

GENERAL AGREEMENT ON TARIFFS AND TRADE

RESTRICTED

BOP/R/71

7 December 1973

Limited Distribution

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 November 1972 (BOP/R/64). In conducting the consultation the Committee had before it: a basic document supplied by the Government of Iceland (BOP/140) and a paper containing supplementary background material dated 13 November 1973 supplied by the International Monetary Fund.
2. The Committee generally followed the plan for such consultations recommended by the CONTRACTING PARTIES (see BISD, Eighteenth Supplement, pages 52-53). The Committee met on 29 November 1973. 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. 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 supplementary background material dated November 13, 1973.

The deficit in the trade account of US\$12.9 million (including "special" trade, i.e. exports of aluminium and imports of ships, aircraft, and for the aluminium smelter complex) during January-August of 1973 represented an improvement of US\$4 million compared with that in the corresponding period in 1972. Gross official reserves increased by US\$16.4 million to US\$100 million (SDR 83 million) during the year ended September 1973. This level of reserves is equivalent to 43 per cent of the value of imports in 1972 and to about one half of the value of imports during January-August 1973. However, the balance of payments position of Iceland is subject to a number of weaknesses and uncertainties, particularly its high dependence on fish catch and unpredictable developments in prices of their main export products on foreign markets. The decline in the deficit in the trade account (with imports on a c.i.f. basis) during the first eight months of this year must be appraised against the background of large deficits in 1971 and 1972 which amounted to US\$70.2 million and US\$42.3 million, respectively.

The par value of the Icelandic krona was changed from IKr 95.5429 to IKr 107.008 per unit of SDR on December 19, 1972, which represented a devaluation of 10.7 per cent. On February 15, 1973 a new central rate of IKr 118.898 per unit of SDR was established which represented a further devaluation of 10 per cent and left the exchange rate in terms of the U.S. dollar unchanged. Since then the current account has shown an improvement. Since early 1973 there had been a marked improvement in the profit situation in the fishing industry largely due to exceptionally favorable export prices, and export receipts had increased rapidly. On the other hand, as a result of the weakening of domestic demand and the increase in import prices there had been only a moderate increase in the volume of imports. Faced with the serious problem of upward price and cost pressures, induced not only by the very rapid rise in export prices but also by the effect on the wage regulating index of the accelerated increase in import prices and of the termination of the price freeze on January 1, 1973 the Icelandic authorities adopted several stabilization measures in April including a change in the central rate of the krona from IKr 118.898 to IKr 112.168 per unit of SDR on April 30 1973 which represented a revaluation of 6 per cent.

The revaluation of the currency was, in part, aimed at reducing the export receipts of the fish processing industry in terms of krona, thereby limiting the scope for an increase in the raw fish prices, and in part at easing the upward pressure on domestic prices and costs through its moderating effect on krona import prices. As the U.S. dollar depreciated vis-à-vis European currencies and Iceland maintained the central rate in relation to the U.S. dollar, the krona was effectively depreciated vis-à-vis the currencies of Iceland's main trading partners. Since these developments cancelled most of the intended stabilizing effects on domestic prices and costs of the earlier revaluation, the authorities decided to pursue a policy of "controlled" floating as from June 15, 1973. The intention of the authorities was to utilize this greater exchange flexibility to set new buying and selling rates for the U.S. dollar which imply a small initial appreciation of the Icelandic krona in terms of the U.S. dollar. Until September the krona in terms of the U.S. dollar floated upward by about 6 per cent; the rate has remained unchanged since.

Thus far in 1973, the balance of payments and reserves position of Iceland has shown considerable strength. However, there is some uncertainty with respect to the continuation of favorable export prices of fish, which have been mainly responsible for the increase in export receipts during recent months. Moreover, during the third quarter of 1973 imports again appear to have risen faster than exports. The Fund annual Article XIV consultation discussions with Iceland are scheduled to be held in early December 1973. Taking into account Iceland's present exchange rate policy, the consultation should place the Fund in a better position to judge whether the continued maintenance of import restrictions is warranted on balance of payments grounds."

Opening statement of the representative of Iceland

4. In his opening statement, the full text of which is reproduced in the Annex, the representative of Iceland outlined the main developments in the Icelandic economy and in the balance of payments during 1972-73. In the light of the slower growth rate achieved in 1972 and the deteriorating balance-of-payments situation which had been forecast for 1973, the króna had been devalued on 17 December 1972 by 10.7 per cent.

5. However, economic developments in 1973 had in many ways been quite unexpected. The volcanic eruption in Vestmannaeyjar, which had temporarily paralyzed the country's most important fishing centre had reduced the economy's growth potential for 1973 by about 1 to $1\frac{1}{2}$ per cent. Following the devaluation of the United States dollar in mid-February 1973, and in view of the importance of this currency for Iceland's export earnings it was decided to let the króna follow the dollar and this policy continued until the end of April 1973. On 27 April, following considerable increases in the export prices of fish production and to counter inflation, the króna was revalued by 6 per cent, and as from 14 June the Government permitted a controlled upward float of the króna against the dollar while keeping its value stable in terms of the currencies important to Iceland's export trade. On 13 September, in the light of the favourable trend in export prices and rising import prices, it was decided to increase the market rate of the króna with respect to all other currencies by 3.6 per cent. In comparison with the situation prior to the devaluation of December 1972, the króna was by mid-November 4 per cent higher than the dollar, but 3 per cent lower than all currencies (including the dollar) weighted by their relative shares in Iceland's foreign trade and payments. In conjunction with the revaluations in April and September 1973 various auxiliary measures were taken to stimulate savings and decelerate monetary expansion.

