

CENTRAL BANK OF ICELAND

# The Economy of Iceland



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The Economy of Iceland

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# Republic of Iceland

## People

Population .....	272,064 (December 1, 1997)
Capital .....	Reykjavík, 106,617 (December 1, 1997)
Language .....	Icelandic; belongs to the Nordic group of Germanic languages
Religion .....	Evangelical Lutheran (95%)
Life expectancy .....	Females: 81 years , Males: 76 years

## Governmental System

Government.....	Constitutional republic
Suffrage.....	Universal, over 18 years of age
Legislature.....	<i>Alþingi</i> with 63 members
Election term.....	Four years

## Economy

Monetary unit.....	Króna (plural: krónur); currency code: ISK
Gross domestic product .....	524 billion krónur (US\$ 7.4 billion) in 1997
International trade .....	Exports 36% and imports 36% of GDP in 1997
Per capita GDP .....	1,938 thousand krónur (US\$ 26.921) in 1997

## 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+	--



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# 1. The Republic of Iceland

## Geography and population

Iceland is located in the North Atlantic between Norway, Scotland and Greenland. Iceland is the second largest island in Europe and the third largest in the Atlantic Ocean with a land area of some 103 thousand square kilometres and an exclusive 200 nautical mile economic zone extending over 758 thousand 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 south and west coast of the country. In Reykjavík, the capital, average temperature in July is around 11 degrees centigrade and just below zero degrees centigrade in January.

Being of volcanic origin, Iceland consists of coastal lowlands and a mountainous interior with several glaciers, the highest of which is 2,119 meters high. 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. Most of the arable land, estimated to be around 20 percent of total land area, is situated along the coast and most of the population lives in the coastal regions. Iceland is one of the least densely populated countries in Europe with only 2.6 inhabitants per square kilometre. The population of Iceland was 272 thousand at the end of 1997. The annual rate of population growth was 0.8 percent between 1990-1997. Approximately 60 percent of the population live in the capital city of Reykjavík and its surrounding towns. The largest town outside the capital area is Akureyri, in the north, with a population of 15 thousand.

Iceland was first settled late in the 9th century. The majority of the settlers were of Norse origin, although a certain element of the early settlers was of Celtic origin. A general legislative and judicial assembly, *Alþingi*, was established in 930 and a uniform code of laws for the entire country was adopted at the same time. In 1262, Iceland entered a treaty that established a union with the Norwegian monarchy. When the Danish and Norwegian monarchies were united in 1380, Iceland came under a Danish rule that 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 its monarchical union with Denmark and founded a Republic.

The native language, Icelandic, belongs to the Nordic group of the Germanic languages. The standard of education is high, and public education is compulsory between the age of six to sixteen. Command of English and the Scandinavian languages is widespread.

## Political structure

The present constitution was adopted on June 17, 1944, when the Republic was established. Iceland has a parliamentary system of government. The legislative power is vested in the Parliament, *Alþingi*, and the executive power in a government headed by the Prime Minister. The government must be supported by a majority of the Parliament to remain in power. The 63 members of the Parliament 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 Parliament 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 long 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. Currently there is an Independence Party - Progressive Party coalition Government with a majority in the Parliament. The results of the election in 1995 were as follows: The Independence Party obtained 37.1 percent of votes and 25 seats, the Progressive Party 23.3 percent and 15 seats, the Social Democratic Party 11.4 percent and 7 seats, the People's Alliance 14.3 percent and 9 seats, the Women's Alliance 4.9 percent and 3 seats, the People's Movement 7.2 percent and 4 seats, others 1.8 percent and no seats. The next general election is due by May 1999.

### **Membership in international organisations**

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 International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank), both established in 1945. Iceland is a founding member of the European Bank for Reconstruction and Development, which was established in 1990. Iceland is one of the original members of the Organisation of European Economic Co-operation that later became the Organisation for Economic Co-operation and Development (OECD). It joined the Council of Europe in 1950 and has participated in the Organisation for Security and Co-operation in Europe since it was initiated in Europe in 1975.

Iceland became a contracting party to the General Agreement on Tariffs and Trade in 1964 and ratified the agreement establishing the World Trade Organisation (WTO) on December 28, 1994, thus becoming a founding member. Iceland joined the European Free Trade Association (EFTA) in 1970 and entered into a free-trade agreement with the European Community (EC) in 1972. In May 1992, the member countries of EFTA and the EC signed an agreement to establish a free-trade zone, the European Economic Area (EEA), which came to effect in January 1, 1994.

Iceland is a founding member of the North Atlantic Treaty Organisation (NATO), established in 1949. Iceland became an associate member of the Western European Union in 1992. Iceland concluded a defence treaty with the United States in 1951. Since then a NATO military base staffed by United States military personnel has been operated at Keflavík in the southwest of Iceland.

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

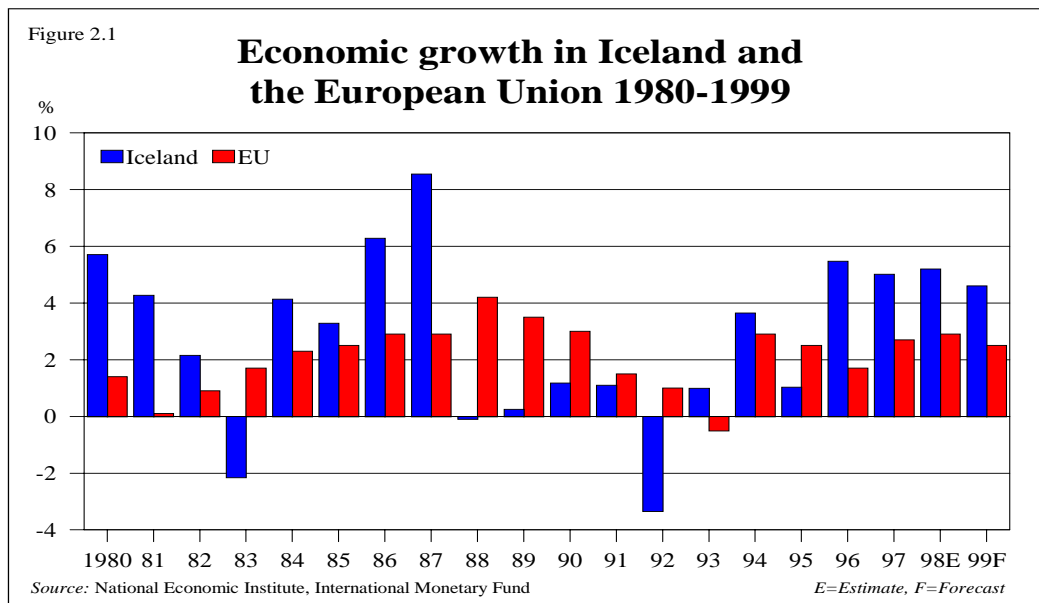


## 2. Recent Developments and Prospects

In recent years the economic environment in Iceland has been characterised by a brisk economic growth and low inflation. In the first half of 1998 growth of output continued and prospects for the second half of 1998 are favourable although the trade balance has deteriorated. Despite a large increase in aggregate demand, inflation has remained at a low level. Unemployment is declining rapidly and is likely to be less than 3 percent at the end of the year.

### Growth and trade

The economy has resumed growth after a period of stagnation from 1988 to 1993 as can be seen in Figure 2.1. The National Economic Institute (NEI) forecasts a 5.2 percent growth in 1998 only slightly below the 1996 (5.6 percent) growth rate. For 1999 a growth rate of 4.6 per cent is forecast. For the period 2000-2003 economic growth is forecast to average about 2.5 percent per year. This growth is similar to rate forecast for the OECD countries. National expenditure has been growing even faster than output (GDP). The growth of national expenditure was 5.4 percent in 1997 and is forecast to be 12.8 percent in 1998. This increase is due to an expansion in gross fixed investment and private consumption while public consumption has been growing more slowly. Real household disposable income is forecast to increase by 8.0 percent in 1998 and 4.5% in 1999.



Exports of goods and non-factor services grew by 5.6 percent on a volume basis between 1996 and 1997 but only 1.5 percent growth in the volume of exports of goods and services is expected in 1998,

mainly because marine production will decrease by 2 percent in volume terms. Catches of cod increased by 12 percent from 1996 to 1997 and the catch in the first half of 1998 was 18 percent higher than the catch in the first half of 1997. Catches of other demersal species and catches outside Icelandic waters are, however, less than they were at the same time last year and will most likely be somewhat below the allocated quota in some cases. Prices of fish products are, however, quite favourable. Prices are forecast to be 8.8 percent higher in 1998 than in 1997 and in 1999 prices are likely to move in line with the general price developments among trading partners.

In 1998 export production of aluminium, in volume terms, is estimated to increase by 44 percent and 27 percent in 1999. A new smelter at Grundartangi started to operate in June with a planned capacity of 60 thousand tons. The price of aluminium, however, has fallen mainly due to the economic situation in Asia. A 18 percent decrease of output is expected in the ferrosilicon smelter at Grundartangi in 1998 but production is forecast to increase in 1999 by 33 percent. Manufacturing exports outside the power intensive sector are expected to grow by 5 percent in 1998 and between 2 and 3 percent in 1999. A volume growth of almost 14 percent in the export of services is forecast for 1998 and between 7 and 8 percent in 1999. The upturn in the economy and increased purchasing power is reflected in a projected increase of general imports (excluding special investment goods) of over 25 percent in 1998. In the first seven months of 1998 imports of investment goods increased by 60 percent over the same period in 1997 while merchandise imports in general increased by 28.4 percent in the same period. An increase of 27 percent in imported services was recorded in first half of 1998. General merchandise imports rose by 16.6 percent in 1996 and by 5.9 percent in 1997. In table 2 output and expenditure 1996-1999 is shown.

**Table 2.1. Output and expenditure 1997-1998 and % volume changes 1996-1999**

<i>1990 prices</i>	<i>Billions of krónur</i>		<i>%</i>			
	1997	1998P	1996	1997	1998P	1999F
Private consumption	320.3	358.1	6.4	6.0	10.0	5.0
Public consumption	107.3	119.6	1.0	2.6	3.0	3.0
Capital formation	98.7	129.3	26.5	11.2	27.3	-10.0
Stock changes	-5.1	0.0	-0.7	-0.9	0.8	0.0
<i>Total national expenditure</i>	<i>521.2</i>	<i>606.1</i>	<i>7.5</i>	<i>5.4</i>	<i>12.8</i>	<i>1.5</i>
Exports of goods and services	191.0	200.2	10.0	5.6	1.5	8.5
Imports of goods and services	187.7	226.5	16.6	8.5	22.6	0.0
<i>Gross domestic product</i>	<i>524.4</i>	<i>580.7</i>	<i>5.6</i>	<i>4.4</i>	<i>5.2</i>	<i>4.6</i>
Net factor income from abroad	-11.5	-12.1	-	-	-	-
Current transfers, net	0.2	-0.3	-	-	-	-
Current account balance	-8.5	-39.6	-	-	-	-
<i>Gross national product</i>	<i>512.9</i>	<i>568.7</i>	<i>6.3</i>	<i>4.3</i>	<i>5.0</i>	<i>4.2</i>
Effects of changes in terms of trade	-	-	-1.7	0.8	2.0	-0.1
<i>Gross national income</i>	<i>-</i>	<i>-</i>	<i>4.7</i>	<i>5.2</i>	<i>7.1</i>	<i>4.1</i>
Current balance, per cent of GDP	-	-	-1.7	-1.6	-6.6	-4.0

P=provisional figures, F=forecast

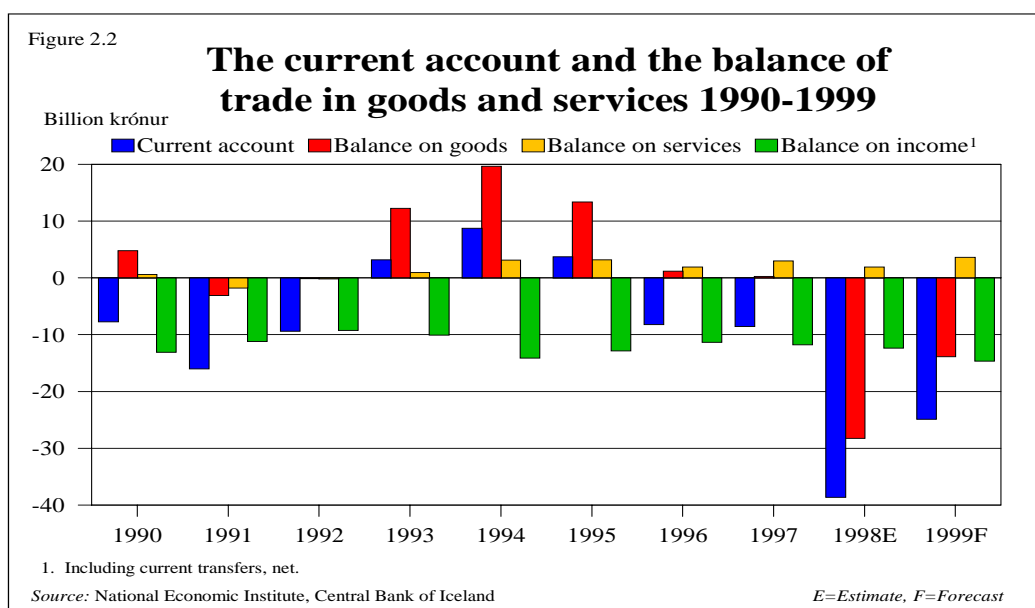
Source: National Economic Institute

Terms of trade for goods and services are expected to improve by 5 percent in 1998 compared to 3.1 percent in 1997. Import prices, especially oil, have declined (measured in krónur terms) but prices of marine products were 13.9 percent higher in krónur terms in August 1998 than in July 1997.

Increased demand and lower supply are the reason for these price increases. The price of aluminium and ferrosilicon is, however, lower in 1998 than in 1997 partly due to the Asian crisis and the outlook is uncertain.

### The balance of payments

In the first half of 1998 the balance of goods and services was in deficit of 24 billion krónur compared to 3.3 billion in the first half of 1997. The deficit in the balance of goods was 16 billion and is forecast to be at the end of the year around 28 billion krónur. The current account balance on goods and services is forecast to show a deficit of 38.6 billion krónur or 6.6 percent of GDP in 1998.



The current account and the balance of trade in goods and trade in services is shown in Figure 2.2. The deficit in 1996 and 1997 was largely due to increased imports of investment goods, including imports associated with the expansion of the aluminium smelter in Straumsvík and the construction of the new aluminium smelter at Grundartangi. For 1999 the National Economic Institute expects the development of the current account to be different from the previous year. Increased goods exports and nearly unchanged goods imports will lead to a narrowing of the trade deficit to 13.8 billion krónur but the balance of factor services including interest payments abroad will show a deficit of around 11 billion making the total projected deficit 4 percent of GDP.

