SM/86/303

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December 19, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Iceland - Staff Report for the 1986 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1986 Article IV consultation with Iceland, which has been tentatively scheduled for discussion on Friday, January 30, 1987.

Mr. Knöbl (ext. 8821) or Mr. Abrams (ext. 8822) 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

Staff Report for the 1986 Article IV Consultation

Prepared by the Staff Representatives for the 1986 Consultation with Iceland

Approved by L.A. Whittome and J.T. Boorman

December 17, 1986

I. Introduction

A staff team consisting of Messrs. A. Knöbl, U. Dell'Anno, R. Abrams, and O-P. Lehmussaari, with Miss C. Byrne as secretary (all EUR), held Article IV consultation discussions in Reykjavik from October 22 to November 3, 1986. The Icelandic representatives participating in the discussions included officials of the Ministries of Finance, Commerce and Fisheries, the Central Bank of Iceland, the National Economic Institute, the National Statistical Bureau, the Institute for Marine Research, the Trade Union Organization, and the Employers' Federation. The mission met the Deputy Prime Minister and Minister of Fisheries, Mr. H. Ásgrímsson; the Minister of Finance, Mr. T. Pálsson; and the Governors of the Central Bank of Iceland, Dr. J. Nordal, Mr. T. Árnason, and Mr. G. Hallgrímsson. Mr. H. Fugmann attended the meetings as an observer.

Iceland accepted the obligations of Article VIII, Sections 2, 3, and 4 from September 19, 1983. Iceland purchased the equivalent of 49.4 percent of its then quota under the compensatory financing facility in December 1982.

Since May 1983, Iceland has been ruled by a coalition of the Independence and Progressive Parties. General elections are due by April 1987.

II. Background

The Icelandic economy is characterized by a high degree of openness, and a strong dependence on the fortunes of the fishing sector, which in 1985 accounted for nearly one-fifth of total output, and about three quarters of export earnings. The fish catch has been subject to substantial swings; it fell sharply in 1982 and 1983, but has recovered strongly since then, with record catches in 1985 and 1986 (Chart 1).

Iceland has repeatedly turned to international capital markets in order to smooth adjustment to supply shocks. Foreign debt was built up in the 1970s to finance large investments in the energy sector and energy-intensive projects, but the increase in external debt was particularly steep in the early 1980s. Net external debt stood at over 60 percent of GDP at end-1985, 1/ double the level of end-1980.

An important feature of Icelandic economic policy has been the maintenance of full employment, even in the face of supply shocks. Full employment has been the overriding objective of the authorities, to the detriment at times of price stability and the balance of payments. The maintenance of full employment has required a significant flexibility of real wages, in order to contribute to adjustment when fish catches fell (Chart 2).

The year 1985 marked the second of a strong economic upturn, with real GDP continuing to rise by over 3 percent, led by a strong increase in the fish catch (Table 1). Final domestic demand increased by 3 3/4 percent, while shifting from investment to consumption; with gross fixed investment flat, both private and public consumption rose by about 5 percent. The external current deficit narrowed from 5 percent of GDP in 1984 to 4 1/4 percent in 1985, as a result of a record fish catch and a rundown of export stocks. The unemployment rate fell from 1.3 percent of the labor force in 1984 to 0.9 percent in 1985, as the labor market became increasingly tight. Some of the significant progress made in 1984 in reducing inflation was reversed; consumer price inflation rose from 19 percent during 1984 to 36 percent during 1985. Although the nominal effective exchange rate depreciated by 16 percent during 1985, the real exchange rate (relative consumer prices) appreciated by 9 1/2 percent, to a level that was even then still 10 percent below its most recent peak in 1981. 2/

At the conclusion of the 1985 Article IV consultation, 3/ Directors expressed concern about the high level of Iceland's external debt, and urged the Icelandic authorities to give the highest priority to external adjustment and to adapt economic policies accordingly. Specifically,

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1/ Measured at end-1985 exchange rates. The Icelandic authorities measure debt at annual average exchange rates, which smooths the effect of exchange rate changes on the ratio of debt to GDP; measured that way net external debt was equivalent to 56 1/2 percent of GDP at end-1985. It should be noted that Iceland's debt figures include all foreign debt, not only public sector debt. Iceland's foreign debt is well structured; in 1985, the net debt service ratio had amounted to 19 percent of exports of goods and nonfactor services.

2/ Staff estimates.

3/ EBM/86/8 (1/13/86).

CHART 1

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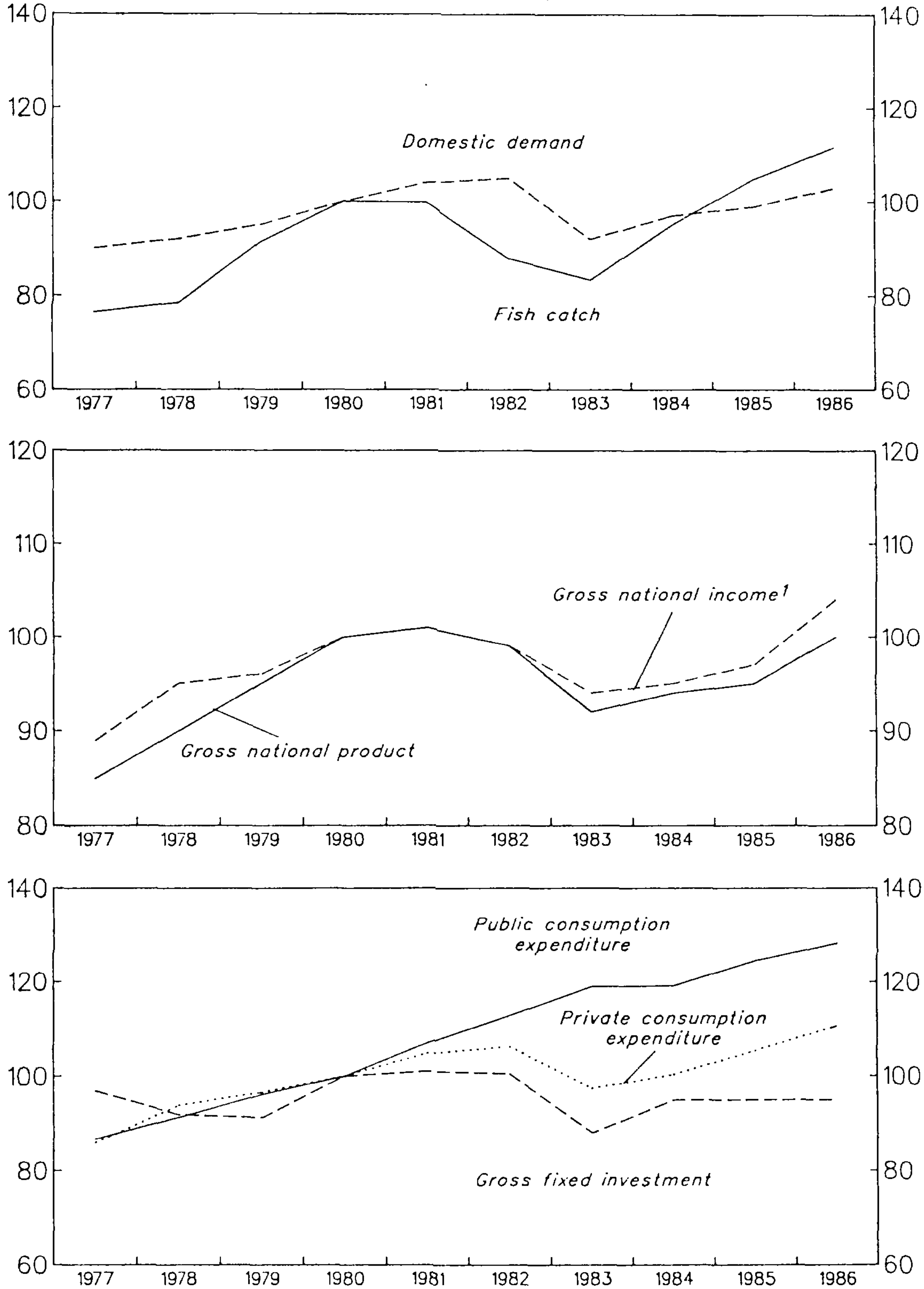
REAL DEMAND AND OUTPUT

(Indices 1980 = 100)



