

CENTRAL BANK OF ICELAND

# The Economy of Iceland



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## Republic of Iceland

### People

Population	275,277 (December 1, 1998)
Capital	Reykjavík, 107,764 (December 1, 1998)
Language	Icelandic; belongs to the Nordic group of Germanic languages
Religion	Evangelical Lutheran (95%)
Life expectancy	Females: 81 years , Males: 76 years

### Governmental System

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

### Economy

Monetary unit	Króna (plural: krónur); currency code: ISK
Gross domestic product	586 billion krónur (US\$ 8.4 billion) in 1998
International trade	Exports 36% and imports 39% of GDP in 1998
Per capita GDP	2.1 million krónur (US\$ 31 thousand) in 1998

### Land

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

### Republic of Iceland credit ratings

	Foreign currency		Domestic currency	
	long-term	short-term	long-term	short-term
Moody's Investors Service	Aa3	P-1	Aaa	P-1
Standard & Poor's	A+	A-1+	AA+	-



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# 1. The Republic of Iceland

Iceland was settled late in the 9th century. The majority of the settlers were of Norse origin, although a certain element of the early settlers was of Celtic origin. A general legislative and judicial assembly, *Alþingi*, was established in 930 and a uniform code of laws for the entire country was adopted at the same time. In 1262, Iceland entered a treaty that established a union with the Norwegian monarchy. When the Danish and Norwegian monarchies were united in 1380, Iceland came under a Danish rule that lasted for more than five hundred years. Iceland was granted a new constitution in 1874 and obtained home rule in 1904. With the Act of Union in 1918, Iceland became a sovereign state in a monarchical union with Denmark. In 1944 Iceland terminated its monarchical union with Denmark and founded a Republic.

## **Geography and population**

Iceland is located in the North Atlantic between Norway, Scotland and Greenland. Iceland is the second largest island in Europe and the third largest in the Atlantic Ocean with a land area of some 103 thousand square kilometres and an exclusive 200 nautical mile economic zone extending over 758 thousand square kilometres in the surrounding waters. Iceland enjoys a warmer climate than its northerly location would indicate because a

part of the Gulf Stream flows around the south and west coast of the country. In *Reykjavík*, the capital, average temperature in July is around 11 degrees centigrade and just below zero degrees centigrade in January.

Being of volcanic origin, Iceland consists of coastal lowlands and a mountainous interior with several glaciers, the highest of which is 2,119 meters high. The coasts are rocky and of irregular outline, with numerous fjords and inlets, except for the south where there are sandy beaches with no natural harbours. Most of the arable land, estimated to be around 20 percent of total land area, is situated along the coast and most of the population lives in the coastal regions.

Iceland is one of the least densely populated countries in Europe with only 2.6 inhabitants per square kilometre. The population of Iceland was 275 thousand at the end of 1998. The annual rate of population growth was 0.8 percent between 1990-1997. Approximately 60 percent of the population live in the capital city of *Reykjavík* and its surrounding towns. The largest town outside the capital area is *Akureyri*, in the north, with a population of 15 thousand.

The native language, Icelandic, belongs to the Nordic group of the Germanic languages. The standard of education is high, and public education is compulsory between the

age of six to sixteen. Command of English and the Scandinavian languages is widespread.

### **Political structure and external relations**

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

Iceland has a tradition of political stability. Since gaining autonomy from Denmark in 1918, governments have normally been formed by a coalition of two or more political parties. Currently there is an Independence Party/Progressive Party coalition Government with a majority in the Parliament. The results of the election in 1999 were as follows: The Independence Party obtained 40.7 percent of votes and 26 seats, the Progressive Party 18.4 percent and 12 seats, Social Alliance 25.8 percent and 17 seats, Left-Green Movement 9.1 and 6 seats, Liberal party 4.2 and 2 seats. Others obtained 0.8 percent and no seats. The next general election is due in the year 2003.

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

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

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

Iceland is a founding member of the North Atlantic Treaty Organisation established in 1949. A defence treaty with the United States was concluded in 1951. A NATO military base, staffed by United States military personnel, is operated at *Keflavik* in the Southwest of Iceland.

### **Social services**

The health-care system is a crucial part of Iceland's extensive system of social protection which has developed for more than 100 years. The first old-age-pension legislation was passed in 1890, partly 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 47 percent of total government spending in 1998.

All residents of Iceland are covered by public health insurance as provided for in the 1993 Act on Social Security. Approximately 87 percent of total medical billings are paid by the public purse. While hospital treatment is free, patients face co-payments for most ambulatory care as well as for pharmaceuticals. The delivery of care is rather decentralised in local communities participating through a system of municipal health boards, but the role of central

government in the planning and co-ordination function is strong. In 1990, primary health care was further centralised, with the central government taking over complete financial responsibility in this domain, but a return of some functions, for example nursing-home care, to the municipalities is currently being contemplated. Ambulatory care is provided in outpatient clinics in major hospitals and by privately practising specialists. Primary health care is mainly provided by a network of some 70 public health centres, supplemented by private general practitioners

## 2. Recent Economic Development and Prospects

The Icelandic economy enjoyed brisk economic growth in 1998. This growth was fuelled by investment and increase in private consumption but export performance was disappointing. Inflation remained at a low level despite a large increase in aggregate demand. Unemployment declined to a very low level. The trade balance deteriorated although terms of trade improved considerably in 1998. The prospects for further economic progress in 1999 and in the year 2000 are favourable. In the first months of 1999 inflation has risen slightly, unemployment further declined and exports increased.

### Growth and trade

The economy has enjoyed economic growth of five percent or more for three consecutive years. The National Economic Institute (NEI) forecasts a 1999 growth rate of gross domestic product (GDP) close to the 1998 growth rate or 4.8 percent. For the period 2000-2003 economic growth is forecast to average around 2.5 percent per year. This growth is similar to the forecast for the OECD countries. In Figure 2.1 annual rate of economic growth in Iceland and OECD is shown.

Economic growth in 1998 was driven by an expansion in gross fixed investment and private consumption while public consumption grew more slowly. Exports grew less than GDP in 1998 or 2.6 percent. The volume of exports of marine products actually declined

while export of services such as tourism continued to grow briskly.

The upturn in the economy and increased purchasing power is reflected in rapid increase of imports in 1998. Imports of consumption goods increased by 17 percent while imports of investment goods increased by 33 percent over the previous year. In the first quarter of 1999 marine exports increased and imports declined.

Catches of cod increased by 17 percent in 1998. The cod quota for the fishing year

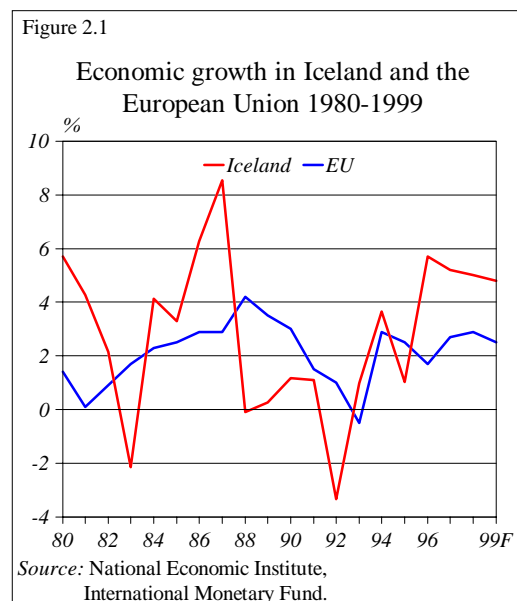


Table 2.1. **Output and expenditure 1998**

Billion krónur	Volume changes percent	
	1998	97/98
Private consumption	362	11.0
Public consumption	123	3.0
Capital formation	125	23.4
Stock changes	1	0.3
Total national expenditure	611	12.0
Exports of goods and services	205	2.6
Imports of goods and services	230	22.1
Gross domestic product	586	5.0
Net factor income from abroad	-7	-
Current transfers, net	-1	-
Current account balance	-34	-

Source: National Economic Institute, Provisional figures.

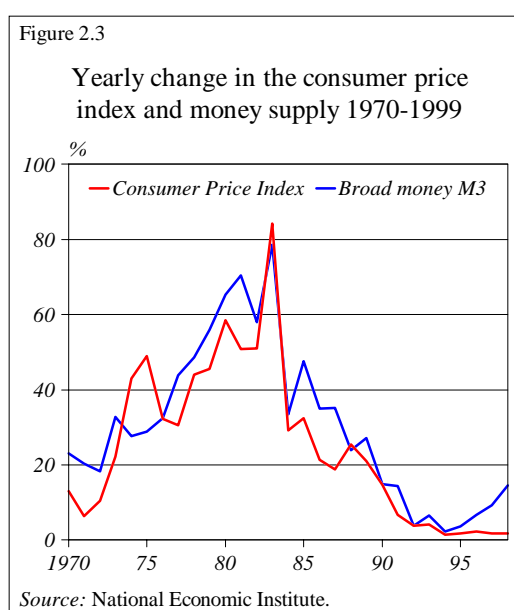
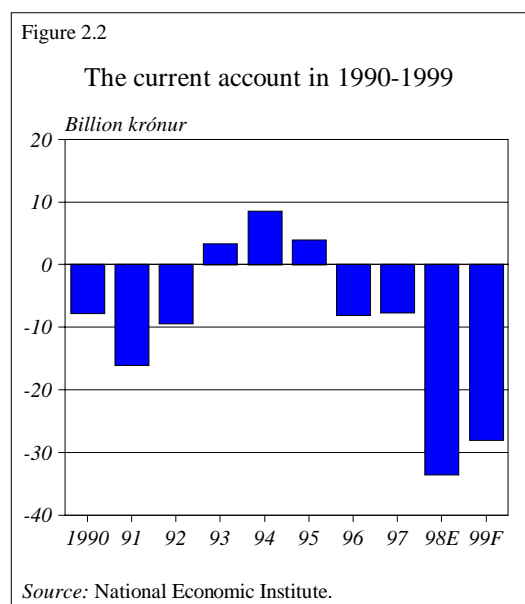
September 1999 to September 2000 will be 3,000 tons below the 250,000 tons allocated for 1998-1999. Total catch in 1998 was 1,690 thousand tons compared to almost 2,200 tons in 1997. The reduction is mainly due to a

decrease in the catch of Capelin. Prices of marine products rose by 12 percent in 1998 but prices of fishmeal and oil have fallen in the last months from the high level in 1997/98.

Terms of trade for goods and services are expected to have improved by 3.9 percent in 1998 but a further improvement is not expected for 1999. The outlook is favourable for an increase in marine export prices other than fish meal and oil as the supply conditions of demersal fish have deteriorated world-wide. The price of aluminium and ferrosilicon suffered in 1998 partly due to the Asian crisis and the outlook is uncertain.

### The balance of payments

In 1998 the deficit in the balance of goods and services was 5.7 percent of GDP compared to 1.4 percent in 1997. For 1999 the National Economic Institute expects the deficit to narrow to 4.4 percent of GDP. The balance on goods will improve slightly as special imports due to investment will stabilise but the balance on factor services will deteriorate due to increased interest payments.



