FOR AGENDA

SM/83/236
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

December 5, 1983

To: Members of the Executive Board

From: The Secretary

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

The attached supplement to the staff report for the 1983 Article IV consultation with Iceland has been prepared on the basis of additional information.

It is proposed to bring this subject to the agenda for discussion on Friday, December 9, 1983.

Att: (1)

Other Distribution:
Department Heads

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ICELAND

Staff Report for the 1983 Article IV Consultation
Supplementary Information

Prepared by the European Department

Approved by L. A. Whittome

December 2, 1983

I. Introduction

Subsequent to the issuance of the Staff Report for the 1983 Article IV consultation with Iceland (SM/83/236, 11/14/83), further information on the economic policy stance of the authorities with respect to 1984 and on the prospects for the important cod catch for that year have become available to the staff. In this connection a staff team consisting of Messrs. A. Knöbl and S. Mitra (both EUR) visited Reykjavik between November 15-17, 1983 and held discussions with Governor Nordal and officials of the Central Bank and of the National Economic Institute.

II. Recent Economic Developments

The latest projection for the external current account indicates a deficit of SDR 46 million (2.3 percent of GDP) in 1983, which would be covered by foreign borrowing. A resumption of capelin fishing has been permitted from November 1983 and is projected to yield 150,000 tons. The projected cod catch at around 297,000 tons represents a sizable reduction over the 1982 figure of 382,000 tons.

In recent months the rate of inflation, as measured by the cost of living index, has continued to abate, with the three-month annualized rate being 30 percent in November compared to nearly 120 percent in August. The twelve-month rate of inflation in November at 84 percent was sharply down from 103 percent in August. At the end of 1983, the annualized three-month rate of inflation is officially projected to be 23 percent with the twelve-month price change at about 77 percent.

The rates of monetary expansion have, however, shown no signs of deceleration with bank lending to the private sector being on a very high trend. The annual rates of growth of M3 have been around 80 percent in recent months. A significant development has been a relative shift from indexed deposit instruments to nonindexed ones, reflecting a dampening of inflation expectations.

III. Economic Policies

1. The budget for 1984 and its financing

Largely on the strength of cuts in expenditure, the fiscal budget for 1984 is estimated to be in much better balance compared to that for 1983. The major areas of restraint in expenditures center on a cut of 4-5 percent 1/ in central government consumption and a reduction in transfer payments by 16 percent. Central government investment is budgeted to decline by 17 percent and public investment expenditure as a whole by close to 10 percent. With the fall in Treasury revenue--largely owing to projected reduced yields from import duties and production taxes--being limited to 5 percent, the cash position of the Treasury is estimated to be in near balance.

The gross borrowing requirement of the Treasury is estimated at ISK 2.5 billion (4 percent of GNP) in 1984 compared to ISK 1.6 billion (3 percent of GNP) in 1983. This increase, despite a better balance in the cash position of the Treasury, is attributed to higher amortization, in particular of a compulsory loan raised in 1978 amounting to ISK 0.3 billion and to a reclassification of certain loans of the National Power Company accounting for ISK 0.2 billion. The budget envisages that approximately ISK 0.9 billion (1.5 percent of GNP) would be financed through domestic borrowing from both the banking and nonbank sectors and ISK 1.6 billion (2.5 percent of GNP) through foreign borrowing.

2. Objectives on money and credit

The authorities consider the recent rates of expansion in the credit and money aggregates to be worrisome and as being inconsistent with their targets for external balance. This has led them to exercise suasion on the deposit money banks to restrict lending and they have also indicated that the effective cost of accommodation of the banks at the Central Bank may be raised. The deposit money banks have agreed within themselves to limit the growth of credit (excluding produce loans). They have further agreed to invest at least 4 percent of the increase in their deposits in long-term bonds of the Government or the Investment Credit Funds.

The Ministry of Finance and the Central Bank are in the process of developing two new instruments to assist in money market management and in sales of government debt to the nonbank public. For the former purpose, a Treasury bill of 3 to 12 months' maturity, to be sold possibly by auction, is being considered; it is thought that demand for this instrument by the banks would be heavy, with pension funds, insurance companies and other private sector also being purchasers. For the latter, SDR-linked government bonds of 5-10 years maturity with a fixed interest rate have

1/ The discussion in this paragraph is in real terms.

been proposed for issue from early spring 1984. In addition, the authorities raised the real interest rate on indexed savings certificates of 17-year maturity (with a redemption option after 3 years) to 4.2 percent from 3.5 percent; the nonbank sector is a significant holder of such certificates, but they are open to banks as well.

