

CENTRAL BANK OF ICELAND

# The Economy of Iceland



**The Economy of Iceland**

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## REPUBLIC OF ICELAND

### People

Population .....269,735 (December 1, 1996)  
Capital.....Reykjavík, 105,487 (December 1, 1996)  
Language.....Icelandic; belongs to the Nordic group of Germanic languages  
Religion.....Evangelical Lutheran (95%)  
Life expectancy.....Females: 81 years , Males: 75 years

### Governmental System

Government .....Constitutional republic  
Suffrage .....Universal, over 18 years of age  
Legislature .....Alþingi (Althing); 63 members  
Election term.....Four years

### Economy

Monetary unit .....Króna (plural: krónur); currency code: ISK  
Gross domestic product.....487 billion krónur (US\$ 7.3 billion) in 1996  
International trade.....Exports 36% and imports 36% of GDP in 1996  
Per capita GDP.....1,760 thousand krónur (US\$ 26.900) in 1996

### 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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# I. THE REPUBLIC OF ICELAND

## Geography and Population

Iceland is one of the Nordic countries, 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 103,000 square kilometres (39,768 square miles) and an exclusive 200 nautical mile economic zone of 758,000 square kilometres (292,680 square miles) in the surrounding waters. Because of the Gulf Stream, Iceland enjoys a warmer climate than its northerly location would indicate.

Being of volcanic origin, Iceland consists of coastal lowlands and a mountainous interior with several glaciers, the highest of which is 2,119 meters (6,952 feet) high. Estimations indicate that 20 percent of the land is suitable for agriculture and the raising of livestock. Most of the arable land is situated along the coast and most of the population lives in the coastal regions. The coasts are rocky and of irregular outline, with numerous fjords and inlets, except for the south coast where there are sandy beaches with no natural harbours.

The population of Iceland is just over one quarter of a million (270 thousand at the end of 1996), which makes it one of the least densely populated countries in Europe with around 2.6 inhabitants per square kilometre (6.8 inhabitants per square mile). Between 1950 and 1965, the average annual rate of population growth was approximately 2 percent, and then it declined gradually to about 0.9 percent in the period 1975 to 1980, but has risen again in recent years to about 1.1 percent. Approximately 39 percent of the population lives in the capital city of Reykjavík and about 60 percent in Reykjavík and its surrounding towns. Approximately 86 percent of the population lives in communities with a population in excess of 1,000 inhabitants. The largest towns are Kópavogur (18,600 inhabitants) and Hafnarfjörður (17,900), both neighbouring municipalities of Reykjavík, and Akureyri (15,000) in the north.

Iceland was first settled late in the 9th century. The majority of the settlers were undoubtedly of Norse origin, but it is generally assumed that a certain element of the early settlers were of Celtic origin. In 930, a general legislative and judicial assembly, the Althing, was established, and a uniform code of laws for the entire country was adopted. In 1262, Iceland entered a treaty which established a union with the Norwegian monarchy. When Norway came under the rule of Denmark in 1380, Iceland became a Danish dominion. Iceland was granted limited home rule in 1874, which was extended in 1904. With the Act of Union in 1918, Iceland became an autonomous state in monarchical union with Denmark. In 1944 Iceland terminated its union with Denmark and became an independent republic.

The native language is Icelandic, which 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.

## Constitution, Government and Political Parties

Iceland has a parliamentary system of government. Legislative power is vested in the Althing, a legislature consisting of 63 members, elected from eight constituencies on the basis

of proportional representation for a term of four years. A parliamentary bill becomes a law if it is passed by the Althing and then signed by the President. The Prime Minister and the other Ministers exercise the executive power and constitute the Government which must be supported by a majority of the members of the Althing in order to remain in power. The President is the head of state and is elected for a term of four years by a direct vote of the electorate. The President of Iceland is Mr. Ólafur Ragnar Grímsson, elected in 1996.

The constitution of Iceland was adopted on June 17, 1944, when the Republic was established. 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. After the last general election in April 1995, a centre-right coalition Government of the Independence Party and the Progressive Party was formed with Mr. Davíð Oddsson, chairman of the Independence Party, as Prime Minister.

The last two general elections have resulted in the distribution of seats among the political parties represented in the Althing as shown in table 1.

Table 1  
**Election Results in 1991 and 1995**

	1 9 9 1		1 9 9 5	
	Percentage of votes	Number of seats	Percentage of votes	Number of seats
Independence Party	38.6	26	37.1	25
Progressive Party	18.9	13	23.3	15
Social Democratic Party	15.5	10	11.4	7
People's Alliance	14.4	9	14.3	9
Women's Alliance	8.3	5	4.9	3
People's Movement	-	-	7.2	4
Other	4.3	0	1.8	0
Total	100.0	63	100.0	63

### **Membership in International Organizations and Foreign Policy**

Iceland became a member of the United Nations in 1946 and is an active participant in most of its affiliated agencies. Iceland was 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 Organization of European Economic Cooperation which later became the Organization for Economic Cooperation and Development (OECD). It joined the Council of Europe in 1950 and has participated in the Conference on Security and Cooperation in Europe (CSCE) since it was initiated in Europe in 1975. Iceland became a contracting party to the General Agreement on Tariffs and Trade (GATT) in 1964, and joined the European Free Trade Association (EFTA) in 1970. Iceland 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 19-nation free-trade zone, the European Economic Area (EEA), which came to effect in January 1, 1994. Iceland ratified the agreement



establishing the World Trade Organization (WTO) on December 28, 1994, and thus became a founding member of the WTO.

Iceland has close ties with the other Nordic countries and is a member of the Nordic Council and the Nordic Investment Bank (NIB). The Nordic nations have established a wide-ranging cooperation in a variety of fields, including economic affairs and international representation.

Table 2  
**Iceland's Membership in International Organizations**

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

Iceland is a founding member of the North Atlantic Treaty Organization (NATO) which was established in 1949. Since 1951, when Iceland concluded a defence treaty with the United States, a NATO military base staffed by United States military personnel has been operated at Keflavík in the south-west of Iceland. In 1992, Iceland became an associate member of the Western European Union (WEU).

## II. RECENT DEVELOPMENTS AND ECONOMIC PROSPECTS

The economic environment in Iceland has been particularly favourable in recent years, characterised by a healthy economic growth and low inflation. In 1996, GDP growth was the strongest since 1987 and growth prospects for 1997 are favourable. Increased national expenditure and strong export growth contributed in particular to these developments. Large-scale foreign investment projects and increased real disposable income has led to a strong growth in business investments and private consumption. The 1998 Budget Proposal was presented with a surplus for the second consecutive year. Improvement in public finances and relatively moderate general wage agreements for the next three years should conform well to continued economic stability and healthy economic growth.

### Economic Growth and Expenditure

In 1996, economic growth was 5.2 percent, which is the highest annual real GDP growth in nine years. The NEI forecasts a 4.5 percent growth in GDP in 1997 and a 3.5 percent growth in 1998.

Since 1994, the Icelandic economy has experienced a strong upswing. As can be seen in Figure 1, a period of brisk growth in 1983 to 1987 was followed by a stagnation in output and demand through 1988 to 1992. This was mostly due to restrictions on fish catches and a dete-

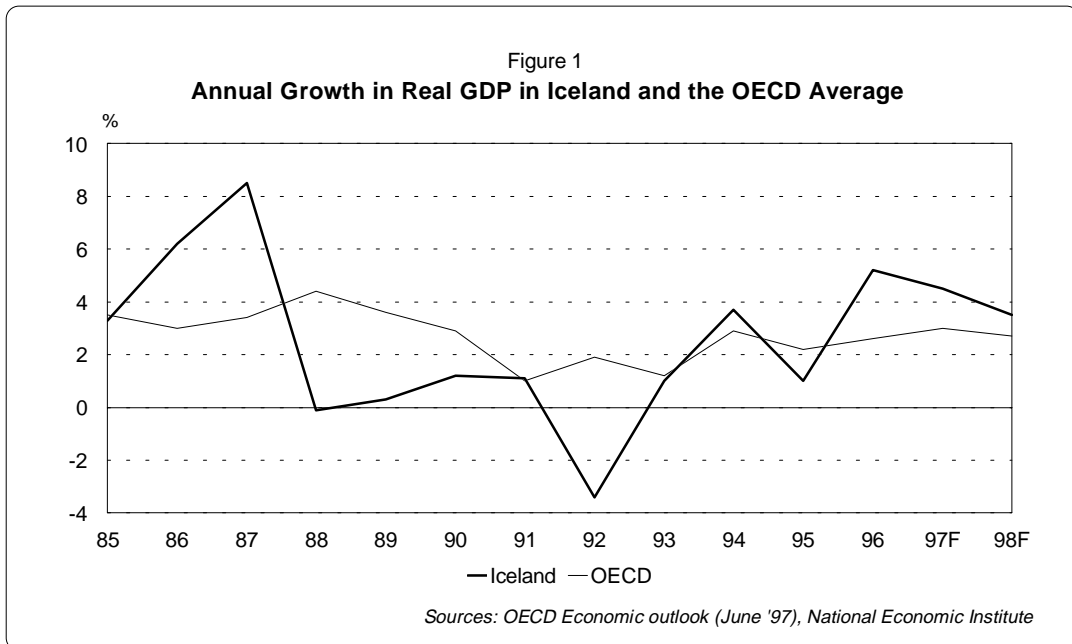


Table 3  
Output and Expenditure

	Billions of krónur		Changes in volume		
	1997F	1995	1996	1997F	1998F
Private consumption	321.6	4.2	6.4	5.0	5.0
Public consumption	108.6	1.3	1.4	2.2	3.0
Gross fixed investment	106.0	-2.8	23.5	18.6	1.3
Stock changes	0.0	0.6	-0.7	0.0	0.0
Total national expenditure	536.2	3.1	7.1	6.7	3.9
Exports of goods and services	184.5	-2.1	10.0	3.2	4.6
Imports of goods and services	199.1	3.8	16.6	9.6	5.9
Gross domestic product	521.6	1.0	5.2	4.5	3.5
Gross national product	510.6	1.4	5.6	4.8	3.3
Gross national income	--	1.9	4.2	5.0	3.7
Current account balance (in percent of GDP)		0.8	-1.7	-3.4	-3.4

Source: National Economic Institute

rioration in the terms of trade. In the period 1993 to 1995 economic growth in Iceland was more or less comparable with the OECD average, but in 1996 and 1997 the growth rate in Iceland turned out to be considerably higher. The NEI forecasts economic growth to average about 3.3 percent per year during 1998 to 2002, or slightly higher than the average forecast for the OECD countries during this period.

National expenditure has risen quite rapidly in recent years after a period of stagnation in investments and consumption in 1992 to 1994. In 1996, the increase in national expenditure was 7.1 percent, mainly due to 23.5 percent rise in investments. This increase is partly due to the expansion of the aluminium smelter in Straumsvík, but also because of an increase in other business investments. Private consumption increased by 6.4 percent, but public consumption by only 1.4 percent. In 1997, national expenditure is expected to rise by 6.7 percent, due to a 18.6 percent increase in investments and 5.0 percent increase in private consumption. The NEI forecasts national expenditure to rise by 3.9 percent in 1998, mainly due to a 5 percent increase in private consumption.

### Foreign Trade and the Balance of Payments

Export growth has been high in the last couple of years and is expected to sustain strong into the next century. Exports of goods and non-factor services grew by 10 percent between 1995 and 1996, which is the largest increase seen since 1985. At constant prices, fish catches increased by 6.7 percent in 1996 and aluminium production increased by 4 percent. Other manufacturing exports than in the power intensive sector decreased slightly in 1996, following a robust growth in 1994 and 1995. Export revenue from non-factor services increased by 13 percent in real terms in 1996. In 1997, exports of goods and services are expected to grow by 3.2 percent, due to a brisk growth in aluminium production and other manufacturing exports. The strong growth in these sectors is expected to continue, and in 1998 the NEI forecasts merchandise exports to increase by 7.8 percent and exports of goods and services to grow by 4.6 percent. During 1998 to 2002, the NEI projects exports of goods and non-factor services to increase by 4½ percent annually on average.

Fisheries are of great importance in the Icelandic economy, with marine products constituting 52 percent of total exports in 1996. Conservation measures led to substantial cuts in cod quotas in early 1990s, cod being the single most important specie 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 allocation of catches on products, fish landed by foreign vessels has increased, and 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 again. In 1996 the total fish catch increased by 6.7 percent at fixed prices, with a slight increase in the cod catch. The marine production for export increased by 8.8 percent. The NEI expects total cod catch to increase by 7.8 percent in fixed prices in 1997, but catches in other ground-fish species to slightly decline. Therefore, NEI projects a 1 percent decline in marine production for exports in 1997. The NEI forecasts marine exports to increase on average by 2½ percent per year in real terms during 1998-2002.

