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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 82/128

SALES

3:00 p.m., September 27, 1982

J. de Larosière, Chairman

Executive DirectorsAlternate Executive Directors

J. de Groote

O. Kabaj
C. Taylor
E. Portas, Temporary

R. K. Joyce

A. Le Lorier
C. Dallara
T. Alhaimus
T. Yamashita
R. J. J. Costa, TemporaryG. Laske
G. LovatoJ. R. Novaes de Almeida, Temporary
J. Reddy, Temporary
F. Sangare
G. GroscheA. R. G. Prowse
J. Sigurdsson
Zhang Z.M. K. Diallo, Temporary
C. J. Batliwalla, Temporary
D. V. Pritchett, Temporary
T. de Vries
B. Legarda
L. VidveiL. Van Houtven, Secretary
J. C. Corr, Assistant

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2. Chile - Fund Representative Page 27

Also Present

European Department: A. Arimo, E. O. C. Brehmer, A. Knöbl, W. E. Lewis, S. Mitra. Exchange and Trade Relations Department: S. Kanesa-Thasan. Fiscal Affairs Department: G. Blöndal. Legal Department: A. O. Liuksila. Personal Assistant to the Managing Director: N. Carter. Advisors to Executive Directors: A. B. Diao, P. D. Péroz. Assistants to Executive Directors: L. E. J. Coene, T. A. Connors, I. Fridriksson, M. Hull, W. Moerke, J. A. K. Munthali, V. K. S. Nair, Y. Okubo, J. G. Pedersen, G. W. K. Pickering.

1. ICELAND - 1982 ARTICLE IV CONSULTATION

Executive Directors considered a staff report for the 1982 Article IV consultation with Iceland, together with a decision concluding the 1982 Article XIV consultation (SM/82/144, 7/21/82; Sup. 1, 9/16/82; and Cor. 1, 9/22/82). They also had before them a report on recent economic developments in Iceland (SM/82/153, 8/3/82).

Mr. Sigurdsson made the following statement:

I would like to thank the staff for a set of clear papers on Iceland. My authorities appreciate the perceptive and balanced analysis of the economic situation in Iceland contained in these papers, and they find many of the recommendations useful.

At the time of the Board discussion of Iceland in December 1980, it was hoped that external developments would improve in 1981 and beyond, and that there would be scope for concentrating on more lasting economic measures to bring down inflation and lay the foundation for balanced growth. In the event, since the latter half of 1981, economic developments have been highly unfavorable. After having achieved a growth rate of 4.7 per cent a year in the 1970s, the rate of growth of GNP fell to 1.3 per cent in 1981, and a current account deficit of 5 per cent of GNP was incurred in contrast to approximate balance in the five preceding years. For 1982, a fall in GNP by 3.5 per cent, and a widening of the current account deficit to about 10 per cent of GNP, is expected.

This unfavorable development is largely due to a halt in the growth of exports in 1981, and a sharp fall in 1982. At the turn of the year, exports had already been weakened by the slack in world demand for metals, which was reflected in falling export prices and stockpiling of aluminum and ferrosilicon. Furthermore, capelin fishing came to an abrupt halt at the end of last year owing to the virtual collapse of the stock. Capelin fishing has not been permitted so far this year, and it is still uncertain whether it can be resumed until sometime next year. This represents a major setback, as only three years ago capelin products accounted for one fifth of the total value of fish production. Even more serious, however, has been the unexpected fall in the cod catch, which in the first seven months of the year was down by 24 per cent in volume terms from 1981. The export difficulties have been aggravated by the virtual closure of the main market for stockfish, which is Nigeria. Export prices for important fish products have also been weak recently. Taken together, these developments have led to a severe shortfall of export production, a fall in export earnings, and a sharp negative impact on the profitability of the export sector, the fishing fleet in particular.

These difficulties, mostly caused by factors beyond the control of the authorities, have been compounded by domestic uncertainties that stimulated private demand--import demand in particular--resulting in the previously mentioned rapid widening of the external current account deficit. For several years, the current account had been close to balance, and even the oil price increases of 1979/80 were weathered without a deterioration of the trade balance. The sharp increase in the current account deficit reflects a combination of resource constraints in the fishing industry, a rise in domestic demand, weak foreign demand for Iceland's exports, and an increase in interest payments on the foreign debt.

Inflation, which had been brought down from 60 per cent through the year 1980 to 40 per cent in 1981, regained momentum and rose to an annual rate of some 50 per cent at about the middle of 1982 (year-on-year increase).

Developments up to the time of the consultations in Reykjavik, as well as the initial policy responses, are detailed in the staff documents. Almost all of the problems I have described had come to light at the time of the consultations, but since then their extent has become clearer, and the Government has announced several measures to counter the external imbalance and the inflationary pressures.

The primary policy objectives of the Government are to eliminate the current account deficit within two years, strengthen the productive base of the economy, maintain full employment, secure the incomes of the lowest-paid, and bring down the rate of inflation.

The most important direct measures were a 14.3 per cent devaluation of the krona on August 23, 1982, a substantial reduction in the indexation increases of wages on September 1 and December 1, an increase in selected indirect taxes, the installation of a ceiling on the rise in raw fish prices on December 1, and a reduction in the maximum permitted markups on imported goods. Furthermore, government transfers will be granted to the lowest-paid wage earners in the remaining months of 1982 and in 1983. The staff has given a description of these measures in the supplement to SM/82/144.

At the same time, the Government announced a set of policy guidelines that it intends to follow in the near future. Most important of these are the following: imports of fishing vessels are to be suspended for two years; the wage indexation system is to be revised; agricultural export subsidies are to be lowered by reducing production; fixed investment is to be reduced in order to decrease the dependence on foreign credit, and, where feasible, the construction of public buildings will be postponed

for up to 18 months; and heavy emphasis will be placed on improving efficiency and quality control in the export industries, as well as on strengthening marketing efforts.

Since the announcement of the measures already cited, the union of public employees has negotiated a new wage contract involving pay increases similar to those provided for in the agreement reached in the private sector earlier in the year.

Clearly, the policy measures mainly aim at the immediate economic problems. Further measures are undeniably called for, but broadly speaking, the results of those already enacted are, first, that profitability in the export sector has been improved. There remain, however, serious, and to some extent structural, problems of profitability for the fishing fleet. Second, the devaluation, the tax increases and the curtailment of wage indexation will dampen private demand and imports, thus exerting a favorable impact on the current account balance. Third, pressures on the price level are partly relieved by allowing less than full indexation increases in wages and by reducing the maximum permitted markups on imports.

In a medium-term perspective, renewed growth of exports can be expected. Capelin fishing is expected to be resumed next year or the year after. Furthermore, the demand for metals should strengthen with a recovery of the world economy. Consequently, the export shortfall can be expected to be a temporary one, and the current account deficit should be brought down to a sustainable level within a relatively short period.

For a long time, modification of the wage indexation mechanism has been considered by the authorities, but only relatively minor changes of a lasting character have been implemented, owing to resistance from labor unions. The most important change in recent years has been the inclusion of a terms of trade effect introduced in 1979. In recent months, a government-appointed committee has been working with union representatives exploring ways to modify the indexation mechanism. This work has not yet come to fruition. The Government is seeking to make some lasting modifications, such as longer intervals between compensation increases, and, in general, new provisions circumscribing the automaticity of the indexation mechanism.

