FOR AGENDA

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November 14, 1983

To: Members of the Executive Board

From: The Secretary

Subject: Iceland - Staff Report for the 1983 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1983 Article IV consultation with Iceland, which will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Knöbl (ext. 74984) or Mr. Hedfors (ext. 75205).

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INTERNATIONAL MONETARY FUND

ICELAND

Staff Report for the 1983 Article IV Consultation

Prepared by the Staff Representatives for the 1983 Consultation with Iceland

Approved by Brian Rose and Subimal Mookerjee

November 10, 1983

I. Introduction

A staff mission consisting of Messrs. Adalbert Knöbl, Antero Arimo, Per Hedfors, Saumya Mitra, with Miss Jill Montgomery, as secretary, (all EUR), held the 1983 Article IV consultation discussions with Iceland in Reykjavik between September 8 and 19, 1983. The Icelandic authorities were represented by officials from the Prime Minister's Office, the Ministries of Finance, Commerce, and Fisheries, the Central Bank of Iceland, and the National Economic Institute. The mission also met the Prime Minister, Mr. Steingrímur Hermannsson, the Minister of Finance, Mr. Albert Gudmundsson, the Minister of Commerce, Mr. Matthías Mathiesen, the Minister of Fisheries, Mr. Halldór Ásgrímsson, and Dr. Johannes Nordal, Governor of the Central Bank of Iceland. Mr. John Tvedt, Executive Director for Iceland, attended 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 quota under the compensatory financing facility in December 1982.

II. The Economic Background

The Icelandic economy achieved a favorable growth performance in the 1970s (averaging 4.7 percent per annum) together with a tolerable current account position largely on the basis of a strong growth in fish catches that owed much to the extension of territorial fishing limits. The economy adjusted swiftly to the sharp deterioration in the external balance caused by the first round of oil price increases and it weathered the second round with a limited rise in the external deficit. Full employment was maintained throughout, but a persistently high rate of inflation, ranging between 30 and 60 percent, provided the main source of concern. The inflation problem had its roots in the tendency for increases in export earnings of the fishing sector to lead to economy-wide wage and cost increases irrespective of differentials in productivity. Inflationary impulses were reinforced by a wage price spiral caused by a pervasive system of wage indexation and accommodated by monetary policy. The practice of indexation--which was expanded to cover many financial

assets--in combination with an accommodating exchange rate and monetary policy stance tended to shield economic agents from the consequences of inflation and, therefore, lowered their resistance to it.

1. The level of real activity declines

A stagnation in the fish catch in 1981 and a sharp decline in 1982 dealt a serious setback to the Icelandic economy. An unexpected depletion of the capelin stock (a tiny fish of the salmon family) led in December 1981 to a virtual ban on capelin fishing, which is still in force; 1/ in 1982, the valuable cod catch also declined markedly. The difficulties in marine exports (which account for three quarters of total merchandise exports) were further aggravated by the virtual closure of the important Nigerian market for stockfish. Moreover, exports of the metal-producing industries (aluminum, ferrosilicon), were affected by the international recession.

As a consequence, real GNP fell by 2 percent in 1982 while the current account of the balance of payments weakened sharply. Domestic demand was held up largely because the authorities were slow to adjust policies to the worsened supply conditions. Strong growth in consumer spending that had begun in late 1981 spilled over into the first half of 1982 supported by expectations of future devaluations of the króna, rising real wage incomes, increases in consumer subsidies, and a lowering of certain import duties. It subsided in the second half of the year as real disposable incomes began to fall, reflecting the income effects of declining output of fish and partial suspension of wage and salary indexation in the second half of the year. For the year as a whole, private consumption rose by 2 percent, and estimates suggest that public consumption increased by a like amount. Fixed investment began to register a decline: in the fishing sector in response to falling catches and the government-imposed ban on imports of fishing vessels on grounds of conservation of fish stocks; and in the energy sector, due to the completion of some important projects and a weak short-term outlook for metal exports. A build-up of inventories, largely involuntary, emanating chiefly from a rise in stocks of dried and frozen fish, and of aluminum took place. All in all, total domestic demand rose by 2 1/4 percent.

The sharp fall in marine export supply, exacerbated by weak demand for certain export products, combined with relatively strong domestic demand resulted in a sharp worsening in the external current account. Exports of goods and services fell in volume terms by 9 percent, whilst imports rose by 1 percent, and current account deficit doubled to reach the equivalent of 10 percent of GNP in 1982.

The downturn in economic activity that began to gather force in the latter part of 1982 continued with added strength in 1983, as the fish

1/ The ban is to be reviewed later this year.

catch continued to fall, and the authorities took strong measures toward adjustment of domestic incomes to the changed supply situation of the economy. The policy package of May 27, 1983 (see in Section III) suspended wage indexation and instead provided for stipulated increases in compensation at rates well below that of inflation. As a result, private consumption is projected to fall by 9 percent in 1983 reflecting a fall in real disposable household incomes of around 12 percent, whilst public consumption is estimated to be unchanged. A large cut in public investment as well as weaker private investment in response to the fall in economic activity are projected to lead to a 10 percent overall decline in fixed investment. In marked contrast to 1982, the inventory cycle--reflecting chiefly the run-down of stocks for exports--will contribute negatively to domestic demand by over 3 percentage points. Total domestic demand is projected to fall by 11 percent.

The chief support to economic activity is to be provided by the net foreign balance, projected to add 6 1/2 percentage points to national output. The volume of exports of goods and services is projected to rise markedly (8 percent), reflecting a sharp upturn in the demand for aluminum and ferrosilicon and a recovery in the demand for marine products, but nearly half of the increase in exports would be met from stocks accumulated in 1981-82. The projected weakening in imports (a volume fall of 6 percent) reflects the sharp fall in domestic demand, chiefly household expenditure and investment, and the effects of the real depreciation of the krona over the past two years. Developments thus far in 1983 suggest that export performance may not be quite as strong as indicated in these official projections, whilst the fall in imports may be somewhat greater. On the whole, real GNP is likely to fall by 5 1/2 percent in 1983. Despite the fall in overall output a high level of employment has been maintained (with unemployment equivalent to around 1 percent of the labor force), which was made possible by the downward flexibility in real wage earnings.

2. A sharp rise in inflation, later restrained by wage moderation

Inflation, as measured by the increase in the cost of living index, rose from 48 percent during 1981 to 60 percent during 1982. The acceleration reflected the resumption of a policy of sharply depreciating the exchange rate as a means of protecting incomes in the important fishing sector from the consequences of the fall in supplies, and of initiating external adjustment. The depreciation, consisting of both step-wise adjustments and a downward crawl, fed the price-wage spiral under the existing system of wage indexation, and the process was accommodated by an easy monetary policy. By May 1983 inflation had risen to an annualized rate of 130 percent and was threatening to rise further.

The May 1983 policy package aimed at breaking the inflationary cycle. While consumer prices continued to rise rapidly in mid-1983, influenced by the devaluation of 14 1/2 percent in May on top of a continued downward crawl of the krona, and sharp increases in agricultural prices and public sector charges in June, most recently price

inflation has slowed down dramatically. As a result of the rigorous incomes policy measures applied as a part of the May package and a decision to hold the nominal effective exchange rate of the króna constant at its post devaluation level, inflation is expected to moderate in the final quarter of 1983 to an annualized rate of less than 30 percent. The first indications suggest that this projection may be realized. Wage earnings are projected to rise by over 20 percent less than consumer prices during 1983. The sharp decline in wage inflation under the statutory incomes policy is the major factor behind the expected slowdown in price inflation.

3. The external balance strengthens

The deficit on the external current account rose to SDR 230 million (10 percent of GNP) in 1982 from the equivalent of 5 percent of GNP in 1981 and 2 1/2 percent in 1980. The deterioration in 1982 reflected largely the fall in the fish catch, but other important factors influencing exports were marketing difficulties and weak world demand for metals; thus inventories of exportables were built up. Despite a healthy increase in exports of services, chiefly transportation and tourism, the volume of overall exports of goods and services declined by 9 percent. Import demand held up in early 1982 but began to fall in the course of the year. Merchandise imports declined by 3 percent in volume terms for the year as a whole, but in view of a rapid rise in imports of services, chiefly transportation and interest payments on the growing foreign debt, the volume of imports of goods and services rose by 1 percent in 1982. The terms of trade deteriorated by 1 1/2 percent in 1982 mainly reflecting a fall in aluminum prices.

