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INFORMATION

November 23, 1984

To: Members of the Executive Board

From: The Acting Secretary

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

The attached supplement to the staff report for the 1984 Article IV consultation with Iceland has been prepared on the basis of additional information.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion on Wednesday, November 28, 1984, 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
Supplementary Information

Prepared by the European Department

Approved by Hans Schmitt.

November 23, 1984

I. Introduction

Subsequent to the issuance of the Staff Report for the 1984 Article IV consultation with Iceland (SM/84/251, 11/7/84), information on wage settlements, the policy response of the authorities as determined so far, and the impact on the economic outlook for 1985 have become available to the staff.

II. Recent Economic Developments and Policy Steps

Trade statistics for the first nine months of the year show that the earlier expectations of a slowdown in imports were not fulfilled and the trade deficit (f.o.b./c.i.f.) amounted to SDR 84 million, compared to a deficit of SDR 29 million for the same period of 1983. These developments indicate that the current account deficit for 1984 might exceed the projection of the equivalent of 5 percent of GDP made at the time of the consultation discussions. This projection is in the process of being revised by the Icelandic authorities. Net reserves of the Central Bank declined by SDR 33.4 million in the first ten months of this year compared to a fall of SDR 4.3 million over the similar period of 1983.

Data for recent months show that the rate of inflation, as measured by the cost of living index, has continued to abate. The cost of living index for the third quarter of 1984 was 20.6 percent higher than the same period of 1983, and prices in October 1984 were 16.4 percent higher than a year earlier. In recent months, the annualized rate of inflation has been running at about 15 percent but it is clearly recognized--for reasons discussed in the main body of the Staff Report--that the low point on inflation has been reached, with a substantial acceleration being projected for the early months of 1985.

The monetary and credit aggregates have continued to expand at very rapid rates. Since the issuance of the Staff Report data for two additional months have become available. In the first ten months of the year, broad money (M₃) rose at an annualized rate of 38.8 percent; at end-October,

the broad money stock was 34.7 percent higher than a year earlier. The narrow aggregate (M_1) has been increasing at a considerably faster pace: at 48.6 percent and 52.5 percent, respectively. (To a degree the shift toward M_1 , especially notes and coins, may be explained by widespread strikes in September and October throughout the country.) The detailed monetary survey--available to end-September 1984--indicates that domestic credit expansion, particularly bank lending to the private sector, has been very strong (DCE contributed over 50 percentage points at an annualized rate to the growth of broad money in the first nine months of 1984), with a marked acceleration in recent months, while net foreign assets of the banking system have declined significantly.

After a long strike, wage settlements in the public sector were concluded on October 30, 1984 and were shortly followed by similar settlements for the private sector. The agreement runs to December 1985 and provides for a 13 1/2 percent increment on November 1, and a series of staggered increases in December 1984, and January, March, and May 1985 as well as various adjustments at other dates. The cancellation of wage indexation stands. The agreement is estimated to yield an average increase in wages in 1985 of approximately 22 percent. Thus, the settlements clearly exceed the official guideline of an average increase of 9 to 10 percent, which was believed to be consistent with the objective of a steady deceleration in the rate of inflation supported by a relatively stable exchange rate.

A committee is to be established for the purpose of conducting a review of public sector pay by June 1, 1985. During the period of the agreement, the labor market parties have agreed to monitor wage and price developments and assess, in particular, the evolution of real wages. Furthermore, the agreements contain a provision permitting re-negotiations at the behest of either party after June 1, 1985; in the event of a reopening of bargaining, should a new agreement not be reached by July 1, 1985, the contracts would stand cancelled as of September 1, 1985.

On November 20, 1984 the exchange rate of the Icelandic króna was devalued by 12 percent in terms of a trade-weighted basket of currencies (EBD/84/297, 11/21/84). This followed a gradual downward move amounting to over 4 percent since the end of October 1984. The nominal effective exchange rate declined by 21 percent in the year until November 21, while the real effective rates (relative consumer prices and relative unit labor costs) had appreciated until the second quarter (Chart 1). The authorities stated that the devaluation had been occasioned by the recent sharp increase in wages which had led to rapid increases in domestic costs and in demand and which would have, in the absence of measures, led to a further deterioration of the external current account. The effect of the wage settlements had already been felt in a rapidly growing demand for foreign exchange and other forms of speculative transactions. The authorities believed that the devaluation would restore the level of competitiveness and profitability to that prevailing before the recent wage settlements.

The Icelandic authorities have declared their intention of keeping the exchange rate relatively fixed through 1985 as had been done for the first ten months this year. Thus, the rate of depreciation during 1985 would be kept within narrow limits. This was believed to be consistent with a broadly unchanged level of competitiveness. On November 20, 1984 the buying and selling rates of the U.S. dollar were ISK 39.19 and ISK 39.30, respectively.

