

# GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

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## CONSULTATION UNDER ARTICLE XII:4(b) WITH ICELAND

### Report of the Committee on Balance-of-Payments Restrictions

1. In accordance with its terms of reference, the Committee has conducted a consultation with Iceland under Article XII:4(b). The Committee noted that the previous consultation with Iceland under the same provisions had been held in June 1971 (BOP/R/55). In conducting the present consultation the Committee had before it: (a) a basic document supplied by the Government of Iceland (BOP/128); (b) a decision taken by the International Monetary Fund Executive Board on 4 October 1972 concerning Iceland (Spec(72)113); and (c) papers containing background material, dated 7 August and 29 September 1972 supplied by the Fund.
2. The Committee generally followed the plan for such consultations recommended by the CONTRACTING PARTIES (see BISD, eighteenth supplement pages 52-53). The consultation took place on 27 October 1972. The present report summarizes the main points of the discussion.

### Consultation with the International Monetary Fund

3. Pursuant to the provisions of Article XV of the General Agreement, the International Monetary Fund had been invited to consult with the CONTRACTING PARTIES in connexion with this consultation with Iceland. In accordance with the agreed procedures, the representative of the Fund made a statement concerning the position of Iceland, as follows:

"The Fund invites the attention of the CONTRACTING PARTIES to the Executive Board Decision of 4 October 1972, taken at the conclusion of its most recent Article XIV consultation with Iceland, and particularly to paragraphs 2 to 4 which read as follows:

'2. Real gross national product showed a rapid increase, for the second consecutive year, rising by 9.5 per cent in 1971. The expansion was sustained largely by domestic demand factors which showed a sharp upturn in the second half of 1970. Imports in 1971 rose at about the same rapid pace as in 1970. The value of exports hardly expanded in 1971; a decline in volume was offset by another sharp rise in export prices of fish products. Official reserves continued to rise in 1971.'

'3. The incomes policy measures adopted in November 1970 to halt the price-wage spiral moderated the increase in nominal wage rates in 1971, but, since they also slowed down the rise in consumer prices, they helped sustain a rapid increase in real personal disposable income. These measures contributed to a significant worsening of the budget position compared with 1970. The weakness in general demand management policies also helped to bring to an end the contractionary influence of the Fish Price Equalization Fund in the second half of 1971.'

'4. The continued sharp increase in domestic demand and the renewal of the price-wage spiral in the first half of 1972 has been threatening Iceland's international competitiveness. To stem this threat and also to gain time for reassessment of economic policy, the authorities introduced in July 1972 a temporary price freeze, and higher consumer subsidies and family allowances. The Fund notes this action and also the Government's intention to finance the additional government expenditure by curtailment of other budget expenditure. In the light of developments so far in 1972, the central government budget accounts are likely to show a continued deficit even though there is already heavy pressure on resources. These pressures, together with the deterioration in the terms of trade, are likely to result in a balance of payments deficit on current account that may not be sustainable in the medium-term.'"

"The Fund believes that at the present time the general level of restrictions of Iceland which are under reference does not go beyond the extent necessary to stop a serious decline in its monetary reserves."

Opening statement by the representative of Iceland

4. In his opening statement, the full text of which is reproduced in the Annex, the representative of Iceland briefly recalled the serious economic difficulties his country had faced in 1967 and 1968 and outlined the gradual recovery, which had started in 1969. Iceland's economic development in 1971 had been characterized by a continuous expansion of demand and production: real GNP had risen by 9 to 10 per cent, the terms of trade had improved with export prices for fishery products increasing by an average 25 per cent. Domestic expenditure had also risen by some 21 per cent in 1971, accompanied by increased imports. As a result, the balance of payment for 1971 had deteriorated and shown a deficit on current account of some \$45 million. However, inflow of foreign capital had offset this imbalance and exchange reserves had increased in 1971. Prospects for the final results of 1972 were somewhat less favourable: real GNP was expected to show a smaller increase, the fisheries sector was expected to suffer a production fall of some 5 per cent, while domestic demand (with full employment restored) was rising, as were imports. The expected result on the balance of payments was a deficit on current account of nearly \$50 million and a decline of foreign exchange reserves of some \$3 million. The representative of Iceland

