



FILE COPY

Report No. E.A. 63

Copy No. 44

This report is limited to those members of the staff to whose work it directly relates.

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

ICELAND - MISSION REPORT

August 31, 1956

Currency Equivalents

\$1.00	=	16.286 I.kr.
1 I.kr.	=	\$0.061
100 million I.kr.	=	\$6.1 million

ICELAND

Summary of Important Statistics

Fish Catch
(thousand metric tons)

	<u>Whitefish</u>	<u>Herring</u>	<u>Total</u>
1926-30 average	243	47	290
1936-40 "	155	160	315
1947	224	207	431
1948	276	133	409
1949	266	71	337
1950	261	62	323
1951	286	85	371
1952	305	32	337
1953	293	70	363
1954	340	48	388
1955	357	52	409

Source: Landsbanki Islands

Prices, Money and Credit

	<u>Cost of Living</u>	<u>Money Supply</u>	<u>Total Bank Credit</u>
	(March 1950 = 100)	(million kronur,	end of previous month)
1950 March	100	301	904
July	115	329	1000
1951 January	128	352	1068
July	142	376	1239
1952 January	153	462	1251
July	157	433	1418
1953 January	157	432	1371
July	157	467	1661
1954 January	158	502	1598
July	159	528	1806
1955 January	161	559	1785
July	165	639	2107
1956 January	175	699	2166
July	185	712	2331

Source: Landsbanki Islands

Estimated Gross Fixed Investment

1954 1955
(millions of kronur, at current prices)

Agriculture	176	181
Fisheries	46	86
Industry, fuel and power	115	104
Transport and communications	179	323
of which private automobiles (mission est.)	(20)	(170)
Dwellings	245	365
Other	68	75
Total	<u>829</u>	<u>1134</u>

Source: Iceland Bank of Development.

Balance of Payments

	<u>1949</u>	<u>1950</u>	<u>1951</u>	<u>1952</u>	<u>1953</u>	<u>1954</u>	<u>1955</u>
Exports (f.o.b.)	40	26	42	39	44	52	52
Imports (f.o.b.) 1/	-59	-33	-50	-48	-63	-66	-71
Government (largely airbase)	-	-	3	4	16	16	17
Other invisibles (net)	4	2	-6	-3	-3	-3	-7
Current balance	<u>-15</u>	<u>-5</u>	<u>-11</u>	<u>-8</u>	<u>-6</u>	<u>-1</u>	<u>-9</u>
Foreign aid and EPU grants	2	7	8	5	6	1	-
Foreign loans	1	3	3	3	2	2	1
Use or accumulation (-) of reserves	5	-1	-3	-2	-2	2	8
Other capital	7	-4	3	2	-	-3	-
Total capital	<u>15</u>	<u>5</u>	<u>11</u>	<u>8</u>	<u>6</u>	<u>1</u> 2/	<u>9</u>

1/ c.i.f. in 1949 and 1950.

2/ Does not equal sum of components because of rounding.

Source: 1949-1954: IMF, International Financial Statistics;
1955: Government Submission to OEEC.

Estimated
Public External Debt Service 1/

	<u>Total Debt</u>			<u>of which \$ Debt</u>		
	<u>Interest</u>	<u>Amortization</u>	<u>Total</u>	<u>Interest</u>	<u>Amortization</u>	<u>Total</u>
	(millions of dollars equivalent)					
1956	0.7	1.8	2.5	0.1	0.4	0.5
1957	0.7	2.0	2.7	0.1	0.4	0.5
1958	0.7	2.2	3.0	0.1	0.2	0.4
1959	0.7	2.4	3.1	0.2	0.4	0.6
1960	0.6	1.8	2.4	0.2	0.4	0.6
1961	0.5	1.6	2.1	0.2	0.4	0.6
1962	0.5	1.2	1.6	0.2	0.4	0.5
1963	0.4	1.0	1.4	0.1	0.4	0.5

1/ Sum of items may not equal totals because of rounding.

Source: Mission estimate.