6. It now appeared that the GNP for 1973 would increase by $4\frac{1}{2}$ -5 per cent over the previous year. In the fisheries sector, the decline of the white fish catch was continuing but this was compensated to a great extent by the increased capelin catch. Due to the rapidly increasing export prices the profitability of the fisheries industry was much improved over the previous year despite large cost increases. Private consumption was expected to increase in real terms by 6 per cent. Fixed investment was expected to rise by 16 per cent in volume compared to the previous year. Due mainly to the very substantial increases in export prices of fish products, total commodity exports would show an increase in value of about 50 per cent. Imports would also rise greatly, or by some 55 per cent. The balance of goods and services was expected to show a deficit of about IKr 4,000 million, or some US\$44 million, but this would be more than offset by a heavy inflow of long-term capital. Consequently, the overall balance of payments for 1973 would be expected to show a surplus of IKr 1,500 million or roughly US\$17 to US\$18 million.

7. Inflation continued to be the major economic problem facing the country. Although the basic balance-of-payments situation was fairly satisfactory the rapid domestic inflation could endanger the balance of payments in the long run.

Iceland's terms of trade were expected to weaken considerably in 1974 with a negative effect on the balance-of-payments position.

8. In conclusion the representative of Iceland drew the Committee's attention to the tariff reductions on a most-favored-nation basis which would shortly come into effect in the context of tariff reductions related to Iceland's membership of EFTA and the new free-trade agreement with the EEC. In regard to quantitative restrictions, he pointed out that commodity liberalization on the basis of 1972 imports amounted to nearly 93 per cent and he reiterated Iceland's undertaking that all restrictions on industrial products (other than those affecting petroleum products) would be removed before 1975 on a most-favored-nation basis.

Balance-of-payments position and prospects and alternative measures to restore equilibrium

9. Members of the Committee expressed appreciation for the detailed information supplied by the representative of Iceland. One member observed that Iceland's reserves were at a very high level and still growing steadily, and furthermore Iceland's balance-of-payments performance had in the past always turned out better than predicted. Commenting on these observations, the representative of Iceland said that it was extremely difficult for a small country with such a turbulent economy and so heavily dependent on foreign trade to determine the optimum level of reserves. He added that the present increase in reserves should be seen as a cyclical phenomenon. In regard to the second observation, he stated that it was only in the last two years that actual balance-of-payments results had been better than those predicted, but this was mainly due to the influence of extraneous factors.

10. A member of the Committee observed that during the period under review there appeared to be a close link between exchange rate adjustments and changes in the balance-of-payments situation, and asked how long the authorities of Iceland intended to pursue this policy. In reply, the representative of Iceland said that the aim of Iceland's exchange rate policy was to secure a healthy export development of the economy. He emphasized that in recent years Iceland's economy had been moving away from almost total dependence on a single crop (fish) towards a more diversified export pattern. In this situation it was important to give adequate incentives to new exports.

11. In reply to a question in regard to the principal currencies involved in Iceland's foreign trade, the representative of Iceland stated that the most important currency was the United States dollar, which was followed by the pound sterling. The United States dollar alone had accounted for about 57 per cent of total foreign exchange receipts in the twelve months ending September 1973, which was some 6 percentage points lower than the preceding twelve months. On the payments' side the dollar in contrast accounted for a little over 23 per cent.

12. Noting that Iceland's present production capacity was fully employed, a member of the Committee asked what measures were envisaged to promote new investments in order to ensure a stable growth of the economy. In reply, the representative of Iceland explained that in the present phase of the business cycle Iceland's problem was to restrain investment, rather than to promote it. In these circumstances, measures taken by Iceland's authorities were concerned with the composition of investments rather than with their absolute size. Thus, for example, they were trying to make relatively more resources available for investment in the industrial sector.

13. While noting the satisfactory rate of increase in industrial productivity, a member of the Committee wondered whether the positive effects of this trend had not been outweighed by the strong rise in wage rates. In reply, the representative of Iceland stated that, while the past five years had seen an unprecedented growth in industrial productivity, this had unfortunately not been sufficient to outweigh inflationary trends in the economy. In addition to the problems posed by domestically generated inflation, Iceland had now to face the problem of an accelerating trend of rising import prices, and this latter question was causing Iceland's authorities considerable concern because of its future implications for the balance of payments.

