

CENTRAL BANK OF ICELAND

# The Economy of Iceland



Winter  
2001/2002

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Winter 2001/2002

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## Republic of Iceland

### People

Population	286,275 (December 1, 2001)
Capital	Reykjavík, population 112,276 (December 1, 2001)
Language	Icelandic; belongs to the Nordic group of Germanic languages
Religion	Evangelical Lutheran (92%)
Life expectancy	Females: 81.4 years, Males: 77.6 years

### Governmental system

Government	Constitutional republic
Suffrage	Universal, over 18 years of age; proportional representation
Legislature	Althingi with 63 members
Election term	Four years, last election May 8th 1999

### Economy

Monetary unit	Króna (plural: krónur); currency code: ISK
Gross domestic product	672 billion krónur (US\$ 8.5 billion, EUR 9.3 billion) in 2000
International trade	Exports 35% and imports 41% of GDP in 2000
Per capita GDP	2.4 million krónur (US\$ 30.3 thous., EUR 32.9 thous.) in 2000

### Land

Geographic size	103,000 km <sup>2</sup> (39,768 mi <sup>2</sup> )
Highest point	2,119 m (6,952 ft)
Exclusive economic zone	200 nautical miles (758,000 km <sup>2</sup> / 292,680 mi <sup>2</sup> )
Climate	Cool temperate oceanic; highly changeable, influenced by the warm Gulf Stream and Arctic currents

### Republic of Iceland credit ratings

	Foreign currency		Domestic currency	
	Long-term	Short-term	Long-term	Short-term
Moody's Investors Service	Aa3	P-1	Aaa	P-1
Standard & Poor's	A+	A-1+	AA+	A-1+
Fitch	AA-	F1+	AAA	.

## Contents<sup>1</sup>

1. Recent developments and prospects .....	9
2. Country and people .....	14
3. Economic development .....	18
4. Structure of the economy .....	22
5. The financial system .....	33
6. The public sector .....	42
7. Monetary policy .....	50
8. Foreign debt .....	54
9. Appendix .....	57

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1. This publication uses information available at the end of December 2001.

## Tables

Table 1.1	The Icelandic economy .....	9
Table 3.1	Financial market liberalisation in Iceland: some important steps.....	19
Table 4.1	Output and expenditure .....	24
Table 4.2	Number of foreign tourists and revenues at constant prices.....	31
Table 6.1	Recent and prospective privatisation.....	48
Table 8.1	Republic of Iceland foreign bond issues 1995-2001.....	55
Table 8.2	Ratings for Icelandic treasury bonds.....	56

## Figures

Figure 1.1	Economic growth and current account balance 1990-2001 .....	9
Figure 1.2	Treasury and public sector financial balance as % of GDP 1995-2000 .....	10
Figure 1.3	Growth of credit and monetary aggregates, Q1 1996-Q3 2001.....	10
Figure 1.4	The effective exchange rate of the króna, January 1996-December 2001 ..	11
Figure 1.5	CPI-inflation, wage growth and exchange rate of the króna, January 1997-December 2001.....	11
Figure 1.6	Central Bank repo rate and money market interest rates, January 1998 - December 2001.....	12
Figure 1.7	Central Bank inflation forecast in November 2001 .....	12
Figure 2.1	Age structure of the population in selected countries 1999.....	15
Figure 3.1	Growth of GDP and export revenue 1945-2000 .....	18
Figure 3.2	Real effective exchange rate of the króna 1960-2000 .....	19
Figure 3.3	CPI inflation 1940-2000.....	20
Figure 3.4	Unemployment 1970-2000.....	20
Figure 3.5	Interest rates in Iceland 1980-2000.....	21
Figure 4.1	GDP per capita in OECD countries 2000 .....	22
Figure 4.2	Breakdown of GDP by industry in 2000.....	23
Figure 4.3	Composition of national expenditure and degree of openness .....	23
Figure 4.4	Exports of goods and services 1980-2000 at constant prices .....	24
Figure 4.5	Geographical division of merchandise trade in 2000 .....	25
Figure 4.6a	Merchandise exports by category in 2000 .....	26
Figure 4.6b	Merchandise imports by category in 2000.....	26
Figure 4.7	Geographical division of trade 1960-2000.....	27
Figure 4.8	Fish catch by Icelandic vessels 1970-2000.....	27
Figure 4.9	The value of marine products for export, percentage breakdown 2000.....	27

Figure 4.10	Composition of manufacturing exports and share in total merchandised exports 1988-2000 .....	27
Figure 4.11	Electricity production in Iceland 1960-2005.....	28
Figure 4.12	Primary energy supply in Iceland 1960-2000 .....	28
Figure 4.13	Icelandic software companies' export earnings 1990-2000 .....	30
Figure 4.14	Labour force participation rate in Iceland and OECD countries .....	32
Figure 5.1	Direct investment and portfolio capital owned by residents 1995-2000 .....	34
Figure 5.2	The Icelandic bond market at end of 2000 .....	34
Figure 5.3	Equity market: Monthly trade volume and daily prices, January 1999-December 2001 .....	35
Figure 5.4	Volume traded on the interbank market for foreign exchange 1993-2001 .....	36
Figure 5.5	Net assets of pension funds 1970-2000.....	39
Figure 6.1	Public sector finances 1980-2002 .....	42
Figure 6.2	General government total outlays 2000 .....	43
Figure 6.3	Local government expenditures 1999 .....	44
Figure 6.4	Central government expenditures 2000.....	45
Figure 6.5	Treasury debt 1990-2000.....	45
Figure 6.6	Central government revenue 1990-2000 in % of GDP .....	46
Figure 7.1	Central Bank of Iceland interest rate corridor, January 1999-December 2001 .....	52
Figure 8.1	Maturity profile of treasury external long-term debt .....	54
Figure 8.2	Total treasury external debt as percent of GDP 1986-2001 .....	56
 <b>Appendix</b>		
Table A1	Iceland's membership in international organisations .....	57
Table A2	Balance of payments 1997-2000.....	58
Table A3	Imports by economic category, 1997-2000.....	60
Table A4	Exports by commodity groups, 1997-2000.....	61
Table A5	Geographic distribution of foreign trade, 1970-2000 .....	62
Table A6	Projected external debt service.....	63

# 1. Recent developments and prospects

In recent years the economy of Iceland has experienced on average one of the highest growth rates of GDP among OECD countries. Since 1998, however, signs of overheating became increasingly visible, particularly in terms of an excessive current account deficit, rising inflation and unsustainable credit growth. Although economic growth has slowed down, imbalances remain.

*After years of strong growth the economy overheated ...*

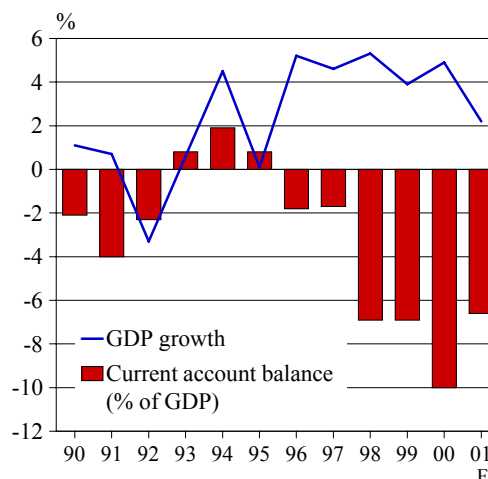
Growth over the period 1996-2000 averaged 4.8%. This period of growth was spurred by brighter prospects in the Icelandic economy following renewed interest in the construction of power-intensive industries and a recovery of fish stocks. The growth was investment-led in the beginning, but became increasingly characterized by a consumption boom in 1998 and 1999, as well as by investment in the non-trad-

Table 1.1 The Icelandic economy  
Growth of output and expenditure

<i>% change in volume unless stated otherwise</i>	Preli- minary 2000	Projec- tions 2001	Fore- cast 2002
Private consumption .....	4.2	-2.0	-1.5
Public consumption .....	3.2	3.4	2.7
Gross fixed investment.....	12.8	-6.3	-14.0
National expenditure, total .....	6.2	-2.8	-3.1
Exports of goods and services .....	6.3	5.7	-1.8
Imports of goods and services .....	9.3	-6.8	-7.1
Gross domestic product.....	4.9	2.2	-1.0
Balance on income in b.kr.....	-19.8	-30.5	-35.8
Current account balance in b.kr.....	-67.1	-49.0	-38.4
Current account balance as % of GDP.....	-10.0	-6.6	-4.9

Figure 1.1

Economic growth and current  
account balance 1990-2001



Source: National Economic Institute.

ed goods sector. In 1998 the current account deficit widened sharply and peaked at 10% of GDP in 2000, as did the positive output gap. The upswing also led to wage growth in excess of productivity growth, higher inflation which reached 6% in the spring of 2000, a stock market bubble and surging real estate prices in the Greater Reykjavík Area.

*... and boosted public finances*

Public finances, particularly those of the treasury, have developed quite favourably in recent years. In 2000, the public sector had a surplus of an estimated 2.3% of GDP. In 2001, however, consumption-related revenues have fallen in real terms while taxes on personal income, corporate income and wealth have more than kept pace with inflation. For the year as a whole, total nominal tax revenues look set to finish similar to or lower than the budgeted figures. On the expenditure side there have been overruns and treasury outlays seem set to exceed the

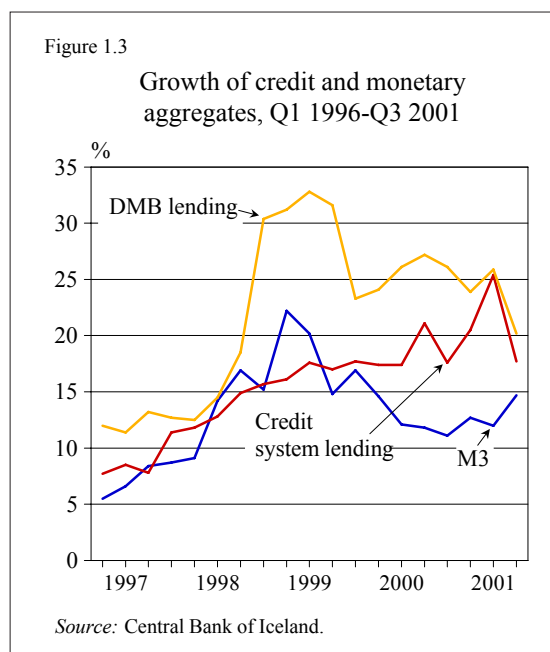
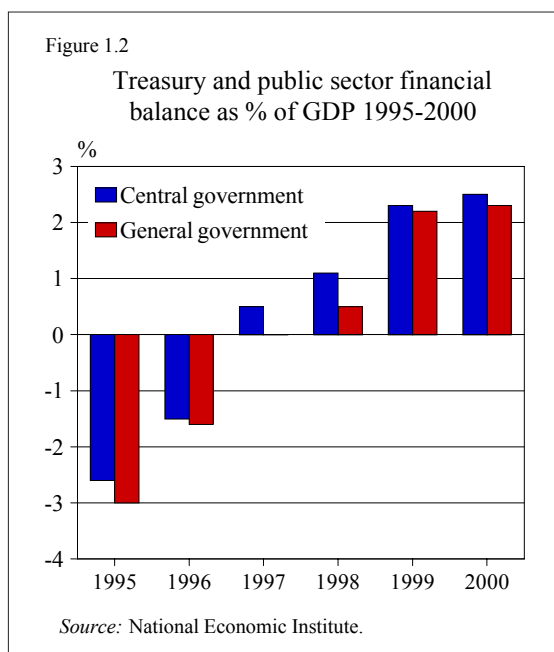
level assumed in the budget by a considerable amount. In part the increase is the result of ad hoc measures: payment of accumulated interest to meet savings bond redemption, buying up of agricultural quotas, unforeseen disability pension payments after the rules for calculating them were challenged in court, and settlements of health insurance expenditures in 2000.

*Privatisation remains high on the agenda*

In recent years, privatisation has been high on the government's agenda and gained momentum in 2001. Privatisation and consolidation in the financial sector are also set to continue. The government is in the process of selling its holding in the telecommunication company, Landssíminn, in 2001-2003 and will relinquish its majority stake (see Chapter 6).

*Activity has begun to slow down ...*

In 2001 economic growth has begun to slow down. The National Economic Institute has



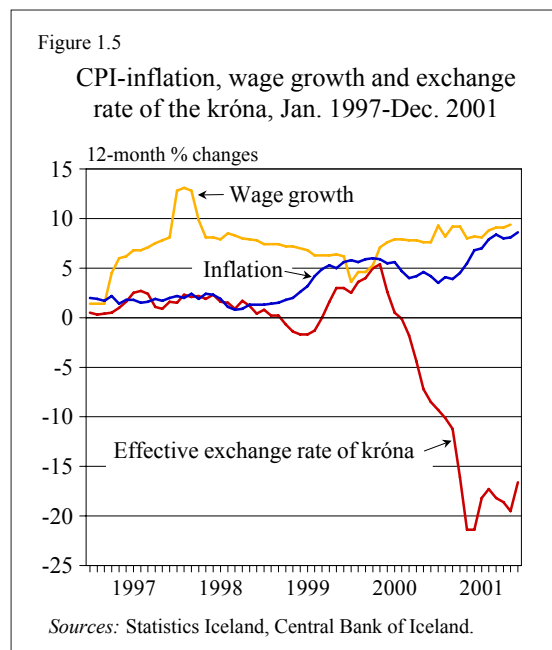


forecast GDP growth of 2.2% in 2001 and in 2002 the outlook is for a contraction in output. The slowdown has already become visible in several areas, most notably in consumption expenditures and imports. Imports of consumer goods contracted by 15% in the first half of 2001 and the growth of retail turnover came to a standstill or even contracted. Excluding volatile items, merchandise imports contracted by 6% in the first half of 2001 and imports of services also contracted sharply. Consequently, the outlook is for a somewhat smaller current account deficit than forecast earlier, notwithstanding a surge in the deficit on the balance on income caused by rising interest payment to abroad. A slowdown is also visible in credit, if adjusted for value changes due to the depreciation of the króna and the automatic revaluation of indexed loans.

... but substantial imbalances remain, ...  
 While the rate of growth of output has slowed

down substantially, it was above potential growth until Q2 in 2001 and a significant positive output gap still remains. This has been reflected in the labour market, which is still characterized by a considerable shortage of labour and an unemployment rate around 1½%. Although the current account deficit has begun to shrink, it still has some way to go before reaching a sustainable position. Credit growth decelerated significantly in late 2001. Compounding the problems resulting from the current account deficit has been an outflow of portfolio capital and direct investment. This required an extraordinary amount of financing in terms of foreign credit in 2000, equivalent to about 1/5 of GDP. These outflows were significantly reduced in the course of 2001.

... undermining exchange rate stability ...  
 These imbalances were the underlying reason for a sharp depreciation of the króna in the latter half of 2000 and in 2001. After reaching a



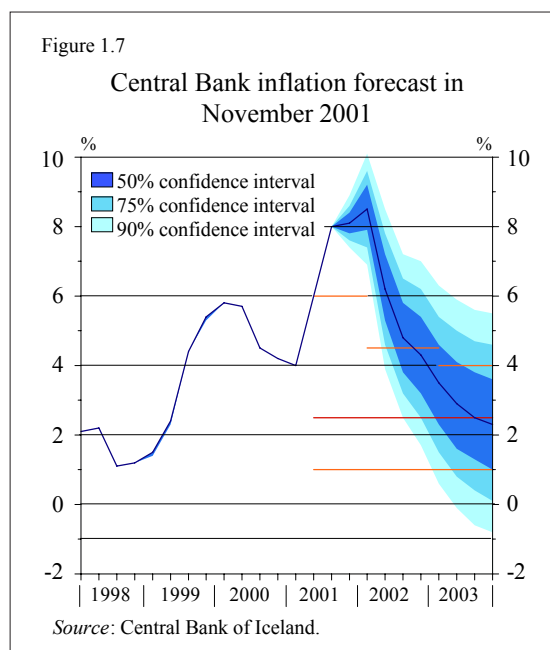
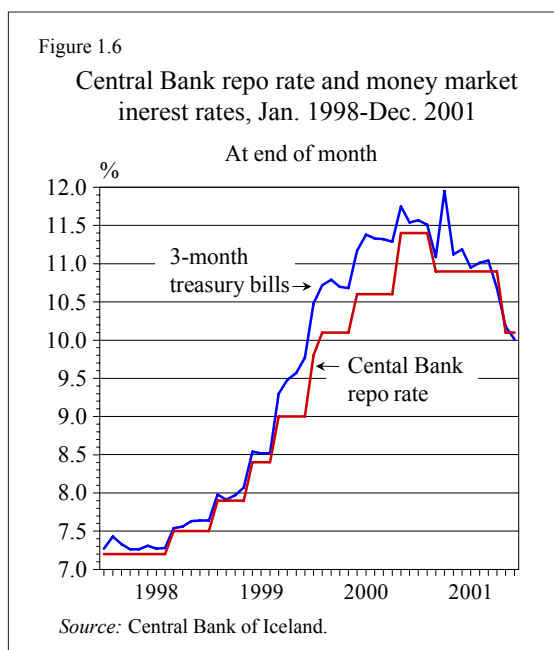
peak in the spring of 2000, the króna had depreciated by almost a quarter in effective terms by mid-year 2001. In real terms the króna reached its lowest level for three decades. A policy of stable exchange rates, defined in terms of an exchange rate band with fluctuation limits of  $\pm 9\%$  ( $\pm 6\%$  until February 2000), was abandoned at end-March 2001, when an inflation target was adopted (see Chapter 7). Prior to the announced shift in policy the króna had already depreciated from being more than 6% on the strong side of the band to a level close to the weak limit of the 9% band. Following the change in policy the króna depreciated further and was 13% lower on average in June than in March. The króna depreciated by a total of 17.4% in the course of 2001.

*... which along with excessive wage growth have spurred inflation ...*

The depreciation of the króna rekindled inflation, which in the beginning of 2001 had abat-

ed somewhat from the peak of 2000. Inflation in June exceeded the 6% upper tolerance limits of the Central Bank of Iceland's inflation target and in the beginning of December inflation reached 8.6%. Inflation is forecast to remain above the tolerance limits until late in 2002. The depreciation of the króna was not the only factor contributing to higher inflation since, as noted in a recent report by the Central Bank to the government, wage growth has far exceeded productivity growth since 1996.