With increased foreign investment in the power intensive industry, its relative importance in the economy is steadily growing. In 1996, the aluminium and the ferro-silicon industry constituted approximately 9 percent of merchandise exports, but in 1998 the ratio will be approximately 13 percent, according to the NEI forecast. Aluminium output has increased steadily in recent years as a result of investments in the ISAL aluminium smelter in Straumsvík and an enlargement of the smelter that was started in 1996. The output increase is estimated to be 25 thousand tons in 1997, rising to 60 thousand tons per year when the expansion is complete. In addition, a new 60 thousand tons aluminium smelter is currently under construction in Grundartangi which is estimated to start production in mid-year 1998. In 1996, export production of aluminium increased by 3.6 percent and it is estimated to increase by 21.4 percent in 1997 and by 46.4 percent in 1998. Production in the ferrosilicon industry has been growing steadily in recent years, but no output increase is expected in the ferrosilicon smelter in Grundartangi in 1997, as it is already being run at full capacity. However, more than 50 percent enlargement of the ferrosilicon smelter has already been decided by 1999-2000. Production of ferrosilicon is expected to increase by 17.8 percent in 1998.

Manufacturing exports, excluding the products of the power intensive industries, have been growing rapidly in recent years. Export production of manufactured goods increased by 24 percent in 1994 and by 15 percent in 1995. The improvement was spread across sectors and was not traced to any particular industry. Among strong growing industries were exports of hi-tech fisheries equipment, pharmaceuticals and software. The growth slowed down in 1996, but the NEI forecasts exports of manufactured goods to grow by 9½ percent per year in 1997 and 1998.

Revenues from the export of non-factor services account for roughly 30 percent of Iceland's total export earnings. Service income has risen considerably in recent years, mainly due to a substantial increase in tourism. In 1996, the number of foreign tourists visiting Iceland continued to rise by 10 percent. However, tourism revenue, excluding travelling tickets, declined between 1995 and 1996 by 5 percent, but revenues from ticket sales increased by 12 percent. In 1997, the revenues from tourism is expected to increase by 6 percent in real terms. Altogether, the NEI forecasts export revenues from non-factor services to increase by 7.7 percent in 1997.

The price of export products slightly declined during the course of 1996 while the price of imports increased, causing deterioration in the terms of trade. The price of marine products deteriorated in terms of foreign currency between 1995 and 1996, but is expected to increase again between 1996 and 1997. The price of aluminium exports is expected to remain similar on average in 1997 as in 1996, and the price of ferrosilicon is expected to stay close to a historically high level. The terms of merchandise trade deteriorated by 5.2 percent in 1996 and

reduced national income by the equivalent of 1.5 percent of GDP. The NEI forecasts the terms of trade to be virtually unchanged between 1996 and 1997, and to improve slightly in 1998, by the equivalent to 0.4 percent of GDP.

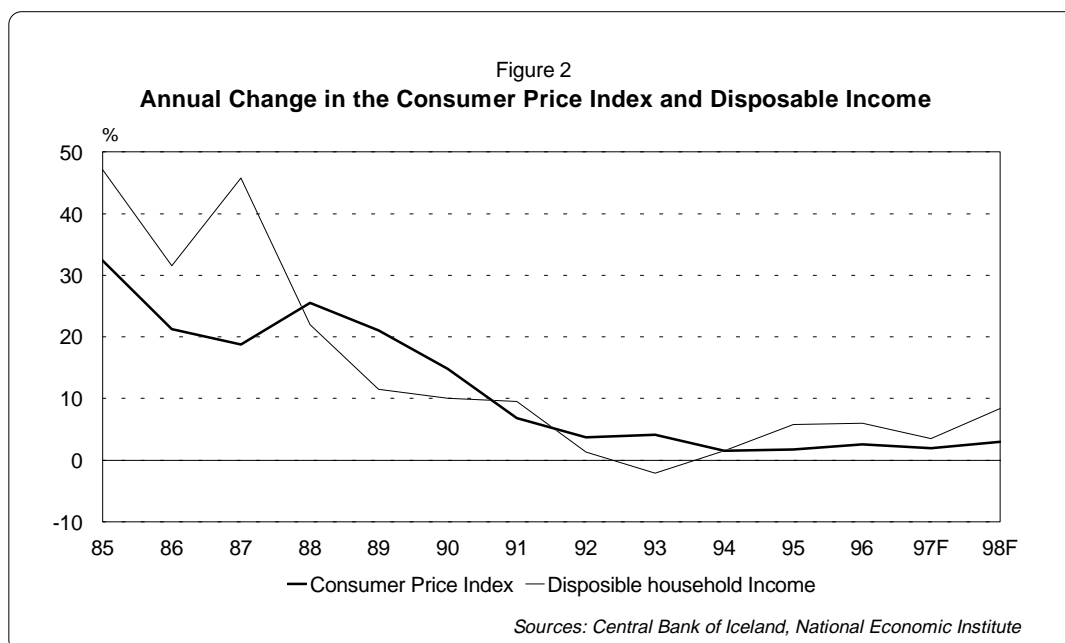
The upturn in the economy is reflected in increased imports, due to increased purchasing power and higher profitability of businesses. Following a total contraction of 23 percent from 1991 to 1993, merchandise imports rose again in 1994 and 1995, largely due to increased imports of investment goods. General merchandise imports are expected to rise by 16.6 percent in 1996, largely due to imports in connection to projects in the power intensive industry.

In 1996, the current account recorded a deficit for the first time in four years, to the tune of 8 billion krónur or approximately 1.7 percent of GDP. The NEI forecasts the current account to continue to be in deficit next year, mainly due to investments in the power intensive industry and increased national expenditure. In 1997, the current account deficit is expected to be around 3.4 percent of GDP.

Since 1993 the country's net foreign debt has declined from 54 percent of GDP down to 47 percent in 1996. The NEI projects that despite of the current account deficit and growing foreign debt in real terms, the debt to GDP ratio will not increase in 1997 and 1998 mainly due to an appreciation of the real exchange rate of the króna.

### Prices, Wages and Unemployment

In few years, Iceland transformed from being a high inflation economy to become one of the OECD countries with the lowest inflation. The stability in prices has been facilitated by a combination of a stable exchange rate policy and moderate wage settlements in a fairly centralized labour market. Wage agreements were concluded in 1997 for the private sector and most of the public sector for three years, to the year 2000. The basic private sector agreements resulted in an immediate 4.7 percent wage increase, and 4.0 percent and 3.65 percent increases in the beginning of 1998 and 1999, respectively. According to the Central Bank forecast, inflation will continue to be at a historically low level in 1997, but increase slightly in 1998.



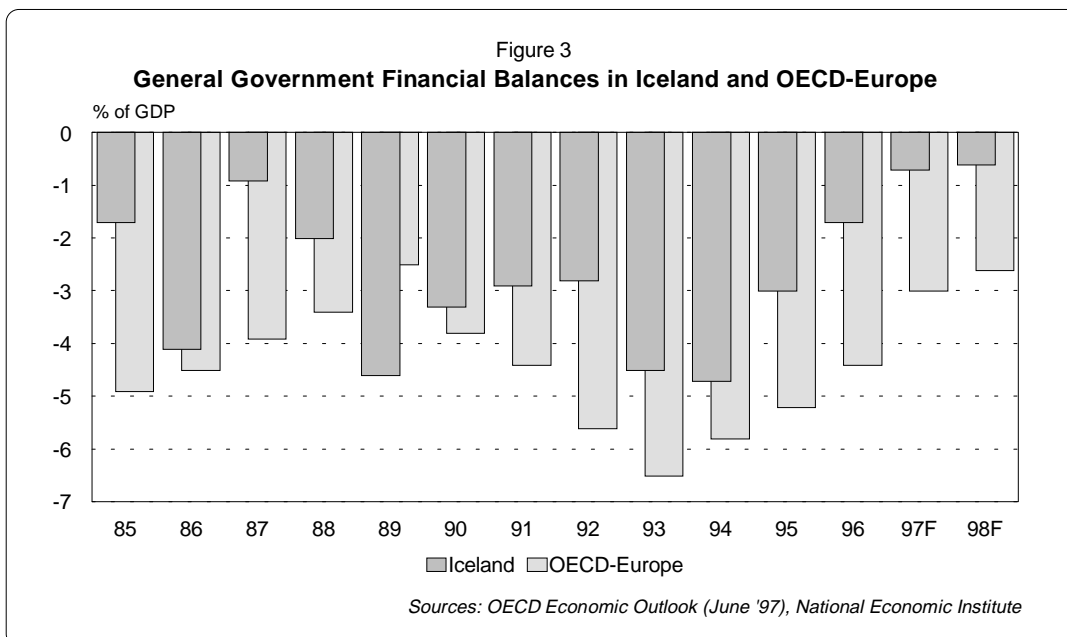
One of the main challenges now in regard to economic policy is to keep the inflation in check in an environment of strong economic growth. The year to year inflation in 1993 and 1994 was 1.5 percent, which is the lowest inflation rate in Iceland since the 1950s. In the two years that followed, the inflation measured by the change in the consumer price index increased slightly, to 1.7 percent and 2.3 percent in 1995 and 1996 respectively. In light of the new three year general wage agreements made in early 1997, the Central Banks forecasts the year to year inflation in 1996 and 1997 to be 1.7 percent. The Central Bank expects the inflation to reach a peak in the first half of 1998. The year to year inflation in 1997 and 1998 is forecast 2½-3 percent. Thereafter inflation is expected to decline again, and the Central Bank forecasts a year to year inflation of 2-2½ percent in 1998 and 1999.

Since late 1995, when the unemployment rate reached its peak at 5 percent of the labour force, unemployment has been on a declining trend. This is mainly due to increased economic activity. Demand for employees in specific groups with particular educational background and skills has been high, such as computer experts and business administration graduates. The unemployment rate is projected to decline between 1996 and 1997, from 4.3 percent down to 3.9 percent of the labour force. The NEI forecasts the unemployment rate to decline further in 1998, to 3.6 percent of the labour force.

### Public Finances

The 1997 Fiscal Budget marked an important step in public finances, as it proposed a surplus in Treasury finances for the first time since 1984. According to the 1998 Budget Proposal presented to the Althing in early October, the Treasury finances will improve even further next year.

Although the fiscal deficits and public debt in Iceland have been well below the OECD average, the persistent deficit and rising indebtedness have for years been among the main economic concerns. As more favourable economic conditions have generated increasing government revenues, the primary goal of policy makers has been to cut down government expendi-



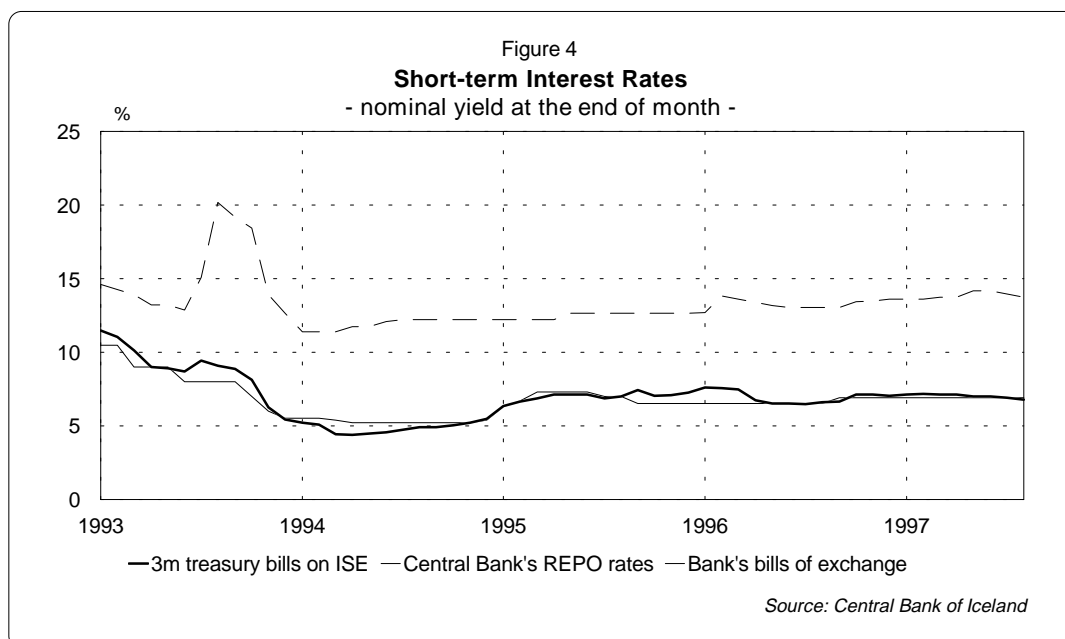
tures in order to eliminate the fiscal deficit. Iceland has fully met the Maastricht criteria since 1995.

According to estimations, the Treasury surplus in 1997 will be 2.7 billion krónur on cash basis, or approximately 0.5 percent of GDP. However, a special redemption of callable government savings bonds in early 1997 lead to extraordinary interest payments, amounting to 4 billion krónur, which in turn will be registered in the cash flow of the government accounts. When this is taken into the account, the budget figures show a slight deficit of 0.2 percent of GDP.

