REPORT ON THE CONSULTATION UNDER
ARTICLE XII:4(b) WITH ICELAND

1. In accordance with its terms of reference, the Committee has conducted a consultation with Iceland under Article XII:4(b). The Committee noted that the previous consultation with Iceland under the same provisions had been held in March 1970 (BOP/R/38 and BOP/102). In conducting the present consultation the Committee had before it: (a) a basic document supplied by the Government of Iceland (BOP/116); (b) a Decision taken by the IMF Executive Board on 22 January 1971 concerning Iceland (Spec(71)42); and (c) a paper containing background material, dated 30 December 1970, supplied by the Fund.

2. The Committee generally followed the plan for such consultations recommended by the CONTRACTING PARTIES (see L/3388). The consultation took place on 15 June 1971. The present report summarizes the main points of the discussion.

Consultation with the International Monetary Fund

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

"The Fund invites the attention of the CONTRACTING PARTIES to the Executive Board Decision of 22 January 1971 taken at the conclusion of its most recent Article XIV consultation with Iceland, and particularly to paragraphs 2 to 5 which read as follows:

2. 'Gross national income, which declined in real terms by some 14 per cent in the two years 1967-68, increased by 3 per cent in 1969 and by an estimated 11.5 per cent in 1970. The recovery was brought about by a rise in the volume of exports of goods and services and by a sharp increase in export prices. Imports continued to decline in 1969 but increased strongly in 1970. Official reserves rose considerably in 1969 and the rise has continued so far in 1970."
3. The rise in exports was followed by wage agreements in mid-1970 involving substantial increases in basic wage rates and in the automatic cost of living adjustments. The cost of living index rose by nearly 22 per cent in 1969, and by about 10 per cent in the first seven months of 1970. Wage rates increased by 15 per cent in 1969 and by about 30 per cent in the year ended September 1, 1970. In order to halt this price-wage spiral, the Parliament in November 1970 adopted several measures, including a temporary price stop and an increase in consumer subsidies and family allowances to be covered mostly by revenue-increasing and expenditure-saving measures. In the present conditions, the Fund believes that this action is appropriate and timely. The Fund welcomes the establishment of the Price Equalization Fund for the Fishing Industry as a new instrument of demand management and hopes that it will be effective in moderating fluctuations in disposable income.

4. The growth of domestic demand during 1970, further stimulated by the wage agreements, is expected to continue in 1971. The Fund welcomes the adoption of a policy of monetary restraint and hopes that the Central Bank will extend its agreement with the banks concerning the moderation of the credit expansion. The Fund believes that the present incomes and monetary policies need to be supported by the fiscal restraint reflected in the proposed budget surplus for 1971. A combination of such policies would, in the view of the Fund, help to sustain the favorable external balance and lead to a higher degree of price and cost stability, which is required for a diversification of the economy.

5. The Fund notes that Iceland has terminated one of its four bilateral payments agreements with nonmembers and reduced its reliance on import restrictions as well as the remaining restrictions on current payments and urges Iceland, in light of the comfortable balance of payments position, to increase its efforts in this regard.

Opening statement by the representative of Iceland:

4. The representative of Iceland made the following opening statement:

"At the last consultation with this Committee a year ago it was forecast that the gross national product would rise by some 4 per cent in volume in 1970. This forecast turned out to be too cautious. The gross national product is estimated to have increased by 6 per cent last year. The terms of trade improved significantly as the export prices of fishery products rose by some 21 per cent from the previous year while import prices rose much less, perhaps 4-5 per cent. As a consequence of this, the gross national income rose in volume by no less than 10½ per cent in 1970. The favourable development in 1970 confirmed the basic recovery achieved in 1969 from the setback of 1967 and 1968. The drastic decline of gross national product and gross national income in those adverse years has almost been offset through 1969 and 1970. The basic factor underlying the economic expansion in 1969/1970 has been the increase in white fish catches. The white fish
catch in 1970 was some 5-6 per cent higher than in 1969. The volume of fisheries production increased by 5½ per cent in 1970, whereas its value increased by some 28 per cent, as prices rose by 21 per cent. Agricultural production remained stagnant. Manufacturing industry (other than fish processing) increased its production significantly, by some 13 per cent in volume, excluding the new activities in production of aluminium and diatomite which contributed not less than 1 per cent to the total rise of 6 per cent in gross national product, as they had their first whole-year full-capacity production in 1970. Turning from production to expenditure, private consumption increased by some 13 per cent in volume, fixed investment by 8 per cent, public consumption increased by 4½ per cent, and total national expenditure increased in real terms by 10½ per cent, or by the same percentage as gross national income. A great improvement of the balance of payments took place in 1969 and this favourable development continued up to mid-year in 1970, but in the second half of the year the impact of rising imports halted the rise in exchange reserves. For the year as a whole the balance of payments on current account showed a surplus of $7.9 million. The foreign reserve position improved by $13.6 million, including sdr's, $2.5 million.