In the wake of upheavals in the Icelandic foreign exchange market, the Central Bank sold foreign currency to support the króna on several occasions in 2000 and 2001. Following the adoption of the new monetary policy framework the Bank has intervened in the foreign exchange market on several occasions. In the autumn the central government borrowed 25 b.kr. abroad to boost the Central Bank's foreign reserve.



*... and precluded further easing of monetary policy*

In conjunction with the announcement of the new monetary policy framework in end-March, the Central Bank lowered its main policy rate from 11.4% to 10.9%. Subsequently, the weak exchange rate of the króna and rising inflation have argued against further easing of monetary policy by cutting interest rates. However, on November 8, the Central Bank lowered its policy rate by 0.8%, when

signs of a substantial slowdown in domestic demand became more visible and the likelihood of attaining the inflation target in 2003 increased. In December, an agreement was reached between major unions and The Confederation of Icelandic Employers on the postponement, until May 2002, of a revision of the current wage contract which was due in February 2002. The agreement improved the medium term inflation prospects and contributed to significant appreciation of the króna.

## 2. Country and people

### *Geography*

Iceland is located in the North Atlantic between Norway, Scotland and Greenland. It is the second-largest island in Europe and the third-largest in the Atlantic Ocean, with a land area of some 103,000 square kilometres, a coastline of 4,970 kilometres and an exclusive 200-nautical miles economic zone extending over 758,000 square kilometres in the surrounding waters.

Iceland enjoys a warmer climate than its northerly location would indicate because a part of the Gulf Stream flows around the southern and western coasts of the country. In Reykjavík, the capital, the average temperature in July is nearly 11 degrees Celsius and just below zero Celsius in January.

Iceland is mostly mountainous and of volcanic origin, with the highest peak reaching 2,119 metres. Lowlands stretch from the coast towards the interior, mainly in the south and the west. The landscape is distinguished by several glaciers, one of them the largest in Europe. The coasts are rocky and of irregular outline, with numerous fjords and inlets, except for the south where there are sandy beaches with no natural harbours. Only around 20% of the total land area is classified as arable land, most of it located in the southern and western part of the country and several fertile valleys stretching from the coast.

Iceland is endowed with abundant natural resources. These include the fishing grounds around the island, within and outside the country's exclusive 200-nautical miles economic zone. Furthermore, Iceland is blessed with abundant hydroelectric and geothermal energy resources, only a fraction of which has been harnessed.

With only 2.7 inhabitants per square kilometre, Iceland is one of the least densely populated countries in Europe. On December 1, 2001, the population of Iceland was 286,275. The annual rate of population growth 1990-2000 was 0.95%. Around 62% of the population lives in the capital city of Reykjavík and its surrounding municipalities. The largest town outside the capital area is Akureyri, in the north, with a population of 15,635. Most of the remainder live in small towns along the coast.

### *People*

Iceland was settled in the ninth century. The majority of the settlers were of Norse origin, with a smaller Celtic element. A general legislative and judicial assembly, the Althingi, was established in 930 and a uniform code of laws for the country was established at the same time. In 1262, Iceland concluded a treaty establishing a union with the Norwegian

monarchy. When the Danish and Norwegian monarchies were united in 1380, Iceland came under Danish rule, which lasted for more than five hundred years. Iceland was granted a new constitution in 1874 and obtained home rule in 1904. With the Act of Union in 1918, Iceland became a sovereign state in a monarchical union with Denmark. In 1944, Iceland terminated this union with Denmark and founded a Republic. The native language, Icelandic, belongs to the Nordic group of the Germanic languages.

Iceland has experienced substantial net immigration in recent years, causing the share of foreign citizens to rise to 3.1% of the total population at the beginning of 2001. Compared to most other developed countries the ratio still remains low. As in other advanced countries the population of Iceland is aging, but at a relatively slower pace than in most OECD countries. In 1999, notwithstanding high life expectancy, the share of the total pop-

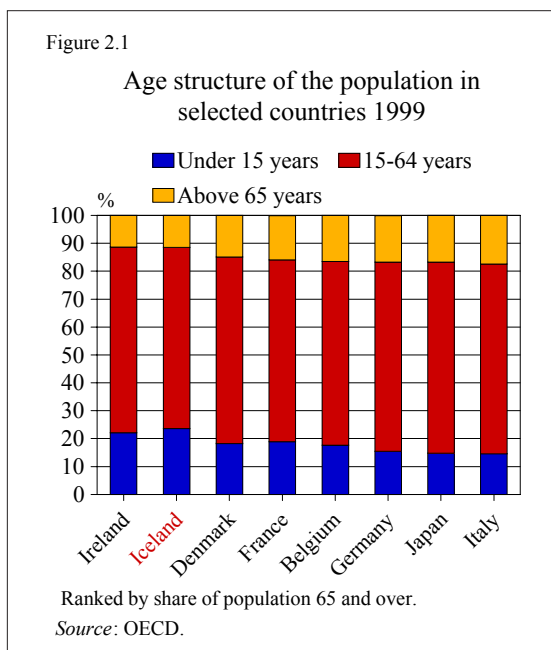
ulation aged over 65 was lower in only three OECD countries: Ireland, Mexico and the Slovak Republic.

#### *Society and the welfare state*

Iceland is a modern welfare state, which guarantees access by its citizens to universal health care, education and a high degree of social security. Spending on health, education, social security, welfare and other social affairs amounted to a little less than one-fifth of GDP in 2000.

Life expectancy among the highest in the world and the lowest infant mortality rate (2.6 per 1000 live births in 1998) testify to the advanced status of health care in Iceland, both primary health care and hospitals. The Icelandic health care system is a tax-financed universal system for all persons who have been legally resident in Iceland for more than 6 months. Health care services are provided mostly free of charge, although user charges have been on the rise. The main exception is dental health care, where adult patients are charged the full cost of service, but children under 17 years of age get most of the cost refunded. In 1998 15.9 hospital beds were offered per 1,000 population, the third highest figure among OECD countries. In 2000, 13% of total employment was in health care and social work, and expenditures on health care amounted to 7.6% of GDP.

The standard of education is high and public education is compulsory between the ages of six and sixteen. Command of English and the Scandinavian languages is widespread. Education is offered free of charge or at a low fee at three levels. First, there are 10 years of compulsory education at the primary level (age 6-16). Secondly, there are 4 years at the secondary level, which provides general educa-



tion and vocational training in a wide range of fields. Finally, higher education is offered at several universities. In 2000, 15% of the employed labour force held a university degree. Roughly one out of every four university degrees held by Icelanders is obtained in other countries. As in most OECD countries, university enrolment has increased substantially in recent years, to 65% in 2000, compared to 60% in OECD countries on average. The ratio of pre-school enrolment is also one of the highest among OECD countries.

#### *Political structure and external Relations*

The present constitution was adopted on June 17, 1944 when the Republic was established. Iceland has a parliamentary system of government. Legislative power is vested in the parliament (Althingi), and executive power in a cabinet headed by the Prime Minister. The government has to be supported by a majority of parliament to remain in power. The 63 members of the Althingi are elected from eight constituencies, on the basis of proportional representation, for a term of four years. A parliamentary bill becomes a law when it is passed by the Althingi and signed by the President. The President is the head of state and is elected for a term of four years by a direct vote of the electorate.

Iceland has a tradition of political stability. Since gaining autonomy from Denmark in 1918, governments have normally been formed by a coalition of two or more political parties which have held a majority in parliament. Since 1995 there has been a coalition government of the Independence Party and the Progressive Party, with a strong majority in parliament.

The results of the 1999 elections were as follows: The Independence Party obtained

40.7% of votes and 26 seats, the Social Alliance 25.8 percent and 17 seats, the Progressive Party 18.4% and 12 seats, the Left-Green Movement 9.1% and 6 seats, and the Liberal Party 4.2 and 2 seats. Others obtained 0.8% and no seats. The next general elections are to be held in 2003.

Iceland has participated actively in international co-operation. Iceland belongs to a group of Nordic countries that includes Denmark, Sweden, Norway and Finland – as well as Greenland and the Faroe Islands. The Nordic countries have established wide-ranging co-operation in a variety of fields, including economic affairs and international representation. Iceland is a member of the Nordic Council and specialized institutions such as the Nordic Investment Bank.

Iceland became a member of the United Nations in 1946 and is an active participant in most of its affiliated agencies. Iceland is a founding member of the Bretton Woods institutions that were established in 1945, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). Iceland is one of the original members of the Organization for Economic Co-operation and Development (OECD). It joined the Council of Europe in 1950 and has participated in the Organization for Security and Co-operation in Europe since it was initiated in 1975.

In 1964, Iceland became a party to the General Agreement on Tariffs and Trade, the predecessor to the World Trade Organization (WTO). Iceland joined the European Free Trade Association in 1970 and entered into a free-trade agreement with the European Community in 1972. In May 1992, the member countries of EFTA and the European Union signed an agreement to establish a free-trade

zone, the European Economic Area (EEA), which took effect on January 1, 1994.

Iceland is a founding member of the North Atlantic Treaty Organization, established in 1949. A defence treaty with the United States

was concluded in 1951. A NATO military base, staffed by United States military personnel, is operated at Keflavík in the southwest of Iceland.

### 3. Economic development

#### *From agrarian subsistence to a services economy*

In the late 19th century a large proportion of Iceland's population still lived near subsistence level. During the 20th century, Iceland made a remarkable transition from one of Europe's poorest and least developed economies to one of its more prosperous. At the beginning of the 20th century Iceland was largely an agrarian society. Almost 2/3 of the labour force worked in agriculture, about 1/7 in the fisheries and approximately 1/5 was engaged in services, either private or public. By the end of the century only 2% of the labour force worked in agriculture, but almost 2/3 were engaged in services of some kind. In the final three decades of the century power-intensive industries were developed, primarily aluminium, making use of the country's vast hydroelectric and geothermal resources.

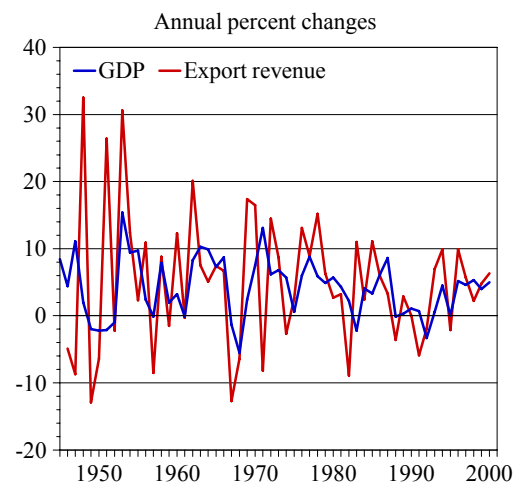
#### *Fisheries become a motor of growth – and source of volatility*

The first decade of the 20th century was characterized by the advent of the fisheries. In the course of the century marine products became Iceland's main source of foreign currency revenue and growth. Swings in the fish catch and export prices of marine products were also the leading cause of fluctuations in the growth rate

of GDP. 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 2000 was about 4%. Studies have shown that the Icelandic business cycle has been largely independent of the business cycle in other countries.

Figure 3.1

Growth of GDP and export revenue 1945-2000



Source: National Economic Institute.



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

The first three decades of the century were characterized by rapid growth, only interrupted 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 licences that took much of the remainder of the century to disentangle. This plethora of trade barriers and restrictions, including a complex system of multiple exchange rates, 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 European Economic Area (EEA) in 1994, which integrated Iceland and other EFTA member countries (except Switzerland) into the internal market of the EU. The EEA negotiations intensified a trend towards liberalisation which started with deregulation of interest rates in the mid-1980s and culminated in the liberalization of the bulk of cross-border capital flows in 1995. It was only during this period of liberalization that fully fledged financial markets developed in Iceland.

*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

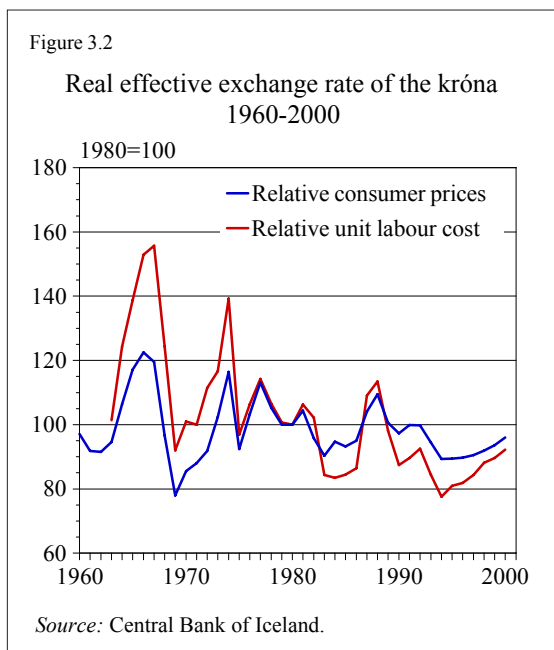


Table 3.1 Financial market liberalisation in Iceland: some important steps

<i>Event</i>	<i>Date</i>
Financial indexation permitted.....	1979
Liberalization of domestic bank rates .....	1984-1986
Interest Rate Act-interest rates fully liberalized.....	1987
Stepwise liberalization of capital movement begins .....	Summer 1990
Treasury overdraft facility in the Central Bank closed.....	1992-1993
New foreign exchange regulation marks the beginning of liberalization of cross-border capital movements.....	1992
Inter-bank market for foreign exchange established.....	May 1993
Iceland becomes a founding member of the EEA .....	January 1994
Long-term capital movements fully liberalized.....	January 1994
Short-term capital movements fully liberalized.....	January 1995
Foreign direct investment liberalized in accordance with EEA agreement .....	1995

surged in the 1970s, reaching a peak in 1983, when the 12-month rate of inflation 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. Among structural factors were highly volatile export growth leading to frequent balance of payments problems, lack of competition in the domestic economy and underdeveloped or nonexistent financial markets. The problems resulting from these features were compounded by policies that undermined a quick return to low inflation in the aftermath of external shocks. Interest rates were kept artificially low, leading to highly negative real interest rates in the 1970s. Exchange rate policy was on several occasions excessively accommodative, preventing proper adjustment of the economy by keeping employment persistently below a level consistent with price stability. Adding to the

effect of an overstretched labour market, wage indexation was frequently applied. Furthermore, devaluation was often not backed up by sufficiently restrictive fiscal policies. While Iceland has a history of inflation that has been one of the highest 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 bring inflation down and broad-based structural reforms, inflation was brought down to the rate prevailing in major trading partner countries.

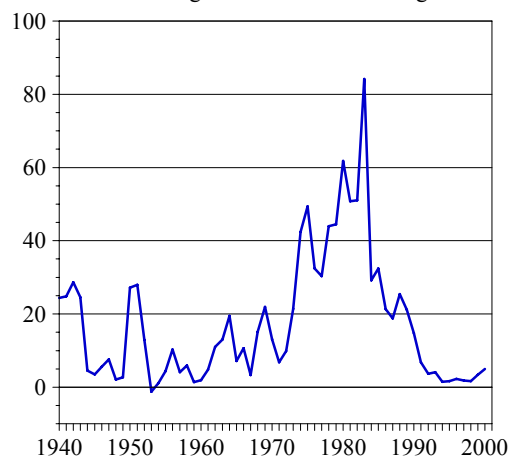
#### *Towards a market-based approach to policy*

A market-based approach to economic policy was adopted to an increasing extent during the late 1980s and the 1990s. Government interference with the allocation of credit was gradually reduced following the liberalization of

Figure 3.3

#### CPI inflation 1940-2000

Percent change between annual averages

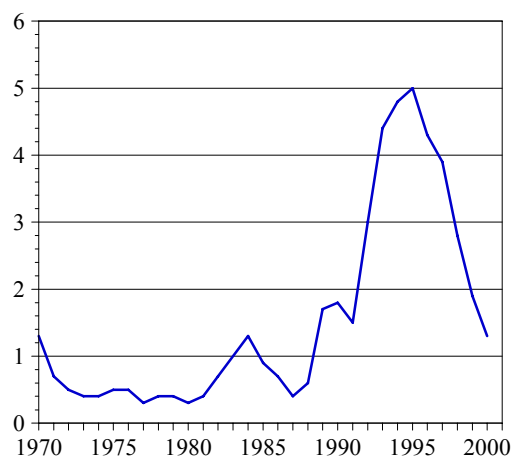


Source: Statistics Iceland

Figure 3.4

#### Unemployment 1970-2000

Percent of labour force



Source: Directorate of Labour.

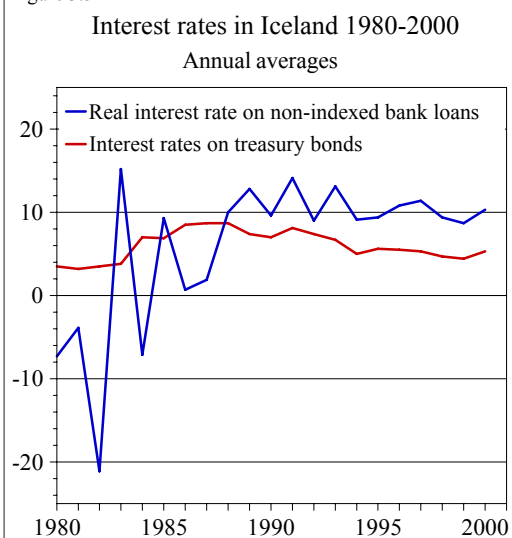
interest rates. A legacy of the controlled economy of the post-WWII years was that substantial segments of the economy became owned by either central or local governments, including areas such as transportation, fishing and fish processing, construction and various industries. A substantial share of the telecommunications industry and banking sector still remains in government hands, but is soon to be privatized.

An exception to the trend towards liberalisation has been agriculture, which became increasingly regulated during the 1980s. Government subsidies and interference in the price mechanism of agricultural products caused oversupply, insufficient productivity growth and prompted a system of production quotas in 1979/1980s, which is still applied.

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. The liberalization of capital movements also made monetary and exchange rate policies in some sense more challenging.

In order to cope with those challenges exchange rate policy became gradually more flexible, until formal commitment to keep the exchange rate at any specified level was relinquished in March 2001, as described in Chapter VI.

Figure 3.5



Source: Central Bank of Iceland.