Imports of investment goods, including imports associated with the expansion of the aluminium smelter in *Straumsvík* and the construction of the new aluminium smelter at *Grundartangi* contributed to the deficit in the years 1996-1998.

### Prices and wages

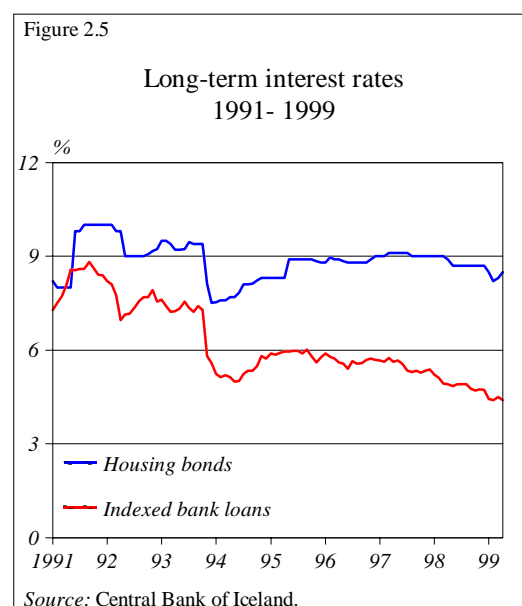
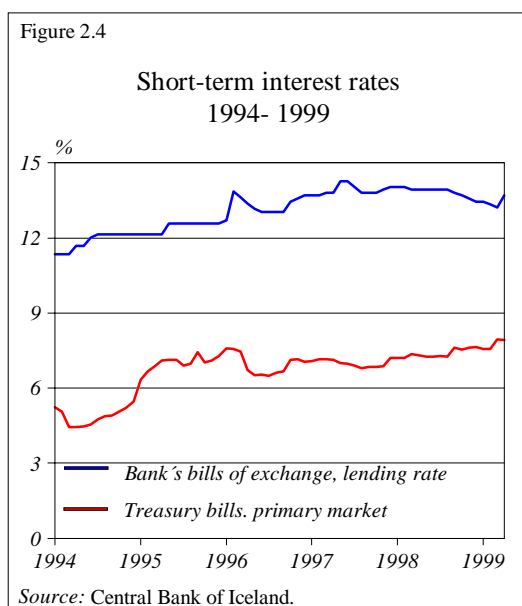
Inflation in Iceland continues to be at a low level. General prices increased by 1.7 percent over the previous year in 1998. The 12 month inflation rate increased from 1.3 percent in January 1999 to 2 percent in May. The main reason for this rather unexpected increase was a surge in housing prices. The Central Bank predicts the Consumers Price Index to rise by 2.8 percent during 1999.

The price stability attained in recent years is the result of a combination of several factors; a stable exchange rate, favourable import prices, tight monetary policy, increased competition in the retail business and moderate wage settlements. In 1997 wage agreements for the next three years were concluded between the private sector and the unions and

for most of the public sector. The agreements resulted in estimated wage increases in the range of 5-6 percent in 1997 and 4-5 percent in 1998. Real disposable household income per capita increased by around 9 percent in 1998 and is forecast to increase by 5.5 percent in 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. Employees in specific groups with particular educational background and skills are in high demand, such as computer experts and business administration graduates. The unemployment rate declined in 1998 to 2.8 percent of the labour force from 3.9 percent in 1997 and an unemployment rate of only 2.0 percent is forecast for 1999 which is the lowest unemployment rate among the OECD countries.

The Central Bank continues its tight monetary policy. The key short-term Central Bank rate, the repo rate, was increased to 7.5 percent in September 1998 from 7.2 percent. The yield in the domestic money market has



been substantially higher than trade-weighted foreign money market rates abroad. The difference was over three percent in the last three months of 1998 and over four percent in the first months of 1999. Long-term interest rates in the secondary market fell during the first half of 1998 but lending rates of commercial banks have been stable. The growth rate of monetary aggregates has been increasing. Broad Money (M3 including accrued interest) rose 14.6 percent in 1998 and in the first three months of 1999 broad money grew at an annual rate of over 20 percent. This was accompanied by a sharp credit expansion. To counter this expansion the Central Bank increased in March 1999 its short-term rate by 0.4 percent to 7.9 percent and introduced liquidity requirements on financial institutions.

### Public finance

The general government posted a surplus in 1998 amounting to 3 billion krónur or 1/2 percent of GDP which is an improvement on the rough balance achieved in 1997. Since the bot-

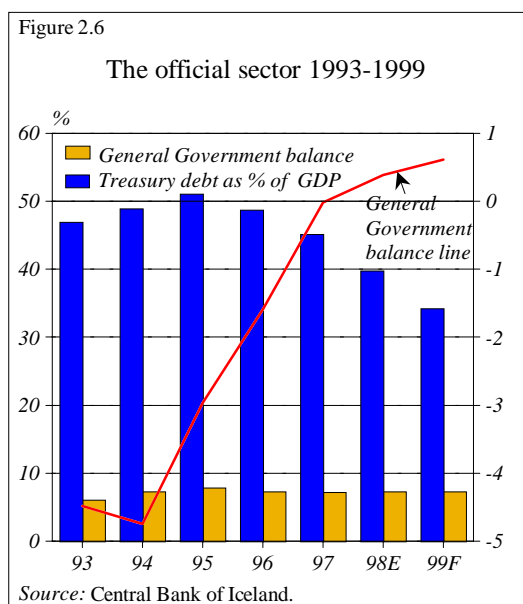
tom of the contraction in 1993, a large deficit has been turned into a slight surplus, with the economy in the sixth year of a vigorous expansion. The national debt has shrunk relative to GDP from a peak of 51 percent of GDP in 1995. The improvement has mostly been on the accounts of the central government, whereas local governments are still running a deficit of 5 percent of their revenues.

While the 1998 Treasury budget aimed for balance, the outcome, according to preliminary results, was a surplus of roughly 6 billion krónur or one percent of GDP in 1998. Revenues rose by 11 percent in nominal terms over 1997 with indirect tax yields rising somewhat faster than direct tax revenue, due to a cut in the general income tax rate at the beginning of 1998. The rise is similar to the increases in consumption and household income. Treasury expenditures rose 9 percent, led by expenditures in the health system. The above figures conform to international standards and neither include receipts from privatisation nor increased liabilities for civil service pensions. Along with the surplus, privatisation receipts and decreasing lending activities of the Treasury allowed the government to retire more than 10 billion krónur of outstanding debt and build up more than 5 billion krónur in deposits with the Central Bank.

The 1999 budget aims for a surplus of 2 billion krónur while privatisation and other favourable cash flow items are scheduled to allow repayments of a further 20 billion krónur of treasury debt, which should fall from around 240 billion krónur at the end of 1997 to less than 220 billion krónur by the end of this year. First quarter results show the Treasury in slightly better shape than last year

### Privatisation

Two state-owned commercial banks, *Landsbanki Íslands* and *Búnaðarbanki Íslands*, were incorporated in 1998 and the banks issued suc-



cessfully new equity for sale to the public later in the year. These changes are a first step towards the full privatisation of these institutions which, however, requires special approval by the parliament. A law has been

passed by parliament allowing for the sale of the remaining 51 percent of the total equity of *Fjárfestingarbanki atvinnulífsins (FBA)* to the public in 1999.

### 3. The Structure of the Economy

Despite the relatively small size of the Icelandic economy, growth and output have been sufficient to provide living standards that are among the highest in the world. The economy, traditionally based on fisheries and agriculture, has diversified into manufacturing and service industries in the last decades. Important primary and secondary industries are based on the use of renewable natural resources, namely the coastal fishing banks and hydroelectric or geothermal power. Tertiary activities employ around two thirds of the manpower and significant new developments have taken place in activities based on

investment in human capital such as software production, financial activities and biotechnology.

The estimated contribution of the various economic sectors to the total GDP in 1998 is shown in table 3.1.

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

The marine sector, including fishing and fish processing, is the main export sector. In 1998, 73 percent of merchandise exports (about half of total exports) originated in this sector. In the early 1960s, exports of fish and fish products constituted over 90 percent of merchandise exports.

The principal part of the Icelandic marine sector is the stock of groundfish, including species such as cod, haddock, saithe, and redfish. The catch of groundfish reached a maximum of 732 thousand tons in 1981 but has declined to 518 thousand tons in 1998 with a slight increase expected in 1999. Conservation measures led to substantial cuts in cod quotas in early 1990s, cod being the single most valuable species in Icelandic waters. The fishing industry offset the cuts by increasing catches in other marine species and by fishing beyond Iceland's exclusive 200 mile fishing zone. More efficiency has been achieved by selective catches, fish landed by foreign vessels has increased and a larger share of the catch has been processed domestically. In the

Table 3.1. **Share of GDP by industry 1998**

	%
Agriculture	2.0
Fishing	8.5
Fish processing	4.4
Manufacturing, water and electricity supply	16.2
Construction	9.1
Trade, restaurants and hotels	13.9
Finance, insurance, real estate and business services	16.4
Transportation	9.9
General government	16.2
Miscellaneous private services and other activities	7.2
Imputed bank service charges	(3.8)

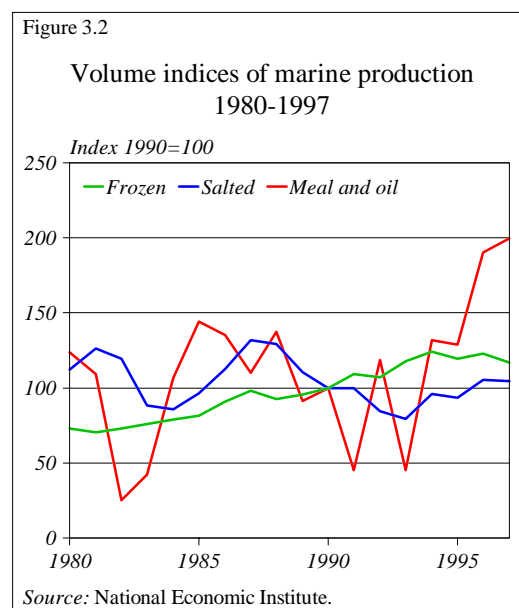
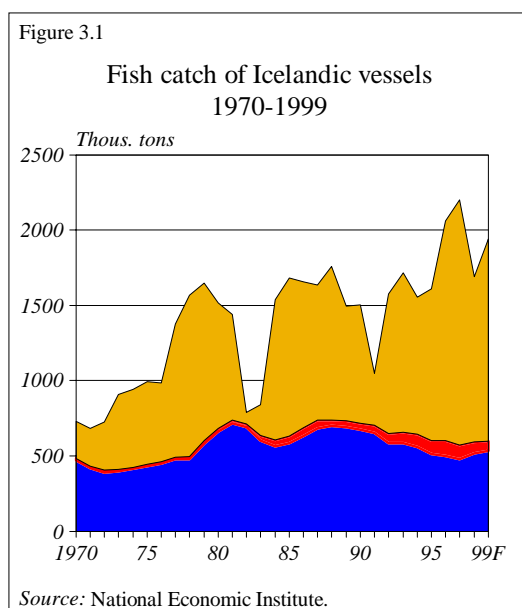
Source: National Economic Institute

last couple of years the cod stock has been recovering. Apart from groundfish and shrimp, the most important fish for Iceland's marine sector is capelin, a small fish of the salmon family. The capelin catch in 1998 was 752 thousand tons down from 1319 in 1997. The National Economic Institute estimates that the total catch will be 994 thousand tons in 1999. The catches of shrimp, lobster and shellfish have been of substantial value in recent years as well as catches of herring, which used to be one of the most important fish in the sixties. The production of fishmeal and oil has been very changeable as shown in Figure 3.2. Well over half of export value is frozen fish but fish on ice and salted fish are also important processing methods.