"The favourable annual balance-of-payments figures for 1970 conceal important changes that took place during the year. Almost the whole of the improvement of the foreign reserve position occurred in the first half of the year. With the general wage agreement reached in the middle of the year, which provides for an average 18 per cent rise in rates, domestic demand caught up with and overtook the growth in output. Imports rose substantially faster in the second half of 1970 than in the first half, and export production of fishery products actually declined in volume, but this was offset by rising export prices.

"The prospects for the white fisheries were generally thought to be good before the start of the winter season in January. Since the year-classes of cod now coming into maturity were believed to be exceptionally large. These hopes, however, were frustrated, since the white fish catch in the first four months of 1971 was some 24 per cent lower than in 1970.

"The volume of fisheries production was down by some 17 to 19 per cent in the first four months of the year. This drop in value has however, been more than offset so far by the continued strength of export prices, particularly prices for frozen fish on all markets and for salted fish. In the last few weeks there has, however, been a marked fall in the prices of fish meal and oil. With reasonable optimism about the May-December catches - and May probably was a favourable month - the fall in fishery production for the year as a whole can be forecast at 5 to 8 per cent in volume. The average rise in export prices could be some 15 to 20 per cent, so there ought to be a considerable increase in value terms.

"The market for aluminium exports has so far been weak in 1971, but an improvement is expected in the second half of the year. The production of aluminium will increase by some 14-15 per cent in 1971. Other manufacturing production is also growing at a high rate and the building trades are booming. Agriculture will probably show an increase in production for the first time in five years, since weather conditions have been unusually favourable so far this year. On the whole an increase in gross national product of some 7-8 per cent can be expected in 1971, with gross national income rising even more."
Consumer expenditure is forecast to rise by at least 12½ per cent in volume, public current expenditure by some 6½ per cent and fixed investment by at least 18 per cent, giving rise to about 14 per cent increase in the volume of national expenditure. Unemployment, which had decreased from 2.5 per cent in 1969 to 1.3 per cent in 1970, has almost completely vanished in 1971.

The strong rise in expenditure at the same time as a decline in export production has had an unfavourable effect on the balance of payments. The balance of payments on current account probably showed a deficit some some 35.5 million in the first quarter compared with a surplus of 22 million in the same period of 1970. This has, however, been more than offset by capital inflow. The foreign reserve position improved over the first three months by some 5.5 million compared with an improvement of 15.5 million in the first quarter of 1970, (in both these figures 2.5 million of sdr's are included).

During the first four months of 1971 the crude balance of trade (exports f.o.b. less imports c.i.f.) was very unfavourable compared with the same period in 1970. There was a sharp increase in imports at a time when exports actually decreased. The deterioration in the crude balance of trade was some 14.5 million.

In addition to the decline in fishery production, three main factors contribute to this: (a) exports of aluminium fell by 40 per cent in value, mostly corresponding to stock build-up, (b) imports for extraordinary large projects increased considerably, (c) "general" imports have risen by 30 per cent.

For the year as a whole a current account deficit of considerable proportions seems to be in store. This will, however, probably be more than offset by inflow of capital, so the foreign reserve position is not likely to deteriorate.

The Icelandic authorities are currently operating a price freeze which was introduced on 1 November 1970 and is to end on 31 August 1971. It followed a round of particularly high wage agreements in the summer of 1970, averaging about 18 per cent. These increases cover the period up to the autumn of 1971. There have been subsequent agreements covering the remainder of the labour force. In October 1970 merchant navy officers were given a salary increase of 35 per cent and public officials were given increases of between 35 and 40 per cent, a third of which was effective from the second half of 1970 and the total rise payable in three stages, the whole increase to be effective from 1 July 1972. Finally, at the beginning of the year, an increase of 25 per cent was agreed for raw fish prices for the processing industry, which implies a rise in fishermen's incomes of a similar order.