The Treasury finances are expected to improve further in 1998, compared to 1997. On a cash basis the revenue balance is expected to amount to 3.2 billion krónur, according to the 1998 Budget Proposal, or 0.6 percent of GDP. However, the proposal is now for the first time presented on accruals basis, in order to show in a concise manner the total activity of the central government and to aid in assessing their long term effects. The revenue balance on accruals basis is also positive, by 0.5 billion krónur. For the first time in years, the net borrowing requirement for the Treasury will be negative in 1998, by 5 billion krónur, or 0.9 percent of GDP. Thus, Treasury debt continues to fall, from 49 percent of GDP at year-end 1996, down to 44½ percent in 1998.

The general government, which includes central government, local government and social security, ran a revenue deficit of 3.5 billion krónur in 1997 on an accruals basis. This is equivalent to 0.7 percent of GDP, compared with 1.7 percent deficit in 1996 and 3.0 percent deficit in 1995. The improvement results from a 3 percent increase in revenues in real terms while real expenditures have only increased by 0.5 percent. Local government finances have improved considerably over the last two years. The combined local government deficit is projected to be 1.3 billion krónur in 1997, or 2.8 percent of revenue. In 1998, general government finances are expected to continue to improve and the revenue deficit will amount to 3.2 billion krónur on accruals basis, or 0.6 percent of GDP.

General government gross debt is estimated 282 billion krónur in 1997, or 54.1 percent of



GDP. This is a decline of more than 3 percentage points from 1996. 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 net debt is estimated to be 197 billion krónur, or 37.7 percent of GDP. General government net borrowing requirement is estimated 3.4 percent of GDP in 1997, and is forecast to go down to 1.4 percent in 1998.

### 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. From 1990 to 1995, all restrictions on short-term capital movements were gradually abolished and all external capital movements were fully liberalised. The regime on external capital movements in Iceland is now in full accord with the EEA agreement and the regime in the European Union.

In recent months the Central Bank has conducted a tight monetary policy in view of the current economic and monetary conditions. This has led to a considerable spread between domestic money market rates and trade-weighted foreign money market rates. Increased private foreign borrowing resulted in a net capital inflow during the second quarter of 1997, and an appreciation of the króna. Long-term interest rates in the secondary market fell slightly during the first three-quarters of 1997, partly due to lower inflation expectations following the three years general wage agreements. Lending rates of commercial banks fell also during the third quarter of 1997.

The growth rate of monetary aggregates has been relatively moderate. At the end of June, the twelve months increase in M3 was 6.6 percent. The deposit money banks' lending and issue of marketable securities rose by 13.7 percent during the same period.

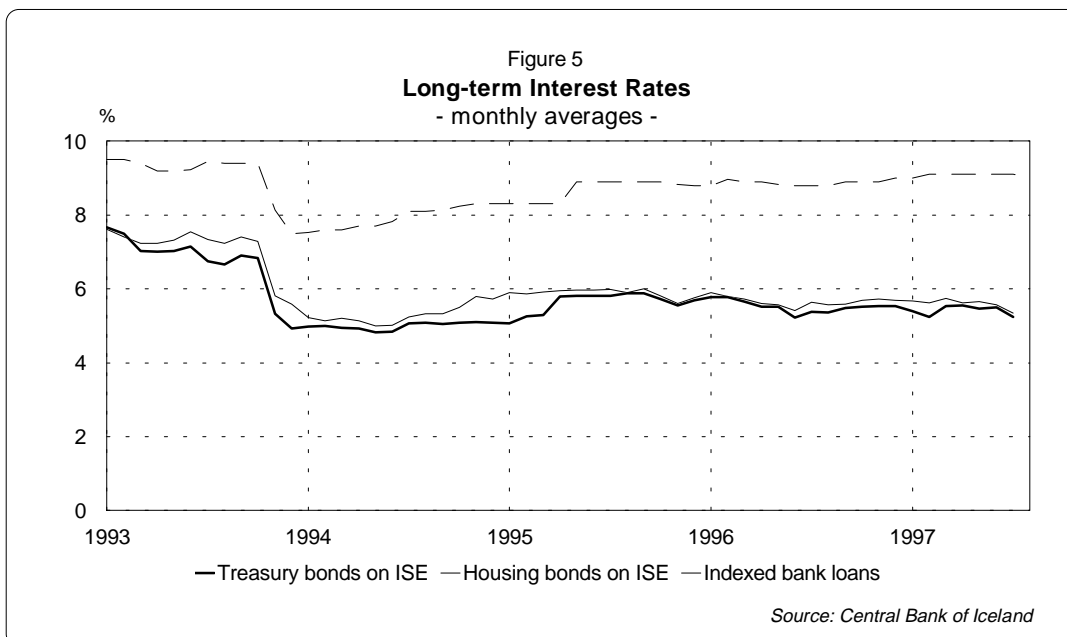




Table 4  
**Basic Economic Indicators**

	1995	1996	1997F	1998F
Percentage change as compared to previous year:				
Real GDP	1.0	5.2	4.5	3.5
Total fish catch (value at fixed prices)	-0.6	7.1	-0.7	-0.2
Exports (goods and services, volume)	-2.1	10.0	3.2	4.6
Imports (goods and services, volume)	3.8	16.6	9.6	5.9
Terms of trade (goods and services)	1.5	-1.5	0.7	
As percentage of GDP:				
Current account balance	0.8	-1.7	-3.4	-3.4
Treasury revenue balance	-2.0	-2.5	-0.2	0.6
Net external debt	50.4	47.2	46.0	..
Percentage change as compared to previous year:				
Consumer price index	1.7	2.3	1.8	2.7
Real disposable income per capita	3.0	3.5	4.5	5.2
Effective price of foreign currency	-0.8	0.0	-1.4	-0.7
Real exchange rate (relative price)	0.1	0.3	1.1	1.4
Unemployment rate (annual averages)	5.0	4.3	3.9	3.6
M1 growth (within year)	11.3	10.8	..	..
M3 growth (within year)	3.7	5.8	..	..
Yield on Treasury bill on the ISE <sup>1)</sup>	7.1	6.8	..	..
Yield on Government bonds on the ISE <sup>2)</sup>	5.6	5.5	..	..

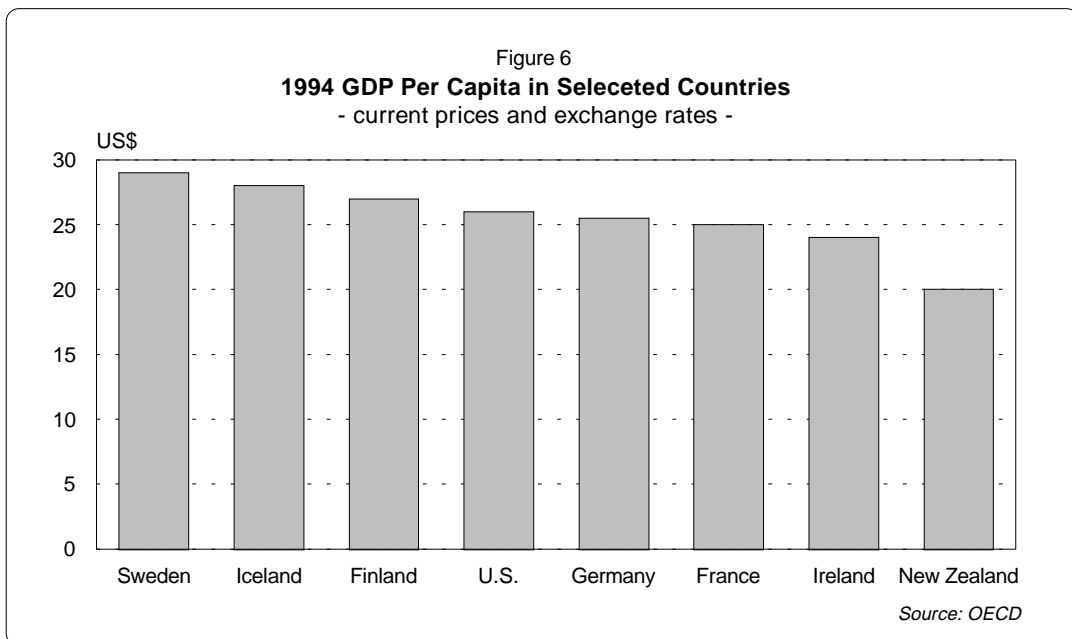
1) Yield on 3 month Treasury bills on Iceland Stock Exchange at end of year.

2) Yield on 5 year indexed government bonds on Iceland Stock Exchange at end of year.

Sources: National Economic Institute, Central Bank of Iceland

### III. THE ECONOMY

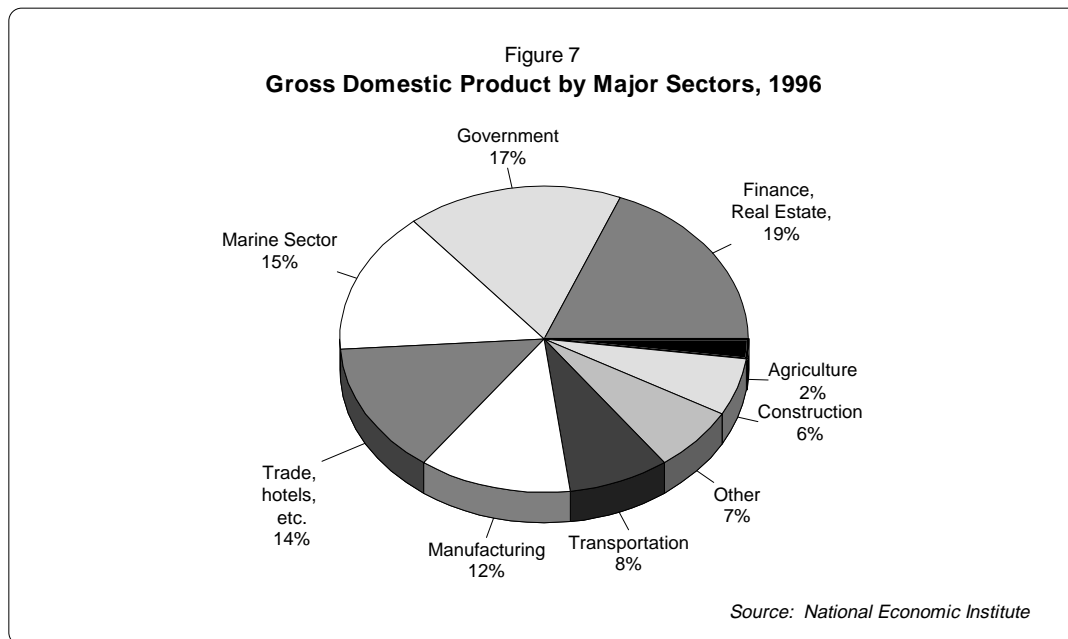
The Icelandic economy is primarily based on the use of renewable natural resources, the most important of which are the coastal fishing banks, hydro-electric and geothermal power and the grasslands which support the livestock industry. Although the economy has traditionally been based on fisheries and agriculture, it has, in the last decades, diversified into manufacturing, processing and service industries, while at the same time diversifying its marine sector. While the size of the economy is small in absolute terms, with a GDP (gross domestic product) of approximately \$7.3 billion in 1996, the per capita GDP of approximately \$26,900 is very high in international standards. In 1996, exports of goods and services, excluding interest receipts, amounted to the equivalent of 36 percent of Iceland's GDP.



The estimated contribution of the various economic sectors to the total GDP in 1996 was 15.0 percent by the marine sector, 12.2 percent by manufacturing (other than fish processing), 2.0 percent by agriculture, 6.4 percent by construction, 18.6 percent by finance, insurance, real estate and business services, 13.8 percent by trade, restaurants and hotels, 8.4 percent by transportation, and 16.8 percent by government.

#### **Fishing and Fish Processing**

The marine sector, including both fishing and fish processing, is of fundamental importance



to the Icelandic economy. In 1993, it contributed 15.4 percent to the GDP, employed on average approximately 13,740 individuals, as calculated in man-years, representing 11.3 percent of the labour force, and generated 57.6 percent of the total foreign exchange earnings of the economy. However, the relative importance of the marine sector has declined somewhat in recent years. In the early 1960s, the exports of fish and fish products constituted some 90 percent of merchandise exports, but this share has declined to approximately 72 percent in 1996.

The principal part of the Icelandic marine sector is the stock of groundfish, consisting of species like cod, haddock, saithe, and redfish. The catch of groundfish reached a maximum of 732 thousand tons in 1981, and after a decline to 585 thousand tons in 1985 it grew again after the mid 1980s, but has declined to 509 thousand tons in 1996. The decline during the early 1980s and 1990s resulted mainly from conservation measures aimed at managing these renewable resources with a view to reap a higher yield in the future. 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 1996 was 1.186 thousand tons. Catches of shrimp, lobster and shellfish have been of substantial value in recent years as well as catches of herring, which had previously suffered a temporary setback. Whaling was a small but important industry in Iceland, accounting for about 1 percent of total merchandise exports in 1985. Commercial whaling, however, was halted in 1985.