The improvement in the current account position projected for 1983 to a deficit of SDR 40-50 million (equivalent to 2-3 percent of GNP) primarily reflects a recovery in exports of fish and metal products, partly out of stocks, a sharp fall in import demand resulting from the substantial contraction in real disposable incomes, and an improvement in the terms of trade of about 3 percent for the year. The pronounced swing in the current account of the balance of payments arises almost entirely from the projected strengthening of the trade balance from a deficit of SDR 140 million in 1982 to a surplus of about SDR 45 million in 1983. Developments in the first half of the year are in line with the expected improvement for the year as a whole.

The trade balance has also benefited from a real depreciation of the króna over the past two years. In the period December 1981-May 1983, the effective exchange rate of the króna was depreciated by almost 60 percent--well in excess of price and cost differentials. The additional devaluation at end-May 1983 led to a real exchange rate (measured in terms of relative unit labor costs) that was about 35 percent lower than in late 1981, and lower than at any time since the 1960s.

The current account deficit in recent years has been mainly financed by external borrowing by the public sector, but also by borrowing by

financial institutions and private entities. Net external debt of the economy (medium- and long-term) rose to the equivalent of nearly half of GNP by end-1982, and is projected to reach about 60 percent of GNP by end-1983--the deterioration in this ratio is partly accounted for by a fall in GNP in 1983 and valuation changes caused by the real depreciation of the króna. Net debt service is projected to be equivalent to 22 1/2 percent of exports of goods and nonfactor services in 1983 (Table 1). The external deficit in 1982 was partly financed by a drawdown of gross official reserves by SDR 66 million. In the first eight months of 1983 official reserves remained practically unchanged; at the end of August 1983 they stood at SDR 131 million (equivalent to about seven weeks of 1983 imports of goods and services).

III. The Policy Discussions

The stringent wages policy has already led to a sharp improvement in the external account and a significant deceleration in inflation. The central policy questions were whether the process of adjustment was to continue in 1984 and beyond, and whether the external adjustment was to be accompanied by a sustained diminution of inflationary pressures. The authorities intend to eliminate the deficit on the external current account in 1984, and aim at a further deceleration in inflation in the course of 1984 to reach an annualized rate below 10 percent by the end of the year. The discussions centered on the policy implications of the authorities' objectives.

1. The May measures and incomes policies

Immediately upon taking office following general elections, the new Government with a secure majority in Parliament, introduced a package of measures in May 1983, the key element of which consisted of the suspension of the quarterly wage indexation for two years and a statutory incomes policy that provided for a sharp slowdown in the growth of nominal wages until end-January 1984. The 22 percent wage increase due in June was annulled and replaced by an 8 percent increment, with a further rise of 4 percent in October 1983. The net effect of these measures was to cause average wage rates to decline on average by 17 percent in the year, but wage drift, and the adoption of certain measures to cushion the effect on household incomes such as increases in child benefits and pensions, reduction in income taxes, and increases in subsidies for home heating would limit the real decline in household disposable incomes to about 12 percent on average and almost 20 percent in the course of 1983. The other key element was the devaluation of the króna designed to improve Iceland's competitiveness further as well as to provide a margin large enough to absorb the effects of the stipulated wage increases until the end of the year.

The May measures represented a forceful response to Iceland's acute economic difficulties and they had led to significant progress in adjustment. The Icelandic representatives recognized, however, that a crucial

test for their 1984 targets on inflation and the external accounts would be posed by the resumption of contractual wage negotiations in early 1984. They stated that, while a continuation of the statutory incomes policy in 1984 was not feasible, they intended to give guidance to labor market participants, in particular by taking a firm position on public sector pay. Although, on present projections, a further fall in real wage earnings in the course of 1984 was unlikely to be required to attain the objectives on the external balance, the Icelandic representatives emphasized the importance of making the real reduction in wages experienced in 1983 stick. They intended to stress the responsibility of the social partners for maintaining employment, as excessive wage settlements would not, as in the past, be accommodated through monetary and exchange rate policies.

2. The stance of monetary policy

Monetary policy in Iceland has traditionally been highly accommodating, with easy resort to rediscounting at favorable rates and to overdraft facilities at the Central Bank. The task of monetary control has been further implicated by the failure of interest rates to respond adequately to accelerating inflation.

The easy stance of monetary policy can be seen from the the fact that net domestic assets of the Central Bank rose by 154 percent in 1982, and further at an annualized rate of 85 percent during the first eight months of 1983 despite the improvement in the external accounts in that period. The ready accommodation of banks had taken the form of rediscounts of bills at highly negative real rates of interest--mainly drawn by the fishing and manufacturing sectors--and the availability of overdraft facilities; both forms of support had been heavily relied on in 1982 and so far this year. In 1983 an additional factor had been the emergence of a budget deficit, financed in large part through the Central Bank. Broad money rose by 58 percent during 1982 and accelerated to an annualized rate of 105 percent during the first eight months of 1983.

The mission emphasized the crucial importance for the achievement of the authorities' twin objectives for inflation and the balance of payments in 1984 of reversing the accommodating stance of monetary policy. In order to support the price objective, money creation from the Central Bank would need to be closely controlled, thereby implying strict limits upon the rediscount and overdraft facilities accorded to the banks as well as upon Treasury access to the Central Bank. The Icelandic representatives had no difficulties with these observations but they pointed out that, despite the institution of a "tranche" system for the overdraft facility with interest rates rising with the degree of accommodation provided to the banks, the Central Bank lacked adequate instruments of control, especially for nonmonetary financing of any budget deficit. In addition, the rediscounting system enjoyed strong political support. The authorities were studying these issues, though no specific decisions had yet been taken.

The mission advocated placing greater importance on interest rates and stressed the importance of adequate real rates if closer control of credit expansion was to be attained. While positive real rates existed in parts of the financial sector, the implicit subsidization of credit to certain sectors of the economy had greatly complicated the task of monetary control. The mission reiterated the importance of reducing the differential between interest rates on rediscountable loans and on other instruments. The institution of new debt instruments to effect sales of Treasury debt to the nonbank public would also assist in more effective monetary management.

The Icelandic representatives agreed on the importance of establishing adequate real rates of interest. They hoped that with the decline in inflation they would be able to establish such positive real rates at lower nominal interest rates. Indeed, the authorities reduced nominal rates of interest, effective September 21, 1983 by 7 percentage points on most instruments but 4 percentage points on rediscounts. 1/ They viewed this reduction as appropriate given that initial signs of deceleration in the rate of inflation had appeared, which implied positive real interest rates at present, and in order to demonstrate to the public that counter-inflation policies had begun to show results. The authorities felt that they had not yet fully utilized the room for reducing interest rates. The mission warned of the risks of a premature lowering of nominal interest rates at this important juncture before the wage negotiations, and stated its view that delaying action until a slowdown in the recent rapid growth in the monetary aggregates was evident, would have been advisable.

3. The emergence of a fiscal deficit

After a number of years of rough balance in the Treasury budget, a significant deficit of around 2 percent of GNP was projected to emerge in 1983--this represented a swing of perhaps 3 percent of GNP from the 1982 outturn. The deterioration in the budget was mainly related to the erosion of the indirect tax base (the yield from indirect taxes accounts for four fifths of Treasury revenues) caused by the contraction in domestic demand, and the measures taken in May 1983 to cushion the effects of pay policy on household incomes. The impact of the public sector's 2/ operations on the economy, when the financing of public sector investment is taken into account, had been considerably more expansionary in recent years than the accounts of the Treasury alone indicate. Such financing had increasingly relied on foreign borrowing. The Icelandic representatives considered it important to constrain foreign financing by the public sector and to strengthen control mechanisms to this end.

1/ Following the reduction, lending rates on overdrafts and prime loans stand at 33 percent; on rediscountable bills at 29 percent. Compounded, the yields are 41 percent and 32 1/2 percent, respectively.

2/ A consolidated measure of the economic impact of public sector operations is not available. Beside central government operations, such a measure should take account of the local authorities' transactions as well as public investment and operation of the public investment credit funds.

