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January 26, 1989

To: Members of the Executive Board

From: The Acting Secretary

Subject: Iceland - 1988 Staff Report on the Interim Article IV Consultation Discussions

Attached for consideration by the Executive Directors is the 1988 staff report on the interim Article IV consultation discussions with Iceland. As agreed between Mr. Ovi and management, this report has been placed on the agenda for discussion on Friday, February 17, 1989.

Ms. Happe (ext. 8330) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

ICELAND

1988 Staff Report on the Interim Article IV Consultation Discussions

Prepared by the Staff Representatives

Approved by Massimo Russo and S. Kanesa-Thasan

January 25, 1989

I. Introduction

A staff team consisting of Mr. H. Ungerer, Ms. N. Happe, and Mr. G. Tersman (all EUR), with Ms. E. Whitely (RES) as secretary, held Interim Article IV consultation discussions in Reykjavik, November 5-15, 1988. The mission met with the Minister of Finance, Mr. O. Grimsson; the Minister of Commerce, Mr. J. Sigurdsson; the Minister of Fisheries, Mr. H. Asgrimsson; the Governors of the Central Bank of Iceland, Dr. J. Nordal, Mr. T. Arnason, and Mr. G. Hallgrimsson; the Economic Advisor to the Prime Minister, Mr. T. Olafsson; and with officials from various agencies. Mr. J. Ovi, Executive Director for Iceland, attended the meetings as an observer. The last Article IV consultation with Iceland was completed on January 29, 1988.

Iceland accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 19, 1983. A new Government has been in office since September 1988; the previous Government resigned over disagreement concerning policies to deal with the present economic difficulties. Iceland is now governed by a four-party center-left coalition with a small majority in Parliament.

II. Background

The most salient feature of the Icelandic economy, apart from its small size and high degree of openness, is the dependency on the fishing sector which accounts for about three fourths of total merchandise exports. Other export products include aluminum and ferrosilicon. The fish catch has been subject to wide swings. Following a collapse in 1982 and 1983, the output of the fishing sector recovered strongly (Chart 1). In addition, substantial increases in fish export prices, reflecting limitations in world supply and an increase in world demand, boosted marine export earnings further. A peak was reached in 1987; since then, marine output and fish export prices have declined slightly.

The main priority of Icelandic economic policies has traditionally been to maximize employment. In recent years, unemployment has been virtually nonexistent, and the labor market has been in a state of excess demand. Other aspects of macroeconomic performance have been less satisfactory. It has proven difficult to restrain domestic demand sufficiently to safeguard the balance of payments, in particular when adverse supply shocks occur (Chart 2). In consequence, the rate of inflation has fluctuated widely, sometimes reaching very high levels.

The large unpredictable swings in marine production and the terms of trade make stabilizing the economy a difficult task in Iceland. 1/ In addition, financial policies have tended to reinforce the cyclical pattern of economic activity rather than to offset the variability of supply. During periods of strong export growth, fiscal and monetary policies have often remained expansionary, necessitating much harsher adjustment when exports fall back than would otherwise have been necessary. In the downward phase, the primary means of such adjustment has typically required a combination of devaluations and statutory incomes policies to reduce incomes and demand.

After the sharp fall in marine production, and the cut in domestic absorption that accompanied it in the early 1980s, the Icelandic economy recovered rapidly (Chart 1). It continued to grow in 1987 (Table 1). However, in contrast to the balanced growth in output and absorption of the preceding years, real final domestic demand in 1987 surged by 12.7 percent, almost twice the growth of real GDP. The strong expansion in 1987 put severe pressure on an already tight labor supply. Job vacancies rose to over 3.5 percent of the labor force and nominal wage earnings increased by 42 percent. The increase in consumer prices was relatively subdued (18.8 percent) due to large terms of trade gains and a policy of maintaining a stable nominal exchange rate. Prices on domestically produced goods outpaced export and import prices by a wide margin. According to the Fund's Information Notice System (INS), the real effective exchange rate, in terms of relative consumer prices, rose by 8.1 percent in 1987 (Chart 3).

Because of natural limits on the fish catch, export volume growth slowed down significantly in 1987 (Table 2). Nevertheless, total exports of goods and services rose by 4 percent. Reflecting the strong rise in real incomes and the appreciation of the real exchange rate, the volume of imports of goods and services increased sharply. The overall trade balance moved from a substantial surplus in 1986 into a deficit equivalent to 1 percent of GDP. The current account balance swung from a small surplus, the first in nearly a decade, to a deficit equivalent to 3.5 percent of GDP. As a percentage of GDP, net external debt declined from 45.2 to 41.3 percent, the result of strong economic growth

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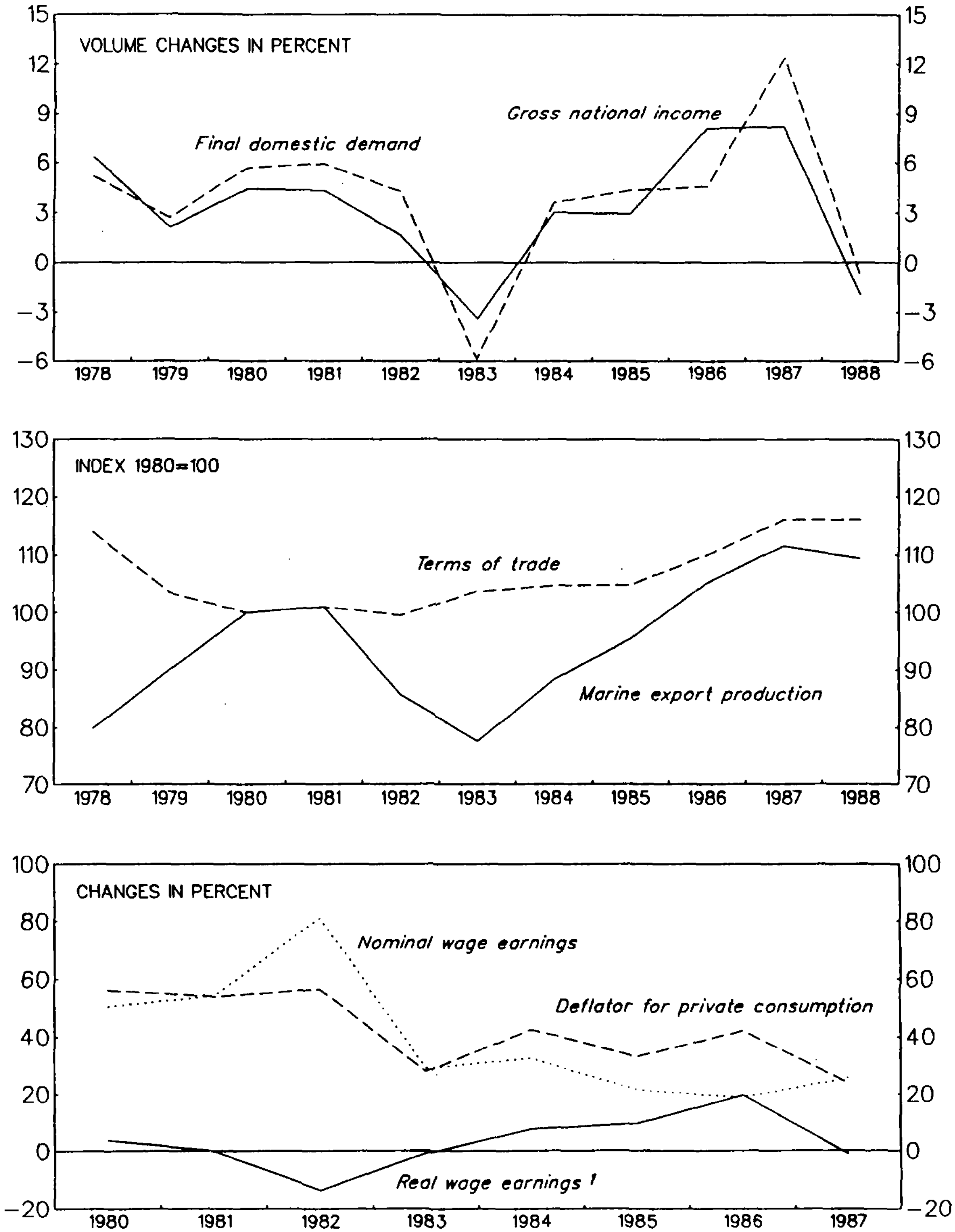
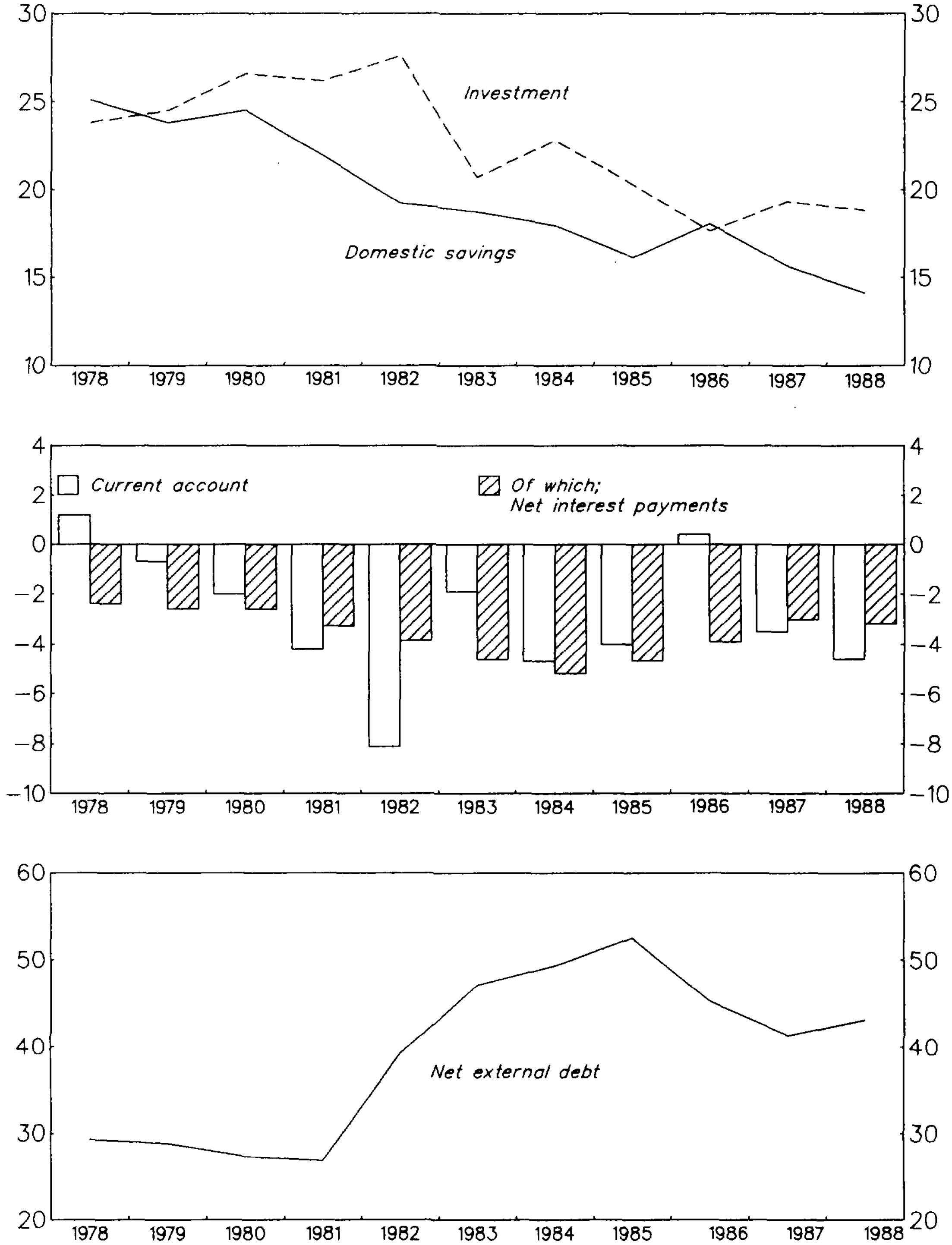
1/ The adjustment to external shocks in Iceland was analyzed in Appendix I to the 1988 Recent Economic Developments report (SM/88/14, 1/15/88).

