FOR AGENDA

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December 19, 1985

To: Members of the Executive Board

From: The Acting Secretary

Subject: Iceland - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Iceland, which is proposed to be brought to the agenda for discussion on Wednesday, January 15, 1986.

Mr. Knobl (ext. 8821) or Mr. Hedfors (ext. 8830) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the 1985 Consultation with Iceland

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

December 17, 1985

I. Introduction

Article IV consultation discussions were held in Reykjavik between October 25 and November 5, 1985. The Icelandic authorities were represented by officials from the Prime Minister's office, the Ministries of Finance, Commerce and the Fisheries, the Central Bank of Iceland, the National Economic Institute, the National Statistical Bureau, and the Institute for Marine Research. The staff mission, consisting of Messrs. A. Knöbl, P. Hedfors, S. Mitra, H.-J. Huss and, as secretary, Mrs. P. Padmore (all EUR), also met the Deputy Prime Minister and Minister of Fisheries, Mr. H. Ásgrímsson; the Minister of Finance, Mr. T. Pálsson; and the Governor of the Central Bank of Iceland, Dr. J. Nordal. Mr. H. Lundström, Executive Director for Iceland, attended the meetings as an observer. Iceland accepted the obligations of Article VIII, Sections 2, 3, and 4 on September 19, 1983. Iceland purchased the equivalent of 49.4 percent of its then quota under the compensatory financing facility in December 1982.

The last consultation was concluded at EBM/84/170 (11/28/84) on the basis of SM/84/251 (11/7/84) and Supplement 1 (11/23/84). In the discussion, Directors commended Iceland's performance in sharply reducing inflation since mid-1983, but regretted that firm incomes and exchange rate policies had not been supported by adequate financial restraint, and that large external deficits were again being experienced. In view of Iceland's onerous debt burden, a sustained improvement in the external current account was regarded as vital and to that end a pronounced strengthening of financial policies and firm management of domestic demand were required. Directors also believed it important to maintain the competitive position in order to initiate external adjustment and also to promote diversification in exports over the medium term (SUR/84/116, 11/30/84).

In the event, financial policies continued to be highly relaxed and the external current deficit is projected at about 5 percent of GNP in 1985 (similar to that of 1984) with inflation at 36 percent during the year.

II. Economic Background

The favorable growth performance of the Icelandic economy in the 1970s (averaging real GNP growth of 4 3/4 percent per annum) owed much to strong increases in fish catches and in marine exports; in 1980, the former accounted for a fifth of national output and the latter for three-quarters of merchandise exports. Throughout this period full employment was maintained but inflation was persistently high, ranging between 30 and 60 percent. The economy was dealt a serious blow in 1982 and 1983 with a decline in the fish catch; in 1983, the fish catch in volume terms was 17 percent lower than in 1980. Furthermore, serious export marketing difficulties emerged. More recently, a revival in the fishing sector has occurred with a volume increase of 14 percent in the catch in 1984. A recovery to almost the level of 1980 is projected for the current year (Chart 1).

The initial policy reaction of the authorities to the 1982 supply shock was to support domestic demand through boosting public consumption and sharply depreciate the króna as a means of protecting incomes in the fishing sector. The combination of supply losses and strong demand led to an external deficit equivalent to 9 percent of GNP in 1982. The depreciation of the króna fueled the price-wage spiral under the then existing system of wage indexation with the process being accommodated through expansionary monetary policy (sharply falling real interest rates). By mid-1983, inflation had risen to an annualized rate of 130 percent.

Despite wage indexation, the authorities after early 1982 have been able to engineer a significant improvement in competitiveness to the benefit of external performance (Chart 2) by decreeing temporary reductions in pay increments. In May 1983, a new government suspended wage indexation, introduced a draconian statutory incomes policy and, after a step devaluation, stabilized the nominal exchange rate. Real average earnings fell by 13 1/2 percent in 1983. As a result of the rigorous incomes policy measures and the depreciated real exchange rate, the current account deficit was narrowed to 2 1/4 percent of GNP in 1983. In the second half of 1983 and during much of 1984, inflation benefitted from stability in the exchange rate and the incomes policy, with the 12-month rate reduced to less than 20 percent by the third quarter of 1984. Financial policies, however, continued to be relaxed in an effort to preserve the very high level of employment but this policy stance threatened to reverse the adjustment effort. At end-1984, pressure in the labor market led to a collapse of incomes policy.

III. Recent Developments

The process of external and internal adjustment has suffered major setbacks in the past two years. In 1984, the external current account deficit widened to the equivalent of over 5 percent of GNP--a ratio projected to fall only slightly in 1985. Inflation accelerated in 1985

in reaction to buoyant monetary conditions and large wage settlements. Labor market conditions remain extremely tight (with unemployment at 1 percent of the labor force) against a background of rapid expansion in domestic demand.

Table 1. Iceland: Major Economic Indicators

(In percent)

	1982	1983	1984	1985 Official projections
Final domestic demand (growth rate)	1.6	-6.8	3.3	3.3
GNP (growth rate)	-0.9	-5.7	2.5	2.0
Consumer prices (changes during year)	40.9	76.6	18.8	36.0
Real average earnings (changes, annual average)	-0.1	-13.6	-0.9	3.0 1/
Unemployment rate	0.7	1.0	1.3	1.0
Nominal effective exchange rate (changes during period)	-43.0	-34.7	-19.3	-13.0
Current account balance (in percent of GNP)	-8.9	-2.2	-5.3	-4.9
Adjusted 2/ (in percent of GNP)	-6.5	-4.7	-5.0	-5.3

Source: Data provided by the Icelandic authorities.

1/ Staff estimate.
2/ Adjusted for fluctuations in export stocks and special imports.

1. The external balance

The deficit on the current account rose in 1984 to SDR 127 million (5.3 percent of GNP) compared to SDR 50 million (2.2 percent of GNP) in 1983. The two major factors behind this deterioration were a 9 percent increase in the volume of imports reflecting buoyant domestic demand conditions, and mounting interest payments on the external debt. An accumulation of export stocks caused by weak markets for marine products also contributed to the worsening of the external performance.

The current account deficit is projected to be slightly smaller in 1985 at SDR 116 million (4.9 percent of GNP) as a result of a projected 5 1/2 percent rise in export volumes partly stemming from a running down

of stocks, and a moderation in the rise in debt service given an easing in interest rates and a lower U.S. dollar. In the first six months of the year, the outturn on the external account was in line with the projections for the year, but in the third quarter the trade account strengthened partly reflecting special factors.

The large current account deficit of recent years has been financed through both official and private sector borrowing, the latter through financial institutions for on-lending to the domestic economy. Gross official reserves were roughly unchanged in 1984 but in the first nine months of 1985 they rose by SDR 50 million to stand at the equivalent of over three months' merchandise imports. This sharp increase is related in significant part to an institutional change in the monetary system whereby the Central Bank has ceased to rediscount bills of exchange related to export stocks (see section IV.3 for details).

2. Inflation and wage developments

The rapid dampening of inflation that followed the May 1983 stabilization package was continued through much of 1984, when, on average, consumer prices rose by 29 percent--the lowest rate of increase since 1973. This result was secured largely through wage moderation and the policy of a relatively fixed nominal exchange rate. However, demand pressures within the economy continued to be strong against a background of highly expansionary financial policies and contributed to the emergence of tension within the labor market. By the autumn of 1984 the conditions for continued wage moderation had been eroded and a period of considerable labor unrest followed. After a 13 1/2 percent rise negotiated in early 1984 an additional 24 percent was granted to end-1985 in October 1984 so that total earnings from employment rose by 28 percent in 1984. The wage settlement of autumn 1984 and the accompanying 16 percent depreciation in November triggered an acceleration in inflation.

With continued weak financial policies, especially a large fiscal stimulus, and buoyant demand conditions, generous wage settlements have been conceded also in 1985 and inflation has remained high. In June the wage contracts were renegotiated and an additional award of 15 percent was made for 1985. In October a further general increase of 3 percent was granted. The economy has also experienced considerable wage drift in 1985. Altogether nominal wages will rise by 36 1/2 percent in 1985; real average earnings are projected to rise by 3 percent in the year. In the second half of the year, the rate of inflation has again been on a rising trend with wage increments being rapidly translated into prices and also with the rise in the rate of depreciation to 13 percent for the year, of which 12 percentage points were already effected by October (see section IV.4 for details). By year-end inflation is projected at 36 percent.

The next round of wage settlements is expected to take place in the beginning of 1986. It is well possible that, against a background of an

overheating economy with worsening inflation expectations, settlements will be large, which would give a further twist to the wage-price spiral.