A comprehensive fisheries management policy has been developed to manage the fish stocks. Quotas regulate catches of all the major species of fish. The total allowable catch is determined on the basis of biological estimates of the status of the fish stocks and forecasts for their development in the near future. This quantity is then allocated among individual

fishing vessels and the quotas can be traded between companies at market price. The fishing quotas were originally allocated, free of charge, to fishing vessels on the basis of fishing experience as measured by the average catch for the last three years before the first allocation in 1986.

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





Increased quality and diversification extends not only to processing, but also to marketing. Icelandic fish products have been actively marketed in the United States, Europe and Japan and Icelandic products have acquired widely established brand names. Progress in the marine industry has to a certain extent limited the risks associated with Iceland's dependence on export of marine products as is evident by the rapid adjustment of the sector to the loss of markets in Japan and elsewhere due to the recent Asian crisis.

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

The largest manufacturing industries in Iceland are based on the extensive use of electric power. Various small scale manufacturing units produce for domestic consumption mainly but an increasing number is also producing for exports. In 1998, manufactured products accounted for approximately 22 percent of total merchandise exports.

The development of power intensive industries is based mainly on competitive energy prices that can be found in Iceland. The Government has been encouraging investment from foreign enterprises to develop such industries. Production of aluminium and ferrosilicon contributed 1.2 percent to GDP in 1996. The largest manufacturing facility in Iceland is an aluminium smelter located at *Straumsvík* near *Reykjavík*. The smelter is owned and operated by the Icelandic Aluminium Company Ltd, ISAL, which is a wholly owned subsidiary of Alusuisse Lonza AG of Switzerland. A 60,000-ton expansion of the *Straumsvík* smelter was completed in September 1997 bringing total capacity to 162,000 tons per year. Nordic Aluminium which is owned by the US company Columbia Ventures, completed the building the first phase of a new 60,000 tons aluminium smelter at *Grundartangi* in June 1998. The Icelandic Government, Elkem

A/S of Norway and the Sumitomo Corporation of Japan jointly own a 72,500 ton ferrosilicon plant, Icelandic Alloys Ltd, *Járnblendifélagið*, at *Grundartangi* in *Hvalfjörður* on the west coast of Iceland. Four medium-sized manufacturing enterprises, a fertiliser plant, a cement plant, a rock wool plant and a seaweed meal plant use locally available raw materials to produce for export (rock wool, seaweed meal) and the domestic market. The products of other manufacturing industries include fishing gear, packaging for exports, building components, machinery, equipment repair and maintenance, soap and related chemical products, plastics, ceramics, food products, beer, liquor, soft drinks, paint and furniture.

Geothermal steam has been used successfully in a diatomite plant in northern Iceland. Geothermal steam is available in several other places and can be of potential use in many industries as well as in the production of electricity.

In recent years, there has been a brisk growth of various high-technology industries such as pharmaceuticals, computer software industry and biotechnology. These industries are first and foremost based on investment in human capital. Production of equipment and electronic appliances for fishing and fish processing has also developed successfully. This development is supported by specialised knowledge and experience obtained from fisheries and fish processing.

### **Agriculture**

Approximately one-fifth of the total land area of Iceland is suitable for fodder production and the raising of livestock. Around six percent of this area is under cultivation, with the remainder devoted to raising livestock or left undeveloped. Production of meat, dairy products and eggs is mainly for domestic consumption. The principal crops are hay and potatoes. Vegetables, flowers and even some fruits are

cultivated in greenhouses heated with geothermal water and steam. A fur industry has developed and knitted clothing made of Icelandic wool is a popular export item.

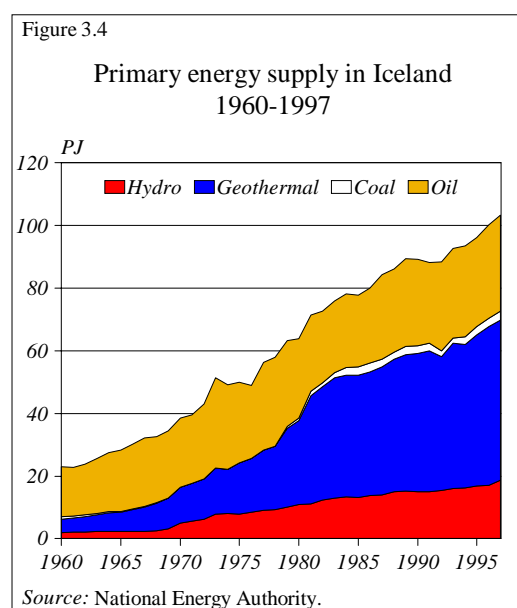
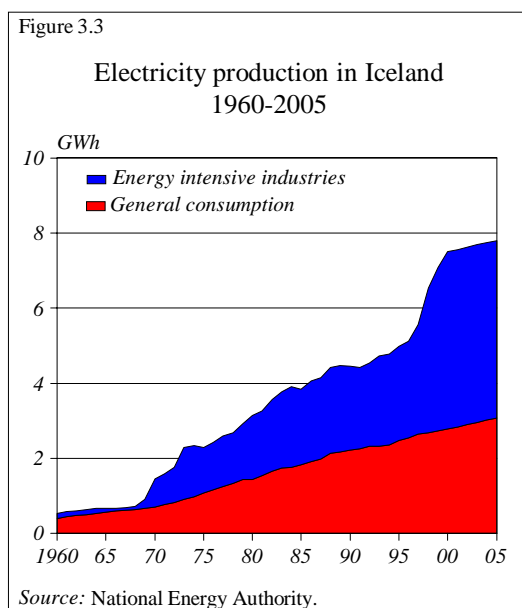
The agricultural sector has undergone structural changes in recent years. Demand for traditional products, especially lamb and mutton, has declined substantially while consumption of pork and poultry has risen in line with increased productivity and efficiency, especially in the production of pork. Price support and export subsidies for the traditional products, sheep and milk, have been replaced with subsidies in the form of direct income payments to the farmers. In the agricultural fiscal year from October 1997 to October 1998, these direct payments are estimated to amount to 42 percent of the farmers' costs in raising lamb and to 40 percent of the costs in milk production. Subsidies to farmers amounted to about 1.5 percent of GDP in 1998. Imports of meat, dairy products and certain vegetables that are produced domestically are limited by high tariffs, controls to prevent diseases and seasonal quotas. Imports are likely to increase

as tariffs go down in line with the WTO agreement on trade in agricultural products.

### Energy

Iceland has extensive hydro and geothermal resources. Electric power potential from hydro and geothermal sources is estimated to be at 50,000 GWh per annum, taking economic and environmental considerations into account. In 1998, the use of electricity in Iceland was approximately 6,300 GWh per year meaning that less than 15 percent of the power potential, as estimated by the National Energy Authority, has been harnessed. Furthermore per capita consumption of energy is close to being the highest in the world. A new 120 MW hydropower station, *Sultartangavirkjun* was completed in 1999.

All towns and villages and virtually all farms are connected to the public power utilities. All the largest hydroelectric power plants as well as the inter-regional power lines are owned and operated by the National Power Company, *Landsvirkjun*, which is the prime supplier of electricity in Iceland. The State



owns 50 percent of the company, the City of *Reykjavik* owns 45 percent and the Township of *Akureyri* owns 5 percent of the company.

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

Almost all of the electricity consumed is produced from indigenous energy resources, hydro and geothermal energy. Oil is only used to meet peak demand and as a reserve resource. Imported oil is used mainly in transportation, for the fishing and commercial fleets and the industrial production of fish meal and fish oil. Oil imports (fuels and lubricants) accounted for around 5 percent of the total value of merchandise imports in 1998, as compared to 19.3 percent in 1979 when oil prices were exceptionally high.

### **Transport and communications**

The domestic transportation network consists of roads, air transportation and coastal shipping. Car ownership is widespread. Iceland had 434 passenger cars per 1,000 inhabitants in 1994 as compared to the United States that had 565 and Denmark 312. Several airlines operate in Iceland. *Icelandair*, *Flugleiðir*, is a private company with international routes and direct flights from Iceland to a number of cities in Europe and the United States. Air Atlanta mainly operates as charter airline on international routes outside Iceland. Some foreign airlines also operate routes to Iceland with maximum activity during the summer. The domestic market is dominated by two airlines namely *Flugfélag Íslands* that is owned by *Icelandair* and *Íslandsflug*, another private company. Both airlines run routes between several towns and villages around the country.

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

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

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

### **The labour force**

In 1998 the total Icelandic labour force was estimated to be 135,021 man-years. The overall participation rate has increased considerably in the last decade, primarily due to increased participation of women. In Iceland, approximately 82 percent of the population between the age of 16 and 74 belong to the labour force. Women accounted for 43 percent of the total estimated labour force in 1998. The participation rate for both the elderly and the young is relatively high compared with neighbouring countries. In April 1999 unemployment was 2.2 percent of the labour force as measured in man-years, 1,776 females and

1,201 males. The average working week in Iceland is considerably longer than in other OECD countries. Early retirement is rather uncommon, retirement age is between 65 and 70.

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

### Service industries

The tourism sector has been one of the fastest growing industries in recent years. Foreign visitors in 1998 numbered 232 thousand, compared to 129 thousand in 1987. The foreign exchange revenues generated by tourism in 1998 amounted to approximately 12 percent of the total foreign exchange revenues of the economy. Whale watching is an example of a new tourist activity that has been growing rap-

idly in recent years. Conditions for whale watching in Iceland are among the best in the world.

Many important structural changes have been implemented in the financial sector in the last decade. Among these are interest rate liberalisation, elimination of automatic access to the Central Bank facilities by the Treasury, liberalisation of foreign exchange regulations and establishment of foreign exchange market. Also the establishment of a stock exchange, the development of secondary markets for public and private bonds. Liberalisation of invisible transactions, long-term capital movements and cross-border financial services, as well as the development of various new financial instruments. The Banks and specialised financial institutions are capable of offering a full range of financial services needed by enterprises whether they are producing for the domestic market or foreign markets. In addition to financial services there has been rapid growth of other business services including computer services and software development.