The formulation of fiscal policy in Iceland as well as effective monitoring and control of the fiscal stance have been greatly complicated by persistent inflation: thus the budget estimates of 1983, prepared at the end of 1982, became rapidly obsolete in the early months of the new year. Moreover, certain features of the fiscal system have hampered the effective use of fiscal policy for demand management purposes. The use of indirect taxes was blunted by wage indexation, at least until their recent suspension. Income taxes are paid on incomes of the preceding year. Plans toward broadly based VAT and PAYE systems have been considered but are not likely to be implemented in the near future.

The budget for 1984 was presented to Parliament in mid-October. The fiscal policy stance is intended to support the macroeconomic objectives on inflation and the external account by eliminating the Treasury's budget deficit in 1984. The budget leaves unchanged the tax burden; in view of the further reduction in households' real disposable incomes --by an average of 5-6 percent in 1984--the Icelandic representatives considered an increase in taxes as unjustified. Restraint would center on expenditures. The chief discretionary measures include an 8-9 percent reduction in investment in real terms, a planned reduction in administrative operational costs by a similar amount, an assumed 2 1/2 percent reduction in the wage bill over and above the envisaged reduction in real wages, no increase in outlays on consumer subsidies in nominal terms and the abolition of transfers to the investment credit funds. All in all, expenditure is budgeted to rise by 10 percent in 1984, and to fall as a ratio to GNP by 2 1/2 percentage points to 27 percent; revenue is budgeted to rise by 17 percent. The gross borrowing requirement in 1984 is expected remain sizable as amortization on government debt is projected to increase markedly, partly reflecting the repayment of an indexed compulsory loan taken in 1978.

The Investment and Credit budget 1/ for 1984, to be issued later this year, will specify the restraint to be exercised in the public sector as a whole. While not all decisions had yet been taken, the Icelandic representatives emphasized that a notable feature of the credit budget would be the assumption that no net foreign borrowing for the economy in 1984 would occur. This increased the importance of greater self-financing for investment credit funds and public enterprises, partly through higher charges. Nevertheless, the restriction on external borrowing and on domestic credit expansion that was likely to be given in the Investment and Credit budget, would imply a firm restraint on investment.

4. Exchange rate, external debt and trade policies

The authorities consider greater stability of the exchange rate of the króna to be desirable and they believe an elimination of the current account deficit in 1984 and the further deceleration in inflation

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1/ The Investment and Credit budget specifies the planned credit expansion by sectors.

to be its preconditions. Iceland has, in general, followed a policy of a continuous downward crawl of the króna in recent years supplemented by discrete devaluations. As a result of such policies, the nominal exchange rate fell by 43 percent in effective terms during 1982, representing a strengthening of Iceland's competitiveness by more than 15 percent (using relative unit labor costs) in the course of the year. Largely in response to accelerating inflation, the monthly rate of depreciation was stepped up in early 1983 following a discrete devaluation of 9 percent in January 1983, and, following general elections, the króna was depreciated by a further 14.6 percent at end-May. The authorities decided to hold the nominal effective exchange rate constant until the end of the year as the May depreciation was judged to have sufficiently sharpened competitiveness so as to absorb the effects of the stipulated pay increases of June and October 1983. By August 1983, the nominal exchange rate had fallen by 36 percent since December 1982; on present estimates the competitive position of the economy in late 1983 would be about 20 percent better in terms of unit labor costs than in late 1982 (Chart 1). 1/

A strengthening of the competitive position, as seen in the past two years, is required for the necessary incentives to be provided for a reallocation of resources for purposes of export diversification--given the uncertain outlook on the fish supply--and import substitution. This has undoubtedly been a factor in promoting external adjustment. The Icelandic representatives stated that, despite initial signs of a slowdown in the rate of inflation, cost and price developments in the country in 1984 were likely to be above that in their trading partners. This would necessitate a depreciation of the króna in the course of 1984 as it was widely agreed that no further erosion in competitiveness was to be countenanced. The Icelandic representatives also stated that the rate of depreciation would have to be conditioned by the need to continue with the struggle against inflation. The mission emphasized the importance of implementing the required extent of the depreciation in a smooth fashion, thereby safeguarding against the creation of incentives for speculative capital outflows or imports. It pointed out that an early shift toward financial restraint would greatly assist in underpinning the authorities' exchange rate policies for the remainder of 1983 and in 1984.

The debt burden (net medium- and long-term debt) as a percentage of GNP is projected to rise to 60 percent by the end of this year (partly for valuation reasons). Although the maturity profile of the debt is well

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1/ According to the latest calculations of Iceland's real effective exchange rate, as measured by the standard index developed in connection with the Information Notice System (relative consumer prices), as of August 1983 the real appreciation of the króna amounted to 11.5 percent since the notification to the Executive Board in June 1983 of the May 27 devaluation. With the sharp decline in real wages since June, there has been little deterioration in labor cost competitiveness.

structured, the authorities consider a debt burden of this magnitude to be unsustainable and they therefore place great importance on attaining a balance in their external current account in 1984, and to keep it at least in balance for a number of years. Staff estimates indicate that, on the basis of tentative official forecasts for exports in 1984, the elimination of the current account deficit in 1984 will require a further decline in domestic demand of the order of 4 1/2 percent. Thereafter, staff estimates underline the dependence of a further sustained, if modest, improvement in the current account on the pursuit of domestic policies that are less expansionary than those abroad (Table 1 and Chart 2), assuming that marine exports are kept at their 1984 levels in volume terms. In the event of Iceland maintaining its current competitive position and domestic demand growing by one percentage point less than abroad in real terms, net total debt in relation to GDP would begin to decline from its peak level of 60 percent in 1984 to about 50 percent by 1988. The net debt service ratio, after an initial rise reflecting the amortization of past contracted debt, would stabilize at around 22 1/2 percent of exports of goods and nonfactor services. It is, of course, recognized that the debt projections are sensitive to the underlying assumptions; they should serve as no more than an indication of trends. In Iceland's case, in particular, the assumption concerning marine exports is of great significance. If the supply of fish were to deviate from the projected trends, the attainment of current account balance and stabilization of the debt burden would require a different development in real demand than has been assumed in the simulation and also a different real exchange rate for purposes of supply diversification.

The Icelandic authorities hold firmly to the view that agreed rules for competition offer the best prospect for the promotion of world trade. Iceland's exports had not been greatly damaged by the emergence of protectionist pressures in recent years, but the virtual closure of an important market for stockfish had adversely affected exports since 1982. The Icelandic trading system remained open; the only quantitative restriction of significance was a ban on the import of fishing vessels for reasons of conservation of the fish stock. With the abolition on July 29, 1983 of a 10 percent tax on purchases of foreign exchange for travel purposes that gave rise to a multiple currency practice, no restrictions on current payments or multiple currency practices remain.

IV. The Economic Outlook

Economic developments in Iceland are, at present, characterized by an improving current account position, a sharp deceleration in inflation projected for the final quarter of this year, and, despite a low level of real activity, high employment. The outlook for 1984 is dominated by the authorities' objectives of attaining balance in the external current account and ensuring a further decline in the rate of inflation.

1. The implications of the external constraint

The level of debt and debt servicing burdens in 1983 has heightened the importance of eliminating the current acount deficit. The preliminary forecasts of the Icelandic representatives indicate a very modest growth in export volumes for 1984 largely because of cautious assumptions regarding the fish catch, and the exceptional increase in metal exports in 1983 cannot be repeated. The volume of total merchandise exports is forecast to rise by less than 4 percent compared to a projected 10 percent in 1983.

On the basis of this projection, imports would have to be further compressed in 1984 for a balance on the current account to be achieved. This would require a further significant decline in domestic demand--perhaps of the order of 4 1/2 percent, with a fall in private consumption of around 4 percent. This could be achieved by a further fall, on average, in real wages in 1984--of the order of 5-6 percent--though possibly no decline in the course of the year. The volume of public consumption would fall by 2 percent. There may be scope for further destocking in 1984, though at a considerably lesser rate than in 1983. With the net foreign balance making a positive contribution to activity, the decline in GNP may be limited to 2 1/2 percent.

2. Inflation and costs

At the turn of the year, the underlying rate of inflation is projected to be below 30 percent. The objective of the authorities to reduce inflation further in 1984 so that, by the end of the year, the differential with their trading partners is virtually eliminated requires a containment of labor costs.