3. Production, demand, and the labor market

The major influences on the level of economic activity in 1984 were a substantial recovery in the fish catch and a sharp rise in domestic demand. GDP rose by 3 percent on the strength of a 14 percent increase in marine output and a 7 percent growth in manufacturing, but the increase of GNP was limited to 2 1/2 percent reflecting growing interest payments on foreign debt. The chief factors behind a 3 1/2 percent rise in final domestic demand were sharply increasing private consumption and also strengthening investment. Part of the rise in output, especially in the fishing sector, went into involuntary stock accumulation. Imports grew steeply and the foreign balance subtracted 2 1/2 percentage points from GNP growth. The brisk pace of economic activity led to the maintenance of extremely tight labor market conditions with unemployment averaging just over 1 percent of the labor force.

A year ago the Icelandic representatives indicated that maintaining the low level of unemployment would remain an important objective in 1985. They believed that GNP would rise by 2 percent and the external deficit to GNP ratio be cut to 4 percent. Although final domestic demand growth is projected to be much stronger and the external deficit somewhat larger, these initial estimates essentially hold. With a rise in real disposable incomes of 5 1/2 percent stemming from real wage gains and income tax cuts, private consumption is projected to grow by 4 1/2 percent. In contrast to 1984, public consumption is also projected to expand significantly (3 percent) but fixed investment is expected to tail off to show little growth. On the supply side, marine output is forecast to rise by 3 1/2 percent, manufacturing output by 4 percent, but construction activity is experiencing a downturn. The labor market continues to be characterized by overfull employment. The total number of declared vacancies far exceeds the number of unemployed and shortages in certain kinds of labor, e.g., manual workers, are being felt.

IV. The Policy Discussions

During the consultation discussions it was evident that the Icelandic authorities had not been able to follow restrictive financial policies in support of the 1983 adjustment package. Expansionary monetary and fiscal policies had led to rapidly rising domestic demand and wage pressures, to widening external deficits, and to the undermining of expectations of a low rate of inflation. The succession of recent external deficits had led to a heavy accumulation of foreign debt. Against this background, the key issue in the discussions was whether external adjustment could be promptly resumed and inflation reduced, and what role financial and exchange rate policies could play

to this end. In view of the heavy external debt burden the Icelandic authorities stated that it was their objective to balance the external current account by 1988.

1. The foreign debt constraint

Iceland's net external debt is projected to exceed the equivalent of 60 percent of GNP by end-1985, and net debt service as a ratio of exports of goods and nonfactor services would then amount to 22 1/2 percent (in gross terms, the debt service ratio would be close to 24 percent). The assumptions and results of an illustrative medium-term debt case study prepared by the staff can be found in Appendix I. The projections indicate that if Iceland's domestic demand were allowed to expand over the medium term at the average annual rate of 1984 and 1985, i.e., at 3 percent, and assuming an unchanged real exchange rate, the current account deficit would continue to widen to reach the equivalent of 9 percent of GNP by 1990 when external debt would reach nearly 80 percent of GNP. The debt service ratio would also mount sharply. The official objective of balancing the current account by 1988 would require a determined adjustment effort centering on holding back domestic demand. On the assumption that exports would grow by 5 percent per annum between 1986 and 1988, the authorities believe that domestic demand growth would need to be no greater than 1 percent per annum until 1988 if the current account objective were to be attained.

The staff team suggested that the assumed rate of export growth might prove to be optimistic not only as the potential growth of the fishing sector was limited but also in view of probable developments in foreign demand for Iceland's exports. Staff simulations, based on the assumption of a more cautious growth in exports (3 percent on the average), indicate that domestic demand would have to be held constant at its 1985 level if the external accounts were to be near balance by 1988. In that event, net external debt would be reduced to 52 percent of GNP by 1990 but net debt service ratio would still rise to 28 percent. The mission emphasized that fiscal and monetary policies needed to be tailored to securing this outcome. The external debt burden had reached the point where it posed the major constraint on economic policy.

The Icelandic representatives pointed out that the external debt predominantly consisted of long maturities and a smooth schedule for repayments had been arranged. Iceland had not encountered any difficulties in borrowing; indeed, it continued to enjoy fine terms in international capital markets. However, a shift toward short term foreign borrowing by commercial banks had occurred in 1985 partly for technical reasons and needed to be reversed. The mission observed that the large external deficits of 1984, 1985, and that projected for 1986 were occurring against the background of a recovery in marine exports and that the use of new debt in support of private consumption was worrisome. Although Iceland's creditworthiness was at present unimpaired, should a determined adjustment effort not occur, market

sentiment could rapidly change to Iceland's serious disadvantage. The Icelandic authorities recognized that rising foreign debt could eventually damage creditworthiness and lead to difficulties in negotiating foreign loans. They observed that foreign debt had to some extent been used to support growth in the economy. They added that fish catches and exports might rise faster over the medium term than assumed in the staff's simulations. Finally, they emphasized that the elimination of the external current deficit by 1988 remained an important goal.

2. Public finances

Fiscal analysis in Iceland has traditionally been conducted in the framework of relatively narrowly defined Treasury accounts, comprising mainly current transactions of the Central Government. Outside these accounts are a number of government financial and nonfinancial institutions responsible for a large part of the Government's investment spending and loan operations as well as some current transactions. These institutions are financed through transfers from the Treasury budget but they also undertake considerable borrowing on their own account. As a result, the Treasury accounts have tended to understate the size of the central government borrowing requirement. Starting with the budget for 1986, however, a broader definition of the Treasury accounts has been adopted, so that these accounts now give a more complete picture of the central government balance. Another problem is that under the present accounting procedures the Treasury budget records only the real portion of interest payments on indexed public debt as expenditure so that the build up of substantial repayment commitments is concealed. 1/

The mission welcomed the improvement in the budget presentation inititated with the 1986 budget but noted that accounting procedures still made an accurate assessment of the overall fiscal stance difficult. The mission urged the authorities to give priority to the task of further clarifying the fiscal accounts.

The initial 1985 budget sought to limit the Treasury deficit to the equivalent of 1/2 percent of GNP primarily by expenditure restraint. The budget also reflected the first year effects of a three-year program designed to eliminate personal income tax. 2/ The cost of this measure, estimated at ISK 0.6-0.7 billion in 1985, was to be recouped through increases in indirect taxation. Developments thus far in 1985 have deviated considerably from the budget estimates. The growth in expenditures has far outstripped increases in Treasury revenue; in the first three quarters of the year, in real terms revenues fell slightly,

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1/ For these reasons the gross borrowing requirement of the public sector is considered to be a better indicator than the Treasury balance of the public sector's claim on financial resources.

2/ For details see RED, Chapter III.

Table 2. Iceland: Public Finances

(In percent of GDP)

	1982	1983	1984	1985		1986 1/
				Budget estimates	Official projection	Budget proposals
Treasury						
Total revenue	25.9	24.2	25.4	23.1	24.7	25.8
Total expenditures	25.4	27.9	24.5	23.8	26.4	25.7
Balance	-0.5	-3.7	1.0	-0.7	-1.7	0.1
Total public sector						
Gross borrowing requirement	6.4	5.8	6.1	4.7	6.4	4.5
Foreign borrowing	5.2	4.7	5.5	4.0	5.7	2.4
Drawings on the Central Bank, net	-0.2	1.1	0.4	...	1.5 2/	...

Sources: Bureau of the Budget, the National Economic Institute, and the Central Bank.

1/ To preserve comparability with earlier years, the Treasury budget data for 1986 are shown according to the old accounting procedures. On the new basis, revenue and expenditure will be equivalent to 27.1 percent and 26.8 percent of GDP, respectively. The data take into account the expenditure and revenue measures proposed in November.

2/ Change from October 1984 to October 1985.

whereas expenditures rose by about 13 percent (year-on-year). The main factor behind the revenue shortfall was the failure to legislate the required rise in indirect taxation in order to make up losses associated with the income tax reform. On the expenditure side, the public sector wage bill ballooned as a result of large wage settlements, debt interest payments exceeded estimates, and outlays for agricultural export subsidies turned out to be unexpectedly large. Treasury transfers to the housing and student loan funds increased sharply but, in part, temporarily. The latest official estimates suggest that the Treasury balance would be in deficit to the tune of 1 3/4 percent of GDP in contrast to the budget estimate of 1/2 percent. The share of revenues in GDP would fall 3/4 of a percentage point to 24 3/4 percent while the expenditure ratio would rise by almost two percentage points to 26 1/2 percent. The gross borrowing requirement of the Treasury would be equivalent to some 3 percent of GDP while the borrowing requirement of the public sector as a whole would run at around 6 1/2 percent.

The mission observed that in past consultation discussions, the Icelandic authorities had emphasized the importance of a balanced Treasury budget as an instrument of adjustment. It had been viewed as a precondition for strictly limiting foreign borrowing and for exercising restraint in domestic demand. In contrast, the Treasury balance in 1985 was now estimated to worsen by the equivalent of 2 1/2 percent of GDP. Moreover, given the sizable financing requirement of government investment and other entities accounted for outside the Treasury budget, it appeared that the Treasury budget itself would need to be moved into surplus if the imbalances within the economy were to be addressed.