III. The Outlook for 1985

Because of the recent wage settlements and the decision to carry out a 12 percent step devaluation of the króna, the outlook for 1985 as discussed during the consultations has changed radically. The Icelandic authorities have not as yet presented a new set of macroeconomic forecasts for 1985 (nor have they presented revisions of the projections for 1984 as given in the Staff Report) in part because they have not fully determined their policy response to the new developments. They have, however, stated that inflation will accelerate to over twice its current rate, i.e., to around 40 percent at annual rates, in the early months of 1985, but it remains their objective to achieve a sharp reduction later in the year such that inflation during 1985 will be held to 20 percent (as compared to the earlier target of 10 percent). They have stressed that this objective requires a fairly restrictive monetary policy stance. Preliminary and highly tentative forecasts indicate that GNP may grow at a rate of 1-1 1/2 percent in 1985 with a 1 percent increase in total domestic demand. The external current account deficit is forecast to be the equivalent of 5 percent of GNP or similar to the likely outturn for 1984. Thus, on the key twin objectives of the authorities--inflation and external adjustment--performance in 1985 is forecast to be significantly worse than given by earlier targets.

As stated in the Staff Report, the staff recognized the contribution that a relatively stable exchange rate had made to the counter-inflationary effort, but emphasized that exchange rate stability had been inadequately supported by financial restraint. The recent devaluation should reduce excess liquidity in the economy and protect competitiveness. However, much will depend upon whether the authorities are able to tighten the stance of financial policies, especially credit policy, rather than accommodate the higher inflation rate. If a substantial deceleration in real credit expansion does not occur, it will be all too likely that the effects of the devaluation will be fast eroded with a renewed upsurge in domestic demand, further deterioration in the external accounts, and a recrudescence of speculative behavior, especially centering on the exchange rate. It will also be important to strengthen the fiscal budget in light of the wage developments--along the lines suggested in the Staff Report--if the borrowing requirement is not to widen and for the process of adjustment to be re-established.

A rapid and pronounced shift toward financial restraint has become all the more vital as the wage agreements contain a clause permitting the reopening of contracts. Pressures toward renegotiations would tend to mount if domestic demand is not contained and if inflation performance turns out to be worse than currently anticipated. Indeed, the large wage settlements of autumn 1984 owed much to the failure to curb demand during the year, not least because of ease in the conduct of monetary policy; these developments were also reflected in the sharp deterioration in the balance of payments. Iceland's own experience illustrates the pressures excessive credit expansion can put upon prices, wages, and the exchange rate.

Iceland - Basic Data

Area: 103,100 square kilometers
 Population: (December 1983) 238,175
 GNP in 1983: ISK 53,004 million; per capita SDR 8,400

	1980	1981	1982	1983	1984 ^{1/}
<u>Demand and supply</u>	<u>(Volume changes in percent)</u>				
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	-10.5	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
<u>Labor market</u>	<u>(Annual averages)</u>				
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/}
<u>Incomes and prices (averages)</u>	<u>(Changes in percent)</u>				
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
<u>Balance of payments</u>	<u>(In millions of SDRs)</u>				
	<u>(1st half)</u>				
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.

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u> <u>1/</u>
	(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
<u>Foreign reserves and liabilities</u>	(SDR millions; end-period)				
Gross official reserves	138	199	133	144	130 <u>2/</u>
Gross official liabilities	-24	-27	-52	-53	-56 <u>3/</u>
Of which: to IMF	(-15)	(-6)	(-22)	(-22)	(-22) <u>3/</u>
Total net reserves	124	180	92	87	20 <u>3/</u>
<u>Public sector</u>	(ISK millions)				
Central Government revenue	3,681	5,993	9,577	15,100	19,500
Central Government expenditure	<u>3,766</u>	<u>6,075</u>	<u>9,379</u>	<u>16,598</u>	<u>19,570</u>
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
<u>Monetary survey</u>	(Change in percent during the year)				
Foreign assets, net <u>3/</u>	1.0	0.9	-26.8	-30.9	-19.5 <u>4/</u>
Domestic assets, net <u>3/</u>	75.1	79.3	101.6	122.7	50.1 <u>4/</u>
Broad money (M3)	65.4	70.5	58.1	78.3	38.8 <u>4/</u>
<u>Exchange rate</u>					
ISK per SDR, period average	6.24	8.52	13.64	26.60	31.64 <u>6/</u>
ISK per SDR, end-period	7.96	9.51	18.34	30.02	38.15 <u>6/</u>
Change in effective rate <u>5/</u>					
Average	-26.1	-23.9	-32.3	-45.4	-13.4 <u>6/</u>
End of period	-30.7	-17.1	-42.8	-34.7	-21.0 <u>7/</u>

1/ Official estimate of September 1984, and staff estimates.