Contractual economy-wide wage settlements are expected to be reached in February 1984; the duration of such contracts and the time schedule of the agreed pay increases are as yet unclear, but much will depend on the progress with inflation. The Icelandic representatives stated that it was vital for their price objectives that the wage settlements be moderate and that the decline in real incomes experienced in 1983 not be reversed. They intend to give strong guidance to labor market participants through a firm stance on public sector pay. A restrictive stance of financial policies would also be required to prevent a resurgence in inflation.

3. The supply position

Over the medium term, the structural adjustment problems of the economy would need to be addressed since the fishing sector may have come close to capacity limits; this gives rise to the need for export diversification. An increase in living standards consistent with external balance would require a strengthening of the supply position in the economy. The most promising prospects can be found in energy-intensive projects that utilize Iceland's abundant resources of hydroelectric and geo-thermal energy. In addition, recent success with various traded

services such as transport and tourism indicates the scope for further expansion. The precondition for an enhanced supply responsiveness is a future revival of investment against a background of maintained competitiveness.

V. Staff Appraisal

Over the past two years the Icelandic economy suffered a serious setback. The fish catch fell sharply and other exports were affected by the international recession. Policy was slow to react to these developments, and the deterioration in the balance of payments was sharp, much sharper indeed than had been feared--the deficit on the current account rose to 10 percent of GNP in 1982. Equally dramatic was the acceleration in inflation to annualized rates of over 130 percent by the middle of 1983.

Immediately after coming into office in May 1983 the new Government took strong steps to correct the situation, and the recent progress experienced in external adjustment--with the current account deficit for 1983 projected at 2-3 percent of GNP--and the sharp deceleration in inflation expected for the final quarter of this year are remarkable. A significant start has been made with what will undoubtedly prove to be a long and challenging task of breaking inflationary expectations that have been entrenched for decades. The suspension of wage indexation--a system that had blunted the effectiveness of the exchange rate and fiscal instruments for adjustment purposes--and the statutory incomes policy led to a sharp fall in the real disposable income of households in 1983. These actions, together with a pronounced depreciation of the real effective exchange rate, were the major factors behind the initiation of adjustment, and they contributed to the maintenance of full employment conditions, despite the fall in overall production.

The Icelandic authorities have adopted, as objectives for 1984, the elimination of the deficit on the current account (and they intend to keep it at least in balance for a number of years), and a further deceleration in inflation to a rate in single digits by the end of that year. The achievement of the first objective is necessary if Iceland is to stabilize, and eventually reduce, its onerous debt and debt service burdens. The second objective is ambitious, and--in the absence of a statutory incomes policy--it requires the pursuit of strict financial policies that have not, in the past, been forthcoming.

The recent improvement in economic performance has rested largely on the use of statutory incomes policies, which expire in early 1984. Financial policies have not yet been supportive of the external adjustment and the disinflation process. In the second phase of their strategy the authorities intend to tighten financial policies in support of their objectives. Not all decisions have yet been made, and the staff would emphasize four areas of importance.

First, it is vital for the success of the authorities' economic strategy that the accommodating stance of monetary policy be decisively broken. Iceland's experience illustrates the pressures excessive credit expansion can put upon prices and the exchange rate. It is particularly important that the supply of credit through the Central Bank be closely controlled; this would imply stringent limits on the accommodation offered to banks through rediscounts and overdraft facilities, as well as on any accommodation of the Treasury. The implication of closer control of credit expansion by the banking system for interest rates--however unpalatable--would need to be accepted. While positive real rates have existed in parts of the financial sector, the implicit subsidization of credit to certain sectors has greatly complicated the implementation of monetary control. A further narrowing of the interest rate differential between rediscounts and other loans is required. The institution of instruments to make effective sales of Treasury debt to the nonbank public also seems important; this is bound to exert upward pressure on real interest rates. In this connection, the staff warned of the risks posed by a premature lowering of nominal interest rates; in its view, delaying action until a slowdown in the continued rapid growth in money and credit aggregates had become evident would have been advisable.

Second, the staff views with concern the emergence of a significant budget deficit in the Treasury accounts in 1983 and the expansionary stance of fiscal policy in recent years, fueled by foreign borrowing. The planned elimination of the budget deficit in 1984 marks a significant step in the stabilization process; it is obviously important that the measures of expenditure restraint be fully adhered to. The constraint to be placed upon foreign borrowing by the public sector, consistent with the official target of no net external borrowing for the economy as a whole, is appropriate.

Third, it is important that the present competitive position be maintained for the protection of the balance of payments. This will necessitate the adoption of exchange arrangements that would yield, in a smooth fashion, the required exchange rate adjustment and avoid providing incentives for speculation. The authorities believe in the importance of greater stability in the exchange rate. Such an objective would need to be underpinned by adequate financial restraint if speculation is to be avoided. The staff would note the threat to the viability of such a policy if financial policies were not sufficiently tightened.

Fourth, it is vital that the reduction in real wages and incomes secured during 1983 is not reversed in the course of 1984. The firm stance on public sector pay that the authorities intend to take will be of assistance. It is clear that should the contractual increases in early 1984 prove excessive, the price objective of the authorities would be unreachable, high employment would be endangered, and the promise of greater stability in the exchange rate would vanish.

The reduction of inflation and the attainment of balance on the external accounts will create the conditions for tackling structural

problems within the economy. Prime among these is the need to diversify the export base and to maximize the use of domestic savings to this end. The expansion of the energy-intensive sectors based on Iceland's plentiful hydro-power and geothermal resources hold promise for the future. A widening of industrial activities and a strengthening of the recent growth in traded services would enhance supply in the economy. For this purpose, maintenance of competitiveness will be crucial.

The staff notes with satisfaction that Iceland has eschewed resort to protectionist measures despite the magnitude of its balance of payments difficulties. It also welcomes its recent acceptance of the obligations of Article VIII, Sections 2, 3, and 4.

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

Iceland. Table 1. Illustrative Medium-Term Debt Projections 1/

	1982	1983	1984	1985	1986	1987	1988
Current account (in percent of GNP)	-10	-3	0.6	1.0	1.1	1.3	1.4
Gross total debt (in percent of GNP)	55.5	67.6	68.7	66.5	65.0	63.3	61.6
Net total debt (in percent of GNP)	48.0	58.4	59.2	56.5	54.3	52.0	49.6
Debt service, gross, as a percent of exports of goods and nonfactor services 2/	24.1	24.5	22.2	21.5	23.6	26.0	23.7
Debt service, net as a percent of exports of goods and nonfactor services 3/	21.2	22.5	20.6	19.8	22.4	24.8	22.4

Source: Staff estimates.

1/ For the principal assumptions underlying the projections, see note below.
2/ Interest payments on total debt plus amortization of medium- and long-term debt.
3/ Interest payments on total debt net of interest receipts on total assets (including official reserves) plus amortization on medium- and long-term debt net of amortization received on medium- and long-term assets.

Note: The illustrative medium-term debt projections have been based on the assumptions contained in the latest WEO paper for 1983 and 1984, and have further assumed that other industrial countries grow at an annual rate of 3 percent and experience an increase in the GNP deflator of 5.5 percent in 1985-88. For 1983 and 1984, the latest official and staff projections are used implying a fall in Iceland's domestic demand of 11 percent and 4 1/2 percent, respectively. Demand management in Iceland for 1985-88 is postulated such that domestic demand is held back to increase by 1 percentage point less than in other industrial countries, i.e., by 2 percent. The volume of exports of marine products is held unchanged from its 1984 level. The relative competitive position of the economy is assumed unchanged from its current position. Interest rates are assumed to gradually decline from their current levels to be positive in real terms by 2 percent on short-term debt and by 4 percent on long-term debt after 1984.