The Icelandic representatives pointed out that a significant retrenchment in public investment had taken place in recent years and that further cuts in this item were difficult to achieve. As regards current expenditures, many items, particularly in the area of transfers, were either fully indexed to prices or to developments in wages in the economy. Thus, restraint was difficult. Although changes in the automaticity of expenditures were under consideration, there were no plans for immediate reform. In addition, despite Iceland's relatively low tax to GDP ratio, there was a firm political commitment to eliminate the personal income tax for most income-earners. On expenditures, the Icelandic authorities intended to reduce subsidies, especially on agricultural production and exports and were willing to consider introducing a degree of user charges in the social services. The Government also intended to privatize certain public sector entities. Present plans envisaged the introduction of a value-added tax by 1987.

The staff team also pointed out that the treatment of interest payments on indexed public debt implied that, as recent experience had shown, if the borrowing requirement were to be manageable over the medium term, the Treasury budget itself would have to be in increasing surplus. However, a survey of medium-term budget trends prepared by the Icelandic authorities, based on unchanged spending commitments and present plans for taxation, showed that the Treasury balance would

worsen significantly over the next three years. The mission observed that the results of this study underlined the need for discretionary fiscal action. It suggested that to the extent cuts in expenditures proved inadequate, consideration would have to be given to increases in taxation and indeed it might be necessary to reconsider the planned step-wise abolition of personal income taxes.

The Icelandic representatives considered the budget for 1986 to be the first step in a medium-term fiscal adjustment effort. The budget was intended to hold Treasury spending as a proportion of GDP constant between 1985 and 1986. It also provided for higher indirect taxation which more than offset the revenue loss associated with the second phase of the income tax reform. It was estimated that the Treasury accounts would be in balance in 1986 and that the public sector would not rely upon external borrowing in net terms.

The authorities have recently announced that they would seek expenditure reductions of the order of ISK 0.6 billion from budget estimates. However, some of the tax increases contained in the original bill would not be enacted, and the net improvement to the budget might be of the order of ISK 0.3 billion. Moreover, the budget estimates were based on the price and wage levels prevailing at the end of 1985 and an increase in wages would upset the budget estimates. The gross borrowing requirement of the public sector would, in any event, continue to be heavy in 1986. The mission observed that given the authorities' objective of no net public sector foreign borrowing in 1986, the domestic financial markets would experience considerable pressure if monetary financing were to be limited. It also wondered whether the budget for 1986 would suffice to reduce domestic demand pressure adequately, and thus safeguard the balance of payments. The Icelandic representatives stated that the Government was now willing to face the interest rate consequences of considerably greater debt sales. Even so, they characterized the measures contained in the budget as being the minimum necessary; political consensus on stronger fiscal action could not be found at this time.

3. Monetary policy

The easy stance of monetary policy is evidenced by the fact that the increase in net domestic credit expansion (DCE) contributed 67 percentage points to the growth of M_3 during 1984. M_3 itself rose by 33 1/2 percent accompanied by a substantial loss in net foreign assets. The pace of monetary expansion has accelerated in 1985; in the year to September, M_3 has grown by 50 percent--far in excess of inflation--and has again been associated with high rates of credit expansion, with DCE contributing 65 1/2 points to growth. The major factors behind rapid credit expansion have been recourse by the Treasury to Central Bank financing, foreign borrowing by the Treasury as well as commercial banks, and a lowering of reserve requirements by the Central Bank. Credit expansion has remained excessive despite a

slowdown in bank advances and a notable increase in real interest rates (Chart 4). A rising proportion of credit has been channelled to the household sector and has been used to support consumption.

Table 3. Iceland: Monetary Developments

(Increase as percent of money stock 12 months earlier)

	1982	1983	1984	1985	
				Sept.	Dec. 1/
Net domestic credit 2/	109.8	132.6	66.8	65.6	63.8
Net foreign assets	-51.8	-53.9	-33.4	-15.5	-16.4
Broad money (M_3)	58.0	78.6	33.4	50.1	47.4

Source: Data supplied by the Icelandic authorities.

1/ Official projection.
2/ Including external borrowing by the Treasury.

The staff team pointed out that rapid credit expansion had contributed to demand pressures within the economy and had provoked a large loss in net foreign assets of the banking system. Control over central bank money remained of particular importance: in this context, it was urgent to limit stringently Treasury financing from abroad as well as directly from the Central Bank, and also to exert firm discipline over accommodation extended to deposit money banks. Foreign borrowing by the private sector (with banks as intermediaries) also needed to be brought under check; it tended to be encouraged by the fact that nominal interest rates abroad were generally much lower than domestic rates and that the exchange rate losses on loans following devaluations of the krona tended at times to be rolled over with fresh credit or even on occasion to be written off by the Central Bank.

The Icelandic representatives agreed with these observations. They expected that a tightened budget for 1986 with a reduced borrowing requirement would assist in monetary management. They also believed that the real costs of excessive foreign borrowing were beginning to be better realized within the private sector. Furthermore, they explained that the persistence of positive real rates of interest on indexed loans averaging between 3 and 5 percent would over time help to curb excessive

credit expansion. Indeed, it was the intention of the authorities to maintain real interest rates at least at these levels and, if necessary, to raise them further in 1986.

The past year had seen significant institutional changes in the area of monetary control. Market forces had been permitted a greater role in the determination of interest rates in money and bond markets and, with two important exceptions, banks were in effect free to set their own rates. This had led to much innovation in instruments and to lively competition. The degree of financial indexation continued to be high and rising, with banks offering deposits that earned the higher of a predetermined nominal interest rate or an indexed (real) rate. In this connection, the Icelandic representatives observed that indexation had protected the banking system from disintermediation during periods of high rates of inflation. 1/ In a potentially important step, the Central Bank had ceased to rediscount bills of exchange drawn to finance stocks, whether for exports or for domestic use; such bills were now held by commercial banks. Bills for export stocks were denominated in SDRs and carried market rates. However, the interest rate on domestic stock bills was still regulated at below market rates. Concomitant with the abolition of rediscounting the Central Bank had lowered reserve requirements from 28 to 18 percent in order to release resources for the additional bill holdings of commercial banks. This institutional change had also encouraged the banks to borrow abroad to match their SDR denominated assets while, as rediscounts were paid off, gross foreign reserves of the Central Bank rose sharply.

Beside the rate on bills related to domestic stocks, the Central Bank continued to prescribe the interest rate on general savings deposits that accounted for almost a fourth of total króna deposits. The Icelandic representatives hoped that both these rates would be deregulated in 1986 but no final decisions had as yet been taken. With the rate of inflation accelerating in the final months of 1985 and with worsening inflation expectations, real interest rates were tending to fall. The mission suggested that in such circumstances interest rates across the spectrum, including rates on certain indexed instruments, needed to be raised. The judgment that current interest rates were inadequate was supported by the fact of continued rapid credit expansion. The Icelandic representatives agreed that it may become necessary to let interest rates rise. The Treasury intended to resume sales by auction of Treasury bills and would accept the interest rate consequences, in contrast to developments in 1984 and 1985 when such sales had been suspended. Furthermore, the real rate of interest on indexed government savings certificates of at least 3-year maturity had recently been raised to over 9 percent.

1/ For a discussion of financial indexation in Iceland, see Appendix I of the RED.

4. Exchange rate policy

The authorities had announced a depreciation target for the króna of 5 percent during 1984 in the expectation that greater stability in the nominal exchange rate would foster a lower rate of inflation and help dampen wage settlements. Cost and price developments in the course of 1984 called the viability of this policy into question. A revision of the exchange rate's basket weights at end-August implied a devaluation of 3 percent and, following large wage settlements in October, the authorities depreciated the króna further by 16 percent in November. At the same time they announced that the rate of depreciation in 1985 would be held within narrow limits.

The staff team pointed out and the Icelandic representatives concurred that credit expansion had been far too rapid in 1984 thus subverting exchange rate policy. The pace of credit expansion in 1985 has produced a repetition of 1984. Indeed, in the course of the year, the authorities were forced to widen the margin of depreciation, notably following the inflationary wage settlements in mid-year, and now intended to depreciate the króna by 13 percent during 1985, of which about 12 percentage points had already been effected by October. This would imply an appreciation of nearly 5 percent in real terms between the final quarters of 1984 and 1985.