CHART 1
ICELAND
INCOME, DEMAND, AND WAGES



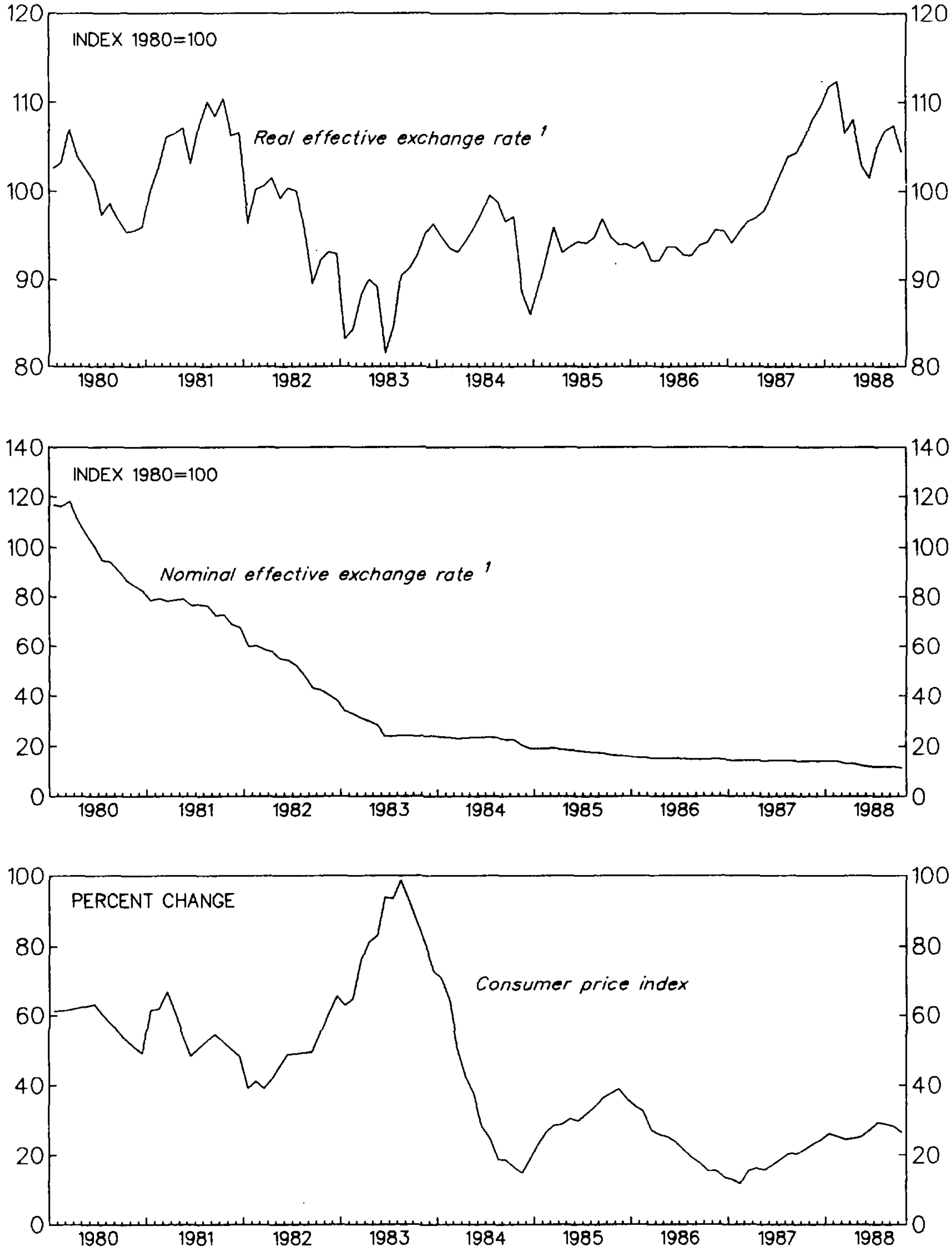
Sources: Central Bank of Iceland and National Economic Institute.
¹ Nominal earnings deflated by deflator for private consumption.

CHART 2
ICELAND
FINANCIAL BALANCES AND EXTERNAL DEBT
(Percent of GDP)



Sources: Central Bank of Iceland and National Economic Institute.

CHART 3
ICELAND
EXCHANGE RATE AND PRICE DEVELOPMENTS



Source: IMF, Information Notice System.
[1] Increase indicates appreciation. Real exchange rate calculated from nominal effective exchange rates deflated by consumer prices.

Table 1. Iceland: National Accounts

	1984	1985	1986	1987 1/	1988 2/	1989 3/
	(Percentage changes; at constant prices)					
Final domestic demand	3.6	4.3	4.6	12.7	-0.8	-2.8
Private consumption	2.7	5.0	6.5	14.0	-1.0	-3.5
Public consumption	0.2	6.2	6.8	5.5	2.0	0.5
Gross fixed investment	8.9	1.0	-2.2	15.7	-2.7	-3.2
Exports of goods and nonfactor services	3.0	11.0	6.2	4.0	-1.0	-1.1
Imports of goods and nonfactor services	9.3	9.7	0.3	22.9	2.2	-3.8
Gross domestic product	3.5	3.4	6.3	6.6	-1.4	-1.6
Gross national product	3.0	3.1	6.3	6.5	-2.2	-2.2
Gross national income 4/	3.0	3.0	8.1	8.2	-2.0	-3.1
	(In percent of GDP; at current prices)					
Gross national saving	17.0	15.3	17.3	15.2	13.6	13.4
Private 5/	8.7	10.0	11.9	11.0	8.8	...
Public 6/	8.3	5.3	5.4	4.2	4.8	...
Gross capital formation	21.7	19.3	17.0	18.7	18.2	17.9
	(In percent of labor force)					
Vacancies 7/						
Spring	...	3.6	2.1	3.5	3.2	...
Autumn	...	1.7	2.9	3.5	0.5	...
	(Percentage changes)					
Memorandum items:						
Nominal earnings per capita	27.8	42.5	33.0	42.0	24.0	6.0
Real disposable income per capita 8/	-0.8	10.5	10.0	20.5	-1.0	-6.3

Sources: The National Economic Institute; Central Bank of Iceland, Economics Statistics Quarterly; and the National Budget.