explained how the rapid rise in prices during the first half of 1972 and the pressures of domestic demand had prompted the Government to re-introduce a strict price freeze in July. Budgetary results for 1972 were uncertain, although a deficit was expected. The rate of monetary expansion had slowed down somewhat, but remained higher in 1972 than had been planned for by the Central Bank. Efforts were being made to contain domestic liquidity by reducing the use of foreign suppliers' credit for imports. He concluded by recalling that, under the circumstances, Iceland had achieved a great degree of trade liberalization - 93 per cent of total commodity imports - and that remaining import restrictions on industrialized products, with the exception of petroleum products, would be removed before 1975. Liberalization measures were carried out on a most-favoured-nation basis and thus were of benefit to all GATT contracting parties.

#### Balance-of-payments position and prospects

5. Members of the Committee expressed appreciation for the detailed information supplied by the representative of Iceland, and welcomed the renewed assurance that Iceland would pursue a continued liberal trade policy which would culminate in the removal of restrictions on industrial products by 1 January 1975. It was noted that, with regard to the balance of payments, a deficit on current account of some \$50 million was expected by the end of 1972 and that the level of foreign exchange reserves might decline by some \$3 million. Asked whether the Icelandic authorities had any quantitative estimates for the 1973 balance of payments, the representative of Iceland replied that there were no official estimates and that it was very difficult to arrive at accurate estimates for the future in view of the special nature of the Icelandic economy which relied on a limited range of products for export earnings which were subject to sharp fluctuations in supply and prices. He said that fish prices were now high and appeared firm in the immediate future.

#### Alternative measures to restore equilibrium

6. Recalling discussions at previous consultations with Iceland on the question of diversification of production, particularly for the export sector, a member of the Committee asked what progress had been achieved in this field, and whether the heavy expenditure being incurred to increase the Icelandic fishing fleet - some 11 per cent of total real fixed investment in 1972 - did not run counter to the general policy of diversification. He noted that Iceland's plans implied a doubling of the trawler fleet between 1971 and 1974, and enquired whether this could not lead to overfishing and therefore poor prospects for returns on such heavy investment. The representative of Iceland explained this investment was aimed at modernizing and increasing a very out-dated trawler fleet. Because of overfishing, Iceland had taken measures to extend the fishing limits, and as this extension would also make for a greater share of Iceland in the total catch the projected investment in forty new vessels by 1974, was considered a viable investment. He stressed that Iceland was still predominantly dependent on fish as a source of export earnings and as such fisheries should be expanded. This

did not detract from the need to diversify the economy, particularly in the export sector. An aluminium smelter, with a total capacity of 77,000 tons per year, had been built although, owing to the depressed world market, stocks of aluminium had been accumulated last year. Various feasibility studies had been undertaken for other projects, e.g., a sea-chemicals plant, heavy water production, sea-weed utilization and oil refining. While most of these projects appeared to be sound, no production decisions had yet been made. On the other hand, there were a number of existing domestic industries which were showing good export potential, such as woollen goods, furs, canned fish products and diatomous earth, etc. While this export sector was small, it was showing good growth - some \$14 million were expected from it in 1972, compared to \$2.8 million in 1968.

The representative of Iceland added that all population projections showed that the fishing sector could not absorb the growing labour force and that, in order to attain full employment as well as the required level of exports, industrial production would have to be developed. He said that the study published last year had assumed that the share of export of aluminium and other energy-intensive production would have to rise from 13 per cent of total commodity exports in 1970 to 32 per cent in 1980, and other manufacturing (including diatomite) from 4 to 10 per cent. This implied that in the same period the share of fish exports would fall from 78 per cent to 56 per cent and that of agriculture from 5 to 2 per cent. Tourism and transportation had shown growth potential and might also contribute in this respect.

7. Members of the Committee noted that the central Government budget was in deficit and was likely to continue to show a deficit, which might unfavourably affect the external balance. The representative of Iceland reiterated his earlier statement that the expansionary effect of higher subsidies and family allowances was to be moderated through a reduction in other items on the expenditure side of the budget and said that there was some concern over the expansionary effects of this year's budget. However, he was not in a position at this stage to say what new measures could result from the current Parliamentary budget debate. He recalled, however, that the price-freeze reintroduced in July, was intended as a temporary measure and that fiscal reforms introduced at the same time were expected to have a stabilizing effect. The representative of Iceland drew attention to that part of paragraph 5 of the IMF Executive Board Decision of 4 October 1972, in which the Fund expressed satisfaction with the intention of the Icelandic authorities to adopt a set of stabilization measures.