Iceland has developed a comprehensive fisheries management policy in order to manage the fish stocks. Catches of all the major species of fish are regulated by quotas. 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 marine sector, and especially the 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 the three most important processing methods, freezing, salting and drying, are to a large extent interchangeable. Thus, it is relatively

easy to divert the raw material to the most profitable processing method, depending on the current market situation. The same is true of the technologically advanced fishing fleet, which includes vessels that can perform high-quality processing at sea. The diversification extends not only to the species and methods of processing, but also to marketing. Icelandic fish products have been actively marketed in the United States, Europe and Japan and, through these efforts, Icelandic products have acquired established brand names. The diversification has therefore limited the risks associated with the Icelandic economy's dependence on export of marine products. The number of companies in this sector has declined in recent years due to several mergers that have taken place.

In recent years, some investment has been made in fish farms which breed fish, mostly salmon and rainbow trout, in cages, either in the sea or on shore, and operate ocean ranching. Iceland offers favourable conditions for this activity, having abundant supplies of hot water and ample quantities of clean spring water. So far, exports have been limited.

### **Manufacturing**

The Government has followed a policy of encouraging the development of the manufacturing sector and of seeking the cooperation of foreign enterprises in the development of power intensive industries. In 1993 manufacturing (other than fish processing) contributed 11.0 percent of GDP, and, on an average, approximately 13,850 individuals, as calculated in man years, were employed in this sector, representing 11.1 percent of the labour force. A number of Icelandic manufacturing firms produce for export markets, and the government-backed Export Council assists such firms in the promotion of exports. In 1996, manufactured products accounted for approximately 24 percent of total merchandise exports, with aluminium accounting for 10 percent of the total amount.

The largest manufacturing facility in Iceland is an aluminium smelter located at Straumsvík near Reykjavík. The 100,000 ton smelter is owned and operated by the Icelandic Aluminium Company Ltd (ISAL), which in turn is owned by the Alusuisse Lonza AG. A 60,000 ton expansion of the Straumsvík smelter will be completed next year. In addition, Nordic Aluminium, a company owned by Columbia Ventures, a U.S. company, is currently building a new 60,000 tons aluminium smelter in Grundartangi which is estimated to be completed in 1999.

The Icelandic Government, Elkem A/S of Norway, and the Sumitomo Corporation of Japan jointly own a 72,500 ton ferro-silicon plant, Icelandic Alloys Ltd. (Járnblendifélagid), at Grundartangi in Hvalfjörður on the west coast of Iceland. In 1997, the Government made an agreement with Elkem to sell part of its share in the ferro-silicon plant to the Norwegian company, which subsequently became a majority owner. In accordance with this agreement, it was decided to increase the production capacity of the smelter by more than 50 percent.

Geothermal steam has been used very successfully in a diatomite plant in northern Iceland. The plant is owned and operated by Kísilidjan Ltd., a joint-ownership company of the Icelandic government and Celite Inc. of the United States.

Four medium-sized manufacturing enterprises, a fertilizer plant, a cement plant, a rock wool plant, and a seaweed meal plant use locally available raw materials and produce mostly for the domestic market. In recent years, there has been a brisk growth of various high-technology industries, particularly in connection with the production of specialized heavy equipment and electronic appliances for fishing and fish processing. Other industries that require high skill labour have been growing rapidly, such as the software industry and pharmaceuticals.

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.

### **Agriculture**

Approximately one-fifth of the total land area of Iceland is suitable for agriculture and the raising of livestock. About 6 percent of this area is under cultivation, with the remainder devoted to raising livestock or left undeveloped. 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. Furthermore, a fur industry has also developed over the past decade. Agriculture contributed an estimated 2.4 percent to GDP in 1995.

The agricultural sector has undergone some structural changes in recent years as market demand for traditional products, such as dairy products, lamb and mutton, has declined substantially. Price supports and export subsidies have been abolished and replaced with direct income payments to farmers in the agricultural sector. In the agricultural fiscal year from October 1996 to October 1997, these direct payments are estimated to amount to 42 percent of the framers' costs in raising lamb and to 40 percent of the costs in milk production.

### **Energy**

The energy resources in Iceland, i.e. the hydro and geothermal reserves, are significant in relation to the size and population of the country. Harnessable electric power from rivers and geothermal sources is estimated at 50,000 GWh per annum, taking economic and ecological considerations into account. As a comparison, in 1996, the use of electric energy in Iceland was approximately 5,113 GWh per annum, which means that less than 10 percent of the economically and ecologically harnessable potential, as estimated by the National Energy Authority, has been harnessed.

Virtually the entire Icelandic population has access to electricity. All towns and villages and virtually all farms are connected to public power utilities. In 1996, total consumption of electricity amounted to 18,958 kWh per capita, ranking Iceland very high in per capita electricity consumption.

All the largest hydroelectric power plants as well as the interregional power lines are owned and operated by the National Power Company (Landsvirkjun) which is the prime supplier of electricity in Iceland. The company is jointly owned by the State, the City of Reykjavík and the Township of Akureyri.

Hot water from geothermal sources and natural steam are 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 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 as well as for the fishing and commercial fleets. To a limited degree, oil is used for domestic heating and, to a larger degree, for the industrial production of fish meal and fish oil. In volume terms, oil imports were at a maximum in 1973 and reached a low in 1983, and 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 1996, as compared to 19.3 percent in 1979.

The possibility of selling electricity to Europe through an ocean cable has come under discussion. Several foreign companies have shown interest in working on such a project with

Icelandic entities. In spite of the fact that construction of this magnitude would require relatively large amounts of capital, this is nonetheless seen as potentially being an economically feasible alternative to nuclear energy, oil and coal. The project's attractiveness also stems from the fact that this is an environmentally sound way of producing energy. However, the project is currently at an early stage of a feasibility study.

### **Transport and Communications**

The domestic transportation network consists of roads, air transportation and coastal shipping. Car ownership is widespread and recent figures show that only the United States has significantly more passenger cars per capita than Iceland.

Several airlines operate in Iceland. Icelandair (Flugleidir) is a private corporation with both domestic and international routes and direct flights to a number of European and United States cities as well as transatlantic flights between several cities in the United States and Europe. Air Atlanta mainly operates as charter airline on international routes outside Iceland and Íslandsflug focuses primarily on the domestic routes. Some foreign airlines operate also routes to Iceland.

Iceland has numerous harbours, all of which are free of ice throughout the year. The three main shipping companies, Eimskip, Samskip and Nesskip, operate regular shipping routes to the major ports of Europe and the United States. Prior to 1992, a coastal shipping route was operated by the Icelandic State Coastal Shipping Company (Ríkisskip) which was privatized and sold to Samskip in early 1992.

The telephone and telegraph system, operated by Post and Telecom Iceland, is both extensive and modern, with satellite earth stations, optical fibre cables, and an extensive cellular mobile phone system. Since 1997, the Post and Telecom Iceland is a limited liability company owned by the Icelandic state.

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

### **Tourism**

The tourism sector has been the fastest growing industry in recent years. Foreign visitors in 1996 numbered 201 thousand compared to 143 thousand in 1992, 131 thousand in 1989 and 97 thousand in 1985. The foreign exchange revenues generated by tourism in 1995 amounted to approximately 12 percent of the total foreign exchange revenues of the economy.

The Government encourages further expansion in the tourism sector through the State Tourist Board (Ferdamálarád Íslands) and a special loan fund.

### **The Labour Force and Labour Relations**

In 1995 the Icelandic labour force was estimated at approximately 149,000 people. The overall participation rate has increased considerably in the last decade, primarily due to increased participation of women. In Iceland, approximately 83 percent of the population between the age of 16 and 74 belong to the labour force. Women accounted for 47 percent of the labour force in 1992. The participation rate for both the elderly and the young is relatively high compared with neighbouring countries.

Most Icelandic employees are members of trade unions. The vast 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.

### **Structural Reforms**

Various structural reforms have been implemented in recent years in order to increase efficiency in the economy.

Recent governments have emphasized the privatisation of the economy. Several state enterprises have been sold to the private sector. The privatized enterprises include a venture capital institution (Thróunarfélag Íslands), an insurance company (Íslensk endurtrygging), a fish processing company (Thormóður rammi), a fish meal company (S.R. mjöl), a coastal shipping line (Ríkisskip) and a machinery and heavy equipment plant (Landsmidjan). The state-owned and operated vehicle inspectorate (Bifreidaeftirlit ríkisins) was incorporated and privatized. In 1997, the government and the City of Reykjavík privatized a joint computer data centre (Skýrr). In 1997, the government made an agreement to sell a part in the ferro-silicon 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. There are plans to divide the new company into two, a postal company and a telecom company.

Legislation has already been passed to incorporate the two state-owned banks, Landsbanki and Búnadarbanki, as of the beginning of 1998. 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 authorize 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, legislation has been passed to merge three of the largest investment credit funds, the Fisheries Investment Fund, the Industrial Loan Fund and the Industrial Development Fund, into a new incorporated investment bank as of the beginning of 1998. A quarter of the capital of the merging investment funds will be used to spin off a venture capital fund. The legislation envisages an immediate sale of up to 49 per cent of the government's shares in the new investment bank.

Many important structural changes have been implemented in the financial sector in the last decade. Among these are interest rate liberalization, elimination of automatic access to central bank facilities by commercial banks, liberalization of foreign exchange regulations and establishment of foreign exchange market, establishment of a stock exchange and leasing operations, the development of secondary markets for public and private bonds, and liberalisation of invisible transactions, long-term capital movements and cross-border financial services.

### **The Environment**

Compared to other industrial countries, Iceland is relatively unpolluted and faces no immediate environmental problems. Electricity and geothermal heating, Iceland's main energy sources, are generated through the use of renewable resources causing little or no pollution, and the use of other energy sources, oil products, coal and natural gas, is not extensive. The acid disposition over Iceland is very small, due to Iceland's geographic location and the limited emissions of pollutants in Iceland. Though pollution of surface and ground water is minimal, some localized pollution of surface and ground water exists, and the pollution threats are increasing. However, the marine environment around Iceland is unpolluted.

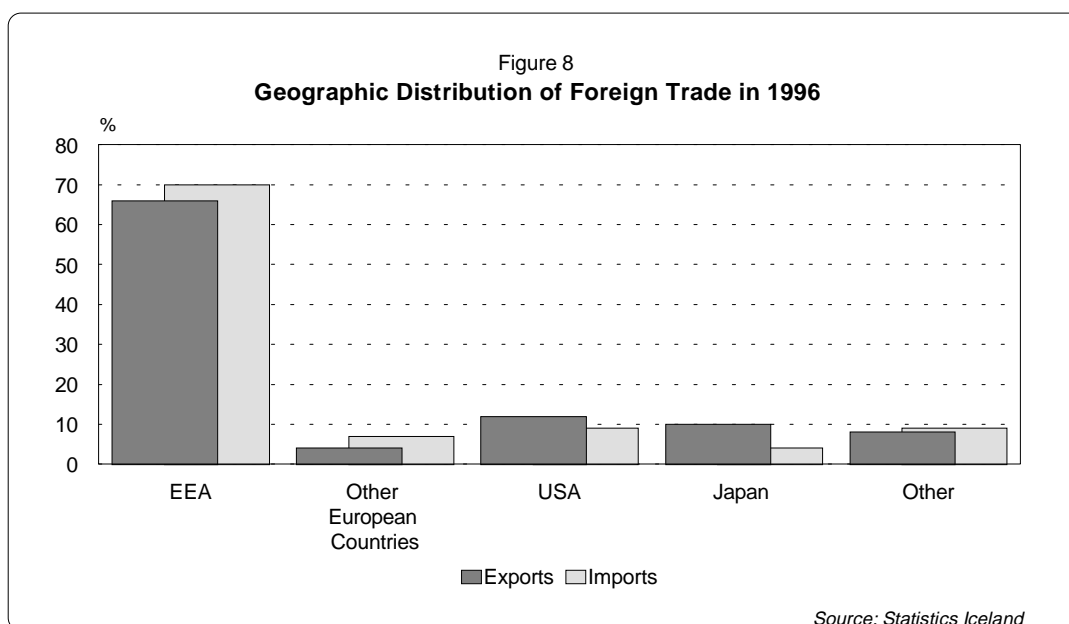
## IV. FOREIGN TRADE AND BALANCE OF PAYMENTS