As described by the staff, fiscal policy--in the narrow sense of the central government budget--has strengthened significantly in the recent past. The Government's latest measures show clearly that the authorities have no intention of weakening the stance of fiscal policy. On the contrary, the need to restrain public sector operations, in particular public investments, in order to reduce reliance on foreign borrowing, is clearly recognized, as is the importance of securing the financial

viability of public sector enterprises. In its appraisal, the staff advocates an increase in direct taxes in the current situation, and point in this connection to the relatively low share of direct taxes in overall taxation. The Icelandic authorities remain skeptical of this recommendation, both because such an increase would have detrimental effects on incentives and because it might be counterproductive to achieving the social consensus necessary to break the wage and price spiral.

No new monetary policy action has yet been announced in connection with the recent measures. The Central Bank has made recommendations to the Government on increases in those interest rates that are not directly indexed, and a substantial increase may well be warranted. Recent months have seen strong credit expansion and falling growth of bank deposits, resulting in a tight squeeze on the banks. At the same time, monetary policy has been unaccommodating, and monetary aggregates have shown a rapidly falling rate of growth. The weak link in this situation has been an inflexible interest rate policy. Fully indexed instruments play an increasingly important role on both the lending and the deposit sides. During periods of rising inflation, the disparities between the real rates on indexed and nonindexed instruments grow larger if the nominal rates on the latter ones are not changed accordingly, and those receiving nonindexed credit are borrowing at increasingly favorable relative terms.

Against the background of the recent economic policy measures and income settlements, assuming unchanged policies, and further assuming--which, of course, is a central assumption--that fish catches will improve and foreign demand for aluminum and ferrosilicon recover, a significant reduction in the current account deficit should be expected for 1983, as well as resumption of economic growth at a modest rate in the latter half of the year.

The growth rate of the economy and the balance of payments developments in 1983 and beyond, are crucially dependent on the fortunes of the fishing sector. At present, it is expected that the cod catch, the mainstay of exports, will recover in the next few years, and that capelin fishing will be again permitted. The outlook for the fishing sector will be easier to assess later this autumn, when the Marine Research Institute presents its most recent findings and recommendations.

Structural adjustment policies have made progress in three areas in particular. First, continued development of domestic energy sources has reduced the dependence on oil imports and made possible considerable progress in diversification of the economy. Realistic pricing of imported oil is a key element in energy policy. Second, the authorities have taken measures,

and intend to take further measures, to curtail agricultural production, which is excessive relative to domestic demand and entails costly export subsidies. Third, the authorities have decided to stop imports of fishing vessels for the next two years because the fishing fleet may have become too large, given the existing resources for fishing. The authorities are continuing their consideration of what methods are best suited over the long run to securing the effective utilization of the common property resources of the economy on which future development depends.

Finally, my authorities appreciate the staff's recommendation to extend the Fund's approval of the travel tax until the end of 1982. They consider this tax a temporary measure, and will keep it under review with the aim of abolishing it as soon as suitable alternative revenue sources are found. The temporary retention of the travel tax should also be seen in the context of the need to maintain a tight fiscal stance. My authorities do not intend to resort to protectionist measures in responding to the serious balance of payments problem confronting the Icelandic economy.

Mr. Lovato noted that disturbing developments in Iceland had severely affected real output growth, which, after slowing down in 1981, was expected to decline in 1982; they had also affected the current account deficit, forecast to rise to 10 per cent of GNP. Those developments also entailed a significant increase in outstanding external debt and in debt servicing obligations. Unemployment had not been responsive to the downturn in GNP, while inflation had regained new impetus. The range of economic policy tools had been perhaps too limited, and, allowing for the unfavorable external developments, ample room existed for improvements in policy design, execution, and control. He was, therefore, in broad agreement with the staff's analysis and with its diagnosis of the disappointing results of Icelandic policy. However, the latest available information suggested that the package of policy measures recently adopted by the Icelandic authorities represented a commitment to implement changes along the lines recommended by the staff.

In his authorities' view, Mr. Lovato observed, Iceland's balance of payments position was the most urgent problem. In the short term, Iceland faced a high and rising current account deficit; over the longer term, the external situation would probably continue to act as a constraint because fishing resources were limited and investment-goods imports were expected to increase in order to develop indigenous energy resources. The large capital investment involved would require Iceland to resort to further foreign borrowing, and the country's credit standing would depend crucially on its ability to reduce domestic demand to sustainable levels and to shift resources from consumption to capital accumulation.

The staff was correct in pointing to the need for tighter budgetary policy, reductions in public sector borrowing abroad, and increases in the level of direct taxation, Mr. Lovato continued. Direct taxes accounted

for only 10 per cent of GNP, a strikingly low level by standards elsewhere. Mr. Sigurdsson had referred to the political difficulties involved in increasing direct taxes. The question arose, therefore, how the Icelandic authorities intended to raise the needed revenue. With regard to reductions in public expenditure, Mr. Sigurdsson had stated that the authorities intended to curtail agricultural production, "which is excessive relative to domestic demand and entails costly export subsidies." It would perhaps be easier to reduce the subsidies.

Monetary policy had been described as being traditionally accommodative, Mr. Lovato observed. Long-term capital inflows had not been sterilized, leading to inflationary money supply growth. In 1981, despite the adoption of new techniques for controlling reserve requirements, money growth had exceeded previously announced targets. He wondered whether any changes were in prospect for more effective monetary control.

In an open economy of Iceland's size, Mr. Lovato remarked, external disturbances--whether fluctuations in export earnings, imported inflation, or exchange rate movements--were easily and quickly transmitted into the domestic structure of costs and prices. An effective depreciation, such as that incurred by the Icelandic currency in nominal terms in 1982, which had validated and only partially offset inflation differentials, was bound to push domestic prices upward through a rise in import prices affecting input costs and the prices of domestic import-competing goods. The wage indexation mechanism gave further upward impetus to domestic prices through the rise in labor costs. The economy rapidly wound up in a wage/price spiral, unless incomes policies or demand restraint policies were adopted. The measures recently enacted by the Icelandic authorities were therefore in the right direction. The increase in excise taxes, the price control arrangements on imports, and the new provisions, albeit imperfect, for reducing the operation of indexation clauses should dampen the inflationary effects to be expected from the depreciation and should therefore enable the economy to reap some current account benefit.

Miss Le Lorier commented that the authorities were to be congratulated on maintaining a reasonable level of economic growth over the previous several years and a probably unique level of employment of over 99.5 per cent of the labor force. However, in the current economic environment, such an outstanding success on the labor front might also prove to be a point of weakness. Iceland's problem appeared to be a classic but severe case of excess demand leading to a current account deficit, probably not sustainable beyond the short term, with a rate of inflation excessive by historical and international norms. The problem was only in part the result of external and unforeseen circumstances, such as the drop in output of the fishing industry arising from the largely unexplained depletion in the stock of certain species of fish. The Icelandic authorities had been taken somewhat by surprise, and might therefore have reacted a little slowly to the new external conditions.