The authorities stated that they considered the real exchange rate prevailing in the final months of 1985 to be adequate in terms of competitiveness and that they intended to hold that rate throughout 1986. The mission observed that, although the real exchange rate was still low in historical terms, Iceland's external circumstances had greatly changed for the worse. A large deficit on the current account was projected for 1985 and 1986 and the heavy burden of interest payments on foreign debt constituted a structural element in the payments imbalance. Only if the authorities were able to tighten financial policies considerably would the present value of the real exchange rate be consistent with sustained adjustment. The Icelandic representatives observed that the exchange rate had been excessively relied upon for adjustment in the past and, while continual depreciation had served to keep the external deficit within certain bounds and helped to protect full employment, the cost had been high rates of inflation and featherbedding of less efficient parts of the economy. They acknowledged the importance of suitably restrained financial policies for the viability of their exchange rate policy.

It was also recognized that changes in the nominal exchange rate could not deviate far from differences in pay settlements with trading partners, and the authorities intended to review the exchange rate following the next round of wage settlements. The mission inquired as to the likely macroeconomic policy response to excessive wage awards. The Icelandic authorities stated that they had not yet arrived at decisions on this matter. The staff team suggested that an early and pronounced tightening of financial policies could play an important part

in dampening price and wage expectations and could also provide the conditions for the renewal of adjustment in 1986; it would also be required to support exchange rate policy.

5. Policies affecting the supply side and trade

The Icelandic authorities have carried out a program of liberalization and deregulation notably in money and capital markets and in internal trade and price setting. They have also taken the position that the size of the Government within the economy needed to be reduced and that greater role ought to be accorded to market forces in previously sheltered sections of the economy. Beside the deregulation in the area of interest rate determination (discussed earlier), rules governing the holding of foreign currency and the retention of export proceeds have been relaxed. Price control has been effectively abolished, except in certain activities that enjoy monopoly powers. In the fishing sector, catch quotas are now tradeable under certain conditions. The size of the fleet is being reduced thereby helping alleviate pressures on the sector's balance sheet position through debt retirement and consolidation.

As the limit on fish catches is being approached, the marine sector cannot be relied upon as a continued source of growth in the future. As has been stressed in the past, it has become important to foster diversification of production and exports. Iceland's resources of electrical and geothermal energy confer comparative advantage upon energy-intensive activities and some projects are in the negotiation stage. Fish farming is also an activity of potential importance. It remains necessary, however, to promote a more stable economic environment and to maintain the degree of external competitiveness which would encourage the shift of resources into the traded goods and services sectors.

Iceland's trading system has remained open. A revision of the tariff schedule is under parliamentary discussion: it consists of a scaling down of the highest rates and simplification. The Icelandic authorities stated that a tariff on salted fish and fish fillets (constituting between 10 and 20 percent of total exports) imposed by the EC was highly disturbing and, in their view, contrary to the spirit of their free trade association with the EC. Arrears on current payments owed to Iceland by Nigeria have been substantially repaid. Iceland stepped up outlays on agricultural export subsidies markedly in 1985 but it is the Government's policy to phase out subsidies altogether. Iceland has supported a new round of trade negotiations under the auspices of GATT.

V. Economic Outlook

The Icelandic authorities have prepared a forecast for 1986 based on the assumption that policies can be so conducted as to limit the growth in domestic demand to 1 percent. The forecasts also assume that marine output would increase by 4 percent and that there would also be a substantial increase in manufacturing output. Total exports are projected to rise by 3 1/2 percent. The authorities characterized these assumptions, especially those concerning marine production and the 1 percent limit on the growth of domestic demand as optimistic but, nevertheless, such developments were necessary if the external deficit was to be reduced. Official forecasts suggest that private consumption would need to grow by no more than 1 1/2 percent in 1986 (i.e., a small increase in per capita terms) but that gross fixed investment in the economy would decline by 2 1/2 percent. The official forecast notes that the real exchange rate of the króna would be higher on average in 1986 than in 1985, which could dampen export growth below that assumed in the forecasts. Imports are projected to rise by only 1 1/4 percent and total GNP by 1 1/2 percent. These developments are expected to be consistent with a reduction in the external current account deficit to the equivalent of 3 3/4 percent of GNP (from nearly 5 percent of GNP in 1985).

The staff calculated that if the required degree of financial restraint was not exercised, domestic demand could increase by 3 percent in 1986 on the strength of the increase of private consumption of 4 percent stemming from a significant rise in real household incomes caused by buoyant wage settlements and lower income taxes. Extremely tight labor market conditions were bound to exert pressures on wage developments. On these assumptions, the staff's projections for the external current account would differ significantly from those of the Icelandic authorities. It appears improbable that growth in exports would exceed 2 1/2 percent in volume terms (given a significant reduction in export stocks in 1985) or that of imports of goods could be held much below 5 percent. These projections suggest that the growth in GNP could amount to 2 percent in 1986 and that the external current account deficit could widen to the equivalent of 6 percent of GNP. This would significantly add to the external debt burden.

The Icelandic representatives agreed that an outcome in line with these forecasts was possible in the event of unfavorable wage developments. They also agreed that the degree of financial restraint necessary to secure the official projections for 1986 had not yet occurred but stressed that tighter financial policies were planned to be put into effect in 1986. They stated that large nominal wage settlements could, of course, be inflated away through the exchange rate, although trade unions had shown a greater tendency to bargain in real terms. The staff team noted that a widening in the external current account deficit would give grounds for serious concern and underscored the urgency of tightening financial policies and of not

waiting until well into the new year before initiating restraint. In the absence of a significant tightening of financial policies, wage and price inflation was very likely to accelerate.

Table 4. Iceland: Outlook for 1986

(Percent change in real terms)

	1985	1986	
		Official Projections	Staff Projections
Private consumption	4.5	1 1/2	4
Public consumption	3.0	1	1
Fixed investment	0.5	-2 1/2	1 1/2
Final domestic demand	3.3	1/2	2 3/4
Total domestic demand	2.0	1	3 1/4
Exports of goods and services	5.7	3 1/2	2 3/4
Imports of goods and services	4.9	1 1/4	4 3/4
GNP	2.0	1 1/2	2
Current account as percent of GNP	-4.9	-3 3/4	-6

Sources: The National Economic Institute; and staff estimates.

VI. Staff Appraisal

In the spring of 1983, the Icelandic Government decided that the external current account deficit which had attained alarming proportions needed to be swiftly reduced and the spiraling rate of inflation brought under control. A bold and wide ranging series of measures which included a steep depreciation of the krona followed by a stable exchange rate, combined with rigorous incomes policy measures served to turn around the external position and to markedly reduce the rate of inflation. However, in the past two years a serious reversal has taken place and, at present, the economy is characterized by strong demand pressures, extremely tight labor market conditions, the resumption of a cost and price spiral, and a large external current account deficit. The root cause of these disturbing developments has been the weak stance of fiscal and monetary policies.

In the staff's view, a continuation of recent developments is clearly unsustainable given Iceland's very high external debt and debt service burden. The authorities, recognizing the need to bring the rise in Iceland's foreign debt to a halt have adopted the target of a balanced external current account by 1988. While this is indeed

necessary if the debt burden is to be stabilized and creditworthiness to remain unimpaired, the staff is concerned that the policies necessary to achieve this objective have not yet been put in place.

Fiscal policy has been particularly weak in 1985 with a large expansionary stimulus emanating from the budget. Particularly disturbing has been the very strong increase in government current spending in real terms thus far in 1985. Moreover, the authorities have not been able to meet their revenue target because of failure to raise indirect taxes sufficiently to take account of revenue losses associated with a reform of personal income taxation. Thus, the tax burden, which was already low by international standards, declined in 1985--a development that the economy could ill afford at this time.

The official survey of medium-term budget trends indicates that with unchanged spending commitments and based on present plans for taxation the fiscal balance would worsen significantly over the next three years. However, for the borrowing requirement to be manageable, the Treasury balance would need to be in increasing surplus over the years. This highlights the need for discretionary fiscal action. The staff agrees with the authorities that cuts in expenditure should be the main element in the strategy of fiscal adjustment; this would undoubtedly require a more assured control over current spending, especially in the area of transfers. To the extent that the desired budget balance over the medium term is not attainable through spending cuts, consideration will need to be given to increases in taxation and it may be necessary to reconsider the planned step-wise abolition of personal income taxes. The staff is concerned that the budget for 1986 does not constitute an adequate first step in the medium-term adjustment strategy and urges that additional measures be taken at an early date. The estimated public sector borrowing requirement remains high and it is unlikely that it could be substantially financed through the nonbank private sector. This would once again put strains upon the conduct of monetary policy.