### Prices and wages

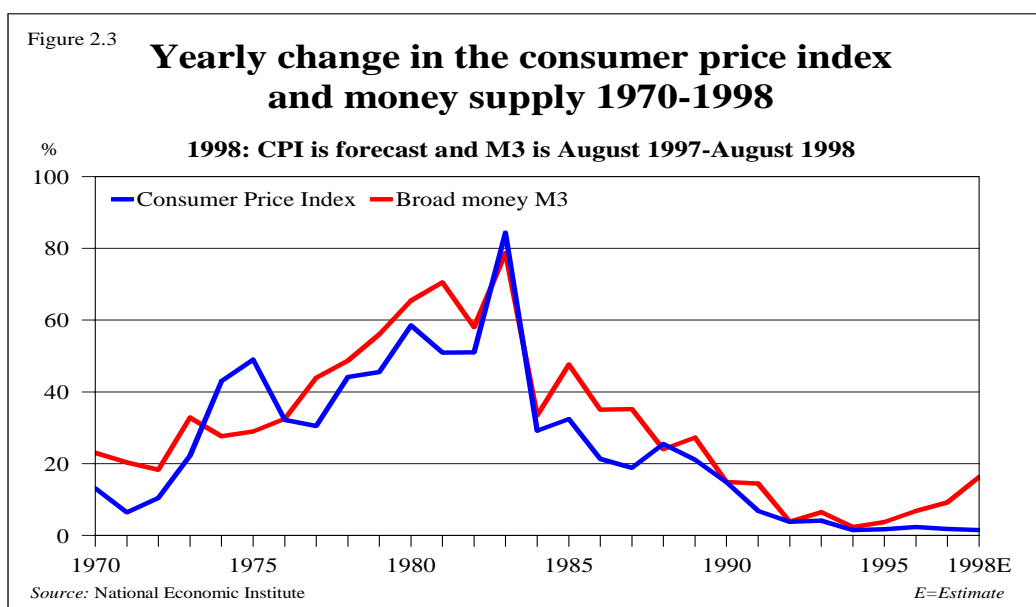
Inflation in Iceland is expected to remain at a low level in 1998. The price stability attained in recent years is the result of a combination of several factors; a stable exchange rate, favourable import prices, tight monetary policy, increased competition in the retail business and moderate wage settlements. Wage agreements were concluded in 1997 for the private sector and most of the public sector for three years. The agreements resulted in estimated wage increases in the range of 5-6 percent in 1997 and 4-5 percent in 1998. Inflation was at a historically low level in 1997 when consumer prices rose by 1.8

**Table 2.2 The current account 1998 and 1999***Million krónur*

	1998 provisional	1999 forecast
Balance on goods	-28,195	-13,834
Balance on services	1,930	3,608
Balance on income	-12,050	-14,348
Current transfers, net	-267	-283
Current account balance	-38,582	-24,857

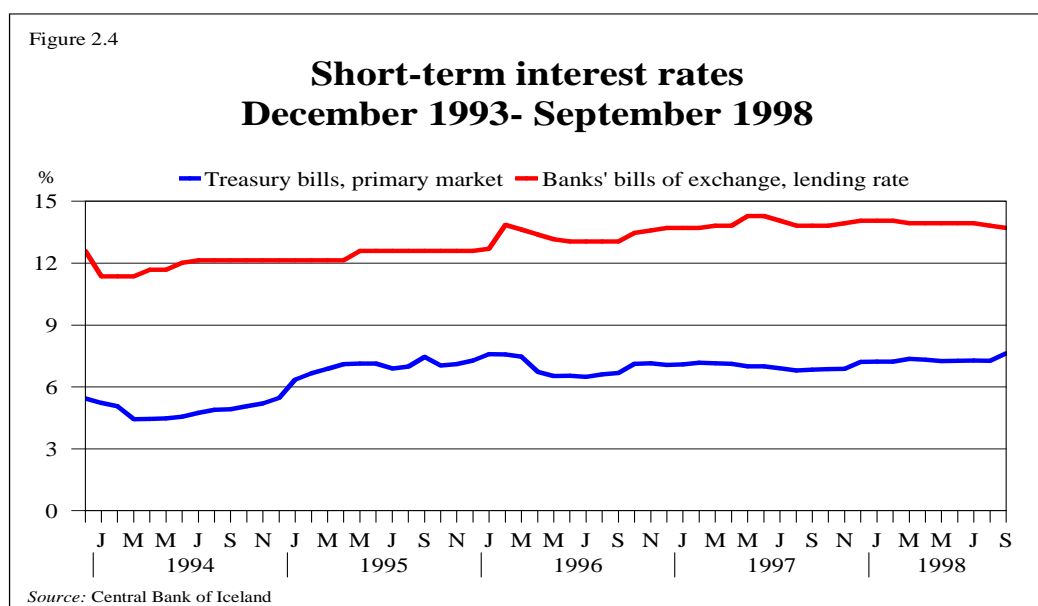
*Source: The National Economic Institute*

percent. The rate of increase on an annual basis is forecast to be 1.5 percent in 1998 although real disposable household income per capita is expected to rise by 8.0 percent in 1998.



Since late 1995, when the unemployment rate reached its peak at 5 percent of the labour force, unemployment has been on a declining trend. Employees in specific groups with particular educational background and skills are in high demand, such as computer experts and business administration graduates. The unemployment rate declined between 1996 and 1997, from 4.3 percent down to 3.7 percent of the labour force. The unemployment rate is expected to decline further in 1998, to 3.0 percent of the labour force.

The Central Bank has continued to pursue the tight monetary policy in 1998. The key short-term Central Bank rate, repo, was increased to 7.5 percent in September from 7.2 percent. The yield in the domestic money market has been substantially higher than trade-weighted foreign money market rates abroad. The difference has been around 2.5-3.0 percent per year.



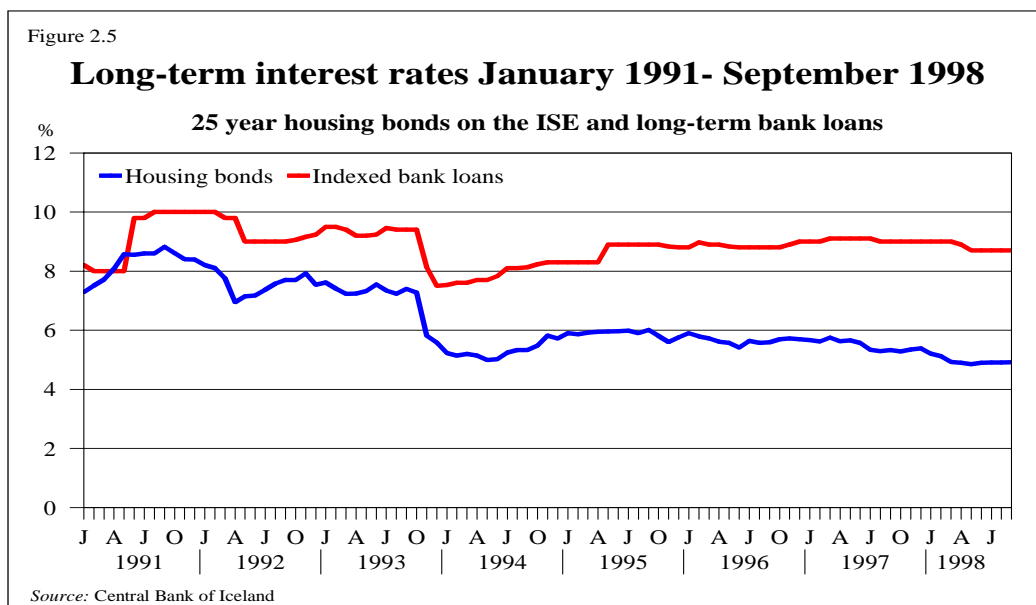
Increased private foreign borrowing resulted in a net capital inflow in 1997, and an appreciation of the króna. Long-term interest rates in the secondary market fell during the first half of 1998 but lending rates of commercial banks have been stable. The growth rate of monetary aggregates has been increasing. M3 including estimated accrued interest rose by 9.2 percent in 1997 but by around 12 percent in the first half of 1998.

#### Public finances

A revised estimate for 1998 indicates that Treasury revenue exceed the budget by 9.1 billion krónur. Expenditure, however, is now expected to exceed the budget by 12 billion krónur, of which increased pension commitments account for 7.2 billion. On an accruals basis, the Treasury revenue balance is expected to be in deficit of 2.8 billion krónur. Excluding accrued pension fund commitments and interest payments, the net borrowing requirement of the Treasury will be negative 14.5 billion krónur.

In 1998, the fiscal balance of local governments is projected to be negative 1.4 billion when revenues will be 53.5 billion and expenditures 55.0 billion or 9.2 and 9.5 percent of GDP. The combined local government deficit is estimated to be negative 2.1 billion krónur in 1997 or 0.4 percent of GDP. The general government, which includes central government, local government and social security finances will be in surplus of 3.2 billion krónur in 1998 on national accounting basis or 0.2 percent of GDP, compared with 4.7 percent deficit in 1994. In 1999 a surplus of 0.6 percent of GDP is forecast.

In 1998 Treasury net borrowing requirement will be negative for the first time in years. Thus, Treasury debt continues to fall, from 46 percent of GDP at the end of 1997 down to 34 percent of GDP in the end of 1999. About half of total public sector debt is foreign debt. It should be noted that most of domestic treasury bonds are zero-coupon and, hence accrued interest charges are included in these debt figures. General government gross debt is estimated to be 272 billion krónur by the end of 1998, or 47 percent of GDP a decline of 6 percentage points from 1997. General government net debt is put at 187 billion or 32 percent of GDP in 1998. Foreign debt is about half of the total. Public sector net borrowing requirement is estimated to be negative 0.3 percent of GDP in 1998, compared to a positive 3.3 percent in 1997 and a forecast of positive 0.3 percent in 1999.



### Privatisation

Recent governments have emphasised a policy of privatisation of enterprises owned by the state. Several state enterprises have been sold to the private sector. The privatised enterprises include a venture capital institution, *Þróunarfélag Íslands*, an insurance company, *Íslensk endurtrygging*, a fish processing company, *Þormóður rammi*, a fish meal company, *S.R. mjöl*, a coastal shipping line, *Ríkisskip*, and a machinery and heavy equipment plant, *Landssmiðjan*. The state-owned and operated Vehicle Inspectorate, *Bifreiðaeftirlit ríkisins*, was incorporated and privatised. In 1997 the government and the City of Reykjavik privatised a joint computer data centre, *Skýrr*. In 1997 the government made an agreement to sell a part in the ferrosilicon plant at Grundartangi to one of its co-owners, *Elkem A/S* of Norway. In addition, the state-owned Post and Telecom Iceland, *Póstur og sími*, was incorporated in the beginning of 1997 and divided into two entities in the beginning of 1998, a postal company and a telecom company.

In the beginning of 1998 the two state-owned commercial banks, *Landsbanki Íslands* and *Búnaðarbanki Íslands*, were incorporated. These changes are a first step towards the eventual privatisation of these institutions and represent a significant step in the evolution of the Icelandic financial market. Initially the state will be the sole owner of the incorporated banks, but the Minister of Commerce can authorise the banks to issue new equity with private ownership being up to 35 percent of the total equity in the banks. Further sales will, however, require parliamentary approval. In addition, four investment credit funds, the Fisheries Investment Fund, the Industrial Loan Fund, the Industrial Development Fund and the Export Credit Fund were merged into a new incorporated investment bank at the beginning of 1998, *Fjárfestingarbanki atvinnulífsins*. A quarter of the capital of the merging investment credit funds was used to spin off a venture capital fund, The Business Venture Fund, *Nýsköpunarsjóður*. The Government has announced its intention to fully privatise the bank in 1999.

### **3. The Structure of the Economy**

Despite the small size of the Icelandic economy, growth and output has been sufficient to provide living standards that are among the highest in the world. In 1996 GDP per person was approximately 23,200 as measured in current PPP (purchasing power parity) US dollars compared to 19,300 for the European Union and 27,800 for the US. The economy, traditionally based on fisheries and agriculture, has been diversifying into manufacturing and service industries in the last decades. Important primary and secondary industries are based on the use of renewable natural resources, such as the coastal fishing banks, hydroelectric and geothermal power and grasslands that support sheep and milk production. Tertiary activities employ around two thirds of the manpower and significant new developments have taken place in activities based on investment in human capital such as software production, financial activities and biotechnology.

The estimated contribution of the various economic sectors to the total GDP in 1997 was 9.5 percent by fishing, 4.9 per cent by fish processing, 15.9 percent by manufacturing, water and electricity supply, 2.1 percent by agriculture, 7.9 percent by construction, 17.4 percent by finance, insurance, real estate and business services, 13.5 percent by trade, restaurants and hotels, 9.1 percent by transportation, 16.6 percent by government and miscellaneous private services 7.1 percent. Imputed bank service charges were estimated to be 4.0 per cent of GDP.

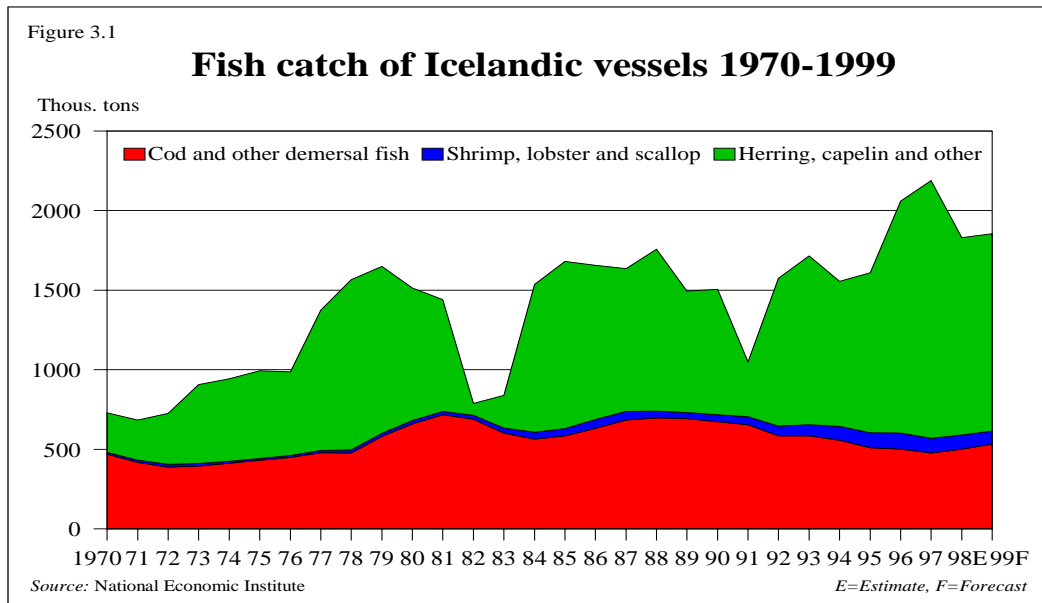
#### **Fishing and fish processing**

The marine sector, including fishing and fish processing, is of fundamental importance to the Icelandic economy. In 1997, it contributed 14.4 percent to gross domestic factor income, generated 71 percent of merchandise exports (49 percent of total exports) and used a labour force of 13,700 man-years or 11.1 percent of the total labour force (1995). In the early 1960s, exports of fish and fish products constituted over 90 percent of merchandise exports.

