EBS/88/114

CONFIDENTIAL

June 9, 1988

To: Members of the Executive Board

From: The Secretary

Subject: Iceland - Exchange Arrangements

Attached for the information of the Executive Directors is a paper on Iceland's recent devaluation of the Icelandic króna.

Mr. Abrams (ext. 8822) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

ICELAND

Exchange Arrangements

Prepared by the European Department and
the Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by Massimo Russo and S. Kanesa-Thasan

June 8, 1988

I. Introduction

In the attached communication, the Icelandic authorities informed the Fund that the Icelandic króna was devalued by 10 percent on May 16, 1988. At the same time, the Central Bank was authorized to allow the króna to depreciate by another 3 percent if it was deemed necessary. On May 20, 1988, the Government announced a package of measures in support of the devaluation.

II. Background

Iceland has grown at the limits of capacity over the last several years. While the surge in growth was initiated by positive external factors, including record fish catches and a strengthening in the terms of trade, growth became driven by domestic demand in 1987 (Table 1). Excess demand spilled over into the external sector, causing imports to rise sharply, and inflation to accelerate anew. Despite another record fish catch and further improvements in the terms of trade, the external current account weakened from a small surplus in 1986 to a deficit equivalent to 3 1/2 percent of GDP in 1987. GDP growth remained rapid at 6 1/2 percent in 1987, while the real exchange rate (relative consumer prices) rose by almost 15 percent during the year (Chart 1). Net external debt fell to about 40 percent of GDP at end-1987.

By late 1987, it was clear that the period of rapid growth was nearing an end. Marine production was projected to be flat, while the terms of trade were not expected to improve. Despite a broad-based tax reform and a tightening of the 1988 Treasury budget--which brought the operational budget into balance--it was soon apparent that further measures were needed.

In late-January 1988, at the conclusion of Iceland's 1987 Article IV consultation, Directors voiced concern that unless domestic

Table 1. Iceland: Selected Economic Indicators

	1984	1985	1986	1987 Prov.	1988 Prel. proj. 1/
			(Percentage change)		
GDP	3.5	3.4	6.3	6.5	-1.0
Total domestic demand	5.7	3.0	3.9	13.4	-1.0
Private consumption	2.7	5.0	6.5	14.0	-1.5
Public consumption	0.2	6.2	6.5	4.0	2.0
Gross fixed investment	8.9	1.0	-2.2	12.7	-2.0
Exports of goods and nonfactor services	3.0	11.0	6.2	4.1	--
Imports of goods and nonfactor services	9.3	9.7	0.3	22.6	0.5
Cost of living index	29.2	32.4	21.3	18.8	28.0
(during the year)	18.8	35.9	13.5	24.3	23.0
Average nominal earnings	27.8	42.5	32.2	42.0	23.5
Average real earnings	-0.9	7.6	8.9	19.5	-3.5
Terms of trade	-1.1	1.3	5.0	4.2	-2.0
			(End of period; percentage change from 12 months earlier)		
Broad money (M_3)	33.4	47.6	35.0	36.0	25.0 2/
Deposit money bank lending	46.2	30.4	21.0	45.9	42.9 2/
			(Percentage)		
Unemployment	1.2	0.9	0.7	0.5	...
			(Percentage of GDP)		
External current account	-5.1	-4.0	0.3	-3.5	-4.5
Net external debt 3/	59.3	55.1	47.8	40.4	...
Public finances					
Treasury					
Revenue	23.5	22.6	24.1	23.8	25.5
Expenditure	22.7	24.6	25.2	25.2	25.5
Operational balance	0.9	-2.0	-1.2	-1.3	--
Gross public sector borrowing requirement	5.7	6.8	6.2	4.2	2.5

Source: Data provided by the Icelandic authorities.