The impact of the large wage increases on profits has been unfavourable for manufacturers catering for the domestic market under the restraint of the price freeze. Fishery exporters' margins have not been squeezed. As wages in general are not due for a rise until the autumn of 1971, profit margins may well improve again during the year. A new raw fish price settlement came, however, into effect from 1 June, providing for a rise of 10 per cent in the most important raw fish prices.
This was justified on the grounds that frozen and salted fish prices are now considerably higher than believed at the beginning of the year. In spite of these rises in raw fish prices it will be possible to build up a substantial export price equalization fund for the fisheries in 1971 as well as in 1970, which was the first operative year for this innovation in economic policy in Iceland.

"Elections to the Althing were held on 13 June and the major wage agreements are up for renegotiations in the autumn of 1971. The policies to prevail after the price-freeze period will thus be open for revision and fresh initiatives."

**Balance-of-payments position and prospects**

5. Members of the Committee expressed gratification over the substantial improvement of Iceland's balance of payments and the considerable increase in the country's foreign exchange reserves in the past two years. They also expressed appreciation for the progressive liberalization of Icelandic imports since 1960, in particular for the measures taken in March 1970 as well as the reduction of the revenue duties on imports. In their view, while the remaining quantitative restrictions were not extensive, they nevertheless still significantly affected access to the Icelandic market for certain products of export interest to certain contracting parties. They expressed the hope that Iceland would take advantage of its present comfortable balance-of-payments position to accelerate the process of liberalizing its imports. The representative of Iceland, in reply, recalled the progress that had been made by his Government in trade liberalization and especially the fact that in spite of the serious difficulties faced at that time, it had avoided recourse to an intensification of import restrictions in 1967-68. In fact restrictions on all industrial products, with only one or two exceptions, would be removed by the beginning of 1975. The general level of tariffs, despite reductions made, was relatively high, but he was confident that it would remain this Government's policy to continue the lowering of tariffs.

6. A member of the Committee, while welcoming the very useful information that had been made available by Iceland on the general trends and prospects for her balance of payments, wished to know whether more detailed and more specific quantitative estimates of the various items of the balance of payments for the current year could also be supplied. In reply, the representative of Iceland stated that he did not have available such estimates. There could be little doubt, however, that the trade and current accounts for the forthcoming half-year period would be less favourable than those for the corresponding months in 1970. It might be noted that imports in the first months of 1971 had been substantially higher than in the corresponding period in 1970, when shipments were deferred in anticipation of the pending tariff reductions arising from Iceland's membership in EFTA.
Alternative measures to restore equilibrium

7. Some members of the Committee referred to the success that had been achieved by the Icelandic authorities in redressing the internal and external disequilibrium after the severe recession and payments deficits of 1967-68 and expressed the view that continued vigilance would appear to be in order, having regard to the special nature of the Icelandic economy which relied on an extremely limited range of products for export earnings and which had proved to be susceptible to sharp, cyclical fluctuations. They therefore particularly welcomed the creation of the new Price Equalization Fund for the Fishing Industry at the beginning of 1970. In their view, having regard to the overwhelming importance of the fishing industry in the economy, this was an important new instrument for the management of domestic demand. In clarification of the information given on the Price Equalization Fund, the representative of Iceland stated that the concept was to support the Fund by raising a levy on the difference between the raw fish price and the actual export price. The Fund’s coverage had been extended from the previous system under the Catch Equalization Fund, and it was hoped that its operations would contribute significantly to lessening the impact on the economy of the often pronounced fluctuations in prices of exported fish products.

8. Members of the Committee observed that the improvement in the balance of payments in the past two years was in part attributable to the various corrective measures that the Government of Iceland had applied in recent years. They congratulated the Icelandic Government for the courageous policies they had formulated and for the resolute manner in which they had been pursued. They referred in particular to certain recent measures of this nature, e.g. the price freeze and related price stabilization measures adopted in November 1970, and enquired whether their effects had already been felt and what additional measures were envisaged.