CONFIDENTIAL

~~DRAFT~~

August 29, 1956

ICELAND - MISSION REPORT

Introduction

1. Between June 1951 and September 1953 the Bank made five loans, on which \$5.7 million is now outstanding, for projects in Iceland. A disagreement then arose when the Bank declined to finance a proposed Government-owned cement plant which Iceland declared its firm intention to build. The Bank took the position that it would not lend further to Iceland until it knew how the cement plant was to be financed and, thereafter, could not make any commitments about future loans until a mission had been to Iceland to review economic conditions.

2. In March this year the Bank was officially informed that foreign financing for the cement plant had been arranged by means of a 15-year loan from the Danish Government. The request was renewed for a mission as soon as possible and the Bank agreed to send one. However, with the fall of Prime Minister Olafur Thors' Independent-Progressive coalition at the end of March, this was postponed until after the elections in June and timed to coincide with a Fund mission, to avoid duplication of effort. In the event, a full month of negotiations elapsed before a new coalition, composed of Progressives, Social Democrats and the Communist-supported "Labor Alliance," was agreed on. It had been in office only a day before the Bank and Fund missions arrived in Reykjavik on July 25.

The Structure of the Economy

3. Many of Iceland's problems, political, economic, and even psychological, stem from her narrow resource base, extremely small population (only 160,000) and isolated geographic position in the North Atlantic. Much of the center of the country is uninhabitable. Apart from the grasslands in the long valleys running inland from the many fjords which break the coastline, and a considerable hydroelectric potential, the island's resources are sparse. Its greatest assets have been its vigorous and well-educated population and its location near some of the richest fishing grounds in the North Atlantic.

4. For about a thousand years after the Viking settlement, conditions of life on the island changed surprisingly little. But about 1900 the introduction of the steam trawler made possible a highly productive fishing industry, on which Iceland's economy has since been based. This ushered in a period of rapid development which is still going on. From time to time there have been serious setbacks, notably in the 'thirties when unemployment was extremely heavy. But the economy received another great stimulus during the second World War when Iceland

became an important allied base and large numbers of troops were stationed there and when there was a ready market in the U.K. for fish at high prices. The real national product doubled in that period and has since continued to rise, supported by the use of accumulated foreign exchange reserves, by foreign loans and Marshall Aid, and, since 1951, by receipts from the NATO airbase at Keflavik.

5. This rapid development has brought a striking change in the distribution of population. Although the population has doubled since the turn of the century, practically all the increase has been concentrated in the southwest corner of the island. Reykjavik, founded on the important fishing grounds of Faxa Bay, has, with the nearby towns and surrounding area including the airbase, continued to provide steadier employment and more attractive living conditions than the isolated farms and small towns around the coast.

6. Today the fisheries have become a highly complex \$50 million industry, accounting for a fifth of the gross national product and 90% of exports. Their development has not always been smooth, for great uncertainty always surrounds both the catching of fish and their marketing. But Icelanders have adapted their methods to changing fishing conditions, and to great and sudden changes in markets and market requirements. In the past Iceland concentrated on exporting salt fish, and later fish-on-ice. Today, about one-third of fish exports (by value) are frozen; the balance is spread among a variety of products: dried salt cod, salt herring, stockfish, fish meal, fish oil, roes, and other products, each with a different market and each requiring special processing facilities. The greater part of these facilities has been built since the war. Although still virtually all fish products, Iceland's exports are in fact more diversified than ever before, and the fish processing industry is on the whole up-to-date and progressive.

7. In other sectors of the economy development is even more recent and perhaps even more striking. Within the last 30 years a network of roads has been laid out and coastal shipping services organized. For the first time, durable concrete houses have been built - using imported cement and timber - and construction activity has been brisk since the end of the second World War. Since that time, too, the farmers, whose share in the economic expansion had hitherto been small, have been draining their land, rebuilding their barns and their houses and buying labor-saving machinery. The majority now have telephones and rural electrification is proceeding rapidly. While the short growing season and cool, moist summers must confine farming very largely to the raising of sheep and cattle, productivity has risen remarkably. Agricultural output has now practically recovered from a disastrous outbreak of sheep disease which entailed the compulsory slaughtering of almost the entire stock after the war, and is now at an all-time high. Finally, the development of air transport across the Atlantic has brought Iceland into much closer contact with the rest of the world than she had ever been before.