The dominant use of the U.S. dollar as the currency used by the fishing sector for invoicing, Miss Le Lorier added, might have temporarily created the impression that the situation was less serious than it

actually was. But it was also true that institutional arrangements, particularly in the labor market, had to a large extent made a smooth and prompt adjustment difficult. The staff appraisal was therefore correct in noting:

The external and domestic situation requires the timely adoption of a comprehensive stabilization program, as only a combination of exchange rate and incomes policies, together with restrictive financial policies, will ensure a lessening of the inflationary pressure and a reduction in the current account external deficit.

Incomes policy measures would have to play a central role in the implementation of restrictive policies, Miss Le Lorier continued. However, it was not yet entirely certain whether the necessary social consensus had been secured to adopt a system of wage determination capable of bringing the wage/price spiral under better control. Such a consensus might be difficult to achieve, given the high level of inflation, which stood at about 50 per cent, or even higher if account was taken of specific inflation-suppressing measures. To reduce inflationary pressures over a reasonably short period would require the acceptance initially of a large gap between future contractual increases in wages and expected wage rates. Another difficulty arising from the maintenance of tight labor market conditions was that wage earners remained in a sufficiently strong bargaining position to resist major concessions. It was remarkable that the slump in the fishing industry had resulted in no increase in unemployment. One reason might be that Iceland's economy was still only moderately diversified and did not require a great variety of professional skills. The type of structural employment problems common in other industrialized economies were less likely to arise.

That situation, together with the expected modest recovery in economic activity in 1983, Miss Le Lorier observed, suggested that restrictions on income would depend heavily on consensus building initiatives and on creative thinking. As for as the latter, the studies carried out on ways to improve the wage indexation mechanism were encouraging, and, if adopted, would go some way to taking pressure off the wage/price spiral. The idea of using a standard of living index appeared particularly innovative, especially in the context of Iceland's definition of welfare outlays. Another possibility would be through the use of the fiscal system, currently biased toward indirect taxes. She wondered whether consideration was being given to the possibility of a shift away from indirect taxes toward direct taxation. For an industrial country, the latter was an unusually low proportion both of GNP and of total tax revenue. Iceland was in the unusual situation of having a budget surplus. The need to increase fiscal revenue did not therefore appear pressing, and all of the potential increases in direct taxation could be offset by correspondingly lower indirect taxes. If such a shift were coupled with an adequate increase in the progressivity of income taxes, a powerful bargaining element vis-à-vis wage earners could be secured without major difficulty.

A restrictive monetary policy ought to be maintained, Miss Le Lorier suggested. At a minimum, the policy should be no more than accommodating, and if possible, it should give active support to a broader policy of demand restraint. The results in 1981 had been disappointing, but significant progress had been made in 1982. While demand for credit remained strong, the new emphasis on controls on foreign borrowing that had been used to circumscribe limits on domestic loans deserved strong support. She agreed with the staff appraisal of the conduct of exchange rate policy, and she supported the proposed decision.

Mr. Laske noted that the Icelandic economy had been exposed to a sharp deterioration in its external accounts over the previous two years, stemming primarily from structural rather than cyclical factors. The depletion of the fishing stock in Icelandic waters--a temporary phenomenon, he hoped--had been compounded by a significant weakness in the market for other export products. Those external developments, as well as the continued high rate of inflation, called for remedial action by the authorities. As Mr. Sigurdsson had noted, some measures had already been taken, but further efforts to address the medium-term aspects of the problem were needed.

There were two noteworthy features of the domestic economy, Mr. Laske suggested: a rate of inflation far in excess of that of any other country around the Atlantic, and the very low rate of unemployment by international standards. The latter situation should allow more room for maneuver than was available to many other governments. The large increase in the current account deficit, to 10 per cent of GNP in 1982, was not sustainable for an extended period. Even if the fish catch recovered in 1983 to the higher levels previously recorded, that alone would probably not contain the current account deficit to a manageable level. The balance of payments data in the staff papers showed that the decline in exports in the past year was not the only cause of the current account problem. Persistent increases in imports over the previous two years had played a considerable role. In the same period, monetary expansion had been significant, while performance in the fiscal area had been mixed. Although the central government budget generated surpluses, the operation of the public sector in its entirety was judged by the staff to have contributed to stimulating domestic demand. Domestic absorption had to be reduced in order to get the external accounts under control.

The authorities had acted in the major policy areas, Mr. Laske noted, for which they were to be commended. The exchange rate, apparently the most powerful tool in the Icelandic context, had been recently adjusted. The extent of the trade-weighted depreciation over the previous 12 months was impressive, but it was not clear whether it was sufficient to re-establish profitability for the marine-based industries and to contain import demand effectively. He would appreciate further comments by the staff or Mr. Sigurdsson on that important issue.

In the fiscal area, Mr. Laske continued, the authorities had concentrated on raising indirect taxes, but only for the short term. Longer-lasting revenue-raising measures might be needed. The concern of the

authorities that higher direct taxes might be too sensitive an issue was not to be taken lightly, but the heavy concentration of revenue on indirect taxes and the rather low share of direct taxes in GNP suggested that a restructuring of the tax revenues might be advisable; it would serve to strengthen the finances of both the Central Government and the public sector.

An earlier tightening of monetary policy would have prevented the current account from going so far into deficit, Mr. Laske commented. New financial instruments appeared to have mopped up the banking system's excess liquidity and thereby circumscribed its lending capacity. However, continued restraint would be needed. Further upward adjustment of interest rates could play a useful role in that regard, and it was, therefore, regrettable that the increase in unindexed interest rates proposed by the Central Bank had not met with approval. The precarious balance of payments position and the present tightness in bank liquidity suggested strongly the need to take corrective action on interest rates. The most recent steps taken to make the system of wage indexation less inflation-prone were welcome. However, they did not go far in the direction of eliminating from the indexation formula those elements that made it self-propelling. He hoped that discussions with the labor market partners about additional adjustments would be successful and would be started rapidly.

Mr. Taylor noted that Iceland had a long-standing inflation problem that had tended to worsen in recent years, and during the same period the current account of the balance of payments had moved into heavy deficit. It was a disquieting picture, and he therefore shared the staff's view that there was a fundamental and urgent need to address the internal and external problems through a comprehensive stabilization package.

The overwhelming priority was to control the inflation that was leading to a misallocation of resources and seriously damaging business confidence, Mr. Taylor argued. Mr. Sigurdsson had mentioned that the control of inflation was one of the priorities of his authorities, although it was not clear whether it was the most important one. The other objectives that Mr. Sigurdsson had mentioned were laudable, but they would be in jeopardy if inflation could not be overcome. It was doubtful therefore whether the counterinflation measures taken in early 1982, which had included devaluation accompanied by increases in consumer subsidies, had been the most suitable ones in the circumstances. They would impose heavy charges on the budget in 1982 and subsequent years, and they did not address the underlying structural problem.

There was a need to go some way toward de-indexing incomes so as to slow the rapid wage/price spiral, Mr. Taylor continued. While Iceland's heavily indexed system of pay determination might make it possible to live with inflation, it did not help to bring it under control. Reliance solely on productivity growth to bring inflation down over a period of years would be a long drawn-out process. In the longer term, the closer alignment of sectoral income changes with productivity growth was necessary

to break the link between wage settlements in the economy generally and those in the export sector. Wage increases in the export sector, leading to higher wage expectations elsewhere in the economy, were at the root of inflation. Although a stabilization fund for fish prices existed, it had not succeeded in insulating the rest of the economy from excessive price fluctuations, and it was worth considering whether other devices might not prove more effective. For example, had the authorities considered a fiscal instrument such as an export tax that could be varied to counteract the effect of variations in fish catches or in the prices of fish products?