1/ Provisional.
2/ Official estimates as of October 1988.
3/ National Budget forecasts as of October 1988.
4/ GNP adjusted for changes in terms of trade.
5/ Calculated as a residual.
6/ Calculated from the accounts of the General Government, which consists of the Treasury, the social security system, and the municipalities.
7/ Excluding agriculture, fishing, and public services other than health care.
8/ Based on the deflator for private consumption.

Table 2. Iceland: Balance of Payments

	1984	1985	1986	1987	1988 1/	1989 2/
			(In millions of SDRs)			
Trade balance	-10	—	83	-39	-87	-89
Merchandise exports, f.o.b.	725	801	933	1,061	1,069	1,064
Merchandise imports, f.o.b.	735	801	850	1,100	1,155	1,152
Net services and transfers	-117	-114	-71	-105	-114	-111
Interest payments	-140	-133	-129	-124	-139	-161
Other	24	19	58	19	25	50
Current account	-126	-114	15	-145	-201	-200
Capital account	98	229	55	133	...	...
Long-term capital	114	131	127	139	...	...
Short-term capital 3/	-16	98	-72	-6	...	...
Overall balance	-28	115	70	-12	...	...
			(In percent of GDP)			
Trade balance	-0.4	—	2.5	-1.0	-2.0	-2.0
Net services and transfers	-4.3	-4.0	-2.1	-2.5	-2.6	-2.5
Current account	-4.7	-4.0	0.4	-3.5	-4.6	-4.5
			(Percentage changes)			
Memorandum items:						
Merchandise export volume	3.7	10.1	10.3	3.2	-1.7	-2.3
Merchandise import volume	8.9	8.7	5.6	24.9	3.0	-3.9
Terms of trade 4/	0.9	0.1	4.9	5.4	—	-1.5
Real effective exchange rate 5/	6.5	-0.8	-0.3	8.1	5.3 6/	...

Sources: Central Bank of Iceland; the National Economic Institute; the National Budget; and IMF, Information Notice System.

1/ Official estimates as of October 1988.
2/ National Budget forecasts as of October 1988.
3/ Including errors and omissions.
4/ Merchandise trade only.
5/ Relative consumer prices according to the INS.
6/ January - October over average for 1987.

rather than a decline of the debt itself, and also of the appreciation of the real exchange rate. Expressed in SDRs, net external debt rose by 11.4 percent.

Although the boom in the Icelandic economy started with the recovery of the fishing sector, it was strongly reinforced by domestic policies. Fiscal policy remained expansionary even as the growth in the economy accelerated. Tax buoyancy has generally been low during periods of economic expansion because personal income tax payments have been based on the previous year's income. The Treasury's operational deficit in 1987 amounted to 1.3 percent of GDP, unchanged from 1986 (Table 3). The Treasury's net financial deficit, including net lending to public and private sector entities, rose to 2.7 percent of GDP in 1987. 1/ Much of it was financed by monetary means.

Overall credit expansion accelerated sharply in 1987. In response to strong demand for loans from both firms and households, commercial bank lending increased 46 percent, or 17 percent in real terms, during the year (Table 4). Total domestic credit relative to the level of M_3 a year earlier, i.e., as a contribution to growth in M_3, rose by 54 percentage points. Because of a decrease in net foreign assets, the increase in M_3 was held to 35 percent. Subsidized mortgage credits through specialized housing funds put further pressure on the financial resources of the economy, and required monetary restraint to be greater than otherwise, as it was applied to only a part of the total credit market. The Central Bank attempted to restrain the strong credit growth by reducing accommodation of commercial banks, and by allowing real interest rates to rise, following financial deregulation. The increase in interest rates, along with an easing of regulations on foreign borrowing in 1986, did encourage a high level of net foreign borrowing by the private sector in 1987. Nevertheless there continued to be a net outflow of liquidity.

1/ Three measures of public sector finances are commonly used. The operational balance consists of revenue less expenditure of the Treasury. It includes only the real portion of interest payments on indexed debt. The financial balance of the Treasury consists of the operational deficit plus the Treasury's net lending and changes in its equity holdings. This represents the Treasury's net borrowing requirement, excluding valuation changes on indexed debt. The gross public sector borrowing requirement (PSBR) consists of the Treasury's gross borrowing requirement plus direct gross borrowing by other public sector entities. Because it represents gross financing needs, it includes the valuation changes on outstanding indexed debt as the debt falls due. The gross PSBR is not a fully satisfactory measure of the government borrowing requirement, however, because the amount of refinancing in any one year can substantially distort the data; it is therefore not used in this report.

Table 3. Iceland: Public Finances

(In percent of GDP)

	1984	1985	1986	1987 Budget law 1/	1987 Outcome	1988 Budget law 1/	1988 Official estimates 2/	1989 Budget proposal
Treasury 3/								
Revenue	23.5	22.6	24.0	24.4	23.7	26.2	26.3	28.1
Expenditure	22.7	24.6	25.2	26.0	25.0	26.2	27.4	27.7
Operational balance	0.9	-2.0	-1.3	-1.6	-1.3	—	-1.2	0.4
Financial balance	-0.3	-3.4	-1.7	-1.5	-2.7	-0.2	-1.4	0.7
Total public sector								
Gross borrowing requirement	5.7	6.8	6.1	4.0	4.2	2.5	4.2	2.3

Source: Data provided by the Icelandic authorities.

1/ As a ratio to GDP, as projected at the time of the budget.
2/ As of October 1988.
3/ Because of a change in coverage, data for 1985 and before are not fully comparable with data for 1986 onward.

Table 4. Iceland: Monetary Survey (Flows) 1/

	1984	1985	1986	1987	1988 12 months to Sept.
	(In millions of krónur)				
Foreign assets (net) 2/	-6,374	-2,576	1,549	-6,270	-12,934
Net domestic assets	13,031	15,223	12,197	25,072	30,033
Of which:					
Credit to public sector 2/	2,828	5,610	2,551	5,193	8,188
Credit to nonbank financial institutions	733	493	868	754	21
Credit to the private sector	11,491	10,847	8,624	22,895	31,058
Broad money	6,657	12,647	13,746	18,803	17,098
	(In percent change)				
Memorandum items:					
Broad money (M_3)	33.4	47.6	35.0	35.5	26.0
Narrow money (M_1)	42.5	27.3	43.8	33.0	19.9
Domestic credit (increase as percent of M_3 one period earlier)	75.5	63.8	30.7	54.4	59.8
Lending of deposit money banks	46.2	30.4	21.0	45.8	39.2
Base money 3/	29.1	50.1	33.0	35.3	21.6

Sources: Central Bank of Iceland, Annual Report 1987 and Economic Statistics, various issues; information provided by the Icelandic authorities; and staff calculations.

1/ Consolidated accounts of the Central Bank and deposit money banks. Does not include mortgage departments of banks.
2/ Net foreign assets and domestic credit to the public sector are adjusted so as to treat foreign borrowing by the Treasury as domestic credit.
3/ Base money is adjusted for changes in the reserve requirement.

The Icelandic authorities have in recent years put increasing emphasis on the exchange rate as a nominal anchor. By fixing the nominal exchange rate, the authorities were able to hold down the rate of inflation during 1987. 1/ However, as this policy was not sufficiently supported by monetary and fiscal policies, it failed to achieve the objective of greater wage restraint. Nominal wages continued to increase rapidly, resulting in large shifts in the relative price of tradables to nontradables, and unsustainable gains in real household incomes.

In concluding the 1987 Article IV consultation, Executive Directors observed that Iceland's period of rapid growth appeared to be coming to an end, and that the purchasing power of exports was likely to rise little, if at all, in 1988. They felt that internal pressures would cause a further substantial deterioration in the balance of payments, unless domestic demand was restrained, and that tighter financial policies were urgently needed. They also voiced concern about the large appreciation of the real exchange rate. While most felt that there would be little benefit from currency depreciation in an overheated economy, they hoped that exchange rate action would be part of a larger policy package, which would also include wage restraint.

III. The Icelandic Economy in 1988

1. Economic developments

The boom in the Icelandic economy ended in 1988. The most important cause of this turnaround was a fall of marine exports as the fish catch and fish export prices declined. However, the estimated fall in marine output by 2 percent should be viewed in the light of the strong recovery in previous years. Similarly, the weakening of fish prices appears to constitute a correction of the rapid price increases in recent years. There were also domestic reasons which contributed to the downturn in economic activity including a decline in profitability of the tradable goods sector, a rise in real interest rates, saturation of investment demand, and stagnation in real household income. Clear signs of the turnaround have included a decline in retail sales, an increasing number of bankruptcies, and a progressive easing of labor market conditions.