8. In short, Iceland today is a small, highly educated and progressive country, proud of its old cultural heritage and jealous of its newly-won independence. Its people have made much of their unusual and in some ways meager resources, and now have a standard of living comparable, say, to some of the Scandinavian countries. Long dependent on the vagaries of the fish catch and

accustomed to living dangerously, they have, on the whole, shown a remarkable ability to adapt their economy to difficult and quickly changing conditions. In view of the country's narrow resource base and extraordinarily high dependence on imports, the national development effort has, from time to time, strained the country's foreign exchange position and resulted in bouts of inflation. During and since the war Iceland has, on balance, been favored by fortune, since extraordinary sources of income from abroad have been large enough to prevent serious or prolonged balance of payments difficulties from occurring. But, by the same token, these windfalls have increased Icelanders' appetite for imports and have led some of them to regard their future more optimistically than they should.

Icelandic Politics

9. Icelandic politics has also many special features. In keeping with the country's ancient parliamentary tradition, it is a game played with enthusiasm by the professionals and followed closely by the whole population. The Independence Party, now composed mainly of town dwellers and strong in the expanding Reykjavik area, still bears the mark of the energetic merchants who were important civic leaders in the early days. The Progressive Party, whose rise is associated with the growth of a strong cooperative movement, particularly in small fishing towns and in rural areas, draws its major support from these sources. Broadly speaking, the Social Democrats - who have attracted a fair number of intellectuals - and the United Socialists (Communists) - often working through the trade unions - vie for the votes of the workers who often show a radicalism typical of seamen and longshoremen. However, political labels are rather loose in Iceland. Changes in party affiliation are fairly common and some surprising political switches have been made. Personal leadership is an extremely important factor, so that political parties often reflect the interests and loyalties of economic groups, localities, and even families more than differences of doctrine or principle.

10. For more than a decade the relative strength of the various political parties has been such that, apart from a minority government which lasted a few months, Iceland has been governed by coalitions of two or more parties. On occasion, the combinations have been startling to the outsider, and the new government of Progressives, Social Democrats and the so-called "Labor Alliance" - which includes the Communists - is not unprecedented. Moreover, whereas coalition-making in most countries involves allocating a few portfolios, in Iceland it is a cumbersome process of redistributing among six ministers the responsibility for several dozen government services. Further, except insofar as particular functions are specifically allotted to the cabinet as a whole, collective cabinet responsibility does not exist and each minister is fully responsible for the conduct of the offices under his jurisdiction.

11. All this hardly makes for strong government, particularly in international affairs and national economic policy. In the former, Iceland's experience is very recent. Her long isolation from the rest of the world was followed by the sudden arrival of large numbers of foreign troops at a time when the country was on the verge of winning the struggle for independence which had absorbed much of its intellectual energy for a century. Understandably enough, Icelanders have found it hard to adjust themselves to the implications of their new strategic position.

In matters of economic policy, governments have found it difficult, in the face of the national enthusiasm for development, to reach satisfactory agreement in times of stress on how the burden of readjustment should be shared.

Recent Political Events

12. In March of this year the Foreign Minister, a Progressive, presented to the Althing a resolution calling for a revision of the arrangements at Keflavik airbase. Iceland entered NATO in 1949 on condition that foreign troops would be stationed on her soil only in time of emergency. Such an emergency was deemed to exist after Korea, and in 1951 a Defense Agreement was concluded with the U.S., governing the operations of the airbase and providing for its staffing with U.S. forces. The recent resolution stated that the foreign policy of Iceland should continue to be based on cooperation in security matters with the NATO countries, but that in view of the lessened international tension since 1951, the system then adopted should be revised so that Icelanders should maintain the defense installations and the defense force should be withdrawn. Only the Independence Party voted against the resolution, the Government fell, and new elections were scheduled for June 24. The Progressives and the Social Democrats then entered into an electoral alliance, agreeing not to oppose each other and to put forward candidates from the one party or the other, depending on their estimated strength in particular constituencies. By this procedure the two parties expected some loss in popular vote but hoped that this would be offset by a gain in seats in the Althing. Arguments about the future of the base were naturally prominent in the election campaign, with both sides painting a rather exaggerated picture of their opponent's views. In a newly independent country with a long background of isolation many people were bound to be sympathetic to the Althing resolution. But it would be wrong to infer that the passage of this resolution and the subsequent election results reflected increasing anti-American and anti-NATO feeling in Iceland. Actually, the Independence Party polled 42% of the popular vote, 4% more than at the previous election.