Fiscal policy, under the staff's definition of public sector operations, had been expansionary in FY 1980 and FY 1981, Mr. Taylor remarked, contrary to the impression given by examining only the fiscal position of the Central Government. Adoption by the authorities of a more comprehensive set of public accounts might lead to better control over public expenditure, and facilitate closer monitoring of the pattern of borrowing. The staff recommendation on stricter control over public sector borrowing overseas was entirely warranted. There was also scope for improvement in monetary policy instruments. The adoption of a flexible reserve requirement in 1981 had been a welcome step, but it had not prevented a 71 per cent increase in borrowing in 1982. He would be interested to know what plans the authorities had to extend the range of instruments available to the Central Bank, and what timetable was envisaged for the consolidation of interest rates and their shift to positive real levels. Because inflation was often an intractable problem in the economy, more emphasis might be placed on domestic monetary conditions and less on the maintenance of external reserves as a focus of economic policy.

It was difficult for a nonexpert to assess the seriousness of the problems confronting Iceland's fishing industry, Mr. Taylor observed, or to determine how readily the deficiencies in fishing stocks could be overcome. Because of the degree to which Iceland depended on fish as a major export, he hoped that Mr. Sigurdsson's prediction of better times for the fishing industry would prove correct. Did the staff believe that the krona was presently at about the correct level, following the devaluation of August 1982? The staff paper indicated that the real trade-weighted effective exchange rate had risen over the previous two or three years, albeit unevenly.

The measures adopted at the time of the recent devaluation to restrain pay increases and restrict bank credit had been appropriate, Mr. Taylor stated, but further measures might be needed if inflationary expectations were to continue to decline. It was regrettable that a PAYE system of income tax was not to be introduced, and that the plans to introduce a value-added tax had been suspended.

Mr. Dallara remarked that Iceland was in a difficult economic situation. The current account deficit had widened markedly, partly as a result of declines in the fish catch and weak world demand for Iceland's other exports. GNP was expected to decline significantly in 1982 after slow growth in 1981 and inflation had remained very high. The authorities

had taken significant adjustment measures recently to deal with some of the problems facing the economy. Adjustment was particularly important under current circumstances since choices appeared to be extremely limited, given the negative effects of the poor fish catch on domestic growth and exports.

The authorities needed to work persistently toward lowering the inflation rate over time through tighter monetary and financial policies, through less than full wage indexation, and through certain structural changes, Mr. Dallara continued. Nevertheless, they should be complimented for their effort to maintain a sensible array of relative prices and costs in the economy during the current inflationary period. Their record was not perfect--subsidies existed, significant areas of credit were subject to negative real interest rates, and the authorities had sometimes resorted to exchange rate changes. However, the distortions were not as great as in many economies with similar rates of inflation. The company tax reform of 1981 was one example of a sensible policy response to high inflation. But more information would be welcome on why interest rates were allowed to remain negative in real terms despite the recommendations of the Central Bank.

Measures designed to offset high rates of inflation, however helpful and desirable in the short term, Mr. Dallara commented, might run the risk that inflationary increases would be institutionalized. Efforts to minimize the distorting effects of inflation tended to require more and more effort over time. While Iceland had demonstrated that it might be possible to live with inflation for a period without doing permanent substantial harm to the economy, it was questionable whether that could continue indefinitely. The need to deal with the underlying inflation problem was pressing. In that connection, although wage indexation existed, there were indications that workers were aware of the difficulties caused by the indexation system since they had agreed not to be compensated for external terms of trade losses.

There were proposals to use a standard of living index that would take account of government expenditures and social welfare benefits in the setting of wages, Mr. Dallara observed. In the context of the policy actions in August, it appeared that workers were willing to accept wage increases in the immediate future lower than they would normally have been entitled to under the wage indexation formulae. That was encouraging since, given the large drop in exports and its negative effects on GDP, real wages would have to decline for a time if significant progress toward internal stability was to be achieved. It would be interesting to know whether labor was prepared to accept real wage declines until growth recovered, or whether Iceland was prepared to continue borrowing heavily in the international financial markets to finance higher levels of income than would otherwise be possible until the fish catch and metals markets recovered.

While he supported the proposed decision approving the retention of the multiple currency practice relating to a tax on foreign exchange purchases for foreign travel, Mr. Dallara welcomed Mr. Sigurdsson's affirmation that the tax was a temporary measure and that the authorities aimed to abolish it as soon as possible.

Mr. Prowse suggested that Iceland was an example of a successful small island economy. Per capita income was about \$11,000, and recorded unemployment amounted to only 406 persons. The authorities' concern to maintain full employment was, therefore, difficult to understand since they had practically achieved that objective. The problem for them was how to maintain the satisfactory state of affairs in the face of adverse developments, some of which were external, others internal, including, among the latter, inflation. On the external side, the major problems were the current account deficit of about 10 per cent of GNP, the debt service ratio of about 21 per cent, and the total external debt approaching 40 per cent of GDP.

Although at first sight Iceland appeared to be a simple economy, based on a narrow but highly productive sector, Mr. Prowse continued, on closer analysis it appeared more complex, for example with regard to the degree of regulation, and one solution might be to seek less regulation in the economy and more freedom for market forces to operate.

There appeared to be some difference of view between the staff and Mr. Sigurdsson on the important question of fiscal policy, Mr. Prowse observed, in particular, on tax policy. The staff suggestion that the authorities should examine ways to increase the yield of direct taxation deserved support. The ratio of tax to GDP was low, as was the proportion of government income derived from taxes. There was a clear need to restrict the growth of domestic demand, yet the authorities had difficulties in raising the price of electric power. It was not an easy issue to resolve given the problems that the authorities faced in increasing revenues and restraining the use of resources outside the direct tax system.

The most evident feature of the Icelandic economy was that it had suffered a significant fall in income, Mr. Prowse noted. The response had involved an increase in inflation and a large increase in the balance of payments deficit. The staff paper showed that while fixed investment had declined, which might be appropriate at a time of declining production, total consumption had continued to increase, although there was a possibility that private consumption might decline slightly in the second half of 1982. The situation was not sustainable beyond the short term, given the adverse external position. The staff suggestion that the level of investment should be restrained further was somewhat worrisome, and additional comment on that question would be welcome.

Should there be no early recovery in export income, which depended heavily on the productivity of the fishing industry, Mr. Prowse went on, consumption would have to be curtailed, and income growth restrained.

Such restraints would mean modifying the wage adjustment system, considering the possibility of increases in direct and indirect taxation, and reconsidering the method of determining welfare payments. The staff had pointed to the need for such policy considerations so as to restrain domestic demand and imports.

A large balance of payments deficit and a high external debt service ratio could not be sustained in an economy with a relatively narrow and fluctuating productive base, Mr. Prowse commented. The restrictions that the authorities had placed on the import of fishing vessels were, therefore, a matter of concern. Although there was some indication of over-capacity in the industry, its productivity was crucial to the economy, and it would be necessary to exert considerable prudence so as not to inhibit the freedom of entrepreneurial activity in that industry. Mr. Sigurdsson had expressed concern about structural problems in the profitability of the industry; any policy that hampered the growth of productivity would be counterproductive.