At the time of the staff visit in November, the Icelandic authorities expected a fall in real GDP and real final domestic demand of 1.4 and 0.8 percent, respectively, in 1988 (Table 1). 2/ Real private consumption was to be surprisingly subdued considering the rise

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1/ The exchange rate of the Icelandic króna is determined on the basis of a basket of currencies.

2/ Most recent information indicates a somewhat larger decline in GDP and domestic demand.

in household saving in the preceeding years. Available information also suggested that, following the rise in real interest rates and a deterioration in business profitability, the share of gross capital formation in GDP had declined slightly. Gross national saving was estimated to have fallen to 13.6 percent of GDP.

Through the first eight months of 1988, prices and wages continued to increase rapidly. Inflation slowed after the introduction of a wage and price freeze at the end of August. In the three months through November, the cost of living index rose by only 2.8 percent at an annual rate. It was estimated that the rate of inflation would amount to 25.5 percent in the twelve months through December, implying an average annual rate of the same amount. Iceland experienced further significant adverse developments in relative prices in 1988. While the GDP deflator was estimated to have risen by 24.3 percent, export and import prices increased far less. According to the Fund's Information Notice System (INS), through the month of October, the real effective exchange rate had appreciated by 5.3 percent compared with the average level of 1987.

Official estimates for 1988 showed a fall in the volume of merchandise exports (Table 2). By contrast, the volume of merchandise imports was expected to increase by 3 percent, reflecting a substantial increase in imports related to the processing of aluminum and ferrosilicon. The terms of trade were unchanged as weaker fish prices were offset by higher prices for aluminum and ferrosilicon and lower import prices for oil. With a trade deficit of 2 percent of GDP, 1/ the current account deficit was estimated to have widened further to 4.6 percent of GDP. On the basis of these estimates and reflecting the real appreciation of the exchange rate, net external debt was estimated to rise only a little, to 43.1 percent of GDP by the end of 1988. At the end of December, gross official reserves amounted to SDR 217.6 million equivalent to 2.2 months of merchandise imports, c.i.f..

2. Policies in 1988

Policies in 1988 were aimed at a combination of structural and contracyclical objectives. The two objectives of fiscal policy for 1988 were the implementation of a tax reform, and the balancing of the Treasury's operational budget. Almost two-thirds of government revenue was covered by the tax reform, including personal income taxes, payroll taxes, sales taxes, excise taxes, and import tariffs. The personal income tax system was greatly simplified, and tax collection was put on a pay-as-you-earn (PAYE) basis in order to make revenue collection more of an automatic stabilizer for the economy. The major change in indirect taxation was a broadening of the base for the sales tax, with an eventual move to a value added tax in mind. The import duty system

1/ Most recent information indicates a somewhat lower trade deficit.

was substantially simplified and the average duty was lowered. The tariff reform was also seen as a means of achieving greater harmonization with the European Community (EC).

In the 1988 budget as approved by Parliament, the ISK 2.7 billion operational deficit in 1987 (1.3 percent of GDP) was to be eliminated by, inter alia, ISK 2 billion in increased net revenue stemming from the tax reform, and from increases in other taxes and Government monopoly profits. The revenue increases were to be partially offset by increased subsidies, particularly on food items, and increases in child allowances in order to cushion the effect of the increased sales tax. With the operational budget balanced, the Treasury's financial balance was to show a deficit of only 0.2 percent of GDP (Table 3). This was to be more than covered by domestic non-monetary borrowing, allowing net repayments to the Central Bank and to creditors abroad.

In February 1988, a number of additional fiscal measures were announced which, along with a devaluation of the króna, were designed to improve the profitability of the export industries, especially the fishing sector. In order to leave the budget in balance, there were tax increases as well as cuts in expenditures.

The Icelandic representatives reported that during the first few months of the year the budget had developed largely as anticipated. From the end of the second quarter onward, however, the slowdown in the economy had had an increasingly negative impact on revenues. By October, it appeared that the operational deficit for 1988 would amount to ISK 3 billion or 1.2 percent of GDP (Table 3), as real revenue was estimated to fall short of the revised February projection by the equivalent of 0.7 percent of GDP. The shortfall in real indirect tax revenue was particularly large. However, the PAYE system seemed to work well, and personal income tax receipts were higher than projected. At the same time, total real expenditure was expected to be 0.5 percent of GDP higher than budgeted, largely as a result of higher than expected interest payments.

By December, after the staff's visit, it had become clear that indirect tax revenue had fallen sharply in the last months of the year due to the decline in economic activity. The estimated operational deficit for the year is therefore likely to be revised upward significantly to about ISK 6 billion, or around 2.5 percent of GDP.

Although the Treasury's financing requirement rose during 1988, there were net redemptions of government securities in the first half of the year, and net repayments on foreign loans. As a result, the Treasury's use of Central Bank credit rose very sharply. To remedy this, the Icelandic representatives stated that in August the Treasury had signed an agreement with the banks and with the securities houses, stipulating that these institutions would underwrite government bonds in an amount that would meet the original budget target for gross bond sales during 1988. The underwriting agreement was part of the Central

Bank's continuing effort to develop secondary markets in government paper to facilitate the nonmonetary financing of the Treasury's borrowing requirement. At the same time, the reserve ratio applied to the banks was reduced by one percentage point, the liquidity ratio was raised by one percentage point, and banks were allowed to count half of their bond holdings as qualifying liquid assets. 1/ By law, any short-term Treasury debt outstanding to the Central Bank at the end of the year, must be repaid by the end of the first quarter of the following year. In order to make these repayments, the Treasury borrowed ISK 3.4 billion abroad at the end of 1988 and was expected to borrow additional amounts in early 1989.

The mission expressed concern about the large monetary financing of the Treasury in 1988 which made control over domestic credit expansion difficult. In addition, the new regulation, allowing part of the banks' holdings of government bonds to count toward satisfying the liquidity ratio, diminished the effectiveness of this particular instrument.

Total domestic credit relative to the level of M_3 one year earlier, rose by 60 percent in the twelve months to September (Table 4). Reflecting the external current account deficit, the net foreign assets of the banking system declined, despite continued foreign borrowing by the private sector. The growth of broad money slowed to 26 percent. Loan demand from the private sector continued to be relatively strong despite the slowdown in domestic demand and the increase in real interest rates. However, much of the growth in credit was to firms in the fishing industry and in other industries in distress.

Although nominal interest rates were lowered briefly in February and March of 1988 following a temporary slowdown in inflation, the average level of both nominal and real rates generally remained high through July (Chart 4). In July, the nominal rate on nonindexed loans stood at about 40 percent; using the ex post inflation rate over the previous 12 months as a deflator, this implied a real rate of 11 percent. Real rates on deposits also tended to increase in 1988, although there remained a large margin between lending and deposit rates.

The previous Government had already moved to support the profitability of the export industry, and to stem the deterioration in the external accounts by devaluing the Icelandic currency in February and again in May of 1988. Nevertheless, when the new Government came into office in September, the economic situation had worsened significantly. In order to deal with accelerating wage and price inflation, and with the deterioration in the balance of payments, the new Government extended through February 1989 a one-month price and wage freeze, originally put into effect at the end of August, and devalued

1/ For a description of the Central Bank's monetary control instruments, see the 1988 Recent Economic Developments report (SM/88/14, 1/15/88), Section IV and Appendix II.

the currency by an additional 3 percent. Other measures aiming at improving the position of the private business sector included the establishment of an Export Industry Restructuring Fund to ease the financial strains of enterprises with weak profitability while at the same time assisting in a restructuring of those enterprises, and the authorization of additional borrowing by the Fish Price Equalization Fund to support the fish processing industry. As it was hoped that the price and wage freeze would help to bring down substantially the rate of inflation, the Central Bank was instructed to negotiate with credit institutions in order to reduce interest rates. The Government also announced that the 1989 budget proposal would show a surplus.