It is notable that the significant changes in the institutional arrangements of monetary policy of the recent past have led to a more market-oriented banking system. However, monetary policy has remained much too easy, with the major factors behind rapid credit expansion being strong foreign borrowing by banks and by the Government, recourse to central bank financing on a large scale by the Treasury, and a lowering in reserve requirements. The staff believes that there is an urgent need to tighten monetary policy in advance of the wage negotiations. In the present conditions of unstable and rising inflationary expectations, real interest rates on nonindexed loans and deposits have tended to become negative again. Interest rates have so far not been high enough to reduce excessive demand for credit and need to rise across the spectrum. It remains important to achieve better control of overall central bank money creation and to accept the resulting interest rates. There is a need for stringent limitations on foreign borrowing by commercial banks and the Government. The staff

believes it important to resume sales of Treasury paper to the nonbank public by auction. A freeing of the rate on bills used to finance domestic stocks would also assist in monetary control.

In the face of stronger domestic price and cost pressures than originally envisaged, the authorities were forced to revise their policy of greater stability in the nominal exchange rate by widening the band of depreciation in 1985 in order to limit the erosion of the competitive position of the economy. Nevertheless, the real exchange rate has appreciated in the course of the year to a level which, although still low by historical standards, needs to be assessed in the context of a large external deficit characterized by a heavy burden of foreign interest payments. The staff notes that at the current value of the real rate much greater weight in external adjustment would need to be placed upon fiscal and monetary restraint. If the required degree of financial restraint was not forthcoming a greater burden of adjustment will need to be carried by the real exchange rate; while this would serve in the short run to protect the balance of payments, it would do so at the cost of accelerating inflation. Therefore, emphasis must lie on financial restraint. In any event, exchange rate policy needs to be reviewed at the latest after the next round of wage agreements.

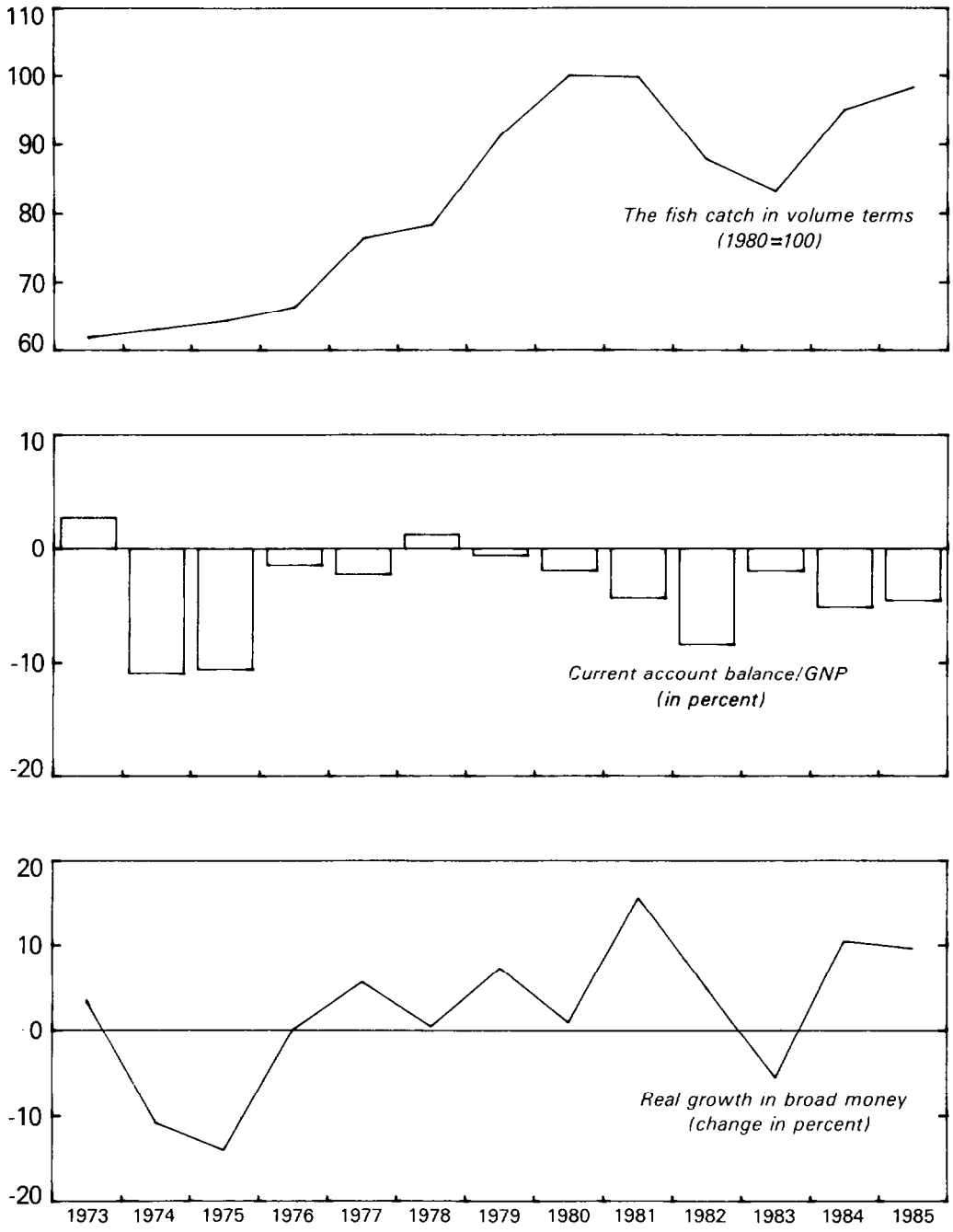
The staff notes with satisfaction the policy of liberalization and deregulation that has been carried out notably in financial and capital markets and the area of price control, and prospectively in foreign trade given the forthcoming streamlining of the tariff structure. These would assist in promoting the supply performance of the economy. Iceland needs to attract investment in other sectors of the economy, as the fishing sector cannot be relied upon as the engine of growth in the future. The staff believes that a more stable economic environment characterized by a lower rate of inflation and an adequate competitive position would be of assistance in this goal. The staff is pleased to note the general anti-protectionist orientation of trade policy in Iceland. Though there was a reliance upon greater agricultural export subsidies in 1985, the authorities intend to phase them out over time.

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

CHART 1

ICELAND

DEVELOPMENTS IN FISH CATCH, CURRENT ACCOUNT, AND REAL MONEY



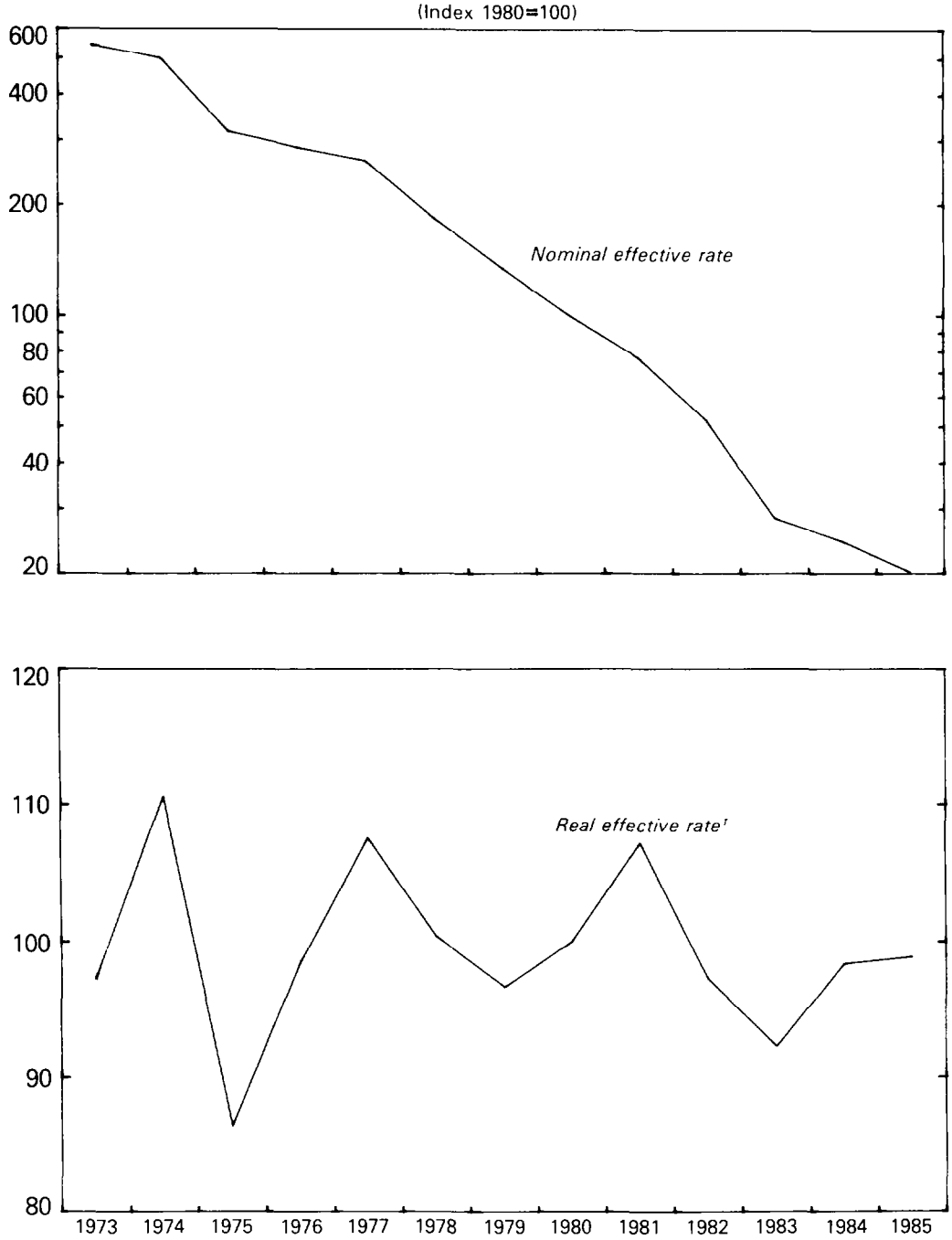
Source: Data provided by the Icelandic authorities and staff calculations.