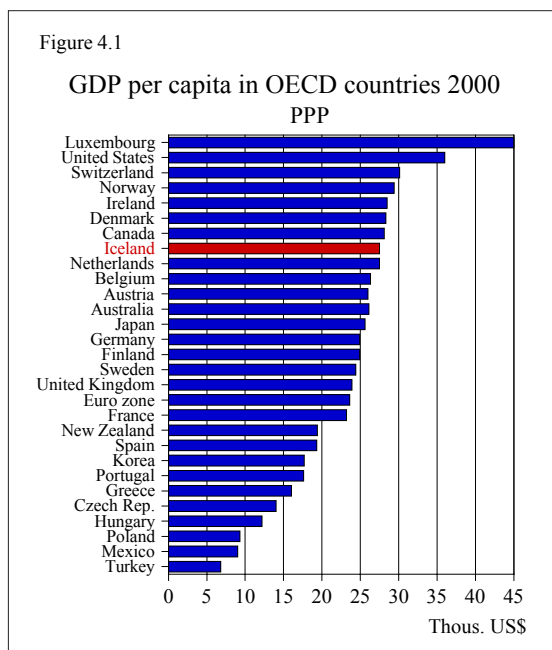
## 4. Structure of the economy

### *Size and income level*

The Icelandic economy is the smallest of the OECD, generating GDP of USD 8.5 billion in 2000. This was less than 1/1000 of the US economy, 1/20 of the Danish economy, half the economy of Luxembourg but 2½ times the economy of Malta. The small size of the Icelandic economy mainly reflects the small size of the population, which was only 283 thousand at the end of 2000.

Iceland is a prosperous country, with all the

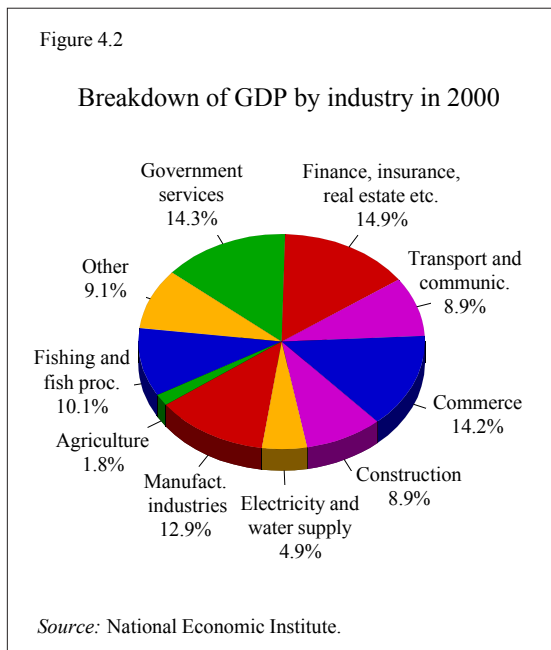
characteristics of a modern welfare state. GDP per capita amounted to USD 30,600 in 2000, the fifth highest in the world. In comparison to the Nordic countries, Iceland's GDP per capita was about the same as Denmark, lower than Norway but higher than Sweden and Finland. Measured in terms of Purchasing Power Parities (PPP), Iceland's GDP per capita is smaller and its rank among OECD countries declines to eighth. At USD 27,500 in 2000, it was similar to the other Nordic countries and somewhat above the EU average, and substantially more below the USA level than if measured in terms of current exchange rates.



### *Composition of output and expenditures*

Small size of the population has not inhibited economic growth and prosperity in Iceland. This prosperity can be attributed to Iceland's ability to utilise its comparative advantage in the international division of labour, by exploiting its abundant natural resources and human capital. As in other developed economies, services, which to a significant degree are non-tradable, form the bulk of economic activity, roughly speaking 2/3. Agriculture contributes

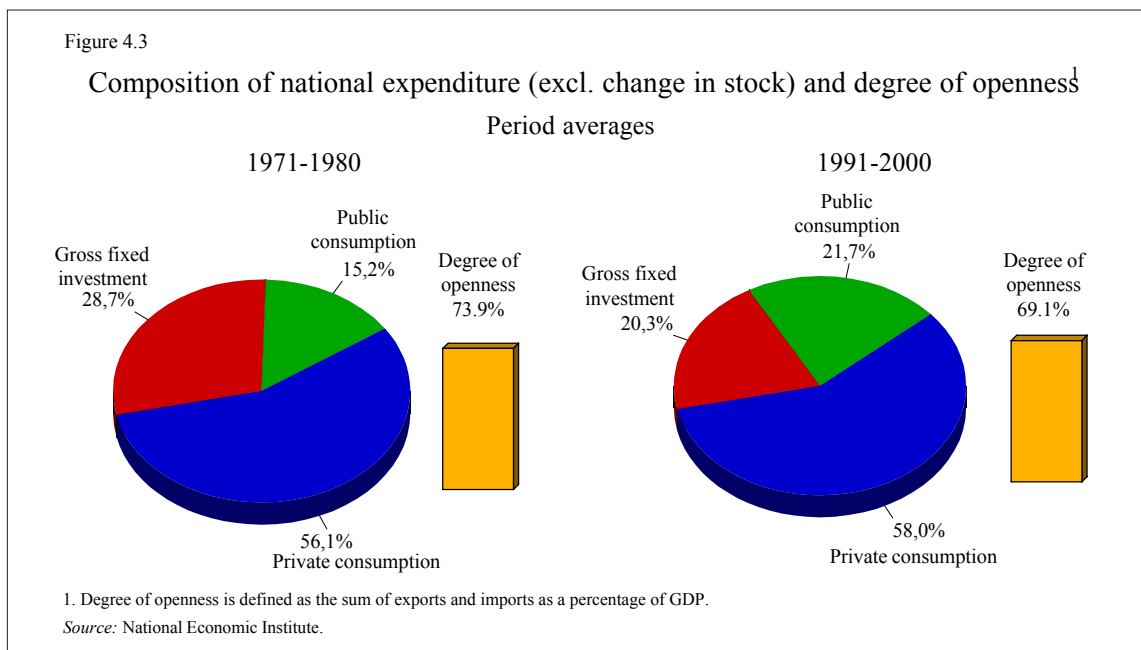
1. It should be noted that fishing is not included. Agriculture and fisheries are often bracketed together in international statistics.



1980 to 10.1% in 2000. The share of manufacturing and electricity supply has risen. These developments reflect a transformation in the utilization of natural and human resources. Scope for expanding the harvesting of Iceland's coastal fishing grounds has been limited in recent years, while the utilization of its hydroelectric and geothermal power potential has intensified. At the same time, the advent of service industries, such as tourism, and several emerging human capital-intensive activities, has continued unabated. Significant progress has been made in human-capital intensive activities such as information technologies, software, financial activities and biotechnology.

only 2% of the country's GDP.<sup>1</sup> While the marine sector is the most important source of export revenue, its share of GDP has declined considerably in recent years, from 16.9% in

Private consumption contributed about 3/5 of GDP in 2000 and public consumption and gross fixed investment about one quarter each. These ratios are affected by a considerable deficit on the trade in goods and services, which amounted to 7% of GDP. The invest-



ment to GDP ratio has risen substantially in recent years, after falling below 1/5 in the mid-1990s. The ratio of public consumption has also risen somewhat over the past two years, after remaining broadly stable through most of the 1990s, and has almost doubled from the level 30 years ago.

#### Foreign trade

Icelandic trade has many of the characteristics of small resource-based open economies; such as a high degree of openness, a large share of primary products and commodities, concentration of exports and limited intra-industry trade. Nevertheless, the diversity of exports has increased significantly in recent years. In 2000, imports and exports amounted to 34% and 42% of GDP, respectively. While this can be seen as fairly an open economy, reflecting the small size of GDP, many larger economies have a considerably higher ratio. To some extent this can be explained by geographic dis-

tance from major population centres, but other factors, such as the limited intra-industry trade, natural resource-based export sector with high value added and extensive protection of agriculture, may also be at work.

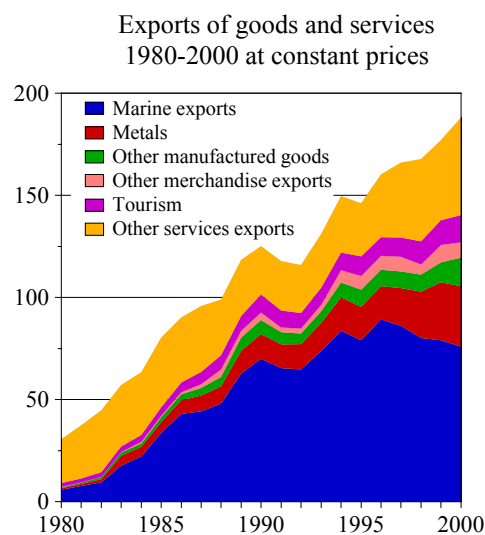
The mainstay of merchandise exports is still fish and other marine products, which in 2000 accounted for 63% of merchandise exports and 41% of total exports. Rapidly growing in importance has been export of manufactured products, which in 2000 accounted for nearly one-third of merchandise exports. This is mainly the result of growth in the power-intensive industries, mostly aluminium smelting. Export of services grew rapidly over the past decade, as the economy became more service-oriented. Services now account for one-third of total export revenues.

Iceland imports a wide range of manufactured goods and commodities, reflecting both the small size of the economy and the limited range of natural resources. One-third of the

Table 4.1 Output and expenditure

	Percentage distribution	
	1970	2000
Private consumption .....	60.1	59.9
Public consumption .....	12.7	23.7
Gross fixed investment .....	25.3	23.5
Changes in stock .....	-0.1	0.3
National expenditure .....	98.0	107.4
Exports of goods and services .....	46.4	34.3
Goods, fob .....	29.3	22.2
Services .....	17.1	12.1
Less: Imports of goods and services .....	43.9	41.6
Goods, fob .....	28.8	27.9
Services .....	15.1	13.7
GDP .....	100.0	100.0
Current account balance .....	1.5	-10.2

Figure 4.4



imports are capital goods. Industrial supplies and consumer goods are roughly a quarter of imports each.

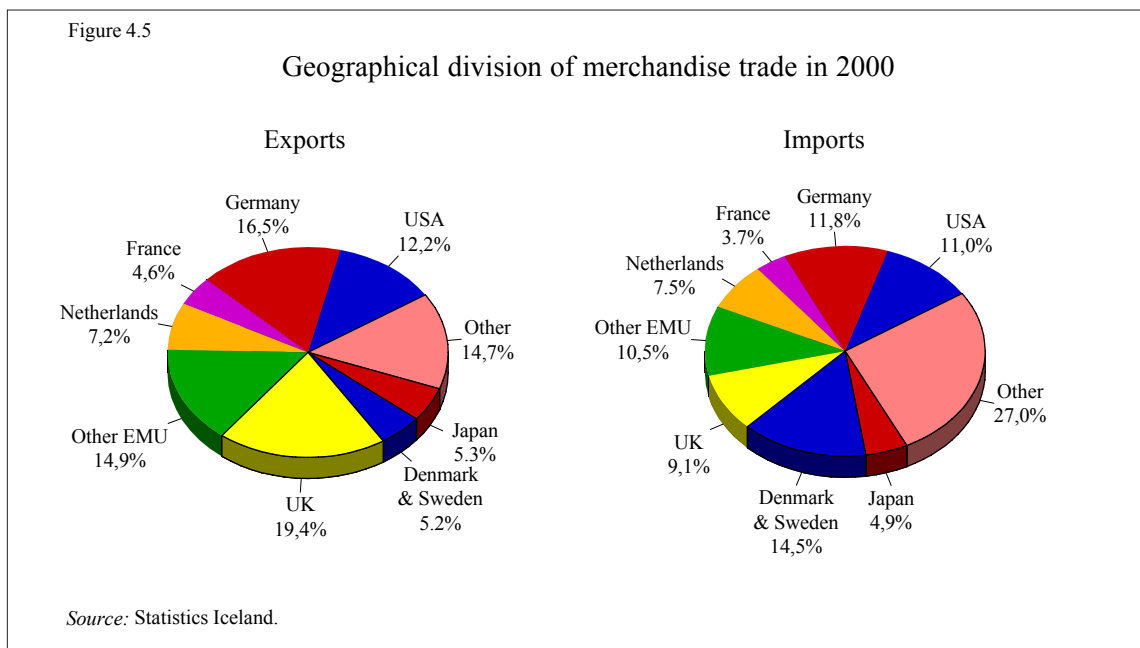
Iceland is the westernmost outpost of Europe and therefore an ideal base for business between Europe and North America. This strategic location is further enhanced by Iceland's membership of EFTA (The European Free Trade Association) since 1971 and the European Economic Area (EEA), which has integrated Iceland into the internal market of the EU since it went into effect on January 1, 1994. The EEA constitutes the world's largest market, with 380 million inhabitants. EEA membership implies that business legislation has been adapted to that of the EU, guaranteeing the free flow of goods, services, capital and labour.

Iceland's free trade arrangements with Europe have stimulated trade with the region, causing the share of North America to fall. In 2000, 72% of merchandise exports went to the member countries of the EEA, which also were

the source of 65% of imports. Currently, the largest trading partners countries are the UK, Germany, the USA and the Nordic countries. In terms of currency areas, the euro area constitutes the largest trading area, with 33.5% of imports and 42.5% of exports.

Iceland has normally had a trade surplus with Japan (although not since 1998), the UK and the USA, but a substantial deficit with its Nordic neighbours.

In 1998, measured in terms of its share in current account expenditures, Iceland's trade in services was the highest among OECD countries and third in terms of current account receipts. Data on the direction of services trade is not as reliable as merchandise trade data. Nearly half of Iceland's services exports in 2000 used USD as the vehicle currency. However, the US share in Iceland's revenue from tourism, estimated on the basis of number of tourists, hotel registration and currency receipts, has been around 1/5 in recent years.



### Marine sector

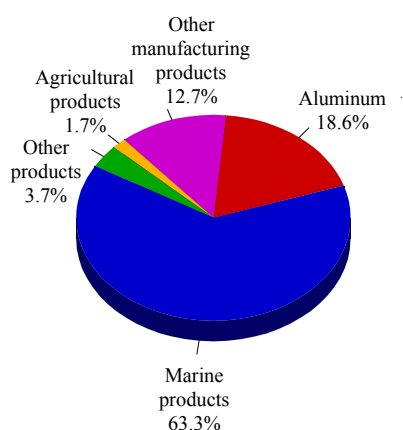
The marine sector is the main export sector. In 2000, fishing and fish processing contributed 63% of total merchandise exports. The importance of the marine sector has diminished dramatically in the last four decades. In the early 1960s, export of fish products constituted over 90% of merchandise exports. The principal part of the Icelandic marine sector is fishing and processing of groundfish species, mainly cod, haddock, saithe and redfish. The catch of demersals was around 480,000 tons in 2000. Conservation measures led to substantial cuts in total allowable catch (TAC) in the 1990s, most substantially in cod quotas. Cod is considered to be the most valuable species in Icelandic waters. The decline in the cod catch has been offset by increased harvesting of other species, such as shrimp and redfish, inside and outside Iceland's exclusive 200-mile fishing zone. Efforts to enhance value added in processing, e.g. by product development, have

partially succeeded in offsetting lower catch volumes in recent years. Efficiency in the fishing and fish processing industry has increased substantially. The industry is increasingly relying on information and communication technology, automation and modern management techniques to increase productivity. Icelandic fishing vessels are regarded as among the most modern and technically advanced in the world. In recent years a number of fisheries companies have merged in order to enhance efficiency. Several of the leading fisheries companies rank with the largest private companies in Iceland.

A comprehensive fisheries management system based on the individual transferable quota system (ITQ system) has been developed to manage fish stocks. Quotas regulate catches of all major species. The total allowable catch (total quota) for each year is set on the basis of biological assessment of the fish stocks and forecasts for their development in near future.

Figure 4.6a

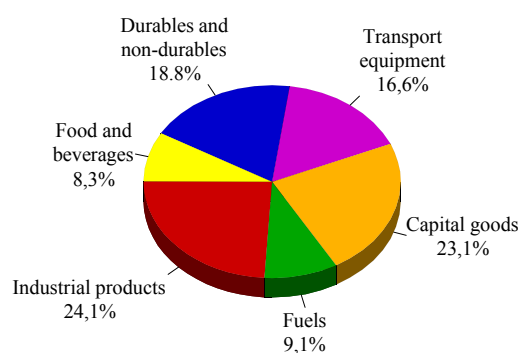
Merchandise exports by category in 2000



Source: Statistics Iceland.

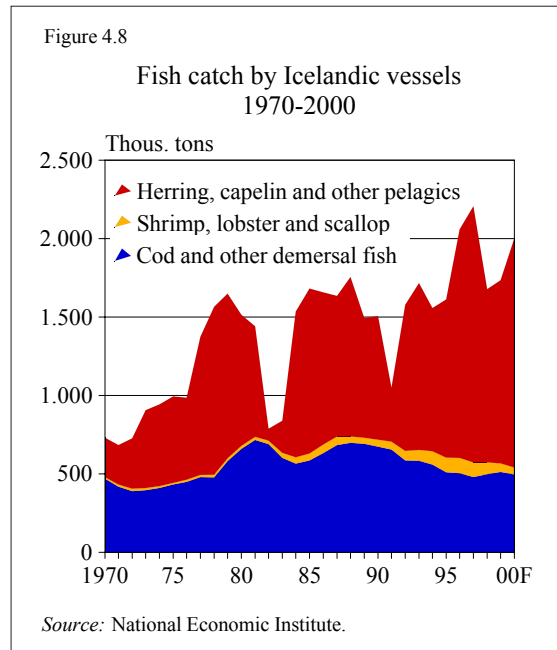
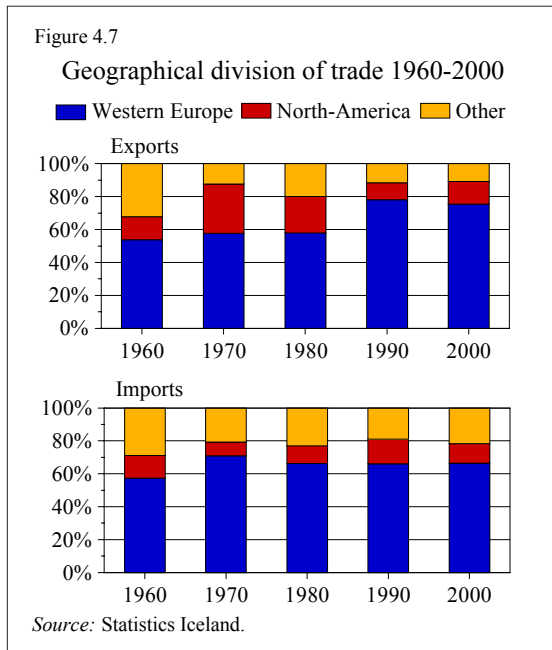
Figure 4.6b

Merchandise imports by category in 2000



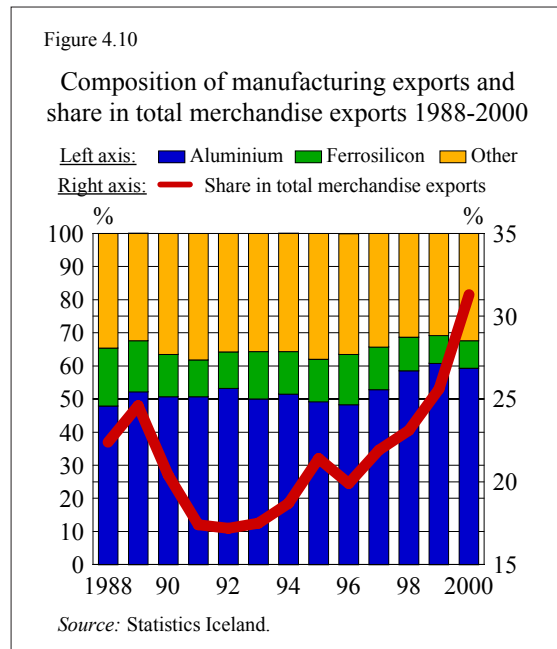
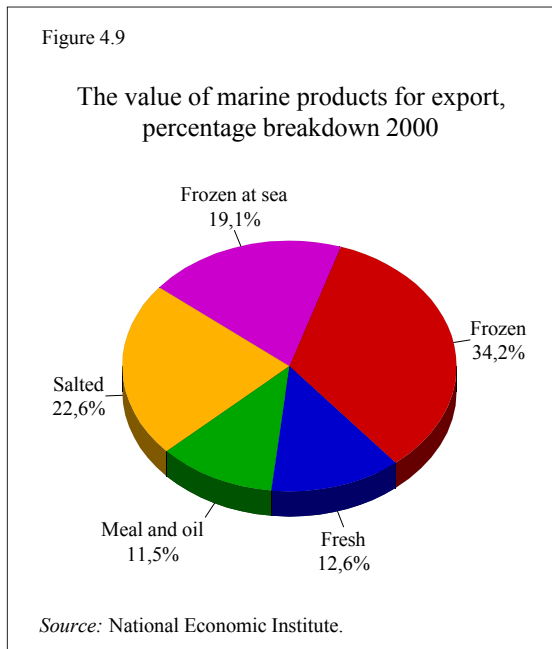
Source: Statistics Iceland.