Methods of restrictions and effect of restrictions

14. A member of the Committee recalled the conclusions of the previous consultation which urged the Icelandic Government to explore the possibilities of accelerating the process of the trade liberalization programme for industrial products which was to be completed by 1 January 1975, and asked whether this recommendation had been acted on. The representative of Iceland pointed out that the commodities which remained restricted belonged to sectors of the Icelandic domestic industry which were very sensitive to foreign competition. He recalled that as a result of Iceland's membership in EFTA and its free-trade agreement with the European Economic Community his country was under contractual obligation to remove quantitative restrictions on all industrial products except oil by 1 January 1975. This liberalization was a significant undertaking and his authorities had to proceed with care in the dismantling of quantitative restrictions. Global quotas had been gradually increased and would be further increased in 1974. The representative of Iceland reiterated his Government's determination to pursue its policy of trade liberalization. In this context the two agreements with EFTA and the EEC had occasioned important most-favoured-nation reductions in quantitative restrictions.

15. The representative of Iceland, drew the Committee members' attention to that part of his opening statement in which he referred to forthcoming tariff reductions. He pointed out that when examining Iceland's trade liberalization it should be borne in mind that the country's trade policy was undergoing fundamental structural change in its trade policy: from a very high tariff structure it was moving toward a low tariff one. Iceland's ability to further lower tariffs would depend to a considerable degree on other countries' tariff reductions for Iceland's exports. In this context his authorities looked forward to an early start of the multilateral trade negotiations.

16. In reply to a question concerning the future of Iceland's trade and payments agreement with the USSR, the representative of Iceland said that this agreement was valid until the end of 1975, and that negotiations for renewal would start at an appropriate time. Questions were also raised concerning the status of Iceland's bilateral trade agreement with the German Democratic Republic. The representative of Iceland explained that prior to the present agreement trade between the two countries had been on a private barter basis. In February 1973 an official bilateral trade agreement on a convertible payments basis was concluded. Aside from general provisions it contained indicative commodity lists of export products for both countries.

Asked what percentage share these agreements represented in Iceland's total imports, the representative of Iceland said that trade with the German Democratic Republic made up 0.2 per cent of Iceland's imports in 1972, and that trade with the USSR accounted for 5-6 per cent of Iceland's total imports for the same year.

17. A member of the Committee asked whether the Icelandic Government was contemplating measures that would allow private importers to deal in products reserved to State trading. The representative of Iceland replied that there was no change in policy in this respect. The commodities reserved for State trading were generally liberalized and could be imported from all sources. State trading for certain products did not influence the choice of source of supply.

18. In reply to a question concerning a termination date for the import levy of 25 per cent on automobiles, introduced by the Ministry of Finance in April 1972, the representative of Iceland said that his authorities had no intention to alter this measure for the time being.

19. One representative asked whether the global quota for coffee had been increased in 1973. The representative of Iceland pointed out that the 1972 quota for coffee had amounted to IKr 5 million and that the global quota for 1973 had been raised to IKr 6 million. He explained that this quota applied only to roasted coffee in small retail packings whereas other coffee imports were unrestricted and duty free.

Conclusions

20. The Committee took note of Iceland's progress in trade liberalization as shown by the gradual removal of quantitative restrictions and increases in global quotas, which would lead to complete liberalization of industrial products (except petroleum products) by 1 January 1975. It welcomed the favourable developments in Iceland's balance of payments and reserve position in 1973, but noted the representative of Iceland referred to uncertainties with respect to some elements of the terms of trade for 1974. The Committee noted that the IMF would be in a better position to provide a determination, in accordance with the provisions of Article XV:2, after the Fund's forthcoming mission to Iceland. The Committee therefore deferred reaching conclusions, pending the Fund's determination and completion of the consultation with Iceland in March 1974.

ANNEX I

Opening Statement by the Representative of Iceland

Gross national product grew at a rate of 6 per cent in 1972, but gross national income showed a slightly lower rate of increase reflecting a deterioration in Iceland's terms of trade. Although the rate of increase in total output and income was above the average for the last twenty years in Iceland, and greater than in most neighbouring countries, it was yet smaller than the rates of growth for the two previous years.

There are two major factors behind the slower growth rates of total output and income in 1972 than in 1971 and 1970. The first explanation is that during the years 1969-1971 unused production capacity was gradually being re-employed, and by the latter half of 1971 total resources were virtually used to the full, leaving a smaller room for an increase in total output. The situation was further accentuated by a decision made at the end of 1971 to reduce standard working hours. Furthermore, the effects of a smaller catch of white fish per unit of effort were first felt in 1971, and again in 1972. The other major explanation is that Iceland's terms of trade deteriorated in 1972 for the first time since 1968 after having improved substantially both in 1970 and 1971. This result was to a large extent caused by the international currency realignments of 1971 and 1972 which had unfavourable effects for Iceland. The exchange rates of European currencies, which dominate the import price level, rose vis-à-vis both the króna and the United States dollar, which predominates in Iceland's export earnings.