8. In reply to questions concerning the operation of the Fish Price Equalization Fund, discussed in previous consultations, the representative of Iceland stated that the Fund was considered a useful instrument for demand management and it had worked well.

9. In the monetary field, members of the Committee referred to the 1971 credit expansion which had turned out to be greater than expected, and asked whether measures were envisaged to restrain further expansion in 1973. It was also noted that the rate of savings had declined in 1972, and inflation, which was of the wage-push situation type, had continued. Asked to comment on what measures were envisaged to contain this trend in the future, the representative of Iceland explained that in his view monetary policy, in the context of an inflationary process, and in particular the use of the bank rate to control credit, could not

be relied upon mainly because the range of interest rate change called for would have excessively unfavourable cost effects. The interest rate pattern as such was not used to control internal demand, mainly because of the absence of organized money and capital markets. However, the rate of monetary expansion had been slower so far during this current year as compared to 1971. The control of money supply expansion was considered as a more effective weapon, given the monetary institutions of the country, and therefore could be relied upon as monetary instrument. While no special measures had been taken to stimulate private savings, changes in the fiscal system such as higher real estate taxes might contribute to a change in the composition of investments in the right direction.

#### Methods of restrictions

10. In reply to questions concerning the trade effects of the agreement with the Soviet Union and Eastern Germany the representative of Iceland said that the non-official agreement with Eastern Germany covered a small amount of trade and was patterned on similar agreements between Nordic countries and Eastern Germany. The future form of this agreement was at present under study. The agreement with the Soviet Union constituted an important and necessary feature of Iceland's trade relations. The USSR bought inter alia certain fish products for which it was difficult to find alternative markets but industrial exports had also been developed. While importing a range of products from the USSR, Iceland reserved its petroleum market for that country. The importance of this agreement to Iceland's economy had been fully recognized by its EFTA partners and also by the EEC in the context of the July 1972 trade agreement. In reply to a query, the representative of Iceland confirmed that petroleum - a major product included in the bilateral agreement with the Soviet Union - would not be liberalized in January 1975. The Committee was informed that the two bilateral payments agreements mentioned above were the only ones now in existence, the agreement with Brazil represented a reciprocal credit arrangement and should be deleted from the enumeration in the basic document BCP/128.

11. A member of the Committee, commenting on the Icelandic present practice of allowing special suppliers' credit for up to three months for imports from bilateral trading partners while denying this facility to imports from convertible currency countries, questioned the consistency of this with the provisions of Article I of the General Agreement. The representative of Iceland took note of this statement, recalling that at the last consultation he had stated that the length of the credit has been reduced from six to three months.

12. In reply to a question regarding the possible duration of the import levy of 25 per cent on automobiles introduced by the Ministry of Finance in April 1972, the representative of Iceland said that there was no provision regarding the termination date of this measure.

13. In reply to questions as to which products would remain restricted after 1 January 1975, the representative of Iceland stated that all the products listed on page 1 of Annex I in the basic document BOP/128, plus tariff items 27.09.00, 27.10.29, 27.10.40, 27.10.50, petrol and petroleum products, and 96.01.00, brooms and brushes would remain restricted. The remaining negative list would therefore be very short, and consist mainly of agricultural items.

14. Asked whether any acceleration of the programme for liberalization could be expected, the representative of Iceland stated that some products under restrictions were progressively being liberalized, as could be seen from the growing size of global quotas, but that because they were in sensitive sectors, any acceleration of the programme, concerning industrial goods, which in any case was due for completion by 1 January 1975, was not to be expected. The timing and completion of the programme was a contractual obligation under Iceland's agreement with EFTA, and would be met. Liberalization was effected on a most-favoured-nation basis.

15. Asked what the prospects were for private importers to enter trade in products reserved to State trading, the representative of Iceland said that his Government had no such intentions.