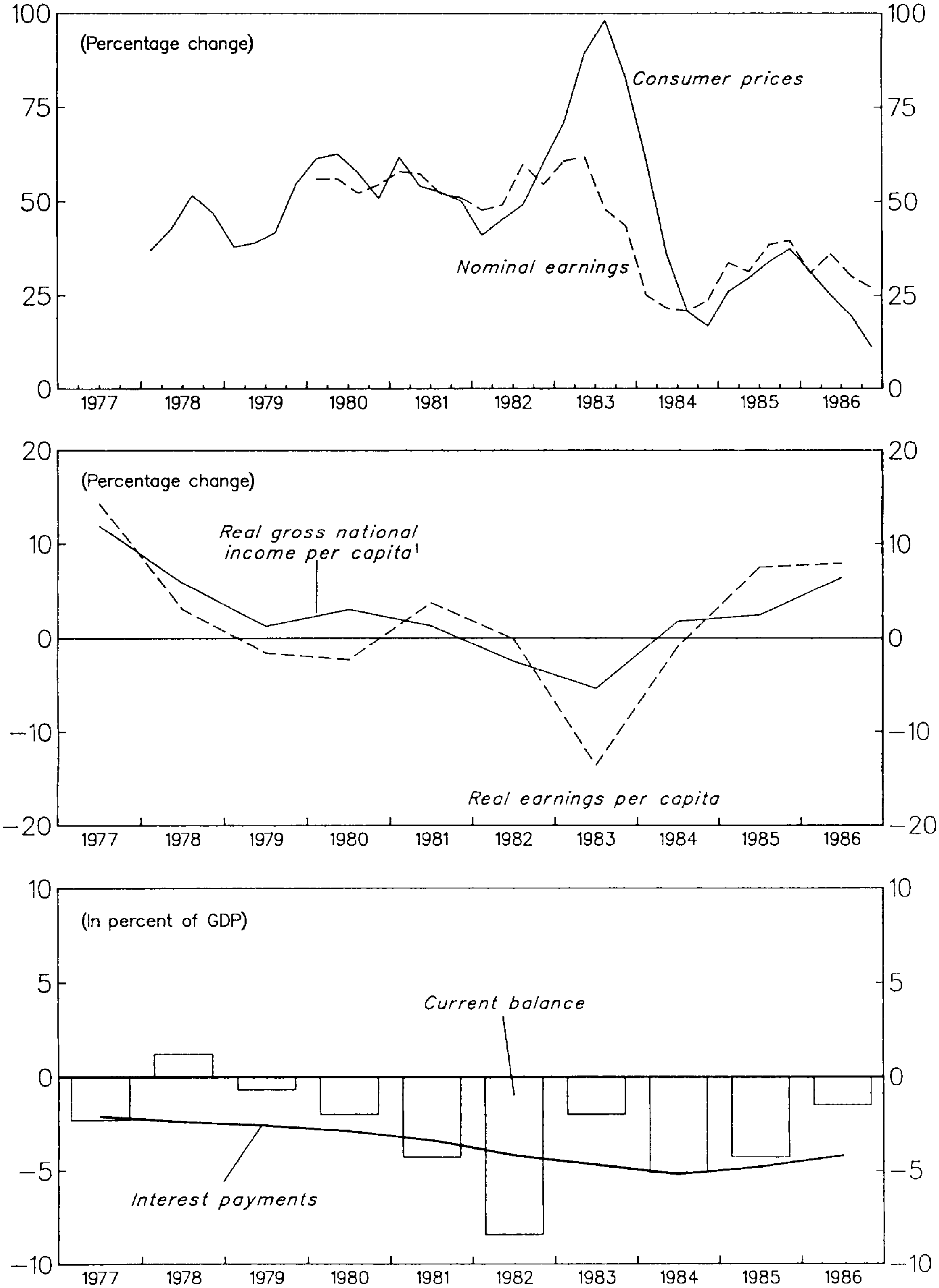
Sources: Central Bank of Iceland, *Economic Statistics;* data provided by the National Economic Institute; and staff estimates.

[1] Real GDP, adjusted for changes in terms of trade.

CHART 2

ICELAND

INFLATION AND THE BALANCE OF PAYMENTS



Sources: Central Bank of Iceland, *Economic Statistics;* data provided by the *National Economic Institute;* and IMF, *International Financial Statistics.*

1 GDP, adjusted for changes in the terms of trade.

Table 1. Iceland: National Accounts and Other Economic Indicators

	1983	1984	1985	1986 1/	1987 Forecasts Official 2/	1987 Forecasts Staff 3/
			(Percentage change, in volume)			
GDP	-5.0	3.4	3.1	5.0	2.2	2 1/2
Final domestic demand	-6.8	3.5	3.7	3.6	1.7	3 3/4
Private consumption	-8.3	3.0	5.0	5.0	1.5	5
Public consumption	5.5	0.1	4.5	3.0	1.7	1 3/4
Gross fixed investment	-12.3	7.8	--	--	2.2	2 1/4
Exports of goods and nonfactor services	10.3	3.0	11.0	6.3	4.0	4
Imports of goods and nonfactor services	-5.7	9.3	9.7	4.4	3.5	8 1/2
			(Percentage change)			
Memorandum items:						
Cost of living index	84.3	29.2	32.4	21	...	...
(during the year)	(76.6)	(18.8)	(35.9)	(11)	...	...
Average nominal earnings	56.5	27.8	42.5	31	...	...
Average real earnings 4/	-13.5	-0.9	7.6	8	...	...
(during the year)	(-22.7)	(5.1)	(2.1)	(14 1/2)		
Unemployment rate (in percent)	1.0	1.3	0.9	0.7	...	...

Sources: The National Economic Institute; and staff estimates.

1/ Official estimates.
2/ Normative official forecast as presented in the National Economic Program for 1987.
3/ Assumes that growth in private consumption can be held to 5 percent.
4/ Deflated by private consumption deflator.

Directors stated that a significant tightening of financial policies and a reduced reliance on external financing were needed in the face of strong domestic cost pressures caused by the overtight labor market.

III. Recent Developments and Economic Policies

1. Recent developments

A year ago the Icelandic authorities indicated that full employment would remain the key priority of the Government in 1986, and was to be achieved without accelerating inflation. Other important objectives were to stop the growth of foreign debt over time, and to balance the external current account by 1988; a first step toward these goals was to be taken in 1986. For this purpose, the authorities intended to limit the growth in domestic demand to 1 percent in 1986. This was considered necessary to reduce the external current deficit to 3 3/4 percent of GDP, given the then foreseen increase in marine output, and unchanged terms of trade. Fiscal restraint was to keep domestic demand in check.

In the event, economic developments have been significantly more favorable than was expected a year ago. The external current account deficit is now estimated to decline to 1 1/2 percent of GDP (SDR 45 million) in 1986 (Table 2). Data for the first nine months suggest that the final figure for the deficit may be even lower, in large part because of special nonrecurrent factors. Exports of goods and services are estimated to rise by 6 1/2 percent, as a result of strongly rising output in the major export categories. Marine output, which was a record in 1985, is again projected to rise sharply, while the aluminum smelter and the ferrosilicon plant are both producing at close to full capacity. The increase in imports of goods and services is estimated to be held to 4 1/2 percent, in part because of a transitory sluggishness of special imports for the aluminum smelter. The terms of trade are also estimated to improve by over 4 percent in 1986, as a result of the fall in oil prices and a rise in fish prices. With the stronger current account, foreign borrowing was reduced; the build up of short-term debt in 1985 was refinanced by the issue of long-term debt. Gross official reserves stood at SDR 194 million at end-September (equivalent to 12 weeks of imports), a level that the authorities view as adequate. Net external debt is estimated to decline to 51 1/2 percent of GDP at end-1986, in large part because of the real appreciation of the króna against the U.S. dollar.

Real GDP is now estimated to rise by 5 percent or more in 1986, rather than 2 percent projected a year ago. Domestic demand is also

Table 2. Iceland: Balance of Payments

(In millions of SDRs)

	1983	1984	1985	1986 1/	1987 Forecasts Official 2/	1987 Forecasts Staff 3/
Exports, f.o.b.	701	725	801	869	916	915
Imports, f.o.b.	-683	-735	-801	-819	-846	-895
Trade balance	18	-10	--	50	70	20
Net services and transfers	-67	-116	-114	-95	-84	-105
Of which:						
Interest payments	-112	-129	-125	-124	-122	-120
Current balance	-49	-126	-114	-45	-14	-85
(in percent of GDP)	(-2.0)	(-5.1)	(-4.3)	(-1.5)	(-0.5)	(-3)
Long-term capital	86	112	153	...	...	...
Short-term capital 4/	-29	-14	76	...	...	...
Capital balance	57	98	229	...	...	...
Overall balance	8	-28	115	...	...	...

Sources: Data provided by the Central Bank and the National Economic Institute; and staff estimates.