IV. Outlook and Economic Policies

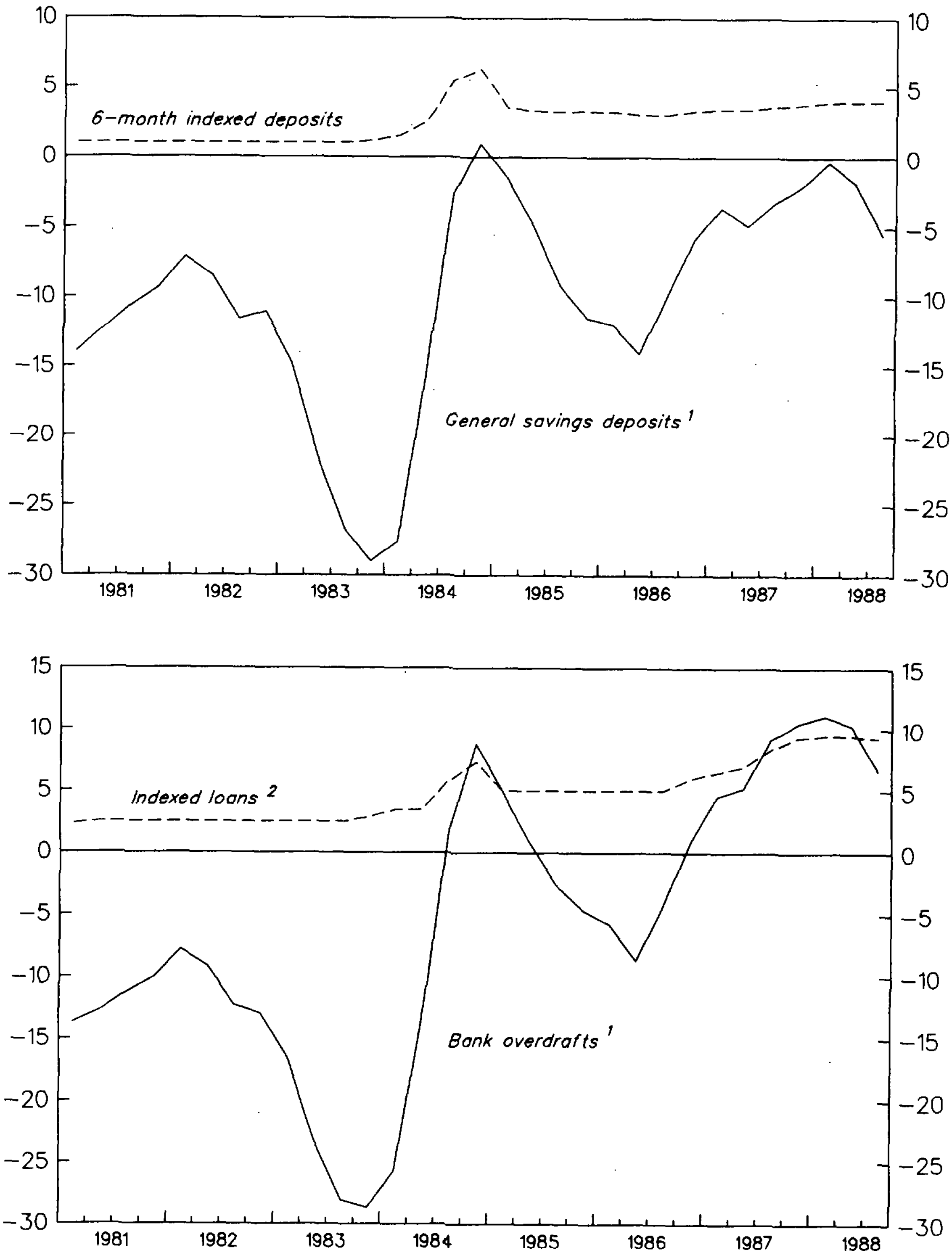
1. Outlook

The economic prospects for 1989 and for some years beyond are not very promising. In particular, the outlook for the fish catch over the next few years is highly uncertain. There are concerns that the catch may have to be reduced sharply. For some time, Iceland's marine biologists have been warning that the recent high catch levels were endangering the future fish supply and have recommended significant cuts in the fishing quotas. At the time of the consultation discussions, it appeared likely that the fishing quotas would be set so as to reduce the catch by 4.5 percent in 1989. The official forecasts for 1989 were based on this assumption. Subsequently, the quotas were set so as to decrease the catch by 6.6 percent.

For 1989, official projections as of October 1988 envisaged a 2.8 percent decline in real final domestic demand (Table 1). 1/ The authorities expected that the weakening economy would result in downward pressure on real wages, and projected a 6.3 percent decline in real disposable income. Household spending, however, would adjust only gradually. A further decrease, by 3.2 percent, was also expected for real gross fixed investment. Despite a positive contribution from foreign trade, real GDP was forecast to decline further by some 1.6 percent. The share of gross capital formation and gross national saving were both projected to decrease only slightly, thereby leaving the external current account deficit unchanged. While it was expected that public sector saving would increase, reflecting a tightening of fiscal policy, private saving would be adversely affected by poor income developments.

1/ It is expected that the forecast for 1989 will be revised because of the above-mentioned lowering of the fish quotas and a larger than expected decline in economic activity in 1988.

CHART 4
ICELAND
REAL INTEREST RATES ON BANK DEPOSITS AND LOANS



Source: Central Bank of Iceland.
1 Deflated by change in credit terms index (consisting two–thirds of the cost of living index and one–third of the building cost index) during the past four quarters.
2 Maturity over 2 1/2 years.

Helped by the lower demand, the wage and price freeze was expected to significantly moderate inflationary expectations. During the year, consumer prices were assumed to increase by only 6 percent which translated to 12 percent on an average annual basis. Nominal wage earnings would increase at the same rate as consumer prices during theyear but would fall behind on an average annual basis. The authorities based the projections for 1989 on the assumption of an unchanged real effective exchange rate.

Reflecting a decline in marine exports and sluggish growth in the remaining parts of the tradable goods sector, which are either constrained by limitations in capacity or hampered by the high real exchange rate, merchandise export volume was projected to decline by 2.3 percent in 1989 (Table 2). A slight increase in exports of services was expected, which would help limit the reduction in total exports to only 1.1 percent. Despite the rise of the real exchange rate, and the relatively modest reduction in domestic demand, the volume of imports of goods and services was expected to decline by as much as 3.8 percent. The trade deficit, however, would remain at 2 percent of GDP because the terms of trade would be negatively affected by weak fish prices and lower world market prices for aluminum and ferrosilicon. The current account deficit would stay unchanged at 4.5 percent of GDP. Net external debt would edge higher reaching 46.9 percent of GDP.

2. Fiscal policy

The budget proposal for 1989, as submitted to Parliament in November 1988, called for an operational surplus of 0.4 percent (Table 3). It was framed against the expectation that the operational deficit in 1988 would be equivalent to 1.2 percent of GDP. The improvement was to be achieved through an increase in tax receipts relative to GDP while nominal expenditures were to be kept largely in line with growth in nominal GDP. The rise in revenue was to be generated by increased taxation of personal net wealth, personal and business income, higher excise taxes, and a tax on lottery tickets. On the expenditure side, the Treasury's wage bill was to rise by only 9 percent, as the number of hours worked was to be reduced 2.5 percent mainly through a reduction in overtime. The largest expenditure increases included outlays for social security and interest payments.

The Icelandic representatives believed that the 1989 budget proposal represented a significant adjustment effort. The budget surplus was also aimed at facilitating a reduction in interest rates. Moreover, additional measures would be taken during the year if necessary to assure that the budgeted surplus was reached. The Icelandic representatives pointed out, however, that, as the recession became more apparent, there was pressure to adopt a more relaxed fiscal policy stance. They agreed that there would have to be continued fiscal adjustment over the medium term in order to put Iceland's external position back onto a sustainable path.

In addition to an operational surplus, the 1989 budget proposal included a significant reduction in lending by the Treasury such that the Treasury's net financial balance would show a surplus equivalent to 0.7 percent of GDP. The Treasury's borrowing requirement was to be more than met by domestic sales of government securities outside the Central Bank.

3. Monetary policy

The Icelandic representatives stated that the indicative credit plan for the economy for 1989 called for a tight credit market. The 1989 budget proposal implied that Treasury operations would result in a net withdrawal of liquidity from the banking system. This would contribute significantly to a reduction in the growth of total credit. The mission noted that it would be important that domestic credit expansion in 1989 be reduced to rates consistent with the authorities' target for nominal income which envisaged a sharp reduction in the rate of inflation.

In conjunction with the wage and price freeze enacted in August 1988 and extended in the package of economic measures adopted at the end of September, the Central Bank was requested to work with the commercial banks to bring about a decrease in nominal interest rates. If the discussions did not lead to an agreement on satisfactory rate reductions, the Central Bank was authorized to determine nominal rates, under the 1986 Central Bank Law. 1/ The Icelandic representatives felt that the policy of more directly influencing the determination of interest rates was necessary because the banking system was not very efficient and interest rates did not adjust quickly enough to changing circumstances. By the end of October, nonindexed lending rates had been reduced from around 40 percent to 20 percent and the rate on general savings deposits from 25 percent to 6 percent. Indexed rates were also reduced slightly, for example from 9.5 to 8.7 percent on loans and from 4 to 3.3 percent on 6-month time deposits. The Icelandic representatives said that based on month-to-month inflation rates under the price freeze, however, nonindexed interest rates were substantially positive in real terms, and that there was pressure for a further reduction in rates.

1/ Throughout the 1970s and early 1980s, nominal nonindexed interest rates were set by the Central Bank. The determination of interest rates was gradually liberalized between August 1984 and November 1986, when the new Central Bank Law went into effect. However, under the new law, the Central Bank, with the approval of the Ministry of Commerce, can impose limits on interest rates to ensure that real rates are not higher than those prevailing in Iceland's major trading partners as well as to ensure that the margin between domestic deposit and lending rates is not inordinately high.