#### Conclusion

16. The Committee took note of Iceland's progress in trade liberalization, as shown by the steady increase in the number of liberalized items and the growing size of global quotas. It welcomed the Government's decision, as mentioned in the IMF decision of 4 October 1972, to pursue a continued liberal trade policy. While appreciating the assurance concerning the completion of the trade liberalization programme for industrial products by 1 January 1975, the Committee urged the Icelandic Government to explore the possibility of accelerating the process. The Committee also expressed concern over the expansionary effects of the present budgetary policies and expressed the hope that adequate measures would be taken to contain this trend so as to ensure progress towards greater price and cost stability and a sustainable external balance.

Annex

OPENING STATEMENT BY THE REPRESENTATIVE OF ICELAND

When Iceland's last consultation in the Committee on Balance-of-Payments Import Restrictions took place shortly before the middle of last year, it was already evident that 1971 would be very favourable for the Icelandic economy. Results in fact turned out better than anticipated as the gross national product per capita exceeded its previous record attained in 1966. Economic development in 1971 was characterized by continuous expansion in demand and production. The real gross national product rose by 9.5 per cent and the terms of trade improved very significantly. Prices on exports of fishery products rose by approximately 25 per cent on average whereas the rise in prices of imports was considerably lower at around 5-6 per cent. As a result the increase in net national product was around 12.5 per cent last year, considerably in excess of the rise in the gross national product.

In 1967 and 1968 Iceland experienced a catastrophic decline in production and exports. This set-back - certainly of much more serious proportions than anything of the kind known in other Western European countries in the post-war period - was followed by sharp recovery in 1970 which was still further accentuated in 1971. The main reason for this growth was the sharp increase in export earnings from 1969 to 1971.

The years 1969 and 1970 saw an increase both in the volume of the white fish catch and in the prices on export markets. In 1971 catches fell somewhat in spite of increased fishing efforts but export prices on important products continued to rise. The white fish catch declined by approximately 54 thousand tons or about 11 per cent whereas the relatively more valuable catch of lobster, shrimp and shellfish increased significantly. On the whole the volume of fisheries products fell by about 4-5 per cent in 1971 but this was much more than compensated for by the rise in export prices, which amounted to about 25 per cent. Last year was favourable for agriculture in Iceland and it is estimated that production in this sector rose by about  $8\frac{1}{2}$  per cent over the previous year. The domestic manufacturing industry which in the last years has been contributing increasingly to exports, experienced a favourable development for 1971 as a whole. Production of aluminium which is based exclusively on exports was faced with difficulties on world markets in 1971 and exports were only about half of what they had been in the previous year as they fell from 33.5 thousand tons in 1970 to 17.6 thousand tons in 1971. As the production of aluminium during the same period rose from 38 thousand tons to 41.3 thousand tons there was a considerable increase in stocks in 1971, which amounted to 30 thousand tons at the end of the year.

Our national accounts indicate that in 1971 private consumption rose by 14-15 per cent in volume, or somewhat more than the increase experienced in 1970. This great increase has of course to be considered in the light of contraction which had taken place in the two previous years. In 1971 it is estimated that

public consumption increased by 6.4 per cent. The sharpest increase, however, was on the investment side. Excluding the extraordinarily high imports of aircraft and ships it is estimated that fixed investment in real terms rose by somewhat less than 28 per cent in 1971. On the whole domestic expenditures increased in real terms by about 21 per cent in 1971. In this situation imports showed a very sharp increase and, as exports failed to maintain a sufficient growth momentum, the balance of payments deteriorated significantly. In 1971 the current account showed a deficit of \$45 million. However, this was more than offset by inflow of capital and foreign exchange reserves increased last year.

Turning now to prospects for the current year, it is estimated that the gross national product will rise by close to 6 per cent in real terms this year while the national income is expected to increase by only some 4 per cent as import prices are expected to rise somewhat more than those of exports. An important factor in this less favourable development is the further fall in catches of white fish we have experienced. It is now expected that total production in the fisheries sector will decrease this year by 8-9 per cent. Exports of fisheries products may however increase because of a running down of stocks. Increase in production in agriculture is estimated to be at about 3 per cent. It is forecast that domestic industrial production may rise by close to 10 per cent and production of aluminium will rise this year from about 41 thousand tons to about 47.5 thousand tons or by about 15 per cent. It is estimated that building activities may rise by 10-11 per cent this year and other branches of domestic activity by something around 9 per cent. An increase in the public sector of around 5-6 per cent is anticipated this year. As these figures show the whole of the increase in activity is due to rising domestic demand. After significant unemployment in the depression years 1968-1969, full employment was quickly restored and unemployment is currently at only about 0.5 per cent of the total labour force, or virtually non-existent.