1/ Official estimates.
2/ Normative official forecast as presented in the National Economic Program for 1987.
3/ Assumes that growth in private consumption can be held to 5 percent.
4/ Including errors and omissions.

more buoyant than targeted, with private consumption rising by 5 percent for the second year in a row. The increase would have been larger had not savings increased, in part as a result of higher real interest rates.

The rapid growth of output caused labor market conditions to tighten further in 1986, with unemployment estimated to average a little over 1/2 percent of the labor force. Moreover, the number of vacancies (2-3 percent of the labor force) by far exceeded the number of unemployed, and severe labor shortages emerged in certain areas, e.g., in fish processing. Even so, incomes policy measures (see below), helped to slow consumer price inflation to an estimated 11 percent during 1986. The extremely tight labor market, however, resulted in substantially stronger wage pressures than the authorities had wished. Real wage earnings are now estimated to rise by 14-15 percent during 1986, with real personal disposable income at year-end expected to be 4-5 percent higher than the average for the year. 1/

2. Incomes policy

Incomes policy was the central economic policy issue in 1986. When it became clear early in the year that the terms of trade would improve significantly because of the fall in the price of oil, the Government felt that this provided an opportunity to achieve its main economic objectives, namely full employment, reduced inflation, and an improvement in the external accounts. Accordingly, the Government tried to influence the wage negotiations, and eventually agreement was reached on an increase in nominal wage rates that was low by recent standards: staggered increases were to result in an increase of 14 1/2 percent until the end of 1986. The contracts also contained renegotiation clauses.

In order to achieve this settlement, the Government made a number of concessions designed to lower inflation and boost real earnings. First, it agreed to implement a package of cuts in customs duties and indirect taxes, increased subsidies, and reduced public sector fees and charges to lower the cost of living index by over 4 percent, with a cost to the budget of about 1 1/4 percent of GDP. Second, nominal interest rates were reduced in line with the expected slowdown in inflation. Third, barring unforeseen events, the nominal effective exchange rate was to be kept unchanged during the remainder of 1986. The agreement, negotiated essentially in real terms, was expected to yield an increase in real average earnings of 4-5 percent in 1986, and to reduce consumer price inflation to single digits in the course of the year. As noted above, inflation exceeded expectations by only a little, but wage pressures were much stronger than anticipated. It is now estimated that

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1/ These estimates are based on preliminary attempts by the National Economic Institute of Iceland to calculate disposable income and the savings ratio of households.

real earnings will increase on average by 8 percent in 1986, but substantially more in the course of the year, implying a large carryover of purchasing power into 1987.

Wage negotiations will take place in early 1987. The Government recognizes the need for containing domestic demand and further reducing inflation, but has refrained from setting wage guidelines. While the authorities have stressed that there will be no scope for similar fiscal policy measures as undertaken in 1986, they have indicated that the pricing policy of public enterprises will be reviewed. They regard this as one instrument to contain price developments in 1987 within acceptable limits. The Icelandic representatives said that, while the excess demand for labor contributed to wage pressures in 1986, real wage growth historically closely followed output growth; thus, should economic growth slow, the real wage growth could also be expected to slow.

3. Fiscal policy

As had been noted in previous reports, fiscal analysis in Iceland has traditionally been conducted in the framework of relatively narrowly defined Treasury accounts, comprising mainly current, and only to a limited extent investment transactions of the Central Government. Moreover, under the present accounting procedures, the Treasury budget includes only the real portion of interest payments on indexed domestic public debt. As a result, the Treasury accounts have tended to understate the size of the public sector borrowing requirement (PSBR). 1/ Progress has been made in 1986 in widening the definition of the Treasury accounts, and the Icelandic authorities are in the process of preparing consolidated central and general government accounts for publication. 2/

The budget for 1986, as passed by Parliament in December 1985, was aimed at moving the operational balance from a deficit of over 2 percent of GDP in 1985 into small surplus in 1986, largely through higher indirect taxation (Table 3). This was to underpin the target of restraining domestic demand. However, as in the previous year, fiscal policy in 1986 has been much more expansionary than originally planned. The operational deficit is now estimated at about 1 1/2 percent of GDP. The PSBR is estimated at 5 1/2 percent of GDP, rather than less than 4 percent as envisaged in the credit budget.

1/ For example, while the narrow, operational Treasury deficit amounted to some 2 percent of GDP in 1985, the conventional balance, which includes net lending and the monetary correction for indexed domestic debt, was in deficit by about 4 percent of GDP; including transactions outside the Treasury, the gross PSBR amounted to 7 1/2 percent of GDP. The PSBR is approved by Parliament as part of the so-called "credit budget."

2/ The accounts would still show only the operational balance.

Table 3. Iceland: Public Finances

(In percent of GDP)

	1983	1984	1985	1986 Budget law	1986 Official proj.	1987 Budget Proposal
Treasury 1/						
Revenue	24.1	25.4	24.5	26.4	25.8	25.9 2/
Expenditure	26.0	24.5	26.7	26.3	27.4	27.0 2/
Operational balance	-1.9	1.0	-2.2	0.1	-1.5	-1.1
Conventional balance 3/	-5.9	-2.5	-4.1	...	...	...
Total public sector						
Gross borrowing requirement	5.8	6.1	7.4	3.8	5.5	3.7
Of which:						
Foreign borrowing	(4.7)	(5.5)	(4.3)	(2.3)	(3.0)	(1.7)
Domestic borrowing	(1.1)	(0.6)	(3.1)	(1.5)	(2.5)	(2.0)
Of which: banking sector 4/	(2.7)	(0.5)	(2.1)	(0.6)	(0.6)	(1.1)

Sources: Data provided by the Icelandic authorities.

1/ Because of a change in coverage, Treasury data for 1985 and before are not fully comparable with data for 1986 and onward.

2/ In 1987, these ratios are reduced by about 1/4 percent of GDP because of the elimination of the tax-transfer system involving the electrical utilities.

3/ The conventional balance is defined as the operational balance, plus net lending, plus the monetary correction for accruals resulting from the indexation of the principal of most of the Treasury's domestic debt.

4/ Bank lending to Government and municipalities.

These deviations stemmed from the fiscal concessions made by the Government as part of the wage settlements; higher wage costs and pension payments; and higher borrowing by municipalities and public enterprises.

The Icelandic representatives said that the budget deficit was the price paid for a reduction in inflation in 1986, even though wage earnings had increased much more than hoped. The Government now intended to eliminate the deficit in steps over some two to three years. The Icelandic representatives recalled that over the past few years expenditure restraint had been achieved primarily by reducing capital outlays. Now it would be desirable to make progress on restraining current spending, though this would be difficult. They noted that the whole tax system, which relied heavily on indirect taxation, was under review, and the authorities had requested technical assistance from the Fund for certain legal aspects of this. The Government was again preparing to introduce a value-added tax proposal to Parliament, upon completion of discussions with business and labor. It now hoped to introduce the VAT on January 1, 1988. The Government was also ready to reintroduce a bill, that had been postponed last year, to streamline the tariff system. A broadening of the income tax base and a lowering of tax rates were also under consideration. The introduction of a pay-as-you-earn system was under study, but a move to such a system was not imminent.

The Icelandic representatives saw the budget proposal for 1987 as a first step in improving the public finances. The operational deficit was to be reduced to some 1 percent of GDP. Government spending on goods and services was budgeted to rise a little in relation to GDP, but total spending was to be roughly unchanged. A lowering of income taxation was to be more than offset by a proposed increase in energy taxes. The Icelandic representatives stated that, given the risk of a backlash in the upcoming wage negotiations, it was necessary for changes in fiscal policy to be made cautiously.

The credit budget for 1987, presented to Parliament together with the Budget, envisaged a gross PSBR of 3 3/4 percent of GDP. Efforts to contain price increases at public enterprises could, however, add further to the borrowing requirement. Moreover, both the Budget and the credit budget were expressed at the price and wage levels of late 1986. Wage increases during 1987 would thus upset these estimates, though the Icelandic representatives stressed that any wage concessions to government workers were unlikely to exceed increases in the private sector. The credit budget called for a higher proportion of the PSBR to be financed domestically than in the past. However, the credit budget envisaged the placement of a large amount of bonds with the banks, carrying the risk of monetary financing of the PSBR, unless credit to the private sector was restrained.

4. Monetary policy

Significant changes in the institutional arrangements of the financial system have taken place in recent years. These changes have been aimed at improving the functioning of financial markets and making monetary policy less accommodating. The Central Bank has gradually allowed domestic banks to set their interest rates, and institutional changes have reduced automatic accommodation of the demand for credit through the Central Bank.