Various signs of excess demand appeared in 1972, which along with the cost push resulting from the wage agreements signed towards the end of 1971, and unusually large price increases from abroad, resulted in bigger general price level increases than in the previous year or 17 per cent as compared with 13 per cent 1971, when measured by the gross national product deflator, and 16 per cent against 10 per cent, when measured by the deflator for expenditure on final domestic use.

Allowing for the effects of reduced standard working hours, both wage and salary rates, and disposable income increased by some 28 per cent in 1972 and, when deflated by the consumer price index, this amounts to an increase of 12½ per cent in real terms. Private consumption grew therefore substantially or by some 10-11 per cent, and residential construction measured in real terms increased in volume by 25 per cent from 1971. Public consumption increased by 6 per cent, and general gross fixed asset formation - leaving out imports of ships and aircraft, major power and aluminium smelter projects - showed a volume increase of 12 per cent over the previous year. Although aggregate demand surged up in 1972 by a substantially larger amount than total production, the effects

were not felt in a worsening balance of goods and services. The goods and services deficit, to the contrary, was smaller by more than IKr 2,000 million than the year before, or IKr 1,800 million against nearly IKr 3,900 million in 1971. This was due to such particular developments as a decline in export stocks, and reduced imports of special investment goods, especially of aircraft. The balance of goods and services deficit was more than matched by a surplus on capital account mostly reflecting long-term foreign borrowing. Foreign exchange reserves increased by nearly IKr 700 million (or US\$8 million) in 1972 and amounted at the beginning of 1973 to IKr 6,180 million measured in terms of the then prevailing exchange rates (or some US\$63 million).

Although foreign reserves did not diminish it became clear in the course of 1972 that the business cycle followed a familiar pattern - where an initial upsurge of incomes in the fisheries sector is propagated after a short lag throughout the whole economy, resulting in higher prices and production costs, which cannot be halted when the fortunes of the fisheries sector start to fall. In 1972 both the increase in export prices slowed markedly down and the catch of white fish declined. Export prices of fish products increased on average by 10 per cent compared with a rise of 25 per cent in 1971. The total value of fish production measured in constant prices fell by 6 per cent and export production of frozen fish products would show a decline of 8 per cent. By the middle of the year there were no indications that the prices of fish production would show any substantial rises in foreign markets, and prospects for an increased catch of white fish were bleak. On the other hand, aggregate domestic demand was on the upswing and increased production costs undermined the competitive position of the exposed sector of the economy. A provisional law of 11 July introduced temporary measures to contain the wage/price spiral and to give scope for a more thorough examination of the economic problems at hand. Accordingly, the Government appointed for this purpose a committee to examine which measures could suitably be taken to ensure stable growth. An evaluation of future prospects at the end of 1972, partly based on the findings of the committee, indicated an apparently deteriorating future balance of goods and services, uncertain profitability prospects in the fishing sector and in other important industries, and generally an unstable economic outlook. In response to these findings the króna was devalued by 10.7 per cent on 17 December, and simultaneously a more flexible policy for the quotation of exchange rates was adopted, increasing the margin of fluctuations around the par value from 1 per cent to 2 1/4 per cent in either direction.

At the outset of 1973 indications were that total output and real income would increase by above 5 per cent. As productive capacity was already fully utilized, circumstances did not seem to allow an increase in production and income beyond the normal annual increase in production capacity. It was also apparent that domestic inflation would probably be hard to contain, thus threatening the durability of the favourable impact of the devaluation on profitability in the fisheries sector and on the balance of goods and services. It had proved very difficult to obtain a consensus on measures to dampen the wage/price spiral, and the wage indexization clause in the current wage contracts seriously limits the Government's scope for stabilization measures.

Economic developments in 1973 have in many ways been quite unexpected and unforeseen at the beginning of the year. In fact it can be said that one serious event has come on the heel of another. The volcanic eruption in Vestmannaeyjar that temporarily paralyzed the country's most important fishing centre obviously reduced the economy's growth potential in 1973, perhaps by 1 to 1½ per cent, and further effects - both direct in the form of taxation to finance the Vestmannaeyjar Emergency Fund, and indirect of various nature - have substantially added to inflationary pressures. In the years to come the reconstruction in Vestmannaeyjar will inevitably require much effort and heavy expenses. The great assistance given by foreign nations - and above all the generous contribution made by the other Nordic countries to the Emergency Fund, and private contributions by individuals and associations in many countries have reduced the heavy impact of the eruption on the economy of both Vestmannaeyjar and Iceland.

By the middle of February the United States Government announced a devaluation of the dollar by 10 per cent. The dollar devaluation was followed by various changes in exchange rates throughout the world, which from the point of view of Iceland had to be seen as unfavourable developments. The impact on Iceland's balance-of-payments position was of the same nature as the effects of the currency realignments at the end of 1971 - i.e., a rise of the exchange rates of the currencies dominating the import side of Iceland's trade and payments, and a fall in the exchange rate of that currency, the United States dollar, which weighs most heavily in export earnings. In view of this, together with the prevailing economic uncertainty of the period, due both to the volcanic eruption in Vestmannaeyjar and increasing import prices and domestic costs, it was thought necessary to let the króna follow the dollar,

and this change took effect on 15 February 1973. The króna thereafter followed the dollar in exchanges vis à-vis other currencies until 30 April 1973.