Table 3.2. **Percentage breakdown of employment by industries**

Man-years	1990	1996
Agriculture	5.5	4.2
Fishing	5.6	5.1
Fish processing	6.0	6.0
Manufacturing other than fish processing	12.7	11.6
Construction and energy	10.1	8.8
Trade, restaurants and hotels	14.3	15.0
Communication	6.9	6.9
Finance, insurance and business services	8.2	8.7
Public sector	18.3	19.8
Miscellaneous	12.3	13.7
Total	100.0	100.0

Source: National Economic Institute

### The environment

Compared to other industrial countries, Iceland is relatively unpolluted and faces few immediate environmental problems. Electricity and geothermal heating, Iceland's main energy sources, are generated by the use of renewable resources. Utilisation of hydro power, however, requires the building of dams and large reservoirs that can affect the landscape. The acid disposition over Iceland is very low, due to Iceland's geographic location and the limited emissions of pollutants. Emission of greenhouse gases from Iceland in the year 2000 are predicted to be 15 percent higher than in the year 1990. If emissions from new power intensive industries are excluded, emissions in the year 2000 will not exceed the 1990 level. The emission limit set for Iceland in the Kyoto Protocol for the period 2008-2012 amounts to

a 10 percent increase from the 1990 levels. The largest emittant is the fishing fleet, then the transport sector and thirdly various industrial processes. The marine environment around Iceland is believed to be relatively unpolluted.

Soil erosion is still a problem especially in areas used for sheep raising. Considerable work is being carried out to regain badly eroded land.

## 4. Foreign Trade

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

Iceland imports a wide range of manufactures, raw materials and food stuffs. The great variety of imports needed results from the small size of the economy, limited manpower and a limited range of natural resources. In table 4.1 imports and exports by main economic categories are shown.

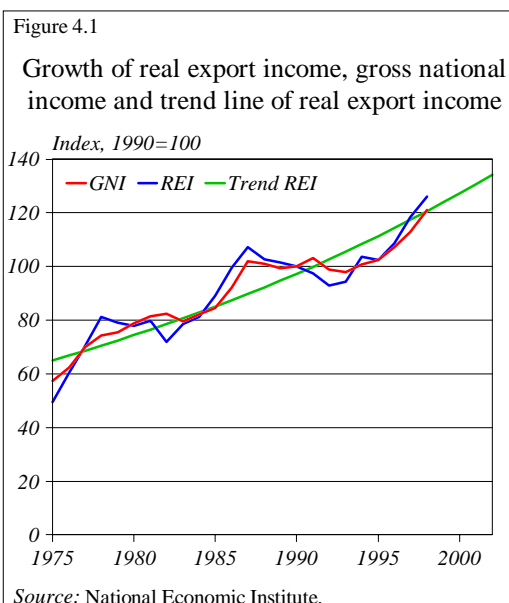
Table 4.1 **Imports and exports by economic category, 1998**

<i>Billions of krónur</i>	<i>Imports</i>	<i>Exports</i>
	<i>CIF</i>	<i>FOB</i>
Food and beverages	16.0	86.3
Industrial supplies	46.1	42.7
Fuels and lubricants	8.9	0.1
Capital goods	44.7	2.4
Transport equipment	27.6	2.4
<i>Passenger motor cars excl. busses</i>	11.8	-
Consumer goods	32.4	1.9
Other	0.3	0.8
Total	187.9	136.6

Source: Statistics Iceland

The growth of the export sector largely determines the rate of growth of the economy as a whole. Imports and exports of goods and non-factor services averaged 67 percent of GDP during the period 1990 to 1997. Growth of exports averaged 3.0 percent per annum during this period and imports grew by 2.8 percent while GDP grew by 2.0 percent. From 1945 to 1997 exports grew by 4.6 percent per annum on the average while GDP grew by 4.0 percent. In figure 4.1 growth of real export income since 1975 is shown.

Real export income is a proxy for the buying power of exports and reflects in some

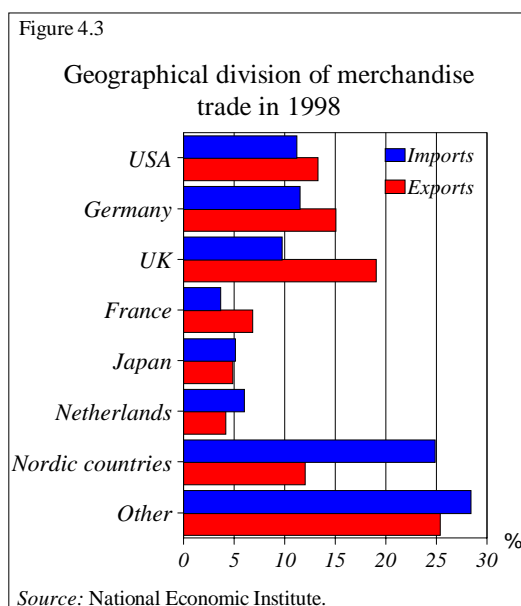
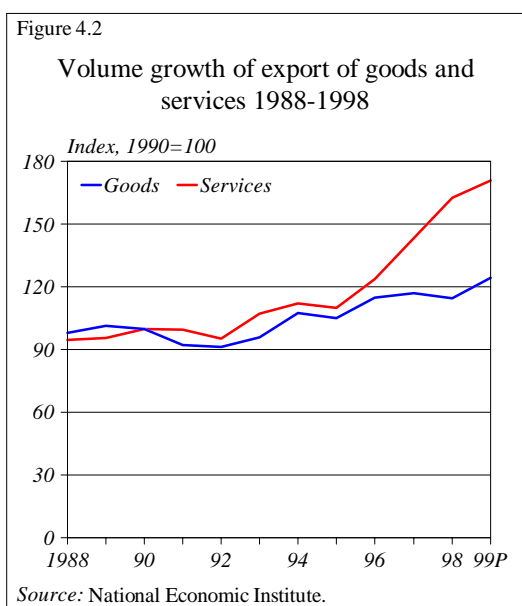


cases better the development of the export sector than volume indices, especially when the volume of exports is very volatile, in the case of Iceland, due to large swings in fish catch. Real export income is calculated by dividing the index of export income by the index of import prices. The growth trend of real export income averages 2.7 percent per annum. Periods of stagnation are usually due to reduced fish catches or lower prices of marine products although large increases in oil prices have also had an effect. Promising new export products are being developed in fisheries equipment, pharmaceuticals, software and bio-chemistry.

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

Free international trade is of paramount importance to Iceland. The dilemma faced by the small economy is that to obtain some economies of scale in production the country must specialise in few export items in which the country has a comparative advantage but at the same time this specialisation makes it more vulnerable to external market instabilities. Iceland has increasingly supported and participated in international efforts aimed at freer trade both at the regional and international level.

Iceland made a free-trade agreement with the European Union in 1972, under which tariffs on most industrial products were removed. Under the agreement on the European Economic Area (EEA) between EFTA and EU, effective January 1, 1994, Iceland and other EFTA countries generally participate in the free cross border movement of capital, labour, goods, and services within the EEA. Certain provisions are subject to implementing legislation in Iceland and elsewhere. A free trade agreement is being negotiated between the EFTA countries and Canada.

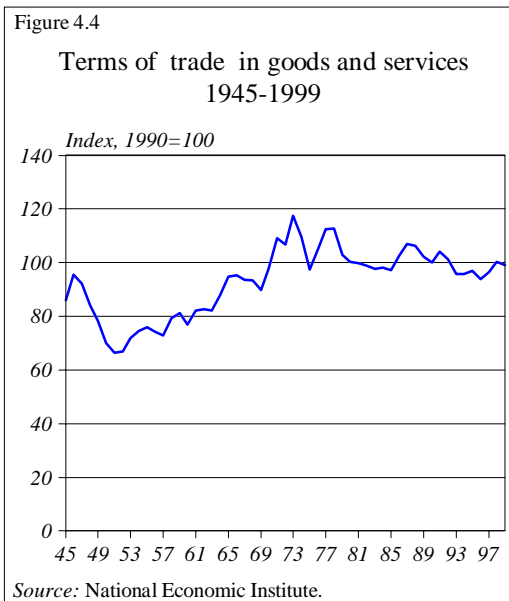


Tariffs in Iceland on most industrial products have been greatly reduced as a result of EEA, EFTA and WTO membership. Only certain agricultural products are still subject to high tariffs but they will be gradually lowered in accordance with the WTO agreement on trade in agricultural products. Tariffs and import levies on general imports and cars constitute between 4 and 5 percent of Treasury income.

In 1998 over two thirds of merchandise exports went to the countries within the European Economic Area and almost two thirds of imports originated in the EEA. Currently, Iceland's largest trading partners are the United Kingdom, Germany, the United States, and the Nordic countries (Denmark, Finland, Sweden and Norway) as is shown in figure 4.3. Iceland has traditionally had a trade surplus with Japan (except in 1998), UK and the United States, but a large deficit against the other Nordic countries.

In Figure 4.4 changes in terms of trade over a long period are shown. Terms of trade were highly unstable when merchandise

exports were mostly fish products but in recent years the terms of trade have become more stable. This increased stability reflects increased diversification in the export industries but more stable import prices especially oil prices have also contributed to this trend.





## 5. Monetary and Exchange Rate Policy

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

### The Central Bank

The Central Bank of Iceland, *Seðlabanki Íslands*, was established in 1961. The Board of Directors (consultative) is elected by the Parliament for a term of four years. The Minister of Commerce and Banking appoints the Governors of the Bank. The Central Bank of Iceland performs all traditional central banking functions. Through market operations, the Central Bank conducts monetary policy consistent with the goal of maintaining low inflation. The Central Bank holds and manages the nation's foreign exchange reserves. Moreover, the Central Bank acts as the bor-

rowing agent for the Republic of Iceland in international capital markets.

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

The Treasury and several government institutions have bank accounts with the

Table 5.1. **Money supply, 1997 - 1998**

<i>Billions of krónur, end of period</i>	1997	1998
Notes and coins	5.8	6.3
Demand deposits	42.6	51.9
Money supply, M1	48.4	58.2
General savings deposits	68.3	73.3
Money supply, M2	116.7	131.5
Time deposits	82.7	99.5
Money supply, M3	199.3	230.9
<i>Percentage increase, 12 months:</i>		
Money supply, M1	17.4	16.6
Money supply, M3	9.2	14.6

Source: The Central Bank of Iceland.

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

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

A stable exchange rate is the intermediate target of the Central Bank's monetary poli-

cy. The market forces have direct influence on the determination of the exchange rate in the interbank market for foreign exchange, but the Central Bank is equipped to intervene in that market through market operations to affect the daily exchange rate of the króna.

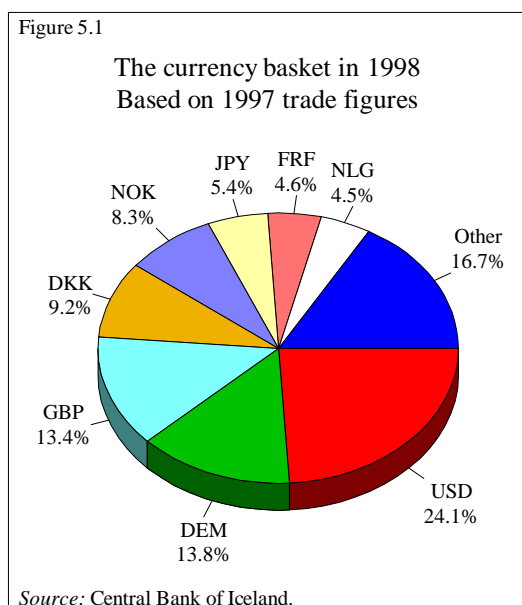
Table 5.2. Foreign exchange reserves of the Central Bank

Millions of krónur, end of period	1997	1998
Gross reserves	27,805	29,753
Gold	187	194
SDR	1	1
IMF reserve position	1,018	1,022
Deposits and securities	26,599	28,534
Conversion rate:		
Krónur per US\$	71.98	69.32

Source: The Central Bank of Iceland.