In August 1984, the banks were given greater freedom to set certain lending and deposit rates. The Central Bank, however, continued to administer a number of key interest rates, including the rates on general savings accounts. Moreover, the Central Bank reserved the right to veto the banks' interest rate decisions, which it did on several occasions. Since November 1, 1986, when the new Central Bank Act became effective, the banks have been free to determine all of their own interest rates.

In the process of deregulation, most interest rates have become positive in real terms (Chart 3). For example, indexed rates on Government savings certificates currently pay a real return of 6.5 percent; however, some nonindexed rates, such as on general savings deposits, have remained negative in real terms. The banks now also offer deposits that earn the higher of a predetermined nominal interest rate, or an indexed, real rate.

A number of institutional changes have been made to allow monetary policy to be less accommodating. In 1985, the Central Bank ceased to discount bills of exchange automatically to finance stocks, an arrangement which had, at times, severely hampered monetary control. The authorities also plan to abolish the banks' automatic access to overdraft credit at the Central Bank. Much will then depend on discretionary central bank lending and the setting of interest rates on such lending. The mechanism for the setting of Central Bank rates was, however, still unclear. The new Central Bank Act also limits the direct financing of the budget deficit to financing within the year; any overdraft of the Treasury outstanding at the end of the year must be paid up within three months. The Central Bank is, however, free to buy Government securities.

The Act also gives the Central Bank the right to impose a required liquidity ratio on the banks. The Icelandic representatives said that there was pressure to reduce the minimum (cash) reserve requirement, which is at present 18 percent of bank deposits, and to supplement it with a liquidity ratio. The mission stressed that care would need to be taken to avoid an unplanned expansionary impulse from such a move.

The Icelandic representatives noted that over the past two years higher real interest rates had led to increased financial savings, so that not all the real incomes gains had been consumed. However, the

CHART 3

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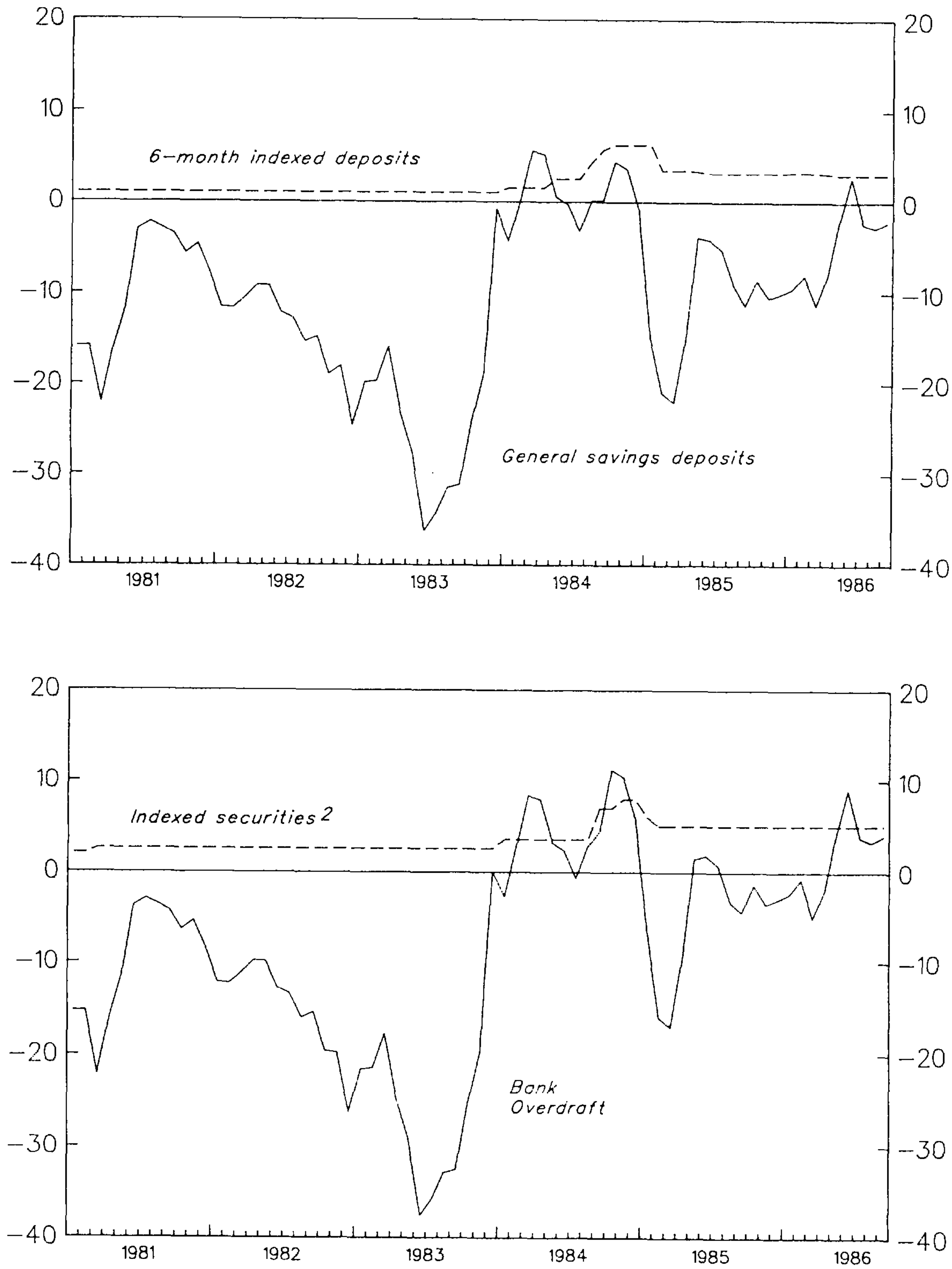
REAL INTEREST RATES ON BANK DEPOSITS AND LOANS[1]



Source: Central Bank of Iceland, *Economic Statistics*.

[1] Deflated by annualized quarterly change in credit terms index.

[2] Maturity over 2 1/2 years.

growth of money and credit had remained very rapid in comparison with the increase in incomes, with broad money rising by 37 1/2 percent in the twelve months to September 1986 (Table 4); external and bank finance of the large PSBR had contributed to this development. While it was difficult to interpret monetary growth because of the recent changes in the financial system and because the slowdown in inflation and higher real interest rates had stimulated the demand for broad money, a significant liquidity overhang may still have developed; therefore the continued rapid monetary expansion was viewed as a matter of concern. The mission stressed that, should a tendency toward greater spending of recent real income gains develop, greater interest rate flexibility would be crucial to protect financial savings.

5. Exchange rate policy

Exchange rate policy has undergone several changes in recent years. After a strong competitive position was established prior to the statutory incomes policy in 1983, the nominal effective exchange rate was stabilized for a time to help reduce inflation. Following the collapse of incomes policy in late 1984, the króna was devalued, but the real exchange rate was then allowed to appreciate during 1985 (Chart 4). The Icelandic representatives said that exchange rate policy in 1986 has had two aims: to protect the competitiveness and profitability of the export sector and to reduce inflationary pressures. The commitment to maintain the nominal effective exchange rate, made in conjunction with the February wage settlement, implied a further appreciation of the real exchange rate. As this would have put strong pressure on parts of the export sector, the authorities allowed the effective exchange rate to depreciate a little. In September 1986, the effective exchange rate was 7 1/2 percent below the level of end-1985, 1/ while the real exchange rate, measured by relative consumer prices, had risen by 2 1/2 percent. 2/

The Icelandic representatives did not view the present level of the real exchange rate as too high, in view of the increase in the real purchasing power of export earnings. They felt that it was not at all clear that a lower real exchange rate would affect exports of fish--the main export item--since its output was constrained by ecological developments. The profitability of the export sector also did not suggest that the real exchange rate was out of line. The Icelandic representatives thought that, against the background of favorable fish catches and terms of trade, external balance could be achieved at the present real exchange rate, as long as demand management policies could be tightened sufficiently.

1/ Staff estimates.
2/ Adjusted for changes in indirect taxes and subsidies that did not affect production costs.

Table 4. Iceland: Contribution to Growth in Broad Money

(Change in percent of money stock; 12 months earlier)

	1983	1984	1985	1986 Sept.
Net domestic credit 1/	132.5	66.8	59.8	39.7 2/
Net foreign assets	-53.7	-33.4	-12.2	-2.1
Broad money (M_3)	78.8	33.4	47.6	37.6 2/
Memorandum item:				
Cost of living (change in percent; end-period)	76.6	18.8	35.9	17.6

Source: Data provided by the Icelandic authorities.

