Borgarskjalasafn Reykjavíkur

# Report on Iceland 22.7.1949.
# E. Harrison Clark

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## Tekið af vef Borgarskjalasafnsins

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Stjórnmálamaðurinn
Askja 2-10, Örk 7

CONFIDENTIAL

# REPORT ON ICELAND

(FIRST DRAFT)

E. Harrison Clark
July 22, 1949

B. Investments and the National Income

Post-war Iceland has become what may be the most rapidly developing under-developed country in the world. Progress in this respect has been so fast as to place the country number one in Europe in capital investment in the post-war years - whether taken as the percentage of national income devoted to investment or net investment in fixed capital per head of population.

Net Investment in Fixed Capital
as Percentage of National Income 1/
(in terms of 1938 dollar prices)

| | 1938 | 1947 | 1948 |
|---|---|---|---|
| Iceland | 13 | 35 | 28 |
| Norway | 15 | 24 | 22 |
| Yugoslavia | 5 | 15 | 15 |
| Denmark | 8 | 11 | 11 |
| Netherlands | 10 | 12 | 11 |
| Sweden | 9 | 13 | 10 |
| United Kingdom | 8 | 9 | 9 |

While the data for investments in Iceland contain a reasonable margin of error, the data on a per capita basis have so wide a margin that any errors would not affect the position of Iceland.

Net Investment in Fixed Capital
Per Head of Population 2/
(dollars in 1938 prices)

| | 1938 | 1946 | 1947 | 1948 |
|---|---|---|---|---|
| Iceland | 34 | 235 | 187 | 139 |
| Norway | 38 | 40 | 59 | 55 |
| Sweden | 32 | 41 | 52 | 42 |
| United Kingdom | 31 | 1 | 33 | 36 |
| Denmark | 27 | 25 | 31 | 32 |
| Netherlands | 34 | 13 | 25 | 27 |
| France | 5 | 12 | 16 | 16 |
| Belgium | - | 12 | 16 | - |

1/ Data, except for Iceland, from ECE "Economic Survey of Europe in 1948".
2/ Ibid.

Even more striking are the figures on net investment in terms of Iceland's pre-war investments (all in 1938 dollar prices).

| | |
|---|---|
| 1938 | $4 m. 1/ |
| 1946 | 29 m. |
| 1947 | 29 m. |
| 1948 | 23 m. |

On the average for the past three years Iceland has been investing on a scale nearly seven times pre-war. The three years investment undoubtedly well exceeds the entire investment program of Iceland from 1918 to 1940.

It would be difficult to compute the capital value of Iceland's present investments in relation to pre-war. Icelandic investments alone, however, during the period from 1940 - 1948 were probably nearly thirty times the pre-war annual rate of $4 m. (at 1938 dollar prices). To these must be added the large expenditures of the occupation forces on airfields, ports, and communications. At an extremely rough estimate, per capita productivity in terms of capital investment may be now about four times pre-war. More accurate data would probably yield a higher figure.

Gross investment in current prices for the pre- and post-war periods shows a peak in 1947 and a steady decline since:

| | | |
|---|---|---|
| 1938 | - | 25 m. kr. |
| 1946 | - | 500 m. kr. |
| 1947 | - | 530 m. kr. |
| 1948 | - | 420 m. kr. |
| 1949(planned) | | 360 m. kr. |

1/ Calculated from 1938 ratio of investment goods imports to total imports and national income.

The last figure is probably too high. The volume of constructio for 1949 is estimated at 25% below the planned amount; imports for the first five months of 1949 are currently well below the planned rate. Gross investment in 1949 may not exceed 330 m. kr. The investment rate has therefore slowed down markedly since 1946.

C. Savings

While no caluculations have been made previously of the volume and rate of savings in Iceland, Dr. Benjamin Eiriksson of the International Monetary Fund has made estimates for 1947 and 1948 of savings as follows:

| | 1947 | 1948 |
|---|---|---|
| Net increase of Savings Deposits | 28 | 30 |
| Profits re-invested | 60 | 80 |
| Other Savings, including amortization, private building and repairs, etc. | 100 | 140 |
| | 190 | 250 |

These figures are gross. In 1947 a certain amount of dissavings took place and it is possible that the reduction in wages in 1948 caused a further additional amount of dissavings. Net savings are probably in a range of 175 to 200 m. kr. per annum. This, of course, is during the present monetary disequilibrium in Iceland. If equilibrium is attained, the volume of savings may be slightly lower, but more is like to channel into institutional forms and less into consumers durable goods, and, probably, there will be lower industrial profits used for re-investment, and consequently larger margins for private savings.