CHART 2

ICELAND

EXCHANGE RATE

(Index 1980=100)



Source: Data provided by the Icelandic authorities and staff calculations

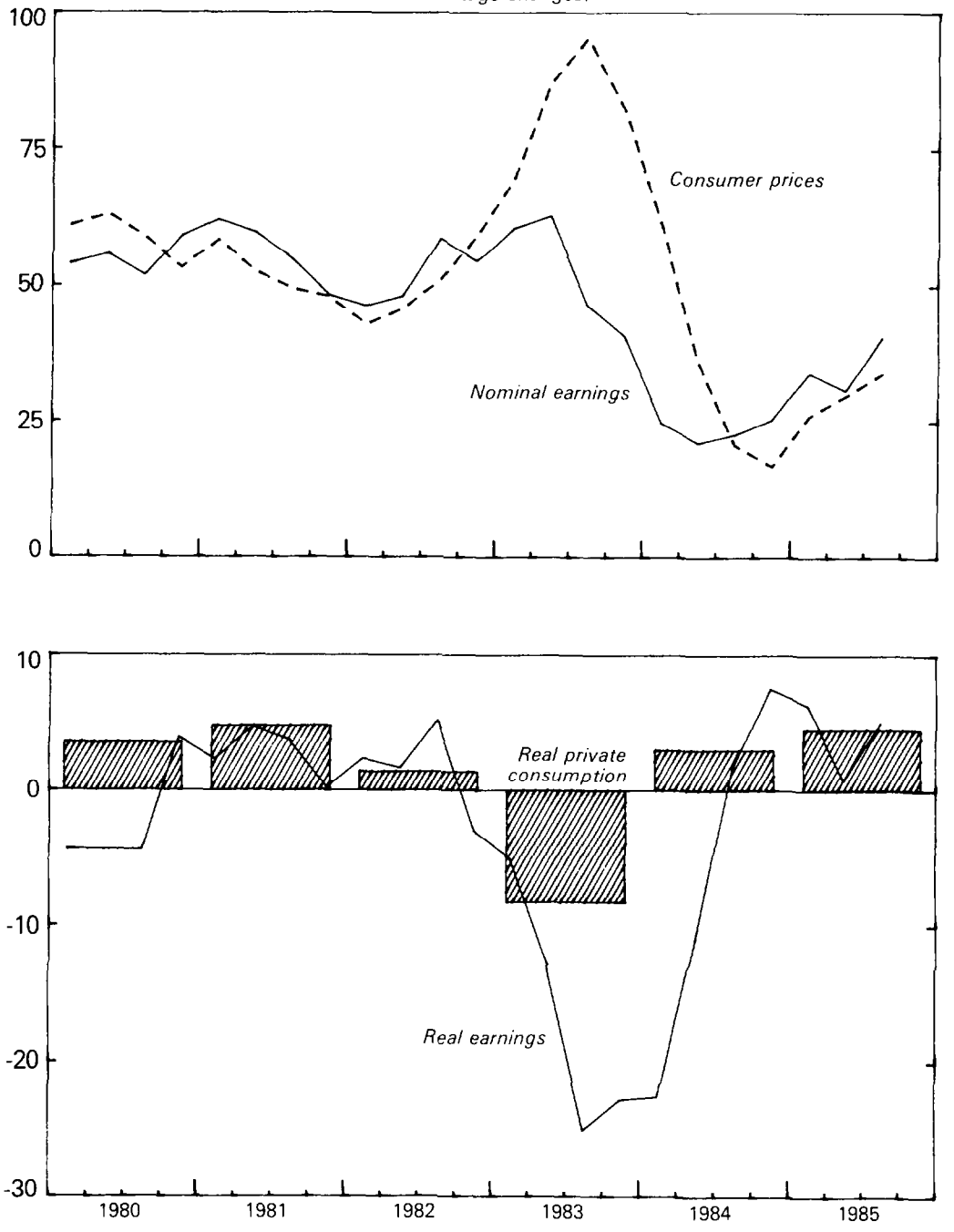
[1] Relative consumer prices.

CHART 3

ICELAND

NOMINAL AND REAL EARNINGS AND PRIVATE CONSUMPTION

(Percentage changes)



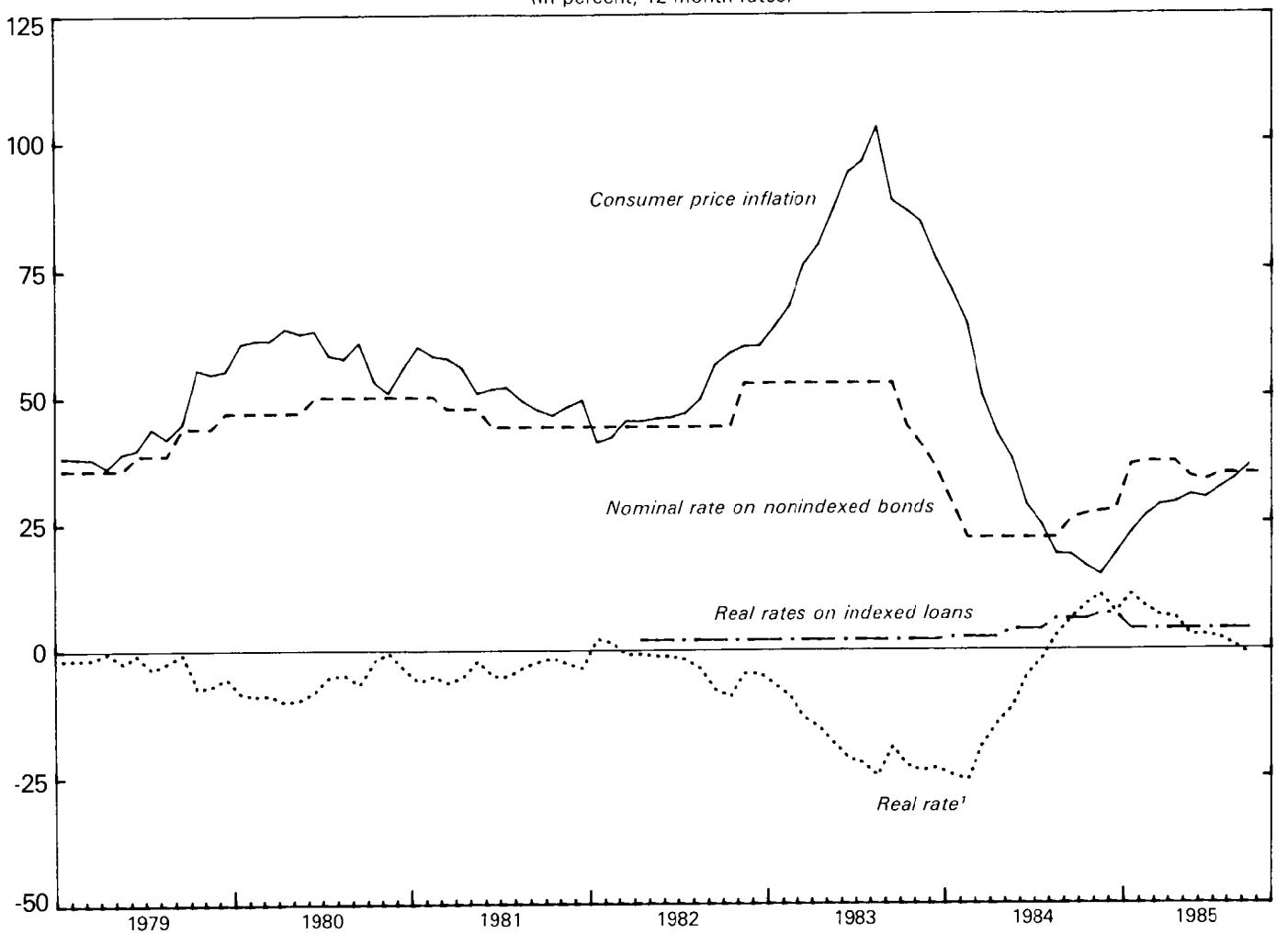
Sources. The Central Bank of Iceland and the National Economic Institute.