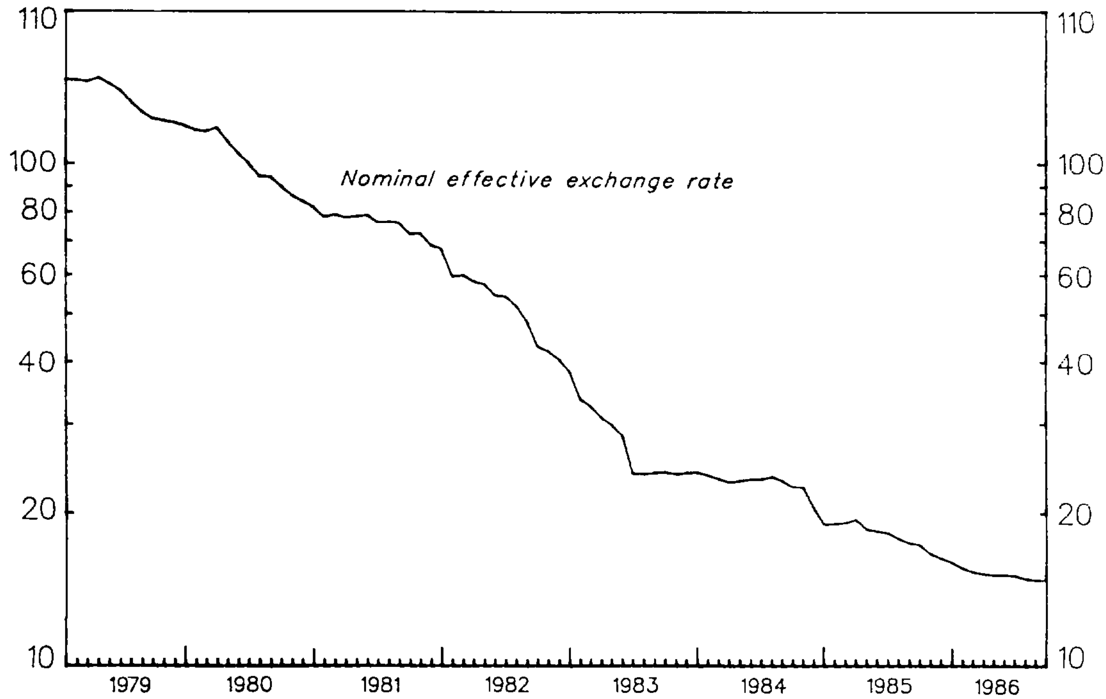
1/ Including external borrowing by the Treasury.
2/ Including accrued interest.

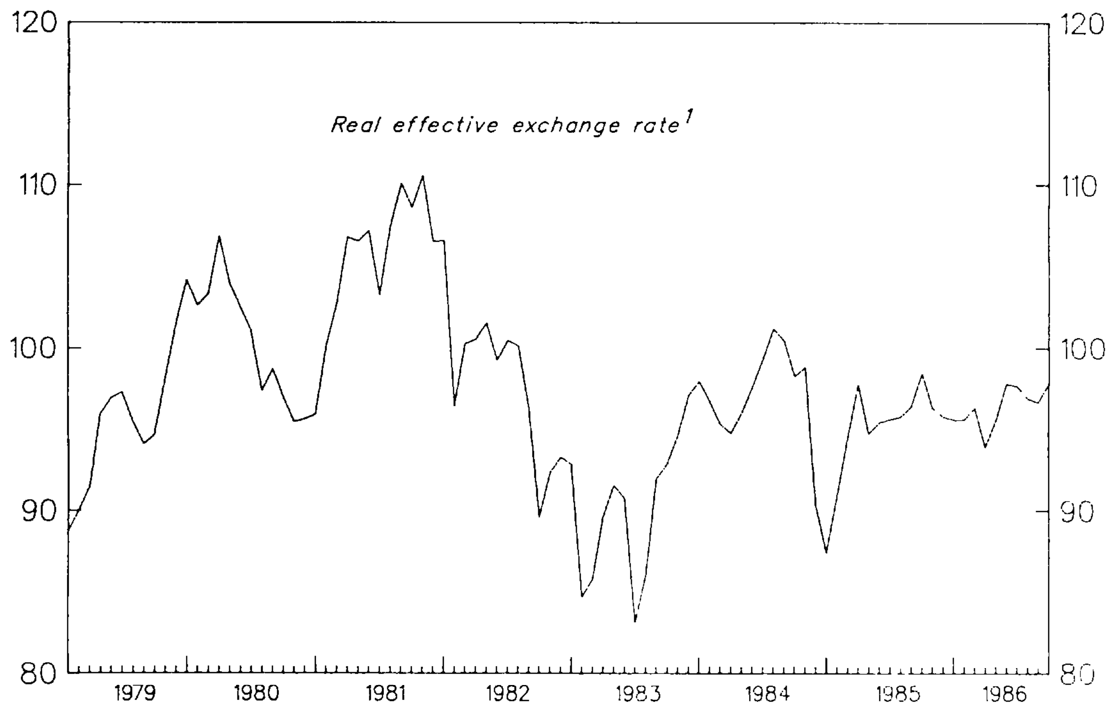
CHART 4

ICELAND

EXCHANGE RATE MOVEMENTS

(Index 1980 = 100)





Source: Information notice system.

[1] Index of nominal effective exchange rate deflated by seasonally adjusted consumer prices; increase means appreciation.

6. Policies affecting the supply-side and trade

As noted above, significant progress in liberalizing and deregulating the money and capital markets has been made in recent years. In addition, the role of price controls has been reduced substantially. Both these factors are expected to promote the improved utilization of resources within the economy. The domestic securities market, which started trading in 1986, should also help to improve the efficiency of the financial system over time.

Over the medium term, Iceland's most important supply-side problems will probably arise from the limitations on its fisheries and its labor force. In recent years, much effort has been devoted to improving the prospects for Iceland's fisheries and to increasing the efficiency of its fishing fleet. The introduction of fishing quotas in 1983/84, aimed at limiting the catch, has allowed the fish stocks to increase and the age distribution of the fish to improve. The introduction of "effort quotas" in 1985, which allow a boat to limit its days at sea rather than its catch, has increased the efficiency of the fishing fleet, without significantly increasing the fishing pressure. The increased transferability of fishing quotas has also improved the efficiency of the fleet. Fisheries policies beyond 1987 have not yet been decided, but it is expected that continued caution will remain necessary so as to reduce the risks of a future slump of the fish catch.

Progress has also been made in increasing the transparency of pricing the fish catch. Prior to 1986, various funds were used to redistribute the income within the fishing sector. However, in May 1986, this system was greatly simplified. In addition, the price of capelin has been freed. Proposals are now being considered to open domestic auction markets through which foreign and domestic buyers would compete directly.

The introduction of fish farming has helped to increase fish production, without putting major strains on fisheries capacity or on scarce labor resources. Fish farming has been growing rapidly, with its share of total investment rising from 0.1 percent in 1983 to 3 percent in 1986. Fish farm exports, mostly salmon and salmon fry, approached SDR 4 million in 1986, and are projected to rise by 20-50 percent annually during the next 3-5 years. Tourism is another potential source of foreign exchange earnings where the authorities consider the prospects to be favorable.

Iceland's large potential capacity for hydroelectrical and geothermal energy gives it a comparative advantage in energy-intensive activities. Such investments could allow for increased domestic output at a minimal cost in terms of labor resources. However, the recent decline in energy prices, coupled with the apparent worldwide excess capacity in basic metals processing, may slow progress in this area.

Iceland's trading system has remained open. The Government is, at present, considering a revision to the tariff system which would streamline and simplify the system, while scaling down the highest rates. Important elements of the proposal include the abolition of customs duties on all industrial machinery and equipment, raw materials and spare parts, as well as the abolition of the few remaining duties based on volume.

IV. Short-Term Outlook and Policy Issues

The Government's economic objectives for 1987 are to consolidate and extend the gains achieved in 1986. Full employment remains the prime objective, but with reduced pressure on the labor market. It is, thus, necessary that economic growth should slow in 1987. The Government hopes that GDP growth of 2 percent can still be achieved while excess demand in the labor market is reduced. Given the high level of external debt, it is also a main objective of the Government to reach near balance on the external current account in 1987. Finally, the Government hopes that inflation can be brought down further during the year, to a level similar to that prevailing in partner countries.