Fund Relations with Iceland

Date of membership:	December 1945.
Status:	Article VIII
Present quota:	SDR 43.5 million.
Proposed quota:	SDR 59.6 million.
Fund holdings of Icelandic krónur:	On September 30, 1983, SDR 65 million, or 149.45 percent of quota.
Use of Fund resources:	Iceland purchased SDR 21.5 million (49.4 percent of quota) under the compensatory financing facility in December 1982 (EBS/82/209, 11/23/82).
SDR position:	Holdings amounted to SDR 0.37 million or 2.26 percent of net cumulative allocations of SDR 16.4 million at September 30, 1983.
Gold distribution:	Four distributions totaling 19,684 fine ounces.
Exchange rate system:	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 43 percent during 1982 and by a further 36 percent until August 1983. On October 12, 1983 the official market rates were ISK 27.79 buying, and ISK 27.87 selling per US$1. There are now no multiple currency practices or exchange restrictions.
Last Article IV consultation:	The Staff Report for the Article IV consultation with Iceland (SM/82/144, 7/21/82) was considered by the Executive Board at EBM/82/128 (9/27/82).

Iceland - Basic Data

Area: 103,100 square kilometers
Population: (end-1982) 236,000
GNP in 1982: IKr 31,063 million; per capita SDR 9,650

	1980	1981	1982	1983 1/
Demand and supply	(Volume changes in percent)			
Private consumption	1.0	5.0	2.0	-9.0
Public consumption	4.0	5.0	2.0	--
Gross fixed investment	9.4	2.1	-3.6	-10.0
Final domestic demand	3.5	4.2	0.5	-8.2
Changes in stocks 2/	0.8	0.4	1.8	-3.3
Total domestic demand	4.2	4.6	2.2	-10.9
Exports of goods and services	2.7	1.9	-9.0	7.8
Imports of goods and services	3.6	8.6	0.8	-6.2
Gross national product	3.9	1.6	-2.0	-5.5
Gross national income 3/	2.7	1.9	-2.3	-3.9
Volume of marine production	10.5	1.5	-12.7	-4.0
Labor market	(Annual averages)			
Unemployment, number of persons	331	406	770	1,193 4/
Unemployment, as percent of labor force	0.3	0.5	0.7	1.1 4/
Incomes and prices	(Changes in percent)			
Hourly wage rates	50.9	49.5	49.9	49.0
Cost of living index	58.5	50.9	51.0	83.5
Real disposable household income	1.7	7.0	2.0	-12.0
Raw whitefish prices 5/	39.3	41.8	75.0	60.7
Terms of trade	-3.4	1.0	-1.5	3.0
Balance of payments	(In millions of SDRs)			
Exports, f.o.b.	714	767	622	730
Imports, f.o.b.	-690	-790	-760	-685
Trade balance	24	-23	-138	45
Net services and transfers	-78	-100	-94	-90
Current balance	-54	-123	-232	-45
Direct investment	13	46	33	...
Long-term borrowing, net	104	125	174	...
Short-term capital, net	-23	1	-61	...
Balance on capital account	94	171	147	...
Current balance (in percent) of GNP	-2.5	-5.1	-10.2	-2.2
External long-term debt, gross (SDR millions; end-period)	736	890	1,083	...
External long-term debt, gross (in percent of GNP)	34.4	36.6	48.0	...
Debt service ratio	14.1	16.4	21.2	...

1/ Official estimate of September 1983.
2/ Change as percent of previous year's GNP.
3/ GNP adjusted for changes in terms of trade.
4/ Average for January-August.
5/ Change during the year. The figure for 1983 refers to the change from January to October.

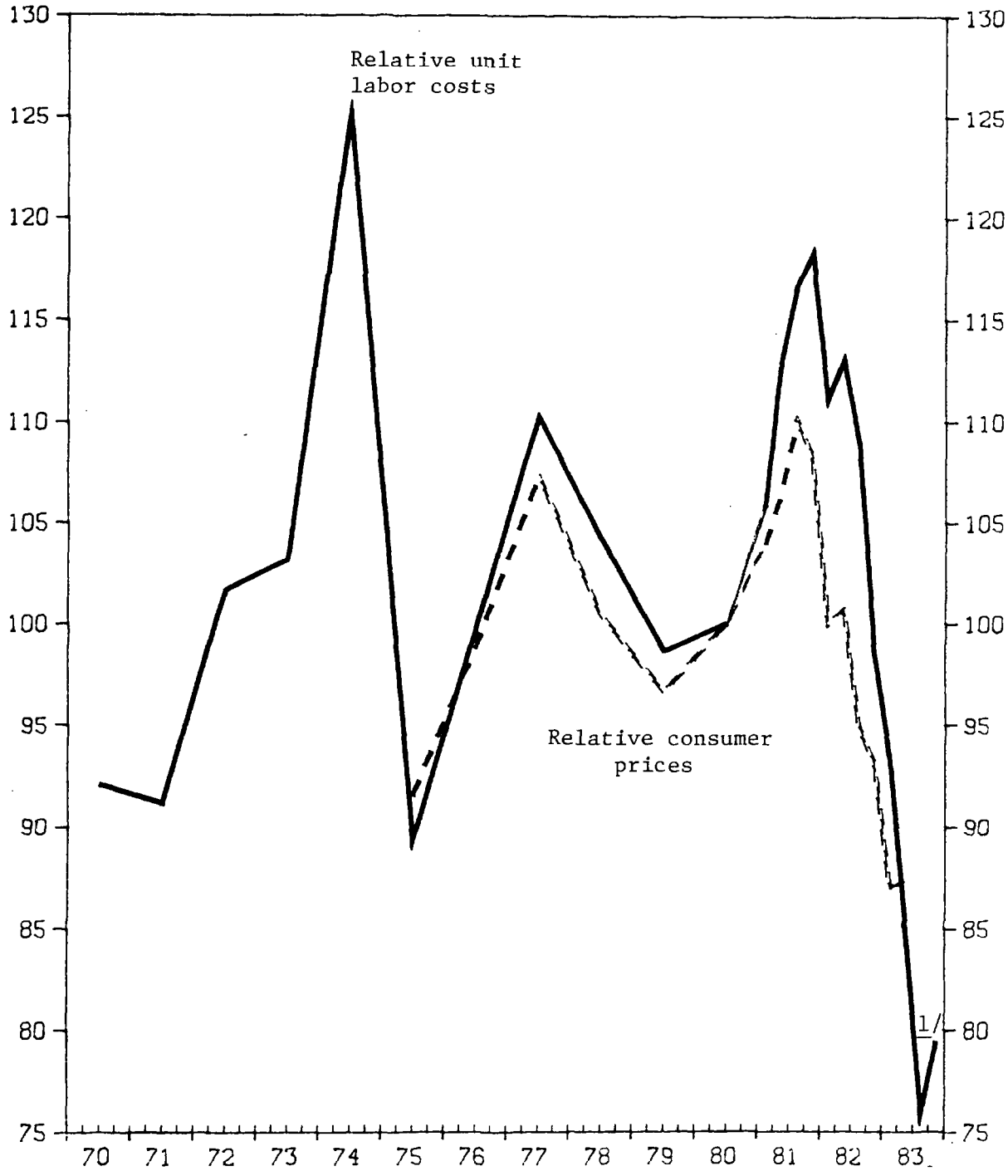
	1980	1981	1982	1983 1/
Foreign reserves and liabilities	(SDR millions; end-period)			
Gross official reserves	138	199	133	131 2/
Gross official liabilities	-24	-27	-52	-58 2/
Of which: to IMF	(-15)	(-6)	(-22)	(-22) 2/
Total net reserves	124	180	91	73 2/
Public sector	(ISK millions)			
Central Government revenue	3,929	6,304	9,562	14,865
Central Government expenditure	3,790	6,129	9,324	15,843
Balance	139	175	238	-978
Central Government, net financial transactions	-77	10	-91	-228
Overall cash balance	62	185	147	-1,206
Balance in percent of GNP				
Balance before financial transactions	1.0	0.9	0.8	-1.8
Overall cash balance	0.5	0.9	0.5	-2.3
Monetary survey	(Change in percent during the year)			
Foreign assets, net 3/	1.0	0.9	-26.9	-34.4 4/
Domestic assets, net 3/	75.1	79.3	100.6	119.6 4/
Broad money (M3)	65.4	70.5	58.4	79.1 4/
Exchange rate				
ISK per SDR, period average	6.24	8.52	13.64	25.01 5/
ISK per SDR, end-period	7.96	9.51	18.34	29.29 5/
Change in effective rate 6/				
Average	-26.1	-23.9	-32.3	-47.3 5/
End of period	-30.7	-17.1	-42.8	-46.5 5/

1/ Official estimate of September 1983.
2/ End-August.
3/ Change in percent of M3 one year earlier.
4/ Change over twelve months ending June.
5/ January-August, alternatively end-August.
6/ Trade-weighted average according to staff calculations.