13. The real motives behind the Progressive-Social Democratic alliance and the call for elections lay rather in the field of domestic politics. The Progressives had been concerned about the increasing power of the Independence Party. They felt that the boom in the Reykjavik area, which was associated with the activity at the airbase, had benefited the Independents disproportionately. They were also worried, for instance, about the growing influence of the Independence Party at the Landsbanki, the largest commercial bank and at the same time the bank of issue. Historically this bank has been associated with the cooperatives, the farmers and the Progressive Party in much the same way as the Fisheries Bank had been linked to the Independents. On the other side, the Social Democrats had seen their power waning for several years. Not only had they lost seats in the 1949 and 1953 elections, they had also been weakened when one of their leaders, Hannibal Valdimarsson, chief of the Icelandic Trade Union Federation, had made common cause with the Communists. This new grouping, which appeared as the "Labor Alliance" in the recent elections, cut further into the strength of the Social Democrats.

14. In the elections the Progressive-Social Democratic Alliance had some success, but not enough to give it a clear-cut victory. It gained three seats, although losing slightly in the popular vote, but its total of 25 seats left it two short of a majority. In spite of its increased popular vote, the

Independence Party won only 19 seats, two less than in the previous election. The "Labor Alliance" obtained the remaining eight, one less than the total held previously by the Communists (7) and the National Defense Party (2), a leftist, isolationist and anti-NATO group, which did not return any candidates. After a month of bargaining a new coalition was agreed on, including two ministers from the Progressive Party responsible for the Prime Minister's Office, the Departments of Agriculture and Finance, two from the Social Democratic Party responsible for Foreign Affairs and Education, and two from the "Labor Alliance" responsible, broadly speaking, for Labor and Commerce. For the first time since 1949 a Communist-supported group entered the Government.

15. It is not yet possible to say how the new Government will act. As regards foreign affairs, the basis of policy will be the Althing resolution, which contemplates continued membership in NATO, at least until that body is due for renewal in 1959. The mission was assured that the "Labor Alliance" had entered the coalition on the understanding that its representatives would have nothing to say on foreign affairs. This is possible under the Icelandic system of ministerial responsibility and so far, at least, the evidence indicates that it is correct. On economic matters the Government has so far put forward only a very general statement. Progressive and Social Democratic ministers stated quite frankly to the mission that they had not yet worked out a detailed program and that the coalition was an experiment in putting labor in a position of authority in the hope that with power would come a greater sense of responsibility. Before taking such a risk they presumably had some indication that labor's attitude would be more cooperative than it had been in 1949 and 1950. Such a coalition could give Iceland stability. On the other hand, it is rather an uneasy marriage - based on a series of compromises. If these should prove untenable, the coalition will break up and new elections will determine its successor in accordance with Iceland's long democratic tradition.

The Problem of Inflation and the Value of the Krona

16. The most urgent economic problem facing the new Government is that of inflation. Iceland experienced successive rounds of inflation during and after the war and devalued the krona twice, most recently in March 1950. Relative stability was achieved in 1952 but not until after the cost of living index (March 1950 = 100) had increased to almost 160. Since the end of 1954, there has been a new bout of inflation. From January 1955 to August 1, 1956 the cost of living rose from 159 to 186, and is expected to go above 190 before the end of the year.

17. Even the stability of 1952-54 was precarious. During that period the air base was established, migration to the Reykjavik area was renewed (in part attracted by work at the base), and construction activities in the southwest rose as a consequence of the general prosperity to which the base contributed. All this was superimposed upon a high level of investment in other sectors of the economy. Even though employment of Icelanders at the base was in 1954 deliberately reduced from 3,000 to 2,000, a growing scarcity of labor developed in the economy, and workers in all sectors sought higher incomes, with their eyes on the high earnings from overtime that could be obtained at the base, and spurred by the strong demand for their services. By the end of 1954 many skilled workers had obtained a rise in income by switching from hourly wages to piecework.