The authorities' normative forecasts outline the requirements for the achievement of these objectives. The outlook for the fisheries is considered favorable, with marine output expected to increase by 4-5 percent in 1987; this implies that the fish catch will rise to about 16 percent above its previous peak in 1980. This forecast is generally regarded as feasible though on the optimistic side. Exports of goods and services are projected to rise by 4 percent in 1987. On the assumptions that oil prices and interest rates remain at their late-1986 levels, the overall terms of trade are forecast to improve on average by some 2 percent in 1987. Under these assumptions, the growth of imports of goods and services would have to be limited to 3 1/2 percent in 1987, if the external current account deficit is to be reduced to 1/2 percent of GDP. Official estimates suggest that domestic demand growth would need to be restrained to less than 2 percent for the import target to be met. Given public spending and investment plans, this would imply that the growth of private consumption would have to be held to 1 1/2 percent in 1987. For the inflation target to be met, wage earnings could not increase by more than 4-5 percent in the course of 1987, and the exchange rate would need to be held fixed, implying that the real exchange rate be maintained at its level of late 1986.

The Icelandic representatives said that it would be left to the social partners to reach a wage settlement compatible with these goals. The authorities had stressed publicly that personal disposable income must not increase by much more than the targeted increase in private consumption, unless savings continued to increase. A tighter monetary policy, with higher real interest rates, could contribute to this. Major changes in fiscal policy were not likely, at least before mid-1987.

The mission noted that a substantial real wage "overhang" had developed in 1986: real wage earnings were estimated to have risen by 14-15 percent in the course of 1986, with real personal disposable income at year-end about 4-5 percent higher than the average for the year. Even with no further increase in real wage rates--which was an optimistic assumption, given the excess demand in the labor market--and allowing only for expected wage drift, real earnings would rise substantially in 1987. The mission estimated that real wage earnings could rise on average by at least 8 percent in 1987, with existing pressures in the labor market.

The challenge for policy would be to bridge the gap between the level of real earnings and the Government's target for private consumption. The mission agreed that real interest rates could be allowed to rise to limit spending, but the gap appeared too large to be closed by monetary policy alone. Exclusive reliance on monetary measures would also affect investment as well as consumption. The mission felt that it was perhaps feasible for monetary policy to restrain consumption to the rate of growth it has recorded in recent years. Even this, however, seemed to imply that the burden placed on monetary policy would be greater than in the recent past, with obvious implications for real interest rates.

Even assuming that monetary policy could shoulder this task, the mission stressed that a major fiscal policy effort would still be required to close the remainder of the gap, essentially between the real wage overhang and the targeted consumption. Staff estimates suggested that a fiscal effort of at least 2 percent of GDP over and above the fiscal improvement budgeted for 1987 was required for this purpose. Such an effort could make the task of monetary policy feasible.

In the staff estimates for 1987, the real exchange rate was assumed to be maintained at its present level. This implied that the exchange rate would be adjusted to offset any gap between Iceland's inflation and inflation abroad, and, therefore, that exchange rate policy would not actively contribute to external adjustment. This, of course, placed greater demands on fiscal and monetary policies, but would also help in limiting the inflation differential between Iceland and abroad.

Although the Icelandic representatives appreciated the staff's assessment that the gap between real earnings and the private consumption target needed to be bridged at least in part by fiscal policy, they stressed that the Government viewed the Budget for 1987 as satisfactory for this purpose. They felt that the deficit could be essentially financed domestically, though that might require higher real interest rates. If this proved to be insufficient, the external balance could be weaker, or the exchange rate could be moved, with consequences for inflation. Staff estimates suggest that, if fiscal policy is not tightened, and the real exchange rate is maintained, but monetary policy succeeds in limiting the increase in private consumption to 5 percent, the external current account deficit could again widen to about 3 percent of GDP in 1987. 1/

V. Staff Appraisal

In many respects economic developments in Iceland have been favorable in 1986. The external current account deficit has been reduced significantly; consumer price inflation has fallen sharply; and economic growth has been very strong. A much larger-than-expected fish catch and rising fish prices, contributed to record exports, while imports have been held down by declining oil prices. Incomes policy measures, particularly the maintenance of a relatively stable exchange rate, have contributed to a slowing of price inflation, and higher real interest rates have helped boost personal savings. However, with strong economic growth the labor market has remained very tight.

The Government's objectives for 1987 are to consolidate and extend the gains achieved in 1986. These objectives include bringing the external current account close to balance; slowing economic growth to reduce pressure on the labor market, while maintaining full employment; and further reducing inflation. The staff agrees with these objectives, especially in light of the high external debt burden. Although Iceland's external debt has fallen in relation to GDP in 1986, this was largely caused by the real appreciation of the króna against the U.S. dollar, and net foreign debt remains at over 50 percent of GDP. The staff feels, therefore, that this period of favorable terms of trade and fish catches should be used to reduce the external debt burden, in order to safeguard the economy against any change in the fortunes of the fishing sector. However, the tight labor market conditions and the strong real wage pressures that have emerged could result in renewed inflationary pressures and a weakening of the external accounts, unless excess demand is reduced.

The authorities expect that, with a good fish catch and buoyant export demand, the external current account target can be met provided that domestic demand is sufficiently restrained. Although there are uncertainties regarding the fish catch and the terms of trade, it is clear that the growth of domestic demand, particularly private consumption, needs to slow down significantly in 1987. This indicates the policy requirements, if the targets for 1987 are to be achieved.

The staff believes that the Budget presented to Parliament does not provide an adequate degree of fiscal tightening to bring the growth of disposable income in line with the objective of containing private consumption. In the staff's view, a substantial fiscal effort is required on top of the budgeted improvement; this would help reduce the threat of overheating in 1987 and contain wage pressures. The staff

1/ With exports and the terms of trade as in the official projection.

would hope that the budget could be strengthened as it passes through Parliament--although the pressure may be in the opposite direction--and that, in any event, fiscal policy should be tightened as the need for restraint becomes clearer during the course of 1987.

Significant institutional changes have taken place in the area of monetary control during the past two years. These changes have been directed toward deregulation and increased flexibility of financial markets. In this process, real interest rates have risen, helping to channel some of the real income gains into increased financial savings. Real interest rates may need to rise further in 1987, if this process is to continue.

In the course of institutional reform, monetary expansion remained very rapid, boosted substantially by external and bank financing of the large PSBR. Although monetary growth is difficult to interpret in the midst of institutional change, and while lower inflation and higher real interest rates must have increased the demand for broad money, the existence of a significant liquidity overhang cannot be ruled out. This underlines the importance of reducing the PSBR or, in the short term, of financing a greater portion of it through the domestic nonbank sector. Greater flexibility of real interest rates would in any case be indispensable, if greater spending were to follow recent gains in real incomes.

As part of the incomes settlement of early 1986, the nominal exchange rate was to be held constant until the end of the year. However, as this would have put adverse pressure on parts of the export sector, the effective exchange rate was allowed to depreciate a little. Nevertheless, during 1986 the real exchange rate rose again close to its level before the devaluation in late 1984. Given the record fish catches, the present level of the real exchange rate would still appear to be consistent with external balance, provided that financial policies are tightened sufficiently. However, should the external accounts deteriorate, financial policies would need to be strengthened, and exchange rate policy may need to pay more attention to the balance of payments.

Economic performance has benefited from supply-side measures taken in recent years. The economy especially benefited from the fisheries management policies. With continued prudence in managing the fish stocks, it may not only be possible to increase the size of the sustainable catch but also to reduce the magnitude and the severity of future cycles. Still, because of the natural limits on the fisheries, the external competitiveness of other sources of foreign earnings, such as fish farming and tourism, need to be protected. The reform of the financial system and the reduction in price controls in recent years should also help promote the improved utilization of resources within the economy. On the other hand, any future use of public sector pricing policy to artificially restrain the cost of living index could lead not only to a misallocation of resources but also add to fiscal difficulties in the public sector.

The staff is again pleased to note that Iceland has continued to follow a generally anti-protectionist trade policy, and that the streamlining of the tariff structure is expected to enhance the efficiency of Iceland's import system.

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

Note on Illustrative Medium-Term Scenarios

The staff's illustrative medium-term scenarios are based on the following main assumptions, derived in large part from the latest World Economic Outlook exercise. Industrial countries are assumed to grow in real terms by 3.1 percent in 1987 and by 3.0 percent annually in 1988-92, while their domestic prices are assumed to rise by 3.4 percent in 1987 and by 3.0 percent annually thereafter. The real effective exchange rate of the króna is assumed to appreciate by 2.0 percent in 1987 and to remain constant thereafter. 1/ The relative price of imported oil is assumed to rise slightly in 1987 and to remain constant thereafter, while the non-oil terms of trade are assumed to be constant throughout 1987-92. The short-term interest rate, LIBOR, is assumed to be 6.5 percent throughout 1987-92; while the interest rate on external borrowing is assumed to be 1/4 percent above LIBOR. Domestic demand growth is assumed to be 3 percent annually, except in years when it is reduced to help achieve balance of payments objectives.