At the end of the first quarter of 1973, it became apparent that the rapid price increases in world markets for food products, which had first been observed at the end of 1972, would continue in 1973, resulting in considerable increases in the export value of fish production in excess of what had been forecast when the decision was taken in February to let the króna follow the United States dollar in exchanges. In particular the prices for frozen fish on the United States market showed a steep rise. These developments simultaneously improved profitability in the fishing industry and the basic balance-of-payments situation. Weighing against these improvements were some domestic cost increases. After a 12-13 per cent increase in wages and salaries on 1 March 1973, indications were that the price indexation of wages would result in a further increase of up to 3 per cent on 1 June 1973. At the same time, demand was on the increase in most domestic markets, especially in housing and construction partly being the aftermath of the volcanic eruption in the Vestmannaeyjar. In view of all these circumstances, it was to be expected that the exchange rate of the króna would come under review and the question arose whether it would be advisable to use the flexibility created by rising export prices to revalue the króna. The króna was then revalued by 6 per cent on 27 April 1973 in order to counter the inflationary trend. Simultaneously, various auxiliary measures were taken in order to stimulate saving and decelerate the monetary expansion. These included increases of bank interest charges by 2-3 percentage points, an increase in the average reserve requirement ratio of deposit institutions from 20 to 21 per cent of deposits, and in addition a provisional law was enacted requiring all prices to be rolled back by 2 per cent immediately following the devaluation. During May the dollar kept on falling in international exchange markets, taking away a substantial proportion of the revaluation of the króna.

On 14 June another provisional law was enacted, which authorized the quotation of the exchange rate of the Icelandic króna above the previously permitted $2\frac{1}{2}$ per cent margin above central rate. This authority was then used to raise gradually the market rate of the króna against the dollar. Until the end of August these revaluations had the purpose of preventing falling dollar rates from lowering the exchange rate of the króna in terms of other currencies weighed by their relative importance in export earnings. As the summer wore on it became clear that the favourable trend in export prices - especially prices of frozen fish in the United States - would continue, and bring earnings to the fishing sector substantially in excess of earlier predictions. These developments also

affected the terms of trade favourably, in spite of rapidly increasing import prices and growing volume of imports. At the beginning of September it was thought necessary to let the market rate of the króna reflect these developments by increasing it with respect to all other currencies by 3.6 per cent. This revaluation was mainly intended to soften the impact of changes in foreign exchange rates and price levels on domestic prices. At the same time it was decided to increase the average reserve requirements of deposit institutions from 21 to 22 per cent.

After the revaluation of 13 September, the market rate of the króna in terms of United States dollars was more than 15 per cent higher than it was before the 30 April revaluation and more than 4 per cent higher than it was before the devaluation in December 1972. The mean value of the króna against all other currencies, however, was at the middle of November 3 per cent lower than it was before the devaluation of 17 December 1972, when the relative shares of foreign currencies in both export and import sides of Iceland's trade and payments are used as weights. (The fall in the average exchange value of the króna over the same period is much smaller when relative shares in exports only are used as weights, or only 1 per cent, due to the relative importance of the United States dollar in export earnings, but on the other hand the fall in average value amounts to 5 per cent when relative shares are based on imports and foreign currency payments.) The revaluation of the króna which has taken place in 1973 and the accompanying auxiliary measures mark the introduction of a new element in economic policy in Iceland. The króna had not been revalued for half a century until this year. In fact it can be said that, already with the exchange rate decision in December 1972, a new approach to exchange rate policy had been established, responding both to the turbulence in international money markets and to our own experience. The revaluation this year represents an attempt to distribute the benefits from unanticipated export earnings partly in the form of lower prices, and thereby increase real earnings instead of distributing increased export earnings throughout the economy in the form of higher money wages and prices, a benefit that may sometimes not be long lasting. It is, however, also recognized that the revaluation has caused difficulties for some industries which have not experienced as large price increases for their products in foreign markets as the fisheries industry has. This amounts to the general problem of securing a balance between the traditional export industries with their wide fluctuations, and new industries which should provide more stable export earnings. Every reasonable means must be used to meet these problems in the months ahead.

Turning again to prospects for 1973, it now appears that the gross national product will increase by $4\frac{1}{2}$ -5 per cent over last year. As the increase in export prices, which is now estimated to average 42 per cent calculated in Icelandic krónur, is much larger than the still unusually large increase in import prices, which is estimated at 25 per cent, the GNI will show a higher rate of increase than the gross national product, or over 7 per cent. In fisheries the decline in the white fish catch continues in spite of increased effort, the figures for the period January-October showing a volume decline of 4-5 per cent from the same period last year. The decline will, however, to a great extent be compensated by the increased capelin catch. For the year as a whole a 3-4 per cent volume increase is forecast for export production of fish products, largely owing to greatly increased capelin meal and oil production, while a 3-4 per cent decrease is forecast for frozen fish products. Due to rapidly increasing export prices the profitability of the fisheries industry will be much improved from the previous year in spite of large cost increases. Generally speaking, production is expected to grow more slowly in most sectors than in 1972, because productive capacity is now fully utilized, limiting opportunities for further expansion. This is especially true of the labour force as the rate of unemployment is very low (0.4 per cent) and clear signs of excess demand for labour can be seen. Agricultural production is expected to increase by about $4\frac{1}{2}$ per cent, and industrial production by about 13 per cent, primarily because of an expansion at the ISAL aluminium smelter and in other export industries. Construction will in addition grow somewhat, and other branches will also show some growth including commerce and the services sector, although at lower rates than in the previous year.