Unskilled workers, unable to supplement their incomes in the same way, struck for higher wage rates in March 1955. After a general strike lasting six weeks, they obtained a wage rise of some 15%, including fringe benefits.

18. The increase in wages started an inflationary spiral that is still going on. A number of factors aggravated the situation:

- a) There is a series of automatic links between wages and the cost of living and between farm prices (and hence incomes) and urban wage rates. While a certain amount of bargaining can take place at the time of major adjustments, the system is now so firmly established that it would be hard to abolish altogether; the last Government was certainly not strong enough to do so.
- b) Bank credit, mainly to business, expanded continuously, and monetary controls were inadequate to check expansion. Central banking is only one of the functions of the Landsbanki, and in any case it has not been able to pursue a credit policy independent of government, and hence political, influence. One of the weak links in the credit system is the obligation on the Landsbanki, stemming from the Government's long-standing agreements with the fishing industry and with the farmers, to rediscount automatically and at preferential interest rates 45-day renewable bills secured by fish or farm products. There is little doubt that credit created in this way has indirectly financed a large part of the current investment boom.
- c) In 1954 and 1955 the Government budget showed a nominal surplus. However, in both years the surplus was appropriated by the Althing to repay interim bank credit which had financed investment projects (especially in agriculture and the fisheries). The Government had gone ahead with these projects hoping that foreign loans would be obtainable for them. When these failed to materialize, the budget surplus had to be used, and thus failed to exert the anti-inflationary influence that had been intended.
- d) Toward the end of 1955 there was a temporary accumulation of exportable goods, both fish and chilled lamb, so that incomes were paid out to fishermen and farmers (financed by the banks) some time before there was a corresponding rise in available goods and services. This stocking unfortunately took place just when the demands on the economy for fixed investment were at their height.
- e) Finally, inflation led to some speculative investment, in housing for example, and this bred more inflation.

19. The previous Government failed to strike in time at the underlying causes of this inflation. In late 1955, it did attempt to check the growth in bank credit, and some forms of credit to sectors other than fishing and agriculture were reduced slightly. The main sources of credit expansion were left untouched, however. The Government also took steps to cut the loss in foreign reserves by stopping the importation of automobiles, which in 1954 had been liberalized, partly in order to provide a base for a large new tax to finance the trawler subsidy. To make up for the loss of these tax receipts, and also to cover the rise in public expenditures stemming from inflation, the

Government levied a number of new taxes and increased others. It failed, however, to develop a budget surplus capable of having a real anti-inflationary effect. Although it would have been desirable to take more rigorous steps, it is on the whole not surprising that the Government failed to do so, for it would have been very difficult politically to impose additional restraints upon Icelanders at a time when construction at the airbase was in full swing.

20. The rise in prices since the last devaluation would make it impossible for Iceland to export, were it not for an elaborate system of export subsidies and import taxes which is in effect a partial and progressive currency depreciation. It enables fish and farm products to be sold at competitive prices abroad, while increasing the cost of most imported goods in terms of kronur. Present price and income relationships are quite artificial and this seriously hampers a rational assessment of investment projects. On balance, many imports remain artificially cheap; almost any proposal to substitute Icelandic for foreign goods seems unattractive. By the same token, activities which use large quantities of imports (the construction industry, for example) are unduly encouraged.

21. The new Government's statement of economic policy recognized the need to stop inflation, and promised changes in the Landsbanki. The Government has just appointed a special committee to investigate the facts, and report before the Althing reconvenes in October. Actually, the Government has until the end of the year, when the annual negotiations with the fishing industry over the price of fish take place, to make up its mind what it will do.

