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CONFIDENTIAL

June 20, 1983

To: Members of the Executive Board
From: The Secretary
Subject: Iceland - Change in the Exchange Rate

There is attached for the information of the Executive Directors a paper on a recent change in the exchange rate of the Icelandic króna.

Att: (1)

INTERNATIONAL MONETARY FUND

ICELAND

Change in the Exchange Rate

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Approved by Brian Rose

June 17, 1983

I. Introduction

On May 27, 1983 the new Government of Iceland 1/ communicated to the Fund their decision to devalue the Icelandic króna by 14.6 per cent (EBD/83/154, 5/31/83). The devaluation was considered necessary because of increases in domestic costs and the external deficit caused by falling fish catches. At the same time the Government announced an economic program with the principal aim of reducing inflation substantially, including the suspension of the link between prices and wages for two years. The program is to be supported by increased monetary restraint.

II. Background

In Iceland, the primary objective of exchange rate policy is to support the profitability of the fishing industry. In addition to a gradual downward float, discretionary devaluations have been needed from time to time. 2/

In the period from September 1982 to May 1983, 3/ the nominal exchange rate of the Icelandic króna, as measured by a trade and payments weighted index on a monthly average basis, depreciated by 35.8 per cent, including two discretionary devaluations (on January 5, 1983 and May 27, 1983) totaling 22.3 per cent. From end-September to end-May the depreciation

1/ The new Government, led by Mr. Steingrímur Hermannsson (Progressive Party), took office on May 26, 1983. It is a coalition between the Independence and Progressive Parties, which together hold 37 seats out of 60 in the new Parliament, elected on April 23, 1983.

2/ For a more detailed discussion on exchange rate policy see Staff Report for the 1982 Article IV Consultation with Iceland (SM/82/144, 7/21/82).

3/ This period covers roughly the time since the last Article IV consultation with Iceland was concluded by the Executive Board (EBM/82/128, 9/27/82).

was 44.9 per cent. In real effective terms, 1/ there was not much change from September 1982 to May 1983 (though the latest devaluation had of course only a slight impact on the average May index); in May 1983 the real effective exchange rate was some 11 per cent below that in 1980. The cost of living index rose by 67 per cent from August 1982 to May 1983, 2/ and the 12-month change accelerated from 49.5 per cent in August 1982 to 86.6 per cent to May 1983. During the three months to May 1983 the annual rate exceeded 130 per cent.

The external current account deficit, which had risen to 5.1 per cent of GNP in 1981, doubled to 10.2 per cent of GNP in 1982. The deficit was primarily due to a sharp (17 per cent) decline in the volume of exports; in fact, the volume of imports fell by 3 per cent, responding to a fall of gross fixed investment. The terms of trade deteriorated by 1 1/2 per cent in 1982.

Two thirds of the current account deficit of SDR 232 million in 1982 was financed by foreign borrowing and other capital imports. The remainder was met by a reduction of foreign exchange reserves. Gross official reserves at the end of 1982 stood at SDR 133 million, equivalent to 10 weeks' merchandise imports. In December 1982 Iceland drew SDR 21.5 million (49.4 per cent of its quota) on the compensatory financing facility. Total long term foreign debt amounted to about 48 per cent of GNP at the end of 1982, up from 37 per cent from a year earlier, and the ratio of payments on long-term external debt to exports of goods and services rose from 16.6 per cent in 1981 to 21.4 per cent in 1982.

In 1982 Iceland's real GNP fell by 2 per cent largely as a result of the decline in the fish catch on which the country is crucially dependent, and recessionary conditions abroad, which caused the demand for some fish products (particularly stockfish) and aluminum to fall. In particular, the cod catch, which had been rising until 1981, fell by nearly a fifth. Fishing of capelin was banned altogether in 1982. Increased catches of other species did not compensate for the declines in cod and capelin catches. The profitability of the fishing industry fell in real terms in 1982.

So far the employment situation has stayed favorable, with the hours worked having been adjusted, especially in the fishing sector. The registered unemployment rate was only 0.7 per cent on average in 1982, and while it has recently risen somewhat, it is still very low by international standards.

1/ Relative consumer prices, adjusted for exchange rate changes (staff calculations).

2/ The cost of living index is calculated four times annually, on February 1, May 1, August 1, and November 1.