CHART 1

ICELAND

REAL EXCHANGE RATE
(Indices: 1980=100)



Sources: Central Bank of Iceland and staff estimates.

1/ Official estimates.

Chart 2

ICELAND

EXTERNAL DEBT SIMULATIONS

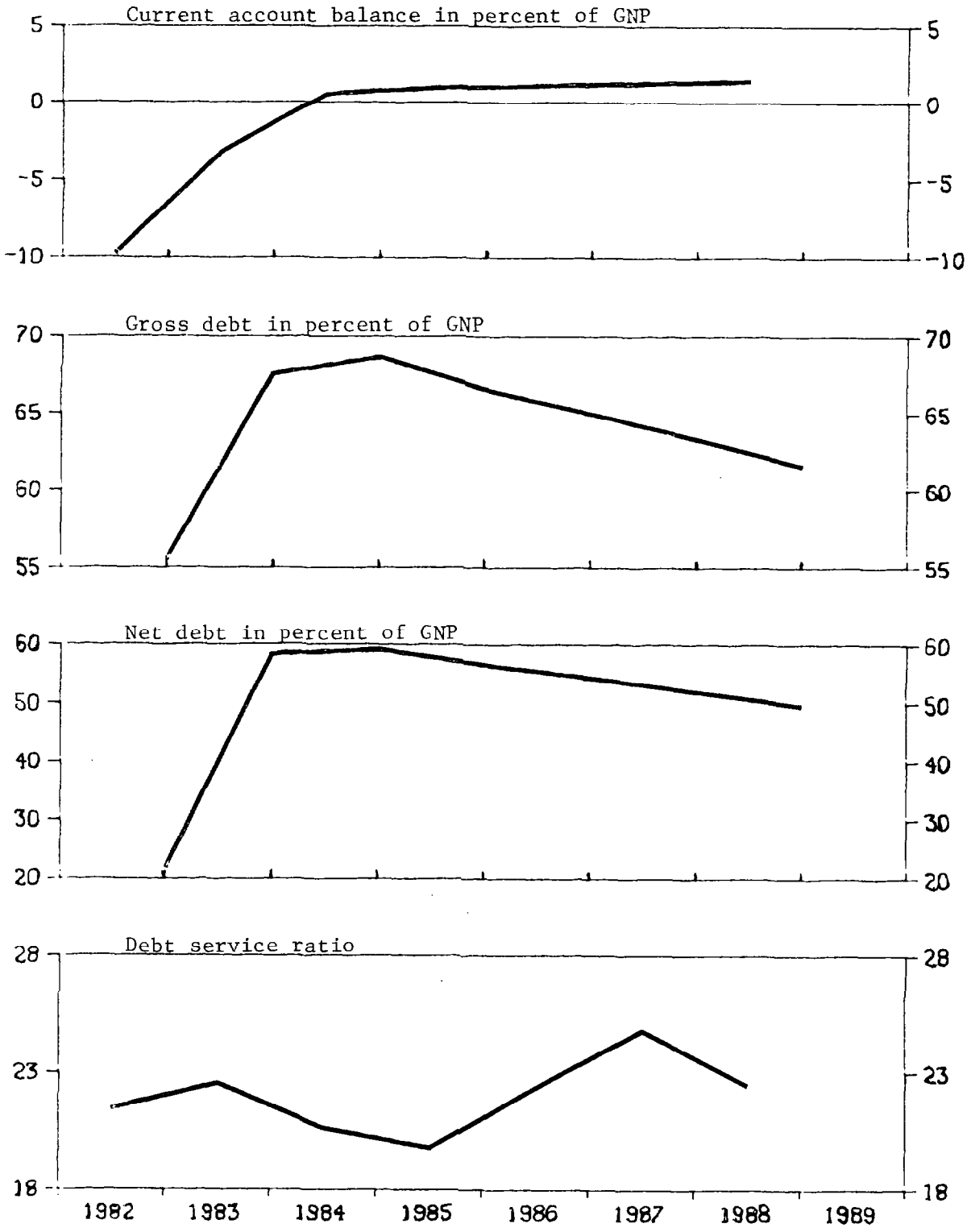
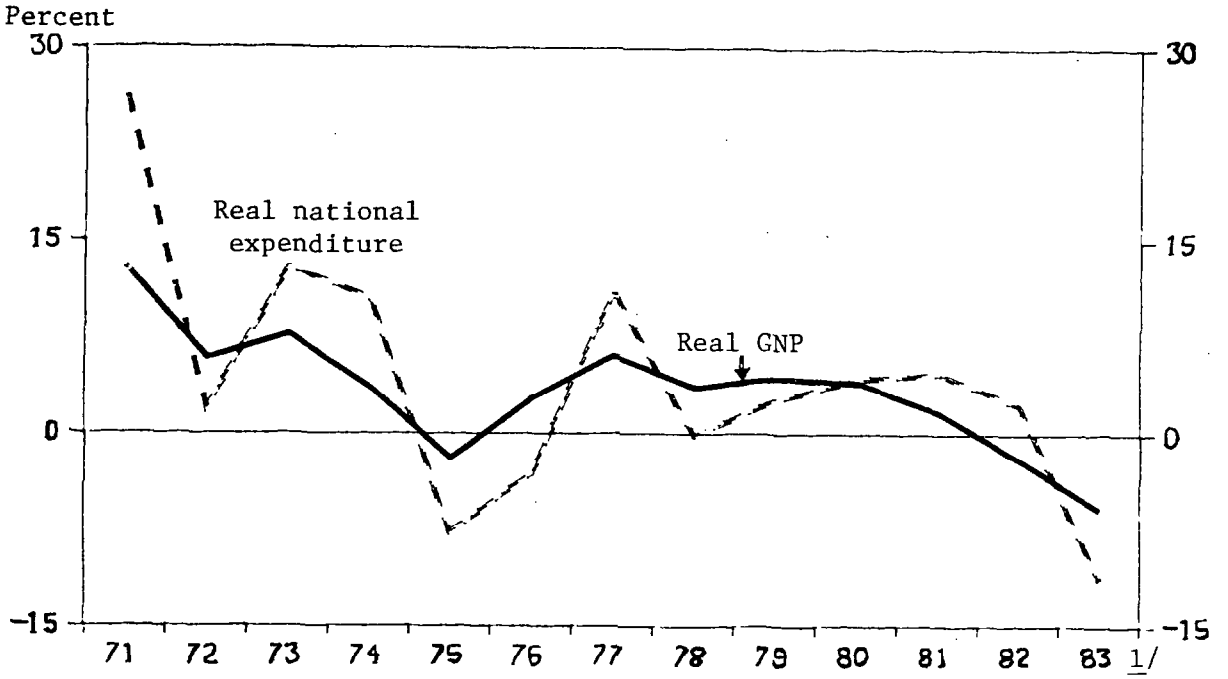