22. There are some grounds for hope that the present round of inflation will be brought under control fairly soon. The new Government should be better able than its predecessor to exercise restraint upon the demands of labor and the farmers. A relatively small reduction in investment - such as might come almost of its own accord if the expectation of speculative profits were removed - would probably be sufficient to restore equilibrium. And the problem has been made easier by the fact that the real national product has continued to grow quite rapidly throughout 1955 and 1956. If and when the underlying causes of inflation were removed, devaluation of the krona would have to be considered. Iceland's memories of past devaluations are not pleasant - and the main supporters of the Government, labor and the farmers, might suffer considerably - but it might be accepted if the burdens were distributed widely enough. However, it is by no means sure that decisive steps will be taken and until the Government has formulated its policy not much more can be said about its chances of success.

23. Even if stability were achieved in the near future the threat of inflation will probably recur from time to time. The continuing enthusiasm for investment will put pressure on Icelandic resources, making it difficult to meet any extraordinary demands on the economy or to adjust to a sharp drop in national output resulting, for example, from a poor fish catch. Icelandic governments have tended to react rather slowly to inflationary pressures. On the other hand, they have so far acted in time to prevent matters from getting completely out of hand.

The Investment Effort

24. Investment in Iceland has been high since the war and now amounts to between a quarter and a third of the national product. It has, unfortunately, from time to time outrun Iceland's fairly large capacity to save, and

as at present, inflation has been the result. In view of the strong national desire for improvement, this tendency will persist. The Icelandic economy is not suited to the kind of overall planning that would limit investment in advance to available resources, simply because the level of resources from the country's main industry is unpredictable. The problem is complicated by the small absolute size of the economy, so that a project which by foreign standards is not big, the proposed Sog hydroelectric extension, for example, looms very large in Iceland and produces unevenness in the rhythm of investment not experienced in larger countries.

25. The investment that has taken place has, however, strengthened the economy greatly in physical terms, and Iceland's postwar economic growth has been fully as rapid as that in other European countries. The entire trawler fleet and much of the motor boat fleet have been renewed since the war, and though the herring catch has been much smaller, that of whitefish has increased by 40%. And whereas three-quarters of Iceland's fish exports in 1945 were shipped on ice, in 1955 the entire catch was processed in one form or another, largely in new plants, before it was sent abroad.

26. The output of hay has risen from an average of 220,000 tons in 1936-40 to over 300,000 tons in 1956, and five-sixths of the crop is now grown on cultivated land compared to one-half before the war. The area of cultivated grassland, on which yields are much higher than on natural meadows, has gone up by 50%. The stock of sheep has been restored to the prewar level of 600,000 and is expected to reach 800,000 in two years. Mainly as a result of higher yields, but also encouraged by subsidies designed to keep down the cost of living, output of meat and dairy products has risen sharply, milk by 40% in 10 years. And agricultural productivity, aided by mechanization and the greater use of fertilizers, has increased considerably; the expansion of farm output has taken place at a time when the agricultural labor force was declining.

27. Electric power production capacity has trebled since the war and output increased fourfold, a fertilizer plant now produces all of Iceland's nitrogen requirements, and a cement plant is under construction. In the field of transport the merchant marine grew from 14,000 to 38,000 gross registered tons between 1938 and 1955, largely under private ownership, and now carries the greater part of Iceland's foreign trade. Two private airlines have been established, carrying almost all of Iceland's growing air traffic. And finally, great progress has been made in meeting the country's housing needs, high not only because of wartime shortages but also because of the rapid rate of family formation and the migration to Reykjavik.

28. With the price structure distorted as it is at present, it is difficult to measure the costs and benefits of many investment projects. One group of projects was, in retrospect, a mistake, namely, the now unused herring factories built just after the war in the enthusiasm engendered by record herring catches, which were not repeated. Some of the record number of dwellings built in 1955 and 1956 are probably larger than necessary, or at least postponable. By and large, however, Iceland's investment seems to have been channeled into the most useful sectors, and the country's output has greatly benefited.