### Foreign Trade

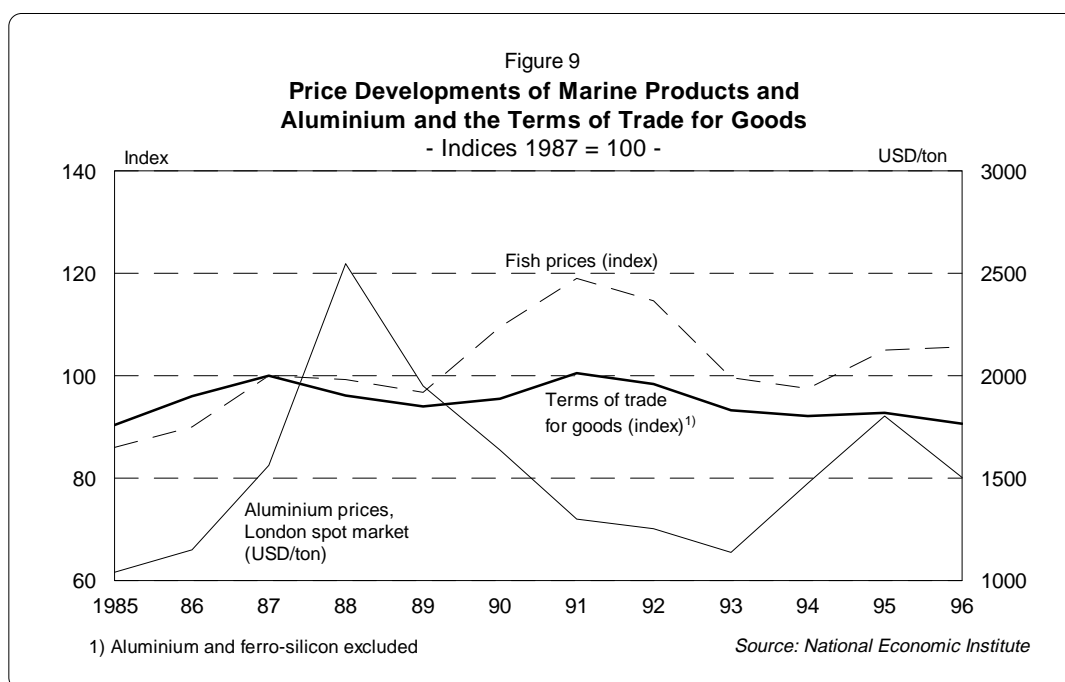
Foreign trade plays an important role in the Icelandic economy. Imports and exports of goods and non-factor services averaged 32.1 and 33.8 percent of GDP, respectively, during the period 1990 to 1996. Between 1993 and 1994, total exports grew by 9.7 percent generating approximately 36 percent of GDP in 1994. Following this period of exceptionally fast export growth, exports of goods and services declined by 2.4 percent between 1994 and 1995, but grew by 1.7 percent between 1995 and 1996, according to provisionally figures.

Since 1970, Iceland has been a member of the European Free-Trade Association, EFTA. 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 EU. Certain provisions are subject to implementing legislation in Iceland and elsewhere.

The main part of Iceland's exports goes to the EU countries, the United States and Japan. Approximately two thirds of merchandise exports go to the countries within the European Economic Area. Currently, Iceland's largest export markets are the United Kingdom, Germany, the United States, and Japan, representing 19.2 percent, 13.0 percent, 12.6 percent, and 10.4 percent respectively, in 1996.







Marine products constitute nearly 70 percent of Iceland's merchandise exports and about 50 percent of total exports of goods and services. Manufactured goods make a roughly 20 percent of merchandise exports, of which aluminium is the single most important product with 9 percent.

In 1996, 70 percent of imported goods were from the EEA countries and 9.5 percent of imports were from the United States. The shares of other countries in imports are smaller, of which Japan is of most importance with 4.1 percent of total merchandise imports. Consequently, Iceland has a trade surplus against Japan and the United States, but a slight trade deficit against the EEA countries as a whole.

The merchandise terms of trade deteriorated by 5.2 percent between 1995 and 1996, mainly due to an increase in import prices. The effects of changes in terms of trade were equivalent to 1.5 percent of GDP. The NEI forecast a slight improvement in the terms of trade between 1996 and 1997, or about 0.7 percent.

### Balance of Payments

The current account of the balance of payments turned into deficit in 1996, after being in surplus for three consecutive years with a concomitant reduction in external indebtedness. Although the current account was in deficit, the net debt to GDP ratio continued to decline in 1996. The current account was in deficit in the period 1987 to 1992, largely due to a deficit on the services account. It balanced with a slight surplus in 1993, and a strong export growth in 1994 left the current account in a surplus of 1.9 percent of GDP. In 1995 the current account remained in surplus, by 0.8 percent of GDP. Greater increase in national expenditure than in national income led to a current account deficit in 1996, by the tune of 1.7 percent of GDP. The deficit is largely due to increased imports of investment goods, including imports associated with the expansion of the aluminium smelter. The current account balance is likely to continue to be in deficit in 1997, mainly due to investments in the power intensive sector but also because

of growth of national expenditure in excess of national income. The National Economic Institute forecasts the current account to record a deficit of 5.0 percent of GDP in 1997.

Table 5  
Exports by Commodity Groups (f.o.b.)  
- Millions of krónur - 1)

	1993	1994	1995	1996
Marine products	74,571	84,837	83,873	86,733
White fish	54,087	56,866	53,341	51,088
Frozen	35,191	35,599	32,663	29,348
On ice	7,599	7,788	6,823	6,173
Salted	9,938	12,138	12,835	13,870
Stockfish	948	779	669	642
Meal	96	330	92	758
Oil	315	273	259	298
Herring and capelin	8,646	10,447	10,488	16,533
Frozen	926	3,509	3,364	5,237
Salted	595	833	778	932
Meal	4,919	4,425	4,697	7,825
Oil	2,206	1,680	1,649	2,539
Lobster, shrimp, scallop	10,319	14,138	16,579	16,140
Other	1,520	3,386	3,465	2,972
Agricultural products	1,620	2,133	2,055	1,984
Meat	150	251	169	454
Dairy products	1	0	1	12
Salmon & trout (fish-farming)	713	728	810	652
Other	756	1,154	1,076	866
Manufacturing products	16,525	21,040	25,000	22,843
Aluminium	8,259	10,833	12,303	11,121
Ferro-silicon	2,361	2,689	3,212	3,441
Diatomite	414	541	637	554
Tanned skins and hides	622	837	977	1,063
Woollen products	378	408	355	333
Canned products	1,521	1,850	1,886	1,348
Other	2,970	3,882	5,631	4,983
Miscellaneous	1,942	4,645	5,679	3,288
Total merchandise exports	94,658	112,654	116,607	126,200

1) Based on current exchange rates

Source: Statistics Iceland

Table 6  
**Imports by Economic Category (c.i.f.)**  
 - Millions of krónur - <sup>1)</sup>

	1993	1994	1995	1996
Food and beverages	9,471	10,342	11,665	11,757
Primary, mainly for industry	336	1,1810	2,720	2,499
Primary, mainly for household consumption	2,248	1,619	1,629	1,636
Processed, mainly for industry	922	1,128	1,080	1,132
Processed, mainly for household consumption	5,965	5,784	6,236	6,490
Industrial supplies not elsewhere specified	25,552	28,161	32,557	33,492
Primary	1,110	1,515	1,688	1,817
Processed	24,442	26,646	30,870	31,676
Fuels and lubricants	8,237	8,366	8,032	9,942
Primary	296	389	374	390
Petrol, including aircraft fuel	1,607	1,761	1,571	1,977
Other	6,334	6,216	6,086	7,575
Capital goods, parts and accessories	17,414	20,358	23,440	27,061
Capital goods (except transport equipment)	10,778	12,602	15,046	18,351
Parts and accessories	6636	7,756	8,394	8,710
Transport equipment	9,677	12,491	13,882	17,457
Passenger motor cars	3,549	3,639	4,978	6,666
Industrial	1,553	1,597	1,533	1,945
Non-industrial	227	213	260	319
Parts and accessories	2,470	2,799	3,193	3,135
Ships	1,702	4,068	3,042	5,284
Aircraft	176	176	876	107
Consumer goods not elsewhere specified	20,738	22,413	23,783	23,818
Durable	4,210	4,643	4,955	5,241
Semi-durable	8,277	8,968	9,542	9,347
Non-durable	8,251	8,802	9,286	9,230
Goods not elsewhere specified	218	410	255	374
<b>Total imports of goods c.i.f.</b>	<b>91,307</b>	<b>102,541</b>	<b>113,614</b>	<b>123,901</b>

1) Based on current exchange rates

Source: Statistics Iceland

Table 7  
**Geographic Distribution of Foreign Trade**  
 - Percentages of total values -

	I m p o r t s			E x p o r t s		
	1994	1995	1996	1994	1995	1996
EFTA	15.5	11.4	15.0	4.6	5.5	5.7
Norway	14.3	10.2	13.5	2.8	3.3	3.7
Switzerland	1.2	1.2	1.5	1.8	2.2	2.0
EU	58.3	59.8	56.4	61.8	62.7	62.1
Austria <sup>1)</sup>	0.7	0.6	0.6	0.1	0.1	0.1
Belgium	2.0	2.0	1.9	1.8	1.8	1.2
United Kingdom	9.9	9.6	10.2	20.5	19.3	19.0
Denmark	9.0	9.4	8.4	6.4	7.8	7.2
Finland <sup>1)</sup>	1.9	1.8	1.6	0.9	0.5	1.0
France	3.5	4.2	3.3	7.2	6.8	6.7
Greece	0.1	0.1	0.1	0.8	0.8	0.7
Netherlands	6.3	6.8	6.0	1.6	3.0	3.6
Ireland	1.0	1.0	1.0	0.2	0.2	0.1
Italy	3.2	3.3	3.2	2.3	2.0	1.9
Luxembourg	0.0	0.0	0.1	0.1	0.0	0.1
Portugal	1.2	0.9	0.7	1.3	1.8	2.6
Spain	1.4	1.6	1.7	4.7	3.7	3.9
Sweden <sup>1)</sup>	7.0	7.0	6.7	1.0	1.3	1.3
Germany	11.2	11.4	10.9	12.8	13.7	12.8
EEA <sup>2)</sup>	72.6	70.0	69.9	64.6	66.0	65.8
Other Europe	3.6	5.6	5.8	1.2	2.4	2.2
Russia	2.2	2.3	2.5	0.6	0.6	1.0
Other	1.4	3.3	3.3	0.6	1.8	1.2
North America	9.9	9.4	10.4	15.7	14.0	13.3
United States	8.9	8.4	9.4	14.4	12.3	12.1
Canada	1.0	1.0	0.9	1.3	1.7	1.2
Japan	4.0	4.4	4.0	14.0	11.3	9.8
Other countries	8.5	9.5	8.4	2.8	4.1	6.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

1) Joined the European Union at the beginning of 1995

2) The EU and the EFTA countries except Switzerland

Source: Statistics Iceland

Table 8  
**Balance of Payments**  
 - Millions of krónur -

	1994	1995	1996
Current Account	8,385	3,433	-9,123
Balance on Goods	19,662	13,356	1,786
Merchandise exports f.o.b.	112,654	116,607	126,200
Marine products	84,838	83,873	92,579
Aluminium and ferro-silicon	13,522	15,514	15,918
Miscellaneous	14,294	17,220	17,703
Merchandise imports f.o.b.	-92,992	-103,251	-124,414
Special imports	-9,440	-10,219	-15,005
General imports	-83,552	-93,032	-109,409
Balance on Services	2,185	1,938	-177
Exports of services, total	43,824	43,412	48,959
Transportation	18,139	17,340	22,479
Travel	9,637	10,773	10,224
Other receipts	16,048	15,299	16,256
Imports of services, total	-41,639	-41,474	-49,136
Transportation	-12,077	-13,371	-16,986
Travel	-17,892	-18,194	-20,597
Other expenditures	-11,670	-9,909	-11,553
Balance on Income	-12,836	-11,555	-10,268
Receipts	5,664	5,862	6,987
Compensation of employees	2,993	3,260	4,242
Investment income	2,671	2,602	2,745
Expenditures	-18,500	-17,417	-17,255
Compensation of employees	-532	-365	-306
Investment income	-17,968	-17,052	-16,949
Current transfer, net	-626	-306	-464
Capital and Financial Account	-8,238	1,628	6,572
Capital transfer, net	-293	-138	-32
Financial Account	-7,945	1,766	6,604
Financial Account excl. Reserves	-18,623	2,012	16,752
Direct investment, net	-216	-121	-411
Abroad	-199	-415	-326
In Iceland	-17	294	-85
Portfolio investment, net	-7,549	-3,737	-1,579
Assets	-7,798	-3,179	-2,139
Liabilities	249	-558	560
Other capital, net	-10,858	5,870	18,742
Assets	-4,796	1,626	-3,926
Monetary authorities	-3,555	-1,073	-266
General government	0	0	0
Deposit banks	-350	4,135	-2,843
Other sectors	-891	-1,436	-817
Liabilities *)	-6,062	4,244	22,668
Monetary authorities	6,862	2,365	-6,397
General government	11,227	14,784	7,072
Deposit banks	-11,953	-5,405	20,564
Other sectors	-12,198	-7,500	1,429
Reserve assets	10,678	-246	-10,148
Net errors and omissions	-147	-5,061	2,551
Memorandum items:			
Long-term borrowing, net	-5,874	-1,284	11,262
Foreign borrowing	33,815	30,541	37,923
Amortization	-39,689	-31,825	-26,661
Short-term borrowing, net	-188	5,528	11,406
Exchange rate: ISK per USD	69.83	64.67	66.50
Preliminary figures			