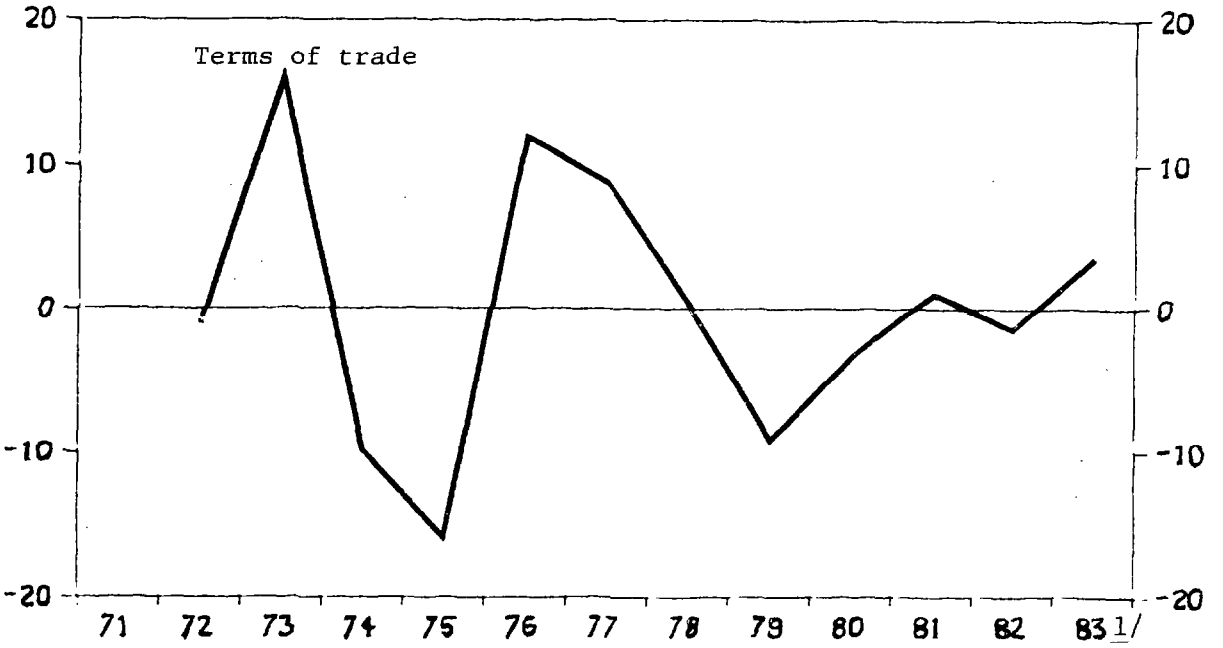
CHART 3

ICELAND

GROWTH AND TERMS OF TRADE

(Annual percentage changes)





Source: National Economic Institute, The Icelandic Economy.

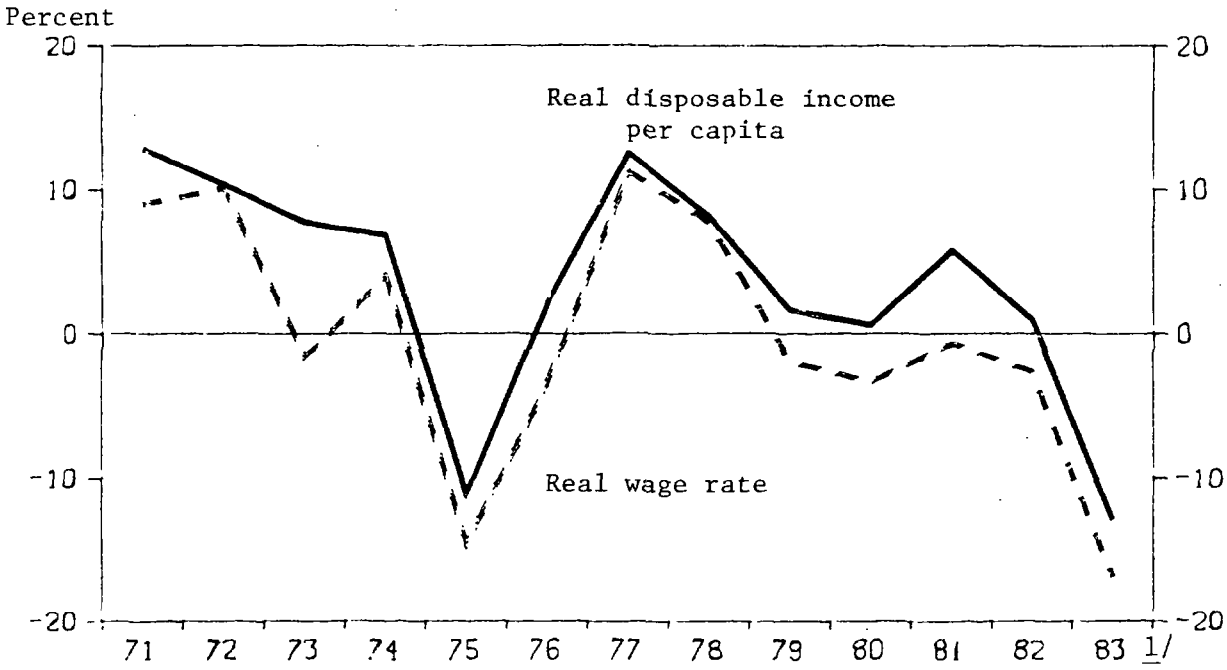
1/ Official estimates.

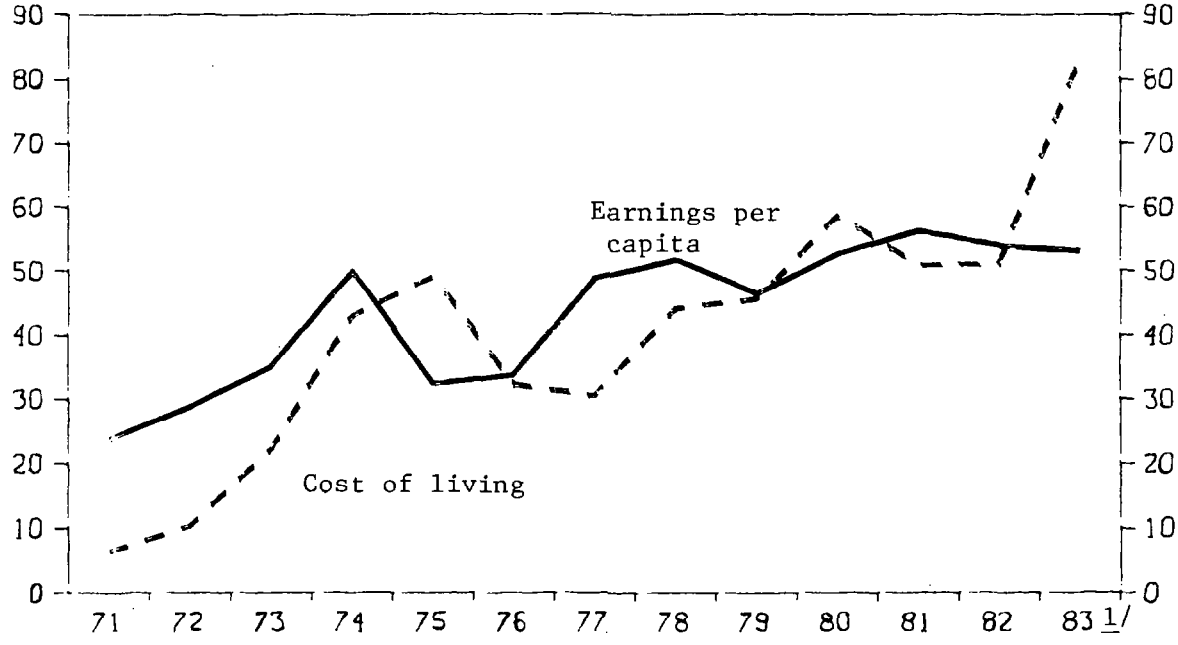
CHART 4

ICELAND

INCOMES AND PRICES

(Annual percentage changes)





Source: National Economic Institute, The Icelandic Economy.

1/ Official estimates.