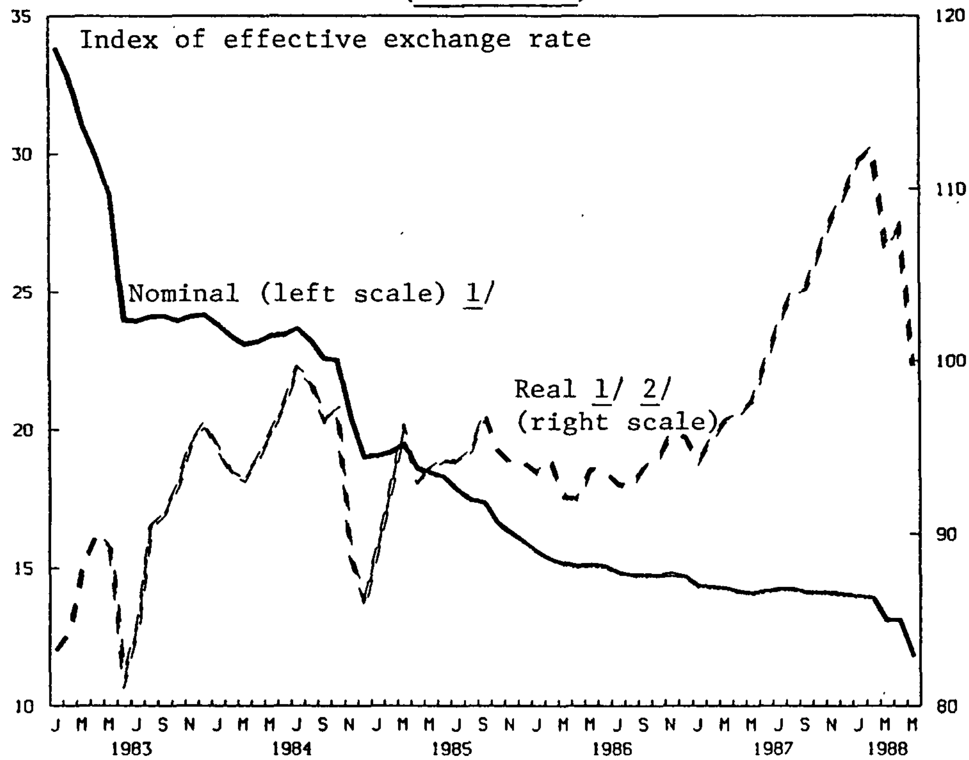
1/ Preliminary projections. The projections were made in May 1988 after the recent measures were introduced. These projections are subject to revision. The new official projections are scheduled to be published at end of June.

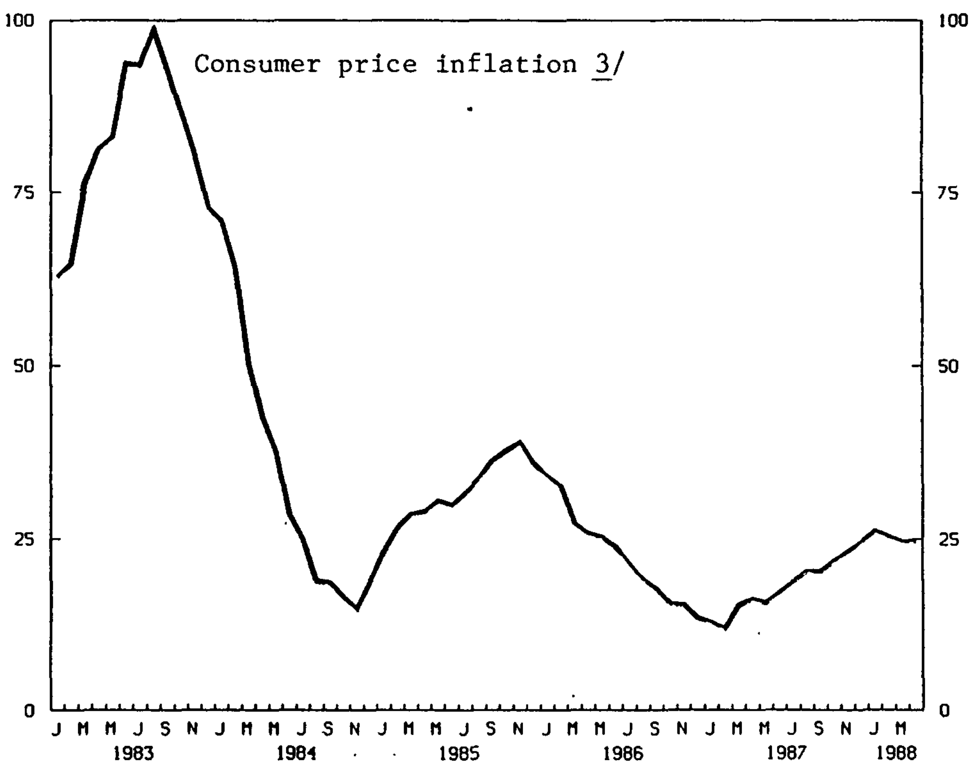
2/ April 1988 over April 1987.