The mission said that the desire to reduce interest rates was understandable given the recessionary tendencies in the economy, but it cautioned against a reduction in rates brought about by direct intervention, particularly in view of the uncertainty about the effect of the wage and price freeze on inflationary expectations after the freeze ended. Interest rates should be allowed to find the level which was consistent with market conditions and sentiments. The Icelandic representatives agreed that the adequacy of the rates depended on whether the general public believed that economic policies would lead to a lasting reduction in inflation. The Government was trying to create a climate allowing for moderate wage growth and low interest rates after the freeze ended in February 1989. However, the Icelandic representatives agreed that if financial policies were not sufficiently restrictive and inflation accelerated after the end of the freeze, it would not be possible to reduce interest rates further but rather it might be necessary to raise them again.

Subsidized mortgage credits through the housing funds continued to grow rapidly in 1988, absorbing a large part of domestic savings. The Government has recognized the need for a review of the housing finance system, and an official committee is preparing recommendations for changes in the system. The proposed changes are likely to include making access to the subsidized credits subject to a means test and more market-oriented financing of housing loans with any interest subsidy being covered by transfers from the Treasury.

4. External competitiveness and exchange rate policy

The exchange rate has increasingly been seen by the authorities as an instrument to moderate price and wage developments. Nevertheless, during 1988 the Icelandic króna was devalued three times, mainly in order to provide relief to the fishing industry at a time when revenues from stagnating exports were insufficient to cover the strong rise in domestic costs. The Icelandic representatives stated the intention to use exchange rate policy to hold down inflation and influence wage settlements. This would be helped in part by the weakening of demand and the easing of labor market pressures. Moreover, by not fully accommodating cost developments, it was hoped that exchange rate policy would encourage a necessary restructuring of the fishing industry, which was troubled by inefficiencies and overcapacity.

While welcoming the general aim of lowering inflation, the staff noted that, as of October 1988 the real exchange rate was still notably higher than in 1986, the year in which the external current account registered a modest surplus. The maintenance of a strong real exchange rate for anti-inflationary purposes would put a heavy burden on financial policies and was likely to risk higher unemployment. The Icelandic representatives agreed that a policy of keeping the nominal exchange rate stable required compatible domestic cost and price developments. The mission observed that for an improvement of the external accounts even stronger adjustment efforts would be needed.

Should fiscal and monetary policies turn out to be insufficient to balance the external accounts, then exchange rate policy would also have a role to play.

5. Devaluation of the Icelandic króna on January 3, 1989

Effective January 3, 1989, the exchange rate of the Icelandic króna was devalued by 4.9 percent against the basket of currencies to which it is pegged. At the same time, the Government authorized the Central Bank to fix the daily rate of the króna within a limit of 1.25 percent in either direction from its effective basket rate. This authorization would be used during periods of unexpected fluctuations in the exchange rates of the main currencies. The devaluation is expected to result in a 1-2 percent increase in the price level.

Due to the fall in the value of the U.S. dollar between December 30, 1988 and January 3, 1989, the devaluation implied a 4 percent decrease in the value of the króna against the dollar from its quotation on December 30, 1988. The previous devaluation of the króna by 3 percent on September 28, 1988 was intended to improve the profitability of the export industries, especially the fish freezing plants, and halt the deterioration of the external current account. The subsequent depreciation of the dollar eroded the benefits of the September devaluation for the dollar-based export industries. The devaluation of January 3, 1989 brought the rate of the króna vis-à-vis the dollar back to its level immediately after the September devaluation.

6. Medium-term scenarios

In the medium-term, Iceland faces a substantial need for adjustment. While the figures of the medium-term scenarios (see Appendix I) are illustrative in nature and any projections beyond 1989 are highly uncertain, they give a general idea of the magnitudes involved. Depending on assumptions about the future fish catch and the mix of domestic and external adjustment policies, domestic demand might have to be reduced substantially in the period from 1989-91. The scenarios point to a dilemma for the authorities to choose between a strategy fully based on domestic policies involving serious losses in economic growth, and more reliance on changes of the exchange rate which, however, would have inflationary consequences and, for a lasting improvement, would still need to be strongly supported by domestic adjustment.

7. Structural issues

The Icelandic representatives explained that the fishing industry was experiencing severe problems due to the decline in fish export prices and the rise in domestic costs. In addition, structural changes were taking place such as an increase in freezing and processing of fish at sea, and containerized shipping of fresh fish to the European markets. There was also a need for an increase in efficiency. These problems were further complicated by social and regional considerations. The small towns along the coast, where fish processing enterprises often are the only employers, had been more adversely affected and have fewer economic alternatives to exploit than in the Reykjavik area. The establishment of the Export Industry Restructuring Fund in September of 1988 constituted a first step to deal with some of these difficulties. The Fund was to support the export industry through loans and rescheduling of debt. The mission expressed understanding for the aim of the authorities to mitigate regional imbalances but wondered to what degree the Fund would only serve to delay necessary changes in the industry. The Icelandic representatives replied that a major objective was to bring about a restructuring of the fishing industry and to improve productivity. The Fund would impose strict requirements on companies that received financial support.

The Icelandic representatives said that there was potential for export diversification through fish farming and manufacturing of fishing equipment. An expansion of aluminum production was also under consideration. However, there was a risk that expansion of these activities would add to regional imbalances, in that they were likely to be located mainly in the Reykjavik area. Furthermore, such expansion would require a release of labor from the fishing sector through higher productivity.

8. Trade and aid

Iceland continues to maintain an open trading system despite pressures from certain domestic industries for protection against imports, and to support multilateralism in world trade. The Government intends to follow closely the efforts by the European Community to create a single internal market by 1992 and to decide flexibly on its own policies. The staff has been informed that the Government is giving serious consideration to making a contribution to the Fund's Enhanced Structural Adjustment Facility (ESAF).

V. Staff Appraisal

After the boom of recent years, the Icelandic economy experienced increasing recessionary tendencies in 1988. Real GDP fell, while prices and wages continued to rise sharply in the first eight months of the year. The budget deficit is likely to have increased significantly over 1987, and domestic credit continued to expand strongly despite the slowdown in economic activity. The external current account deficit is estimated to have widened to about 4 1/2 percent of GDP. Prospects for 1989 and beyond are not bright either, mainly because of the likelihood of continued lower fish catches and uncertainties concerning fish export prices.

The previous Government had attempted to deal with the difficulties in the external sector by devaluing the Icelandic currency twice in 1988, but in the absence of supporting policies and wage restraint without lasting success. When a new Government came into office in September 1988, Iceland's economic situation had worsened further, calling for corrective action. In order to break the inflationary spiral and to assist the export industries, a number of interim measures were taken at once. The wage and price freeze is expected to significantly moderate inflationary expectations, helped also by the slowdown in economic activity. Of course, inflationary expectations are not easily turned around. The test is not in the low monthly figures during the price freeze but in developments after the freeze comes to an end in March.

In their general strategy, the authorities place special emphasis on the role of the exchange rate in restraining price and cost inflation. The devaluation of January 3, 1989 was moderate in size, and its impact on inflation is expected to be limited. Its purpose was to give relief to particular export industries affected by the decline of the U.S. dollar. A lasting improvement in the situation of export industries and in the external current account, however, will depend on the future mix of policies. For the authorities to succeed in maintaining a relatively stable exchange rate over time, it will be indispensable to keep cost developments in line with those in partner countries. To reduce the deficit in the external current account in the absence of further devaluations, domestic demand would have to be substantially reduced by very stringent financial and incomes policies which would risk higher unemployment. On the other hand, any exchange rate action would also need to be supported by tight financial and incomes policies if past cycles of devaluations and inflationary outbursts are not to be repeated, and a lasting improvement of the external accounts is to be achieved. The medium-term scenarios in Appendix I give a general idea of the required adjustment over the medium-term, and the tradeoff between different adjustment strategies.

Budget developments in the recent past, including 1988, have been disappointing. For 1989, the Government has introduced a budget which contains a small operational surplus. The staff recognizes the effort implied in the budget as proposed, but this has to be seen against the magnitude of the external imbalance as shown by the current account deficit and Iceland's foreign debt. Therefore, the Government should resist pressure to ease the fiscal policy stance on grounds of recessionary risks. In the staff's view, the budget surplus can only be seen as a first, although significant, step, and additional adjustment efforts will be needed in future years. In this connection, the staff would like to suggest that the authorities undertake a medium-term fiscal programming exercise.

The level of real interest rates has received particular attention from the authorities, as recessionary tendencies have become more pronounced. The staff understands the desire to obtain lower real interest rates but is not convinced that the time has come for a significant reduction. In particular, the effect of the wage and price freeze on inflationary expectations, after the freeze ends, remains uncertain. Interest rates should be allowed to find the level which is consistent with market conditions and with the need to secure adequate nonmonetary financing for the Treasury's borrowing requirement. Setting interest rates too low would risk excessive monetary growth. The expansion of credit in 1989 should be reduced to a rate which is consistent with the lower inflation target and the need to safeguard the balance of payments.