Quotas are then allocated among individual fishing vessels and can be traded at market price. The fishing quotas are mostly allocated free of charge, with only a nominal charge col-

lected by the state for fisheries inspection purposes. The introduction of the ITQ system has led to substantial rationalization and improvement in performance in the marine sector.



### Manufacturing and power-intensive industries

The largest manufacturing industries in Iceland are power-intensive industries based on the use of electric power. They produce almost exclusively for export. A number of smaller-scale export-oriented manufacturing industries have emerged in recent years, in areas such as pharmaceuticals, capital goods for fisheries and food processing, medical equipment and other IT-intensive high-tech activities. In 2000 manufactured products accounted for 31% of total merchandise exports (up from 25.5% in 1999), of which power-intensive products (mainly aluminium) amounted to 22% and pharmaceuticals and other high-tech products to 5%.

The development of power-intensive industries is mainly based on competitive energy costs and a highly educated and skilled labour force. The government has actively encouraged foreign direct investment in power-intensive industries. The largest manufacturing faci-

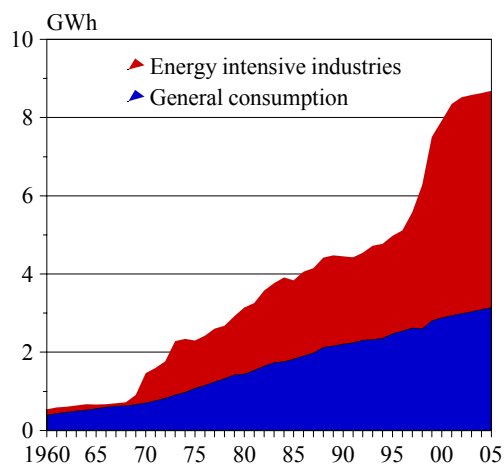
lity in Iceland is an aluminium smelter located near Reykjavík, owned and operated by the Icelandic Aluminium Company Ltd., a wholly owned subsidiary of Alusuisse-Lonza AG of Switzerland. Its total capacity is 162,000 tpy, after being expanded by 60% in 1996-98. The second aluminium smelter is Columbia Venture (Nordic Aluminium) with a capacity of 90,000 tpy. Icelandic Alloys plc. is a ferrosilicon plant with an annual capacity of 115,000 tons. It has been listed on the Icelandic Stock Exchange but Elken ASA of Norway has a majority stake.

### Energy

Iceland has extensive hydro- and geothermal resources and is the only country in Western Europe that still has large-scale, competitively priced power remaining to be harnessed from such sources. Although electricity consumption per capita is one of the highest in the world, at some 28,000 kWh per person, only a

Figure 4.11

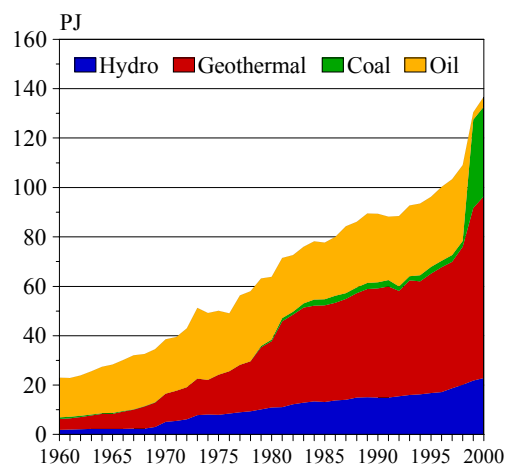
#### Electricity production in Iceland 1960-2005



Source: National Energy Authority.

Figure 4.12

#### Primary energy supply in Iceland 1960-2000



Source: National Energy Authority.

fraction of the energy potential has been tapped.

Electric power potential from hydro and geothermal sources is now estimated to be 50,000 GWh/year, taking into account economic and environmental considerations. Some 8,500 GWh/year of this power had been harnessed in 2000, or only about 17% of total energy potential. Economically exploitable electricity from hydro resources is estimated at around 30,000 GWh/year. In 2001, total installed hydropower was estimated at 1,270 MW in 20 power plants capable of producing 7,000 GWh per year. Installed geothermal power now amounts to 183 MW or 1,460 GWh/year. The largest single hydropower plant has an installed power capacity of 270 MW and the largest geothermal plant a capacity of 75 MW.

All the largest hydroelectric power plants as well as the inter-regional power lines are owned and operated by The National Power Company (Landsvirkjun). The company is jointly owned by the Icelandic state, the City of Reykjavík and the Akureyri Municipality.

Iceland is a world leader in the use of geothermal energy for domestic and industrial purposes. Some 86% of all homes are heated by geothermal energy at a cost of less than half the comparable cost of fossil fuels or even electricity heating. Geothermal steam is applied in a number of industrial processes and increasingly also for electricity generation.

Both hydro and geothermal power are sustainable and environmentally friendly power resources, free from the harmful atmospheric emissions of fossil fuels and the potential danger of radioactive power sources.

### *Agriculture*

Approximately one-fifth of the total land area of Iceland is suitable for fodder production and

the raising of livestock. Around 6% of this area is cultivated, with the remainder devoted to raising livestock or left undeveloped. Production of meat, dairy products and eggs is mainly for domestic consumption. The principal crops are hay and potatoes. Raising of other crops, such as barley, has yielded promising results. Vegetables and flowers are cultivated in greenhouses heated with geothermal water and steam. A fur industry has developed in the last two decades.

The agricultural sector has undergone structural changes in recent years. Demand for traditional products, especially lamb, has declined substantially while consumption of white meat (pork and poultry) has risen in line with changes in taste and relative prices. Price support and export subsidies for the traditional products of sheep and dairy farming have been replaced with subsidies in the form of direct income payments to farmers in these segments. In 2000, such direct payments are estimated to have amounted to 48% of farmers' income in lamb and mutton production and 47% of the farmers' producer price for milk production. Total on-budget transfers to farmers amounted to about 1.1% of GDP in 2000. Imports of meat, dairy products and vegetables that compete with domestic production are subject to high tariffs, controls to prevent diseases, and seasonal quotas. Imports are likely to increase as tariffs go down in line with WTO agreements on trade in agricultural products.

The total agricultural support in Iceland ranks fifth highest in OECD, with PSE (producers support estimate) of 63, behind Korea, Switzerland, Norway and Japan with PSE of 73, 71, 64 and 63 respectively. In the EU the producers support amounts to 38 on average and 34 in the OECD countries.

### Transport and communications

The domestic transportation network consists of roads, air transportation and coastal shipping. Car ownership is widespread. In 2000, Iceland had 572 passenger cars per 1,000 inhabitants, the third highest ratio within the OECD after the USA and Australia. Several airlines operate in Iceland. Icelandair (*Flugleiðir*), is a private company with international routes and direct flights from Iceland to a number of cities in Europe and the United States. Air Atlanta mainly operates as a charter airline on international routes outside Iceland. Some foreign airlines also operate to Iceland from time to time. The domestic market is dominated by Air Iceland (*Flugfélag Íslands*), owned by Icelandair. It serves routes between several towns and villages around the country and also operates services to Greenland and the Faroe Islands.

Iceland has numerous harbours that are almost without exception free of ice throughout the year. In exceptionally cold years, drift ice from Greenland can close harbours in the northern part of the country. The three main shipping companies, Eimskip, Samskip and Nesskip, operate regular shipping routes to the major ports of Europe and the United States.

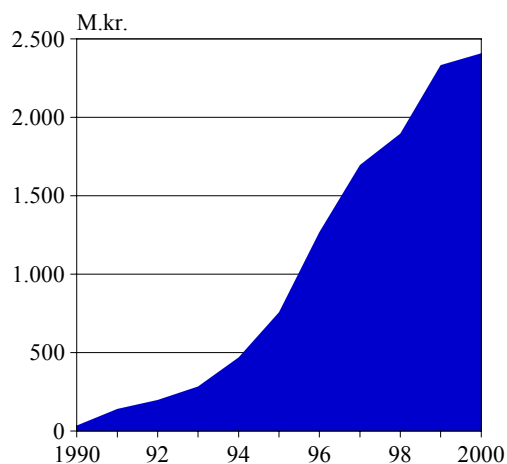
In January 1998, Iceland Post and Telecom (Póstur og sími) was divided into two separate entities, Iceland Post (*Íslandspóstur*) and Iceland Telecom (*Landssíminn*). The telephone and telegraph system, operated by Iceland Telecom, is both extensive and modern, with satellite earth stations, optical fibre cables and an extensive cellular mobile phone system. Iceland Post and Iceland Telecom are limited liability companies and have been state-owned until now. First steps in privatizing Iceland Telecom were taken in September 2001 and

the government's policy is that it will be fully privatized in 2002. As a result of technological developments, deregulation and enhanced competition, telephone charges in Iceland, both at residential and business rates, are among the lowest within the OECD. The telecommunication sector is developing rapidly and competition is increasing. New private companies are being established, offering various services such as Internet connections and GSM services. The cellular mobile telephone network is extensive. In 2001, Iceland had the second-highest mobile telephone penetration in the world, surpassed only by Finland.

The National Broadcasting Service (*Ríkisútvarpið*) operates two radio channels and one television channel, covering virtually the whole country. The Icelandic Broadcasting Corporation (*Íslenska útvarpsfélagið*) is a private company that operates television and radio channels. Skjáreinn is a new television company. There are several private radio sta-

Figure 4.13

Icelandic software companies' export earnings (at 2000 prices) 1990-2000



Source: Central Bank of Iceland.

tions and a few local television stations. In addition, dozens of foreign TV channels are widely received via satellite, cable or UHF relay.

#### *Service industries*

The tourism sector has been one of the fastest-growing industries in recent years. Foreign visitors in 2000 numbered 303,000, compared to 142,000 in 1990. The foreign exchange revenues generated by tourism in 2000 amounted to approximately ISK 30 billion.

Besides tourism there is an expanding array of emerging services industries in Iceland and others have been fundamentally transformed in recent years. Important structural changes, for instance, have been implemented in the financial sector in the last two decades, as described in Chapter IV. Rapid growth has also taken place in other business services including computer services and software development.

The Icelandic software industry has extensive knowhow and long practical experience in design of software for sophisticated food and fish processing equipment. Icelandic software developers are also actively engaged in multimedia and Internet applications, e-commerce, real-time communication, medical software and general office and database systems. An emerging industry is biotechnology which is based on Iceland's genetic resources.

#### *The labour market*

The Icelandic labour market has one of the highest participation rates among OECD countries. Over the past 10 years it has consistently been well above 80%. This is explained partly by the fact that the rate of unemployment has normally been one of the lowest among OECD countries. The participation rate of women has also been very high by international comparison. In 2000, female participation was in fact the highest among OECD countries, with women accounting for 47% of the labour force. Participation rates among the young and the elderly have also been quite high. Icelandic workers tend to work long hours. The participation rate and number of jobs are positively correlated with economic growth, dampening cyclical movements in unemployment.

Iceland's EEA membership facilitates the movements of labour within the area. The Icelandic labour market tends to attract both foreign and Icelandic nationals during upswings and the opposite applies during downswings. Furthermore, a high degree of interregional and intersectoral labour mobility prevents large differences in regional unemployment from emerging, even in the case of significant shifts in sectoral or regional employment.

The influx of foreign labour has increased substantially in recent years, both from within and outside the EEA area. In 1998-2000 it is estimated that approximately one out of every four new jobs was filled by foreign nationals.

Table 4.2 Number of foreign tourists and revenues at constant prices

	1990	1995	2000
Foreign visitors .....	141,718	189,796	302,913
Revenues from tourism (constant prices in m. ISK).....	18,572	22,893	30,459

Nevertheless, as this is a rather recent phenomenon, the share of foreign nationals in the labour force remains at a modest level. In 2000 approximately 3½-4% of the labour force was foreign.

The wage bargaining process in Iceland is highly centralized and usually leads to more or less nationwide settlements. More than 90% of the labour force is unionized and the employers are also highly organized. The government has frequently been involved in wage settlements, either through tax concessions and social transfer or legislative acts aiming to accomplish moderate settlements. In addition, a decentralized system of sectoral and firm-level negotiations makes it possible to take specific sectoral conditions into account.

Notwithstanding its high degree of centralization, the Icelandic labour market appears to be quite flexible. Substantial and increasing labour mobility, flexible hours and variable participation rates serve to dampen the effects of external shocks. Furthermore, various studies indicate that real wages respond quickly to external shocks and therefore reduce their employment effect, although the measured flexibility may to some extent be the result of high inflation.

#### *The environment*

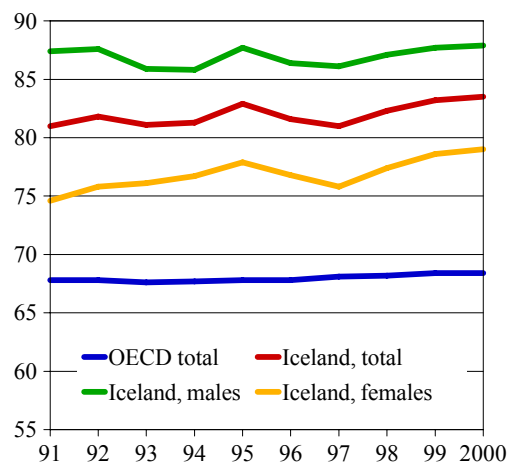
Compared to other industrial countries, Iceland is relatively unpolluted and faces few immediate environmental problems. Soil erosion, however, has been a longstanding problem, as a result of the combined effects of climatic changes, volcanic activity and overgrazing. The intensity of grazing has fallen sharply since the 1970s and considerable work is being carried out to reclaim eroded land.

Electricity and geothermal heating, Iceland's main energy sources, are generated by

the use of renewable resources. Utilization of hydroelectric power, however, requires the building of dams and large reservoirs that can affect the landscape. The acid disposition over Iceland is very low, due to its geographic location and limited emissions of pollutants. Emission of greenhouse gases from Iceland in 2000 is estimated to be 15% higher than in the year 1990. If emissions from new power-intensive industries are excluded, emissions in 2000 will not exceed the 1990 level. The emission limit set for Iceland in the Kyoto Protocol for the period 2008-2012 entails a 10% increase from the 1990 levels. In addition, emissions from single projects, which increase the emissions by more than 5%, can be reported separately but not included in the above set limit. The largest source of emissions is the fishing fleet, followed by the transport sector, then by various industrial processes. The marine environment around Iceland is relatively unpolluted.

Figure 4.14

#### Labour force participation rate in Iceland and OECD countries



Source: OECD, Central Bank of Iceland.

## 5. The financial system

### *Overview and recent developments*

In recent years the Icelandic financial system has been in transition, the result of liberalization and legislative reform. A changed domestic and international business environment as well as increased competition have necessitated the restructuring of Icelandic capital markets and financial institutions. Financial services in Iceland have become more international in character due to increased co-operation between Icelandic and foreign financial institutions and adoption of international financial legislation and standards. In order to keep pace with international developments substantial amendments have been made to the financial legislative framework in Iceland.

Iceland participates in the European Single Market for financial services. As a member of the European Economic Area (EEA) since 1994, Iceland is obliged to transpose into national law all existing and future EU legislation in the field of financial services. Iceland has thus implemented all the EC directives on banking, insurance and securities trading. The general objective of these directives is to accomplish an integrated market for financial services, in particular with respect to the right of establishment, provision of services, prudential rules and capital movements. Iceland's obligations to the EEA have prompted a major

reform of financial legislation and its framework in Iceland is now in line with that in other EFTA states and EU member states. This has facilitated the offering of financial services by Icelandic financial institutions across borders and the establishment of operations abroad.

The European financial market is constantly developing. A series of policy objectives and specific measures will be adopted on the basis of the Financial Services Action Plan from 1999. This will enhance harmonization, competition and effectiveness of financial services, payment systems and electronic commerce throughout Europe. The Icelandic authorities, in close co-operation with the market participants, have already begun the necessary preparatory work for the implementation of the Action Plan.

A new Act on the Central Bank entered into force in 2001. The Act provides for important changes. It simplifies and clarifies the objectives of the Central Bank, provides full independence for applying its monetary instruments and increases its financial independence.