The principal part of the Icelandic marine sector is the stock of groundfish, including species such as cod, haddock, saithe, and redfish. The catch of groundfish reached a maximum of 732 thousand tons in 1981 but declined to 477 thousand tons in 1997.

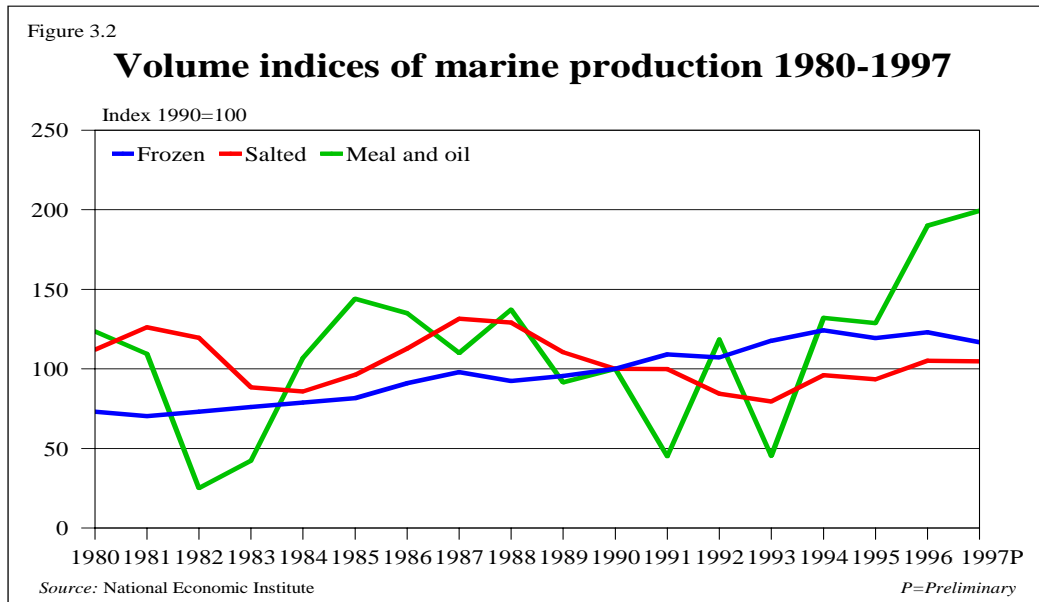
Conservation measures led to substantial cuts in cod quotas in early 1990s, cod being the single most important species in Icelandic waters. The fishing industry offset the cuts by increasing catches in other marine species and by fishing beyond Iceland's exclusive 200 mile fishing zone. More efficiency has been achieved in the allocation of catches on products, fish landed by foreign vessels has increased, and a larger share of the catch has been processed domestically. In the last couple of years, the fishing industry has started to reap the benefits of the conservation measures and the cod stock has gradually been recovering.

Apart from groundfish, the most important fish for Iceland's marine sector is capelin, a small fish of the salmon family. The capelin catch in 1997 was 1.3 million tons and the quota for 1998 is close to one million tons. The capelin catch was adversely affected by the fisheries strikes in February and March 1998. In the first half of 1997 the capelin catch was 771 thousand tons but only 497 thousand tons in the same period 1998. The National Economic Institute estimates that the total catch will be 915 thousand tons in 1998. The catches of shrimp, lobster and shellfish have been of substantial value in recent years as well as catches of herring, which used to be one of the most important fish in the sixties.



Production of fishmeal and oil, frozen fish and salted fish is shown in Figure 3.2. The production of fishmeal and oil has been very changeable. Frozen fish amounted to 56.6 percent of the value of marine exports in 1997, salted fish was 16.4 percent of value and salted fish was 14.6 percent of export value. Other processing methods amounted to 12.4 percent of marine exports. Total production volume was around 7 percent higher in 1997 than 1990.

Iceland has developed a comprehensive fisheries management policy to manage the fish stocks.





Quotas regulate catches of all the major species of fish. The total allowable catch is determined on the basis of biological estimates of the status of the fish stocks and forecasts for their development in the near future. This quantity is then allocated among individual fishing vessels and the quotas can be traded between companies at a market price. The fishing quotas were originally allocated to fishing vessels on the basis of fishing experience as measured by the average catch for the last three years before the allocation.

The fish processing industry increasingly relies on computers, electronics and modern management techniques, as well as research and development in biotechnology. The production systems are flexible and it is relatively easy to divert the raw material to the most profitable processing method whether it is freezing, salting or drying. The technologically advanced fishing fleet includes vessels that can perform high-quality processing at sea. The number of companies in this sector has declined in recent years due to several corporate mergers.

Increased quality and diversification extends not only to processing, but also to marketing. Icelandic fish products have been actively marketed in the United States, Europe and Japan and Icelandic products have acquired widely established brand names. Progress in the marine industry has to a certain extent limited the risks associated with Iceland's dependence on export of marine products.

### **Manufacturing and power intensive industries**

The Government has encouraged the development of the manufacturing sector to reduce dependence on the marine sector and to further broaden the productive base of the economy. The development of power intensive industries is based mainly on competitive energy prices that can be found in Iceland. The Government has been encouraging investment from foreign enterprises to develop power intensive industries. In 1997 manufacturing (other than fish processing) contributed 12.0 percent of GDP and employed 11.3 percent of the labour force (man-years). Production of aluminium and ferrosilicon contributed 1.2 percent to GDP in 1995. A number of Icelandic manufacturing firms produce for export markets. In 1997, manufactured products accounted for approximately 22 percent of total merchandise exports, with aluminium accounting for 11.6 percent of the total amount.

The largest manufacturing facility in Iceland is an aluminium smelter located at Straumsvík near Reykjavík. The smelter is owned and operated by the Icelandic Aluminium Company Ltd, *ISAL*, which is a wholly owned subsidiary of *Alusuisse Lonza AG* of Switzerland. A 60,000-ton expansion of the Straumsvík smelter was completed in September 1997 bringing total capacity to 162,000 tons per year. Nordic Aluminium, a company owned by Columbia Ventures, a U.S. company, completed the building of the first phase of a new 60,000 tons aluminium smelter at Grundartangi in June 1998. The Icelandic Government, *Elkem A/S* of Norway, and the *Sumitomo* Corporation of Japan jointly own a 72,500 ton ferrosilicon plant, Icelandic Alloys Ltd, *Járnblendifélagið*, at Grundartangi in Hvalfjörður on the west coast of Iceland. In 1997 the Government made an agreement with *Elkem* to sell a part of its share in the ferrosilicon plant to the Norwegian Company, which subsequently became a majority owner. Another part of the share owned by the state was offered for sale to the public. In addition it was decided to increase the production capacity of the smelter by more than 50 percent. The expansion is expected to be completed by year-end 1999.

Four medium-sized manufacturing enterprises, a fertiliser plant, a cement plant, a rock wool plant, and a seaweed meal plant use locally available raw materials and produce for export (rock wool, seaweed meal) and the domestic market. Other manufacturing enterprises are generally small in scale and are largely based on imported raw materials and components. The products of these industries include fishing gear, packaging for exports, building components, machinery, equipment repair and maintenance, soap and related chemical products, plastics, ceramics, food products, beer, liquor, soft drinks, paint and furniture.

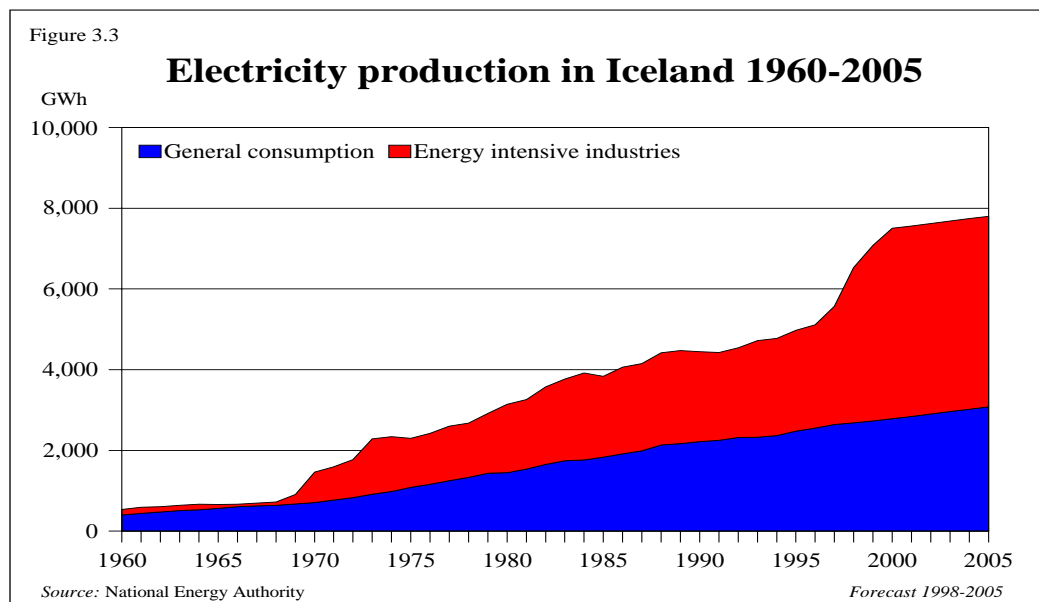
Geothermal steam has been used successfully in a diatomite plant in northern Iceland. The plant is owned and operated by *Kísiliðjan Ltd*, a company owned jointly by the Icelandic government and *Celite Inc.* of the United States. Geothermal steam will also be of significant use in a proposed 50,000 tons/year magnesium plant to be located in the Reykjanes area around 50 kilometres from Reykjavik. In 1998 an Australian company became a shareholder in the Icelandic Magnesium Corporation. The Australian company is developing a new production process for magnesium metal.

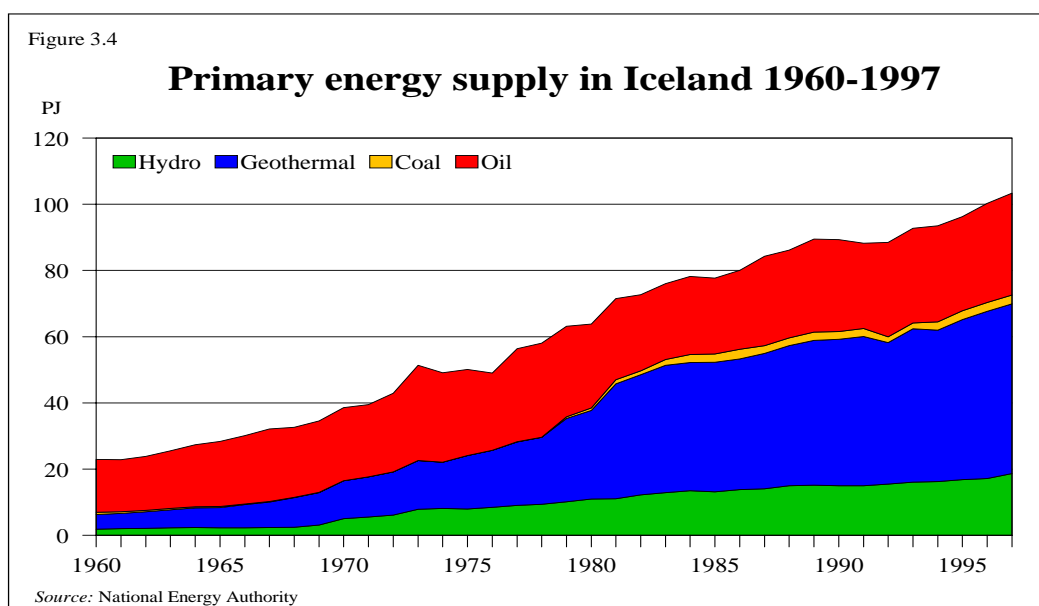
In recent years, there has been a brisk growth of various high-technology industries such as pharmaceuticals and the production of heavy equipment and electronic appliances for fishing and fish processing. Activities that require high skill labour have also been growing rapidly such as the software industry and biotechnology.

### Agriculture

Approximately one-fifth of the total land area of Iceland is suitable for fodder production and the raising of livestock. About 6 percent of this area are under cultivation, with the remainder devoted to raising livestock or left undeveloped. At the given market conditions, Iceland is self-sufficient in meat, dairy products and eggs. The principal crops are hay and potatoes. Some fruits, vegetables and flowers are cultivated in greenhouses heated with geothermal water and steam. A fur industry has developed and knitted clothing made of Icelandic wool is a popular export item. Agriculture contributed an estimated 2.1 percent to GDP in 1997.

The agricultural sector has undergone some structural changes in recent years as demand for traditional products, especially lamb and mutton, has declined substantially but consumption of pork and poultry has risen. Price supports and export subsidies for the traditional products have been abolished and replaced with direct income payments to the farmers. In the agricultural fiscal year from October 1997 to October 1998, these direct payments are estimated to amount to 42 percent of the farmers' costs in raising lamb and to 40 percent of the costs in milk production. High tariffs and seasonal quotas limit imports of meat, dairy products and certain vegetables but imports are likely to increase as tariffs go down in line with the WTO agreement on trade in agricultural products.





## Energy

Iceland has extensive hydro and geothermal resources. Electric power potential from hydro and geothermal sources is estimated to be at 50,000 GWh per annum, taking economic and environmental considerations into account. As a comparison, in 1997, the use of electricity in Iceland was approximately 5,581 GWh per year meaning that less than 15 percent of the power potential, as estimated by the National Energy Authority, has been harnessed.

All towns and villages and virtually all farms are connected to the public power utilities. In 1997 total consumption of electricity amounted to 20,490 kWh per capita, which is close to the highest per capita electricity consumption in the world. All the largest hydroelectric power plants as well as the inter-regional power lines are owned and operated by the National Power Company, *Landsvirkjun*, which is the prime supplier of electricity in Iceland. The State owns 50 percent of the company, the City of Reykjavik owns 45 percent and the Township of Akureyri owns 5 percent of the company.

Hot water from geothermal sources and natural steam is extensively used for residential heating and cultivation in greenhouses. Approximately 85 percent of all households are heated with geothermal energy. In industry, geothermal heat is mainly used for the drying of seaweed and for the production of diatomite and salt.

Almost all of the electricity consumed is produced from indigenous energy resources, hydro and geothermal energy. Oil is only used to meet peak demand and as a reserve resource. Imported oil is used mainly in transportation, for the fishing and commercial fleets and the industrial production of fish meal and fish oil. In volume terms, oil imports were at a maximum in 1973 but reached a low in 1983. They have since grown with the rise in economic activity. Oil imports (fuels and lubricants) accounted for 7.4 percent of the total value of merchandise imports in 1997, as compared to 19.3 percent in 1979.

## Transport and communications

The domestic transportation network consists of roads, air transportation and coastal shipping. Car ownership is widespread. Iceland had 435 passenger cars per 1,000 inhabitants in 1993 while the United States had 556 and Sweden 404 significantly more passenger cars per capita than Iceland (Source: National Economic Institute).

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 charter airline on international routes outside Iceland. Some foreign airlines operate also routes to Iceland. The domestic market is dominated by two airlines namely Flugfélag Íslands that is owned by Icelandair and Íslandsflug, another private company. Both airlines run routes between several towns and villages around the country.