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

Iceland presently has a quota of Special Drawing Rights (SDR) 117.6 million in the International Monetary Fund. Since 1962, the Central Bank has been a party to an agreement between the Nordic central banks which consists of an exchange of credit lines, allowing each of the banks to draw on the others on a short-term basis in times of temporary foreign reserve shortage. According to the current agreement the Central Bank of Iceland can draw up to ECU 200 million. In addition, the Central Bank has access to committed interbank lines for a total amount of US\$275 million and uncommitted interbank lines with a number of international banks.



### **Monetary policy instruments**

The main monetary instruments are the Central Bank interest rates, money market operations and intervention in the foreign exchange market. The Central Bank offers lending facilities to credit institutions and sets reserve requirements. Financial institutions are free to set all their interest rates, with the exception that the Central Bank decides penalty interest rates on overdue payments.

In the first half of 1998 the Central Bank of Iceland made significant changes to its monetary policy instruments, modelled on the decisions taken for the European Central Bank. The reform was not intended to alter the monetary policy framework. The operating variable of the Central Bank continues to be short-term interest rates with the repo rate as the main signal variable. The main objective of the reform was twofold: First, to level the playing field of credit institutions in the domestic market and their access to the Central Bank facilities, and second, to create operating conditions for domestic credit institutions similar to those prevailing in the European Economic Area. Other aims were also kept in mind, such as to simplify the policy instruments, to enhance the Central Bank discretion in carrying out monetary policy and to stimulate the development of the money market, not least the interbank market and the secondary market for government securities.

An important change was the expansion of the reserve base, both in terms of coverage of institutions and types of liabilities. To compensate for the expansion of the base, the reserve requirement ratio for longer-term liabilities was lowered from 2.5 percent to 1.5 percent. This left the reserve requirement of the deposit money banks, already subject to reserve requirements, more or less unchanged. The remuneration of required reserves was also changed from indexed terms to nominal interest rates, leaving the expected nominal

yield unchanged. This is in line with the official policy of reducing the scope of indexation in the financial system.

With an establishment of an overnight credit facility in March 1998 the Central Bank has effectively created a corridor for money market rates setting an upper limit to their movements. The interest rate paid on current accounts of credit institutions provides the lower limit. The main changes as regards the repurchase facility are twofold. First the tap availability of repurchase contracts was discontinued, and second, the eligible collaterals were expanded to include all government registered securities on the Iceland Stock Exchange. This imposes a significant widening of the eligible collateral as only treasury bills and Central Bank Certificates of deposits had been eligible previously. The tap availability was replaced by regular weekly auctions where the Central Bank announces beforehand whether the auctions will be repurchase or reverse repurchases auctions. The Bank can vary the auction form between a volume tender to fixed price auctions, the latter being the rule.

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

The changes made to the Central Bank instruments in March 1998 put increased pressure on interbank market reform and led to the issuance by the Central Bank of new rules for the interbank market. These became effective in early June and eight credit institutions are now active members in this market, four commercial banks, two investment banks and two savings banks. The interbank rates are called REIBOR and REIBID. The trading volume in

the interbank market started to rise following the change in monetary policy instruments in March 1998 but after the new arrangement became effective, trading volume increased dramatically.

In the first half of 1999 the Central Bank set new liquidity requirements for credit institutions. Those rules are prudential, aimed to ensure that credit institutions have at all times enough liquidity to be able to meet their obligations.

### **Capital movements**

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

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

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

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

## 6. Financial Markets

Over the last decade the Icelandic financial system has undergone an important transition, generated by liberalisation and legislative reforms. The current Central Bank Act was adopted in 1986 and at the same time the final phase in the deregulation of interest rates was completed. In the mid-eighties the Iceland Stock Exchange was established, securities companies emerged and the first mutual funds were established. Towards the end of the decade a process of rationalisation in the banking sector took place through mergers. A new Foreign Exchange Act entered into force in November 1992, implementing a policy of a phased elimination of foreign exchange restrictions by the beginning of 1995. The BIS standard for rules on capital adequacy of commercial and saving banks became effective in the beginning of 1993. In connection with the agreement on the European Economic Area (EEA) a new legislation was enacted in 1993 based on EU financial directives. This includes acts on commercial and savings banks, other credit institutions, securities transactions, mutual funds and the Iceland Stock Exchange. With this legislation 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 Financial Supervisory Authority was also strengthened.

### Credit institutions

There are four commercial banks in Iceland, two are state-owned corporations, *Landsbanki Íslands* and *Búnaðarbanki Íslands*, one is a private limited liability company, *Íslandsbanki*, and one, *Sparisjóðabanki Íslands* (Icebank Ltd.), is owned by the savings banks. Three of the four commercial banks perform all the traditional banking operations, accept deposits, grant credit, deal in foreign currencies and maintain accounts with correspondent banks abroad. The two state-owned commercial banks were converted into limited liability companies as of the beginning of 1998. Initially the state was the sole owner, but there was an authorisation to sell new equity up to 35 percent of the current equity position. A public offering of 15 percent of new equity in *Landsbanki Íslands* came to market in September 1998. A similar offering of equity in the *Búnaðarbanki* came to the market in December. The Icebank functions on behalf of the 29 savings banks as their banking institution. The savings banks are generally private institutions with local operations and they perform most traditional banking operations. In addition to commercial and savings banks there are two other types of deposit receiving institutions, namely the savings departments of the co-operatives and the Post Giro.

The new incorporated investment bank *Fjárfestingabanki atvinnulífsins hf.*, created by

a merger of four investment credit funds and initially fully owned by the government, has operated since the beginning of 1998. Almost half (49 percent) of the government's shares in the bank have been sold with an equity issue on the market. Parliamentary approval has been granted for the sale of the remaining equity. A new State Housing Fund started to operate at the beginning of 1999 replacing the previous housing institution. The new fund is based on legislation, approved by the Parliament in June 1998, that is aimed at rationalising the existing state housing fund system. The three operating leasing companies have recently diversified their activities by granting loans in addition to making conventional leasing contracts.

### The securities market

The securities market has expanded rapidly in recent years. Since 1964 the Government has issued indexed Government bonds, and in the 1980s a secondary market for these bonds began to develop. In recent years, there has been an increase in the variety and volume of

financial instruments that the government, municipalities and financial institutions have offered on the market. The bond market has continued to develop as well as money and equity markets. Two milestones in the development of the bond market were the introduction of the housing bond system in 1989, with tradable securities, and Government securities auctions where Treasury bills, Treasury notes and Government savings bonds have been offered in regular auctions since 1992. In 1985, marketable bonds and money market instruments were equivalent to 6 percent of GDP, but at the end of 1998 they amounted to over 60 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 a period when Iceland suffered a high rate of inflation. The two-tier system of indexed and non-indexed obligations has tended to cause nominal interest rates to change in accordance with inflationary trends rather than as a reflection of changes in

Table 6.1. Selected market securities

<i>Millions of krónur, end of year</i>	1994	1995	1996	1997	1998
Treasury bills	14,630	15,459	16,803	12,296	15,207
Bank bills	1,682	4,028	8,106	13,427	7,968
Treasury bonds	72,474	77,959	77,360	86,925	84,960
Treasury notes	5,550	6,577	10,349	13,280	19,602
Bank bonds	20,655	20,067	24,062	27,307	45,045
Housing bonds	64,739	77,637	92,052	107,852	127,238
State housing fund bonds	7,738	7,603	13,013	17,716	23,832
Bonds issued by other inv. credit funds	11,941	17,497	17,235	17,169	19,818
Bonds issued by leasing companies	6,106	4,866	6,903	8,533	7,671
Mutual funds units (open-end)	16,289	14,517	20,533	33,397	72,644
Shares (market capitalisation)	45,909	65,327	94,802	151,009	231,402

Source: The Central Bank of Iceland.

credit supply and demand. As price stability has taken firm hold, indexation is receding from the short end of the financial market.

The Iceland Stock Exchange was established in 1985 and now operates under new legislation adopted in 1998. The new act required the Icelandic Stock Exchange to be converted into a limited liability company (implemented in 1999), abolished its monopoly on exchange activities but at the same time gave it increased room to grow and offer new services. Currently there are twenty members of the Exchange, including the Central Bank, all the commercial banks and securities houses and some savings banks. Among securities listed on the exchange are the stocks of around 70 companies, government bonds, notes and bills and various private bond issues, primarily by credit institutions. Listing on the Exchange is subject to listing requirements set by the Exchange, including disclosure requirements. Turnover on the exchange has risen rapidly in recent years. At the end of 1998, the market capitalisation of listed securities was 633 billion krónur or seven percent above GDP. Of this sum 369 billion krónur were bonds, 232 billion krónur equities, and 32 billion krónur money market instruments. The largest brokers have operated a non-regulated over-the-counter (OTC) market for non-listed shares since 1992. The Stock Exchange allowed its members to utilise the Exchange's trading system for the trading in this market.

### **Institutional investors**

Currently there are 65 pension funds in Iceland. Their number has decreased in recent years due to mergers. The pension funds receive payments from employers and employees and are the most important source of long-term finance in the country. The pension funds have traditionally invested in bonds issued by the Treasury, other financial institutions, municipalities and companies. They also

extend credit to members. About 20 percent of their assets are in Icelandic and foreign equity and in mutual funds. In recent years the pension funds have started to invest in foreign securities.

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

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

### **Supervision and regulations**

The Bank Inspectorate of the Central Bank and the Insurance Supervisory Authority merged into a separate entity, *Fjármálaeftirlitið*, the Financial Supervisory Authority (FSA), on 1 January 1999. The FSA has a Board of Directors appointed by the Minister of Commerce. The institution supervises commercial banks, savings banks and other credit institutions, insurance companies, companies and individuals acting as insurance brokers, undertakings engaged in securities services, mutual funds, management companies, stock exchanges and other regulated markets, central securities depositories (CSD) and pension

funds. The Financial Supervisory Authority also supervises other activities which the institution has been authorised in accordance with special laws.

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

The Icelandic legislation and regulations regarding credit institutions and other financial institutions have been adapted to the various regulations and directives of the European Union as a consequence of Iceland's participation in the European Economic Area .

The current rules on capital adequacy for credit institutions and securities firms are

based on the Basel guidelines and the EU capital adequacy directive, with a minimum capital ratio of 8 percent. According to rules that the Central Bank has imposed, commercial and savings banks are limited in their foreign exchange exposure to 30 percent of equity as defined by the Capital Adequacy Rules (CAD) rules. The same applies to indexed assets and liabilities.