Inflexible interest rate policies were the weak link in the monetary area, Mr. Prowse stated. The whole system was full of distortions, particularly the large role played by fully indexed instruments. The degree of distortion was shown by the fact that there had been recently a strong credit expansion accompanied by a slowdown in the growth of bank deposits and an unaccommodating monetary policy. Such a development could be explained only by the complexity of the Icelandic system.

The Government's objectives were far-reaching, Mr. Prowse noted, although there might be some conflicts among them, at least in the short run. The staff's suggestions would be helpful in resolving some of those problems, but everything depended on recovery in the export industry, without which a more substantial adjustment would be inevitable, both in the short term to restrain demand and in the medium term to restructure the economy. The recent measures had been directed at the immediate short-term problem, and he hoped that the authorities would come forward with appropriate medium-term policies.

Mr. de Vries observed that Iceland depended heavily on the fortunes of the fishing industry. In that respect, the authorities might wish to consider establishing a fund that could be built up in the good years to take care of the lean years. However, the opportunity to do so had temporarily passed, and there was no alternative but to reduce real income. A longer-term possibility would be to pursue diversification of the economy.

The measures that the authorities had taken were somewhat dirigiste, Mr. de Vries remarked. Like Mr. Prowse, he was struck by the complexity of the Icelandic economy and the high degree of regulation, and he wondered whether more reliance on market forces would not be beneficial. An extreme example of regulation was the extent of indexation. While it gave protection against inflation, indexation undermined the effectiveness of a number of policy instruments and forced the authorities into more

complex measures that reinforced the cycle. Given that the authorities were faced with the necessity of reducing real incomes while working through the wage indexation system, the techniques that they employed would be of interest to the Fund, which often had to deal with such problems in members' economies, although perhaps not in as severe a form as encountered in Iceland.

Iceland's income was determined to a large extent by the vagaries of the fish catch, Mr. de Vries continued. Why then did inflation persist even when the fish catch, and therefore income, declined? For example, why did the authorities not peg their currency to a major currency, such as the dollar, in which many of their exports were denominated, so as to reduce the inflation rate to the rate that existed in that particular currency? The advantages of an independent policy were relatively small because Iceland's economy was small and there could not be a large market in financial assets dominated in Icelandic kronur. The high degree of inflation increased the rigidity of the economy, making it more difficult to adjust; but the Icelandic authorities apparently did not share that view. Any information that Mr. Sigurdsson or the staff could provide on those general questions would be welcome.

Mr. Pritchett stated that, following commendable growth in the 1970s, the basic medium-term problem for the Icelandic economy was twofold. First, there was the high inflation rate, and, second, perceptions about the causes of inflation seemed to be unusually diverse, creating problems for the authorities in finding solutions. For each of the previous five years, inflation had been running at an annual rate of over 40 per cent. While there had been significant improvement in the previous two years, it was expected to be approximately 50 per cent in 1982.

Commenting on the fundamental causes of inflation, Mr. Pritchett noted that three of the several alternative explanations in the staff paper deserved consideration. On page 2 of SM/82/144, the staff suggested that the inflation problem had its roots in sizable fluctuations of export earnings in the important fishing sector and was thereby transmitted throughout the economy. However, the analysis used for the periods of strengthening fish catches was quite different from that used for periods of weakening output for the fishing sector. The two different analyses resulted in positive inflation pressures regardless of whether the fishing sector had been expanding or contracting. In short, an explanation based on the fishing sector could not be used to explain the persistence of high inflation over time.

A second explanation of inflation in Iceland involved wage indexation, Mr. Pritchett continued. The staff had noted that the authorities had found it increasingly difficult to control the wage/price spiral over time as wage indexation had been a general feature of the wage determination process. From the theoretical point of view, if full indexation occurred, policies geared to unsustainable growth would lead to high inflation at an earlier stage. As soon as the inflationary effects of such policies were observed, however, policymakers undoubtedly would adapt more realistic

output targets. If no indexation existed, on the other hand, policy-makers might try to achieve additional output, at least in the short term, through money illusion. But there was no evidence that wage earners did not catch up over time. Thus, while indexation could result in early indications of unsustainable policies, it was not, on theoretical grounds, an adequate explanation of the basic inflation problem. There were also some practical issues concerning wage indexation in Iceland. Indexation could lead to a deterioration in the terms of trade even if moderate policies were pursued. However, that did not appear to have been a significant factor in Iceland; the terms of trade had improved between 1975 and 1981. Moreover, the wage indexation scheme did not seem unreasonable; it took account of changes in the terms of trade so as to produce less than full adjustment to price increases. Insofar as wages were the problem, fault should be placed on the size of the overall wage increases, especially the substantial increase in basic wages. The wage indexation scheme included a flexible review each year, and wage indexation per se did not appear to have been a major contributor to Iceland's inflation.

A third explanation for Iceland's high inflation, Mr. Pritchett remarked, included the failure of the authorities to take certain demand management and incomes policy measures. There seemed to lie the appropriate explanation. Nonetheless, he saw little evidence that inflation would be significantly reduced in the medium term. Faced with a weak fishing sector and deteriorating trade balance in 1981-82, the authorities had adopted a number of stabilization measures, for which they should be commended. But the measures followed expansionary macroeconomic policies in earlier years and continuing deterioration in the current account. Furthermore, the overall medium-term effect of anti-inflationary policies was unclear, in part because some major decisions had not yet been taken; for example, to raise interest rates on nonindexed instruments. Although fiscal policy had tightened somewhat in 1982 relative to 1981, a final judgment should await the 1983 budget that would be available shortly. Regarding incomes policies, the extent to which workers in 1983 would accept a real cut in wages so as to reflect fully the shortfall in output in the fishing sector was unclear. The authorities' objectives with regard to avoiding protective measures for international transactions were appreciated. With those overall objectives in mind, the proposed decision regarding the temporary exchange measures was acceptable.

Mr. de Groote stated that the staff documents and Mr. Sigurdsson's statement provided insights into the situation of a country that had taken the first steps in the direction of the adjustment necessary to preserve its past achievements, specifically its high level of real income and its unique situation of full employment. The first problem was the current account deficit, arising partly from reasons beyond the control of the authorities and partly from excessive domestic demand. The second, related, problem was inflation, which the staff attributed to the indexation mechanism. However, indexation accounted for only 17 per cent of the increase in the cost of living and more importance should be attached to the tight labor market conditions that led to high contractual wage increases. Furthermore, the attempt to counter inflation in 1981 by

maintaining a stable exchange rate had led inevitably to a large surge in imports. The appropriate policy recommendations were straightforward: a more active incomes policy; a more restrictive fiscal policy; exchange rate policies; a more restrictive monetary policy; and a set of structural measures.

Commenting on incomes policy, Mr. de Groote noted that further wage increases were expected in 1982, following increases in both 1980 and 1981 of about 4 per cent in real terms. Further improvements in the indexation mechanism would have only a marginal effect on wage developments unless direct action on the level of nominal wages could be taken over a period of years with the aim of reducing real wages. Fiscal policy had to complement incomes policy in order to offset the excessive real income gains of the previous year. The staff correctly pointed out that further action should be considered to increase direct taxes. The argument that increases in direct taxes would have damaging effects on the social consensus was understood but it was difficult to see how the authorities could succeed in bringing down the inflation rate without increasing some taxes. Furthermore, an excessive part of the local government budgets was financed through external borrowing. There was, therefore, an urgent need to reduce overall public investment, especially investment by local authorities.