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.

On the first of January 1998 the Post and Telecom Iceland was divided into two separate entities, Iceland Post and Telecom Iceland. The telephone and telegraph system, operated by Telecom Iceland, is both extensive and modern, with satellite earth stations, optical fibre cables, and an extensive cellular mobile phone system. Iceland Post and Telecom Iceland are limited liability companies owned by the Icelandic State. A new private firm, Tal hf, started to operate in 1998 offering GSM services in competition with Telecom Iceland.

The Public Broadcasting System, Ríkisútvarp, operates two radio channels and one television channel, reaching virtually the whole country. Íslenska útvarpsfélagið is a private company that operates two television channels and two radio channels. In addition, there are several private radio stations and a few local television stations.

### Tourism

The tourism sector has been one of the fastest growing industries in recent years. Foreign visitors in 1997 numbered 202 thousand, compared to 129 thousand in 1987. In 1998 227 thousand foreign visitors are expected. The foreign exchange revenues generated by tourism in 1997 amounted to approximately 12 percent of the total foreign exchange revenues of the economy. Although private firms play a leading role in the expansion of the tourist industry, the state also helps to develop the industry through the State Tourist Board, Ferðamálaráð Íslands, and a special loan fund. Whale watching is an example of a new tourist activity that has been growing rapidly in recent years. Conditions for whale watching in Iceland are among the best in the world.

**Table 3.1. Percentage breakdown of employment by industries 1985 and 1995**

<i>Man-years</i>	1985	1995
Agriculture	6.1	4.5
Fishing	5.0	5.2
Fish processing	8.0	5.9
Manufacturing other than fish processing	14.6	11.3
Construction and energy	10.4	9.0
Trade, restaurants and hotels	15.0	14.8
Communication	6.8	6.8
Finance, insurance and business services	6.8	8.6
Public sector	16.5	19.8
Miscellaneous	10.7	14.0
Total	100.0	100.0

*Source:* National Economic Institute

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**The labour force and labour relations**

In 1995 the total Icelandic labour force was estimated at approximately 130,000 man-years. The overall participation rate has increased considerably in the last decade, primarily due to increased participation of women. In Iceland, approximately 82 percent of the population between the age of 16 and 74 belong to the labour force. Women accounted for 46 percent of the labour force in April 1998. The participation rate for both the elderly and the young is relatively high compared with neighbouring countries. In July 1998 unemployment was 2.5 percent of the labour force, 2,449 females and 1,145 males.

Most Icelandic employees are members of trade unions. The majority of the larger trade unions of private sector employees are affiliated with the Federation of Labour. Most of the trade unions of public sector employees are affiliated either with the Federation of Public Employees or the Federation of University Graduates.

**Social services**

The health-care system is a crucial part of Iceland's extensive system of social protection, which has developed over a period of more than 100 years. The first old-age-pension legislation was passed in 1890, in part to replace poor relief that had been available from local communities for centuries. The first comprehensive social-insurance legislation was enacted in 1936. Following enhancement in recent decades, health and social security represented approximately 44 percent of total government spending in 1997.

All residents of Iceland are covered by public health insurance as provided for in the 1993 Act on Social Security. Approximately 87 percent of total medical billings are paid by the public purse. While hospital treatment is free, patients face co-payments for most ambulatory care as well as for pharmaceuticals. The delivery of care is rather decentralised in local communities participating through a system of municipal health boards, but the role of central government in the planning and co-ordination function is strong. In 1990, primary health care was further centralised, with the central government taking over complete financial responsibility in this domain, but a return of some functions, for example nursing-home care, to the municipalities is currently being contemplated. Ambulatory care is provided in outpatient clinics in major hospitals and by privately practising specialists. Primary health care is mainly provided by a network of some 70 public health centres, supplemented by private general practitioners.

**The financial sector**

Many important structural changes have been implemented in the financial sector in the last decade. Among these are interest rate liberalisation, elimination of automatic access to the Central Bank facilities by the Treasury, liberalisation of foreign exchange regulations and establishment of foreign exchange market. Also the establishment of a stock exchange, the development of secondary markets for public and private bonds. Liberalisation of invisible transactions, long-term capital movements and cross-border financial services, as well as the development of various new financial instruments.

**The environment**

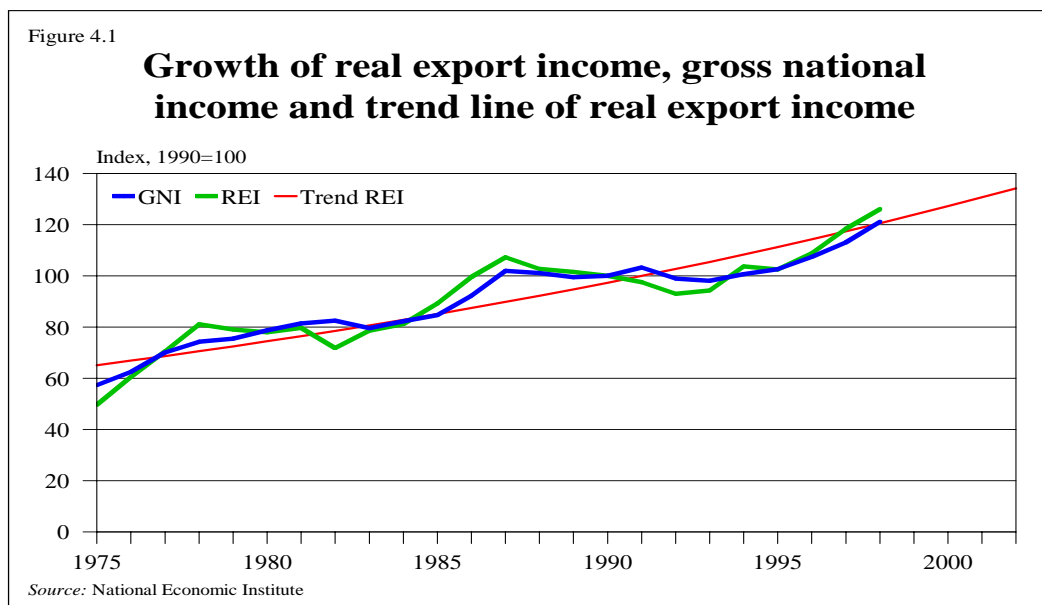
Compared to other industrial countries, Iceland is relatively unpolluted and faces few immediate environmental problems. Electricity and geothermal heating, Iceland's main energy sources, are generated by the use of renewable resources. Utilisation of hydro power, however, requires the building of dams and large reservoirs that can affect the landscape. The acid disposition over Iceland is very small, due to Iceland's geographic location and the limited emissions of pollutants. Soil erosion is still a problem especially in areas used for sheep raising. Considerable work is being carried out to regain badly eroded land. Emission of greenhouse gases from Iceland in the year 2000 are predicted to be 15 percent

higher than in the year 1990. If emissions from new power intensive industries are excluded, emissions in the year 2000 will not exceed the 1990 level. The emission limit set for Iceland in the Kyoto Protocol for the period 2008-2012 is a 10 percent increase from the 1990 levels. The largest emittant is the fishing fleet, then the transport sector and thirdly various industrial processes. The marine environment around Iceland is believed to be relatively unpolluted.

## 4. Foreign Trade

Foreign trade of Iceland is characterised by a relatively high ratio of trade to gross national product, a high ratio of primary exports, concentration in export production, geographical concentration of export markets and limited intra-industry trade<sup>i</sup> and specialisation. These are characteristics that can generally be found in small economies.

The growth of the export sector largely determines the rate of growth of the economy as a whole. Imports and exports of goods and non-factor services averaged 67 percent of GDP during the period 1990 to 1997. Growth of exports averaged 3 percent per annum during this period and imports grew by 2.8 percent while GDP grew by 2 percent. From 1945 to 1997 exports grew by 4.6 percent per annum on the average while GDP grew by 4.0 percent. In figure 4.1 growth of real export income since 1975 is shown.

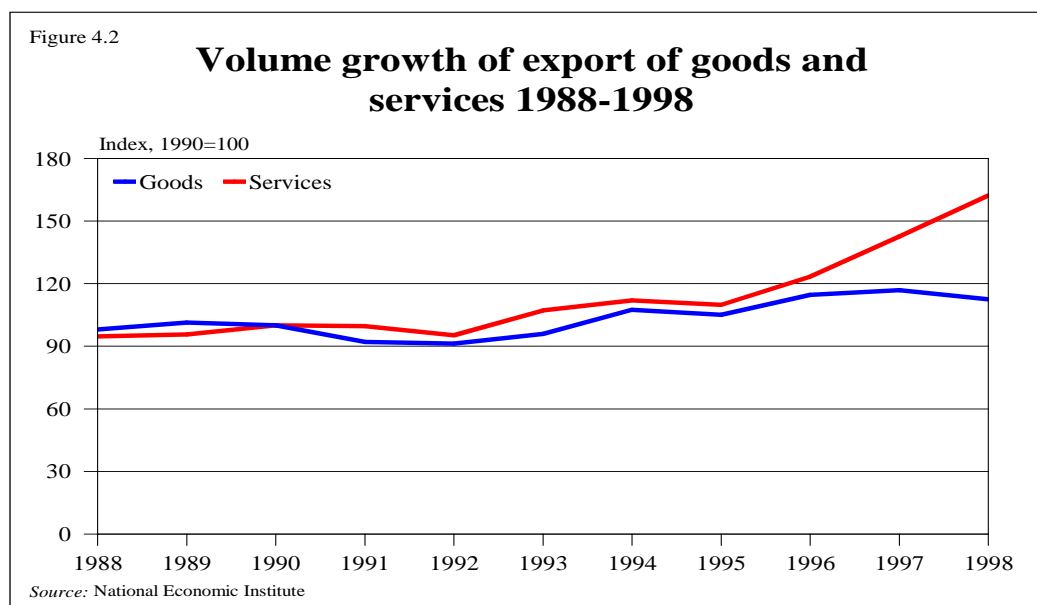


Real export income is here calculated by dividing the index of export income by the index of import prices. Real export income is a proxy for the buying power of exports and reflects in some cases better the development of the export sector than volume indices, especially when the volume of exports is very volatile due to, in the case of Iceland, large swings in fish catch. Average growth of real export income calculated from the trend of growth<sup>ii</sup> has been around 2.7 percent per annum. Periods of stag-

i Simultaneous import and export of similar or close-substitute goods and services

ii The equation of the trend line is  $y = 63.4 * e^{0.027x}$ ,  $r^2 = 0,78$

nation are usually due to reduced fish catches or lower prices of marine products. Marine products constitute roughly 71 percent of Iceland's merchandise exports and about 49 percent of total exports. Manufactured goods make up roughly 22 percent of merchandise exports, the share of aluminium being around half. Production of manufactured goods increased by 14 percent from 1990-1997. The improvement was spread across sectors and was not traced to any particular industry. Promising export products are being developed in fisheries equipment, pharmaceuticals, software and biochemistry.



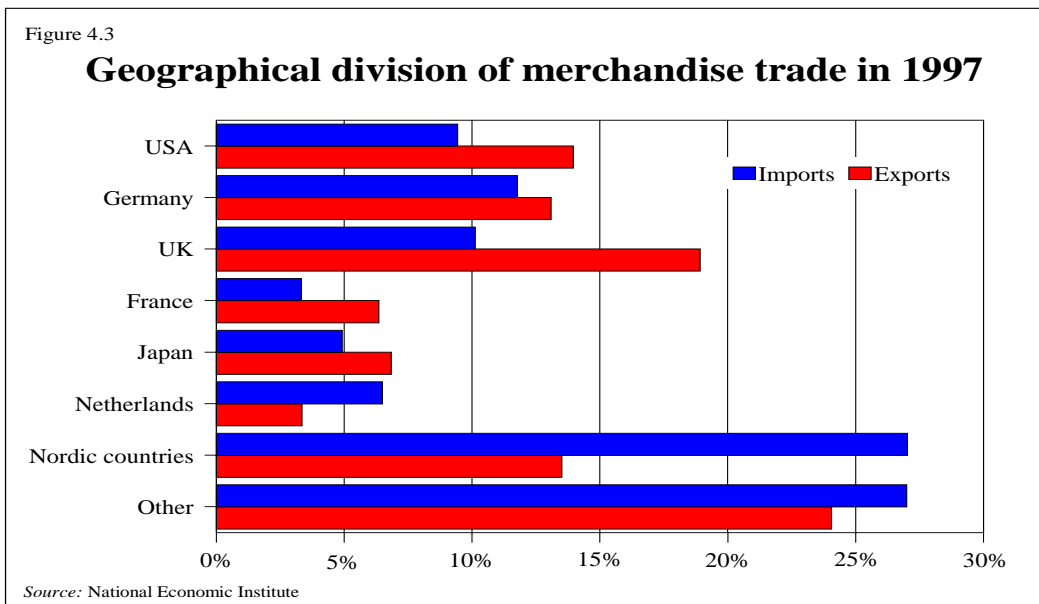
Growth of export in services, especially tourism, has been rapid in the last decade. Growth of services has helped to diversify the export industries and made the economy less vulnerable to supply and demand conditions in the marine industry. Revenues from the export of non-factor services account for roughly 31 percent of Iceland's total export earnings. Service income has risen considerably in recent years, mainly due to a substantial increase in tourism.

Iceland reached a free-trade agreement with the European Union in 1972, under which tariffs on most industrial products were removed. Under the agreement on the European Economic Area (EEA) between EFTA and EU, effective January 1, 1994, Iceland and other EFTA countries generally participate in the free cross border movement of capital, labour, goods, and services within the EEA. Certain provisions are subject to implementing legislation in Iceland and elsewhere. Tariffs on certain agricultural products are still very high but will be gradually lowered in accordance with the WTO agreement on trade in agricultural products. Tariffs and import levies on general imports and cars constitute between 4 and 5 percent of Treasury income.