Source: Central Bank of Iceland

Table 9  
**Current Account as Percent of GDP**

	1991	1992	1993	1994	1995	1996
Trade account <sup>1)</sup>	-0.8	0.0	3.1	4.5	3.7	0.4
Imports	-24.6	-22.1	-20.0	-21.5	-22.5	-25.5
Exports	23.8	22.1	23.1	26.0	26.4	25.9
Services account	-3.9	-3.0	-3.0	-2.5	-2.7	-2.3
Net interest	-3.9	-3.4	-3.5	-3.6	-3.6	-3.6
Other	-0.0	-0.4	0.5	1.1	0.9	0.7
Current account	-4.7	-3.0	0.1	2.1	0.9	-1.9

1) Merchandise trade

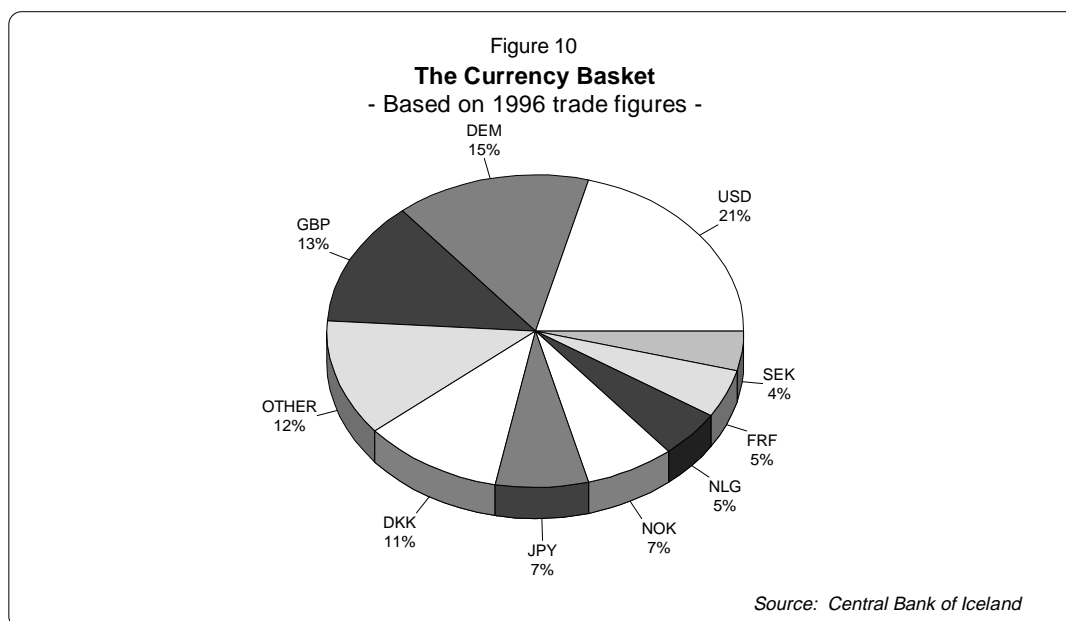
Source: Central Bank of Iceland

## V. FOREIGN EXCHANGE

### Foreign Exchange Rates

A stable exchange rate is the intermediate target of the Central Bank's monetary policy. 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 in order to affect the daily exchange rate of the króna. Since July 1997, the Central Bank has, however, ceased its role as a market maker in the interbank foreign exchange market.

The currency basket 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 6 percent. Since the trade weighted basket was introduced in September 1995, the króna has never moved more than 2 percent from the central rate.



Rules and regulations governing inward and outward capital transactions in Iceland have been gradually liberalized. The final step in the liberalization of external capital movements was taken 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.

Table 10  
**Buying Exchange Rate of the Króna Against Selected Currencies  
 and the Index of the Nominal Effective Exchange Rate**

- End of period -

	1992	1993	1994	1995	1996	Sept.1997
ISK per USD	63.84	72.63	68.21	65.14	66.71	71.46
ISK per DEM	39.55	41.88	44.33	45.49	42.95	40.47
ISK per JPY	0.512	0.651	0.684	0.633	0.573	0.5899
Nominal effective exchange rate <sup>1)</sup>	296.5	320.8	326.0	325.6	322.3	315.8

1) 1983 = 100

Source: Central Bank of Iceland

### Foreign Exchange Regulations and Direct Investments

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 liberalized, including travel expenses, interest payments, dividends and other forms of income from capital.

Direct investments and purchases of residences abroad by Icelanders are fully liberalized. 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 maximum of 33 percent.
2. Investment in energy production and energy distribution in Iceland are prohibited.
3. Investments by residents outside the EEA in aviation companies are restricted to 49 percent.

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

### Foreign Exchange Reserves

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. A revised agreement entered into force in the beginning of 1993, according to which the Central Bank of Iceland can draw up to ECU 200 million. In addition, the Central Bank has access to two committed interbank lines. and uncommitted interbank lines with a number of international banks.



Table 11  
**Foreign Exchange Reserves of the Banking System**  
 - Millions of krónur, end of year -

	1994	1995	1996
Gross reserves of the Central Bank	24,351	22,538	24,800
Gold	172	167	183
SDR	7	2	11
MF reserve position	1,043	1,005	1,005
Convertible currencies	23,129	21,364	23,601
Convertible foreign assets of the Icelandic commercial banks	4,505	2,713	10,878
Gross total foreign exchange reserves	28,856	25,251	35,678
Conversion rate (mid): Krónur per USD	68.21	65.23	66.71

Source: Central Bank of Iceland

## **VI. FINANCIAL MARKETS**

### **Financial Markets Developments**

Over the last decade the Icelandic financial system has undergone an important transition, generated by liberalization 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 mutual funds were established. Towards the end of the decade a process of rationalization 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 savings 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, including acts on commercial and savings banks, other credit institutions, securities transactions, mutual funds and the Iceland Stock Exchange. The general impact of this legislation has been twofold. Firstly, 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, which is in the hands of the Central Bank, has been extended and strengthened at the same time. Secondly, the new legislation is an important anchor for the deregulation process that has been under way for some time, with the most important changes being the abolition of centralized control over interest rates in 1986 and the gradual liberalization of capital movements completed in the beginning of 1995.

### **Commercial Banks and Savings Banks**

There are four commercial banks in Iceland, of which two are state-owned (Landsbanki and Búnadarbanki) one is a private limited liability company (Íslandsbanki) and one is owned by the savings banks (Icebank). Three of the four commercial banks perform all the traditional banking operations, accept deposits, grant credit, deal in foreign exchange and maintain accounts with correspondent banks abroad. Legislation has already been passed to turn the two state-owned banks into limited liability companies as of the beginning of 1998. Initially the state will be the sole owner, but the Minister of Commerce is authorized to sell new equity up to the point where 35 percent of equity will be in private hands. The fourth commercial bank (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 cooperatives and the Post Giro.

### **Other Credit Institutions**

Investment credit funds have played an important role in the financial system as providers of long-term credit. The majority of the investment credit funds is government-backed. Legislation has now been passed to merge three of the largest investment credit funds, the

Fisheries Investment Fund (Fiskveidasjóður), the Industrial Loan Fund (Idnlánasjóður) and the Industrial Development Fund (Idnþróunarsjóður), into a new incorporated investment bank as of the beginning of 1998. A quarter of the capital of the merging credit investment funds will be used to spin off a venture capital fund. The legislation permits an immediate sale of up to 49 per cent of the government's shares in the new investment bank, but further sales require Parliamentary approval. The Regional Development Institute (Byggðastofnun) and the State Housing Fund (Byggingarsjóður ríkisins), however, will remain unchanged.

In recent years, there has been a structural change in the financing of the investment credit funds. They have increased their public issuance of bonds on the domestic market and reduced the use of foreign funds and borrowing from other financial institutions.

There are three leasing companies in operation. Recently, the leasing companies have diversified their activities to some extent by granting loans in addition to making conventional leasing contracts.

	1992	1993	1994	1995	1996
Securities issues	185	224	268	318	416
Short-term paper	19	21	16	20	23
Long-term paper	121	156	193	216	241
Mutual fund shares	9	12	16	14	21
Stocks	36	35	45	68	131
Credits of financial institutions	668	742	801	864	932
Banking system	210	229	235	240	257
Investment credit funds	200	224	243	263	282
Pension funds	165	189	211	236	265
Leasing companies	9	10	10	8	11
Insurance companies	17	20	23	27	32
Government lending funds	67	70	79	90	85
Foreign borrowing	255	291	283	283	300

*Source: Central Bank of Iceland*

### The Securities Market

The securities market has expanded gradually in Iceland. Since 1964 the Government has issued indexed savings bonds, and in the seventies 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. Treasury bonds, notes and bills are auctioned regularly. In 1985, marketable bonds and money market instruments were equivalent to 6 percent of GDP, but at the end of 1996 they amounted to 58 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 very high rate of inflation. The two-tier system of indexed and non-indexed obligations has tended to cause nominal interest rates to change in

Table 13  
**Securities in the Domestic Market**  
 - Billions of krónur at end of year -

	1992	1993	1994	1995	1996
Government Savings bonds	53.2	64.0	72.5	78.0	77.4
Treasury bills	15.5	17.5	14.6	15.5	15.3
Treasury notes	. .	2.1	5.6	6.6	10.4
Bank bonds and bills	20.6	22.7	22.3	24.2	31.0
Housing bonds	35.8	49.1	64.7	77.6	92.5
State housing fund bonds	1.2	5.6	7.7	7.6	15.0
Bonds of other inv. credit funds	3.9	6.6	9.2	14.3	13.8
Mutual funds unit (open end)	9.0	12.1	16.2	14.5	20.5
Bonds of leasing companies	4.1	5.4	6.1	4.9	6.9
Shares (market capitalization)	36.2	35.1	45.9	65.3	131.5

Source: Central Bank of Iceland

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 have eliminated indexation from new instruments with a maturity under seven years by the year 2000.

The Iceland Stock Exchange was established in 1985 and operates now on basis of legislation adopted in 1993. Currently there are seventeen members to 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 44 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 1996, the market capitalization of listed securities was 350 billion krónur, of which 240 billion krónur were bonds, 93 billion krónur equities, and 17 billion krónur money market instruments.

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

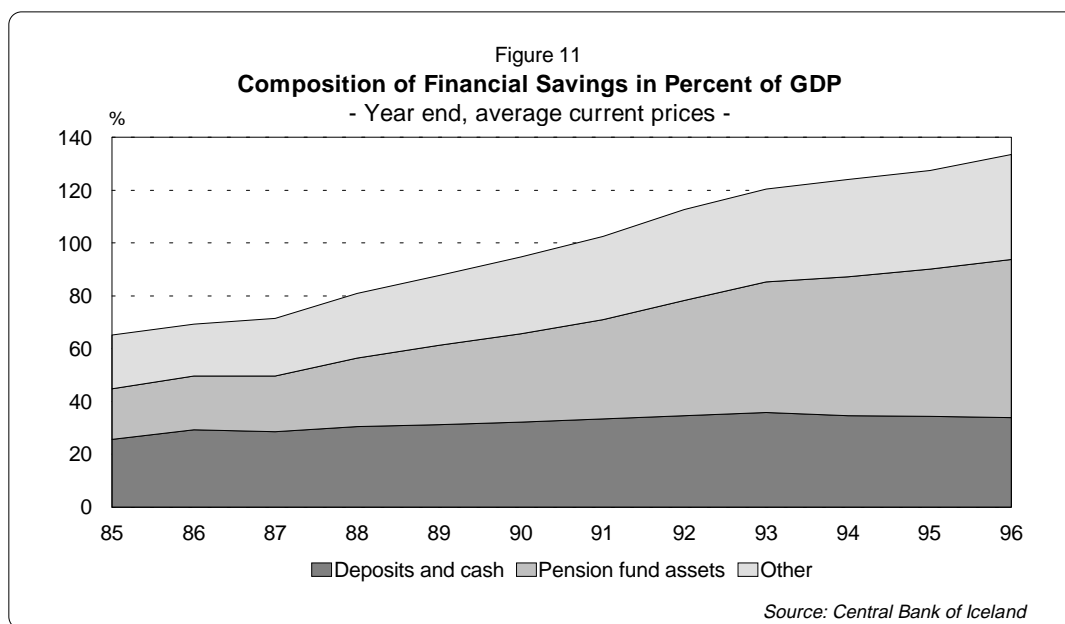
### **Institutional Investors**

There are currently 66 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 invest mainly in bonds issued by the Treasury and the investment credit funds, but also in bonds issued by other financial institutions, municipalities and companies, and to some extent in shares. They also extend credit to members. 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 fifteen closed-end mutual funds in operation in Iceland. They are limited liability companies, and nine of them are quoted on the Iceland Stock Exchange. There are eight open-end mutual funds in Iceland, which are operated in 31 divisions. One securities firm, Kaupthing, also operates mutual funds quoted in Luxembourg Stock Exchange.