The development of wages and salaries in 1973 has primarily been governed by the 6-7 per cent increase in basic pay last March, and by index compensations linked to the cost of living. It is now estimated that wage and salary rates will increase by 23-24 per cent in 1973, when no allowance is made for the outcome of the rounds of wage negotiations at the end of the year. Incomes of fishermen will increase more due to rising fish prices and in spite of falling white fish catch. On the whole it is estimated that gross personal income will increase by 29 per cent this year, and households disposable income by some 28 per cent. On the basis of latest forecasts of price developments this represents an increase in real incomes of some 3-4 per cent, while private consumption is expected to show a greater rise, or about 6 per cent in real terms. In the years 1971, 1972, and 1973 the purchasing power of the households disposable income has increased by 35 per cent in all, while in the same period the national income in real terms has increased by some 29 per cent.

The rate of increase of public consumption this year will be similar to that of private consumption, or some 6 per cent in volume. Fixed investment will expand more than any other category of domestic expenditure, or by 16 per cent in volume from the previous year. This is primarily due to unusually large imports of fishing vessels, chiefly stern trawlers, but residential construction will also increase greatly, partly due to the importation of pre-fabricated houses by the Vestmannaeyjar Emergency Fund. When the above-mentioned special capital formation is left out along with the power project at Thjórsa and investments at the aluminium smelter, other fixed capital formation is expected to show a slight increase over the high level of 1972.

Very substantial increases in export prices have outweighed the effects of considerable domestic price increases and aggregate demand pressures in the impact on the overall balance-of-payments position, which is expected to show a surplus of more than IKr 1,500 million (or US\$17-18 million) in 1973, improving the foreign exchange reserves of the country by the same amount. At the end of September foreign currency reserves amounted to IKr 6,445 million (or US\$77 million and had then increased by IKr 820 million (or US\$14 million) since the beginning of the year.

In the first nine months of this year, commodity imports, excluding the so-called special imports (ships and aircraft, power projects, aluminium smelter and imports for the Vestmannaeyjar Emergency Fund) increased by some 37 per cent in value as compared with the same period last year. For the year as a whole a 8-9 per cent volume increase is forecast for general commodity imports while the special imports are forecast to more than double in volume. As a result of the extraordinary import price increases of 25 per cent in kronur terms as mentioned above this implies a forecast increase in value of 36 per cent for general commodity imports and of some 55 per cent for total commodity imports. Commodity exports are forecast to show an increase in volume of over 5 per cent, mainly reflecting greatly increasing aluminium exports, both as a result of increased production and run-down of stocks. Owing to the steep export price increases, mainly of fish products with lower price increases for other exports, total commodity exports are forecast to show an increase in value of close to 50 per cent. On these trends the balance of goods and services is expected to show a deficit of over IKr 4,100 million (or US\$44 million) or $4\frac{1}{2}$ per cent of gross national product as compared with 2.7 per cent in 1972. This deficit is forecast to be more than offset by heavy inflow on capital account, most of it long-term capital to finance imports of investment goods, especially fishing vessels, together with the substantial grants from abroad to the Vestmannaeyjar emergency funds, which also play a rôle in bringing about the expected result of an increase of over IKr 1,500 million (or US\$17 million) in

the foreign exchange reserves in 1973. Notwithstanding the forecast current deficit, there is no doubt that the basic balance of goods and services in 1973 will be more favourable than in the previous year, when allowance has been made for the unusual fluctuations in the imports of special investment goods, and changes in export stocks. Substituting a three year moving average for special imports and changes in export stocks the balance of goods and services is reduced to some $2\frac{1}{2}$ per cent of gross national product in 1973 corresponding to a figure of $4\frac{1}{2}$ per cent for 1972.

Inflation can now more clearly than ever be seen as the major economic problem facing the country. Price level increases in 1973 are estimated at 24 per cent, when measured by the consumer price index, and 21 per cent by the cost-of-living index. The domestic inflation has been much influenced by price increases of imported goods in foreign markets, which are now estimated to average some 12 per cent, and to this has to be added the impact of exchange rate changes. It is also obvious that the mechanism of price and wage determination - and that includes the wage indexization system - is also at fault.