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



## 7. Public Finance and Foreign Debt

A primary goal of policy makers has been to cut down government expenditures to eliminate the fiscal deficit. The fiscal deficits and public debt in Iceland have been well below the OECD average and Iceland has fully met the Maastricht criteria for general government finances since 1995. The financial balance of the general government in 1999 is expected to be in surplus of around 1 percent of GDP. Preliminary estimates put total Treasury debt at 235 billion krónur at the end of 1998 and according to debt repayment plans, it should fall to around 217 billion krónur by the end of 1999.

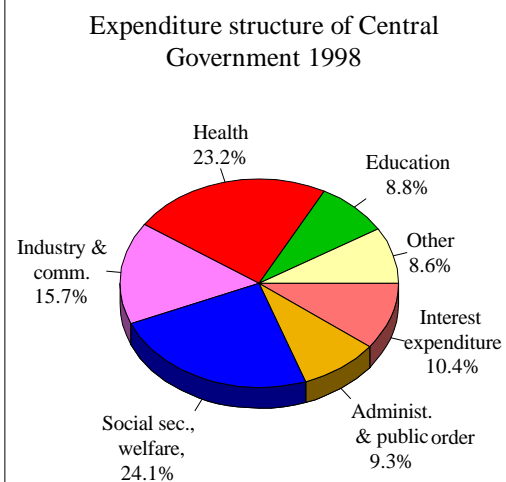
### The size and nature of the Icelandic government sector

Compared to European countries, Iceland has a relatively small public sector, which has shrunk in recent years relative to GDP. Expenditures have fallen from a relatively steady 40 percent of GDP in the period 1988-1994 to an estimated 36.5 percent in 1998 while revenues have held steady between 36 and 37 percent of GDP. In this process a serious fiscal deficit has been corrected. During this period of declining expenditures, government consumption has actually increased while current transfers have hardly budged. Subsidies, fixed investment and capital transfers have borne most of the decrease. The reduction in subsidies ties in with changes in agricultural support in the early 1990's, the

reduction in capital transfers is concentrated in agriculture and housing. On the revenue side, there is a clear switch from indirect taxes on goods and services to direct taxes on income and wealth, the increase occurring mostly through broadening of the tax base rather than rate hikes.

The most obvious reasons why the Icelandic government sector is smaller than those of European neighbours is a much smaller welfare sector than in the other Nordic countries, for example. More precisely, expenditure on unemployment benefits are a significantly

Figure 7.1



Source: Central Bank of Iceland.

smaller percentage of GDP in Iceland than in the Nordic countries (0.7 percent of GDP vs. 3.4 percent). The same goes for total pension payments, even if private sector pension funds are included (7.7 percent of GDP vs 15.3 percent). Lower expenditure on unemployment is easily understood given the low unemployment rate and relatively low payments to each unemployed person. A younger population and a higher retirement age partially explain lower pension expenditures, while the rest is due to lower payments per recipient.

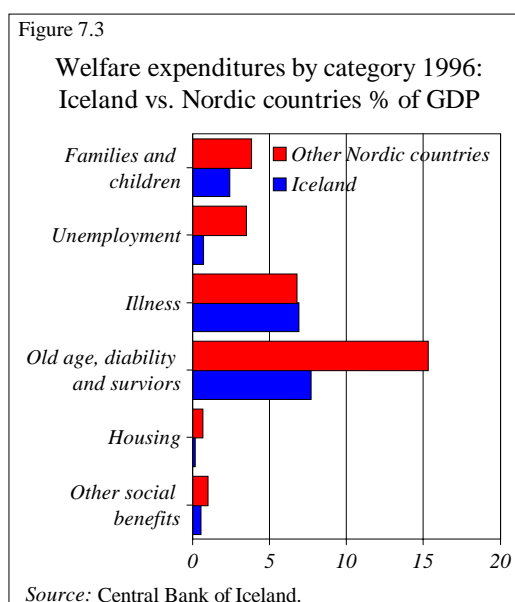
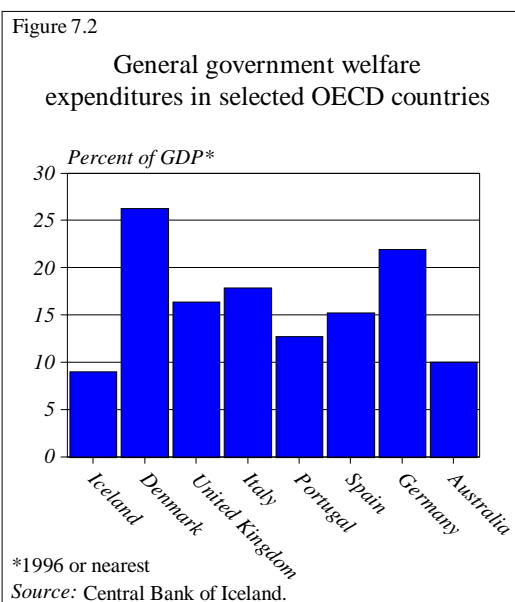
### The division of responsibility

The local authorities are responsible for street construction and planning, for education from pre-school through the 10th grade, for welfare services of all kinds, in particular for the care for the disabled and elderly outside institutions, and for solving housing problems of those who cannot find housing on their own. In the area of welfare, local governments provide supplementary assistance to general programs of pensions otherwise run by central government. The centre, by contrast, is responsible

for the police, courts and foreign service, higher education, health service, institutional care for the disabled and elderly and general support and services for industry. It administers basic old-age and disability pensions, means tested rebates on housing related interest payments and means tested benefits to families with children. By the latest figures, total expenditures of local governments run around 10 percent of GDP as against a central government budget of 27 percent of GDP.

### The budget process of the Central Government

The Icelandic Constitution requires the authorisation of the Parliament, *Alþingi*, for all central government expenditures, taxation and borrowing. The fiscal year coincides with the calendar year. The budget proposal for the coming year is presented to the Parliament at the beginning of each regular session in early October and usually passed by the third week of December. A supplementary budget bill is almost invariably introduced in the next fall session and a third bill accompanies the



accounts of each year into the parliament. The use of supplementary appropriations has become more measured with the slowing of inflation in this decade. The central government's accounts are subject to audits and control by the General Auditor's Office, *Ríkisendurskoðun*, which is an independent entity under the Parliament.

### Accounting standards

Fundamental changes were made to the presentation of the budget and the central government accounts in the beginning of 1998. There are three changes: First, the budget is now presented on accruals basis, containing authorisations to commit to expenditures. The government accounts have been based on accruals since 1965, but the budget previously contained authorisations for payments. The difference between payments and accruals is quite significant at times for items such as interest on bullet bonds, increases in pension liabilities and write-offs of tax claims. Second, the budget now itemises grants for numerous activities which were previously off-budget but financed by levies set by law. Third, significant expenditures which were previously shown as subtracted from revenues are now shown explicitly as expenditures. These expenditure items include child benefits and housing benefits as well as payments to the church and other established religious groups. These changes, which were put into effect with the 1998 budget, boosted the total budget numbers by 20 percent and treasury account totals by somewhat less.

### The Tax system

The Central government, as represented by the Treasury, derives over 90 percent of its revenue from taxes, of which 28 percent comes from direct taxes on income and wealth and 62 percent come from indirect taxes.

A 27.4 percent tax is levied on personal incomes up to 3.1 million krónur, while higher

incomes are charged an additional 7 percent. A tax credit of 280 thousand krónur per year implies that individual incomes are tax free up to annual income of around 1 million krónur or 14 thousand US dollars. For individuals with lower income, the tax credit applies towards a flat local government income tax which ranges from 11.24 to 12.04 percent, depending on municipality. Accordingly, individuals with income up to the equivalent of around ten thousand dollars per annum are exempt from general income taxes. The combined average rate of general and municipal income taxes has been reduced in steps from 42 percent in 1996 to 38.3 percent at the beginning of 1999. During this adjustment period, the share of local governments has risen relative to the treasury share to compensate for increasing responsibilities of local government in the area of education.

Interest, dividend and rental income of individuals, as well as capital gains up to 3 million krónur, are exempt from the general income tax and from municipal taxes, but carry a lower tax of 10 percent.

A net wealth tax of 1.2 percent is assessed to net assets above 3.7 million krónur for individuals while net wealth beyond 5.3 million is taxed at 1.45 percent.

Corporations pay a 30 percent tax on profits. This rate has come down from 50 percent in 1991. Capital income of corporations are treated like other revenue for tax purposes and corporations pay a 1.2 percent tax on net wealth.

A payroll tax of 5.44 percent is charged on most wages, while certain basic or important industries pay 4.69 percent. The final step of a harmonisation process will implement a single rate of 5.14 percent at the end of 1999. Besides the tax, employers must also contribute at least 6 percent to a pension fund to match an employee contribution of at least 4 percent. Although membership is mandatory,

operations of pension funds are regulated and their charters must be approved by the Treasury, the funds are independently managed and considered independent of government.

The largest single source of treasury revenue is a value added tax, which is levied at 24.5 percent on most goods and services. Services of hotels and guesthouses, broadcasting services, newspapers, heating fuel and foodstuffs are taxed at 14 percent, while certain services, including health service and passenger transportation, are exempt.

Excise taxes were levied on a range of goods at three rates, while some goods are charged unit fees. The custom duty is in the range of 0-30 percent, but most imports from EFTA and EU 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. The revenue

from excise taxes and import duties has fallen from around 1.5 percent and 3 percent of GDP in the early 1980's to around 0.5 and 0.4 percent in 1998.

There is a stamp duty on larger financial transactions as well as on most bank transactions. Taxes on the ownership of motor vehicles and excise taxes on gasoline make up between 7 and 8 percent of Treasury revenue, while between 4 and 5 percent is derived from charges on the sale of alcohol and tobacco.

The taxes described above account for around 95 percent of Treasury tax revenue. Non-tax income accounts for 7 to 10 percent of Treasury revenue and consists mostly of interest income, dividends, profits from sale of government assets and charges for services.

### Local government finances.

At the beginning of 1999, Iceland was divided into 124 municipalities, of which 9 have population exceeding 5000. The number of municipalities has decreased from 224 in 1980 due to mergers. In the same period, the municipalities have taken on increasing responsibilities, especially in the area of compulsory education, while in area of health care, some tasks have been handed over to central government. The expenditures of local governments have expanded from around 6.5 percent of GDP in the early 1980's to 9.5 percent of GDP in the late 1990's, with increased education responsibilities accounting for more than 1 percent of GDP. The composition of local government expenditure is described in the accompanying chart.

The municipal income tax is the major source of local government revenue, accounting for 66 percent of total revenue in 1997, while real estate taxes account for an additional 12 percent. Income from local government enterprises and other property accounts for 6 percent and grants from the municipal equalisation fund for another 5 percent.