There are now 17 insurance companies operating in Iceland. Three of them are life-insur-

ance companies, representing only 5 percent of total assets of the companies. One reason for the small share of life insurance is probably the employees' compulsory membership in pension funds. About half of the insurance companies' portfolio consists of marketable securities, which make them fairly big players in the Icelandic securities market.



### The Central Bank

The Central Bank of Iceland (Sedlabanki Íslands) was established in 1961 and 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 and monitors the operations of financial institutions. 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 the international capital markets.

The Central Bank has decisive influence, subject to Government approval, in the formulation of the exchange rate policy. The exchange rate of the króna is determined in an interbank market within a range of fluctuations set by the Government, presently 6 percent from a central rate. The Central Bank will buy and sell currency in order to keep the exchange rate within this range.

The Treasury and several government institutions have their bank accounts with the Central Bank, which acts as banker, economic adviser and fiscal agent for the Government. Until few years ago the Treasury had unlimited access to a short-term overdraft facility with the Central Bank. In 1992, an agreement on Central Bank credit accommodation was reached between the Central Bank and the Minister of Finance which 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 2.5 or 4.0 percent of total disposable funds, depending on maturity. In addition

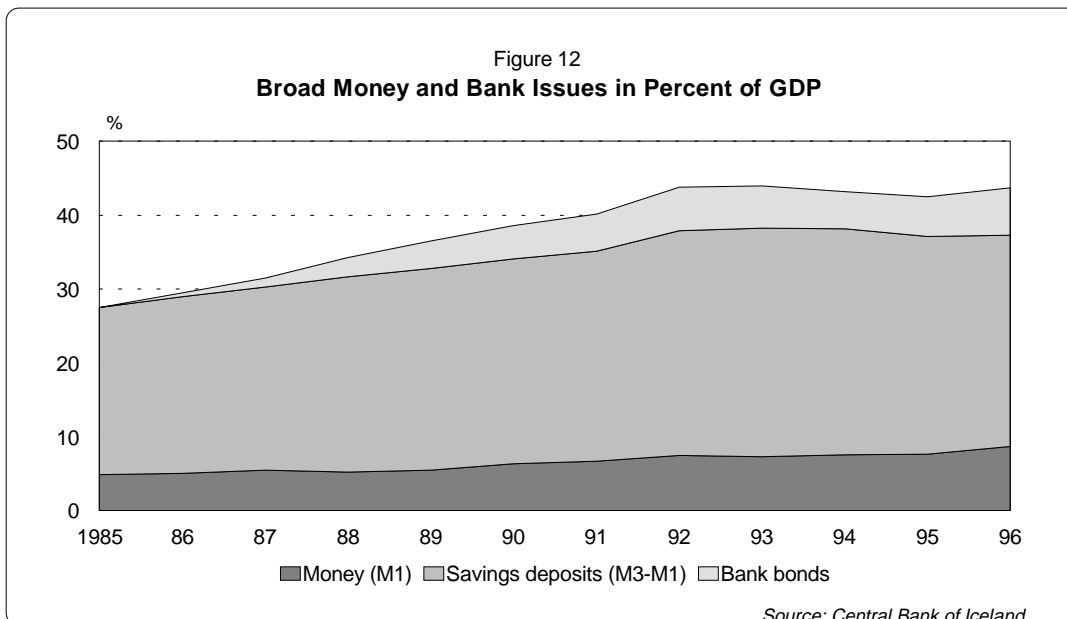
there is a 12 percent liquidity ratio requirement, as measured by the ratio of liquid assets against total liabilities, not including Central Bank financing and foreign funding. During the last decade the direct access that banks have to the Central Bank accommodation has been greatly reduced.

In March 1997, the Central Bank renewed an agreement from February 1996 with three securities houses according to which they assume the responsibility of market makers in the secondary market for government securities. The Central Bank ceased its operations as a market maker for Treasury bonds and Treasury notes last year.

### Supervision and Regulations

The Central Bank has 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 supervises the annual statements and the audit of pension funds. Thus the field of surveillance covers the whole range of financial institutions except insurance companies, closed-end mutual funds and the state owned Building Fund. These functions are vested in the Bank Inspectorate, a department within the Central Bank. The main task of the Bank Inspectorate is 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 Inspectorate. The operations of insurance companies, however, are 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 banks and other financial institutions have been adapted to the various regulations and directives of the European Union. The current rules on capital adequacy are based on the Basel guidelines, with a minimum capital ratio of 8 percent. According to rules which the Central Bank has imposed, commercial and savings banks are obliged to keep the difference between foreign exchange assets and liabilities within a certain level (30 percent of capital and reserves). The same is true for indexed assets and liabilities.



There are deposit insurance schemes in force, one for the commercial banks and the other 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 savings banks own their insurance funds.

### Monetary Policy

The Central Bank is primarily responsible for the monetary policy. A stable exchange rate is the intermediate target of monetary policy. The instruments used by the Central Bank are its own interest rates (discount rate, repo rates and intervention rates on the money market) and the access that the banks are granted to Central Bank financing. The Central Bank has independence in setting its own interest rates but the use of some of its instruments is subject to Government consent, the most important being the reserve requirement. Thus, 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 Treasury regularly sells Treasury bills, Treasury notes and Government savings bonds by competitive bids at auctions. The Treasury started to auction T-bills in 1992, but prior to that the Treasury only sold bills on tap at 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 now 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.

The Central Bank has been gradually developing 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, reserve requirements and minimum liquidity ratio. Financial institutions are free to decide all their interest rates with the exception that the Central Bank decides penalty interest rates on overdue payments.

Table 14  
**Money Supply**

- Millions of krónur, end of year -

	1992	1993	1994	1995	1996
Notes and coins	3,593	3,907	4,641	5,169	5,442
Demand deposits	26,350	27,657	30,314	33,147	37,029
Money supply, M1	29,943	31,564	34,955	38,316	42,471
General savings deposits	94,449	98,341	78,770	72,793	71,822
Money supply, M2	124,392	129,905	113,725	114,285	114,293
Time deposits	29,638	34,222	54,193	57,371	67,287
Money supply, M3	154,030	164,127	167,918	171,656	181,580
Percentage changes over the year:					
Money supply, M1	1.3	5.4	10.7	11.3	10.8
Money supply, M3	3.8	6.6	2.3	3.7	5.8

Source: Central Bank of Iceland.

## VII. PUBLIC FINANCE

### Central Government

The Icelandic Constitution requires the authorization of the Althing for all state expenditures, taxation and borrowing. The budget proposal is presented to the Althing 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 (Ríkisendurskodun), which is an independent entity under the Althing.

In the 1997, the total projected revenues amount to 130.9 billion krónur, while the total expenditures are estimated to amount to 132.2 billion krónur, resulting in a Treasury deficit of approximately 1.3 billion krónur. It should be noted, however, that in February 1997 it was decided to stage redemption of callable Treasury savings bonds and reduce future interest payments. This led to a surge in interest payments in 1997, of 4 billion krónur, which in turn will be registered in the cash flow of the government accounts and affect the budget figures for 1997. If these prepayments are excluded, the fiscal budget will show a surplus of 2.7 billion krónur, compared to a near balance in the 1997 Budget passed by the Althing last year.

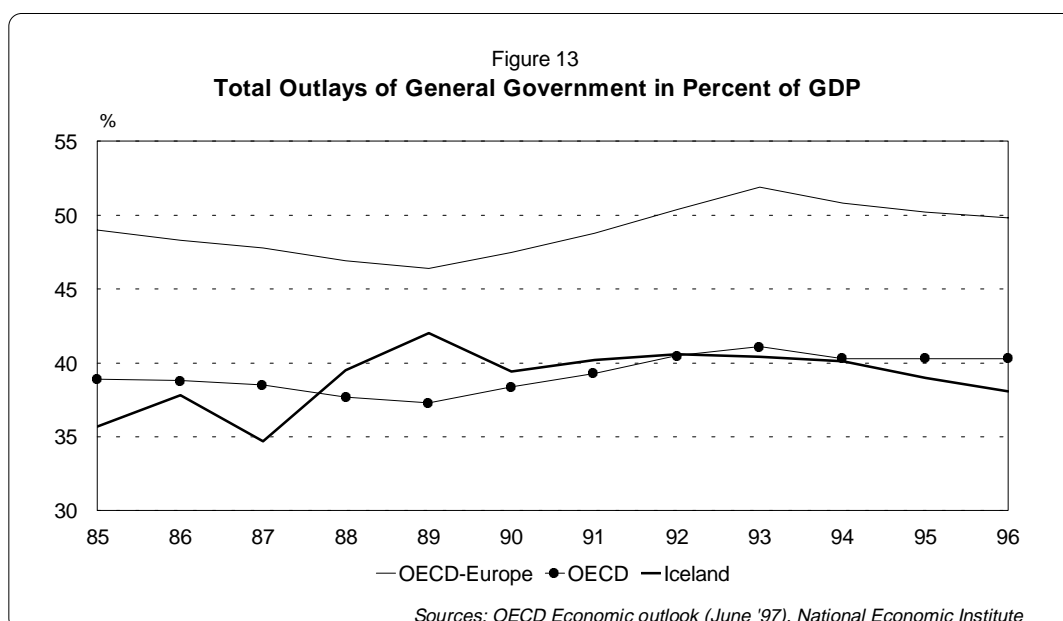
In spring 1997, a new act was passed on the presentation of the Budget. The act comes into effect with the 1998 Budget Proposal, where it is presented on accruals basis for the first time.

Table 15  
**Treasury Revenues and Expenditures**  
 - In millions of krónur-

	Cash basis		Accruals basis
	1997	1998	1998
Revenues	130,927	137,600	163,484
1. Tax revenues	121,830	128,215	148,106
Taxes on income and profit	22,674	23,675	37,937
Social security taxes	14,710	15,232	14,990
Wealth taxes	3,966	4,200	7,959
Taxes on goods and services	77,390	81,844	86,810
Other taxes	3,090	3,264	305
2. Operating revenue	8,397	7,485	12,785
3. Sale of assets	700	1,900	1,921
4. Capital transfers	0	0	672
Expenditures	132,700	134,538	162,963
1. Operating expenditure	47,900	52,038	62,140
2. Transfer payments	52,900	56,018	68,570
3. Cost of capital, interest payments	17,550	12,300	16,200
4. Maintenance	3,800	3,753	3,730
5. Capital expenditures	10,550	10,429	12,323

Source: Ministry of Finance





The main aim of presenting the Budget on accruals basis is to show in a concise manner the total activity of the central government and aid in assessing their long term effects. This includes commitments for central government employees' pensions and accumulated interest payments on government securities.

The Treasury aims for a larger revenue surplus in the 1998 Fiscal Budget. According to the Budget Proposal, the surplus will amount to approximately 0.5 billion krónur on accruals basis, or 3.2 billion krónur on cash basis. Total revenues are projected to increase due to continued economic upswing and amount to 163.5 billion krónur on accrual basis. At the same time total expenditure is expected to fall considerably, or by 1.6 percent of GDP, and amount to 163.0 billion krónur on accruals basis. For the first time in years, the net borrowing requirement for the Treasury will be negative in 1998, by 5 billion krónur, or 0.9 percent of GDP. This represents a shift of 8 billion krónur from 1997, and is largely due to plans to sell government owned corporations. Thus, Treasury debt continues to fall, from 49 percent of GDP at year-end 1996, down to 42½ percent in 1998. This development is also reflected in public debt, which falls from 57 percent of GD in 1996 to 51 percent in 1998.

In 1996, the central government derived approximately 64 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 40.88% and was reduced from 41.98% in

Table 16  
**Treasury Finances**  
 - In millions of krónur -

	1995	Cash basis		1998	Accruals basis
		1996	1997		1998
Revenue	114,413	127,735	130,927	137,600	163,484
Expenditure	123,344	139,729	132,200	134,438	162,963
Revenue balance	-8,931	-11,994	-1,273	3,162	521
- in percent of GDP	-2.0	-2.5	-0.2	0.6	0.1
Revenue balance excl. special redemption	-	-1,982	2,727	-	-
Net lending	-9,659	-713	-1,825	1,827	3,450
Net borrowing requirement	18,590	12,707	3,098	-4,989	-4,989
- in percent of GDP	4.1	2.6	0.6	-0.9	-0.9

Source: Ministry of Finance

1997. Further reduction to 38.88% is planned by January 1 1998. 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 1996 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 1996. Expenditure on communications, including public roads investment, amounts to approximately 7 percent of total spending in 1996.

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 Althing. The credit budget authorizes 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.

### Local Government

Iceland is divided into 165 municipalities, of which 31 are classified as towns. 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.

**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 35 percent of total government spending in 1993.

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, a share that had been gradually rising until approximately 1980, but which has been declining since 1984. While hospital treatment is free, patients face co-payments for most ambulatory care as well as for pharmaceuticals. The delivery of care is rather decentralized 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 in the capital area.