Monetary developments in 1973 have been characterized by increasing money and credit expansion. For the first three quarters of this year the rate of increase of money supply was some 44 per cent as compared with 28 per cent in the same period last year. As in 1971-1972 the main factor underlying the monetary expansion was bank lending with net foreign exchange purchases now only playing a very minor rôle. Deposit money bank lending showed a rate of increase of 25 per cent in the first three quarters of 1973 as compared with 15 per cent in the same period last year, and Central Bank lending increased by over IKr 2,000 million as compared with an increase of about IKr 570 million in the first nine months of 1972. The increase in Central Bank lending has to a substantial extent been caused by a seasonal upswing in central government financial needs, while lending to the Vestmannaeyjar Emergency Fund (IKr 600 million) and the industrial Development Fund (provisional loan of IKr 500 million for repayment in October 1973) has also been of major importance. As has already been mentioned, a number of restrictive monetary measures have been taken in the course of the year, especially in connexion with the revaluations of April and September. Thus in April interest charges were raised by 2-3 percentage points, and the deposit money banks average reserve requirements have been raised twice, while the marginal reserve requirements have remained unchanged.

Although the outlook both for profitability in the fisheries sector and for the basic balance-of-payments position is fairly satisfactory, the rapid domestic inflation of the last few months may endanger in the long run both the balance of payments and the competitive position of exposed industries. In this connexion it should be kept in mind that next year takes effect an instalment of tariff reductions under Iceland's membership agreement with EFTA and new trade agreement with the EEC which was ratified at the beginning of the year.

In order to secure increased exports in the future a free access to world markets is essential. Freer trade also implies a greater need than before to contain domestic price and cost developments in order that the industries may withstand foreign competition.

The persistent inflation of the last 3 to 4 decades in Iceland shows clearly how difficult it has proved to contain inflation and at the same time attain full employment and growth. In practice the task of economic policy has tended to be a choice among various alternatives for offsetting the undesirable effects of inflation rather than a choice between price stability and inflation.

Any successful counter-inflationary policy must clearly be based on concerted action in the field of wage and price policy, fiscal policy, and monetary and foreign exchange policy. The general wage and salary negotiations, which are now in progress, with new agreements coming into force in December and January, both between the Federation of Labour and Employers Federation, and the federations of public employees and the Government, will strongly influence economic developments in 1974.

As always it is at present difficult to evaluate with certainty next year's basic economic trends. For example, the trend for food prices in world markets next year is highly uncertain. It is generally expected, however, that the exceptionally high food prices now prevailing will rather tend to fall than rise as the year unfolds, and some market indications are already showing this. There seem, however, to be reasons to believe, that the high prices for white fish products will remain stable for the next few quarters. The outlook for the white fish catch is not particularly bright, but the extended fisheries limit and the renewed fishing fleet will hopefully bring some additional catch next year. On the whole production and income seem capable of growing some 5-6 per cent in real terms in 1974 but there are no indications that the coming year will bring any windfall gains in the form of improvements in the terms of trade.

The rapid growth of wage earners' real incomes over the last three years should form a solid foundation for moderate settlements in the collective bargaining rounds this autumn. The Government's attitude in the negotiations with the Federation of State and Municipal Employees, and The Association of University Graduates, will obviously reflect these circumstances. The claims made by these unions and later the Federation of Labour have, however, not been moderate.

Hopefully, a moderate agreement would also include a reform of the current system of wage indexization which at present both ties the hands of government in economic management and is unfair to those whose incomes are not automatically adjusted for cost-of-living changes. Wage indexization cannot, however, be examined in isolation, but as a part of the whole system of wage determination.

Even with a moderate wage settlement in December the prospects are now that the "underlying" current account position will weaken in 1974 since Iceland's terms of trade are on present indications expected to deteriorate considerably following the drastic rise in prices of oil and other vital production goods, e.g. fishing gear made from synthetic fibres. It is also - as will be familiar to you - to be expected that trade prices of manufacturing goods in general will rise considerably in the months ahead in the wake of this year's upsurge in commodity prices - which Iceland, of course has been enjoying in 1973, through fish price rises. The reversal from 1973 to 1974 in the terms-of-trade effect could perhaps amount to some Kr. 1,500 to 2,000 million, or \$ 18-24 million.

In conclusion I would like to say a few words about our trade policy. Earlier in this statement I made reference to tariff reductions which will come into force shortly. We will no doubt have a chance to discuss this further as regards its detail and implications. I would merely like to state that these reductions, which will shortly be before our Parliament for approval, are quite extensive. As far as quantitative restrictions are concerned our policy is described in detail in the Basic Document you have before you. The commodity liberalization on the basis of 1972 imports amounts to nearly 93 per cent. As has been fully explained to this Committee on previous occasions, restrictions on industrial products - except petroleum products - will be fully removed before 1975. This is in consequence of our agreements with EFTA and the European Economic Community but the liberalization is carried out on a most-favoured-nation basis.