29. There will continue to be reasons for Iceland to continue to invest as much as is consistent with financial stability. At the moment there is a

scarcity of labor but as the population is growing at the rate of 2% per annum, in the long run new employment opportunities must be created at a fairly high rate. Investment in the fishing industry has recently been rather low, but it is now picking up again, and ought to be active if the country's main industry is to remain efficient. And though investment needs in agriculture may taper off somewhat in a few years, other sectors, for instance transport and electric power, will need to grow as the rest of the economy expands. There will be a more or less continuous growth of light industries, and occasionally a larger scheme, like the fertilizer and cement plant, will present itself. The interest of Icelanders in innovation will ensure that as many of these opportunities as possible are seized. This interest - one of the most striking features of present-day Iceland - is reflected in the great amount of owner effort being put into the rehabilitation of farms, the improvement of fishing boats and gear, and the construction of houses. It is also behind the new Government's first public statement, expressing the intention of buying 15 new trawlers, expanding the Sog plant, building new port facilities and pressing on with agricultural development and rural electrification, all with the aid of foreign loans. Given Iceland's large investment requirements, it is normal that she should seek to cover some of them by borrowing abroad; provided, of course, that the resulting burden of debt service is not too heavy.

External Creditworthiness

30. The Icelandic economy faces three major potential sources of difficulty which constitute risks from the point of view of the foreign lender. First, and most important, the catch may fail in particular years. Second, foreign markets for fish are particularly volatile. And third, inflation may recur and cause balance of payments difficulties. There is an additional uncertainty at the moment about future receipts from the airbase.

31. In the last few years gross receipts from the base have amounted to some \$15 million per annum. Net receipts (after deducting about \$3 million worth of imports used directly at the base and making an allowance for imports indirectly "induced" by the unusually high incomes received for work for the base) have been lower, perhaps about 10% of gross foreign exchange receipts. But whatever the outcome of the forthcoming negotiations over the base with the U.S., Iceland cannot and should not count on receiving these sums indefinitely. The question is rather when and how quickly they will taper off and what the effect of such a decline would be. It seems on the whole likely that they will taper off rather slowly, but even if they were to cease abruptly, the problem of adjustment would not be insuperable. It would be much easier than, for example, the adjustment which took place after the poor fish catch in 1950, when in one year imports had to be reduced by over one-third despite receipts of Marshall Aid.

32. The long-term outlook for the fish catch is more promising than it appeared some years ago. The unusually good summer herring runs of 1935-1945 have not been repeated, but new and better techniques have recently improved the catch, even when the herring were far from the shore. This season was the best since 1947. The catch of whitefish, mainly cod, haddock and ocean perch, has expanded steadily over the last five years, and is now at an all-time high. Signs of over-fishing are said to have disappeared since conservation measures were taken in 1950 and 1952. Recently, new fishing grounds discovered off

Greenland have yielded good catches of ocean perch, valuable both for freezing and for grinding into meal and oil. On the whole the long-run prospect is for a slow growth in the total fish catch. Nevertheless, there will inevitably be years when the catch is poor, and in such years Iceland will have to tighten her belt severely to make ends meet. Ideally a country in this position should accumulate substantial foreign reserves to tide her over lean years, but for the time being at least there is little prospect that Iceland will do this, so great is the desire to channel all possible resources into fixed investment.

33. As regards markets for fish, Iceland has over the last 30 years shown noteworthy flexibility in adapting her processing industry and sales to changing markets. Before the war, the staple export was salt fish sent to the Mediterranean area but this market was very much reduced by the Spanish Civil War. During and just after World War II the principal market was that for fish-on-ice in the U.K., most of it carried directly by the trawlers that made the catch. This market, already suffering from the glut of fish in the U.K., was closed altogether in 1951 by a private boycott of Icelandic iced fish, imposed in retaliation for Iceland's restrictions on trawling in coastal waters. The dispute was near settlement early this year, but the change of government intervened. Both sides have now shown a conciliatory attitude and a solution should eventually be reached. If and when this happens, the U.K. market would not regain its former importance, but it would provide a useful additional outlet, welcome to trawler owners and seamen who bought gear and spent part of their wages at U.K. ports of call.