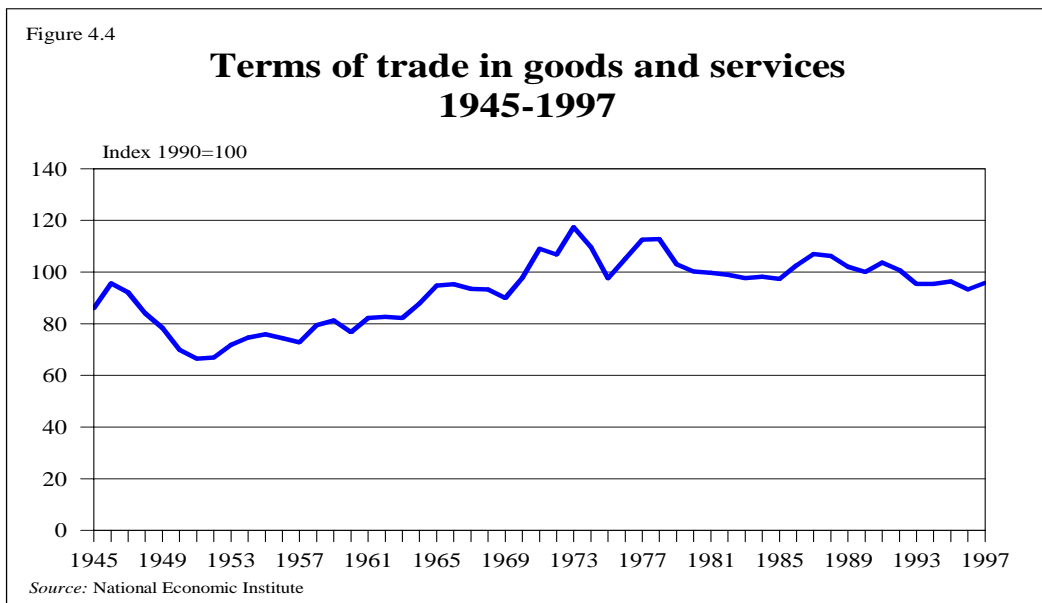
In 1997 two thirds of merchandise exports went to the countries within the European Economic Area and 70 percent of import originate in the EEA. Currently, Iceland's largest trading partners are the United Kingdom, Germany, the United States, and the Nordic countries (Denmark, Finland, Sweden and Norway) as is shown in figure 4.3. Iceland has traditionally had a trade surplus with Japan, UK and the United States, but a large deficit against the other Nordic countries.

In Figure 4.4 changes in terms of trade over a long period are shown. Terms of trade were unsta-





ble when merchandise exports were mostly fish products but in recent years the terms of trade have been relatively stable reflecting more diversification in the export industries, higher value marine production and more stable import prices especially oil prices.



## 5. Monetary and Exchange Rate Policy

The Central Bank is responsible for implementing monetary policy. The main monetary policy objective is price stability. A stable exchange rate is the intermediate target of monetary policy. The instruments used by the Central Bank are its own interest rates (repo rate and overnight rates for deposits and loans) and access to Central Bank financing granted to banks. The Central Bank sets its own interest rates independently but the use of some of its instruments is subject to Government consent, the most important being the reserve requirement. The Central Bank mainly pursues its monetary policy by indirect means through market operations, primarily in the money market and the inter-bank market in foreign exchange.

### **The Central Bank**

The Central Bank of Iceland, Seðlabanki Íslands, was established in 1961. The Board of Directors (consultation) is elected by the Parliament for a term of four years. The Minister of Commerce and Banking appoints the Governors of the Bank. The Central Bank of Iceland performs all traditional central banking functions. Through market operations, the Central Bank conducts monetary policy consistent with the goal of maintaining low inflation. The Bank Inspectorate of the Central Bank supervises financial institutions. On January 1, 1999 the Bank Inspectorate will be merged with the Primary Supervisory Authority to form a new Financial Supervisory Authority. The Central Bank holds and manages the nation's foreign exchange reserves. Moreover, the Central Bank acts as the borrowing agent for the Republic of Iceland in international capital markets.

The Central Bank has decisive influence, subject to Government approval, in the formulation of the exchange rate policy. The present policy specifies a fluctuation band of  $\pm 6$  percent from a central rate. The band is based on an trade weighted index. The exchange rate of the króna is determined in an interbank market. The Central Bank will use its instruments in the interbank market to keep the exchange rate within this range.

The Treasury and several government institutions have bank accounts with the Central Bank, which acts as banker, economic adviser and fiscal agent for the Government. The Treasury had unlimited access to a short-term overdraft facility with the Central Bank until 1992 when an agreement on Central Bank credit accommodation was reached between the Central Bank and the Minister of Finance that terminated this facility, requiring the Treasury to meet all its borrowing needs in the financial market.

The Central Bank conducts active business with commercial and savings banks, being a lender of last resort, a clearing agent for checks as well as a provider of liquidity. The Central Bank imposes a reserve requirement on all commercial and savings banks, at the present amounting to 1.5 or 4.0 percent of total disposable funds, depending on maturity. The Central Bank ceased its operations as a market maker for Treasury bonds and Treasury notes in early 1996 but still acts as a market maker for Treasury bills.

### **Monetary policy**

The Central Bank's main monetary policy objective is price stability. A stable exchange rate has played an important role in reducing inflation in recent years and has thus been an intermediate target of monetary policy.

**Table 5.1. Money supply, 1993 to 1998***Billions of krónur, end of period*

	1993	1994	1995	1996	1997	August 1998
Notes and coins	3.9	4.6	5.2	5.5	5.8	5.6
Demand deposits	27.7	30.3	33.1	36.1	42.6	49.9
Money supply, M1	31.6	35.0	38.3	41.6	48.4	55.6
General savings deposits	98.3	78.8	72.8	71.9	68.3	83.4
Money supply, M2	129.9	113.7	111.1	113.4	116.7	139.0
Time deposits	34.2	54.2	60.6	70.0	82.7	87.4
Money supply, M3	164.1	167.9	171.7	183.4	199.3	226.4
<i>Percentage increase:</i>						
Money supply, M1	5.4	10.7	11.3	8.5	17.4	24.4
Money supply, M3	6.6	2.3	3.7	6.8	9.2	16.3

*Source:* The Central Bank of Iceland.

The Central Bank has gradually developed its monetary instruments. The instruments which are mainly used to implement monetary policy are the Central Bank interest rates, money market operations, intervention in the foreign exchange market, Central Bank credit facilities for financial institutions and reserve requirements. Financial institutions are free to decide all their interest rates, with the exception that the Central Bank decides penalty interest rates on overdue payments.

The Treasury regularly sells Treasury bills, Treasury notes and Government savings bonds at auctions. The Treasury started auctioning T-bills in 1992, but prior to that the Treasury only sold bills on tap at a price decided by the Ministry of Finance. In addition, it had unlimited access to a short-term overdraft facility with the Central Bank. Consequently, the Central Bank had a rather limited ability to influence short-term interest rates of commercial banks and savings banks. Following the 1992 agreement on Central Bank credit accommodation between the Government and the Central Bank, the Treasury meets all its borrowing needs in the financial market. As a result of this agreement, a significant money market has developed in only few years, the largest financial market in Iceland in terms of turnover.

In first half of 1998 the Central Bank of Iceland has made significant changes to its monetary policy instruments, modeled after the decisions taken for the European Central Bank. The reform of monetary policy instruments was not intended to have impact on the monetary policy framework. The operating variable of the Central Bank will continue to be short-term interest rates with the repo rate as the main signal variable.

The main objective of the reform in the instruments of monetary policy was twofold: First, to level the playing field of credit institutions in the domestic market and their access to the Central Bank facilities, and second, to create operating conditions for domestic credit institutions similar to those prevailing in the European Economic Area.

Other aims were also kept in mind, such as to simplify the instruments, to enhance the Central Bank discretion in carrying out monetary policy and to stimulate the development of the money market, not least the interbank market and the secondary market for government securities.

The coverage and availability of the Central Bank instruments and facilities was largely confined to deposit money banks. Since the 1980s the institutional landscape in the financial markets has developed rapidly with the emergence of new financial institutions. One of the motivations behind the change in instruments was to ensure uniformity of treatment of different institutions and financial instruments. In March 1998 the following changes were implemented:

1. The secondary liquidity requirement (liquidity ratio) was replaced with weekly auctions of such agreements. The maturity of repos was extended from 10 to 14 days. Collateral for repos was extended from treasury bills and Central Bank CDs to all state guaranteed securities registered on the Iceland Stock Exchange as well as Central Bank CDs
2. The tap-sale of 45 day Central Bank CDs was abolished but the Central Bank reserved the option to auction 14 days CDs on the weekly auction when it wishes to reduce liquidity. CDs of 90-day maturity will continue to be available on tap
3. An overnight facility was established in the Central Bank for credit institutions, which are subject to reserve requirements. Overnight loans will have to be collateralised with securities eligible for repurchase agreement

The second phase of the changes became effective in May 1998 when the following changes were implemented:

1. The new rules for reserve requirements became effective
2. The discount quota was abolished
3. Foreign currency deposit accounts of credit institutions in the Central Bank were closed.

An important change was the expansion of the reserve base, both in term of coverage of institutions and types of liabilities. To compensate for the expansion of the base, the reserve requirement ratio for longer-term liabilities was lowered. This left the reserve requirement of the deposit taking institutions, already subject to reserve requirements, more or less unchanged. The remuneration of required reserves was also changed from indexed terms to nominal interest rates, leaving the expected nominal yield unchanged. This is in line with the official policy of reducing the scope of indexation in the financial system.

The new rules on required reserves provide for the possibility that one institution can fulfil the reserve requirements on behalf of another or other institutions. This is a new feature and it was partly designed with the system of saving banks in mind. Other changes made to the monetary instrument were intended to simplify the structure, increase central bank discretion and stimulate the development of the interbank market in krónur.

With the establishment of the overnight credit facility the Central Bank has effectively created a corridor for money market rates setting an upper limit to their movements. The interest rate paid on current accounts of credit institutions provides the lower limit. The main changes as regards the repurchase facility are twofold. First the tap availability of repurchase contracts was discontinued, and second, the eligible collaterals were expanded to include all government registered securities on the Iceland Stock Exchange. This imposes a significant widening of the eligible collateral as only treasury bills had been eligible previously. The tap availability was replaced by regular weekly auctions where the Central Bank announces beforehand whether the auctions will be repurchase or reverse repurchases auctions. The Bank can vary the auction form between a volume tender to fixed price auctions, the latter however being the rule.

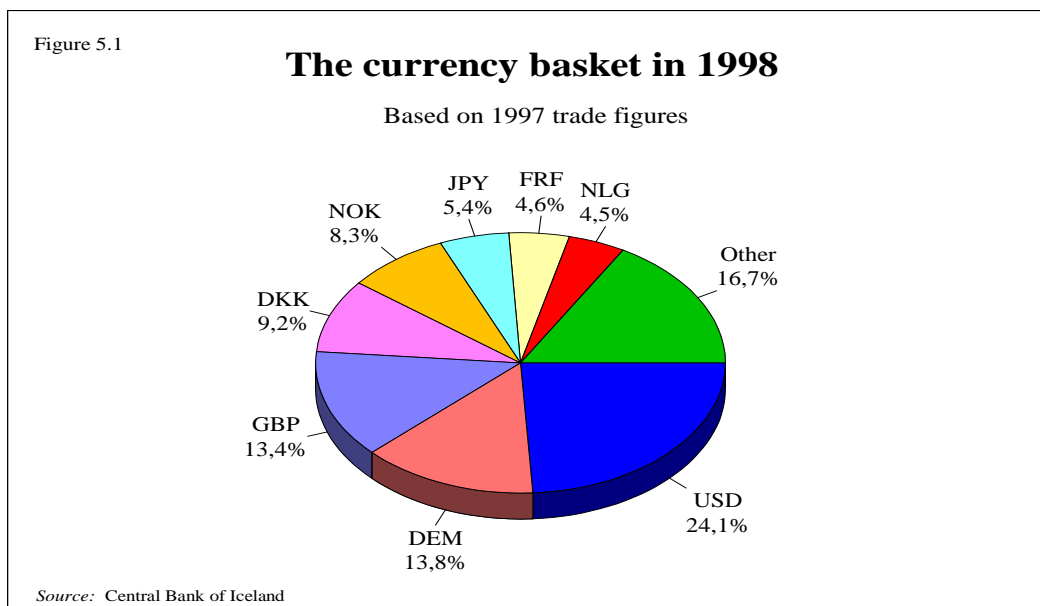
This new agreement will enhance Central Bank discretion and stimulate interbank market activity. The older arrangement made the Central Bank the hub for intermediation of short-term funds between credit institutions. With the repo window open only once a week the credit institutions are encouraged to enter the interbank market to take-up or place short funds.

The changes made to the Central Bank instruments in March put increased pressure on interbank market reform and led to the issuance by the Central Bank of new rules for the interbank market. These became effective in early June and eight institutions are now active members in this market, four com-

mercial banks, two investment banks and two savings banks. According to the new rules members must quote indicative interest rates for interbank loans and deposits for different maturities. On demand from another market participant, binding quotes must be given for minimum amounts for a specified maturity. The Central Bank calculates between 11.15 and 11.30 a.m. each day the average of the quotation of the market participants for the different maturities and displays them publicly on the Reuters information system. The interbank rates are called REIBOR and REIBID. The trading volume in the interbank market started to rise following the change in monetary policy instruments in March but after the new arrangement became effective, trading volume increased dramatically.

### Foreign exchange

A stable exchange rate is the intermediate target of the Central Bank's monetary policy. The market forces have direct influence on the determination of the exchange rate in the interbank market for foreign exchange, but the Central Bank is equipped to intervene in that market through market operations to affect the daily exchange rate of the króna. Since July 1997 the Central Bank has ceased its role as a market maker in the interbank foreign exchange market and six credit institutions are now market makers for the króna in this market.



The currency basket, shown in figure 5.1 is composed of 16 currencies, weighted in terms of the respective country's share in trade of goods and services. The basket is revised once a year based on the composition of the previous year's trade. The fluctuation band of the króna is plus/minus 6%.

The Central Bank follows a policy of maintaining foreign exchange reserves that as a minimum amount to the equivalent of three months' worth of merchandise imports. Iceland presently has a quota of Special Drawing Rights (SDR) 85.3 million in the International Monetary Fund. Since 1962, the Central Bank has been a party to an agreement between the Nordic central banks which consists of an exchange of credit lines, allowing each of the banks to draw on the others on a short-term basis in times of temporary foreign reserve shortage. According to the current agreement the Central Bank of Iceland

can draw up to ECU 200 million. In addition, the Central Bank has access to committed interbank lines for a total amount of US\$275 million and uncommitted interbank lines with a number of international banks.

**Table 5.2. Foreign exchange reserves of the Central Bank**

*Millions of krónur, end of period*

	1995	1996	1997	July 1998
Gross reserves	20,239	30,806	27,805	30,273
Gold	168	183	187	187
SDR	1	10	1	22
IMF reserve position	1,014	1,004	1,018	993
Deposits and securities	19,054	29,609	26,599	29,070
Conversion rate: Krónur per US\$	65.14	66.71	71.98	71.28

*Source:* The Central Bank of Iceland

### **Capital movements**

Rules and regulations governing inward and outward capital transactions in Iceland have been gradually liberalised. The final step in the liberalisation of external capital movements was taken on January 1, 1995, when all restrictions on short-term capital movements were abolished. The regime on external capital movements in Iceland is now in full accord with the EEA agreement and the regime in EU countries. Foreign exchange conversions for current payments are unrestricted since a new Act on Foreign Exchange and the Regulation on Foreign Exchange became effective on January 1, 1993. Payments in connection with trade in goods and services are also fully liberalised, including travel expenses, interest payments, dividends and other forms of income from capital.

Direct investments and purchases of residence abroad by Icelanders are fully liberalised. However, there are still restrictions on direct investments by foreigners in three sectors; fishing and fish processing, the energy sector, and aviation:

1. Direct investments by non-residents in fishing and fish processing is prohibited, indirect investment is limited to a maximum of 33 percent.
2. Investment in energy production and energy distribution in Iceland is allowed to residents and companies residing inside the EEA. Residents and companies residing outside the EEA can apply for such rights, by having such investment contracts approved by the parliament.
3. Investments by residents outside the EEA in aviation companies are restricted to 49 percent.