Table 7.1 **Composition of general government revenues and expenditures**

<i>Percent of GDP</i>	<i>88-94 97-99 change</i>		
Direct taxes	12.9	16.4	3.5
Indirect taxes	21.2	18.0	-3.2
Property income	2.6	2.1	-0.5
Other nontax revenue	0.1	0.1	0.0
Total revenue	36.7	36.6	-0.1
Government final consumption	19.9	20.9	1.0
Interest payments	3.6	3.0	-0.7
Subsidies	3.2	1.8	-1.4
Current transfers	7.3	6.8	-0.5
Fixed capital formation	4.1	3.1	-1.0
Capital transfers	2.9	1.4	-1.5
Total expenditures	40.3	36.3	-4.0

Source: Central bank of Iceland

The finances of central and local government are interrelated in many ways. Many public services and investment projects are jointly financed. The intertwining of state and local income taxes was described in the section on the tax system. The municipal equalisation fund, which is jointly financed by the central and local government tax revenue, has the obvious role of enhancing the revenues of weak municipalities with emphasis on education expenses and infrastructure investment.

In many instances, local government owns and operates major utilities. Waterworks and harbour facilities are almost invariably owned by the community, as are geothermal heating systems, where they exist. A few communities own their electricity distribution system, the rest being served by a state owned company. In the capital region, several communities are served by the heating and electricity distributor in Reykjavík, which thus serves almost 60 percent of the Icelandic population. Finally, the National Power Company, which produces 95 percent of total electricity in the country, and Iceland State Electricity, the

main rural distributor of electricity, are government controlled.

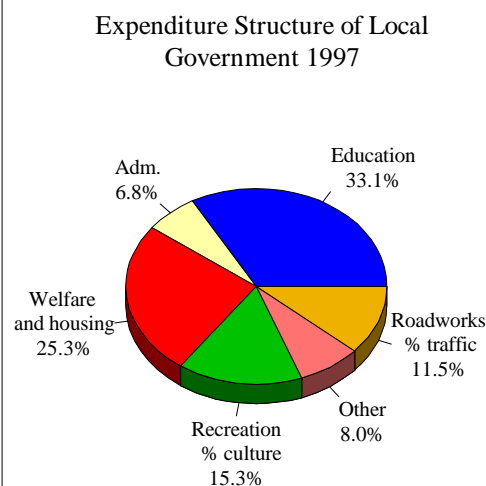
### Treasury foreign debt

The Republic of Iceland has been the largest and most active Icelandic borrower in international markets. In recent years, the surplus on government finances has led to a reduction in the total outstanding foreign debt. The Treasury foreign debt to GDP ratio has fallen from 28 percent in 1995 to 20 percent in 1998 and a further fall is expected in 1999.

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

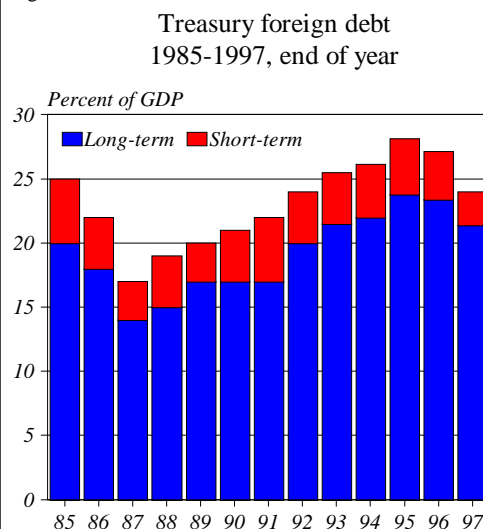
At end-1998, the Treasury's long-term foreign debt amounted to 104 billion krónur and the outstanding stock of euro-commercial

Figure 7.4



Source: Central Bank of Iceland

Figure 7.5



Source: Central Bank of Iceland.

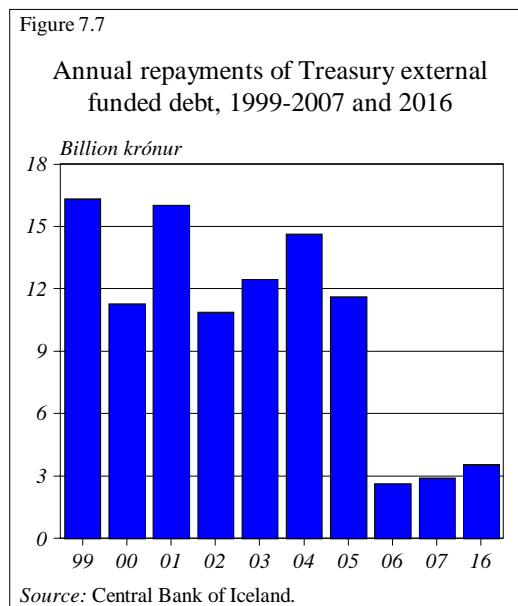
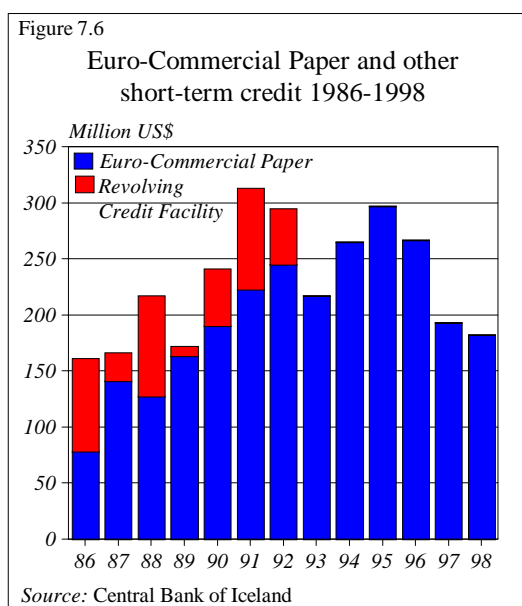
papers stood at 13 billion krónur. Around 26.2 percent of the Treasury's foreign obligations were denominated in US dollars, 12 percent in Japanese yen and around 61.8 percent were denominated in the various European currencies. Around 38.5 percent were denominated in currencies which were converted into the Euro at the beginning of 1999. The share of European currencies has risen and is now close to 62 percent. The share of the US dollar has declined, and is now just above 26 percent, in line with the increasing importance of trade with Europe. The share of the Japanese yen is now around 12 percent which is somewhat higher than the trade weight of the yen.

At end-1998, 60.8 percent of the Treasury's total foreign debt carried fixed interest rates. Of the long-term debt, 68 percent loans carried fixed rates of interest. The average maturity of the foreign long-term debt was 3.8 years and the average duration 2.7 years. Including the short-term debt, these numbers are 3.4 years and 2.4 years, respectively.

The Republic of Iceland Euro-Commercial Programme plays an important

role in the foreign financing of the Republic. 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. The size of the programme is US\$ 500 million. A multi-currency option allows for issuance in alternate currencies. The paper is issued at a spread of approximately 10 basis points below LIBOR. Currently there are four dealers on the programme: Citibank International, SEB in London, JP Morgan and Deutsche Bank. Amount, maturity, and yield are negotiated at the time of issuance in view of market conditions.

In 1990, the Parliament enacted legislation to provide for the establishment of a national debt management agency, *Lánasýsla Ríkisins* (NDMA). The NDMA commenced operations in June 1990. Under this legislation, borrowing and debt management functions of the Treasury, both domestic and foreign, and government guarantees have been assigned to the NDMA. However, under a special agree-



ment with the Minister of Finance, the Central Bank is responsible for the execution of foreign borrowing for the Treasury.

### National debt

Reported figures in the coverage of Icelandic foreign debt statistics include private as well as public debt, amounting to the total external debt of the economy. The net external debt of the Icelandic government, financial institutions and the private sector amounted to the equivalent of US\$ 3,408 million, or 44.7 percent of GDP at the end of 1997. In 1998 estimated figures indicate a slight increase in net external debt or US\$ 4,205 million equivalent to 48 percent of GDP. The ratio peaked at 54.3 percent at the end of 1993. The fluctuations in the debt ratio do not only reflect changes in the volume of debt but also the volatility of exchange rates.

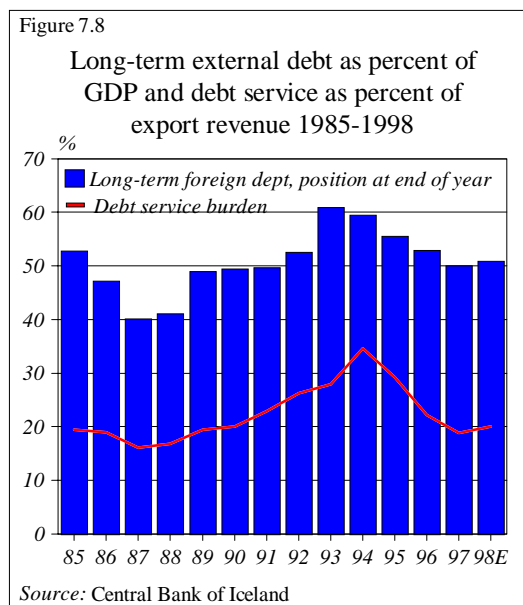
Debt service payments of long-term debt fluctuated between 14 to 24 percent of

total export revenue in the 1980's. The debt service ratio peaked at 34 percent in 1994 but declined to 18.9 percent of GDP in 1997. It is estimated to be 21 percent in 1998 and still lower or between 17 percent and 18 percent in 1999. The Republic of Iceland has always paid when due the full amount required in respect of principal, interest and sinking fund installments of all internal and external obligations.

### Credit ratings

In 1996 and 1997 Moody's and Standard & Poor's upgraded Iceland's credit ratings to reflect the country's increased creditworthiness. Standard & Poor's announced in 1996 that it had upgraded the credit rating for the Republic of Iceland's long-term foreign currency denominated debt from A to A+, and short-term debt from A-1 to A-1+. Furthermore, Standard & Poor's assigned a first time rating of AA+ to Iceland's long-term local currency debt. In July 1997 Moody's upgraded the Republic's foreign currency rating to Aa3 and assigned Aaa rating to the Republic's long-term krónur bonds. 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 new foreign investment projects that take account of the country's clear comparative advantages such as abundant renewable geothermal and hydro energy and environmentally friendly tourism. Further, the improved ratings reflect the wide-spread restructuring and stabilisation of the Icelandic economy in the past years coupled with strong economic growth, low inflation, declining debt service and falling debt ratios.

In June 1998 Standard and Poor's announced that it had placed a positive outlook on Iceland's long term foreign currency debt. In December Moody's confirmed its previous ratings.