In the past, the staff had welcomed the deregulation of financial markets, which is a precondition for their efficiency. Continuity in this area is important for policy to be credible. A renewed reliance on intervention in the determination of interest rates would be a set-back in this respect. The staff also welcomes the Central Bank's efforts to develop secondary markets in government paper.

The Icelandic economy is facing structural problems. In this respect, social and political priorities have to be respected. Nevertheless, the measures chosen also need to be consistent with overall economic and financial balance. The staff is encouraged, therefore, by the fact that the newly established Export Industry Restructuring Fund is not seen as an instrument simply to accommodate enterprises in difficulties, but also to assist in the restructuring of the industry. The structural weaknesses would also be eased by export diversification. However, with limited labor resources, a necessary condition for future expansion of the non-traditional economy is an improvement in the efficiency of the fishing sector.

The staff commends Iceland's support for an open and multilateral world trading system and welcomes the consideration the Government is giving to making a contribution to the Fund's Enhanced Structural Adjustment Facility.

Iceland has been placed on the bicyclic procedure by the Executive Board, and therefore the 1989 Article IV consultation with Iceland will be completed not later than January 1990.

Iceland - Illustrative Medium-Term Scenarios

This note presents the results of medium-term simulations of Iceland's balance of payments and external debt for the period 1989-94. The intention is not to provide forecasts but rather to highlight major developments that may take place under various assumptions about the external environment and domestic policies. The calculations are based on the official balance of payments and national accounts estimates for 1988 as of October of that year.

The assumptions concerning external developments are consistent with the Fund's latest World Economic Outlook exercise (WEO) in December of 1988. 1/ Other external assumptions relate to the output in the fishing sector. The prospects for the fish catch over the next couple of years are uncertain. In recent years Iceland's marine biologists have been concerned that current catch levels have been unsustainable and have stressed the need for building up the fish stock in order not to have a sharp decrease in the catch over the medium-term. However, it is also possible that a recovery may take place in the beginning of the 1990s depending on the conditions in Icelandic waters.

Scenarios 1 and 2 assume that the fish catch will decline by 6.6 percent in line with official forecasts for 1989. The two scenarios are drawn up under the staff's assumption that the fish catch will be unchanged in 1990, recover by 4 percent in 1991, and then grow by 2.5 percent annually. Scenario 3 is based on the more pessimistic assumption that the fish catch will decrease by 7.5 percent in 1989 and by 4.5 percent in 1990. It then recovers only slowly, increasing by 3 percent in 1991, and by 1.5 percent each year in 1992-94. In all scenarios, exports of aluminum and ferrosilicon are increased slightly in 1989 as envisaged in official forecasts and are then held constant reflecting capacity constraints. Other items of goods and nonfactor services exports and imports are, apart from relative prices, largely determined by demand in partner countries and domestic demand, respectively.

Scenarios 1 and 2 are based on a target for the ratio of net external debt to GDP by 50 percent in 1994. Although this is higher than at present, a more ambitious target would not appear to be realistic considering the adjustment effort that is required. The two scenarios differ only with respect to domestic policies. Scenario 1 assumes an unchanged real effective exchange rate. Instead, adjustment

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1/ Marine export prices have been assumed to increase in line with consumer prices abroad. Prices of aluminum and ferrosilicon are based on Research Department's forecasts of metals prices. Other export and import prices follow export unit values of partner countries. Interest payments on floating rate loans and newly contracted debt are calculated using the WEO assumptions for the six-month LIBOR. Other WEO assumptions include output and imports of partner countries.

is assumed to take place through demand compression brought about by monetary and fiscal policies. 1/ Scenario 2 is used to evaluate the consequences of allowing changes in the real exchange rate. Scenario 3 illustrates the impact of a less favorable fish catch assumption with an even more stringent policy response.

Scenario 1 requires that real domestic demand is reduced by a total of nearly 15 percent in 1989-91 through domestic financial policies only. 2/ It then grows by 1 percent annually. Scenario 2 assumes that the real exchange rate is reduced by 13 percent in 1989-90, thereby reversing the appreciation that took place in 1987 and 1988, and that it is unchanged in subsequent years. Even so, real domestic demand has to be reduced by 9.5 percent in 1989-91. Thereafter, it can grow by only 1 percent per annum if the external debt target is to be met. Scenario 3 is based on the same path for the real exchange rate as scenario 1. *With the lower fish catch, real domestic demand needs to be reduced by* 12.5 percent in 1989-91 and is then held constant. All scenarios show a gradual improvement in Iceland's external position (Chart 5). The most significant difference between the scenarios concerns real GDP growth in the 1989-91 period. Scenario 1 envisages an annual average decline in real GDP by 3.5 percent per annum. In scenario 2, with the depreciation of the real exchange rate, the decline in real GDP would be limited to only 1.5 percent. In both scenarios, real GDP would increase by nearly 1.5 percent in 1992-94.

Sensitivity tests for scenario 2 are shown below (Table 5). The table summarizes the impact in 1994 of changes in the following assumptions: (1) one percent lower growth rate in marine export prices or the fish catch from 1989 onward; (2) one percent higher international interest rates from 1989 onward; (3) one percent additional reduction of domestic demand in 1989; and (4) five percent less reduction of the real exchange rate in 1989-90.

The calculations show that Iceland's external position is heavily influenced by the development of the fish catch. Weaker fish prices or further reductions in the fish catch could lead to a substantial rise in the debt ratio over the medium term. Significant further adjustment efforts would need to be taken in order to stem the deterioration in the external accounts. Conversely, it should be noted that a higher growth in the volume of marine exports or higher fish prices would have effects of about the same magnitude but in the opposite direction. In that case, less stringent policies would be needed in order to meet the debt target. An additional reduction of domestic demand in 1989 would have a

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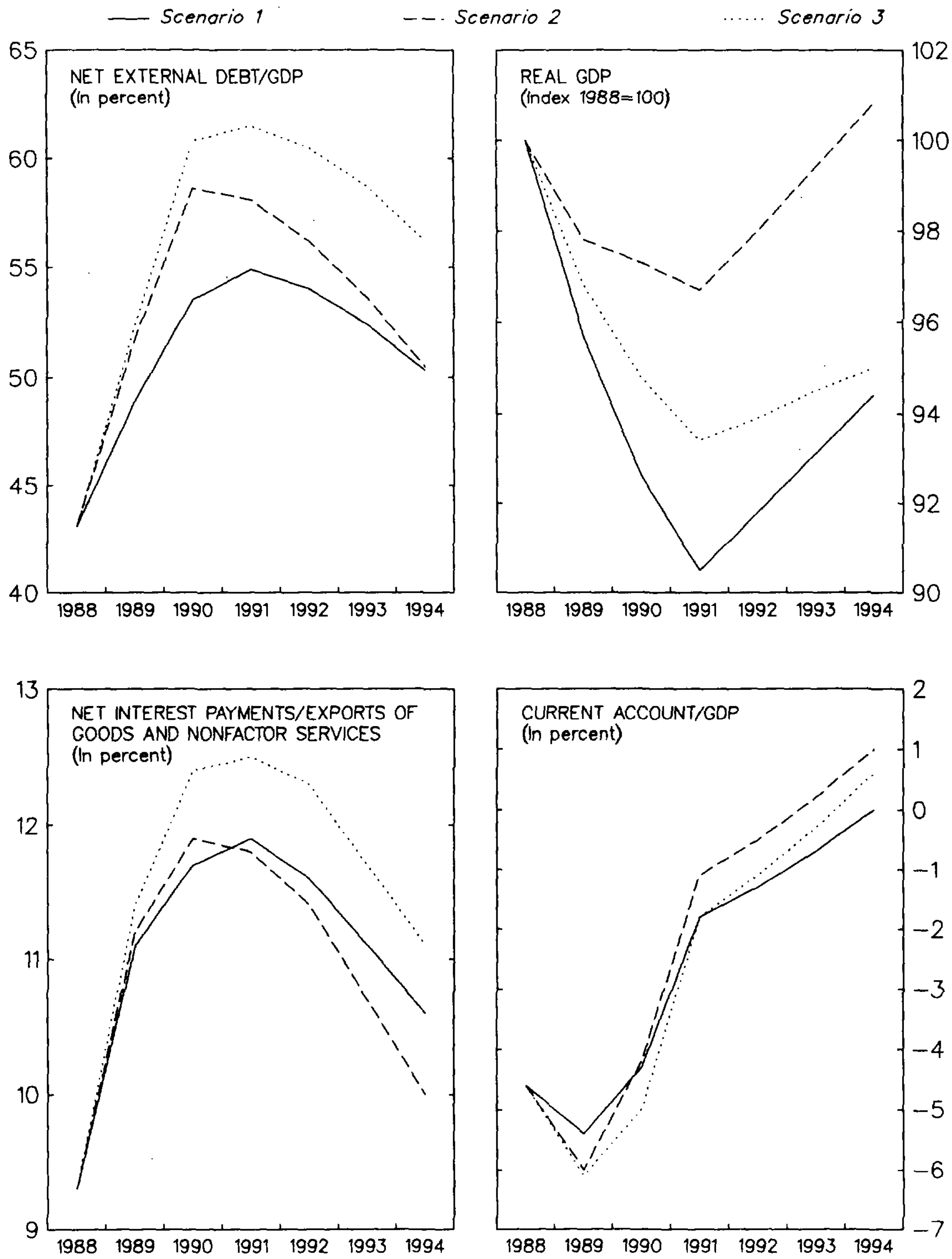
1/ These policies are, however, not explicitly introduced in the calculations as domestic demand is exogenously determined.