### *Capital movements*

Since the beginning of 1995, in accordance with the EEA agreement, capital movements have been fully liberalized, with the exception

of certain restrictions that apply to foreign direct investments in fisheries and fish processing, energy production and distribution, and aviation companies. The restrictions on investment by foreign entities in fisheries are the only ones that apply to EEA residents. They have the purpose of protecting the nation's exclusive rights to the fishing grounds around Iceland. Foreign ownership in fisheries companies is restricted to 25% (up to 33% in certain circumstances). Energy harnessing rights and production and distribution of energy are restricted to EEA entities. Entities domiciled outside the EEA must not own more than 49% of the shares in Icelandic aviation companies.

The liberalization of cross-border capital movements has led to a profound change in the composition of financial asset portfolios of residents. Before full liberalization in 1995 residents owned only approximately 10 b.kr. in foreign securities. By the end of 2000 these

assets had risen twenty-fold, amounting to 35% of GDP.

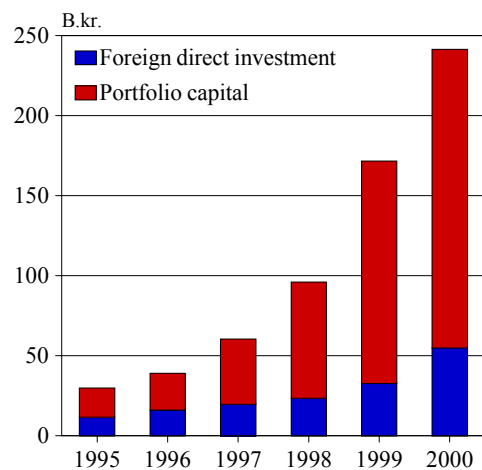
Foreign borrowing by the treasury requires authorization by parliament. These authorizations are listed in the annual budget approved by parliament. In addition there is a standing authorization to refinance outstanding public debt.

#### The bond market

The Icelandic bond market consists of a primary market which usually takes the form of bond auctions, and a secondary market which is mainly operated on the Iceland Stock Exchange (ICEX). Icelandic bond issues can be broadly divided into four categories: 1) Government bonds, issued by the treasury, are indexed against inflation and paid up with accrued interest at maturity date. 2) Treasury notes and treasury bills which are non-indexed zero coupon bonds. 3) Housing bonds and housing Authority bonds which are interest-

Figure 5.1

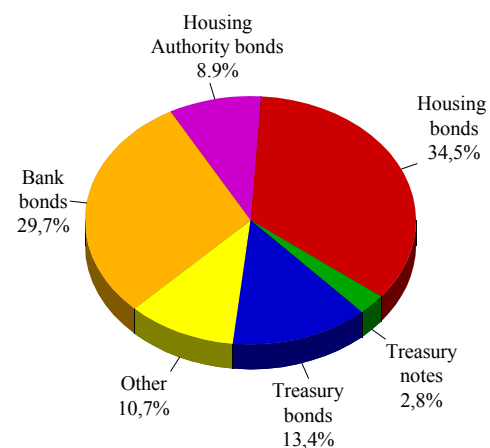
#### Direct investment and portfolio capital owned by residents 1995-2000



Source: Central Bank of Iceland.

Figure 5.2

#### The Icelandic bond market at end of 2000



Source: Central Bank of Iceland.



bearing bonds in an annuity format. The annuity format of the former is realized by a lottery of all issued bonds at preset intervals. 4) Bonds that are issued by government agencies, private firms or institutions such as banks.

An active market making scheme on the stock exchange ensures sufficient liquidity in the market for benchmark government bonds, housing bonds and Housing Authority bonds. A primary dealer system is in place for treasury notes and bills. Primary dealers have an exclusive right to bid at auctions and must actively engage in market making on the stock exchange. Most new issues are registered in the Icelandic Securities Depository Ltd. and trading is done on a payment versus delivery basis. Settlement takes place on a T+1 basis.

The Icelandic bond market has several outstanding features which set it apart from those in other countries. Firstly, indexed bonds dominate the market. Major issues of maturity exceeding 5 years are linked to the CPI. In end-2000, the share of indexed bonds was 86% of the bond market's value. Secondly, the majority of bonds carry a state guarantee, including housing bonds, which are the market's most liquid issues. Thirdly, yields on the Icelandic bond market have tended to be high in international comparison. Over the past decade real yields of indexed housing and government bonds have fluctuated in the range 4% to 8%, and recently between 5% and 6%. At the end of 2000, the market value of marketable bonds amounted to USD 6.4 billion.

#### The money market

The money market can be divided in two parts: the secondary market in treasury bills, bank bills and other short-term bonds on the stock exchange, and the interbank loan market. The interbank market is operated by the Central

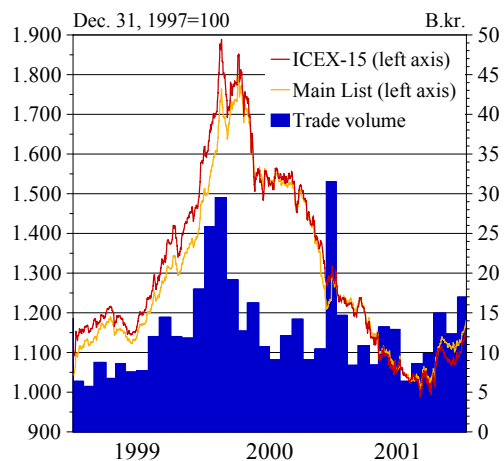
Bank of Iceland and consists of unsecured loans between the members of the market. The members must display indicative bid and ask yields on various maturities, ranging from overnight loans to 12-month loans. Yields are published on a closed Reuters page and trades must be reported to the Central Bank. Once a day, the Central Bank fixes REIBID and REIBOR rates for the market. In 2000, turnover on the interbank market for krónur amounted to USD 6.8 billion. There is also a primary market in treasury bills.

#### The equity market

Icelandic equities are traded on ICEX, which in 2000 became a member of NOREX, the cooperative framework for Nordic exchanges. The four member exchanges (Copenhagen Stock Exchange, Oslo Börs, Stockholmsbörsen and ICEX) share a joint trading system, SAXESS. The regulatory environment of ICEX, through various recent reforms, has

Figure 5.3

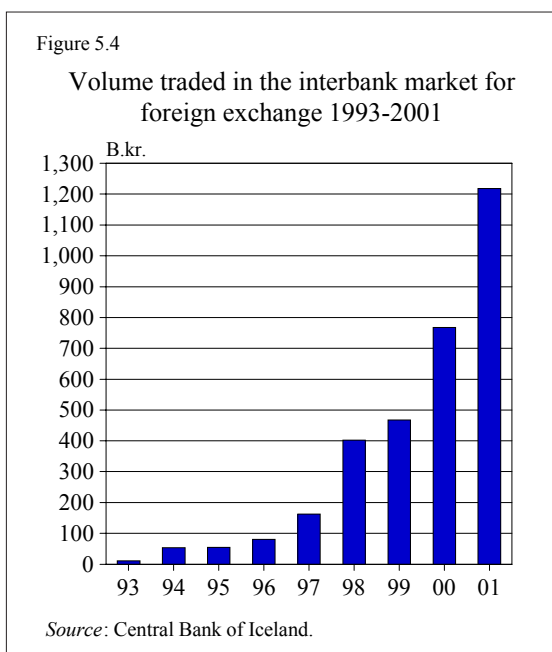
Equity market: Monthly trade volume and daily prices, Jan. 1999 - Dec. 2001



Source: Iceland Stock Exchange (ICEX)

reached a similar status to that of markets in other countries and the technically important step of electronic registration of all listed shares has nearly been accomplished.

Market capitalization has increased in recent years as a growing number of Icelandic companies has gone public and equity prices have soared. Altogether 66 companies, all Icelandic except one, are now listed, as well as 9 equity mutual funds. The market capitalization of those companies was 336 b.kr. (USD 3.4 billion) in end-June 2001, or 47% of GDP. Since 1998, Icelandic share prices have broadly followed a similar trend to that in foreign markets. An all-time high was reached in February 2000 but by September 2001 the market had lost 46% of that value as measured by the ICEX-15 index. In 2001, volume dropped as well as value, bringing the combined on- and off-exchange turnover ratio down from over 50% at year-end 2000 to around 40% in August 2001.



#### *The foreign exchange market*

The foreign exchange market is an interbank market run by the Central Bank of Iceland. Participants are market makers and the Central Bank. Market makers are subject to stringent rules, requiring them, for example, to quote a binding bid and ask price every five minutes to each other if requested. The spread between bid and ask prices must be within a set limit. The interbank market for foreign exchange was established in 1993. In the beginning, the Central Bank was a dominant player on the market, but with increasing market depth and as the exchange rate regime became more flexible, the Central Bank withdrew from daily activity, limiting its role to discretionary interventions. Activity on the market is highly variable, with traded volume reaching 300 million dollars on a busy day, but occasionally falling down to little or no activity.

#### *Credit institutions*

The Icelandic Act on Commercial Banks and Savings Banks and the Act on Other Credit Institutions provide a legislative framework for credit institutions equivalent to other European banking legislation and international banking standards. These acts stipulate rules on, inter alia, the establishment, authorization, management and activities of banks, liquidity and own funds requirements, annual accounts and mergers, as well as activities of foreign banks in Iceland. Several regulations have been adopted on the basis of these laws, in areas such as annual accounts and capital adequacy requirements, which are consistent with European requirements.

In June 2001, domestic commercial and savings banks provided 26% of total credit in Iceland. Foreign credit institutions provided

around 28%, pension funds 15% and the Housing Financing Fund 11%.

There are currently four commercial banks in Iceland, i.e. Búnaðarbanki Íslands hf., Íslandsbanki hf., Landsbanki Íslands hf. and Sparisjóðabanki Íslands hf. (Icebank). The first three provide all conventional banking and securities services. There are 25 savings banks in Iceland and Icebank serves as a banking institution for them. Total assets of commercial and savings banks amounted to USD 8.6 billion at the end of 2000, with the commercial banks accounting for 80% of this figure. Twelve other credit institutions currently operate in Iceland, five of which are investment banks,<sup>1</sup> four are investment funds<sup>2</sup> and three are leasing companies.<sup>3</sup>

Several investment funds were merged and subsequently privatized in 1998. The merged investment bank, FBA, was granted a licence to operate as a commercial bank and subsequently merged with Íslandsbanki in April 2000. The merged bank is Iceland's largest commercial bank. The two remaining partially privatized commercial banks, in which the state has still a majority stake, Landsbanki and Búnaðarbanki, will also be privatized.

#### *Securities firms and brokerages*

Icelandic legislation on securities firms and securities brokerages is based on the European framework legislation in this field. The law regulates fields including authorization, public offerings, confidential information, insider trading, market manipulation, annual accounts

and supervision. A number of regulations have been adopted on the basis of these laws. There are currently seven securities firms and four securities brokerages operating in Iceland.

The Act on Undertakings for Collective Investments in Transferable Securities (UCITS) provides for rules on, among other things, authorization, registration, articles of association of UCITS, management and depository companies, investment policy, management, annual accounts and supervision. There are currently nine UCITS authorized in Iceland and five management companies of UCITS.

#### *The Iceland Stock Exchange Ltd. and the Icelandic Securities Depository Ltd.*

The Stock Exchange Act stipulates that a stock exchange must be a limited liability company where public listing of securities and securities trading are carried out. A stock exchange must have authorization from the Minister of Commerce. There is currently one stock exchange operating in Iceland, i.e. the Iceland Stock Exchange Ltd. (ICEX). ICEX is also licensed to operate a market for securities which are not officially listed on a stock exchange. The Stock Exchange Act furthermore regulates listing, takeover bids, disclosures and flagging in the event of the acquisition of major shareholdings and accompanying rights. The Stock Exchange is a member of the Nordic Stock Exchanges (NOREX).

Icelandic law provides that the electronic issue of securities and registration of titles to electronic securities can only be carried out by a securities depository authorized by the Minister of Commerce. The Icelandic Securities Depository Ltd. has been authorized as a securities depository. The main activities of the Icelandic Securities Depository Ltd. are the issue of electronic securities, registration of

1. Kaupþing hf. (Kaupthing), Greiðslumiðlun hf. (VISA Ísland), Frjálsi fjárfestingarbankinn hf., Eignarhaldsfélagið Alþýðubankinn hf., Kreditkort hf. (Europay Ísland).

2. The Tourism Fund, Agricultural Loan Fund, Regional Development Institute and Harbour Improvement Fund.

3. Glitnir hf., Lýsing hf. and SP-Fjármögnun hf.

titles to electronic securities, electronic depository of securities and settlement of electronic securities.

#### *The pension system*

Iceland will face less problems due to the ageing of the population during the coming decades than most other developed nations. There are three main reasons for this. Firstly, the nation is younger and will continue to be so during the coming decades. The old-age dependency ratio, i.e. over 64-year-olds as a ratio of 15-64-year-olds, was 17.8% in 1999, compared to 19.6% on average in the EU and 19.3% in the US. Secondly, labour participation rates among the elderly are high and the pension system does not give special incentives for early retirement. The official retirement age is 67 and 34% of 65-74-year-olds worked at least one hour a week in 2000. Thirdly, membership of a fully funded occupational pension fund is mandatory for all employees and self-employed. The Icelandic old age pension system is composed of a tax-financed public pension scheme, mandatory funded occupational pension schemes and voluntary pension saving with tax incentives.

Public pensions are fully financed by taxes. The public pension system provides an old age pension, disability pension and survivors pension. The old age pension is in most cases paid from the age of 67. It is divided into a basic pension and supplementary pension. Both are means-tested but pensions received from other sources are treated differently from other income. These do not affect the basic pension and the level at which they begin to reduce the supplementary pension is higher than for other income. The basic pension amounts to around 13% of the average earnings of unskilled workers but the maximum total old age pen-

sion to around 52% of the same earnings. The public pension system still pays a higher total in pensions than the occupational funds. In 1999 the amounts were 21 b.kr. or 3.3% of GDP in the case of the public system and nearly 17 b.kr. or 2.7% of GDP in the case of pension funds. Pension funds have been increasing in this respect relative to the public system and they will overtake it in the years to come as they approach maturity and means testing reduces the public pension.

It is mandatory to pay at least 10% of total wages and salaries to pension funds. Many of the funds were established through a collective labour agreement in the late 1960s. Most are managed jointly by representatives from the trade unions and employers. The funds have grown by leaps and bounds in recent years (Figure 5.5) as their coverage has become almost total and the return on their assets has been good. Assets were equivalent to 83% of GDP in 2000 and are predicted to reach at least 1½ times GDP around the middle of the twenty-first century. Pension funds in Iceland are large relative to GDP by international comparison as Iceland ranked fourth in 1998 among EU and EFTA countries on this criterion.

At the beginning of 2001 there were 43 fully operational pension funds in Iceland, thereof 13 with employer guarantees from the government, municipalities or banks. Funds without employer guarantee are required under current legislation to be fully funded. The ten largest pension funds had around two-thirds of the net assets of all pension funds in 1999, and the two largest ones accounted for over a quarter. The average fund had net assets of around 8½ b.kr. (USD 120 m.), while the biggest had assets of 75½ m.kr. (over USD 1 b.).

The benefits paid by occupational pension funds without employer guarantee will ulti-

mately depend on their net return and will therefore vary from one fund to another. But the investment risk is born collectively by the members of each fund and there are no individual accounts as in pure DC plans. It has been estimated that a typical general occupational pension fund will, at full maturity, be able to pay a pension amounting to 50-60% of full-time earnings, giving a total replacement ratio of 60-70% when the basic public pension is added.

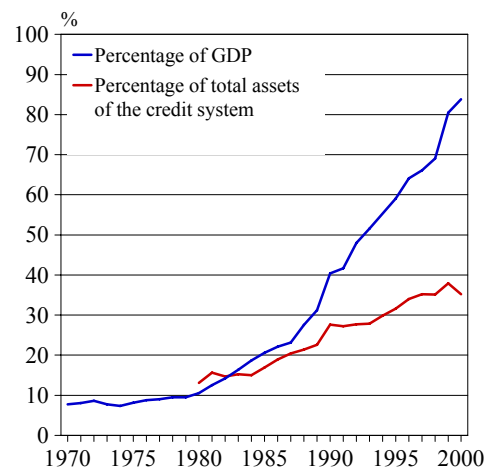
In the third pillar of pension saving, employees are allowed to deduct from their taxable income a contribution to authorized individual pension schemes of up to 4% of wages. Employers contribute in such cases 0.4% of wages, which is financed by lowering the social security tax to an equal degree. The pension schemes have to be authorized by the Ministry of Finance. They are in most cases defined contribution individual accounts. The pension saving is not redeemable until the age of 60 and has to be paid in equal instalments over a period of at least seven years. It is estimated that 20% of wage earners were paying into such schemes at the end of 1999.

Pension funds used to invest most of their assets in government-guaranteed bonds, housing finance and loans to members. During the last decade a significant shift took place in the asset allocation of pension funds, with the shares of equities and foreign assets increasing strongly. The proportion of equities was just over 1% of total assets in 1990 but had increased to 30% in 2000. The share of foreign assets went from less than 2% in 1995 to over 22% at the end of 2000. Current legislation sets upper limits on the share of equities in a pension fund's portfolio at 35% and restricts exposure to exchange rate risk to 50% of net assets.

The buildup of the pension funds has contributed a great deal to the development of financial markets in Iceland. It is estimated that their assets were equivalent to 38% of the size of the credit system in 1999. The funds held 60% of the stock of marketable bonds in the same year and around half of the stock of housing bonds. At the end of 1999 the funds owned domestic equities and shares in equity funds that amounted to around 13% of the size of the organized equity market. This figure really underestimates their importance, due to extensive cross-ownership of listed companies. Finally, foreign asset accumulation of the pension funds is very significant in terms of the national economy. Their foreign assets accounted for over 70% of all foreign portfolio assets of Icelandic residents at the end of 1999 and over 40% of total foreign assets as recorded in the international investment position of the country.

Figure 5.5

## Net assets of pension funds 1970-2000



Source: Central Bank of Iceland.

*Insurance companies*

Icelandic insurance law consists of two main acts, i.e. the Act on Insurance Activity and the Act on Insurance Contracts. An insurance company must only conduct insurance activities and specifically defined ancillary activities. Life insurance activities must be separated from other types of insurance services. Icelandic insurance law is based on the EC insurance law.

There are 14 insurance companies authorized to operate in Iceland, with total assets of 0.8 billion USD at year-end 2000. Sjóvá-Almennar Tryggingar hf., Vátryggingafélag Íslands hf. and Tryggingarmiðstöðin hf. are by far the largest with a combined market share around 85%. The three life insurance companies<sup>4</sup> represent only 5% of total assets of insurance companies. Almost 60% of the insurance companies' portfolio consists of marketable securities, which make them fairly sizeable investors in the Icelandic securities market. In addition, 169 foreign insurance companies have licenses to provide services in Iceland, two of which have established branches.