## 8. Appendix

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

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



Table A2. **Output and expenditure 1998-1999 and volume changes 1996-1999**

	<i>Billions of krónur</i>		<i>Percent change from previous year</i>			
	<i>1998P</i>	<i>1999F</i>	<i>1996</i>	<i>1997</i>	<i>1998P</i>	<i>1999F</i>
Private consumption	361,593	392,318	6.4	6.0	11.0	6.0
Public consumption	123,181	135,814	1.0	3.1	3.0	3.4
Capital formation	125,365	120,557	27.4	11.2	23.4	-5.3
Stock changes	1,143	0	-0.7	0	0.3	-0.3
Total national expenditure	611,283	648,689	7.6	6.4	12.0	3.0
Exports of goods and services	204,659	221,512	10.0	5.6	2.6	7.4
Imports of goods and services	230,207	239,911	16.7	8.5	22.1	2.3
Gross domestic product	585,735	630,290	5.7	5.4	5.0	4.8
Net factor income from abroad	-6,933	-9,141	-	-	-	-
Current transfers, net	-1,003	-438	-	-	-	-
Current account balance	-33,484	-27,978	-	-	-	-
Gross national product	578,802	621,149	6.4	5.2	4.8	3.9
Effects of changes in terms of trade	-	-	-1.6	0.9	1.9	-0.4
Gross national income	-	-	4.8	6.2	6.9	3.5
Current balance, percent of GDP	-	-	-1.6	-1.4	-5.7	-4.4

P = provisional figures, F = forecast, volume changes in 1990 prices.

Source: National Economic Institute.

Table A3. Balance of Payments

Millions of krónur	1996	1997	1998
<b>A Current Account</b> .....	-7,989	-7,620	-33,484
1 Balance on Goods .....	1,201	254	-25,053
11 Merchandise exports fob.....	125,690	131,213	136,598
111 Marine products .....	92,582	93,648	99,280
112 Miscellaneous .....	33,108	37,565	37,318
12 Merchandise imports fob .....	-124,489	-130,959	-161,651
121 Investment goods .....	-46,281	-50,719	-68,168
122 Other goods.....	-78,208	-80,240	-93,483
2 Balance on Services .....	1,935	2,975	-495
21 Exports of services, total .....	51,173	59,732	68,061
211 Transportation .....	22,479	25,732	31,108
212 Travel .....	11,722	12,316	14,633
213 Other receipts .....	16,972	21,684	22,320
22 Imports of services, total .....	-49,238	-56,757	-68,556
221 Transportation .....	-17,213	-18,836	-25,152
222 Travel .....	-20,472	-22,893	-28,049
223 Other expenditures .....	-11,553	-15,028	-15,355
3 Balance on Income .....	-10,661	-10,611	-6,933
31 Receipts .....	7,688	9,022	14,159
311 Compensation of employees.....	4,242	4,128	4,742
312 Investment income .....	3,446	4,894	9,417
32 Expenditures .....	-18,349	-19,633	-21,092
321 Compensation of employees.....	-306	-391	-293
322 Investment income .....	-18,043	-19,242	-20,799
4 Current transfer, net .....	-464	-238	-1,003
<b>B Capital and Financial Account</b> .....	7,365	12,298	37,836
5 Capital transfer, net.....	-32	14	-324
6 Financial Account.....	7,397	12,284	38,160
61 Financial Account excl. Reserves.....	17,559	9,100	40,421
611 Direct investment, net.....	-244	7,154	-87
6111 Abroad.....	-4,337	-3,472	-7,158
6112 In Iceland .....	4,093	10,626	7,071
612 Portfolio investment, net.....	-3,713	-14,743	-22,545
6121 Assets .....	-4,020	-16,291	-22,708
6122 Liabilities .....	307	1,548	163
613 Other capital, net .....	21,516	16,689	63,053
6131 Assets .....	-2,274	-11,480	5,933
61311 Monetary authorities .....	-83	-66	-66
61322 General government .....	0	0	0
61323 Deposit banks .....	-2,649	-6,016	3,613
61324 Other sectors .....	458	-5,398	2,386
62 Reserve assets .....	-10,162	3,184	-2,261
A+B Net errors and omissions .....	624	-4,678	-4,352
*Memorandum items:			
Long-term borrowing, net	14,003	18,087	60,991
Foreign borrowing	40,359	42,035	91,368
Amortization1	-26,356	-23,948	-30,377
Short-term borrowing, net	9,787	10,082	-3,871
Exchange rate: ISK per USD	66.52	70.76	70.95

Table A4. Imports by economic category <sup>1</sup>

<i>Millions of krónur, cif</i>	1995	1996	1997	1998
Food and beverages	11,665	12,692	12,849	16,037
Primary, mainly for industry	2,72	2,67	2,478	4,585
Primary, mainly for household consumption	1,629	1,805	1,925	1,988
Processed, mainly for industry	1,08	1,212	1,051	1,128
Processed, mainly for household consumption	6,236	7,007	7,395	8,337
Industrial supplies not elsewhere specified	32,557	36,593	37,593	46,078
Primary	1,688	1,973	2,079	3,193
Processed	30,87	34,975	35,514	42,885
Fuels and lubricants	8,032	10,454	10,712	8,898
Primary	374	392	353	428
Petrol, including aircraft fuel	1,571	2,085	2,035	1,748
Other	6,086	7,978	8,324	6,721
Capital goods, parts and accessories	23,44	29,906	34,778	44,739
Capital goods (except transport equipment)	15,046	20,183	22,317	29,166
Parts and accessories	8,394	9,723	12,461	15,573
Transport equipment	13,882	19,38	19,435	27,624
Passenger motor cars	4,978	7,095	9,06	11,792
Industrial	1,533	2,105	2,733	3,428
Non-industrial	260	323	309	365
Parts and accessories	3,193	3,4	4,072	4,12
Ships	3,042	6,35	3,102	4,409
Aircraft	876	107	160	3,511
Consumer goods not elsewhere specified	23,783	26,227	27,623	32,406
Durable	4,955	5,917	6,3	7,894
Semi-durable	9,542	10,234	10,745	12,429
Non-durable	9,286	10,077	10,578	12,083
Goods not elsewhere specified	255	386	237	332
Total imports of goods cif	113,614	135,994	143,227	176,114

1. Current exchange rates.

Source: Statistics Iceland.

Table A5. Exports by commodity groups <sup>1</sup>

<i>Millions of krónur, fob</i>	1995	1996	1997	1998
Marine products	83,873	92,582	93,648	99,28
White fish	53,341	54,505	55,522	63,936
Frozen	32,663	30,944	31,055	36,84
On ice	6,823	6,851	7,46	8,072
Salted	12,835	14,914	14,85	17,272
Stockfish	669	694	1,003	1,023
Meal	92	785	840	422
Oil	259	318	314	306
Herring and capelin	10,488	18,228	17,751	17,409
Frozen	3,364	5,586	4,123	2,833
Salted	778	1,054	760	800
Meal	4,697	8,034	8,578	9,472
Oil	1,649	3,553	4,29	4,304
Lobster, shrimp, scallop	16,579	17,258	16,899	14,598
Other	3,465	2,591	3,475	3,337
Agricultural products	2,055	2,55	2,105	1,967
Meat	169	469	229	193
Dairy products	1	12	0	0
Salmon & trout (fish-farming)	810	712	661	666
Other	1,076	1,356	1,216	1,107
Manufacturing products	25	25,039	28,757	31,455
Aluminium	12,303	12,104	15,197	18,417
Ferro-silicon	3,212	3,813	3,709	3,212
Diatomite	637	596	572	548
Tanned skins and hides	977	1,193	1,2	624
Woollen products	355	357	382	378
Canned products	1,886	1,567	1,919	1,751
Other	5,631	5,408	5,778	6,526
Miscellaneous	5,679	5,52	6,704	3,897
Total merchandise exports	116,607	125,69	131,213	136,598

1. Based on current exchange rates.

Source: Statistics Iceland.

Table A6. **Geographic distribution of foreign trade**

<i>Percentages of total values</i>	<i>Imports</i>			<i>Exports</i>		
	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>
EFTA	15.0	13.8	10.7	5.7	8.6	9.4
Norway	13.5	11.5	9.2	3.7	5.6	4.8
Switzerland	1.5	2.2	1.5	2.0	3.0	4.6
EU	56.4	58.1	56.2	62.1	60.6	65.0
Austria	0.6	0.6	0.6	0.1	0.1	0.1
Belgium	1.9	2	1.9	1.2	1.1	1.3
United Kingdom	10.2	10.1	9.7	19	18.9	19.0
Denmark	8.4	8.6	7.7	7.2	5.7	5.5
Finland	1.6	1.6	1.6	1.0	1.1	0.7
France	3.3	3.3	3.6	6.7	6.3	6.8
Greece	0.1	0.1	0.1	0.7	0.6	0.5
Netherlands	6.0	6.5	5.9	3.6	3.3	4.1
Ireland	1.0	1.2	1.5	0.1	0.2	0.4
Italy	3.2	3.2	3.2	1.9	1.8	1.7
Luxembourg	0.1	0.1	0.1	0.1	0.2	0.3
Portugal	0.7	0.7	0.7	2.6	2.6	3.8
Spain	1.7	1.6	2.0	3.9	4.4	5.0
Sweden	6.7	6.7	6.3	1.3	1.1	0.9
Germany	10.9	11.8	11.5	12.8	13.1	15.0
EEA <sup>1</sup>	69.9	69.6	65.4	65.8	66.1	69.8
Other Europe	5.8	4.8	6.3	2.2	4.3	2.8
Russia	2.5	2.5	2.2	1.0	1.8	1.1
Other	3.3	2.3	4.1	1.2	2.5	1.7
North-America	10.4	10.5	12.8	13.3	15.2	15.4
United States	9.4	9.4	11.1	12.1	13.9	13.2
Canada	0.9	1	0.8	1.2	1.2	1.5
Asia	9.1	10.2	10.7	12.2	9.1	6.3
Japan	4.0	4.9	5.1	9.8	6.6	4.8
Oceania	2.5	1.8	3.2	0.1	0.1	0.1
Other countries	8.4	7.9	5.6	6.9	4.7	1.5
Total	100	100	100	100	100	100

1. The EU and the EFTA countries except Switzerland.

Source: Statistics Iceland.

Table A7. **Projected external debt service**<sup>1</sup>

<i>Billions of krónur</i> <sup>2</sup>	1998	1999	2000	2001	2002	2003	<i>Principal thereafter</i>	<i>Total</i>
<b>Public authorities</b>								
Principal	14.3	28.4	15.7	31.8	17.1	17.2	45.7	181.4
Interest <sup>3</sup>	10.0	9.2	7.7	6.0	5.1	3.8		
Total	24.2	37.6	23.4	37.8	22.2	21.0		
<b>Financial institutions</b>								
Principal	8.7	6.9	13.1	9.7	2.0	5.7	8.4	59.3
Interest <sup>3</sup>	2.3	1.9	1.5	1.1	0.7	0.6		
Total	11.0	8.8	14.6	10.7	2.7	6.2		
<b>Private sector</b>								
Principal	1.8	1.7	2.1	2.0	1.8	1.5	4.7	17.1
Interest <sup>3</sup>	0.8	0.7	0.7	0.5	0.4	0.3		
Total	2.6	2.4	2.7	2.5	2.3	1.8		
<b>Total payments</b>								
Principal	24.8	37	30.8	43.5	20.9	24.4	58.8	252.4
Interest <sup>3</sup>	13.1	11.8	9.9	7.6	6.2	4.7		
Total	37.8	48.8	40.7	51.1	27.1	29.1		

1. Based on debt outstanding at the end of 1996. 2. Exchange rates at the end of 1996. 3. US dollar Libor is assumed at 5.5 % per year.

Source: The Central Bank of Iceland.