Foreign borrowing by the Treasury and government institutions requires authorisation by the Parliament. These authorisations are listed in the annual budget approved by the Parliament. In addition, there is a standing authorisation to refinance outstanding public debt.

## 6. Financial Markets

Over the last decade the Icelandic financial system has undergone an important transition, generated by liberalisation and legislative reforms. The current Central Bank Act was adopted in 1986 and at the same time the final phase in the deregulation of interest rates was completed. In the mid-eighties the Iceland Stock Exchange was established, securities companies emerged and the first mutual funds were established. Towards the end of the decade a process of rationalisation in the banking sector took place through mergers. A new Foreign Exchange Act entered into force in November 1992, implementing a policy of a phased elimination of foreign exchange restrictions by the beginning of 1995. The BIS standard for rules on capital adequacy of commercial and saving banks became effective in the beginning of 1993. In connection with the agreement on the European Economic Area (EEA) a new legislation was enacted in 1993 based on EU financial directives. This includes acts on commercial and savings banks, other credit institutions, securities transactions, mutual funds and the Iceland Stock Exchange. The impact of this legislation has been twofold. First, stricter rules have been adopted to ensure the economic health of banks and other financial institutions, including rules on a minimum capital ratio and exposure to risk. Bank supervision, currently in the hands of the Bank Inspectorate of the Central Bank, has been extended and strengthened at the same time. Second, the new legislation is an important anchor for the deregulation process such as the abolition of centralised control over interest rates in 1986 and the liberalisation of capital movements.

### Credit institutions

There are four commercial banks in Iceland, two are state-owned corporations, *Landsbanki Íslands* and *Búnaðarbanki Íslands*, one is a private limited liability company, *Íslandsbanki*, and one, Icebank, is owned by the savings banks. Three of the four commercial banks perform all the traditional banking operations, accept deposits, grant credit, deal in foreign currencies and maintain accounts with correspondent banks abroad. The two state-owned banks were turned into limited liability companies as of the beginning of 1998. Initially the state will be the sole owner, but the Minister of Commerce is authorised to sell new equity up to 35 percent of the current equity position. A public offering of 15 percent of new equity in *Landsbanki Íslands* came to market in September 1998. The Government has announced its intention to seek parliamentary approval for a full privatisation of the bank in 1999. The Icebank functions on behalf of the 29 savings banks as their banking institution. The savings banks are generally private institutions with local operations and they perform most traditional banking operations. In addition to commercial and savings banks there are two other types of deposit receiving institutions, namely the savings departments of the co-operatives and the Post Giro.

A new incorporated investment bank FBA, *Fjárfestingabanki atvinnulífsins*, has been in operation since the beginning of 1998. The legislation on FBA permits an immediate sale of up to 49 per cent of the government's shares in the investment bank, but further sales require parliamentary approval. A new State Housing Fund will be established in the beginning of 1999. The new fund is based on legislation approved by the Parliament in June 1998, which is aimed at rationalising the existing state housing fund system. The Regional Development Institute, *Byggðastofnun*, will remain a state-owned institution. There are three leasing companies operating. Recently, the leasing companies have diversified their activities to some extent by granting loans in addition to making conventional leasing contracts.

### The securities market

The securities market has expanded gradually. Since 1964 the Government has issued indexed Government bonds, and in the 1980s a secondary market for these bonds began to develop. In recent years, there has been an increase in the variety and volume of financial instruments that the government, municipalities and financial institutions have offered on the market. The bond market has continued to develop, and money and equity markets have been growing rapidly. Two milestones in the development of the bond market have been the introduction of the housing bond system in 1989, with tradeable securities, and Government securities auctions, which were established in 1992, where Treasury bills, Treasury notes and Government savings bonds have been offered in regular weekly auctions. In 1985, marketable bonds and money market instruments were equivalent to 6 percent of GDP, but at the end of 1997 they amounted to 56 percent of GDP.

The extensive practice of indexation of financial obligations in Iceland has been one of the main characteristics of the domestic financial market. Indexation was brought into the financial market during period when Iceland suffered a high rate of inflation. The two-tier system of indexed and non-indexed obligations has tended to cause nominal interest rates to change in accordance with inflationary trends rather than as a reflection of changes in credit supply and demand. As price stability has taken firm hold, indexation is receding from the short end of the financial market, and the current policy is to eliminate indexation from new instruments with a maturity under seven years by the year 2000.

**Table 6.1. Selected marketable securities**

*Millions of krónur, end of year*

	1994	1995	1996	1997	June 1997	June 1998
Treasury bills	14,630	15,459	16,803	18,222	19,624	13,554
Bank bills	1,682	4,028	8,106	10,600	12,711	11,307
Treasury bonds	72,474	77,959	77,360	77,341	86,498	91,537
Treasury notes	5,550	6,577	10,349	10,589	12,668	18,242
Bank bonds	20,655	20,067	24,062	24,067	25,231	36,548
Housing bonds	64,739	77,637	92,052	92,863	98,468	116,802
State housing fund bonds	7,738	7,603	13,013	14,542	16,276	21,485
Bonds issued by other inv. credit funds	11,941	17,497	17,235	17,536	17,526	20,506
bonds issued by leasing companies	6,106	4,866	6,963	6,963	7,514	8,111
Mutual funds units (open-end)	16,289	14,517	20,533	20,496	24,532	46,136
Shares (market capitalisation)	33,335	49,695	94,802	99,227	150,225	170,432

*Source:* The Central Bank of Iceland

The Iceland Stock Exchange was established in 1985 and now operates under new legislation adopted in 1998. The new act requires the Icelandic Stock Exchange to be converted into a limited liability company, abolishes its monopoly on exchange activities but at the same time gives it increased room to grow and offer new services. Currently there are twenty members of the Exchange, including the Central Bank, all the commercial banks and securities houses and some savings banks. Among securities listed on the exchange are the stocks of around 70 companies, government bonds, notes and bills and various private bond issues, primarily by credit institutions. Listing on the Exchange is subject to listing requirements set by the Exchange, including disclosure requirements. Turnover on the exchange has risen rapidly in recent years. At the end of 1997, the market capitalisation of listed secu-



rities was 350 billion krónur equivalent to 67 percent of GDP. Of this sum 240 billion krónur were bonds, 93 billion krónur equities, and 17 billion krónur money market instruments.

In 1992, the largest brokers started operating a non-regulated over-the-counter (OTC) market for non-listed shares, and the Stock Exchange allowed its members to utilise the Exchange's trading system for the trading in this market.

### **Institutional investors**

Currently there are 65 pension funds in Iceland. Their number has decreased in recent years due to mergers. The pension funds receive payments from employers and employees and are the most important source of long-term finance in the country. The pension funds have traditionally invested in bonds issued by the Treasury, other financial institutions, municipalities and companies. They also extend credit to members. About 20% of their assets are in Icelandic and foreign equity and in mutual funds. In recent years the pension funds have started to invest in foreign securities.

In 1985 mutual funds were first established in Iceland. There are now eleven closed-end mutual funds in operation. They are limited liability companies, and nine of them are quoted on the Iceland Stock Exchange. There are eight open-end mutual funds that are operated in 32 divisions. One credit institution, Kaupping, also operates mutual funds quoted on the Luxembourg Stock Exchange.

There are now 15 insurance companies licensed to operate in Iceland. Three of them are life-insurance companies, representing only 4.5 percent of total assets of the companies. One reason for the relatively small share of life insurance can probably be traced to the employees' compulsory membership in pension funds. About half of the insurance companies' portfolio consists of marketable securities, which make them fairly sizeable investors in the Icelandic securities market. In addition, 126 foreign insurance companies have licenses to provide services in Iceland, of which two have established branches.

### **Supervision and regulations**

As mentioned before the Bank Inspectorate and the Insurance Supervisory Authority will be merged into a separate entity, the Financial Supervisory Authority at the beginning of 1999. The new institution will answer directly to the Minister of Commerce. The Central Bank had a supervisory role in monitoring the activities of commercial and savings banks, leasing companies, securities firms and mutual funds (open-end) and all other credit institutions. Furthermore the Central Bank has been responsible for supervising the Icelandic Stock Exchange, securities firms, mutual funds (open-end), the housing bond department of the state housing institution and pension funds. Thus the Bank's field of supervision covered the whole range of financial institutions except insurance companies, closed-end mutual funds and the state owned Building Fund. These functions have been vested in the Bank Inspectorate, a department within the Central Bank. The main task of the Bank Inspectorate has been to ensure that the activities of the above institutions and firms are conducted in accordance with the relevant laws and regulations, and they remain sound in other respects. These institutions and firms are obligated to provide all the information considered necessary by the Bank Inspectorate. The operations of insurance companies, however, have been subject to supervision by the Insurance Supervisory Authority.

In connection with Iceland's participation in the European Economic Area the Icelandic legislation and regulations regarding credit institutions and other financial institutions have been adapted to the various regulations and directives of the European Union. The current rules on capital adequacy for credit institutions and securities firms are based on the Basel guidelines and the EU capital adequacy directive, with a minimum capital ratio of 8 percent. According to rules that the Central Bank has imposed, commercial and savings banks are limited in their foreign exchange exposure to 30 percent of equity as defined by the CAD rules. The same is true for indexed assets and liabilities.

There are deposit insurance schemes in force, one for the commercial banks and another for the savings banks. In recent years the commercial and savings banks have contributed 0.15 percent of their deposits annually to these funds. The present law stipulates that the insurance fund of the commercial banks is a government entity while insurance funds of the savings banks are private institutions of which all savings banks are members.

## 7. Public Finance and Foreign Debt

A primary goal of policy makers has been to cut down government expenditures to eliminate the fiscal deficit. The fiscal deficits and public debt in Iceland have been well below the OECD average and Iceland has fully met the Maastricht criteria for general government finances since 1995. The financial balance of general government was in a slight surplus in 1997 and that performance is expected to be repeated in 1998. On December 31, 1997, Iceland's total Treasury debt amounted to an estimated 239 billion krónur. Of the total debt, 112 billion krónur was domestic debt and 127 billion krónur was external debt. On December 31 1997, Iceland had guaranteed a total amount of 255 billion krónur of external debt. Since 1993 the country's net foreign debt has declined from 54 percent of GDP down to 45 percent in 1997.

### Public expenditures and government

The Icelandic Constitution requires the authorisation of the Parliament, *Alþingi*, for all central government expenditures, taxation and borrowing. The budget proposal is presented to the Parliament at the beginning of each regular session in early October. The fiscal year coincides with the calendar year. The central government's accounts are subject to audits and control by the General Auditor's Office, *Ríkisendurskoðun*, which is an independent entity under the Parliament.

A fundamental change was made to the presentation of the budget and the central government accounts in the beginning of 1998. The main change is that both the budget and the accounts are on an accruals basis whereas the budget was previously on a cash basis. This means that all claims and commitments of the Treasury incurred during the year are entered simultaneously as expenditure even if they do not come up for payment until later. Presenting the Budget on an accruals basis allows monitoring of total activity and assessment of long term effects in a more concise manner. This includes items such as commitments for central government employees' pensions and accumulated interest payments on government securities.

In the 1998 Treasury budget, the total projected revenues amounted to 165.8 billion krónur, while the total expenditures were estimated to amount to 165.7 billion krónur, resulting in a Treasury surplus of approximately 0.1 billion krónur on accruals basis. A revised forecast indicates that revenue in 1998 will be 174.9 billion krónur and expenditure 177.7 billion, resulting in a negative balance of 2.8 billion. Treasury finances on a cash basis have improved sharply in the course of this year, reflecting on one hand the revenue impact of the stronger than expected economic upswing. The Treasury's net financial transactions reflect the impact of Treasury finances on the economy within the year and clearly show the favourable impact of Treasury finances upon the economy in recent months. The budget anticipated a net debt repayment of 5 billion krónur, mainly because of the expected sale of 49% of the shares in the Icelandic Investment Bank. A revised forecast indicates that net debt repayment will be considerably higher, 14.7 billion krónur by the end of the year.

The 1999 budget bill is presented to the *Alþing* at the beginning of October. The *Alþing* will pass the budget before Christmas. The revenue surplus on an accruals basis amounts to 1.9 billion krónur, 0.3 per cent of GDP. The net debt repayment is expected to be 15 billion krónur, 2.5 per cent of GDP, about the same as in 1998, thus exerting a strong offsetting impact upon the expansion in economic activity.

Both direct taxes on income as well as indirect taxes on expenditure are rising in concert with expanding economic activity, whereas restraint is exercised on the expenditure side. Total revenue is forecast to rise by just over 6 billion krónur from the estimate for 1998 to the budget figure forecast for 1999. Taxes on income and profit are expected to increase by 2 billion to 42 billion in 1999. The personal income tax is estimated to yield 32.2 billion despite a reduction of 1 percentage point in the central government tax rate to 26.4%. The personal withholding tax, including the share of municipalities, will thus have been reduced from 42% in 1996 to 38% in 1999. Furthermore, the personal contributions to pension funds that may be deducted from income before tax will rise from 4% of income by an additional 2 percentage points. The corporate income tax is expected to yield 7 billion krónur in 1999, an amount similar to the estimate for 1998. Social security taxes are expected to rise by some 550 million krónur or 3.4% to 16.5 billion. The payroll tax, intended to meet the needs of the general social security scheme, is expected to increase by about 1 billion, but this is being offset by a lower contribution to the Unemployment Insurance Fund due to less unemployment. Wealth taxes are estimated to yield about 300 m. kr. over the 1998 for a total of 8.4 billion krónur in 1999. Taxes on goods and services constitute the largest category of government revenue and are estimated to yield a total of close to 97 billion krónur in 1999. The value added tax is the single most important tax on goods and services and is estimated to yield 61.5 billion krónur, 1.8 billion more than this year. This estimate is based on the forecast of the National Economic Institute of changes in prices and general turnover. Private consumption is estimated to increase by 5% and general imports are thought to remain broadly unchanged from this year, following an increase of about one-quarter in 1998.

Sales of government assets are estimated to yield 2.4 billion krónur in 1999, slightly less than this year. Most of the sales proceeds are expected from sales of shares in the Iceland Investment Bank and Iceland Prime Contractors. The proceeds from sales of assets recorded as revenue constitute sales profits over book value. The proceeds from the book value part are recorded as below-the-line capital transactions. Overall proceeds from sales of assets are estimated at 6-7 billion krónur in 1999.

The expenditure budget for 1999 stands at 179 billion krónur, an increase of 1.5 billion on the 1998 estimate and 13.5 billion over the 1998 budget. Excluding pension liabilities, there is an increase of 5.5 billion or 3.3%. On a cash basis, expenditure is projected at 165 billion. The difference between the accruals and cash figure is mostly explained by three factors: Unfunded pension liabilities for government employees amount to 7.2 billion, accrued but unpaid interest to 4 billion and tax claims that must be written off to close to 4 billion.