*Supervision and deposit insurance*

The Bank Inspectorate of the Central Bank and the Insurance Supervisory Authority were merged into a separate entity, the Financial Supervisory Authority (FSA), on January 1, 1999. The FSA has a Board of Directors appointed by the Minister of Commerce. The institution supervises commercial banks, savings banks, and other credit institutions, insurance companies, companies and individuals acting as insurance brokers, undertakings engaged in securities services, UCITS, man-

agement companies, stock exchanges and other regulated markets, central securities depositories (CSD) and pension funds. The FSA also supervises other activities as authorized in accordance with specific laws.

The main task of the FSA is to ensure that the activities of the above institutions and firms are conducted in accordance with the relevant laws and regulations and that they remain sound in other respects. These institutions and firms are obligated to provide all the information considered necessary by the FSA to facilitate statutory supervision of their activities.

A deposit insurance scheme is in force. The commercial and savings banks have annually contributed 0.15% of their deposits to this scheme (until the limit of 1% of total insured deposits is reached, which was the case at year-end 2000). Since the beginning of 2000, the Insurance Fund of the commercial banks and the savings banks has been a private institution. An insurance scheme also comprises equity investors that are covered in a special department of this institution.

By law, the Central Bank of Iceland sets rules for the liquidity ratio, i.e. the ratio of liquid claims to liquid liabilities, of credit institutions and for their foreign exchange balance. Other prudential regulations of financial markets are either sanctioned by law or adopted by government minister or the FSA. The regulation on liquidity aims to ensure that credit institutions always have sufficient liquidity to meet foreseeable and conceivable payment liabilities over specific periods. For instance, the ratio of claims to liabilities which fall due or can be liquidated within 3 months must not be lower than 1. The following limits on the balance of foreign denominated assets and liabilities are stipulated. Firstly: exposure in individ-

4. Althjóða líftryggingafélagið hf., Líftryggingafélag Íslands hf. and Sameinaða líftryggingafélagið hf.

ual currencies is restricted to 15% of equity, 20%. Secondly, total foreign exchange exposure is limited to 30% of equity. except for the US dollar where the limit is

## 6. The public sector

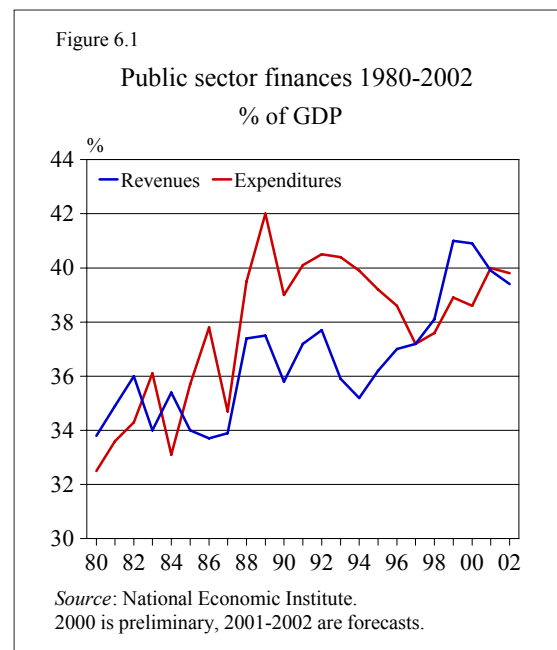
After heavy deficit spending in the eighties, public sector finances stabilised towards the end of the nineties. Since the mid-nineties, the public sector balance<sup>1</sup> has been significantly above the OECD average, and Iceland has fully met the European Union's Maastricht criteria for general government finances – a deficit of less than 3% of GDP and gross public debt of less than 60% of GDP – since 1995.

Iceland, like many other OECD countries, ran up a relatively large public sector deficit in the late eighties and early nineties, with deficits averaging 3% of GDP from 1985 to 1995. Since 1994, however, public expenditures have fallen slightly, from around 40% of GDP to around 39% while revenues have risen from a 1994 low of 35% of GDP to 41% according to preliminary estimates for 2000. In this period the central government moved from a deficit of around 2½% of GDP to a corre-

spondingly large surplus, mostly through an increase in revenues and fall in welfare expenditures due to the upturn of the economy.<sup>2</sup> In the same period local governments seem to have succeeded in closing a deficit which averaged 0.6% of GDP in 1997-9, mostly through increases in tax revenue.

*The size and nature of the government sector*  
Compared to its neighbours, Iceland has a relatively small public sector, with expenditures

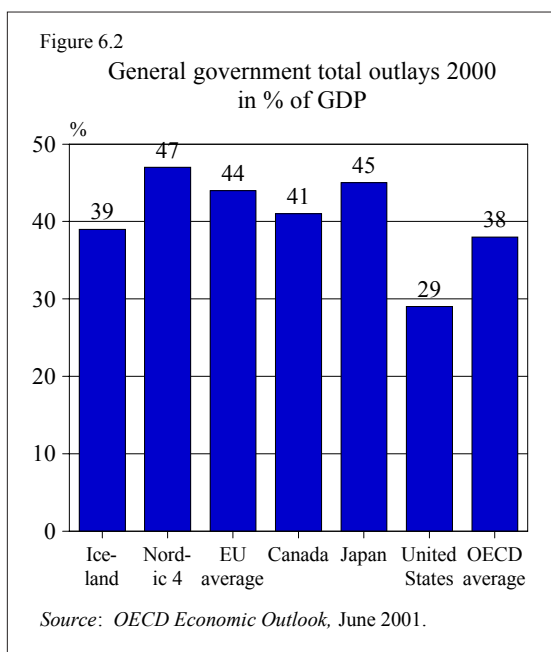
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1. General government in the terminology of national accounts.
  2. It should be pointed out that according to accounting standards used by the treasury's accounting office, the central government budget was in deficit by 4.3 b.kr., or 0.6% of GDP in 2000, while under the ESA95 standard, preliminary estimates by the National Economic Institute show a surplus of around 3% of GDP. The difference lies in stricter reporting of pension liabilities under the national standard as well as in an one-time write-off of tax claims in the year 2000, which mostly reflects past overestimates of revenue.





between 38% and 40% of GDP. This is significantly lower than in the Nordic countries and the mainland countries of the European Union, higher than the US and Japan and close to the OECD average.

An obvious reason why the government sector in Iceland is smaller than in neighbouring countries is the absence of defence expenditures. However, what matters most are lower expenditures on social affairs in general. For this there are several explanations besides a difference in politics and tradition. Firstly, unemployment has been historically quite low in Iceland and exceptionally so in the last few years. Secondly, occupational fully funded pension funds are the dominant pillar of the pension system, in contrast to public pay-as-you-go systems in many other OECD countries (See Chapter 5). The relatively young population and high retirement age also contribute to the lowering of overall pension expenditures.



#### *Division of responsibilities*

In the last few years, local government expenditures have run at around 10% of GDP as against a central government budget of around 28% of GDP. The central government regulates local governments, controls their authority to collect revenue and actually collects more than 80% of local government tax revenues. The centre completely administrates and finances the social security sector of government.

Central government is responsible for the police, courts and foreign affairs, education after 10th grade, health services, institutional care for the disabled and elderly, general support and services for industry and most infrastructure construction and maintenance. It administrates basic means-tested benefits for elderly and disabled persons and shares in old-age and disability pensions, means-tested rebates on housing-related interest payments, and means-tested benefits to families with children.

Local governments are responsible for local planning, most local infrastructure, day care and education from pre-school to the 10th grade, and welfare services of various kinds, in particular the care of the disabled and elderly outside institutions. They are also responsible for solving the housing needs of low-income households. This is done via rent support, partially financed by the centre, and by providing rental housing for those who cannot find housing on their own. Local governments provide supplementary assistance to general programmes of pensions otherwise run by the central government.

#### *Central government finances*

Central government revenues as presented in the treasury's accounts amounted to around

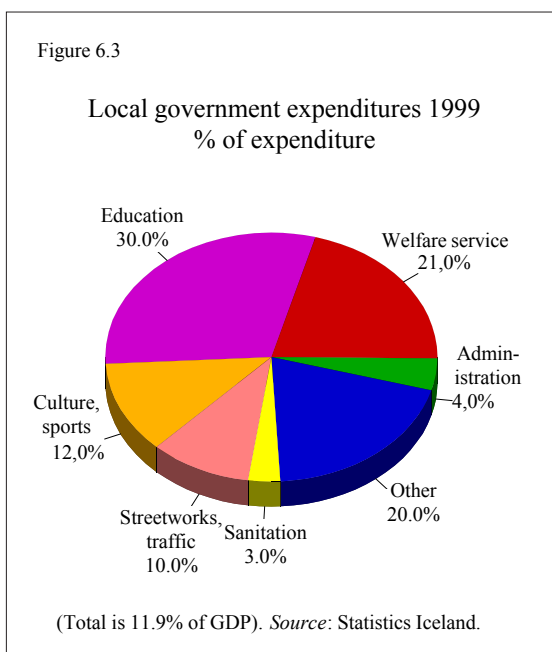
34% of GDP in 2000. Out of this total, about a third came from value-added tax, some 22% from taxes on personal income, 9% from personal income and payroll taxes, 4½% each from taxes on wealth and corporate income, 15% from excise taxes on consumer items such as cars, motor fuel and alcoholic beverages, and 9% from dividends, interest and non-tax levies.

By far the largest part of central government expenditure goes to social security, welfare and health. In 2000, regular treasury expenditures, as presented in the treasury's accounts, amounted to around 29% of GDP. Special pension charges and special write-offs of old tax claims added another 5½% to bring total expenditures to 34% of GDP. In a normal year, pension charges and write-offs would be expected to amount to around 1½%. Just over a quarter of regular expenditures went on health, slightly less on other social issues (mainly social security and welfare), and 12% on administration and safety; education

received 9%, a total of 16% was spent on infrastructure, farm supports and industrial affairs and the bulk of the remaining 10% consisted of interest payments. Figure 6.4 shows this functional breakdown of central government expenditure in percent of GDP according to the treasury accounts. The latest figures according to the internationally standardised national accounts only date to 1998 and show a distribution similar to that of regular treasury expenditures. A final detail to note is that the discretionary part of treasury expenditures is quite low and has been falling. In particular, expenditure on fixed capital and capital transfers have in recent years been in the range of 5-7% of total outlays, while in the 1980's they averaged more than 16%.

The central government and, intermittently, local governments ran up large deficits between 1985 and 1996. Considerable weakening of central government finances in the early part of this period was associated with tax reductions and increased welfare spending, as well as the softening of the economy after 1987.

The consolidation in the mid to late 1990s is at least partially explained by the sensitivity of Icelandic treasury finances to the business cycle and to corresponding swings in the current account. First, the upswing in the economy and the associated consumption boom expanded revenue from taxes on expenditure relative to GDP from 14.1% of GDP in 1995 to 15.7% in 2000. Second, a cut in personal income tax rates in 1997 was outweighed by a reduction in cut-off levels of taxable personal income relative to average income. Since 1995, tax-free income under the combined state and local income tax has been raised by 9% while wages have risen by around 40%. Thus the tax applies to a rapidly growing share



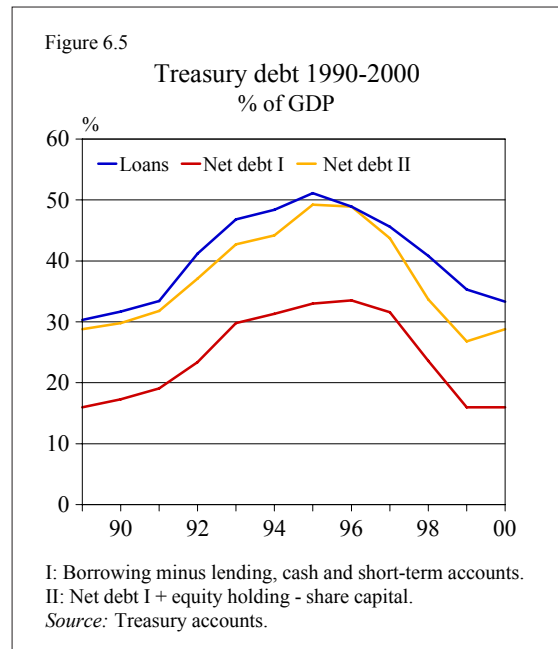
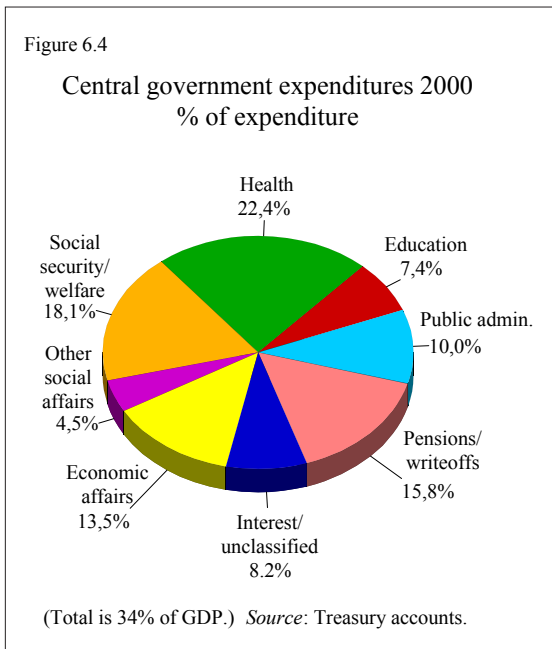
of gross income. This has more than outweighed a cut in the main marginal rate from 33.2% in 1995 to 26.1% in 2001, and revenues rose by 88% between 1995 and 2000 while total taxable incomes rose by 61%. As a result, the personal income tax yield rose from 5.9% of GDP to 7.5%. Third, the upswing, along with policy changes, has lowered expenses on unemployment benefit, child benefits and interest rebates to homeowners from a total of 2.5% of GDP in 1995 to 1.4% in 2000. The combined effect is upward of 4% of GDP.

With the domestic business cycle topping off and the current account deficit dwindling, revenue from expenditure taxes has started to decline. Furthermore, although the bracket creep in personal income tax and social benefits will not be reversed automatically, it will quite likely come under pressure given that it was justified with the desirability of counter-cyclical budget policy.

Treasury surplus since 1997, asset sales, contracting lending activity and strong economic growth contributed to a fall in gross treasury debt from 50% of GDP in 1996 to 33% in 2000, while net debt fell from 35% to 19% of GDP. This figure, however, omits pension liabilities in public sector pension funds which have risen from 19% of GDP at the end of 1996 to 24% in 2000. Even including the pension debt and thus applying a much tougher yardstick than is customary in standard international statistics, net liabilities of the treasury have shrunk from a 1996 peak of 49% of GDP to 29% at the end of 2000, cf. Figure 6.5.

*Local government finances*

Local government revenues amounted to 9.8% of GDP in 1999, the last year solidly recorded. Of this figure, 55% came from municipal income tax, another 9% from real estate taxes, 5% from the Municipal Equalisation Fund and 22% and 8% respectively



from service fees and contributions to capital formation.

Local government expenditures amounted to just over 10% of GDP in 1999, with 30% of the total going to education, 21% to welfare services, 12% to recreational services and 10% to street works.

The response of local government budgets to the business cycle is quite different from that of the treasury budget. Municipal income tax is a fixed percentage of an individual's gross income with minimal exemptions and is much more stable than the treasury's share of income taxes. There is a lagged cyclical effect in real estate taxes which, however, only account for around 10% of local government revenues. On the expenditure side, there is a much larger discretionary factor in local budgets than those of the central government. In particular, fixed investment accounts for some 20% of local government budgets compared to around 5% for central government.

The size of local government budgets has grown in recent years from an average of 6½% of GDP in the early eighties to around 10% in the late nineties, mainly because of new duties in the area of primary education. In spite of cumulative deficits of around 26% of one year's revenue, or 2% of GDP, in the last four years, gross local government debt has hovered around 7% of GDP and net debt around 5% since 1994, as asset sales and economic growth have helped municipalities hold ground on the debt front.

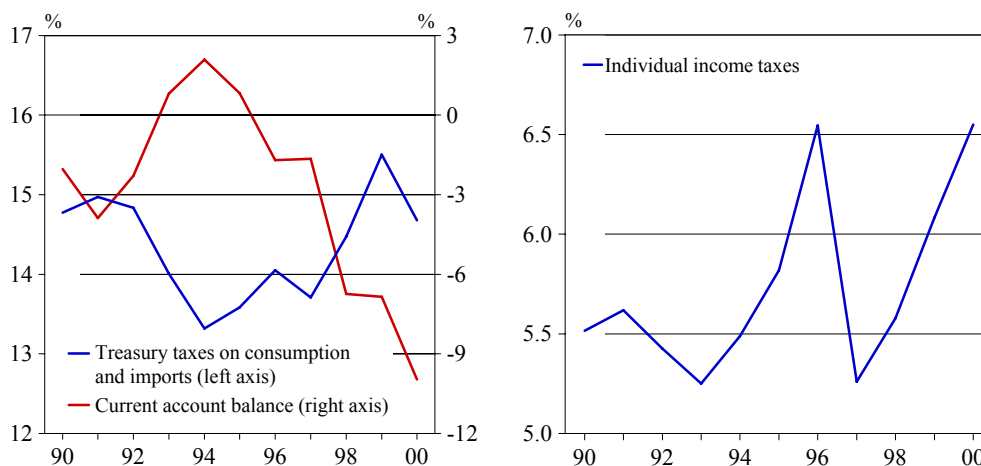
#### *Divesting government holdings in the business sector*

In Iceland, both central and local government have traditionally been heavily involved in the business sector, notably in the operation of utilities and banking institutions.

The central government has long been a major player on the domestic business scene, its involvement considered necessary because

Figure 6.6

#### Central government revenue 1990-2000 in % of GDP



Source: Treasury accounts.

of the small size of the economy. At the end of the 1980s, it ran a boat company and owned factories producing fertiliser, cement, ferro-silicon and pharmaceuticals. Furthermore, the central government held shares in the largest airline, owned a majority share in the dominant electricity producer, most of the power grid and electricity distribution networks outside the Reykjavík area. It owned the sole operator of telephone services and postal services and the dominant broadcasting service, as well as financial institutions responsible for more than 60% of domestic credit.