9. A member of the Committee thought that the price-wage spiral should be regarded as a fundamental problem which would have to be effectively dealt with before economic growth could be pursued on a sound basis, and asked whether the price-freeze measure was likely to be continued beyond 1 September 1971. With reference to the recommendation of the IMF that the present incomes and monetary policies of Iceland needed to be supplemented by the fiscal restraint reflected in the proposed budget surplus for 1971, the member asked whether any contingency measures had been devised to ensure the realization of this surplus in the face of rapidly expanding expenditures.

10. In the course of discussion of these questions, the representative of Iceland recalled the enormous difficulties faced by his country in the years immediately preceding the recent upswing; in 1967-68, export prices had fallen by 15 per cent, fishery exports had declined by 30 per cent, and commodity export earnings had dropped by one half. The circumstances had forced two devaluations which brought down the external value of the currency by 51 per cent. They had brought about serious hardships in the country and raised unemployment to levels unseen at any time since the great depression of the 1930’s. It might safely be said that no country at a comparable stage of economic development had faced difficulties and hardships of this magnitude and the various monetary and fiscal measures that were considered necessary had equally been exceptionally severe. The subsequent recovery had fortunately been more rapid than had been expected, but it had also
been accompanied by inflationary pressures. Since under the present full-employment conditions, wage claims were difficult to resist by employers, the stabilization of prices had to be achieved by direct Government action; the present price freeze would certainly be maintained until next September. While a budget surplus was undoubtedly desirable in present circumstances, how this could be achieved would depend on the basic policies of the Government, and not much could therefore be said on this subject at this moment, when a new Government was being formed following the general election that had just taken place.

11. A member of the Committee recalled discussions at previous consultations with Iceland on the question of domestic production diversification and asked what the prospects were for further diversification. He also referred to the recently established Nordic Industrial Development Fund, which in 1970 had contributed to the development of the woollen, fishing gear and ceramic industries in Iceland, and enquired whether any plans existed for using this Fund to encourage the establishment or expansion of major export industries, possibly as a spur to joint ventures with foreign investors. In reply, the representative of Iceland described the nature and origin of the Nordic Fund and confirmed that the main purpose of this was to help diversify the Icelandic economy. So far applications for allocations had related to the expansion or consolidation of existing industries with a good export potential, such as the woollen textile, tanning, leather and skin processing, clothing, ceramic industries. Exports in some of these products had, in fact, been stimulated and given greater scope by Iceland's accession to EFTA. A fundamental modification of the Icelandic economic structure would, however, require persistent efforts over a long period of time; spectacular results were not to be expected in the near future. As regards exports, the present boom conditions were such that most enterprises were fully occupied in producing for the domestic market. Nevertheless, there was some evidence of increased export consciousness among Icelandic business firms (e.g. in their interest in trade promotion abroad).

12. A member of the Committee pointed out that according to the IMF documentation, the Icelandic Development Fund, which allocated credit to the investment credit funds, was in the position to influence the lending policy of those funds, but these funds had continued to gear their lending to specific sectors of the economy rather than to new ventures. Invited to comment on this situation in relation to the policy of industrial diversification, the representative of Iceland explained that the Development Fund was not an entirely new institution but was a successor to the Development Bank which had served as a mobilizer of investment funds and borrower of the first instance. The Fund, however, represented an improvement over the previous institution in that it followed more streamlined and rationalized procedures, which facilitated industrial borrowing. The operation of the Fund was not oriented in favour of any particular sectors, but aimed at developing all viable branches of the economy. There was nothing, however in the Fund's set-up that might detract from the general policy of favouring export industries and of encouraging new ventures. The general climate created by the liberalization of trade was likely to bring about new projects and new ventures for which this Fund's resources would certainly be available.
13. In response to a question on the Icelandic Government's policy with regard to the attraction of foreign capital in the interests of industrial development and diversification, the representative of Iceland stated that for historical, geographical and other reasons, Iceland had in this regard followed a policy which was somewhat more restrictive than that of most other European countries. There was, however, a growing recognition of the need for attracting foreign capital and there was a growing acceptance of foreign participation in domestic industrial enterprises. For example, following Iceland's accession to EFTA, there had been cooperation between Finnish and Icelandic enterprises in the processing of sheepskins and in the manufacture of fashion goods based on sheepskins. An outstanding example of the new attitude towards foreign capital was the aluminium smelter, which was by far the largest industrial unit in Iceland and which was entirely foreign owned.