Several expenditure areas receive increased emphasis in the budget. Health expenditures are estimated to increase by close to 4% in real terms from the 1998 estimate. Research and development expenditures will increase by 520 m.kr. of which 320 m.kr. will go to projects improving information technology. About 260 m.kr. will be spent on preparing for events associated with the year 2000. These are primarily two: the celebration of thousand years since the adoption of Christianity in Iceland and a commemoration of the discovery of America by Leifur Eiríksson in the year 1000. Appropriations for higher vocational and university education are being increased as well as facilities for the handicapped. Police and law enforcement is strengthened. An agreement has been reached on the fiscal support of the church, where the state church will receive full control over its finances in return for receiving a set amount over the fiscal budget. Expenditures on current operations and social transfers increase by about 2 per cent from the 1998 estimate, whereas outlays for interest payments, maintenance and investments will decline by about 1 per cent.

In 1997, the central government derived on accruals basis approximately 50 percent of its total tax revenue from indirect taxes, mainly the 24.5 percent value added tax, tariffs and excise taxes. Excise taxes were levied on a range of goods at two rates until December 31, 1993 and are levied at six rates since January 1, 1994, due to the implementation of the EEA agreement. The custom duty is in the

range of 0-30 percent, but most imports from EFTA and EC countries are exempted from the duty. With the implementation of the EEA agreement as of January 1, 1994, all custom duties on industrial goods, imported from countries that have implemented the EEA agreement, have been abolished. Ownership of motor vehicles and accessories is subject to taxation. There is a stamp duty on larger financial transactions as well as on most bank transactions. Revenue is also derived from a government alcohol and tobacco monopoly.

Direct taxes to the central government consist of personal and corporate income taxes and a net wealth tax. The personal income tax is collected through a pay-as-you-earn (PAYE) scheme. The level of personal income tax stands at 39.88 percent and has been reduced gradually from 41.98 percent in 1997. Corporate income tax was reduced from 45 percent to 39 percent in 1993 and was further reduced to 33 percent in 1994. Other business taxation has been adjusted to the framework applied in the European Union, and the municipal turnover tax on corporations was abolished in 1993.

The functional distribution of central government expenditure is typical as compared to other industrial countries. The largest category of central government expenditure, amounting in 1997 to approximately 44 percent of total expenditures, covers welfare, including social security, pensions, health, and public housing. The second largest category includes education, culture and the church, amounting to approximately 15 percent of the total expenditure in 1997. Expenditure on communications, including public road investment, amounts to approximately 7 percent of total spending in 1997.

In the area of public investment, the policy is laid out in the fiscal and credit budgets, which are presented to and approved by the Parliament. The credit budget authorises domestic and foreign borrowing by the central government and public enterprises. The domestic borrowing of the government has been mostly in the form of indexed savings bonds, which have been issued every year since 1964. Treasury bills and Treasury notes with a maturity of one to two years have in recent years become important instruments in domestic borrowing.

Iceland is divided into 129 municipalities, of which 31 are classified as towns. The number of municipalities has decreased in recent years due to mergers. The finances of central and local government are interrelated in many ways. To a certain extent, the same tax base is used for direct taxation by both authorities. Furthermore, many public services and investment projects are jointly financed. The major source of local government revenue is a personal income tax at a rate of up to 11.99 percent, accounting for about 50 percent of total revenue. An additional important source of revenue is a real estate tax. The coverage of the various social services is by far the largest expenditure category of local government.

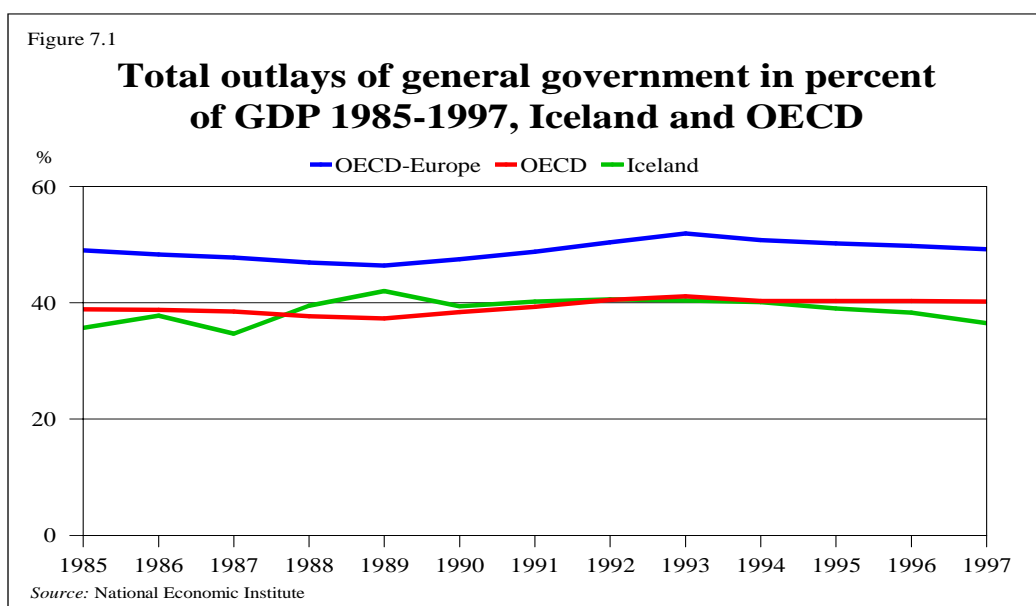
General government finances, local and central government combined, are estimated to show a surplus of 3 billion krónur in 1998 or 0.6 percent of GDP and is forecast to be in surplus of 0.9 percent of GDP in 1999. The total public sector net borrowing requirement is put at 2 billion krónur in 1999.

### **Treasury foreign debt**

The Republic of Iceland is the largest and most active Icelandic borrower in international markets. The National Power Company, *Landsvirkjun*, and the commercial banks are also active in this area.

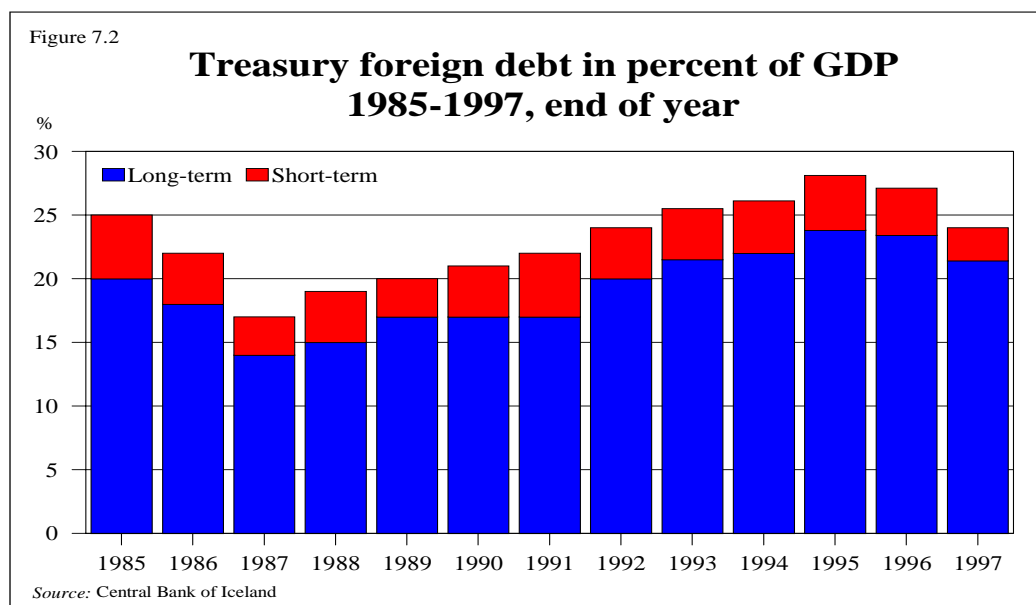
The Republic of Iceland has generally followed a policy of borrowing at long maturities. The maturity profile of Iceland's public external debt extends to the year 2016. At the end of 1997, the foreign debt of the Treasury amounted to 127 billion krónur, of which long-term debt was 113 billion krónur, and the amount of Euro-Commercial Paper outstanding was 14 billion krónur.

At the end of 1997 approximately 32.7 percent of foreign debt was in US dollars, 10.1 percent in Japanese yen and 57.2 percent in various European currencies. At this time 63 percent of the foreign debt carried fixed interest rates when 71 percent if short-term debt is included. Average lifetime of for-



eign long-term debt was 4.5 years with a duration of 3.3 years. The average lifetime of foreign debt including short-term funding was 4 years with a duration of 3 years.

The U.S. dollar has long been a very important currency for Icelandic borrowers, although the share of the dollar in the total external debt of the economy has diminished in recent years. This decline in the dollar component is a result of diminishing dollar denominated foreign trade in the Icelandic economy.



**Table 7.1. Currency composition of Treasury debt**In percent of total, *at the end of period*

	1994	1995	1996	1997	August 1998
US dollar	40.4	38.4	33.6	32.7	27.3
Japanese yen	14.7	13.6	10.7	10.1	10.1
European currencies	44.9	48.0	55.7	57.2	57.3
Deutsche mark	19.4	17.7	29.8	29.9	33.2
Pound sterling	12.2	10.2	11.2	12.3	13.6
Swiss franc	8.9	11.1	9.4	9.7	10.5
French franc	0.6	0.6	0.5	0.5	0.0
Dutch guilder	0.1	0.0	0.0	0.0	0.0
ECU	3.7	8.4	4.8	4.8	5.3

*Source:* The Central Bank of Iceland

The change in trade patterns affects the currency structure of the Treasury external debt, since the currency mix of the Republic of Iceland debt portfolio is determined with a broad reference to trade patterns. Management of the Treasury's foreign debt involves establishing a favourable composition of the debt, inter alia with respect to interest rates, maturity and currency composition. In recent years, prepayment options have been used to refinance debt at more favourable terms. In addition, interest rate and currency swaps, along with other financial products, have been used to achieve the objectives of debt management.

In 1985, Iceland set up an Euro-Commercial Paper Programme, the first sovereign ECP Programme to be established. Over the past decade the ECP Programme has provided the Republic of Iceland with a flexible source of funds at attractive terms. The size of the programme has been increased gradually from US\$ 50 million in 1985 to US\$ 500 million in 1995. The programme has been assigned the highest possible short-term ratings of A-1+ by Standard & Poor's and P-1 by Moody's.

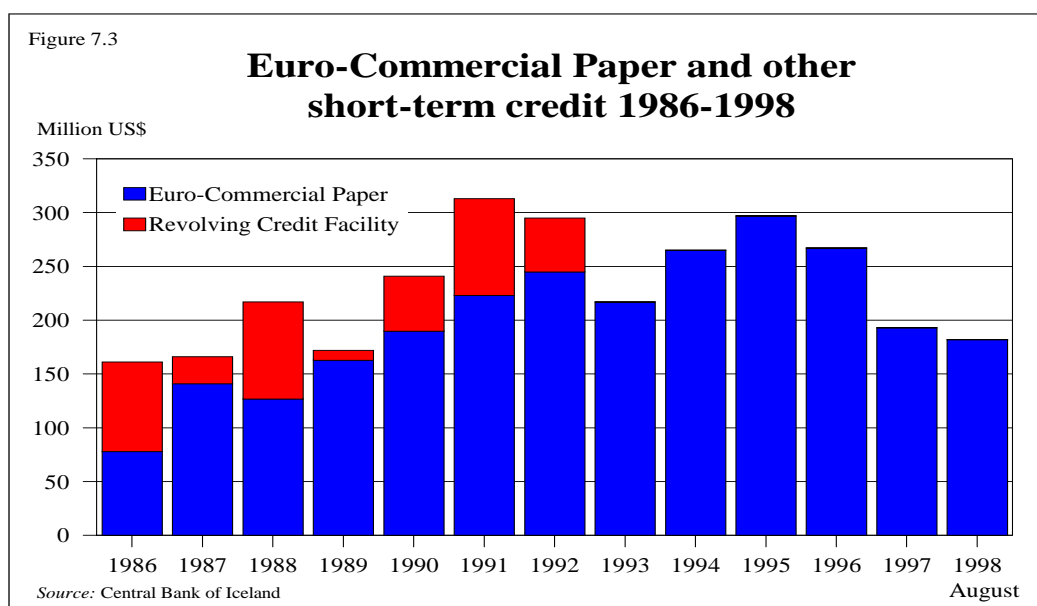
In 1990, the Parliament enacted legislation to provide for the establishment of a National Debt Management Agency (NDMA). The NDMA commenced operations in June 1990. Under this legislation, borrowing and debt management functions of the Treasury, both domestic and foreign, and government guarantees have been assigned to the NDMA. However, under a special agreement the Central Bank is responsible for the execution of foreign borrowing for the Treasury.

### **National debt**

Reported figures in the coverage of Icelandic foreign debt statistics include private as well as public debt, amounting to the total external debt of the economy. At the end of 1997, the net external debt of the Icelandic government, financial institutions and the private sector amounted to the equivalent of \$3,340 million, or 45.6 percent of GDP. The ratio peaked at 58 percent at the end of 1993 but has been falling since. The fluctuations in the debt ratio do not only reflect changes in the volume of debt but also the volatility of exchange rates.

Debt service amounted to 19.0 percent of total export revenue in 1986. The debt service ratio fell to 16.1 percent in 1987, but rose again to 20.0 percent in 1990 and to 34.6 percent in 1994. The debt service ratio declined again in 1996 and 1997, down to the current level of 23 percent of GDP.

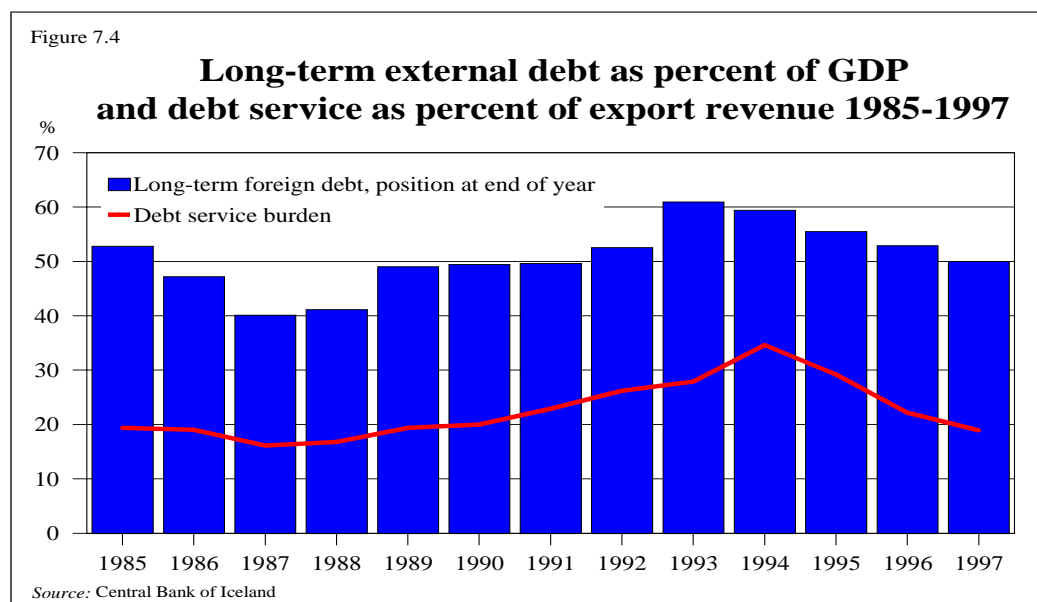
The Republic of Iceland has always paid when due the full amount required in respect of principal, interest and sinking fund installments of all internal and external obligations.