During the last 10 years the government has embarked up on an extensive plan of privatisation. Ships, fertiliser plants, pharmaceuticals company, airline shares and two-thirds of the shares in the ferro-silicon firm have been sold, as well as sizeable chunks of the financial institutions and sundry other holdings. The first of the three dominant banks was privatised in 1990, after running into financial trouble in the late eighties. The government has sold close to 30% in each of the remaining two and the rest is due to be sold shortly. The telephone company now faces competition from new entities in the market for long-distance and mobile phone calls. The government intends to sell its shares in the company in the next couple of years, but the loss-making postal service remains in government hands. After the pending sales, the state's most important business holdings will be large stakes in the production and distribution of electricity, as well as the Housing Financing Fund, the Student Loan Fund and a few smaller financial institutions, altogether responsible for around 25% of credit in the economy. Thus state involvement in the business sector has already shrunk significantly since 1990 and looks set to continue doing so for the next few years.

Local governments own more than half of all electricity production capacity in Iceland, notably through holdings in the national power company, Landsvirkjun. They almost invariably own geothermal power companies responsible for central heating for most homes. Many own their local distributor of electricity and they generally own operating companies for the harbours. By legal requirement they hold 40% of seats on the boards of specially chartered savings banks, which accounted for some 20% of the banking sector in the year 2000. Historically, local governments tended to be deeply involved in the fisheries sector, but most of those holdings have been divested in the last 15 years. In 1998, local governments were barred from providing loan guarantees for non-governmental businesses, a practice which in the past had led to significant municipal involvement and ownership in troubled corporations.

#### *The tax system*

The central government or treasury derived around 90% of its revenue from taxes in 2000. Around 30% of revenues came from direct taxes on income and wealth, 32% from value-added tax, 9% from payroll taxes and 18% from various excise taxes on imports, production and consumption.

A 25.8% tax is levied on personal income up to 3.9 m.kr., while an additional 7% is charged on higher income. A personal tax-free allowance of 312 thousand kr. per year entails that an individual's annual income of up to around 1.2 m.kr. or USD 12,000 is tax-free. For individuals with lower income than that, the tax-free allowance applies towards local government income tax, which ranges from 11.2% to 13.0% of income in different municipalities and accounts for around 70% of local

Table 6.1 Recent and prospective privatisation

Year	Company sold	Action taken	Millions of ISK at	
			current prices	Oct. '01 prices
1998			6,194	7,361
	Icelandic pharmaceuticals Ltd.	Sale of remaining 50% treasury holding	201	
	Icelandic Alloys Ltd.	Sale of 26.5% treasury holding	1,033	
	FBA Ltd. (Investment bank)	Sale of 49% treasury holding	4,664	
1999			16,506	19,002
	IAV Ltd. (Building contractors)	Sale of 12.1% treasury holding	266	
	State fertilizer plant	Sale of entire 100% treasury holding	1,257	
	FBA Ltd. (Investment bank)	Sale of remaining 51% treasury holding	9,710	
	Agricultural Bank (Commercial Bank)	Sale of 13% treasury holding	2,234	
	National Bank (Commercial bank)	Sale of 13% treasury holding	3,283	
2000	Miscellaneous		64	70
2001	Miscellaneous (as of October 31)		62	67
	Total		25,200	29,600
<i>Prospective privatisation:</i>				
	Agricultural Bank (Commercial Bank)	Sale of remaining 68% authorised		
	National Bank (Commercial bank)	Sale of remaining 73% authorised		
	National Telephone Company	Sale of entire company authorised		
	IAV Ltd. (Building contractors)	Sale of 20% authorised		

government revenue. Accordingly, individuals with an annual income of up to around USD 8,000 are exempt from the combined local and state income taxes.

Interest, dividends, rental income of individuals and, beginning in 2001, all capital gains of individuals are taxed at a lower rate of 10%.

Corporations have paid a 30% tax on profits. This rate has come down from 50% in 1991. The corporate income tax will decline to 18% in 2002. Capital income of corporations is treated like other revenue for tax purposes.

A payroll tax of 5.14%, rising to 5.91% in 2003, is charged on wages. In addition, employers must contribute at least 6% to a pension fund to match an employee contribu-

tion of at least 4%. Although membership is mandatory and the charters and investment guidelines must be approved by the treasury, pension funds are independently managed and considered independent of the government.

A net wealth tax of 1.2% is assessed on net assets exceeding 4.7 m.kr. for individuals, with an additional 0.25% applying to net assets above 6.3 m.kr. Corporations pay 1.45% tax on net assets. From 2002 net wealth taxes of both individuals and corporations will be cut to 0.6%. There is a 1.5% stamp duty on most debt instruments, a 0.25% duty on bills of exchange and 0.5% on the issue of equity shares.

The largest single source of treasury revenue is value-added tax, which is levied at 24.5% on most goods and services. Food, heat-

ing fuel and some services are taxed at 14%, while a few specific sectors are exempt, notably financial services, education, health services and passenger transportation.

A general excise tax is levied on a range of goods at three rates, while unit fees are charged on some goods. Customs duties range from 0 to 30% of cif value, but most imports from EFTA and EU countries are exempt from them. The revenue from excise taxes and import duties has fallen from around 2% and 3% of GDP respectively in the early 1980s to around 0.4% each in 2000.

Taxes on imports and ownership of motor vehicles and excise taxes on motor fuel made up almost 9% of treasury revenue in 2000, at the height of a consumption boom, while 4% were derived from charges on the sale of alcohol and tobacco.

The taxes described above accounted for 87% of treasury revenues and 97% of tax revenues in the year 2000. Non-tax income accounts for just over 10% of treasury revenue and consists mostly of interest income, dividends, profits from sale of government assets and charges for services.

#### *Government guarantees*

Besides debt on the books of government entities, state and local governments guarantee certain debts of various enterprises. Even though state guarantees must be authorised explicitly in budget legislation, historically they were granted to private as well as public enterprises in order to facilitate their borrowing. In recent years, guarantees have mostly been confined to government enterprises and institutions related to government. In 1998, local governments were legally prohibited from granting loan guarantees except to their own subsidiary institutions.

At the end of 2000, the National Debt Management Agency estimated treasury guarantees at around 280 b.kr., or 41% of GDP. This, however, excludes guaranteed debt of Landsvirkjun, in which the treasury is a 50% partner and whose debt is guaranteed in solidum by the treasury and the townships of Reykjavík and Akureyri. Landsvirkjun's total debt stood at 77 b.kr. at the end of 2000, or 8.7% of GDP.

## 7. Monetary policy

### *The Central Bank*

The Central Bank of Iceland was established as a separate institution in 1961. The current Central Bank Act came into effect in May 2001 and involved substantial changes from the previous Act. The main features of the new Act are that the Bank was given the single main objective of ensuring price stability, it was granted instrument and financial independence, the transparency and accountability provisions were strengthened and provisions were included which serve to strengthen the capital position of the Bank. The legislation grants the Central Bank of Iceland full independence to implement monetary policy as defined by the inflation target, without interference from the government and formally closes any direct access by the government to Central Bank financing. Simultaneously, the legislation aims to improve the transparency of monetary policy and make the Bank more accountable towards the government and the public at large. The monetary policy decision-making authority continues to be vested in the Board of Governors consisting of three governors appointed by the Prime Minister to seven-year terms. The new Act specifically authorised the adoption of an inflation targeting policy.

The activities of the Central Bank have evolved over the years. Foreign exchange con-

trol, for example, disappeared with the liberalisation of capital flows and the supervisory responsibilities of the Bank were moved to a separate Financial Supervisory Authority at the beginning of 1999. In recent years the Bank, like many other central banks, has put increasing emphasis on monitoring financial stability.

### *Inflation targeting*

Recently, Iceland joined an growing number of countries which have adopted a formal inflation target as a framework for monetary policy. Currently, nearly 20 countries, including Australia, Canada, New Zealand, Norway, Sweden, Switzerland and the United Kingdom, have adopted a formal inflation target. The inflation target was specified in a joint declaration of the government and the Central Bank of Iceland on March 27 as inflation of 2½%, measured in terms of the twelve-month rate of change in the consumer price index (CPI). To reflect the Central Bank's imperfect control of inflation, there are symmetric tolerance limits. If the inflation rate breaches these limits the Bank is obliged to submit a report to the government, explaining the causes for the deviation, how it intends to respond and when it expects the inflation target to be reached again. The report shall be made public.

The upper tolerance limit is set at 3½% for



the year 2001 (i.e. at a 6% inflation rate) and at +2% for 2002 (i.e. at a 4½% inflation rate). From 2003 onwards, the upper tolerance limit is set at +1½% (i.e. at a 4% inflation rate). The lower tolerance limit is -1½% from 2001 onwards (i.e. at a 1% inflation rate). Hence, the bank aims to attain the 2½% inflation target by no later than the end of 2003 with the tolerance limits specified as ±1½% from the beginning of 2003 onwards.

To guide monetary policy, the Bank publishes a quarterly inflation forecast, projecting

two years ahead. This forecast will more or less serve as the intermediate target of monetary policy instead of the previous currency peg. The króna will therefore float freely without interventions by the Bank, unless it deems this necessary in order to attain the inflation target, or to preserve financial stability.

Following the joint declaration, new Central Bank legislation was passed by parliament on May 23, 2001, which defines the role of the Central Bank in the formulation of monetary policy in accordance with the new mone-

#### Monetary policy arrangements in Iceland since 1970

1970-1973	After the collapse of the Bretton-Woods system the Icelandic króna followed an adjustable peg against the US dollar.
1974-1983	Implementation of exchange rate policy became increasingly flexible and can be described as a managed float. The króna was first pegged against the US dollar and then against various baskets of trading partner countries' currencies.
1984-1989	Exchange rate policy became more restrictive, with increasing emphasis on exchange rate stability. In 1989, however, the króna was devalued ten times in small steps.
1990-1995	More emphasis was again put on exchange rate stability as the anchor of monetary policy. Until 1992 the currency peg was specified against a basket of 17 currencies, weighted according to merchandise trading shares, with ±2¼% fluctuation bands. The basket was redefined in 1992, with the ECU given a 76% weight, the US dollar a 18% weight and the Japanese yen a 6% weight. The króna was devalued twice in this period, in November 1992 by 6% and in June 1993 by 7½%.  In September 1995 the fluctuation band was widened to ±6% in response to the abolishment of capital controls. The currency basket was also changed. The new basket contained 16 currencies, weighted by their share in Iceland's trade in goods and non-factor services.
1996-2000	Fluctuation of the króna within the bands increased as the foreign exchange market deepened and the emphasis on price stability relative to exchange rate stability increased. Reflecting this, the exchange rate band was widened to ±9% in February 2000.
2001-	The fluctuation band was abolished in March 2001 and an inflation target adopted. The Central Bank gained full independence in setting monetary policy to attain this target without interference by the government.

tary policy framework and brings the Bank's status in line with best practice around the world. The new legislation sets price stability, as defined by the inflation target, as the main goal of monetary policy. Hence, monetary policy may only be applied to achieve other economic goals, to the extent deemed by the Bank to be consistent with the inflation target.

#### *Exchange rate policy*

Under the current monetary policy framework, exchange rate developments are a cause of concern for the Central Bank only insofar as they affect the prospects for price stability or are likely to threaten financial stability. This was a significant departure from earlier policies, since Iceland has had a long history of using the exchange rate as a monetary anchor, although with varying degree of commitment, as can be inferred from the table on p. 51.

#### *Foreign exchange reserves*

One of the functions of the Central Bank is to preserve the foreign exchange reserves of the country. The investment guidelines for the reserves are laid out in a resolution by the Board of Governors. The resolution states the minimum amount of reserves, currency composition and the investment categories of the portfolio. Currently the size of the reserves should not be less than the value of 3 months imports. The portfolio consists mainly of deposits and investment grade bonds. The Central Bank holds a small position of gold reserves amounting to about 62 thousand ounces and Iceland has a quota of SDR 117.6 million at the International Monetary Fund.

The reserves are also supported by committed and uncommitted credit lines. Since 1962 the Central Bank has been a party to an agreement between the Nordic central banks (cur-

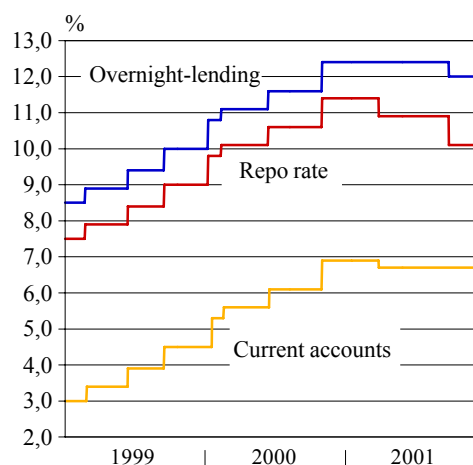
rently Denmark, Sweden and Norway) which consists of an exchange of credit lines. According to the agreement The Central Bank of Iceland can draw up to EUR 200 million. Additional committed credit lines amount to USD 525 million. The Central Bank has access to uncommitted interbank lines with a number of international banks.

#### *Monetary instruments*

The main monetary instrument of the Central Bank of Iceland is its weekly repurchase auction. Usually the Bank auctions two-week contracts. So far the auctions have been fixed price, with unlimited access subject to collateral. No reverse repurchase agreements have been issued. However, there is scope for reverse repurchase auctions within the rules. Repurchase agreements are secured with collateral in the form of listed securities that the Bank recognises. The Central Bank offers an overnight loan facility to the banks subject to

Figure 7.1

Central Bank of Iceland interest rate corridor, January 1999 - December 2001



Source: Central Bank of Iceland.

collateral requirements. The Bank can issue notes of deposit to a bank and these can be submitted as a collateral against repurchase agreements and overnight loans. Banks are subject to reserve requirements and can deposit money at will on an interest-bearing account with the Central Bank. The required reserve base is the

balance sheet total less equity and interbank liabilities at the end of the preceding month. Currently, the required reserve ratio is 1.5% for the part of the required reserve base which is for one year or longer, and 4% for the part tied for a shorter term.

## 8. Foreign debt

### *Treasury foreign debt*

The Republic of Iceland has been a modest borrower in international markets. In recent years, the surplus on government finances has led to a reduction in the total outstanding foreign debt. The treasury foreign debt to GDP ratio fell from 28% in 1995 to 20% in 2000 but rose again in 2001 to an estimated 40% of GDP.

A primary aim in debt management is to spread the amortisation of foreign loans evenly over coming years as well as to achieve a favourable composition of the debt in regard to interest rates, maturity and currency denomination. In recent years prepayment options have been exercised in order to refinance debt on more favourable terms. Interest rate and currency swaps have also been used to achieve debt and risk management objectives.

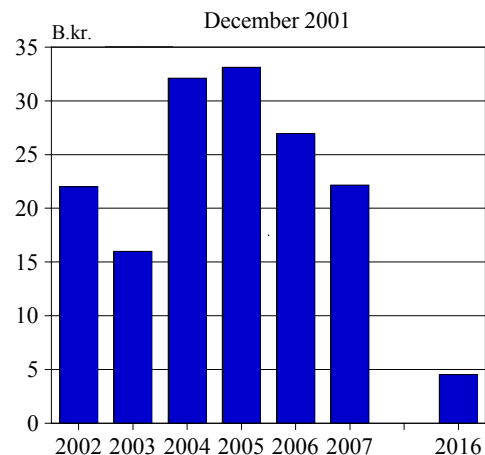
In December 2001, the treasury's long-term foreign debt amounted to 160.5 b.kr. and the outstanding stock of Euro-commercial paper stood at 46.8 b.kr. Around 40.5% of the treasury's foreign obligations were denominated in US dollars, 39.2% in euros, 7.6% in Japanese yen, 9.6% in sterling and 3.1% in Swiss francs.

At year-end 2001, 33% of the treasury's total foreign debt carried fixed interest rates. Of the long-term debt, 42% of loans carried

fixed rates of interest. Average maturity of foreign long-term debt was approximately 2.8 years and the average duration 2.5 years.

The Republic of Iceland has established three financial programmes to facilitate its financing requirements. These are a Euro Commercial Paper (ECP) amounting to 500 million USD, an United States Commercial Paper (USCP) amounting to one billion USD and finally a Medium Term Note (MTN) programme amounting to one billion USD. The latter

Figure 8.1  
Maturity profile of treasury external long-term debt in billions of ISK



Source: Central Bank of Iceland.

Table 8.1 Republic of Iceland foreign bond issues 1995-2001

<i>Currency</i>	<i>Amount</i>	<i>Issue date</i>	<i>Maturity</i>
JPY	15,000,000,000	31.1.1995	31.1.2005
EUR	36,000,000	5.5.1995	5.1.2007
EUR	40,000,000	28.8.1995	25.7.2005
DEM	250,000,000	11.4.1996	11.4.2001
DEM	63,000,000	5.6.1996	20.5.2006
DEM	100,000,000	25.7.1996	11.4.2001
DEM	150,000,000	18.3.1997	18.3.2000
CHF	100,000,000	22.10.1999	22.10.2002
EUR	200,000,000	14.3.2000	1.3.2007
EUR	250,000,000	6.4.2001	6.4.2006
USD	100,000,000	5.10.2001	5.4.2004
EUR	90,000,000	5.10.2001	5.10.2005
EUR	87,000,000	8.10.2001	10.10.2005

two programmes were introduced in 2001. The ECP and USCP programmes have been assigned the highest possible short-term ratings of A-1+ by Standard & Poor's and P-1 by Moody's. A multi-currency option allows for issuance in alternative currencies. Amount, maturity and yield are negotiated at the time of issuance in view of market conditions.

In 1990, the National Debt Management Agency (*Lánasýsla ríkisins*, NDMA) was established. Under this legislation, borrowing and debt management functions of the treasury and government guarantees were assigned to the NDMA. Under a special agreement with the Minister of Finance, the Central Bank is responsible for the execution of foreign borrowings for the treasury.

The Republic of Iceland has always paid when due the full amount required in respect to

principal, interest and sinking fund instalments for all internal and external obligations.

#### *National debt*

Reported figures in coverage of Icelandic foreign debt include private as well as public debt. Total external debt of the economy amounted to 895 b.kr. in mid-2001. The net external debt of the Icelandic government, financial institutions, and the private sector (international investment position) amounted to 567 b.kr. (around USD 5.4 billion), or 73% of GDP, up from 62% at the end of 2000. Fluctuations in the debt ratio reflect not only changes in the volume of debt but also the volatility of exchange rates. The debt service ratio peaked at 34% in 1996, then it declined but increased to about 37% in 2000.