System and methods of restrictions

14. Members of the Committee took note of Iceland's intention to remove its import restrictions in the industrial sector on all but a few products before 1975. Satisfaction was expressed over the fact that no new import restrictions had been introduced in the period under review. It was appreciated that new global quotas had been introduced and that further global quotas would be established in the coming year.

15. In reply to a question, the representative of Iceland stated that, even with the improved balance-of-payments situation, an acceleration of the planned liberalization measures was not feasible. The plan which had been elaborated was being relied upon by some of the branches of his country's industry. Especially those branches which were comparatively weak and employed a considerable number of personnel needed time to adjust.

16. Asked about the way the liberalization plan was going to be implemented the representative of Iceland replied that, in connexion with his country's accession to EFTA, a timetable for the gradual removal of import restrictions on industrial products had been published; as had been explained in the previous consultation this liberalization applied to imports from all countries.

17. In reply to a question as to which industrial products would not be liberalized, after 1974, the representative of Iceland pointed out that for petrol and petroleum products as well as brushes made by the blind, no change of policy was envisaged and these commodities would remain subject to quota restrictions beyond 1974.

18. Several questions were asked with regard to Iceland's bilateral trade and payments agreements. The representative of Iceland stated that the most important bilateral trade and payments agreement was the one with the USSR, which covered certain fishery products for which his country had difficulties in finding outlets elsewhere. As a counterpart, it provided for the import of petroleum and petroleum
products from the USSR. No time-table had been envisaged for the introduction of any modifications to the arrangement. With regard to the arrangement concluded with Brazil, the Committee noted that this did not constitute a trade or payments agreement in the normal sense of the term.

19. One member expressed his satisfaction over the fact that the bilateral trade and payments agreement with Hungary had been terminated. While he fully understood the reasons that had led Iceland to maintain the bilateral agreement with the USSR, he wondered whether similar justifications existed with regard to the private arrangement entered into with the Chamber for External Trade in East Berlin, and to the bilateral agreement concluded with Romania. In this context, the representative of Iceland stated that a revision of the private arrangement in question was under study.

20. It was noted by a member of the Committee that special credit arrangements granted to importers of motor vehicles from East European countries were not available to importers of vehicles from other countries. He wondered if this was due to the fact that the Eastern countries were important buyers of Iceland's fish products. The representative of Iceland stated that the whole matter was under study by his authorities and that in any case the length of the credit in question had been reduced from six to three months.

21. One member recalled that at the last consultation the representative of Iceland had stated that his Government had found it impractical to discontinue the monopoly on matches. Asked whether this still was his Government's view the representative of Iceland declared that there was no intention to discontinue the monopoly for the time being.

22. In reply to a question as to the purposes of subjecting commodities such as matches, fertilizers, alcoholic beverages, tobacco, potatoes and fresh vegetables, to State-trading arrangements, the representative of Iceland pointed out that some of these commodities were liberalized and others were not. However, all purchases were carried out on a commercial basis and were in no way in conflict with GATT rules. This applies to agricultural products which were not liberalized and were being imported only to the extent that domestic production could not meet the demand. In this instance centralized buying was thought to be more effective. Tobacco and alcoholic beverages were handled by a monopoly as a means of raising revenue. This monopoly was not applied in any restrictive or discriminatory way, alcoholic beverages and tobacco being among the liberalized commodities and imported according to consumer tastes.

23. In reply to a query, the representative of Iceland confirmed that imports into Iceland which were not liberalized were subject to individual licensing granted on a discretionary basis.
Conclusions

24. The Committee expressed satisfaction on the remarkable economic recovery that had been achieved by Iceland in the past two years and congratulated the Icelandic authorities on the various stabilization measures which had been adopted. The Committee expressed the hope that a continuation of these policies would lead to greater price and cost stability and a sustained external balance. The Committee recognized that a programme to eliminate all but a few restrictions on industrial products was under way and urged Iceland to take advantage of the present comfortable balance-of-payments position to increase its efforts in the liberalization of restrictions. The Committee welcomed the recent termination of one bilateral payments agreement and recommended further progress in this regard.