ANNEX II

Balance of Resources 1971-1972
(IKr million)

	Constant prices of 1971		Change in volume %	Change in prices %	Preliminary 1972 at current prices
	1971	Preliminary 1972			
1. Private consumption	34,055	37,520	10.2	14.0	42,780
2. Public consumption	5,385	5,710	6.0	22.6	7,000
3. General fixed asset formation (gross)	12,198	13,550	11.1	21.0	16,390
4. Special fixed asset formation (gross) ^{1/}	3,852	2,350	-39.0	15.3	2,710
5. Changes in stocks and livestock	1,580	-970	.	.	840
6. National expenditure	57,070	58,160	1.9	17.0	68,040
7. Merchandise exports	13,178	15,890	20.6	5.1	16,700
8. Exports of services	9,195	9,050	-1.6	4.2	9,430
9. General merchandise imports	13,610	15,170	11.5	5.5	16,000
10. Special merchandise imports ^{2/}	3,908	2,660	-31.9	5.3	2,800
11. Imports of services	8,715	8,730	0.2	4.2	9,100
12. Balance of goods and services	-3,860	-1,620	.	.	-1,770
13. Gross national product	53,210	56,540	6.3 ^{3/}	17.2	66,270
14. Effects of change in terms of trade	.	-150	.	.	.
15. Gross national income	53,210	56,390	6.0	.	.
General domestic expenditure (1+2+3)	51,638	56,780	10.0	16.5	66,170

^{1/} Búrfell and Sigalda power projects, aluminium smelter, imported ships and aircraft.

^{2/} Ships and aircraft, imports for the Búrfell and Sigalda power projects and the aluminium smelter.

^{3/} Measuring at constant prices of 1969, which is now the base year for the national accounts, gives a somewhat lower rate of increase of GNP or 5.6 per cent.

Balance of Resources 1972-1973
(IKr million)

	Constant prices of 1972		Change in volume %	Change in prices %	Forecast 1973 at current prices
	Preliminary 1972	Forecast 1973			
1. Private consumption	42,780	45,350	6.0	23.0	55,780
2. Public consumption	7,000	7,420	6.0	24.0	9,200
3. General fixed asset formation (gross)	16,390	16,610	1.3	25.6	20,860
4. Special fixed asset formation (gross) ^{1/}	2,710	5,600	106.6	23.4	6,910
5. Changes in stocks and livestock	-840	+340	.	.	+480
6. National expenditure	68,040	75,320	10.7	23.8	93,230
7. Merchandise exports	16,700	17,580	5.3	41.6	24,900
8. Exports of services	9,430	9,570	1.5	10.0	10,530
9. General merchandise imports	16,000	17,340	8.4	25.5	21,760
10. Special merchandise imports ^{2/}	2,800	6,130	118.9	22.0	7,480
11. Imports of services	9,100	9,380	3.1	10.0	10,320
12. Balance of goods and services	-1,770	-5,700	.	.	-4,130
13. Gross national product	66,270	69,620	5.1	28.0	89,100
14. Effects of change in terms of trade	.	+1,570	.	.	.
15. Gross national income	66,270	71,190	7.4	.	.
General domestic expenditure (1+2+3)	65,170	69,380	4.9	23.7	85,840

^{1/} Búrfell and Sigalda power projects, aluminium smelter, imported ships and aircraft and houses for inhabitants of Vestmannaeyjar.

^{2/} Ships and aircraft, imports for the Búrfell and Sigalda power projects, for the aluminium smelter and for the Vestmannaeyjar Emergency Fund.

Balance of Payments
(IKr million)^{1/}

	1971	1972	Estimate 1973
Trade balance	-4,340	-2,100	-4,340
Total imports f.o.b.	-17,518	-18,800	-29,240
Special investment goods	-2,994	-1,806	-5,210
Ships	-678	-961	-3,850
Aircraft	-1,572	-155	-50
For power projects	-282	-130	-110
For aluminium smelter	-462	-560	-100
Houses for Westmann Islanders	-	-	-1,100
Raw material for aluminium smelter	-914	-994	-2,270
General imports	-13,610	-16,000	-21,760
Total exports f.o.b.	13,178	16,700	24,900
(Of which aluminium products)	(888)	(2,716)	(4,300)
Net services	480	330	210
Total payments	-8,715	-9,100	-10,320
Total receipts	9,195	9,430	10,530
Balance of goods and services	-3,860	-1,770	-4,130
Unrequited transfers, net	-10	20	1,800
Balance on capital account	5,207	2,202	3,880
Direct investment: long-term	718	820	290
short-term	1,008	-580	-600
Private long-term: repayments	-814	-950	-1,040
borrowing	2,204	800	885
Private short-term, net	175	-540	495
Official long-term: repayments	-432	-805	-600
borrowing	1,529	2,845	2,755
Official short-term, net	158	-150	-35
Financial institutions long-term:			
repayments	-200	-285	-390
borrowing	649	1,047	1,820
Contribution to the Nordic Industrialization Fund	212	-	300
Allocation of SDR's	217	215	-
Net errors and omissions	-61
Overall balance	1,493	667	1,550

^{1/} Exchange rate used to convert IKr to United States dollars 1971 IKr 87.61, 1972 IKr 87.12 and 1973 IKr 89.62. Effective exchange rate 1972 = 100, 1973 = 110, 1971 = 97.