In the first eight months of this year, commodity imports, excluding so-called special imports (ships, aircraft etc.) increased by 17 per cent compared with the corresponding period last year. As the rate of increase is expected to be higher in the second half of the year, general imports are expected to rise by about 22 per cent in value in 1972 but owing to a likely fall in special imports the rise of total commodity imports is expected to be about 15 per cent. On these trends it is expected that the balance of payments of current account will show a deficit in excess of \$49 million for the year as a whole and that foreign exchange reserves may decline by about \$3 million.

As was stated in the examination of Iceland by this Committee last year the price freeze then in operation was due to expire in the latter part of last year but was extended to cover the whole year. In conjunction with new wage agreements which were concluded in December the price freeze was replaced by extensive price control. The wage agreements concluded at the end of last year cover a two-year period. They provided for an immediate increase of 8 per cent for lower paid workers and a 4 per cent rise for others. A further 4 per cent was paid on 1 June 1972 and 6 per cent is to be paid on 1 March 1973. Furthermore the working week is reduced from 44 to 40 hours as of 1 January 1972. The agreement covers about 50 per cent of the labour force and indirectly other groups such as farmers

whose incomes are linked to the wages controlled by the agreements. As the agreements provide for index linking it is estimated that wage rates of those affected will rise by 17-18 per cent on average during 1972 without taking into account the reduction in working hours.

Due to the rapid rise in prices during the first half of this year and increasing domestic demand, the Government was prompted to re-introduce a strict price freeze in July last. Consumer subsidies and family allowances were increased to offset the effect of rising prices on the cost of living index and thus keep the wage compensation index stable. The increase in Government expenditure resulting from this action should not have an expansionary effect on the budget as the intention is to make reductions on other expenditure items. The budgetary results for 1972 are subject to some uncertainty, inter alia because of a different method of collecting the sales tax which is being introduced. Current estimates are that the result may be a deficit of IKr 300-400 million.

Monetary expansion has slowed down somewhat in the present year compared with the very expansionary 1971. Credit expansion on an annual basis was about 20 per cent in the first eight months of 1972 compared with 27 per cent for the same period of 1971. This rate of credit expansion is, however, considerably higher than the Central Bank had aimed at at the beginning of the year. The main reason was the adverse development of the central government accounts in the first eight months of 1972. This development is partly seasonal, but partly due to a functional transfer to the central government from the municipalities with an adverse seasonal pattern of expenditures and revenues. There is also, however, undoubtedly some underlying weakening of government finances. The liquidity of the commercial banks improved somewhat in the first eight months of 1972. But it is expected that this will change abruptly in the last months of the year, due to both the seasonal pattern of government finances and the deterioration of balance of payments, foreseen in this period.

As part of the effort to contain domestic liquidity the use of suppliers' credits from abroad for import purchases has been curtailed. A new regulation in this field took effect on 1 April last. Previously the use of suppliers' credit of up to three months had been prohibited for 17 per cent of commodity imports. With the new regulation about 30 per cent of commodity imports are now excluded from these credits and this applies mainly to various kinds of consumer goods. The main aim of these measures is to control domestic demand and it should be borne in mind that in Iceland foreign suppliers' credits plays a comparatively very important rôle. This should of course also help to bring about a healthier balance-of-payments situation but the measure taken is not designed to be of a trade restrictive nature.

Finally, Mr. Chairman, it should be noted as is stated in our Basic Document that Iceland has attained a high degree of trade liberalization as the commodities which now are liberalized represent nearly 93 per cent of total commodity imports. The remaining import restrictions on industrialized products - except petroleum products - will be removed before 1975 under the terms of Iceland's accession agreement with EFTA. As has been pointed out on previous occasions, these liberalization measures are carried out on a most-favoured-nation basis and are thus to the benefit of all GATT contracting parties.