The staff's simulation for 1987 was used in most of the scenarios, instead of the official forecast, with the main difference being that private consumption was assumed to again rise by 5 percent (unless fiscal policy was tightened significantly). The official forecast for 1987 was taken as a normative target, rather than as a projection of the expected outcome. Since the staff believed that the policy measures needed to achieve these targets were not yet in place, and they were not likely to be put in place during the next few months, the staff elected to simulate 1987.

Two pairs of scenarios are considered, based on the alternative assumptions for the fish catch presented in the Government's National Economic Program for 1987. Scenarios 1 and 2 are based on rather optimistic assumptions about the fish catch throughout 1988-92, with marine production rising by 4 percent in 1988 and 3 percent annually thereafter. Scenario 1 is based on the assumptions that no new adjustment measures are taken, while scenario 2 is based on the assumption that sufficient fiscal measures are taken to achieve the authorities' normative targets for 1987, and that domestic demand growth is 2.7 percent per annum during 1988-1992. Scenario 2 closely corresponds to the optimistic medium-term scenario in the National Economic Program for 1987. In scenarios 3 and 4, the fish catch is assumed to fall markedly during 1988-90, in a manner which parallels the setback in 1981-83, though the contraction is assumed to be less drastic. In these scenarios, fish production is assumed to remain unchanged in 1988, and then to fall by 8 percent in 1989, and by 5 percent in 1990; the catch is then assumed to rise by 5 percent annually in 1991 and 1992. While improved fisheries management policies

1/ The real exchange rate is assumed to appreciate in 1987 because at end-1986 it is expected to exceed the average for 1986 by 2 percent.

may have reduced the likelihood of a setback of this magnitude, a renewed deterioration of environmental conditions in Iceland's fisheries could bring about such a reversal. Scenario 3 is based on the assumption that no adjustment measures are taken following the setback, while scenario 4 is based on the assumption that measures are taken in 1989-90 to restore approximate external balance by 1992.

Scenario 1, the baseline scenario with a favorable fish catch, shows a slow deterioration in the balance of payments, with the current account deficit rising from 3 percent of GDP in 1987 to 4 1/2 percent in 1992 (Chart 5). Should the authorities take the fiscal measures needed to achieve their normative targets for 1987, as in scenario 2, the current account deficit would fall to about 1/2 percent of GDP in 1987, and then stabilize at that level during 1988-92.

Scenario 3, the baseline scenario with a sharp fall in the fish catch, has the current account deficit rising from 3 percent of GDP in 1987 to 12 percent in 1990, and then stabilizing; however, such an outcome would not be plausible, since, as on previous occasions, the authorities would implement major adjustment measures before such a deterioration in the external accounts could take place. Therefore, this scenario is not included in the chart. To restore external balance by 1992, as in scenario 4, would require, for example, sustained real devaluations of 5 percent in both 1989 and 1990, coupled with 3 1/2 percent reductions in domestic demand in both years. 1/ While these measures would be severe, they would be less severe than those taken by the authorities in 1982-83.

The National Economic Program for 1987 contains two medium-term scenarios for 1987-91. Both assume that the authorities' normative targets for 1987 are achieved and that domestic demand rises by 2.7 percent annually in 1988-91. The export growth assumptions in the authorities' first scenario are the ones used in the staff's optimistic scenarios, scenarios 1 and 2, while export growth assumptions in the authorities' second scenario are those used in the staff's setback scenarios, scenarios 3 and 4. In the authorities' optimistic scenario, the current account improves from a deficit of 1/2 percent of GDP in 1987 to balance in 1988-91, little different from the deficit of 1/2 percent of GDP during 1988-91 in the corresponding staff scenario, scenario 2. In the authorities' setback scenario, the deficit rises from 1/2 percent in 1987 to 6-6 1/2 percent in 1990-91.

Sensitivity tests of the simulations to changes in the underlying assumptions are shown below (Table 5). The table summarizes the impact in 1992 of changes in the following major assumptions: (1) 1 percent higher rate of domestic demand growth from 1987 onward; (2) 1 percent

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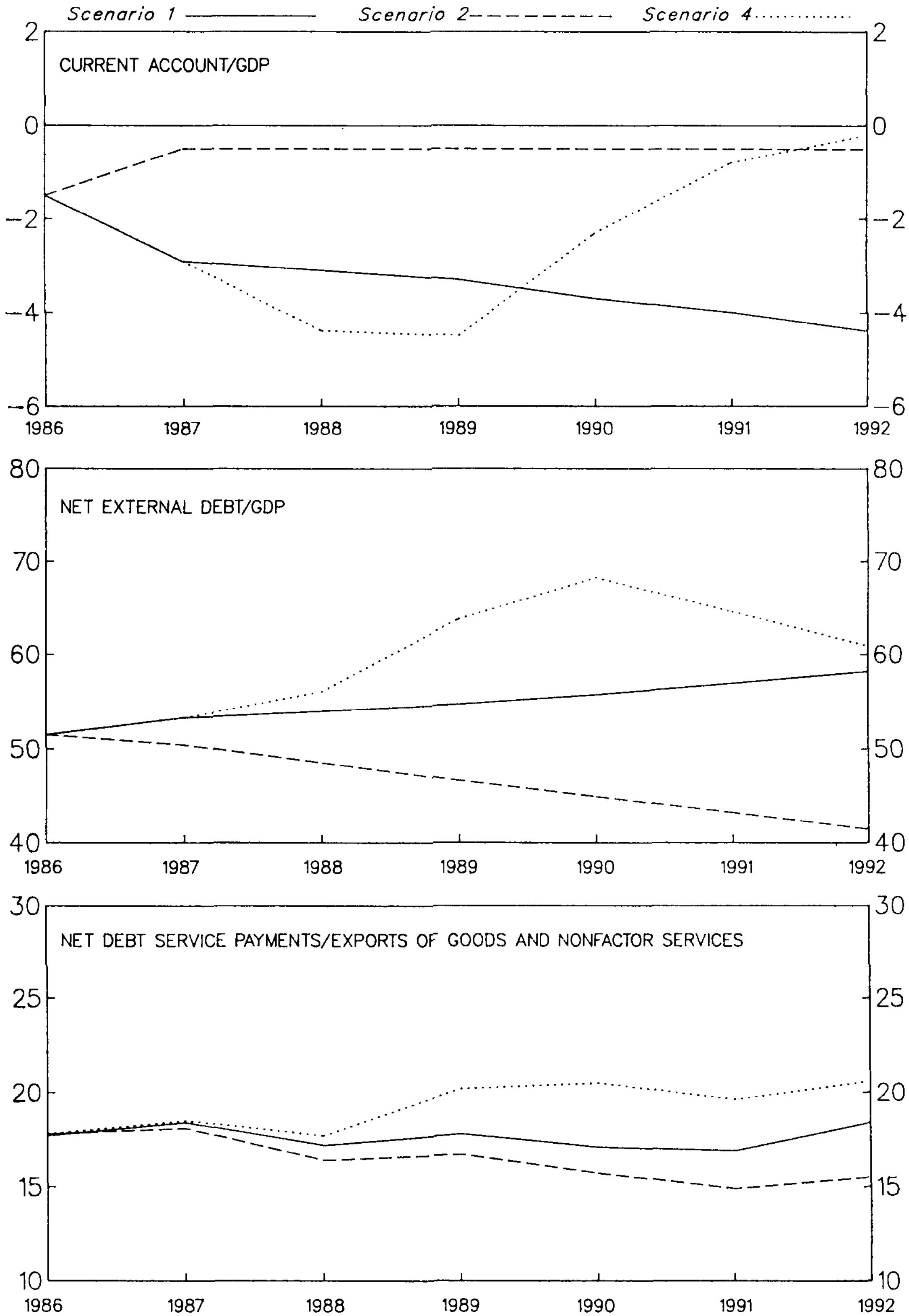
1/ If adjustment was to be achieved through demand restraint alone, domestic demand would have to contract by 7 percent in both 1989 and 1990.

CHART 5
ICELAND
MEDIUM-TERM SCENARIOS
(In percent)



Sources: Data and projections provided by Icelandic authorities; and staff estimates, projections, and calculations.

higher rate of export growth from 1987 onward; (3) 1 percent appreciation in the real exchange rate, or 1 percent deterioration in the terms of trade, in 1987; (4) 1 percent lower rate of increase of fish prices, or of the fish catch, from 1987 onward; and (5) 1 percent higher interest rates from 1987 onward.

