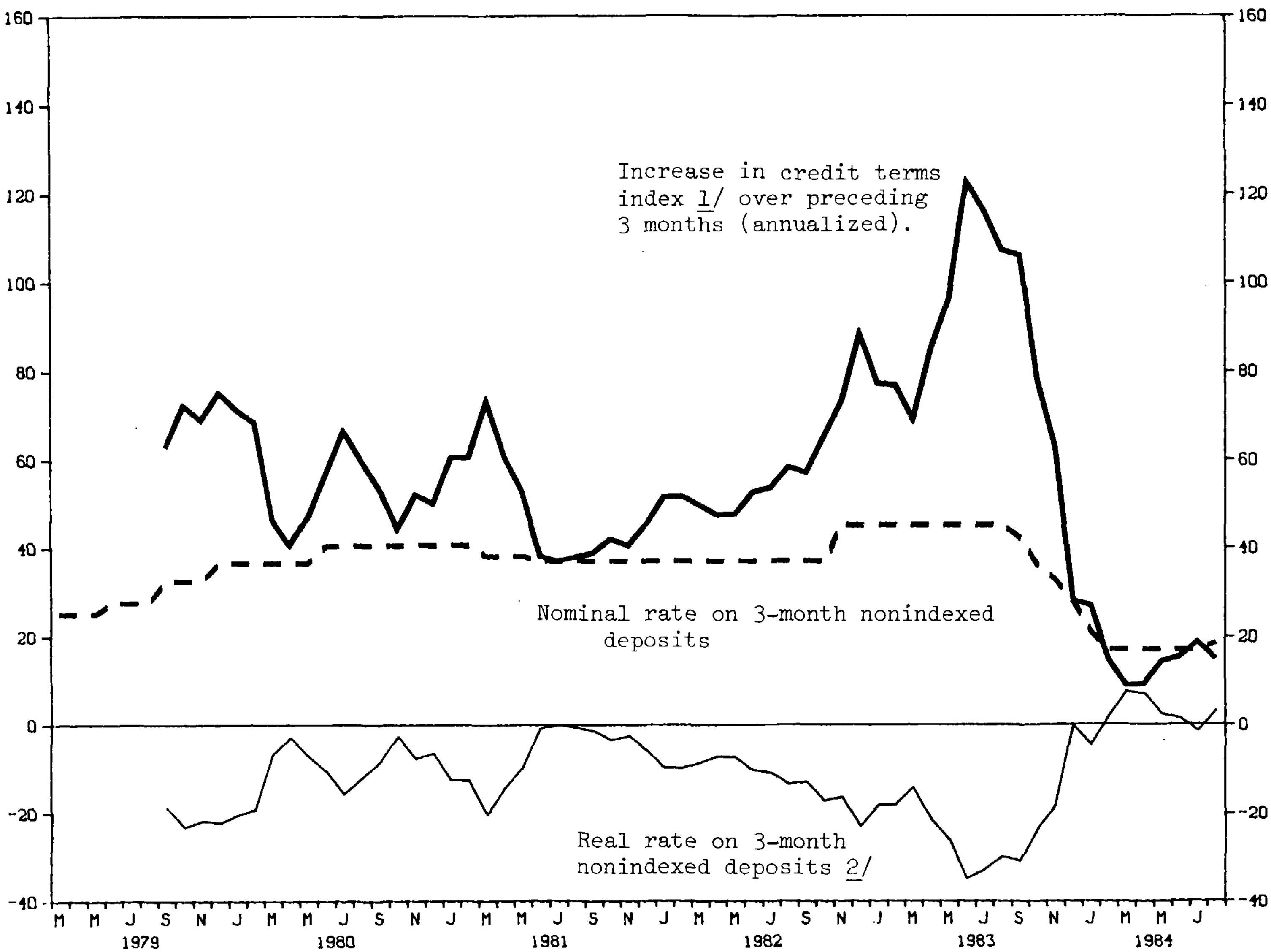
Source: Central Bank of Iceland.

CHART 7

ICELAND

INTEREST RATE AND INFLATION

(Percent)



Source: The Central Bank of Iceland.