2/ End-October.

3/ End-August (preliminary).

4/ Annual rate January-September 1984; January-October 1984 for M₃.

5/ Trade-weighted average according to staff calculations.

6/ January-October.

7/ January-November 1984.

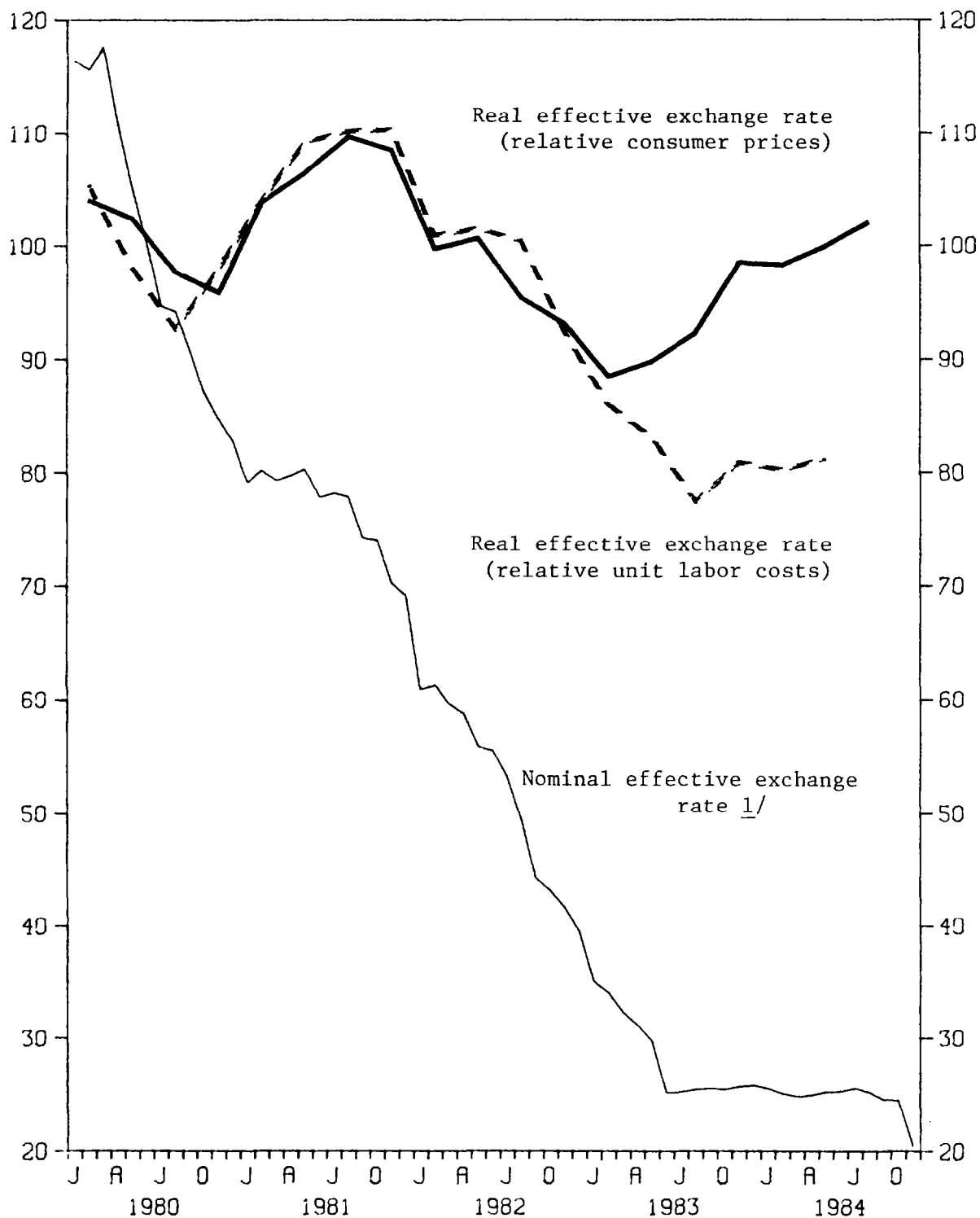
CHART 1

ICELAND

EFFECTIVE EXCHANGE RATES

(Indices 1980 = 100)

nominal rate: monthly averages
real rates: quarterly averages



Source: Staff calculations.

1/ For November 1984: rate as on November 20, 1984.