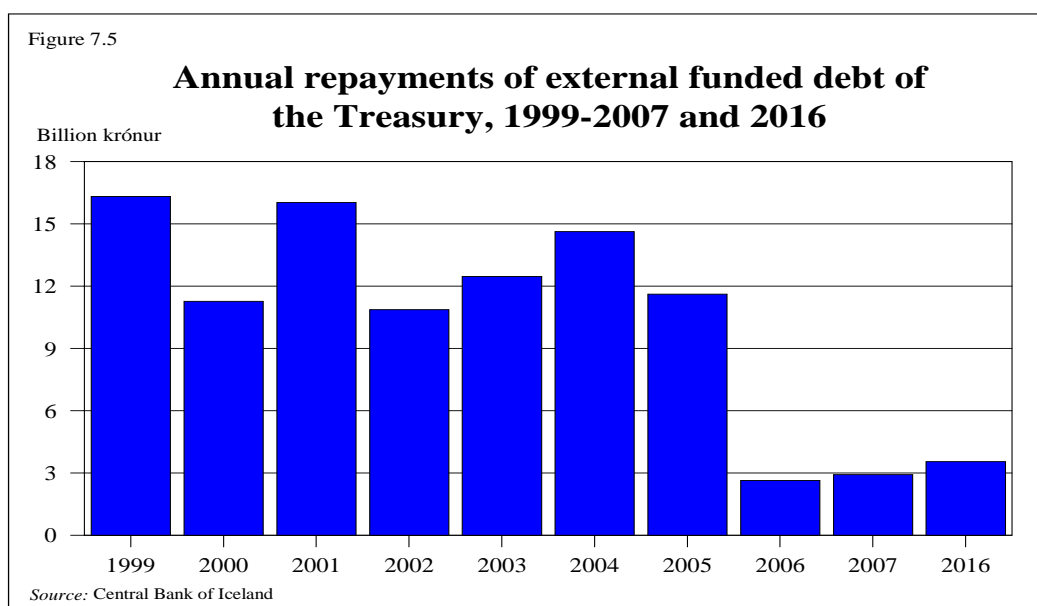
#### Credit ratings

In 1996 both Moody's and Standard & Poor's upgraded Iceland's credit ratings to reflect the country's increased creditworthiness. A further upgrade was announced in July 1997 when Moody's upgraded the Republic's foreign currency rating to Aa3 and assigned Aaa rating to the Republic's long-term krónur bonds. The current Republic of Iceland credit ratings are shown in table .

In its press release announcing the rating upgrade Moody's made a reference to increased diversi-







fication in the Icelandic economy as a consequence of an influx new foreign investment projects that take account of the country's clear comparative advantages such as abundant renewable geothermal and hydro energy and environmentally friendly tourism. Further, the improved ratings reflect the widespread restructuring and stabilisation of the Icelandic economy in the past years coupled with strong economic growth, low inflation, declining debt service and falling debt ratios.

In March 1996, Standard & Poor's announced 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 June 1998 Standard and Poor's announced that it had placed a positive outlook on Iceland's long term foreign currency debt.

**Table 7.2. 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+	--

## Appendix

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

	Year of Association
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 Cooperation 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 Cooperation in Europe (CSCE)	1975
Western European Union (WEU)	1992
European Economic Area (EEA)	1994
World Trade Organization (WTO)	1995

**Table A2. Balance of payments**

Millions of krónur, Preliminary figures	1995	1996	1997	January - June	
				1997	1998
<b>Current Account</b>	<b>3,717</b>	<b>-8,892</b>	<b>-8,125</b>	<b>-3,313</b>	<b>-23,981</b>
Balance on Goods	13,356	1,201	254	3,486	-15,963
Merchandise exports f.o.b.	116,607	125,69	131,213	65,339	64,683
Marine products	83,873	92,582	93,648	47,759	47,868
Aluminium and ferro-silicon	15,514	15,917	18,906	8,576	10,782
Miscellaneous	17,220	17,191	18,659	9,004	6,033
Merchandise imports f.o.b.	-103,251	-124,489	-130,959	-61,853	-80,646
Special imports	-34,83	-46,281	-50,718	-24,643	-36,109
General imports	-68,421	-78,208	-80,241	-37,210	-44,537
Balance on Services	3,169	1,219	3,237	29	-1,528
Exports of services, total	44,643	50,457	59,010	25,470	30,044
Transportation	17,340	22,479	25,732	11,295	14,206
Travel	12,004	11,722	12,316	4,178	4,876
Other receipts	15,299	16,256	20,962	9,997	10,962
Imports of services, total	-41,474	-49,238	-55,773	-25,441	-31,572
Transportation	-13,371	-17,213	-18,016	-9,067	-13,164
Travel	-18,194	-20,472	-22,893	-9,482	-11,847
Other expenditures	-9,909	-11,553	-14,864	-6,892	-6,561
Balance on Income	-12,502	-10,848	-11,779	-7,023	-5,859
Receipts	5,755	7,501	8,129	3,477	4,531
Compensation of employees	3,260	4,242	4,128	1,916	2,428
Investment income	2,495	3,259	4,001	1,561	2,103
Expenditures	-18,257	-18,349	-19,908	-10,500	-10,390
Compensation of employees	-365	-306	-391	-140	-134
Investment income	-17,892	-18,043	-19,517	-10,360	-10,256
Current transfer, net	-306	-464	163	195	-631
<b>Capital and Financial Account</b>	<b>1,551</b>	<b>7,726</b>	<b>13,309</b>	<b>3,107</b>	<b>23,171</b>
Capital transfer, net	-286	-32	14	56	-161
Financial Account	1,837	7,758	13,295	3,051	23,332
Financial Account excl. Reserves	2,083	17,920	10,111	6,234	28,990
Direct investment, net	-811	-244	7,112	1,980	3,489
Abroad	-1,653	-4,337	-1,834	-654	-523
In Iceland	842	4,093	8,946	2,634	4,012
Portfolio investment, net	-3,737	-1,828	-12,818	-3,720	-7,527
Assets	-3,179	-2,139	-14,360	-4,795	-7,573
Liabilities	-558	311	1,542	1,075	46
Other capital, net	6,631	19,992	15,817	7,974	33,028
Assets	473	-3,549	-7,559	-751	6,265
Monetary authorities	-1,073	-83	-66	-21	0
General government	0	0	0	0	0
Deposit banks	2,982	-2,649	-6,016	702	2,220
Other sectors	-1,436	-817	-1,477	-1,432	4,045
Liabilities <sup>1</sup>	6,158	23,541	23,376	8,725	26,763
Monetary authorities	2,365	-6,578	-27	-19	21
General government	14,784	7,072	-3,301	-2,334	-4,006
Deposit banks	-3,491	21,156	21,723	13,714	13,988
Other sectors	-7,500	1,891	4,981	-2,636	16,760
Reserve assets	-246	-10,162	3,184	-3,183	-5,658
Net errors and omissions	-5,268	1,166	-5,184	206	810
<sup>1</sup> Memorandum items:					
Long-term borrowing, net	-3,290	13,754	13,294	3,808	11,186
Foreign borrowing	28,535	40,110	37,242	19,239	18,131
Amortisation	-31,825	-26,356	-23,948	-15,431	-6,945
Short-term borrowing, net	9,448	9,787	10,082	4,917	15,577
Exchange rate: ISK per US\$	64.67	66.52	70.78	70.10	71.87

Source: The Central Bank of Iceland

**Table A3. Imports by economic category<sup>1</sup>**

	1994	1995	1996	1997
<i>Millions of krónur, cif</i>				
Food and beverages	10,342	11,665	12,692	12,849
Primary, mainly for industry	1,181	2,72	2,67	2,478
Primary, mainly for household consumption	1,619	1,629	1,805	1,925
Processed, mainly for industry	1,128	1,08	1,212	1,051
Processed, mainly for household consumption	5,784	6,236	7,007	7,395
Industrial supplies not elsewhere specified	28,161	32,557	36,593	37,593
Primary	1,515	1,688	1,973	2,079
Processed	26,646	30,87	34,975	35,514
Fuels and lubricants	8,366	8,032	10,454	10,712
Primary	389	374	392	353
Petrol, including aircraft fuel	1,761	1,571	2,085	2,035
Other	6,216	6,086	7,978	8,324
Capital goods, parts and accessories	20,358	23,44	29,906	34,778
Capital goods (except transport equipment)	12,602	15,046	20,183	22,317
Parts and accessories	7,756	8,394	9,723	12,461
Transport equipment	12,491	13,882	19,38	19,435
Passenger motor cars	3,639	4,978	7,095	9,06
Industrial	1,597	1,533	2,105	2,733
Non-industrial	213	260	323	309
Parts and accessories	2,799	3,193	3,4	4,072
Ships	4,068	3,042	6,35	3,102
Aircraft	176	876	107	160
Consumer goods not elsewhere specified	22,413	23,783	26,227	27,623
Durable	4,643	4,955	5,917	6,3
Semi-durable	8,968	9,542	10,234	10,745
Non-durable	8,802	9,286	10,077	10,578
Goods not elsewhere specified	410	255	386	237
Total imports of goods <i>cif</i>	102,541	113,614	135,994	143,227

<sup>1</sup> Based on current exchange rates

Source: Statistics Iceland

**Table A4. Exports by commodity groups<sup>1</sup>**

	1994	1995	1996	1997
<i>Millions of krónur, fob</i>				
Marine products	84,837	83,873	92,582	93,648
White fish	56,866	53,341	54,505	55,522
Frozen	35,599	32,663	30,944	31,055
On ice	7,788	6,823	6,851	7,460
Salted	12,138	12,835	14,914	14,850
Stockfish	779	669	694	1,003
Meal	330	92	785	840
Oil	273	259	318	314
Herring and capelin	10,447	10,488	18,228	17,751
Frozen	3,509	3,364	5,586	4,123
Salted	833	778	1,054	760
Meal	4,425	4,697	8,034	8,578
Oil	1,680	1,649	3,553	4,290
Lobster, shrimp, scallop	14,138	16,579	17,258	16,899
Other	3,386	3,465	2,591	3,475
Agricultural products	2,133	2,055	2,550	2,105
Meat	251	169	469	229
Dairy products	0	1	12	0
Salmon & trout (fish-farming)	728	810	712	661
Other	1,154	1,076	1,356	1,216
Manufacturing products	21,040	25,000	25,039	28,757
Aluminium	10,833	12,303	12,104	15,197
Ferro-silicon	2,689	3,212	3,813	3,709
Diatomite	541	637	596	572
Tanned skins and hides	837	977	1,193	1,2
Woollen products	408	355	357	382
Canned products	1,850	1,886	1,567	1,919
Other	3,882	5,631	5,408	5,778
Miscellaneous	4,645	5,679	5,52	6,704
Total merchandise exports	112,654	116,607	125,69	131,213

<sup>1</sup> Based on current exchange rates

Source: Statistics Iceland

**Table A5. Geographic distribution of foreign trade***Percentages of total values*

	Exports			Imports		
	1995	1996	1997	1995	1996	1997
EFTA	11.4	15.0	13.8	5.5	5.7	8.6
Norway	10.2	13.5	11.5	3.3	3.7	5.6
Switzerland	1.2	1.5	2.2	2.2	2.0	3.0
EU	59.8	56.4	58.1	62.7	62.1	60.6
Austria <sup>1</sup>	0.6	0.6	0.6	0.1	0.1	0.1
Belgium	2.0	1.9	2.0	1.8	1.2	1.1
United Kingdom	9.6	10.2	10.1	19.3	19.0	18.9
Denmark	9.4	8.4	8.6	7.8	7.2	5.7
Finland <sup>1</sup>	1.8	1.6	1.6	0.5	1.0	1.1
France	4.2	3.3	3.3	6.8	6.7	6.3
Greece	0.1	0.1	0.1	0.8	0.7	0.6
Netherlands	6.8	6.0	6.5	3.0	3.6	3.3
Ireland	1.0	1.0	1.2	0.2	0.1	0.2
Italy	3.3	3.2	3.2	2.0	1.9	1.8
Luxembourg	0.0	0.1	0.1	0.0	0.1	0.2
Portugal	0.9	0.7	0.7	1.8	2.6	2.6
Spain	1.6	1.7	1.6	3.7	3.9	4.4
Sweden <sup>1</sup>	7.0	6.7	6.7	1.3	1.3	1.1
Germany	11.4	10.9	11.8	13.7	12.8	13.1
EEA <sup>2</sup>	70.0	69.9	69.6	66.0	65.8	66.1
Other Europe	5.6	5.8	4.8	2.4	2.2	4.3
Russia	2.3	2.5	2.5	0.6	1.0	1.8
Other	3.3	3.3	2.3	1.8	1.2	2.5
North America	9.4	10.4	10.5	14.0	13.3	15.2
United States	8.4	9.4	9.4	12.3	12.1	13.9
Canada	1.0	0.9	1.0	1.7	1.2	1.2
Japan	4.4	4.0	4.9	11.3	9.8	6.6
Other countries	9.5	8.4	7.9	4.1	6.9	4.7
Total	100	100	100	100	100	100

1. Joined the European Union at the beginning of 1995

2. The EU and the EFTA countries except Switzerland

*Source:* Statistics Iceland

**Table A6. Projected external debt service<sup>1</sup>***Billions of krónur*<sup>2</sup>

	1998	1999	2000	2001	2002	2003	Principal thereafter	Total
<b>Public authorities</b>								
Principal	14.3	28.4	15.7	31.8	17.1	17.2	45.7	181.4
Interest <sup>3</sup>	10.0	9.2	7.7	6.0	5.1	3.8		
Total	24.2	37.6	23.4	37.8	22.2	21.0		
<b>Financial institutions</b>								
Principal	8.7	6.9	13.1	9.7	2.0	5.7	8.4	59.3
Interest <sup>3</sup>	2.3	1.9	1.5	1.1	0.7	0.6		
Total	11.0	8.8	14.6	10.7	2.7	6.2		
<b>Private sector</b>								
Principal	1.8	1.7	2.1	2.0	1.8	1.5	4.7	17.1
Interest <sup>3</sup>	0.8	0.7	0.7	0.5	0.4	0.3		
Total	2.6	2.4	2.7	2.5	2.3	1.8		
<b>Total payments</b>								
Principal	24.8	37.0	30.8	43.5	20.9	24.4	58.8	252.4
Interest <sup>3</sup>	13.1	11.8	9.9	7.6	6.2	4.7		
Total	37.8	48.8	40.7	51.1	27.1	29.1		

1 Based on debt outstanding at the end of 1996

2 Exchange rates at the end of 1996

3 US dollar Libor is assumed at 5.5 percent per year

Source: The Central Bank of Iceland