CHART 5

ICELAND

GROWTH IN MONEY SUPPLY AND
CONTRIBUTION TO GROWTH 1/

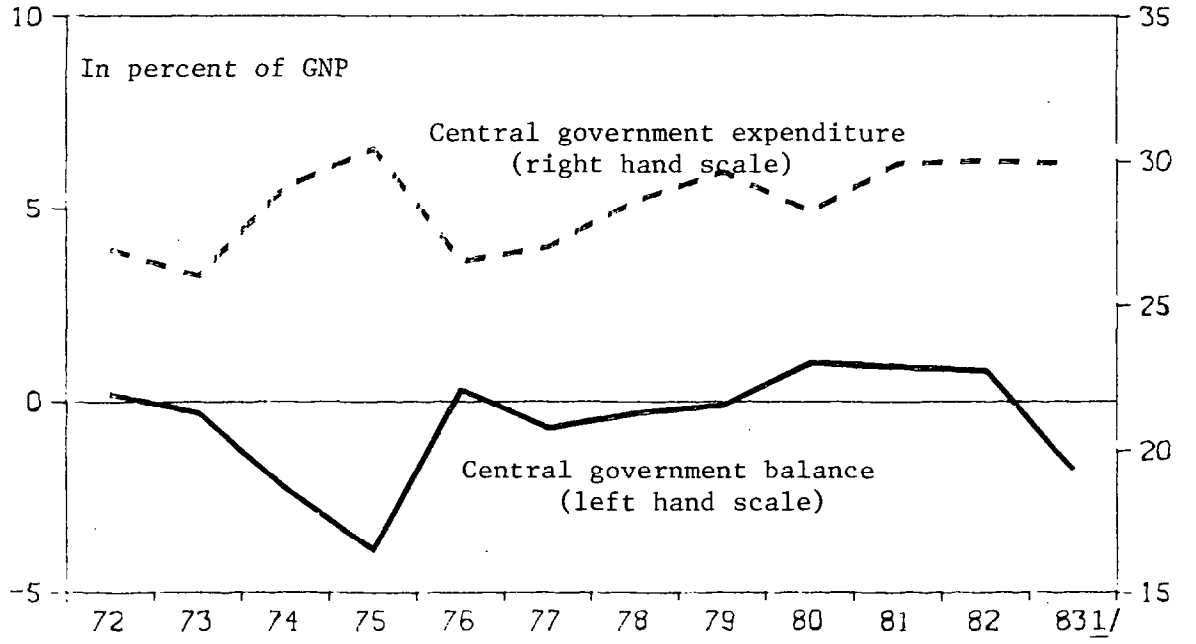
Source: IMF, International Financial Statistics.

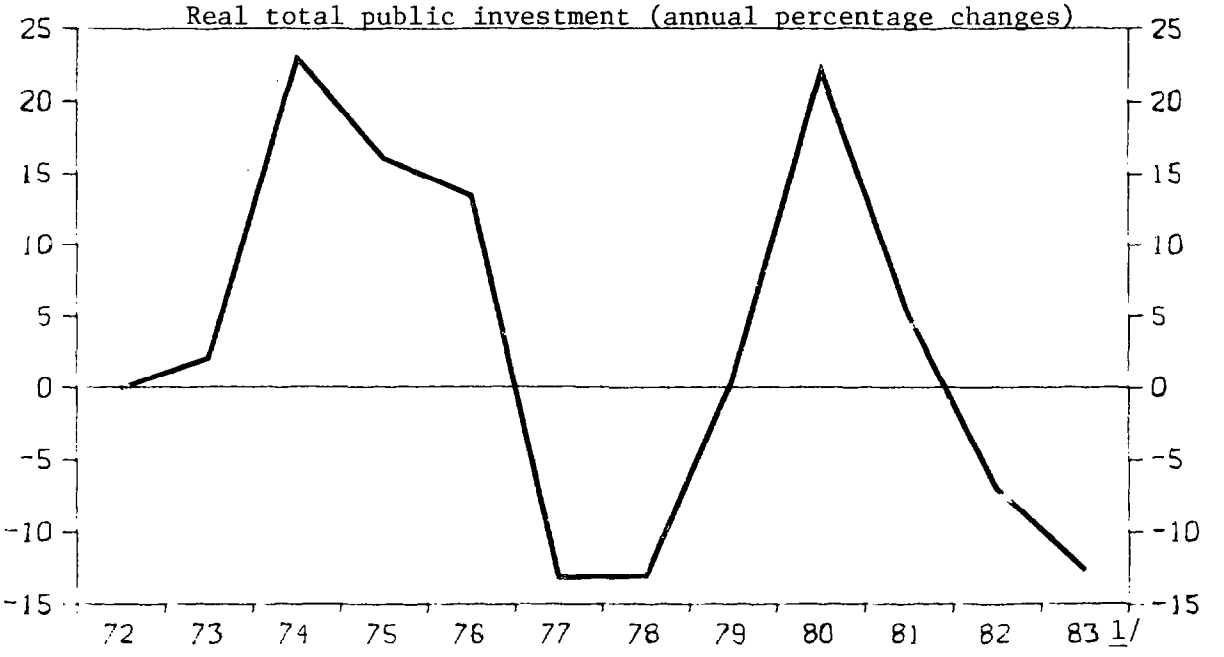
1/ Increase over twelve months as a percentage of the money stock at the beginning of the period.

CHART 6

ICELAND

FISCAL INDICATORS





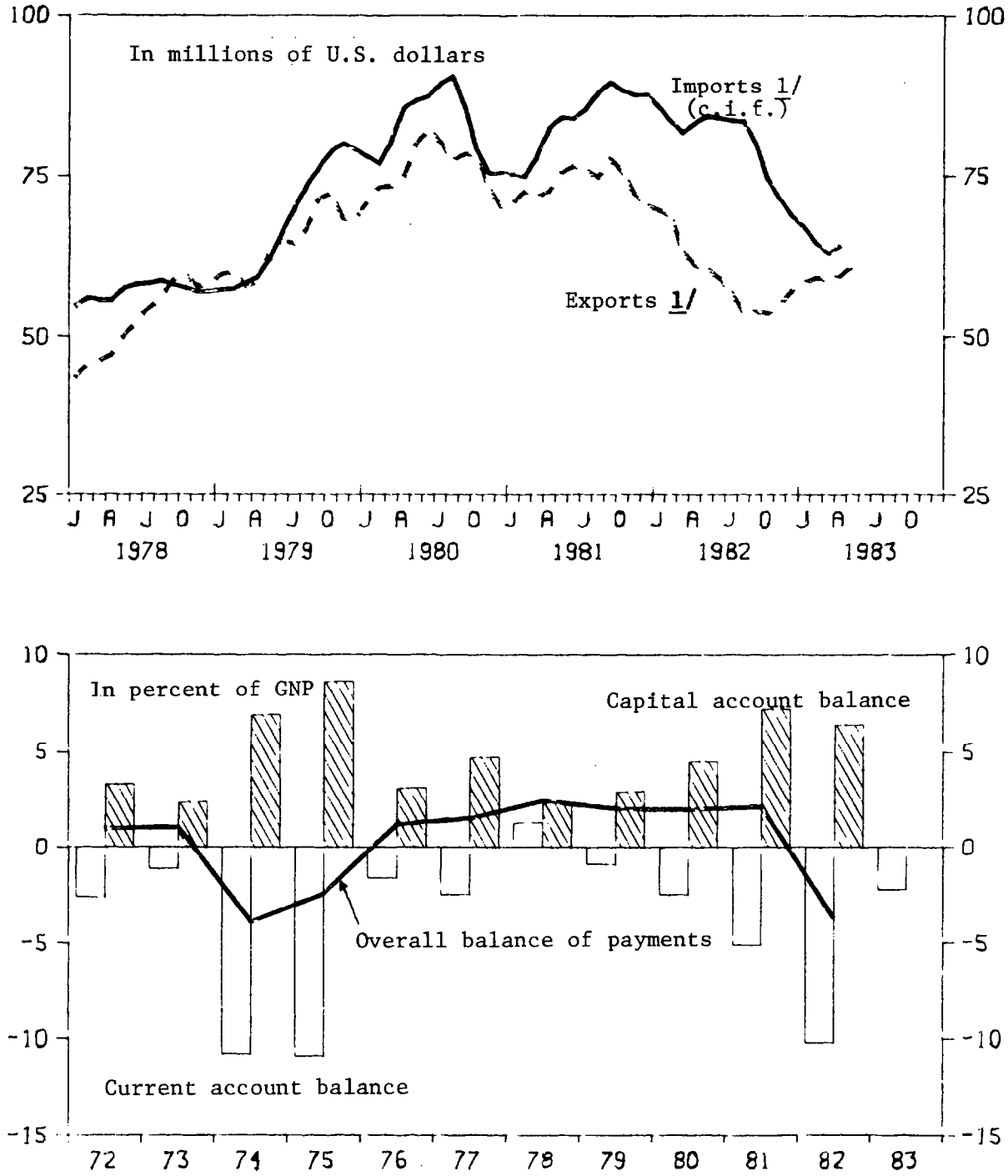
Source: National Economic Institute, The Icelandic Economy.

1/ Official estimates.

CHART 7

ICELAND

BALANCE OF PAYMENTS



Sources: National Economic Institute, The Icelandic Economy; and IMF, International Financial Statistics.

1/ Six-month moving average.