2/ Lower imports for 1988 than included in the October 1988 estimates would in all scenarios imply a more favorable outcome with regard to the debt ratio in 1994 or, alternatively, a diminished need for adjustment over the medium-term.

substantial favorable impact on Iceland's external debt burden or, alternatively, require less adjustment efforts in subsequent years. Finally, a less ambitious policy with regard to the real exchange rate would result in a higher debt burden.

In conclusion, the calculations indicate that Iceland faces significant difficulties over the medium-term. The degree of the adjustment effort Iceland has to undertake depends to a large extent on the development of marine exports. Even under fairly optimistic assumptions, however, much would be required. Holding the real effective exchange rate at its present level would require fiscal and monetary policies to be more stringent in reducing domestic demand than otherwise. This approach would therefore result in substantial reductions in economic activity and is likely to be costly in terms of employment.

CHART 5
ICELAND
MEDIUM–TERM SCENARIOS



Source: Data provided by Icelandic authorities and staff calculations.

Table 5. Iceland: Impact of Changes in the Assumptions for Scenario 2 in 1994

Medium-Term Outlook Sensitivity Analysis

	Current Account/GDP	Net External Debt/GDP	Net Interest/ Total Exports 1/
	(Deviations in percentage points)		
Changes in assumptions as compared to scenario 2:			
1 percent lower growth rate of marine exports 1989-94	-1.6	5.8	1.2
1 percent higher interest rates 1989-94	-0.4	1.4	1.0
1 percent additional reduction of domestic demand in 1989	0.6	-2.3	-0.4
5 percent less reduction of real effective exchange rate in 1989-90	-1.4	3.5	1.0
	(In percent)		
Scenario 2	1.0	50.5	10.0

Source: Staff calculations.

1/ Goods and nonfactor services.

Fund Relations with Iceland

(As of December 31, 1988)

I. Membership status

(a) Date of membership: December 27, 1945.

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

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 59.60 million.

(b) Total Fund holdings of krónur: SDR 55.58 million (93.26 percent of quota).

(c) Fund credit: none.

(d) Reserve tranche position: SDR 4.03 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 16.41 million.

(b) Holdings: SDR 0.99 million or 6.06 percent of net cumulative allocation.

(c) Current designation plan: not applicable.

V. Administered accounts

Not applicable.

VI. Overdue obligations to the Fund

None.

B. Nonfinancial Relations

VII. Exchange rate arrangements

There is no organized foreign exchange market in Iceland. Official buying and selling rates for the U.S. dollar, the principal trading and reserve currency, are quoted by the Central Bank of Iceland, and fixed so that the króna remains pegged to a trade-weighted basket of currencies. The nominal effective exchange rate depreciated by 4 percent during 1987. During 1988, the króna was devalued three times by a total of 19 percent. On December 30, 1988 the official market rates were ISK 46.16 buying, and ISK 46.28 selling per US$1. On January 3, 1989 the króna was devalued by 4.9 percent. There are no multiple currency practices or exchange restrictions.

VIII. Last Article IV consultation

Discussions for the 1987 Article IV consultation were held in Reykjavik during the period October 29-November 9, 1987. The Staff Report (SM/87/289, 12/11/87) was discussed by the Executive Board on January 29, 1988 (EBM/88/12). The next consultation is expected to be a full Article IV consultation, to be held within 12 months.

IX. Technical Assistance

Technical assistance was provided by the Legal Department in 1986-87 relating to a revision in Iceland's personal and corporate income tax legislation.

Iceland: Statistical Issues

1. Outstanding statistical issues

a. Monetary accounts

No monthly or quarterly finance data are reported for publication in IFS, and the most recent annual data published for central government in IFS and in the 1987 GFS Yearbook are for 1985. During the 1987 Article IV consultation mission the authorities stated that, with increased computerization, they expect to improve currentness significantly in the immediate future. For local government, data have not been reported beyond 1977, but the authorities have indicated that the accounts are available; the Statistical Bureau of Iceland and the Government Accounting Office are presently working on the preparation of 1979-86 local government data.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published for Iceland in the January 1989 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Central Bank of Iceland which, during the past year, have been provided on a timely basis.

Status of IFS data

		Latest Data in January 1989 IFS
Real Sector	- National Accounts	AA 1987
	- Prices: CPI	November 1988
	- Production: Total fish catch	October 1988
	- Employment	n.a.
	- Earnings: Wages hourly	Q4 1986
Government Finance	- Deficit/Surplus	1985
	- Financing	1985
	- Debt	1985
Monetary Accounts	- Monetary Authorities	October 1988
	- Deposit Money Banks	October 1988
	- Other Financial Institutions	n.a.

Interest Rates	- Discount Rate	September 1988
	- Bank Lending/Deposit Rates	September 1988
	- Bond Yields	n.a.
External Sector	- Merchandise Trade: Values	July 1988
	Unit values	AA 1986 1/
	- Balance of Payments	Q4 1987
	- International Reserves	November 1988
	- Exchange Rates	November 1988

1/ Data on unit value of frozen fish exports shown through October 1988.

Iceland: Basic Data

	1984	1985	1986	1987	1988 Official estimates	1989 Official projections
			(Percentage changes)			
National accounts (constant prices)						
Gross domestic product	3.5	3.4	6.3	6.6	-1.4	-1.6
Final domestic demand	3.6	4.3	4.6	12.7	-0.8	-2.8
Private consumption	2.7	5.0	6.5	14.0	-1.0	-3.5
Public consumption	0.2	6.2	6.8	5.5	2.0	0.5
Gross fixed investment	8.9	1.0	-2.2	15.7	-2.7	-3.2
Exports of goods and nonfactor services	3.0	11.0	6.2	4.0	-1.0	-1.1
Imports of goods and nonfactor services	9.3	9.7	0.3	22.9	2.2	-3.8
Selected indicators						
Unemployment rate (in percent of labor force)	1.2	0.9	0.7	0.5	0.5 1/	-5.4
Real average earnings	-0.9	7.6	9.5	19.5	-1.0	-5.4
Consumer prices (during year)	18.9	35.9	13.6	24.4	25.5 2/	6.0
Consumer prices (average annual)	29.2	32.4	21.3	18.8	25.5 2/	12.0
Nominal effective exchange rate	-16.2	-21.1	-16.2	-5.4	-12.4 3/	...
Real effective exchange rate	6.5	-0.8	-0.3	8.1	5.3 3/	...
Terms of trade 4/	0.9	0.1	4.9	5.4	--	-1.5
Money and credit						
Deposit money bank lending	46.2	30.4	21.0	45.8	39.2 5/	...
Broad money	33.4	47.6	35.0	35.5	26.0 5/	...
Interest rates (period averages)						
Central bank discount rate	16.5	28.4	21.5	34.1	48.1 6/	...
Six-month indexed deposits (margin above inflation)	3.5	3.3	3.1	3.5	3.9 6/	...
			(In percent of GDP)			
Public finance						
Treasury						
Revenue	23.5	22.6	24.0	23.7	26.3	28.1 7/
Expenditure	22.7	24.6	25.2	25.0	27.4	27.7 7/
Operational balance	0.9	-2.0	-1.3	-1.3	-1.2	0.4 7/
Financial balance	-0.3	-3.4	-1.7	-2.7	-1.4	0.7 7/
PSBR (gross)	5.7	6.8	6.1	4.2	4.2	2.3 7/
Balance of payments						
Current account	-4.7	-4.0	0.4	-3.5	-4.6	-4.5
Trade balance	-0.4	--	2.5	-1.0	-2.0	-2.0
Services balance	-4.3	-4.0	-2.2	-2.5	-2.6	-2.5
Net external debt	49.3	52.5	45.2	41.3	43.1	46.9
Debt service ratio (percent of exports of goods and services)	24.3	19.2	18.9	16.0	16.5	18.0

Social and demographic indicators

Area	103,000 square kilometers
Population (December 1, 1988)	251,743
Population growth (1988)	1.8 percent
GDP per capita (1988)	SDR 17,388
Life expectancy at birth (1987)	
Female	74.1 years
Male	79.9 years
Infant mortality (aged under 1, in percent, 1984)	0.6
Population per physician (1984)	417
Population per hospital bed (1982)	124

Sources: National Economic Institute; Central Bank of Iceland; and IMF.

1/ Average January-September 1988.
2/ Official estimate as of October 1988.
3/ January-October 1988 over average for previous year.
4/ Merchandise trade.
5/ Change in the twelve months to September.
6/ Average January to October.
7/ Budget proposal.