

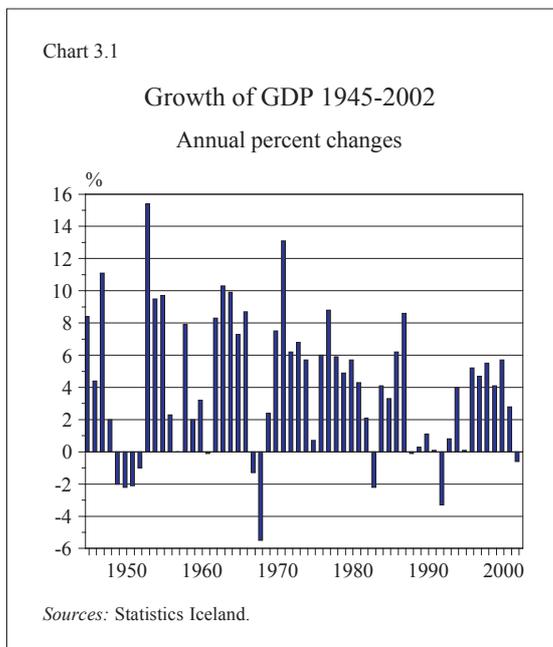
### 3. Economic history

#### *A century of high but volatile growth*

In the course of the 20th century Iceland was transformed from one of Europe's poorest economies, with almost 2/3 of the labour force employed in agriculture, to a prosperous modern economy employing 2/3 of its labour force in services. For most of the century economic growth was led by the fisheries. Consequently, swings in the fish catch and export prices of marine products were the leading source of fluctuations in output growth.

By international comparison, post-WWII economic growth has been both significantly higher and more volatile than in other OECD countries. The average annual growth rate of GDP from 1945 to 2002 was about 4%. Studies have shown that the Icelandic business cycle has been largely independent of the business cycle in other industrialised countries. This can be explained by the natural resource-based export sector and external supply shocks. However, the volatility of growth declined markedly towards the end of the century, which may be attributed to the rising share of the services sector, diversification of exports and better economic policies.

Volatility may also be attributed to deficient economic policies and structural rigidities. Like most other advanced economies, Iceland became highly regulated towards the middle of 20th century and only started to liberalise markedly in the 1960s. Gradual deregulation culminated in membership of the European Economic Area (EEA) in 1994 and liberalisation of the bulk of cross-border capital flows by 1995. It was only during the final decade of the 20th century that all the main pillars of a modern market economy were essentially in place.



### *From liberal trade to a controlled economy and on to European integration*

The first three decades of the last century were characterised by rapid growth, interrupted only by WWI. This growth occurred in the context of fairly liberal economic policies. In the wake of the depression and WWII, however, Iceland, like many other countries, became entangled in a web of trade barriers, capital controls and a complex system of multiple exchange rates which led to serious distortion of the price mechanism and misalignment of real exchange rates.

A radical departure from these policies occurred in 1960, when barriers to trade were lowered considerably in conjunction with a large devaluation of the króna, leading to more efficient allocation of resources. Trade barriers were further lowered when Iceland became a member of the European Free Trade Association (EFTA) in 1971 and further still when it became a founding member of the EEA in

1994, which integrated Iceland and other EFTA member countries (except Switzerland) into the internal market of the European Union (EU).

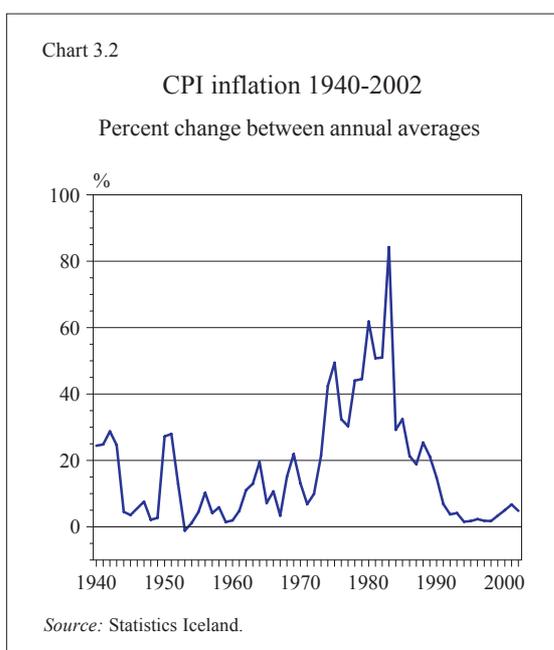
### *Episodes of inflation and disinflation*

A distinguishing feature of Iceland's economic development in the post-WWII era has been the high and variable rate of inflation. Inflation surged in the 1970s, reaching a peak in 1983, when the 12-month rate briefly exceeded 100%. The inflationary tendencies can be explained by the combination of structural features of the economy, which generally make attaining price stability a difficult task, and excessively accommodative policies.

While Iceland has a history of one of the highest inflation rates among OECD countries, it also provides one of the more remarkable examples of a successful disinflation strategy. Through a combination of less accommodative monetary and exchange rate policies, incomes policies that managed to reach a wide-ranging consensus on the need to reduce inflation, and broad-based structural reforms, inflation was brought down in the early 1990s to broadly the rate prevailing in major trading partner countries.

### *Towards a market-based approach to policy*

Over the past two decades, significant structural reforms have taken place in the Icelandic economy and financial markets. These reforms have aimed to enhance allocative efficiency by increasing the role of market forces through deregulation and integration into the world economy. This process was accelerated by the need to align the Icelandic legislative and regulatory framework to those prevailing in the European Union when Iceland became one of the founding members of the EEA in 1994.



Through its EEA membership Iceland became a part of the internal market of the EU, except in a few specific areas.

Government interference with the allocation of credit was gradually reduced following the deregulation of interest rates. A legacy of the regulated economy of the post-WWII years was that substantial segments of the economy became owned by either central or local governments. Many of these have been privatised in recent years, with the formerly state-owned banks being the latest addition. The energy sector, housing finance and large parts of the telecommunication sector are still publicly owned, however. An exception to the trend towards liberalisation has been agriculture, which is still widely supported by government subsidies, price intervention and a system of production quotas.

The emergence of a money market in the early 1990s and the establishment of an inter-bank market for foreign exchange in 1993 laid the foundation for modern monetary policy implementation. Liberalisation of capital movements also made monetary and exchange rate policies in some respects more challenging. In order to cope with those challenges, exchange rate policy became gradually more flexible, until the króna was officially floated in March 2001, under a new framework of monetary policies based on inflation targeting. By the turn of the century Iceland had become an advanced economy, thoroughly integrated into the European market, with most of the paraphernalia of a modern market economy.

