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DRC/WP(75)2
ICELAND

DEFENCE REVIEW COMMITTEE

NATO DEFENCE PLANNING 1976-1980

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Note by the Chairman

Attached is a draft for this year's country chapter for Iceland, which has been prepared on the basis of the information available from national sources and the OECD.

2. This draft will be discussed on Tuesday, 25th November, 1975. Following this examination the paper will be revised, if necessary, and issued as a document for the Defence Planning Committee.

(Signed) D.C. HUMPHREYS

NATO,
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The facilities available to NATO in Iceland provide early warning of enemy activities in the area, a base for maritime air surveillance and a base for logistic support of NATO naval forces. In addition, Iceland provides staging and emergency diversion facilities for reinforcement aircraft. The country has no armed forces of her own, but Iceland continues to contribute to the NATO military budget.

Current economic trends and policies

2. During the first years of the 1970s, economic growth has been stronger in Iceland than in other member countries. For the years 1970 to 1973 the real growth of the national product averaged 7% yearly. In 1974 the growth rate slowed to 3% partly as a consequence of the international recession, but also because of resource and capacity restraints. With exports and export prices sharply lower and imports continuing to rise in price the Icelandic economy has experienced a sharp deterioration in the terms of trade and a difficult balance of payments situation, although imports have declined substantially in volume. For the year as a whole the gross national product is expected to be 3% lower than in 1974. Beyond 1975 the outlook remains very uncertain.

3. The slowdown has been accompanied by a serious inflationary development and at rates considerably higher than those experienced in other member countries. For the decade 1961-1971 the annual average rise in consumer prices was already 12% in Iceland compared with an OECD average of 3.7%.

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Consumer prices jumped by 25% in 1973 and then accelerated to above 40% in 1974 mainly as a result of rapidly expanding internal liquidity and strongly rising import prices that were reinforced by the oil price increases. Economic policy measures taken by the Government during 1975 to stabilise the economy together with a moderate wage settlement in the middle of the year might dampen the inflationary development substantially in the latter half of 1975. The external inflationary effects will also be considerably weaker than during the two preceding years. The inflation rate is however expected to remain above the level of other member countries during the next year.

4. In order to bring about a balance in the economy the Government has taken a number of economic policy measures that will contain domestic demand within acceptable limits. The Icelandic Krona has been devalued twice, first in August last year by 17% and then again in February 1975 by 20%. At the same time Government expenditures for 1975 were cut and a freeze was put on increases in bank lending. Excise taxes of 12% have been imposed on a wide range of products, both imported and domestic with a view to bringing about a balance in the government budget which would otherwise have been very heavily in deficit. In the monetary field the Central Bank and commercial banks have co-operated to institute a tight bank credit policy. A ceiling on increases in bank credit was effectively enforced from March up to June. Later small increases in credit were allowed up to the end of August.

5. The prospects for curbing increases in wages and salaries are a key element that would influence the future stability of the economy. These increases have been very strong over the last few years and have been one of the main

factors behind the inflationary development in Iceland. Following a sharp rise in real purchasing power up to mid-1974, most wages have since suffered a serious decline in purchasing power which is now down to the 1971/72 level. Despite this development, labour unrest has been limited since the Spring, when a prolonged trawler and merchant marine strike had considerable repercussions on economic activity. The Trade Union association has now adopted a policy of gradually trying to regain the loss in wage and salary purchasing power as the economy recovers.

Structure of industry

6. The longer term problem of bringing the Icelandic economy into better balance is closely tied to extending the economic base which currently is strongly dependent upon the fishing industry. Conditions for manufacturing industries other than fish processing have not been favourable. There are many reasons for this. The domestic market is small and isolated, mineral resources are exceedingly scarce, and the economic environment has not offered favourable conditions for fostering manufacturing industry. In spite of this, manufacturing industries other than fish processing showed an average rate of growth during 1970-1974 of 12% compared with 6% for the GNP. Exports mainly based on fishing, whose output is dependent upon incalculable factors, has led to economic fluctuations almost impossible to control.

7. Today the primary sector accounts for less than 20% of the labour force of which 6% is directly engaged in the fisheries. Some 26% is engaged in manufacturing industry, including 8% in fish processing. This industry consists, with a few exceptions, of a large number of very small intensive labour enterprises. In all, manufacturing, construction and communications take some 46% of the labour force while services take less than 37%.

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8. It has been recognised for some time that the Icelandic fishing industry has reached a point of diminishing returns. An economy based preponderately on fisheries probably cannot in the longer term sustain improvement in the relatively high living standard of the population. It is therefore essential to develop high productivity industry with a strong export potential to supplement the fisheries, but in a country with such limited resources the alternatives are few. However, there are ample hydro and geothermal power reserves, which are only beginning to be developed. The efforts so far made have been matched by large scale industrial establishments using power intensive processes. These industries already include a fertiliser plant, cement factory, a diatomide plant, and the country's largest enterprise, an aluminium plant. Such development programmes require both investment capital and technical knowledge from abroad, and further projects are now in the planning stage.