1/ The credit terms index is a composite price index of the CPI (2/3) and the building cost index (1/3).

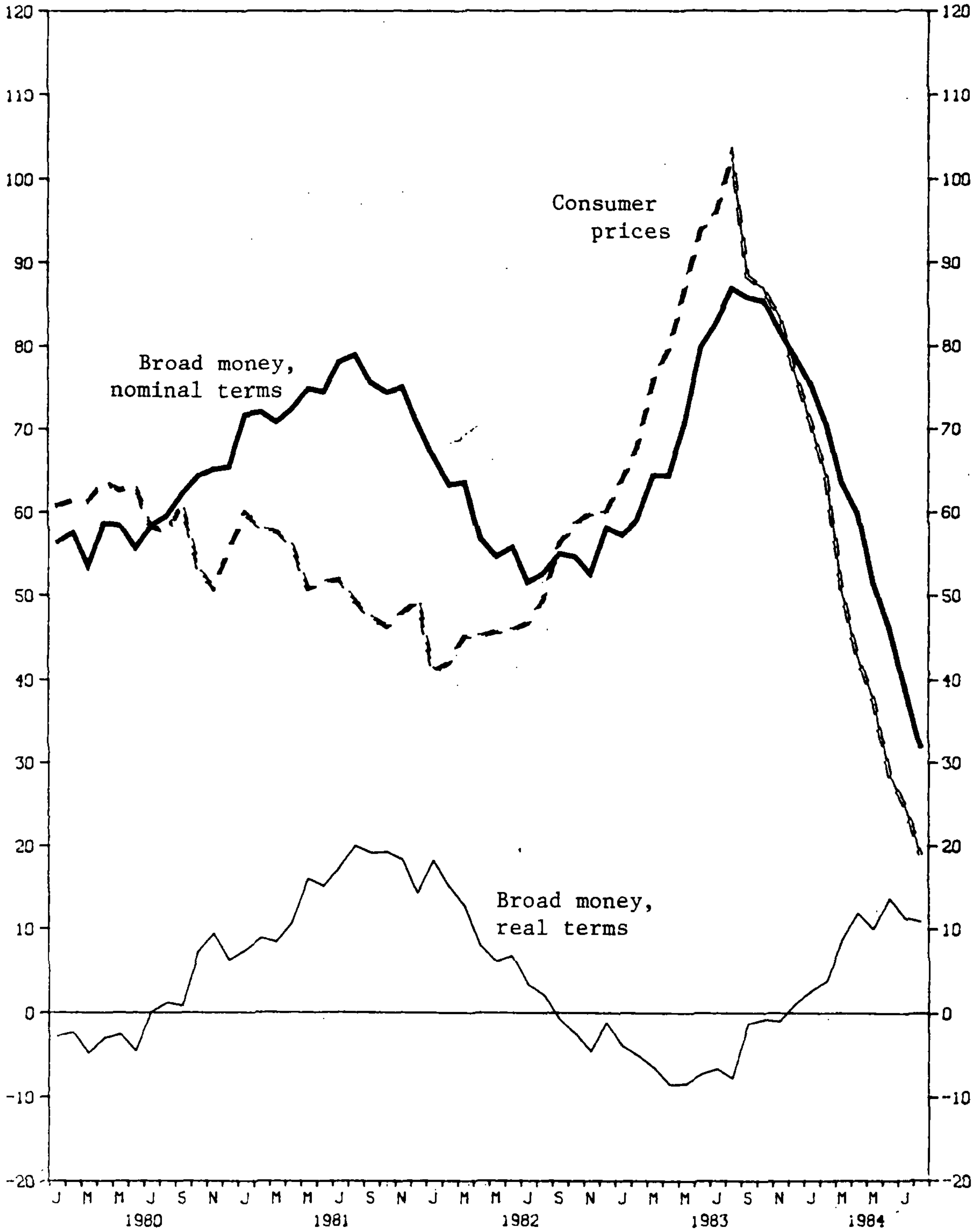
2/ Since the introduction of 3-month indexed deposits in April 1982, the interest rate on these deposits has been zero percent.