3/ Net external debt calculated using end of year exchange rates.

CHART 1
ICELAND
INFORMATION NOTICE SYSTEM INDEX OF
EFFECTIVE EXCHANGE RATE AND CONSUMER PRICE INFLATION

(1980 = 100)





Sources: IMF, Information Notice System and Data Fund.
1/ May 1988 figures are estimated end of month values.
2/ Trade weighted index of nominal exchange rates deflated by seasonally adjusted relative consumer prices; increases mean appreciation.
3/ Percentage change from 12 months earlier.

demand was restrained, internal pressures would cause a further substantial deterioration in the balance of payments (SUR/88/10, 2/5/88). Directors warned that tighter financial policies were urgently needed. They also expressed concern about the large appreciation of the real exchange rate. Although most also observed that there would be little benefit in using the exchange rate in an overheated economy, except perhaps as a holding action. Directors hoped that the exchange rate action would be part of a larger package, including appropriate wage restraint, which should be introduced with a minimum of delay.

At end-February 1988, the Government announced a package designed to increase the profitability of the exposed sector. Key measures included a 6 percent devaluation of the króna and fiscal measures reducing the taxation of export industries, while keeping a balanced Treasury budget. However, unfavorable price developments in Iceland's main export markets, together with the new wage settlements, soon eroded the benefits of the February devaluation and speculative pressures emerged in mid-May. During the three days from May 9 to May 11, central bank sales of foreign exchange were equivalent to about 25 percent of reserves, leading to a one day suspension of the quotation of exchange rates. On Monday, May 16, the króna was devalued by 10 percent, and the Central Bank was authorized to allow the króna to depreciate by up to another 3 percent if it was deemed necessary. Currency outflows were reversed following the devaluation. The Government also announced that it would soon present additional measures.

On May 20, 1988, the Government issued the new policy package. Its centerpiece was a provisional law limiting wage increases for all unions which had yet to settle and extending all labor contracts through April 10, 1989; work stoppages were also made illegal during the life of the law. It was hoped the law would help avoid a potential surge in nominal wages and contribute to a reduction in real earnings of roughly 3 1/2 percent in 1988. However, there are some risks of wage drift, and action on the escalation clauses in the existing contracts was delayed. Government concessions in support of the law were minor, primarily allowing pensions and social security benefits to rise with wages, and moving up a planned cut in personal income taxes by one month. On the other hand, the budget was protected by freezing all expenditure categories in nominal terms except wages, pensions and social security benefits. Overall, the stance of fiscal policy was largely unchanged.

Several other measures were also introduced, including one rule making price increases by public enterprises subject to prior government approval and another abolishing the direct indexation of the principal of bank instruments with maturities of under two years. The Government also announced a number of its plans for 1989, including its intention to hold real government expenditure growth in line with real GDP growth and to balance the 1989 operational budget.

The authorities also made preliminary revisions of their 1988 projections. The projections now show a fall in GDP of 1 percent, because of small declines in private consumption and investment. The current account deficit is expected to rise to 4 1/2 percent of GDP, while the CPI may rise by 28 percent on average. These projections, however, depend on the planned real earnings cut being achieved, with any deviation likely to be reflected in higher inflation and/or a further deterioration in the current account. A new national economic forecast for 1988 is being prepared and will be presented at the end of June.

III. Staff Appraisal

Iceland now faces a significant adjustment problem brought about by the emergence of large external and internal imbalances. The external balance has deteriorated because of surging import demand and falling export prices, while the overheated domestic conditions have resulted in strong wage pressures and renewed high rates of inflation. The Government has responded by devaluing the króna and by introducing a statutory incomes policy. However, financial policies remain little changed. It is doubtful whether the policies in place will be sufficient to deal with the imbalances, and a major strengthening of financial policies seems to be necessary. Domestic demand could easily exceed projections, and the external position remains fragile, with the risks on the side of a larger deficit. The authorities have stated that they will respond to the situation as it develops and they realize that additional measures may be necessary.