## VIII. FOREIGN DEBT

On December 31, 1996, Iceland's total Treasury debt amounted to an estimated 237 billion krónur. Of the total debt, 105.4 billion krónur was internal debt and 131.6 billion krónur was external debt. On December 31 1996, Iceland had guaranteed an aggregate amount of 111.8 billion krónur of internal debt and the equivalent of 246.5 billion krónur of external debt.

### Treasury Foreign Debt

The Republic of Iceland is the largest and most active Icelandic borrower in international markets. The National Power Company (Landsvirkjun), the commercial banks and some of the investment credit funds 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 1996, the foreign debt of the Treasury amounted to 131.6 billion krónur, of which long-term debt was 114 billion krónur, and the amount of outstanding Euro-Commercial Paper was 18 billion krónur. Approximately 32.7% of foreign debt was in US dollars, 11.5% in Japanese yen and 55.8% in various European currencies. At the end of 1996, 64% of the foreign debt carried fixed interest rates and 74% excluding short-term funds. Average lifetime of foreign long-term debt was 5.2 years with a duration of 3 years. Average lifetime of foreign debt including short-term funding equals 4.5 years with a duration of 2.7 years.

The U.S. dollar has long been very important currency for Icelandic borrowers, although the

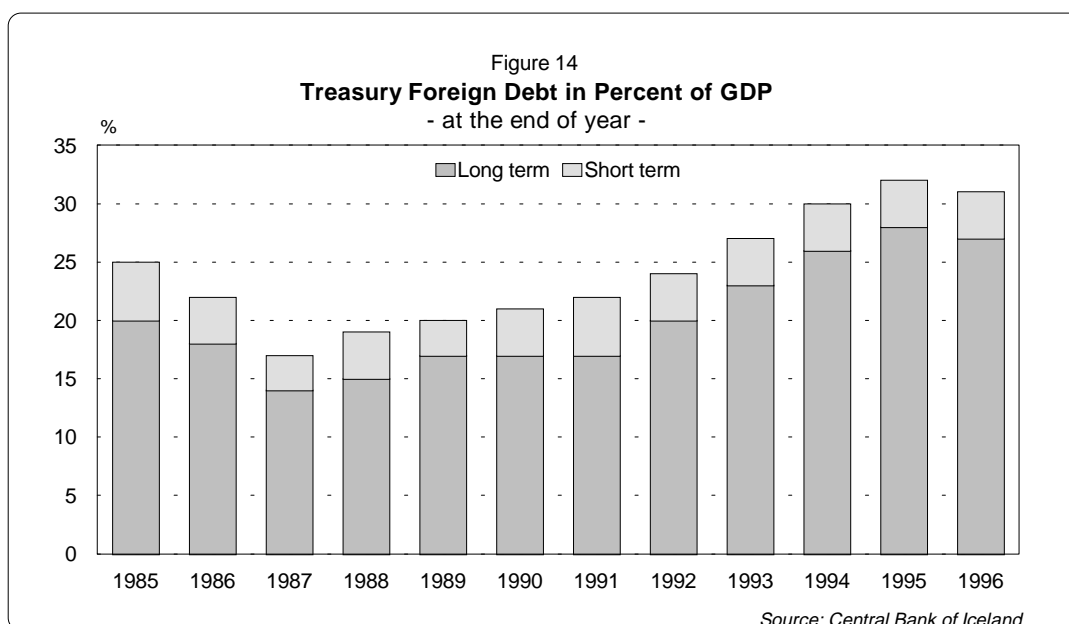


Table 17  
**Currency Composition of Treasury Debt**  
 - In percent of total, at the end of period -

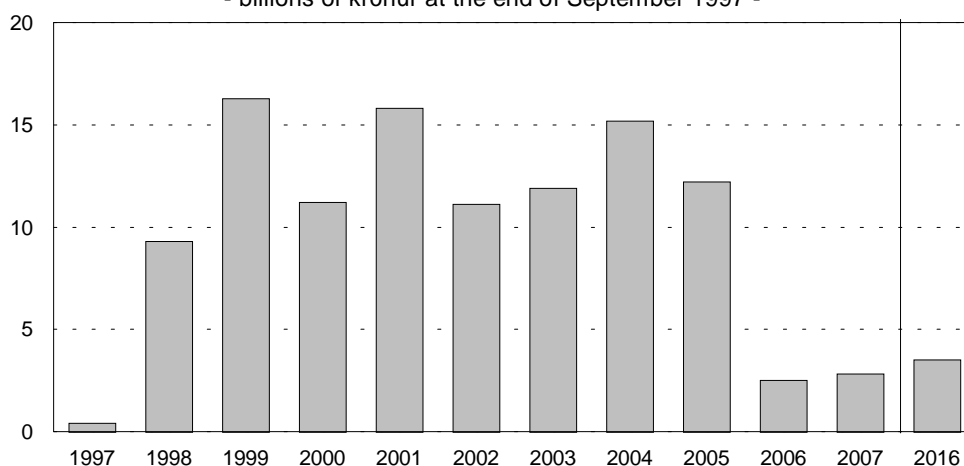
	1994	1995	1996	Sept.1997
U.S. dollar	40.4	38.4	33.6	32.6
Japanese yen	14.7	13.6	10.7	10.9
European currencies	44.9	48.0	55.7	56.5
Deutsche mark	19.4	17.7	29.8	29.9
Pound sterling	12.2	10.2	11.2	11.8
Swiss franc	8.9	11.1	9.4	9.6
French franc	0.6	0.6	0.5	0.5
Dutch guilder	0.1	-	-	-
ECU	3.7	8.4	4.8	4.8
Total	100.0	100.0	100.0	100.0

Source: Central Bank of Iceland

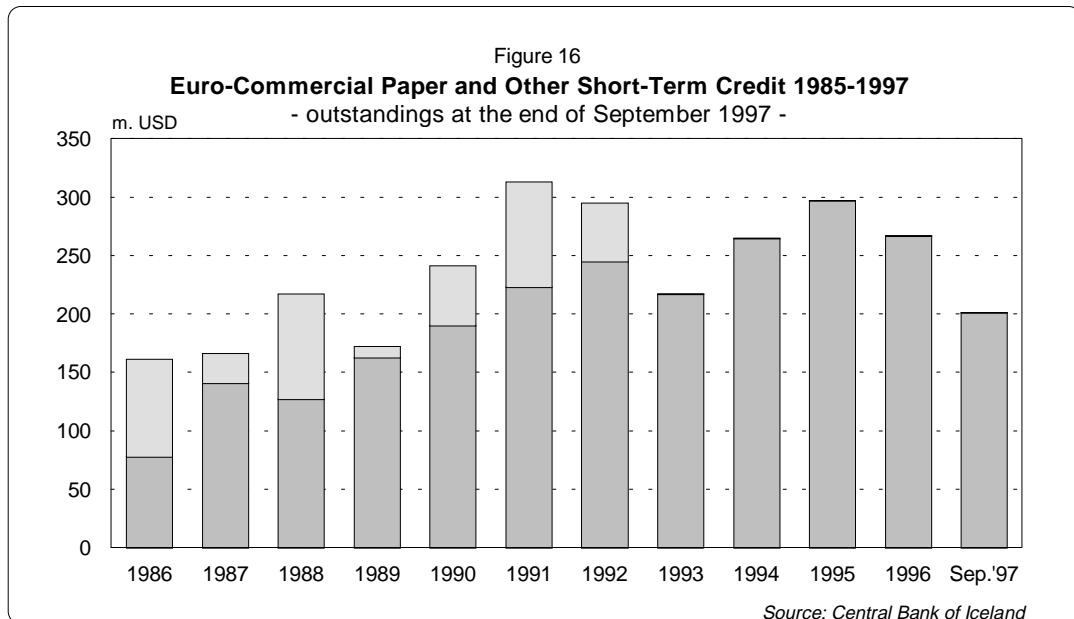
share of the dollar in the total external debt of the economy has diminished in recent years. This decline in the dollar component is a result of diminishing dollar denominated foreign trade in the Icelandic economy. The change in trade patterns affects the currency structure of the Treasury external 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 a Euro-Commercial Paper Programme, the first sovereign ECP

Figure 15  
**Annual Repayments of External Funded Debt of the Treasury**  
 - billions of krónur at the end of September 1997 -



Source: Central Bank of Iceland



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 Althing 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 for-

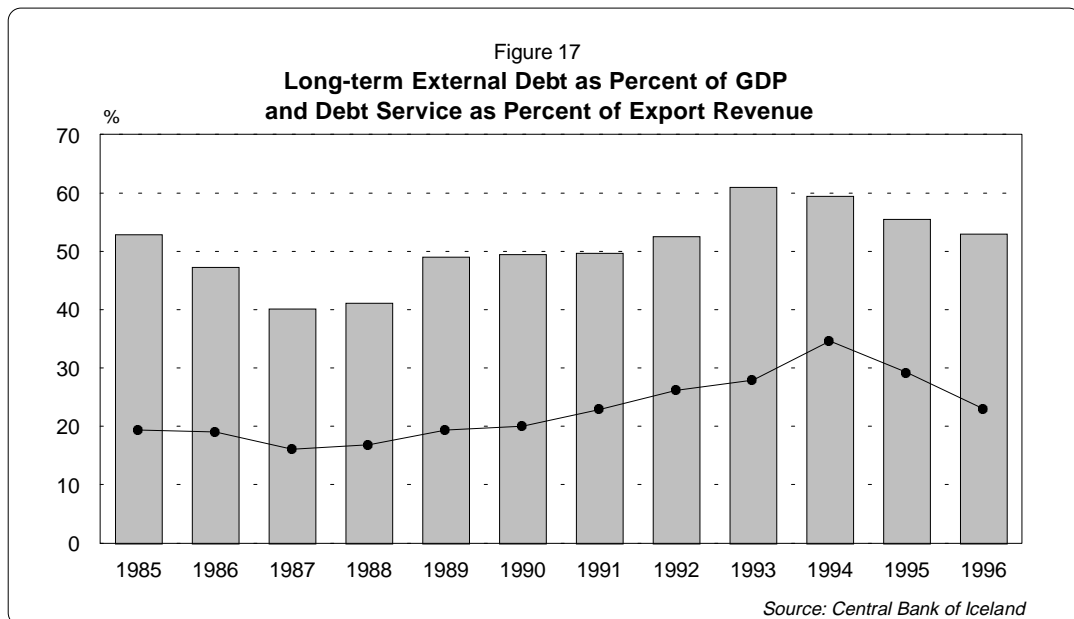


Table 18  
**Projected External Debt Service** <sup>1)</sup>  
 - In billions of krónur - <sup>2)</sup>

	1997	1998	1999	2000	2001	2002	2003	Principal thereafter	Total
<b>Public authorities</b>									
Principal	14.3	14.3	28.4	15.7	31.8	17.1	17.2	45.7	181.4
Interest <sup>3)</sup>	10.6	10.0	9.2	7.7	6.0	5.1	3.8		
Total	24.9	24.2	37.6	23.4	37.8	22.2	21.0		
<b>Financial institutions</b>									
Principal	7.5	8.7	6.9	13.1	9.7	2.0	5.7	8.4	59.3
Interest <sup>3)</sup>	2.6	2.3	1.9	1.5	1.1	0.7	0.6		
Total	10.1	11.0	8.8	14.6	10.7	2.7	6.2		
<b>Private sector</b>									
Principal	2.1	1.8	1.7	2.1	2.0	1.8	1.5	4.7	17.1
Interest <sup>3)</sup>	1.0	0.8	0.7	0.7	0.5	0.4	0.3		
Total	3.1	2.6	2.4	2.7	2.5	2.3	1.8		
<b>Total payments</b>									
Principal	23.9	24.8	37.0	30.8	43.5	20.9	24.4	58.8	252.4
Interest <sup>3)</sup>	14.2	13.1	11.8	9.9	7.6	6.2	4.7		
Total	38.1	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) U.S. Dollar LIBOR is assumed at 5.5 percent per annum

Source: Central Bank of Iceland

eign, 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.

### Debt Service

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 1996, the net external debt of the Icelandic Government, financial institutions and the private sector amounted to the equivalent of \$3,413 million, or 46.8 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 1995 and 1996, down to the current level of 23 percent of GDP.

### Debt Service Record

The Republic of Iceland has always paid when due the full amount required in respect of principal, interest and sinking fund instalments 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. Another upgrading came in July 1997 when Moody's upgraded the Republic's foreign currency rating to Aa3 and assigned a Aaa rating to the Republic's long-term krónur bonds. The current Republic of Iceland credit ratings are shown in table 19.

When announcing the decision to upgrade Iceland's ratings Moody's cited various factors. Thus, in its press release announcing the rating upgrade Moody's made a reference to increased diversification in the Icelandic economy as a consequence of an influx of new foreign investment projects that take account of the country's clear comparative advantages: abundant renewable geothermal and hydro energy and environmentally friendly tourism. Further, the improved ratings reflect the widespread restructuring and stabilization 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 rating of AA+ to Iceland's long-term local currency debt for the first time.

Table 19  
**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+	-