### Credit ratings

In 1996 and 1997 Moody's and Standard & Poor's upgraded Iceland's credit rating to reflect the country's increased creditworthiness. Standard & Poor's announced in 1996 that it had upgraded the credit rating for the Republic of Iceland's long-term foreign currency-denominated debt from A to A+, and short-term debt from A-1 to A-1+. Furthermore, Standard & Poor's assigned a first-time rating of AA+ to Iceland's long-term local currency debt. In July 1997, Moody's upgraded the Republic's foreign currency rating to Aa3 and assigned an Aaa rating to the Republic's long-term krónur bonds.

In February 2000 Fitch assigned an AA-long-term foreign currency rating for Iceland. A short-term rating of F1+ and an AAA rating for long-term local currency were also assigned.

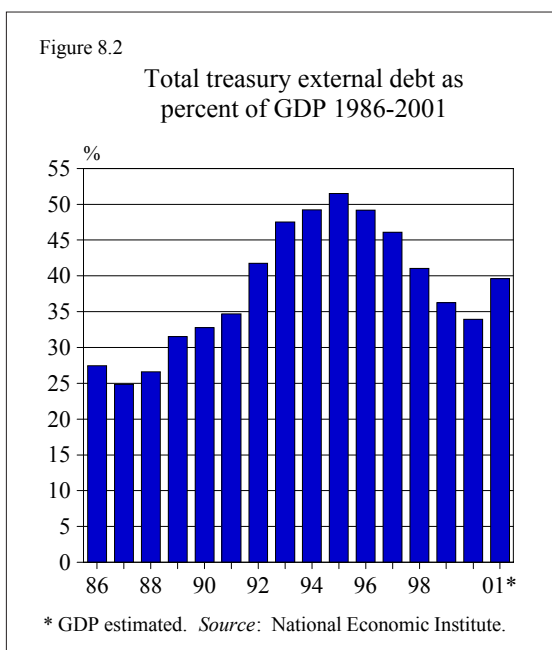
In February and March 2001, Moody's, Standard & Poor's and Fitch confirmed their

Table 8.2 Ratings for Icelandic treasury bonds

	<i>Foreign currency</i>		<i>Domestic currency</i>	
	<i>Long-term</i>	<i>Short-term</i>	<i>Long-term</i>	<i>Short-term</i>
Moody's	Aa3	P-1	Aaa	P-1
S&P	A+	A-1+	AA+	A-1+
Fitch	AA-	F1+	AAA	.

previous ratings on long-term debt. Also all three agencies confirmed their highest ratings for short-term debt. However, Standard & Poor's amended its previous positive economic outlook to a neutral one and in October changed the outlook to negative.

In the reports from the ratings agencies it can be inferred that Iceland's creditworthiness has strengthened significantly over the past decade, supported by a major fiscal consolidation programme and progress with structural reform. The reports cite robust GDP growth in the last years but all three have been concerned with the surging current account deficit and the contribution of above-trend growth to a rise in inflation. The rating agencies also agree that the banking sector has become more vulnerable to a sudden economic downturn.



## 9. Appendix

Table A1. **Iceland's membership in international organisations**

	<i>Year of Association</i>
International Monetary Fund (IMF) .....	1945
International Bank for Reconstruction and Development (World Bank).....	1945
United Nations (UN).....	1946
North Atlantic Treaty Organization (NATO).....	1949
Organization for Economic Co-operation and Development (OECD) .....	1949
Council of Europe.....	1950
Nordic Council.....	1952
International Finance Corporation (IFC).....	1956
International Development Association (IDA).....	1961
General Agreement on Tariffs and Trade (GATT) .....	1964
European Free Trade Association (EFTA).....	1970
Conference on Security and Co-operation in Europe (CSCE).....	1975
Western European Union (WEU) .....	1992
European Economic Area (EEA).....	1994
World Trade Organization (WTO).....	1995

Table A2. Balance of Payments 1997-2000

<i>Millions of krónur</i>	1997	1998	1999	2000 <sup>l</sup>
<i>Current account</i> .....	-8,899	-40,051	-42,728	-67,112
<i>Balance on goods, services and income</i> .....	-8,661	-39,048	-42,003	-66,350
Exports .....	198,275	212,210	221,596	244,112
Imports .....	-206,936	-251,258	-263,599	-310,462
<i>Balance on goods and services</i> .....	3,231	-26,329	-28,501	-46,569
Exports .....	190,948	203,726	212,981	232,071
Imports .....	-187,717	-230,055	-241,482	-278,640
<i>Balance on goods</i> .....	254	-25,019	-22,382	-37,482
Merchandise exports f.o.b. ....	131,213	136,592	144,928	149,273
Marine products .....	93,648	99,233	97,682	94,498
Aluminium and ferro-silicon .....	18,906	21,629	25,668	31,572
Ships and aircrafts .....	5,201	2,245	6,390	3,136
Other goods .....	13,458	13,485	15,188	20,067
Merchandise imports f.o.b. ....	-130,959	-161,611	-167,310	-186,755
Investment goods .....	-32,704	-42,223	-41,356	-44,207
Transport equipments .....	-18,015	-25,945	-29,288	-31,824
Fuels and lubricants .....	-9,868	-8,027	-8,900	-17,250
Industrial supplies .....	-33,460	-41,123	-38,970	-43,235
Consumer goods .....	-36,912	-44,293	-48,796	-50,239
<i>Balance on services</i> .....	2,977	-1,310	-6,119	-9,087
Exports of services, total .....	59,735	67,134	68,053	82,798
Transportation .....	25,735	31,109	30,819	40,833
Air transport .....	17,380	22,692	23,097	30,194
Sea transport .....	8,355	8,417	7,722	10,639
Travel .....	12,316	14,633	16,070	17,967
Other receipts .....	21,684	21,392	21,164	23,998
Communications services .....	1,673	1,336	696	820
Insurance services .....	377	402	414	435
Government services .....	8,344	7,557	7,531	8,457
Other services .....	11,290	12,097	12,523	14,286
Imports of services, total .....	-56,758	-68,444	-74,172	-91,885
Transportation .....	-17,916	-22,766	-25,622	-32,697
Travel .....	-22,893	-28,049	-31,487	-37,082
Other expenditures .....	-15,949	-17,629	-17,063	-22,106
Communications services .....	-1,738	-1,451	-529	-155
Insurance services .....	-918	-931	-740	-432
Government services .....	-845	-1,202	-1,077	-1,205
Other services .....	-12,448	-14,045	-14,717	-20,314
<i>Balance on income</i> .....	-11,892	-12,719	-13,502	-19,781
Receipts .....	7,327	8,484	8,615	12,041
Compensation of employees .....	4,128	4,742	4,901	5,516
Investment income .....	3,199	3,742	3,714	6,525
Dividends and reinvested earnings .....	576	611	1,421	3,016
Interest payments .....	2,623	3,131	2,293	3,509
Expenditures .....	-19,219	-21,203	-22,117	-31,822
Compensation of employees .....	-391	-293	-341	-844
Investment income .....	-18,828	-20,910	-21,776	-30,978
Dividends and reinvested earnings .....	-2,093	-2,332	-1,005	-2,459
Interest payments .....	-16,735	-18,578	-20,771	-28,519
<i>Current transfer, net</i> .....	-238	-1,003	-725	-762
Public transfer, net .....	-718	-675	-661	-813
Private transfer, net .....	480	-328	-64	51
Exchange rate indices (1994=100).....	97.8	96.2	96.0	96.1



Table A2 (continued). **Balance of Payments 1997-2000**

<i>Millions of krónur</i>	1997	1998	1999	2000 <sup>1</sup>
<i>Capital and Financial Account</i> .....	17,739	45,912	60,386	66,026
<i>Capital transfer, net</i> .....	14	-324	-57	-222
<i>Financial account</i> <sup>2</sup> .....	17,725	46,236	60,443	66,248
<i>Financial account excl. reserves</i> .....	14,541	48,497	65,789	60,940
Direct investment, net .....	6,628	5,374	-2,925	-18,036
Abroad .....	-3,637	-5,021	-7,688	-30,440
Equity capital .....	-2,627	-1,756	-4,578	-30,853
Reinvested earnings .....	-70	-174	-529	-867
Other capital .....	-940	-3,091	-2,581	1,280
In Iceland .....	10,265	10,395	4,763	12,404
Equity capital .....	4,796	11,295	4,086	16,606
Reinvested earnings .....	1,380	862	-3,622	-380
Other capital .....	4,089	-1,762	4,299	-3,822
Portfolio investment, net .....	-17,252	-16,831	42,632	34,841
Assets .....	-14,441	-21,537	-28,136	-49,199
Equities .....	-12,805	-17,937	-26,785	-49,947
Debt securities .....	-1,636	-3,600	-1,351	748
Bonds and notes .....	-1,731	-3,419	-5,055	591
Money-market instruments .....	161	-115	-561	-1,061
Financial derivatives .....	-66	-66	4,265	1,218
Liabilities .....	-2,811	4,706	70,768	84,040
Equities .....	-60	981	4,026	-7,950
Debt securities .....	-2,751	3,725	66,742	91,990
Bonds and notes .....	2,520	4,169	43,905	88,932
Money-market instruments .....	-5,271	-438	26,936	4,369
Financial derivatives .....	0	-6	-4,099	-1,311
Other investment, net .....	25,165	59,954	26,082	44,135
Assets .....	-11,575	270	-12,662	-7,112
Deposits and loan .....	-6,345	-2,271	-12,325	-5,681
Trade credits .....	-1,385	-1,368	-337	-1,431
Other capital .....	-3,845	3,909	0	0
Liabilities .....	36,740	59,684	38,744	51,247
Deposits and loan .....	34,022	60,453	35,953	48,539
Long-term borrowing .....	21,387	63,198	38,530	27,356
Short-term borrowing .....	12,635	-2,745	-2,577	21,183
Trade credits .....	2,147	-297	2,002	79
Other capital .....	571	-472	789	2,629
Reserve assets .....	3,184	-2,261	-5,346	5,308
<i>Net errors and omissions</i> .....	-8,840	-5,861	-17,658	1,086
Memorandum items:				
Debt securities, loans, etc., net .....	33,989	63,409	105,486	143,237
Long-term borrowing, net .....	23,907	67,367	82,435	116,288
Monetary authorities .....	0	0	0	0
General government .....	4,876	-3,093	-5,970	4,512
Deposit banks .....	9,104	47,439	61,231	76,053
Other sectors .....	9,927	23,021	27,174	35,723
Short-term borrowing, net .....	10,082	-3,958	23,051	26,949
Monetary authorities .....	-27	3,903	-4,275	9,429
General government .....	-5,271	-438	11,573	11,456
Deposit banks .....	12,657	-12,461	-5,209	-1,944
Other sectors .....	2,723	5,038	20,962	8,008
Average exchange rate: ISK per USD .....	70.76	70.92	72.22	78.65
Average exchange rate: ISK per SDR .....	97.34	96.21	98.70	103.55

1. Preliminary figures. 2. Positive number represents inflow of capital due to foreign borrowing or decrease in assets. Negative number accounts for outflow of capital, debt repayments or increase in assets. *Source:* Central Bank of Iceland.

Table A3. Imports by economic category, 1997-2000<sup>1</sup>

<i>Millions of krónur, cif</i>	1997	1998	1999	2000
Total merchandise imports .....	143,227	176,072	182,322	203,222
Food and beverages .....	12,849	15,990	17,489	16,952
Primary, mainly for industry .....	2,478	4,538	5,462	5,140
Primary, mainly for household consumption .....	1,925	1,988	2,042	1,963
Processed, mainly for industry .....	1,051	1,128	1,088	1,053
Processed, mainly for household consumption .....	7,395	8,337	8,897	8,797
Industrial supplies not elsewhere specified .....	37,593	46,083	43,849	48,678
Primary .....	2,079	3,198	1,954	2,789
Processed .....	35,514	42,885	41,895	45,889
Fuels and lubricants .....	10,712	8,898	9,752	18,525
Primary .....	353	428	330	634
Motor spirit .....	2,035	1,748	1,922	3,788
Other .....	8,324	6,721	7,501	14,104
Capital goods (except for transport) .....	34,778	44,739	43,817	46,963
Capital goods (except transport) .....	22,317	29,166	28,371	31,957
Parts and accessories .....	12,461	15,573	15,446	15,006
Transport equipment .....	19,436	27,624	31,306	33,753
Passenger motor cars (excl. busses) .....	9,060	11,792	14,250	13,040
Transport equipment (excl. ships, aircraft) .....	2,733	3,428	3,780	5,162
Other, non-industrial .....	309	365	547	505
Parts and accessories .....	4,072	4,120	4,482	5,099
Ships .....	3,102	4,409	4,842	6,006
Aircraft .....	160	3,511	3,405	3,942
Consumer goods not elsewhere specified .....	27,623	32,406	35,871	38,142
Durable .....	6,300	7,894	9,016	9,350
Semi-durable .....	10,745	12,429	13,402	14,999
Non-durable .....	10,578	12,083	13,453	13,793
Goods not elsewhere specified .....	237	332	237	209

1. At current exchange rates.

Source: Statistics Iceland.

Table A4. Exports by commodity groups, 1997-2000<sup>1</sup>

<i>Millions of krónur, fob</i>	1997	1998	1999	2000
Total merchandise exports.....	131,213	136,592	144,928	149,273
Marine products.....	93,648	99,233	97,682	94,498
White fish.....	55,522	63,930	78,983	76,813
Frozen.....	31,055	36,847	39,991	36,435
On ice.....	7,460	8,059	10,187	10,945
Salted.....	14,850	17,272	19,349	19,086
Stockfish.....	1,003	1,023	1,024	1,246
Meal.....	840	422	8,102	8,761
Oil.....	314	306	330	339
Herring and capelin.....	17,751	17,409	4,061	3,530
Frozen.....	4,123	2,833	776	837
Salted.....	760	800	724	601
Meal.....	8,578	9,472	445	541
Oil.....	4,290	4,304	2,116	1,551
Lobster, shrimp, scallop.....	16,899	14,598	12,920	11,544
Other.....	3,475	3,296	1,719	2,611
Agricultural products.....	2,105	1,966	2,141	2,576
Meat.....	229	193	214	313
Dairy products.....	0	0	13	11
Salmon & trout (fish-farming).....	661	666	582	588
Other.....	1,215	1,106	1,333	1,664
Manufacturing products.....	28,757	31,496	37,080	46,673
Aluminium.....	15,197	18,417	22,539	27,691
Ferro-silicon.....	3,709	3,212	3,129	3,881
Diatomite.....	572	548	627	222
Tanned skins and hides.....	1,200	624	385	557
Wool products.....	382	378	266	297
Canned products.....	1,919	1,791	1,483	1,249
Other.....	5,778	6,527	8,651	12,794
Miscellaneous.....	6,704	3,897	8,025	5,526

1. At current exchange rates.

Source: Statistics Iceland.

Table A5. Geographic distribution of foreign trade, 1970-2000<sup>1</sup>

	<i>Share of total</i>					<i>B.kr.</i>
	<i>1970</i>	<i>1980</i>	<i>1990</i>	<i>1999</i>	<i>2000</i>	<i>2000</i>
<i>Merchandise exports, fob</i>						
European Union.....	52.8	52.3	70.7	64.1	67.8	100.5
Euro area.....	25.4	30.2	37.6	38.3	42.5	63.1
Other EU countries.....	27.4	22.0	33.1	25.8	25.2	37.4
United Kingdom.....	13.2	16.5	25.3	19.7	19.4	28.8
Other Western European countries.....	2.8	2.3	3.4	10.1	7.8	11.6
Eastern Europe and former Soviet Union	9.6	8.8	2.9	1.0	1.4	2.1
Russia.....	6.8	5.4	2.5	0.3	0.4	0.6
United States.....	30.0	21.6	9.9	14.7	12.2	18.2
Japan.....	0.1	1.5	6.0	5.0	5.3	7.8
Other OECD countries.....	0.5	0.6	0.5	1.9	2.0	3.0
Developing countries <sup>2</sup> .....	4.2	12.9	5.5	2.4	2.4	3.6
Other countries.....	0.0	0.0	1.1	0.8	1.0	1.5
Total.....	100.0	100.0	100.0	100.0	100.0	148.4
<i>Merchandise imports, cif</i>						
European Union.....	64.9	58.0	59.9	55.9	57.0	115.9
Euro area.....	32.0	33.2	35.5	32.4	33.5	68.0
Other EU countries.....	33.0	24.8	24.4	23.5	23.6	47.9
United Kingdom.....	14.3	9.5	8.1	9.2	9.0	18.2
Other Western European countries.....	5.4	8.1	5.2	11.8	9.7	19.6
Eastern Europe and former Soviet Union	10.4	10.9	6.5	5.2	5.7	11.7
Russia.....	7.2	9.7	5.0	1.9	1.8	3.6
United States.....	8.2	9.4	14.4	10.9	11.0	22.3
Japan.....	2.9	4.0	5.6	5.5	4.9	10.0
Other OECD countries.....	0.4	5.8	3.7	4.7	4.5	9.1
Developing countries <sup>2</sup> .....	7.2	2.7	3.1	4.5	5.6	11.4
Other countries.....	0.6	1.1	1.4	1.6	1.5	3.1
Total.....	100.0	100.0	100.0	100.0	100.0	203.2

1. Country groups are based on the year 2000. 2. International Monetary Fund's definition.

Source: Statistics Iceland.

Table A6. Projected external debt service<sup>1</sup>

Billions of krónur	2001	2002	2003	2004	2005	2006	Thereafter	Principal total
General government								
Principal .....	18.0	18.9	15.1	19.9	16.9	3.7	37.3	130.4
Interest <sup>2</sup> .....	7.1	6.7	5.5	3.7	3.1	2.2		
Total .....	25.1	25.6	20.6	23.6	20.0	5.9		
Financial institutions								
Principal .....	49.2	94.2	102.4	36.3	25.1	4.2	6.1	317.4
Interest <sup>2</sup> .....	14.3	12.4	6.6	3.0	1.8	0.5		
Total .....	63.5	106.6	109.1	39.3	26.9	4.7		
Other sectors								
Principal .....	20.9	7.5	33.9	17.2	27.8	9.9	20.7	137.2
Interest <sup>2</sup> .....	7.7	6.7	5.9	4.2	3.2	1.9		
Total .....	28.6	14.1	39.8	21.5	31.0	11.8		
Total payments								
Principal .....	88.1	120.6	151.4	73.4	69.8	17.7	64.1	585.0
Interest <sup>2</sup> .....	29.1	25.7	18.1	11.0	8.1	4.7		
Total .....	117.2	146.3	169.5	84.4	77.8	22.4		

1. Based on debt outstanding at the end of 2000.

2. Floating rate, LIBOR-USD is assumed at 6% per year.

Source: The Central Bank of Iceland.