34. To make up for the loss of the U.K. market for fish-on-ice, Iceland expanded her freezing industry, and sold large amounts of frozen fish, first in the U.S. and more recently in the Soviet Union, Czechoslovakia and Eastern Germany. In 1952, the U.S. took 25% of Iceland's exports, today it takes only 12%, while the Soviet Union takes 25% and is Iceland's largest customer. Canadian competition, coupled probably with a rather rigid price policy on the part of the Icelanders, was responsible for the decline in sales to the U.S., while, on the other hand, Iceland has so far been able to obtain satisfactory prices from the Soviet Union, and also to obtain oil, steel and other essential commodities at world prices. During the postwar period, Iceland has also increased her sales of salt fish to Spain, Portugal and Italy, expanded exports of fish meal and oil to EPU countries, and for the first time became an important competitor of Norway in the West African market for fried fish.

35. Nevertheless, there are two inherent weaknesses in Iceland's export position. One is the fact that Iceland tends to be an outsider in many of her markets, and has suffered in the past - and may again in the future - from the protectionist policies of fish-importing countries, like the U.S., anxious to protect or develop their own fishing fleets. The second weakness is the large share of exports at present taken by Russia. It is not inconceivable that for political or other reasons Russia might suddenly cease fish purchases in Iceland, as she did once before in 1948, after taking 20% of Iceland's exports in 1946 and 1947. Both these weaknesses suggest that Iceland may from time to time be faced with the necessity of finding new markets quickly. The flexibility she has shown in the past augurs well for her ability to do the same in the future, though temporary difficulties may well occur.

36. The third potential source of difficulty is domestic inflation. In the short run, equilibrium in the Icelandic balance of payments depends on avoiding inflation, or at least in maintaining controls over its external effects. A very large part of any increase in domestic spending power is quickly reflected in the demand for imports. In 1954, a year of domestic financial stability, external accounts were almost in balance, without very stringent controls over imports. But in 1955, a year of inflation, imports rose and there was a balance of payments deficit of \$9 million, or 10% of total receipts, met by drawing on Iceland's already meager foreign exchange reserves. The deficit was mainly with EPU countries. The dollar accounts showed a surplus, thanks to receipts from the base. Trade and payments with clearing account countries such as Russia and Czechoslovakia, which have tended to grow in importance, were virtually in balance. Iceland's clearing agreements normally provide for settlement of outstanding balances above the "swing" in sterling, but Iceland and her partners have preferred to alter the volume of trade rather than make substantial payments in transferable currency.

37. How the Government will tackle its current inflation and balance of payments problems will be clearer in a few months. There is little doubt that if it were to take effective anti-inflationary steps, Iceland would be able to balance her external accounts without much difficulty, the more so if at the same time the krona were devalued and imports were made more expensive. Even if some inflationary pressure persisted, however, import controls could and would be tightened without affecting production. Iceland possesses an effective mechanism for preventing commercial arrears from piling up, administered by the banks. An Icelander is not allowed to contract for a foreign payment, even if he has an import license, until the banks have approved his application for exchange. If sufficient foreign exchange is not on hand, these applications are allowed to pile up and the danger of default on contractual payments avoided.

38. Iceland's public external debt amounts to about \$24 million, of which \$8 million is repayable in U.S. dollars and the rest in various European currencies. The Bank holds \$5.7 million of this, just over one-fifth of the total, all of it repayable in EPU currencies. Annual payments of interest and amortization rise to about \$3 million in 1959, but because much of Iceland's recent borrowing has taken the form of medium-term suppliers' credits, debt service falls off rather sharply after 1959. Debt service in 1959 is 5% of 1955 non-military foreign exchange receipts; in 1962 only 2½%. Iceland has recently incurred a certain amount of private debt abroad for the purchase of merchant ships and fishing vessels. The mission was informed that the foreign exchange earned and saved by these ships would be about sufficient to repay the debt incurred in purchasing them. All in all, Iceland's debt service burden is not a heavy one, especially after 1959. It is much lighter than the burden of debt that she carried before the war.

Conclusions and Recommendations

39. Because of her unique dependence on exports of fish, lending to Iceland is fraught with risks of an unusual kind. On the other hand, her relatively small debt burden, her record in giving a high priority to debt service payments, her demonstrated ability to develop the resources she has and to adjust to sudden and unpredictable changes in her export receipts, if need be by cutting imports