Exchange rate policy, Mr. de Groote continued, should remain flexible so as to improve profitability in the export sector and reduce imports. The appreciation of the krona in real terms in 1981 was, therefore, most unwelcome. Monetary policy had relied on inadequate policy instruments to restrain credit creation sufficiently, and real interest rates remained negative. The automatic discounting of produce bills on favorable terms by the central bank was responsible for a large fraction of the excess liquidity creation and was especially inappropriate. Difficulties were also created by the fact that interest rates were not related to market mechanisms, in particular the rate set by the depository monetary banks.

The staff recommendations on structural measures were commendable, Mr. de Groote stated, including the need for development of domestic energy resources, a reduction of agricultural production, and a limitation on the import of fishing vessels. He hoped that the Icelandic fishing industry would recover rapidly and that the authorities would adopt a comprehensive adjustment program in a timely fashion.

Mr. Joyce noted that Iceland was going through a difficult period, one which the authorities recognized required stronger measures than had been taken to date. In 1982, despite the corrective measures that had been taken, there had been a worsening of the economic situation in four important respects. First, the annual rate of inflation had risen to about 50 per cent; second, the gross national product was expected to fall by 3.5 per cent; third, the current account deficit was widening and was expected to increase to 8-9 per cent of GNP, having doubled in absolute terms over the 1981 level; and finally, the debt service ratio had increased sharply, partly as a result of higher interest rates but also in response to additional borrowing by the Icelandic authorities.

It was true that the fall in GNP and the widening of the current account deficit could be partly attributed to a decline in exports, particularly with respect to metal and fish, Mr. Joyce continued. With regard to the fish catch, the question arose whether it was not partly the result of overfishing that could be avoided through better resource management. However, the decline in exports was not the sole reason for Iceland's difficulties. Exchange rate uncertainties and the consequent speculative imports had played a role, but the authorities were also responsible because of their failure to raise direct taxes, which were exceptionally low in Iceland. Although there had been some strengthening of fiscal policy, it had arisen from the revenue effects of increased imports rather than from increased taxes. Another area of weakness was the failure to cope adequately with wages and prices, especially the problem arising from the wage indexation system. Furthermore, the authorities had been slow in responding to exchange rate developments. As the staff had pointed out, the efforts in 1981 to dampen import-induced inflation through the devaluation of the krona had proved unsuccessful. It was encouraging that the authorities had changed course and were allowing the rate to settle at a level that would ensure adequate profitability for the export industries. Inflation in Iceland remained significantly higher than in its trading partners. That raised questions about the current level of the exchange rate. Any additional information that the staff could provide on movements of real effective exchange rates would be welcome, particularly with regard to the profitability of the fishing industry in recent months and with regard to the appropriateness of the current exchange rate level.

The authorities had failed to take effective action to restrain the growth in the money supply, Mr. Joyce remarked. It was regrettable that monetary policy had been overaccommodating in 1981 and 1982. The authorities needed to strengthen their policy options, particularly with respect to minimum reserve requirements, the rediscounting of export produce bills, and administrative interest rates. The efforts that the authorities had made to establish positive interest rates were encouraging, although it was disappointing that so many real rates remained negative. The major weakness of monetary policy lay in the inability of the authorities to offset the domestic liquidity consequences of large public sector borrowing abroad. Nevertheless, they should be commended for the steps they had taken or intended to take with respect to the wage indexation system, the reduction of agricultural subsidies, and the reduction in fixed investment, especially in public buildings.

As to the future, Mr. Joyce observed, much faith was being pinned on a recovery in world demand for metals and a recovery in the fish catch. How quickly that might occur was open to question. Success would depend on the continuation and strengthening of demand restraint, tighter fiscal policy, and stricter monetary policy. The intention of the Icelandic authorities to allow the scheme of advanced deposits on furniture imports to expire at the end of 1982 was welcome, although their intentions with respect to other multiple currency practices, particularly the tax on foreign exchange for travel, were less clear.

The staff representative from the European Department observed that the question of subsidies had been raised. The Icelandic Government had been placing less emphasis on subsidies and subsidies had been declining as a proportion of total revenue, at least until the end of 1981. Unfortunately, there had been a sharp increase in consumer subsidies in early 1982, a point that several Directors had correctly criticized as an inappropriate way of bringing down inflation. It was not yet clear what would happen in the second half of 1982, although, as Mr. Sigurdsson had pointed out, the authorities intended to lower agricultural subsidies, and to that extent they were proceeding along the lines suggested by Directors.

Several Directors had asked whether more could be done to improve the effectiveness of monetary policy, the staff representative continued. One option would be to increase interest rates, but the proposal by the Central Bank to raise unindexed bank interest rates by 6 per cent had not yet been accepted by the authorities, partly because of the opposition by industry. One reason why the monetary targets had been exceeded was that inflation in Iceland had often turned out to be much higher than the price forecast underlying the credit budget. Another reason was that capital inflows from abroad had been much higher than assumed in the budget.

Responding to questions related to the wage indexation system, the staff representative pointed out that there was great difficulty in abolishing the system because of the existing high inflationary expectations in the economy. Some elements in Icelandic society favored abolition, but others felt it to be a practical impossibility at present; the Government had therefore succeeded in achieving only a modification of the system. The Government was also discussing proposals for further modification of indexation with the unions.

One Director had asked why the slump in the fishing industry had not resulted in higher unemployment, the staff representative noted. One reason was that construction activity had been high, and workers freed from the fishing fleet could easily be employed ashore. There had also been a reduction in overtime work, so that the unemployment rate was not expected to move up much from its very low level.

As several Directors had suggested, fiscal policy could be tightened through increases in direct taxes, the staff representative continued, but the political realities made that unlikely, and measures in the fiscal area would probably have to be based mainly on cuts in expenditure, particularly in public investment. However, with regard to industrial investment, the staff did not believe that it was too high, except perhaps in the trawler fleet. On the latter point, the staff believed, nevertheless, that the ban on the import of fishing vessels was counter to the principles of free trade and probably unnecessary in view of the tightening of credit from the Fishery Loan Fund for the financing of trawlers and the natural decline in demand arising from the slump in the fishing sector.

Commenting on profitability in that sector, the staff representative suggested that exchange rate depreciation would probably not have been capable of offsetting the loss of revenue from the decline in the fish

catch although depreciation might have modified the effect. Devaluation would have had an effect on domestic demand, but that impact would have been offset by the wage indexation system. The depreciation of the krona between January and August 1982 had been about 36 per cent, an amount that the staff considered appropriate. An attempt had been made in the first five months of 1981 to stabilize prices by keeping the exchange rate stable, originally by pegging the krona to the U.S. dollar, as one Director had suggested. Because the unexpected appreciation of the dollar had led to an appreciation of the krona vis-à-vis the currencies of Iceland's European suppliers, Iceland had pegged the krona to a trade-weighted basket of currencies that was used as an informal guideline in the short run.