The devaluation of the króna has been accompanied by supporting measures. All provisions on wage indexation ^{1/} have been suspended for the period June 1, 1983-June 1, 1985. Instead wages and salaries are to be raised 8 per cent on June 1, 1983 and 4 per cent on October 1, 1983. No further increases will be allowed in the period until January 31, 1984. Price controls will be strengthened until January 31, 1984.

Official forecasts made in April 1983 had already pointed to a considerable decline in the current account deficit in 1983 (Table 1), in response to a sharp decline in domestic demand. Preliminary and as yet incomplete official forecasts incorporating the effects of the recent measures indicate a 14 per cent decline in real disposable household income and a current account deficit of about 3 per cent of GNP in 1983. The rate of inflation is now expected to come down sharply in the course of the year. The debt service ratio to exports of goods and services is expected to stay at the 1982 level, as higher amortization payments are expected to be compensated for by lower foreign interest rates and higher export earnings.

III. Staff Appraisal

Iceland's external position deteriorated substantially during the past two years. Given the high level of external indebtedness, the continued high current account deficit, and the very high and rising rate of inflation, rapid adjustment is required. In the staff's view the recent measures were needed and should help in correcting the external imbalance. Especially encouraging is the suspension of wage indexation for two years, which offers an opportunity to break the vicious circle of price and cost increases. The authorities have also indicated that they intend to support the devaluation and incomes policy with increased monetary restraint, which will be essential for the success of the policy package.

A more detailed review of the Icelandic economy and economic policies will be obtained during the next Article IV consultation discussions, to be held in Reykjavik in September 1983. The devaluation and the related measures can then be evaluated in the context of an overall assessment of the country's economic situation and policies.

^{1/} Without measures, the June 1, 1983 increase in wages and salaries due to the quarterly indexation would have been 22 per cent, and the next increases would have been due on September 1 and December 1, 1983. The wage-regulating index is based on the cost of living index excluding the effects of increases in alcohol and tobacco prices, the wage component of agricultural prices, and indirect taxes to finance oil heating allowances to households. Moreover, 30 per cent of the deterioration of the terms of trade is deducted, and 30 per cent of an improvement in the terms of trade is granted as an additional compensation.

Table 1. Iceland: Selected Economic Indicators

	1979	1980	1981	1982	1983 Official forecast (April)
	<u>(Percentage change)</u>				
Domestic economy					
Real GNP	4.4	3.9	1.6	-2.0	-5 1/2
Real domestic demand	2.6	4.2	4.6	2.2	-9
Cost of living index	45.5	58.5	50.9	51.0	over 100
Unemployment, in per cent of labor force	0.4	0.3	0.5	0.7	...
	<u>(In millions of SDRs)</u>				
External indicators					
Current account balance (in per cent of GNP)	-16 (-0.9)	-53 (-2.5)	-123 (-5.1)	-232 (-10.2)	... (-4)
Long term external debt at the end of the period (in per cent of GNP) <u>1/</u>	637 (34.6)	736 (34.4)	890 (36.6)	1,081 (48.0)
Gross official reserves	125	139	199	133	...
	<u>(Percentage change)</u>				
Financial indicators					
Broad money (M3)	55.9	65.4	70.5	58.4	...
Domestic credit	46.6	53.6	69.7	77.1	...
Central government financial surplus before loan transactions in per cent of GNP	-0.1	1.0	0.9	0.8	...

Sources: National Economics Institute, Central Bank of Iceland, and staff estimates.

1/ Based on average exchange rate every year.

Table 2. Iceland: Exchange Rate Indicators

(Period averages, 1980=100)

	Index of U.S. dollars per krona	Trade and payments weighted effective rate <u>1/</u>	Real trade- weighted effective rate <u>2/</u>
1978	177.0	184.5	102.2
1979	136.1	137.8	97.4
1980	100.0	100.0	100.0
1981	66.4	72.9	106.0
1982	38.8	45.3	95.0
1981 I	75.0	78.2	103.2
II	69.3	75.8	105.6
III	63.0	71.8	108.2
IV	60.3	67.3	107.0
1982 I	49.6	56.5	97.6
II	45.0	52.0	98.6
III	36.4	43.1	92.4
(September)	(33.2)	(39.6)	(87.7)
IV	30.2	36.6	91.5
1983 I	24.7	30.0	84.8
April	22.4	27.4	83.6
May	20.8	25.4	88.6

Sources: Central Bank of Iceland, and staff estimates.

1/ Trade and currency transactions weighted index of 17 countries.

2/ Trade-weighted index of 18 countries deflated by relative consumer prices, calculated by the staff.