Foreign trade and payments

9. A consequence of the industrial structure is that marine products are the most significant category of merchandise exports accounting for about three-quarters of their total volume. The share of manufactures in exports has increased from only 2% in 1968 to around 20% today. Most of this is due to exports of aluminium.

10. The share of total trade taken by the USSR and Eastern European countries has not changed very much from a figure of 10% over the last decade. On the other hand, trade with NATO member countries, that continues to account for most of Iceland's foreign trade, has shown a decrease in imports from the United States matched by an increase of imports from Europe. On the export side a revised trend has taken place with exports to the United States rising strongly (15% to 30%).

11. Iceland is one of the countries in the Alliance heavily dependent on foreign trade and payments. Exports of goods and services have in recent years been running at about 40% of the gross national product. Fluctuations in the balance of payments therefore have a very strong influence on economic developments. Since 1968 the current balance has been in considerable deficit. This has, however, been more than outweighed by a surplus on the capital account. As a consequence the foreign exchange reserves increased from 2,512 million krona in 1968 to more than 9,000 million krona by the middle of 1973. A serious current account deficit in 1974, corresponding to 12% of the GNP, resulted in a decline of exchange reserves to 4,633 million krona in January 1975. Since then, the economic policy measures taken have resulted in reduced imports and exports may increase this year. Combined with continued capital inflows the reserves rose to 7,633 million krona in June 1975.

12. Like other member countries, the Icelandic economy has been hit by the international recession and for the immediate future there are considerable problems to be overcome, notably the need to reduce inflation from today's record level of from 40 to 50% annual rate and to create conditions of overall balance in the economy. In the longer term continued membership of the Alliance and close co-operation with other member countries will considerably facilitate the implementation of the economic restructuring process foreseen by the Icelandic Authorities.

Table 2 - National Income and Expenditure

	1972 Kronur million (current prices)	Percentage change from previous year			
		Volume		Price	
		1973	1974	1973	1974
Private consumption	42,720	6.5	7½	26.0	42
public consumption	7,000	6.0	6	24.0	42
gross fixed investment	19,100	20.1	4	24.5	45
(a) General	16,390	5.0	7½	26.5	46½
(b) Special(1)	2,710	93.0	-8	27.0	39
Changes in export stocks and livestock	-840	..	..	..	..
<u>Gross National Expenditure</u>	68,040	11.3	7½	25.5	43
Exports of goods and services	26,130	8.9	-1½	31.1	31
Imports of goods and services	27,900	19.5	8½	20.0	39½
of which : Special merchandise(2)	(2,800)	103.0	10	22.5	36
General merchandise	(16,000)	12.1	8	24.0	48½
<u>Gross National Product</u>	65,270	5.9	3½	31.5	39½
Effects on changes in terms of trade(3)	..	4.0	-4½	..	..
<u>Gross National Income</u>	65,270	9.9	-½	..	..

(1) Burfell and Sigalda power projects, aluminium smelter, imported ships and aircraft, imported houses for inhabitants of Vestmannaeyjar.

(2) Ships, aircraft, imports for power projects and the aluminium smelter, as well as imported homes for inhabitants of Vestmannaeyjar.

(3) Expressed as percentage of previous year's GNP.

Source: Icelandic submission to the OECD.

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Table 3 - Growth of Gross Domestic Product by Industrial Origin

Per cent

	Relative Weight 1972	1970	1971	1972	1973 (1)	1974 (2)
Agriculture	7.0	0	8½	4	2½	4
Fish and Fish Processing	11.7	5½	-5	6	3	2
Manufacturing other than fish Processing	18.9	22	15	8	12	4
Construction	15.0	2	15	12	6	5
Public Services	7.2	4½	6	6	6	6
Ownership of Dwellings	7.3	) 5	5	2½	1½	3
Other	32.9	) 5	12½	8	5	5
Total	100.0	6	9½	6	6½	4½

- (1) Provisional
(2) Forecast

Note: This table is subject to very wide margins of error and should be treated as indicating approximate values only.

Source: Economic Development Institute.

Table 4 - Wage Rates, Incomes and Prices

Average percentage change from previous year

	1972	1973	1974
Wage and salary rates of all employees	27.5	23.5	47.0
Total personal earnings (nominal)	30.5	37.0	52.0
Disposable income of household (nominal)	28.0	37.0	53.5
Cost of living	10.4	22.1	43.0
Prices of consumer goods	13.8	25.1	42.0
Real earnings(1)	18.2	12.2	6.6
Real disposable income(2)	12.5	9.5	8.1

(1) Deflated by the cost of living index.

(2) Deflated by index of consumer goods prices.