The Fish Price Equalization Fund had been ineffective in insulating Iceland against inflation, the staff representative from the European Department said. In 1981, it had moderated the effect of price fluctuations, particularly in the price of fish meal and oil, on the operations of the fish processing industry, but it had been unable to counteract the effect of the secular increase in the price of whitefish, nor did it have a significant demand management function. It had been suggested by one Director that more effective demand management policies could include export taxes. In fact, Iceland had export levies on exports of fish products. Changes in export levies of different fish products, as well as the operations of the Fish Price Equalization Fund and the oil surcharge for boat owners, paid by fish processors, were used for income redistribution purposes within the fishing sector. With regard to measures to offset the decline in the fish catch, there was a possibility that Iceland could direct its fishing efforts toward other species, such as the blue whiting, but that would involve changes in consumer taste in Europe and did not appear to be an immediate prospect.

Mr. Sigurdsson commented that Executive Directors had generally supported the staff appraisal, with which his authorities were in broad agreement. Inflation, the focal point of the staff report, was a long-standing problem in Iceland, and its causes, consequences, and cures raised complex questions. The staff was correct in saying that the inflationary problem had its roots in sizable fluctuations in export earnings, but that was only a partial explanation. On the external side, import price increases and sharply fluctuating terms of trade had dominated economic developments in the 1970s. External instability was a major cause of Icelandic inflation, which had to be seen in the context of the constantly pressing demands and the fixed domestic policies of a highly developed consumer society and welfare state. While it was true that the Icelandic authorities saw full employment and growth as the primary objectives of economic policy, they did not minimize the importance attached to reducing the rate of inflation. There could be no room for complacency in that regard, if only because far too much of the time and energy of the private as well as the public sector was spent on alleviating the detrimental effects of inflation, rather than dealing with the tasks of economic development. The most serious effect of inflation was its pervasive weakening of economic planning mechanisms at the micro as well as at the macro level of the economy.

With regard to structural policies, Mr. Sigurdsson continued, Iceland had taken strong practical measures in energy policy. Both hydroelectric and geothermal development had been vigorously pursued. The percentage of households using geothermal systems for heating had risen from some 40 per cent to about 75 per cent in the course of the 1970s. Over the coming years, the share of imported oil in primary energy use would be substantially further reduced. The main difficulty for energy and industrial development, aggravated by the current world recession, was to identify viable power-related industrial projects. With reference to Mr. Prowse's comment on electricity prices, the problem of adjusting the price of electricity to existing power-based industries might have been overstated in the staff report, which had said that Iceland had not been able to raise that price at all. In recent years, there had been some, albeit limited, changes in energy pricing to the power-intensive industries, and the question was under active review.

Prospects for the fishing sector and the fish stocks, so vitally important to Iceland, had been commented upon by Directors, Mr. Sigurdsson noted. Great uncertainties surrounded the accuracy of the assessments of stock size, but it was clear that the prospects for further growth in the fishing industry were limited, although the potential for diversification within the sector should not be discounted. Some Directors had felt that there was an ill-advised "dirigiste" tendency in the policy of suspending imports of fishing vessels for two years, but that was not the case. That decision had been based upon the neoclassical welfare economic arguments for government intervention. Free access would, in the long run, tend to overtax the fish stocks, at least from the point of view of economic return, and possibly beyond the point of natural renewal, because each individual entrepreneur took no account of the detrimental effects his fishing had on the catch of others, and consequently, on the industry as a whole.

The suspension of imports of new vessels for two years might not be an ideal solution, but better methods were difficult to implement, and the potential waste due to overinvestment was the main concern, Mr. Sigurdsson went on. However, more flexible, market-oriented methods of fishery management should be sought. In that connection, export taxes had been considered, as suggested by several Directors, and were used to a limited extent for smoothing out export fluctuations, even though they created problems of income distribution and could also harm economic efficiency.

The prospects for 1982 and 1983 were not good, Mr. Sigurdsson remarked. A fall in GNP of 3.5 per cent was expected in 1982, and a further fall for 1983 as a whole might occur even if growth resumed in the latter half of that year. The terms of trade might continue to decline. The current account deficit could be about 10 per cent of GNP in 1982, partly the result of stock accumulation. The effect of the recently enacted policies would appear in 1982 in a marked slowdown in domestic demand and in a small decline, expected to continue into 1983, in the volume of merchandise imports. If there were a recovery in

exports, there could be as much as a 50 per cent reduction in the current account deficit in 1983. It was the authorities' aim to reach approximate balance in the current account in two years.

His authorities had shown by their recent actions their agreement with the staff appraisal, Mr. Sigurdsson went on, in particular the point highlighted by Miss Le Lorier, namely, that

The external and domestic situation requires the timely adoption of a comprehensive stabilization program, as only a combination of exchange rate and incomes policies, together with restrictive financial policies, will ensure a lessening of the inflationary pressures, and a reduction of the current account deficit.

The recent measures were limited both in scope and duration, having been enacted by a provisional law, subject to parliamentary approval, and would last only until the beginning of 1983. Therefore, further comprehensive measures in fiscal, monetary, exchange rate, and incomes policy were needed, as recognized by his authorities. While the Icelandic economy currently faced serious imbalances, it was worth remembering that on earlier occasions it had shown its resilience and ability to overcome adversity. For example, Iceland had succeeded in turning a current account deficit of 9-10 per cent of GNP in 1967 and 1968 to a surplus within two years, and a current account deficit of about 11-12 per cent in 1974 and 1975 to a surplus within three years.

Responding to Directors' comments on real wages, Mr. Sigurdsson remarked that there would be no increase in real wages in 1982, and by the beginning of 1983 the purchasing power of wages might be 6 per cent lower than the annual average for 1982. On the question of wage indexation, few meaningful generalizations could be made about its effects, because those effects would vary with the assumptions made about the behavior of the labor market in the absence of indexation, and with the type of wage indexation under study. However, most Directors would agree that from the point of view both of the efficacy of economic policy and of flexibility in the labor market, less than full indexation was better than full indexation. In particular, provisions to prevent losses in the terms of trade from being translated into nominal wage increases seemed to be a minimum limitation, a limitation that had been in effect in Iceland since 1979. There remained, however, a need to curtail the indexation mechanism further, and steps in that direction had recently been taken, although on a temporary basis. The Government was actively seeking additional lasting modifications, such as eliminating the effects of changes in all indirect taxes and energy prices, and/or offsetting such effects through the recognition of improved services derived from public expenditure, as for example petroleum taxes used for road building. The results of that approach were still awaited, but recently the labor unions had shown greater understanding of those efforts, at least temporarily, and were accepting the recent curtailment of indexation, to some extent even in collective agreements.

There was general agreement that a curtailment of wage indexation was needed to make exchange rate policy an effective instrument for external adjustment, Mr. Sigurdsson observed. In an open economy with widespread indexation, major imported inputs, and foreign-funded debt of the corporate sector as well as the public sector, the leverage of exchange rate policy was severely circumscribed. To make it more effective, it needed to be supplemented by appropriate measures of demand restraint and incomes policies. In an indexed economy, prices tended to move with the exchange rate, setting in motion an interaction between exchange rate changes and the domestic price level. The problem was to define a proper role for exchange rate policy in the context of a comprehensive policy stance. Broadly speaking, for most of the time in recent years, Icelandic exchange rate policy had aimed at offsetting the inflation differential vis-à-vis other countries, and at securing the profitability of the export sector, which had been done mostly through gradual depreciation. In the latter half of the 1970s, that policy had sufficed to keep the current account approximately in balance, although it was perhaps open to criticism as being too accommodating. However, in 1981, an attempt had been made for a short time to use the exchange rate deliberately to apply downward pressure on the rate of domestic price increase. The krona had been pegged to a basket of currencies, as one Director had suggested. However, the policy had proved insufficient to the task, because it had not been supported by restraint in other areas. A successful outcome would have required a fundamental change in domestic policies, not an easy precondition to satisfy.