Table 5. Iceland. Impact of Changes in the Assumptions About the Medium-Term Scenarios: Results in 1992

	Current Account/ GDP	Net Debt/GDP	Net debt service ratio 1/
	(Changes in ratios; in percentage points)		
Changes in assumptions			
1 percent higher growth rate of domestic demand growth	-3.6	+9.5	+1.4
1 percent higher export growth rate	+3.2	-10.7	-2.1
1 percent appreciation of the real exchange rate or deterioration in the terms of trade	-0.6	+2.8	+0.5
1 percent lower rate of increase in fish prices or the fish catch	-2.4	+8.2	+1.6
1 percent higher interest rates	-0.5	+1.8	+1.2
	(Ratios; in percent)		
Memorandum items:			
Baseline scenario, favorable export growth (Scenario 1)	-4.4	58.2	18.4

Source: Staff calculations.

1/ Ratio of net debt service to exports of goods and non-factor services.

Fund Relations with Iceland

(As of end-October 1986; in millions of SDRs)

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 69.02 million (115.81 percent of quota).

(c) Fund credit: SDR 13.44 million.

(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 .66 million or 4.04 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 arrangments

There is no organized foreign exchange market in Iceland, and official buying and selling rates for the U.S. dollar, the principal trading and reserve currency, are quoted by the Central Bank of Iceland. The effective exchange rate depreciated by 15 percent during 1985 and by a further 7 1/2 percent through September 1986. On November 25, 1986 the official market rates were ISK 40.60 buying, and ISK 40.72 selling per US$1. There are no multiple currency practices or exchange restrictions.

VIII. Last Article IV consultation

Discussions for the 1985 Article IV consultation were held in Reykjavik during the period October 25-November 5, 1985. The Staff Report (SM/85/333, 12/19/85) was discussed by the Executive Board on January 13, 1986 (EBM/86/8). It is expected that the next consultation will be held on the standard 12-month cycle.

Iceland: Statistical Issues

1. Outstanding Statistical Issues

a. Financial institutions

Work is underway to implement an updated version of IFS money and banking statistics using the data tape which is sent on a regular basis.

The sectoral classification of monetary aggregates in IFS will be improved on the basis of the existing reporting system, incorporating separate data on claims on government, public nonfinancial enterprises, and nonmonetary financial institutions. Accordingly, the definition of money and quasi-money will be improved. In addition, a new IFS section on other banking institutions is also under preparation which would include data on the Investment Credit Funds and the Pension Funds based on the definition used by the Central Bank. At a later stage, the data could be revised to reflect an improved classification of State Lending Funds. However, the revision of IFS data could only be finalized if the issues relating to the definition of the Central Government and the delineation between government and public financial institutions have been resolved. These issues have been raised in a money and banking statistics mission report which was sent to the authorities in September 1985.

b. Interest rates

Data on the deposit rate (line 60l) and the lending rate (line 60p) have been added to the IFS page for Iceland and updated from the Monthly Financial Statistics of the Central Bank. However, regular updates are presently not available for the money market rate (line 60b) and the Treasury bill rate (line 60c).

c. Government finance

The 1986 Government Finance Statistics Yearbook (GFSY). to be issued shortly, will contain data through 1984 for consolidated central government and through 1977 for local government.

The next GFS questionnaire letter will seek more current data on local government as well as background information on financial indexation in Iceland and its implications for the recording of data on financing and debt.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Iceland in the December 1986 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 December 1986 IFS
Real Sector	- National Accounts	AA 1984
	- Prices: CPI	October 1986
	- Production: (Total fish catch)	September 1986
	- Employment	n.a.
	- Earnings: Hourly	April 1986
Government Finance	- Deficit/Surplus	1984
	- Financing	1984
	- Debt	1984
Monetary Accounts	- Monetary Authorities	September 1986
	- Deposit Money Banks	September 1986
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	September 1986
	Unit values	AA 1985 1/
	- Balance of Payments	Q4 1985
	- International Reserves	October 1986
	- Exchange Rates	October 1986

1/ Data on unit value of frozen fish exports shown through August 1986.

Iceland: Basic Data

Area: 103,000 square kilometers
Population: (December 1985) 241,750
GNP in 1985: ISK 104,939 millions; per capita SDR 10,300

	1982	1983	1984	1985	1986 1/	1987 2/
Demand and supply			(Volume changes in percent)			
Private consumption	1.4	-8.3	3.0	5.0	5.0	1.5
Public consumption	5.5	5.5	0.1	4.5	3.0	1.7
Gross fixed investment	-0.5	-12.3	7.8	--	--	2.2
Final domestic demand	1.6	-6.8	3.5	3.7	3.6	1.7
Changes in stocks 3/	2.2	-1.3	2.3	-1.0	0.6	0.2
Total domestic demand	2.8	-10.1	5.8	2.7	4.2	1.9
Exports of goods and services	-9.7	10.3	3.0	11.0	6.3	4.0
Imports of goods and services	-1.1	-5.7	9.3	9.7	4.4	3.5
Gross domestic product	-0.3	-5.0	3.4	3.1	5.0	2.2
Gross national product	-0.9	-5.7	2.8	2.8	5.2	2.1
Marine export production	-12.7	-6.6	11.0	8.0	8.5	5.0
Labor market			(Annual averages)			
Unemployment, as percent of labor force	0.7	1.0	1.3	0.9	0.7	...
Incomes and prices (averages)			(Changes in percent)			
Earnings per employee	53.8	56.5	27.8	42.5	31	...
Cost of living index	51.0	84.3	29.2	32.4	21	...
Terms of trade (including services)	-1.5	4.3	1.0	--	4 1/4	2 1/4
Balance of payments			(In millions of SDRs)			
Exports, f.o.b.	622	701	725	801	869	916
Imports, f.o.b.	-760	-683	-735	-801	-819	-846
Trade balance	-138	18	-10	--	50	70
Net services and transfers	-94	-67	-116	-114	-95	-84
Current balance	-232	-49	-126	-114	-45	-14
(in percent of GDP)	(-8.4)	(-2.0)	(-5.1)	(-4.3)	(-1.5)	(-0.5)
Long-term capital, net	209	86	112	153	...	...
Short-term capital, net 4/	-69	-29	14	76	...	...
Balance on capital account	140	57	98	229	...	...

1/ Official estimates as of October 1986.
2/ Official normative projections as of October 1986.
3/ Change as percent of previous year's GDP.
4/ Including errors and omissions.

Iceland: Basic Data (continued)

	1982	1983	1984	1985	1986 1/	1987 2/
			(In millions of SDRs)			
Total external debt, net						
(SDR millions; end-period)	1,091	1,172	1,343	1,463	1,503 3/	...
(in percent of GDP)	(52.4)	(56.2)	(65.4)	(61.2)	(51.4) 3/	(...)
Interest payments 4/	11.8	10.8	12.0	10.4	8.3 3/	...
Foreign reserves and liabilities			(SDR millions; end-period)			
Oficial reserves	133	144	132	189	194 5/	...
Official liabilities	-61	-74	-92	-23	-15 5/	...
Of which: to IMF	(-22)	(-22)	(-22)	(-22)	(-13) 5/	...
Net official foreign assets	-72	70	40	166	179 5/	...
Public sector				(ISK millions)		
Treasury revenue	9,577	15,100	20,747	27,110	37,000	40,001
Treasury expenditure	9,379	16,263	19,964	29,497	39,177	41,584
Operational balance	198	-1,163	783	-2,387	-2,177	-1,583
(as percent of GDP)	(0.5)	(-1.9)	(1.0)	(-2.2)	(-1.5)	(-1.1)
Public sector borrowing requirement						
(as percent of GDP)	6.4	5.8	6.1	7.4	5.5	3.7
Monetary survey			(Change in percent during the year)			
Foreign assets, net 6/	-51.8	-53.7	-33.4	-12.2	-2.1 7/	...
Domestic credit, net 6/	109.8	132.5	66.8	59.8	39.7 7/ 8/	...
Broad Money (M_3)	58.0	78.8	33.4	47.6	37.6 7/ 8/	...
Exchange rate						
ISK per SDR, period average	13.64	26.60	32.49	42.13	47.99 9/	...
ISK per SDR, end-period	18.34	30.02	39.74	46.20	49.02 5/	...
Change in effective rate						
end-period 10/						
Nominal	-43.6	-36.7	-21.4	-16.1	-7.6 11/	...
Real	-12.9	5.5	-10.7	9.4	2.3 11/	...

1/ Official estimates as of October 1986; and staff estimates.
2/ Official normative projections as of October 1986.
3/ Staff estimates.
4/ Payments as percent of exports earnings.
5/ End-September.
6/ Change as percent of M_3 at the beginning of period; domestic assets include external borrowing by Treasury.
7/ September 1986/September 1985.
8/ Including accrued interest.
9/ Average for January-September.
10/ Trade-weighted, based on information notice system. Positive figures denote appreciation.
11/ September 1986/December 1985.