CHART 4

ICELAND

INFLATION AND INTEREST RATES

(In percent, 12-month rates)



Source: Data provided by the Icelandic authorities and staff calculations.

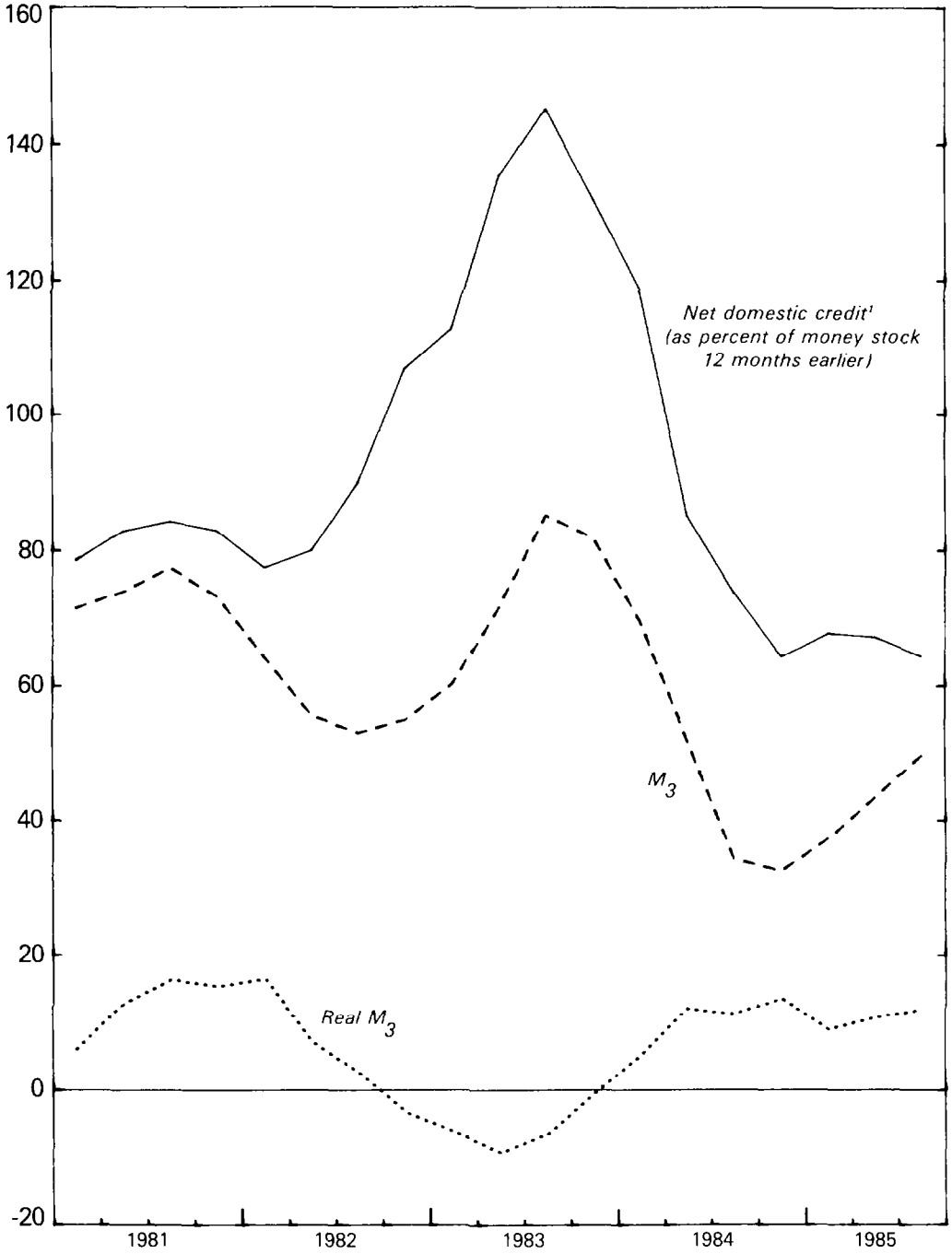
[1] Yield on bonds deflated by current inflation

CHART 5

ICELAND

MONETARY GROWTH

(In percent, 12-month changes)



Source: Data provided by the Icelandic authorities and staff calculations

[1] Including foreign borrowing by the Treasury.

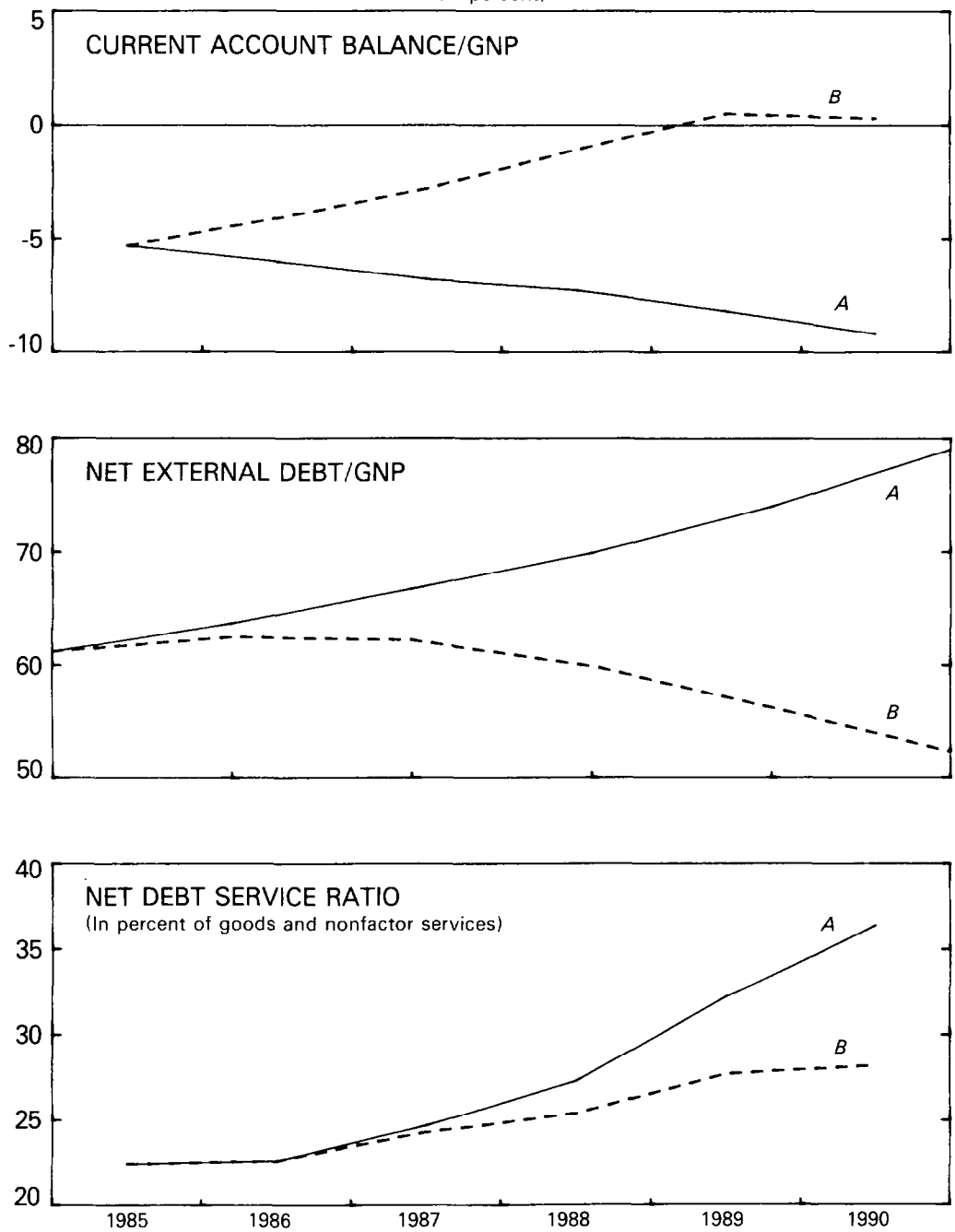
APPENDIX I

CHART 6

ICELAND

EXTERNAL DEBT SIMULATIONS[1]

(In percent)



Source: Staff calculations.

[1] For explanations, see note overleaf.