The authorities intend to lower interest rates (on nonindexed items) commensurate with a continued decline in the rate of inflation but at the same time to maintain positive real interest rates. From September 21, three reductions in interest rates totalling 13 percentage points (for a representative loan or deposit instrument) have been undertaken, the most recent on November 21, when interest rates were reduced by 3-4 percentage points. Interest rates (compounded) on general loans and overdrafts now stand at around 33 percent; at current rates of inflation, they are now positive in real terms. The interest rate on produce loans has, however, been reduced by much less, thereby leading to a sharp narrowing of the differential. Since September 21, export produce loans have been denominated in SDRs with a gradually diminishing proportion being rediscounted by the Central Bank. Other produce loans--chiefly related to stocks--will continue to be króna-denominated; a proportion of these will continue to be subject to automatic rediscounting by the Central Bank.

The investment and credit budget for 1984, presented to parliament recently, specified indicative targets for domestic credit expansion by the financial system, authorization for foreign borrowing by the Treasury and various state and municipal bodies as well as a target for the growth in the money supply. The credit budget is based on the assumption that gross capital formation would decline by 6 percent in real terms in 1984 to be equivalent to 23.4 percent of GDP compared to 25.1 percent in 1983. Investment by industry is projected to decline by 6 percent and public investment by 10 percent but residential construction is expected to be unchanged in volume terms. The ceiling on gross foreign borrowing by the economy is fixed at ISK 4.5 billion (SDR 150 million) compared to ISK 5.5 billion (SDR 240 million) in 1983, which represents a decline in net foreign borrowing from SDR 106 million in 1983 to SDR 45 million in 1984. The total medium- and long-term debt of the economy is projected to decline marginally from the equivalent of 60 percent of GNP in 1983 to 59 percent in 1984.

With rough balance being projected for the current account, the additional net foreign borrowing by the economy is to be devoted to a strengthening of reserves, to a consolidation of certain short-term debt items into medium- and long-term debt, and to the financing of projected net short-term trade-related capital outflows arising from a continued improvement in the trade account.

Domestic credit expansion is projected at 12 percent in the course of 1984 (compared to a projected 78-80 percent in 1983) and the target for the rate of growth of M3 during the same period has been set at 15 percent (compared to a projected 85 percent in 1983).

3. <u>The inflation objective and exchange rate policy</u>

The authorities aim at a steady reduction in the rate of inflation in the course of 1984 such that by the end of the year the annualized rate of inflation is targeted to be below 10 percent. It is the objective of the authorities to limit a depreciation of the exchange rate of the króna to 5 percent during 1984. It is recognized that the realization of the inflation target is crucially dependent upon contractual wage settlements in the spring of 1984 being not in excess of the Government's guideline of 6 percent, which, if realized, would leave the competitive position of the economy broadly unchanged. The authorities have stated that excessive wage settlements would not be relieved by a devaluation of the króna and they consider that their declared objective of relative stability in the exchange rate exerts a beneficial influence on expectations in the labor and financial markets. Nevertheless, the evolution of the competitive position of the economy and any unexpected changes in external conditions would also affect the judgment of the authorities on the appropriate exchange rate.

IV. Prospects for the Cod Catch in 1984

In November the Marine Research Institute published a reappraisal of the strength of the important cod stock in Icelandic waters. The Institute, which had recommended a maximum permissible catch of 300,000 tons for 1983 had, in light of its recent findings, sharply scaled down its recommendation for the catch for 1984 to 200,000 tons. This recommendation is the subject of study by the authorities and, if followed would imply a significant weakening of export prospects and incomes in 1984 from the levels at present projected by the authorities. To some extent the direct loss in export revenues would be offset by increases in exports of frozen fish and greater fishing effort directed at other species so that the net effect on exports may be limited to about SDR 50 million, but the impact on production and incomes is likely to be, nevertheless, significant.

As yet, the Icelandic authorities have not revised their macroeconomic projections in light of this development nor have they fully determined their policy response to it. They have, however, stated that their objectives on inflation and the wage target would be unaffected. In their view, pressures for moderate wage settlements have been strengthened by this development. The fiscal position may be weakened on account of lower revenues and the current account may continue to register a deficit in 1984, which, if lower than that in 1983, would still be consistent with continued adjustment.