Since the last quarter of 1981, exchange rate policy had been redirected to give primary consideration to the profitability of the export sector, Mr. Sigurdsson explained. The serious downturn in the economy had made devaluation unavoidable, and the average real effective exchange rate was expected to be 6 per cent lower in 1982 than in 1981. It was unclear whether that effective depreciation was sufficient; unfortunately, the terms of trade had declined further in 1982 and were not expected to improve in 1983. A new mix of policy instruments to secure the gains made by the provisional measures of August 1982 was needed. An effective exchange rate policy would have both income and relative price effects, and therefore supporting policies were needed. It was, however, important to put the stabilization effort in a medium-term perspective. Exchange rate policy had structural as well as short-term management implications that needed to be taken into consideration.

Commenting on fiscal policy and the financial position of the public sector, Mr. Sigurdsson suggested that Iceland had in certain ways done better than many other high-income countries. However, as the staff and many Directors had warned, the authorities should avoid relying too heavily on foreign borrowing for public sector investment. His authorities intended to restrain public expenditure and investment to achieve that end, and further measures to secure greater financial savings domestically were needed. His authorities were not in favor of a general increase in direct taxes at the moment, but such an attitude did not indicate disagreement with the staff on the need to maintain a tight

fiscal stance. They intended to secure the buoyancy of public sector revenue in other ways, and had demonstrated in recent years their ability to do so. The new company tax law, to which Mr. Dallara had referred, was an interesting response to inflationary conditions. The reform, which introduced inflation-accounting for tax purposes, was not intended to increase revenue but to distribute the company tax burden more equitably and efficiently by shifting the burden away from firms with a higher degree of self-financing, and in general by offsetting the arbitrary effects of inflation resulting from different forms of financing, as well as by creating the conditions for more orderly renewal of capital and less tax-speculative investment.

As the staff and many Directors had suggested, monetary policy needed to be strengthened, Mr. Sigurdsson observed, and a better balance could be achieved between domestic savings and investment by an increase in bank interest rates. The Government still adhered in principle to the policy laid down in the economic management law of 1979 to aim at interest rate levels that were positive in real terms. Steps had been taken in that direction, both through direct indexation and by increasing nominal rates in the banking system; the staff had described that effort well in SM/82/144 and in the appendix to SM/82/153. Recently, the implementation of that policy had been halted. As Directors would probably agree, it could be politically awkward to press for full indexation of financial assets at a time when limitations were being sought on wage indexation. That, however, did not detract from the importance attached to the long-run goal of establishing real interest rates on financial assets, for reasons of both equity and efficiency. As with exchange rate policy, it was preferable to achieve the desired result by coming to grips with the internal cost and price problems through reductions in inflation, rather than by pursuing the goal from the other side.

The Chairman made the following summing up:

Executive Directors expressed their general agreement with the thrust of the staff appraisal. They noted that, following a period of satisfactory growth, a tolerable current external position, and exceptionally low unemployment, Iceland had been confronted with severe supply constraints in the fishing sector in 1981-82. That development had combined with adverse cyclical factors to produce negative economic growth in 1982 and an increase in the current external deficit to an unsustainable level. The rate of inflation was running very high.

Directors felt that although the adverse cyclical and other temporary influences on the current external account in 1981-82 might be partly reversed in 1983, the remaining current external deficit was likely to remain too large since the resource constraints in the fishing sector could well persist for some time. Therefore, Directors suggested that Iceland should adjust itself to those constraints by a curtailment of excessive domestic demand.

In that connection, Directors pointed to the need to adopt a combination of exchange rate and incomes policies together with restrictive financial policies that would lessen the inflationary pressure, reduce the current external deficit, and help to preserve Iceland's international credit standing required for further development of its natural resources. Directors welcomed the further devaluation of the krona in August 1982, and the accompanying measures designed to curtail domestic demand and to moderate domestic cost and price pressures. But they felt that more needed to be done to secure satisfactory progress.

Directors advocated a shift of public sector operations in a more restrictive direction, including stricter control of public sector borrowing abroad, which constituted the main part of the public sector's credit financing. Several Directors felt that the envisaged curbing of public investment needed to be supported by a reduction in public subsidies, especially in the agricultural sector, and by further restrictive tax measures, given the high level of private consumption that was likely to be sustained following the new wage agreements.

Directors stressed that Iceland should urgently examine ways of strengthening the efficiency of fiscal policy. In that context, a number of Directors noted the fairly low burden of direct taxes in Iceland. Regret was expressed regarding the postponement of plans to introduce a PAYE system of income taxation and a value-added tax.

Pointing to the weakness and overaccommodating stance of monetary policy, several Directors suggested that, despite the upward adjustment of nominal interest rates since 1979, further increases in bank interest rates to levels that were positive in real terms needed to be achieved to establish a better balance between domestic savings and investment. Several Directors also stressed the need for a more restrictive monetary policy, including better control of consumer credit.

A number of Directors stressed that given the deterioration in the current account and the relatively high level of the external debt service, there was no alternative but to accept a reduction in real wages. In that respect, they welcomed, as a step in the right direction, the proposals made by the Government in discussions with the labor market partners to further limit indexation of wages, particularly since recently concluded wage agreements would not alleviate inflationary pressures.

A number of Directors stressed the need for timely adjustment of exchange rate policy in the future to forestall the emergence of speculative import demand and ensure profitability in the fishing sector. Directors welcomed Iceland's intention not to respond to its balance of payments problem with protective measures.

The Executive Board then turned to the proposed decision, which it approved.

The decision was:

Decision Concluding 1982 Article XIV Consultation

1. The Fund takes this decision relating to Iceland's exchange measures subject to Article VIII, Sections 2 and 3, in concluding the 1982 Article XIV consultation with Iceland, in the light of the 1982 Article IV consultation with Iceland conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. The Fund notes the intention of the Icelandic authorities to remove, by December 31, 1982, the deposit requirement on furniture imports and grants approval for the retention of the resulting exchange restriction until that date. Iceland continues to maintain, for fiscal reasons, a 10 per cent exchange tax on purchases of exchange for foreign travel. The Fund notes the intention of the authorities to remove the tax as soon as alternative measures are available and grants approval for the retention of the resulting multiple currency practice until December 31, 1982.

Decision No. 7210-(82/128), adopted
September 27, 1982

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/82/127 (9/27/82) and EBM/82/128 (9/27/82).

2. CHILE - FUND REPRESENTATIVE

In response to a request from Chile for a Fund representative, the Executive Board approves the proposal set forth in EBAP/82/337 (9/22/82).

Adopted September 27, 1982

APPROVED: March 18, 1983

JOSEPH W. LANG, JR.
Acting Secretary