Iceland: Illustrative Medium-Term Debt Simulations 1/

		1985	1986	1987	1988	1989	1990
Current account	A	-4.9	-6.0	-6.8	-7.3	-8.2	-9.2
(in percent of GNP)	B	-4.9	-4.1	-2.8	-1.1	0.5	0.3
Total external debt, net 2/	A	61.0	63.7	66.7	69.9	74.0	79.0
(in percent of GNP)	B	61.0	62.5	62.2	59.9	56.2	52.3
Debt service ratio, net 3/	A	22.4	22.6	24.7	27.3	32.2	36.4
	B	22.4	22.6	24.3	25.4	27.7	28.2

Source: Staff estimates.

1/ For explanation of Cases A and B see note below.
2/ Net medium- and long-term debt and net short-term debt including official reserves.
3/ Net interest payments plus amortization on medium- and long-term debt, in percent of exports of goods and nonfactor services.

Note: The illustrative medium-term debt projections have been based on the following main assumptions. Output of industrial countries is assumed to grow at 2 3/4 percent in 1986 and at 3 percent per annum during 1987-90, and their GDP deflator at 4 percent throughout the period. The price of oil expressed in U.S. dollars is assumed to remain unchanged in 1986, and thereafter to remain unchanged in real terms. (An assumption of a 10 percent fall in oil prices in 1986 would ceterus paribus benefit the current account by the equivalent of nearly 1/2 percent of GNP.) Interest rates are assumed to decline gradually from 10 percent in 1986 to 9 percent in 1990. The relative competitive position of the economy is assumed unchanged from its 1985 position. The volume of total exports is assumed to rise by 3 percent per annum.

Given the above environmental assumptions, two scenarios are postulated for domestic demand. In the first scenario, Case A, domestic demand is assumed to rise at the same rate as on average in the past two years, i.e., 3 percent per annum. In the second scenario, Case B, a more restrictive demand management is assumed consistent with moving the current account to balance after 1988; domestic demand would be held flat in 1986-89 and would be permitted to rise by 2 percent in 1990.

Fund Relations with Iceland

(As of end-October 1985; in millions of SDRs)

I. Membership status

(a) Date of membership: December 1945.

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

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 59.6 million.

(b) Total Fund holdings of krónur: SDR 77.1 million (129.3 percent of quota).

(c) Fund credit: SDR 21.5 million.

(d) Reserve tranche position: SDR 4.0 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 .384 million or 2.34 percent of net cumulative allocation (end-November).

(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

Iceland does not maintain exchange margins. 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 19 percent during 1984 and by a further 12 percent during the first ten months of 1985. On December 3, 1985 the official market rates were ISK 41.45 buying, and ISK 41.57 selling per US$1. There are no multiple currency practices or exchange restrictions.

VIII. Last Article IV consultation

Discussions for the 1984 Article IV consultation were held in Reykjavik during the period September 6-17, 1984. The Staff Report (SM/84/251, 11/7/84 and Supplement 1) was discussed by the Executive Board on November 28, 1984 (EBM/84/170).

Iceland: Basic Data

Area: 103,100 square kilometers
Population: (December 1984) 240,443
GNP in 1984: ISK 77,012 millions; per capita SDR 9,859

	1981	1982	1983	1984	1985 1/
Demand and supply		(Volume changes in percent)			
Private consumption	4.7	1.4	-8.3	3.0	4.5
Public consumption	7.2	5.5	5.5	--	3.0
Gross fixed investment	1.0	-0.5	-12.3	6.8	0.5
Final domestic demand	4.2	1.6	-6.8	3.3	3.3
Changes in stocks 2/	0.6	1.2	-3.6	2.3	-1.3
Total domestic demand	4.7	2.8	-10.1	5.6	2.0
Exports of goods and services	1.4	-9.7	10.3	2.2	5.7
Imports of goods and services	7.2	-1.1	-5.7	8.7	4.9
Gross domestic product	2.6	-0.3	-5.0	3.1	2.4
Gross national product	2.1	-0.9	-5.7	2.5	2.0
Marine export production	1.5	-12.7	-6.6	11.0	3.5
Labor market		(Annual averages)			
Unemployment, number of persons	406	770	1,184	1,480	1,110 3/
Unemployment, as percent of labor force	0.5	0.7	1.0	1.3	0.9 3/
Incomes and prices (averages)		(Changes in percent)			
Earnings per employee	56.2	53.8	56.5	27.9	36.0
Cost of living index	50.9	51.0	84.3	29.2	32.5
Real disposable income	7.0	2.2	-10.3	0.5	5.5
Terms of trade	1.3	3.8	4.0	1.2	-0.5
Balance of payments		(In millions of SDRs)			
Exports, f.o.b.	767	622	700	725	755
Imports, f.o.b.	-790	-760	-683	-735	-769
Trade balance	-23	-138	17	-10	-14
Net services and transfers	-100	-94	-67	-116	-106
Current balance	-123	-232	-50	-127	-120
Direct investment	46	33	1	14	...
Long-term borrowing, net	125	174	109	100	78
Short-term capital, net	1	-61	-66	6	125
Balance on capital account	171	147	44	120	203

1/ Official estimate of November 1985.
2/ Change as percent of previous year's GNP.
3/ Average for January-September.

	1981	1982	1983	1984	1985 1/
		(In millions of SDRs)			
Current balance (in percent) of GNP	-4.5	-8.9	-2.2	-5.3	-4.9
External long-term debt, gross (SDR millions; end-period)	890	1,083	1,210	1,316	...
External long-term debt, gross (in percent of GNP)	28.1	42.0	51.2	56.1	...
Interest payments 2/	9.2	11.4	11.3	13.2	12.4
Foreign reserves and liabilities		(SDR millions; end-period)			
Oficial reserves	199	133	144	132	183 3/
Official liabilities	-37	-61	-74	-92	-24
Of which: to IMF	(-6)	(-22)	(-22)	(-22)	(-22)
Total net foreign asset position 4/	12	-95	-168	-194	-189
Public sector		(ISK millions)			
Treasury revenue	5,993	9,577	15,144	20,747	27,141
Treasury expenditure	6,075	9,379	17,457	19,964	29,000
Balance	-82	198	-2,313	783	-1,859
(as percent of GDP)	-0.3	0.5	-3.7	1.0	-1.7
Public sector borrowing requirement (as percent of GDP)	...	6.4	5.8	6.1	6.0
Monetary survey		(Change in percent during the year)			
Foreign assets, net 5/	-12.6	-51.8	-54.0	-33.4	-15.5 6/
Domestic assets, net 5/	83.1	109.8	132.6	66.8	65.6 6/
Broad Money (M_3)	70.5	58.0	78.6	33.4	50.1 6/
Exchange rate					
ISK per SDR, period average	8.52	13.64	26.60	32.49	...
ISK per SDR, end-period	9.51	18.34	30.02	39.74	43.63 3/
Change in effective rate 7/					
Average	-23.9	-32.3	-45.4	-13.8	...
End of period	-17.1	-42.8	-34.7	-19.3	...

1/ Official estimate of November 1985, and staff estimates.
2/ Net payments as percent of exports of goods and nonfactor services.
3/ End-September.
4/ Including net position of commercial banks.
5/ Change as percent of M_3 at the beginning of period; domestic assets including external borrowing by Treasury.
6/ September 1985 over September 1984.
7/ Trade-weighted.

Iceland: Statistical Issues

1. Outstanding Statistical Issues

a. Money and banking

The report of a Bureau of Statistics mission on money and banking statistics, forwarded to the Icelandic authorities in September 1985, identified some important deficiencies in data on central government and public financial institutions which result in a substantially different coverage of monetary statistics when compared with government finance statistics. The report also identifies areas for improvement of money and banking statistics in IFS using available data. They include separate identification of accounts of nonmonetary financial institutions in the Central Bank and deposit money bank sections in IFS. In addition, the report proposes the introduction of a new IFS section on other financial institutions which would cover investment credit funds and pension funds.

b. Government finance

The 1984 GFS Yearbook includes statistical and derivation tables for the consolidated government through 1982. Data for local government are also included through 1977. No new data were received for publication in the 1985 Yearbook. The annual time series in IFS correspond with the data in the GFS Yearbook.

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 1985 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 1985 IFS
Real Sector	- National Accounts	1984
	- Prices: Consumer	October 1985
	- Production: (Total fish catch)	September 1985
	- Employment	n.a.
	- Earnings: Hourly wages	Q4 1984
Government Finance	- Deficit/Surplus	1982
	- Financing	1982
	- Debt	1982
Monetary Accounts	- Monetary Authorities	September 1985
	- Deposit Money Banks	August 1985
	- Other Financial Institutions	n.a.
External Sector	- Merchandise Trade: Values	September 1985
	Unit value (aggregates)	1984
	Unit vlaue (frozen fish)	September 1985
	- Balance of Payments	Q4 1984
	- International Reserves	October 1985
	- Exchange Rates	October 1985