CHART 8

ICELAND

GROWTH OF BROAD MONEY

(Percent changes; year-on-year)



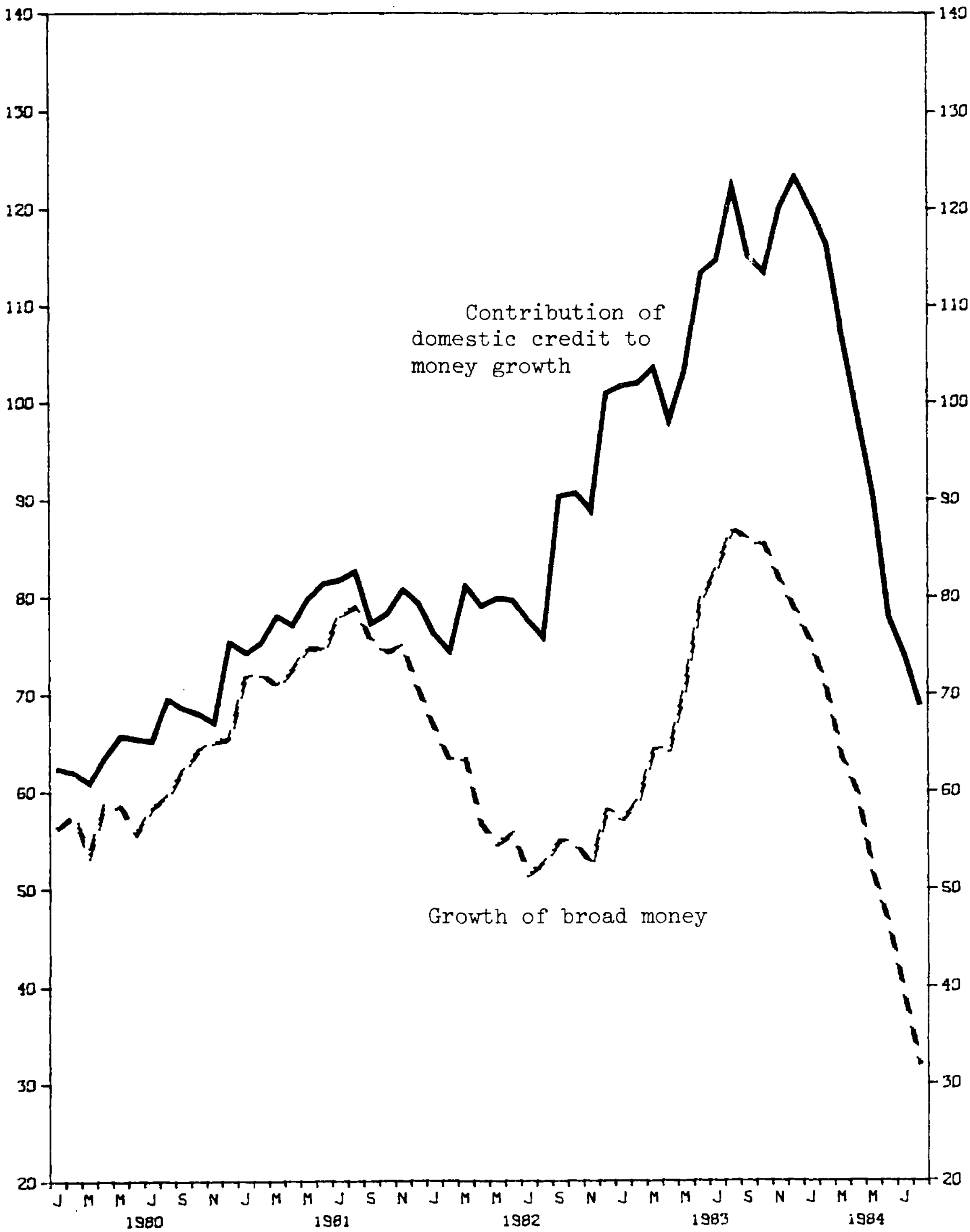
Source: Central Bank of Iceland.

CHART 9

ICELAND

CONTRIBUTION OF DOMESTIC CREDIT TO MONEY GROWTH

(Change over 12-month period as percent of money at the beginning of the period)



Source: Central Bank of Iceland.