Source: Icelandic submission to the OECD.

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Table 5 -- Central Government Finances(1)

Kr. million

	1972		1973		1974	
	Accounts	Budget(2)	Accounts	Budget	Accounts	Budget
Revenue	17,337	21,970	24,046		29,180	
Wealth and income taxes	3,624	4,937	5,237		7,190	
Sales tax	4,365	5,020	5,499		6,702	
Import duties	4,503	5,515	6,328		7,029	
Other	5,345	6,498	6,982		8,259	
Expenditure	18,222	21,936	24,942		29,403	
Consumption	5,325	6,488	..		8,745	
Investment	1,575	2,023	..		2,649	
Transfers	11,322	13,425	..		18,009	
<u>Revenue Balance</u>	-385	34	-396		-223	
Long-term borrowing (net)(3)	560	908	677		1,923	
of which foreign	..	288	..		287	
Short-term borrowing (net)(3)	-3	..	16		..	
Other	-40	-603	-98		-1,308	
<u>Financial Transactions Balance</u>	517	305	595		615	
<u>Overall Cash Balance (+ = surplus)</u>	132	339	-301		392	

- (1) On cash basis.
 (2) Excludes special taxes imposed after passage of Budget to finance the Emergency Fund, but includes extra-budgetary element of public works investment and financing programmes to make comparable with 1974 Budget figures.
 (3) Excluding borrowing from Central Bank.
Source: Icelandic submission to OECD.

Table 6 - Balance of Payments
\$ million(1)

	1972	1973	1974(2)
Exports of merchandise(fob)	191.7	267.0	373.9
Imports of merchandise(fob)	215.5	299.2	501.5
of which special imports(3)	32.2	71.5	113.9
<u>Trade Balance</u>	-23.8	-32.2	-127.6
Services, net	3.8	5.4	-7.6
Transfers, net	0.2	14.9	1.1
<u>Current Balance</u>	-19.8	11.9	-134.1
Long-term borrowing(net)	31.1	37.6	92.2
of which official	24.0	20.6	26.2
financial institutions	9.5	14.0	42.9
private	-2.4	3.0	23.1
Private direct investment(net)	2.7	-2.3	-3.3
Other(net)	-7.2	-13.1	-6.1
<u>Capital Balance</u>	26.6	22.2	82.8
Errors and omissions	-1.6	..	..
SDR's	2.4		
Change in foreign exchange reserves	7.6	10.3	-51.3

(1) Average conversion rates (Icelandic Kronur)

per \$US	1970	87.90
	1971	87.58
	1972	87.12
	1973	89.67
	1974	99.77

(2) Forecast

(3) Ships and aircraft, imports for power projects and aluminium smelter, 1973 data include houses for the Vestmannaeyjar population

Source: Icelandic submission to OECD

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Table 7 - Percentage distribution of Iceland's Imports and Exports

	Imports			Exports		
	1972	1973	1974	1972	1973	1974
NATO European Countries of which	59.3	55.5		40.8	47.3	
- Germany	14.3	11.3		8.5	11.9	
- United Kingdom	14.8	10.7		10.9	10.6	
Other (non-NATO Western European Countries(a))	12.9	14.5		12.9	14.2	
North America of which	8.3	7.7		30.8	27.0	
- United States	8.0	7.4		30.7	26.9	
Japan	3.9	7.0		0.8	2.8	
Eastern European Countries(b) of which	10.3	8.9		11.5	8.7	
- USSR	5.8	6.4		7.3	5.6	
Rest of World	5.4	5.8		3.2	0.1	
TOTAL*	100.0	100.0		100.0	100.0	

(a) Austria, Finland, Ireland, Spain, Switzerland, Sweden and Yugoslavia

(b) Bulgaria, Czechoslovakia, East Germany, Hungary, Poland, Rumania and the Soviet Union

* Totals do not add due to rounding

Source: Central Bank of Iceland

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Table 8 - Percentage distribution of Exports by
main Categories

	1966	1968	1970	1972	1973	1974	1st $\frac{1}{2}$ 1975
Fishing Products	93	88	78	74	74	74.8	85.0
Agricultural Products	4	8	3	3	3	2.9	2.2
Manufacturing Products	2	2	17	22	22	19.9	11.7
of which Aluminium	-	-	(13)	(16)	(17)	(14.6)	6.0
Other Products	1	2	2	1	1	2.4	1.1
Total	100	100	100	100	100	100.0	100.0

Source: Central Bank of Iceland

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Table 9 - Net Income from the
US Defence Force

	1967	1968	1969	1970	1971	1972	1973 (a)	1974
In million US \$	14.1	9.4	9.9	12.8	14.8	16.4	20.9	
- as % of goods (fob) and services	7.8	6.0	5.4	5.3	5.8	5.4	7.2	

(a) Preliminary figures

Source: Central Bank of Iceland