The volume of institutional savings in Iceland is not too large but it is capable of expansion. The Icelander is much more familiar with a capital market and savings banks than the more backward countries. Perhaps one family in three owns shares in the Iceland Steamship Company. Recent lottery bond issues have been reasonably successful. The main outlet for savings, however, tends to be housing, other durable consumers goods and re-invested profits of business enterprises.

In part, this arises from continued inflation and depreciation of the currency. Stabilization should be an important factor in promoting additional institutional savings, particularly since the level of national income is high and the present volume of savings higher than in any corresponding Western European country.

D. Consumption Standards and Imports

A crude comparison of available data indicates that consumption standards in Iceland in 1948 were approximately on the same level as in the United Kingdom. The disparity in per capita national income between the two is reflected in the high investment rate in Iceland which has brought about declining consumption standards since 1945. These, though they are lower than the immediate post-war years, still represent a much higher level than the immediate and depressed pre-1939 years.

Consumption goods imports which were 114 m. kr. in 1945 reached a peak of 145 m. kr. (or 33% of imports) in 1946 and then dropped off rapidly to 92 m. in 1948 (or 22% of imports). Planned imports in 1949 show a further fall to 83 m. (or 21% of imports). Consumption goods imports in the first five months of 1949 have been running around 72-75 m. at an annual rate or at about half the 1946 rate. In several cases (e.g. sugar and textiles) per capita imports are below pre-war. Consumption goods imports for the whole of 1949 will be affected by the result of the summer herring catch as well as future ECA action.

A calculation has been made in Iceland concerning the imports of consumer goods in pre- and post-war years:

Index of Imports of Consumer Goods Per Capita 1/

| | | |
|---|---|---|
| 1938 | - | 100 |
| 1940 | - | 90 |
| 1942 | - | 170 |
| 1944 | - | 234 |
| 1945 | - | 306 |
| 1946 | - | 391 |
| 1947 | - | 313 |
| 1948 | - | 219 |
| 1949 | (planned) | 193 |

The consumption goods imports have been held to a very low level, particularly since 1947. Though exports in 1948 reached the highest level in Icelandic history (396 m. kr.) corresponding imports of consumers goods were only 83 m. kr. or only 21% of corresponding exports. In relation to the high level of national income, and of exports, the policy may be regarded as unnecessarily austere. It has been a contributing factor to both inflation within the country and the difficulties of internal financing.

1/ Deflated by 1938 price level.

It should be clearly recognized that in Iceland, which has an unusually high propensity to import, additional income generated results in a demand for foreign goods of between 40 and 50% of each additional krona placed in circulation. A very rough ratio of investment to domestic and foreign demand in Iceland is as follows:

| | |
|---|---|
| Total Investment Costs | 100 |
| Investment Goods Imports 1/ | 45 |
| Domestic costs: | 55 |
| a) of which additional demand for foreign consumption goods | 20 |
| b) demand for domestic goods and services | 25 |

This table is given solely for illustrative purposes. However, it probably approximates fairly closely the actual situation in Iceland where as much as three-quarters of the costs of capital investment in the country result in a demand for foreign exchange and imports. The secondary demand for domestic goods and services probably results in a further, tertiary, demand for foreign imports.

The policy of the Government of Iceland has not fully taken into account this relationship. It would be theoretically possible for the Government to hold the level of taxation at such a high level and wages at such a low level that there would be no additional demand for foreign exchange arising from the investment program. However, in the type of political and social structure that Iceland has, this solution is neither

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1/ Interpreted here to mean not only capital equipment, but building materials, etc. which is the usual rather broad classification used in Iceland. The ratio of 45:55 is roughly the relationship of these imports to total investments over the past three years.

possible nor practical. What is important to note is that a) Iceland has had too large an investment program in relationship to its financial resources which has resulted in an inflationary gap over the past three years which has led to a greatly increased effective demand for imports of consumers goods b) the consumers goods imports have been cut at the same time to an exceedingly low level. The result has been increased pressure on prices, and a further distortion of Iceland's economic and social structure.

E. Wage Policy

Data on wage changes in Iceland in both real and monetary terms are available only in rather fragmentary form. The basic wage rate was linked, from 1941 on, to the cost of living index and advanced proportionately with the rise of the latter. There were, however, continuing upward adjustments in the basic wage rate and the wage rates therefore advanced more rapidly than the cost of living:

| | | Unskilled Wage Rate | Official Cost of Living Index | Purchasing Power |
|---|---|---|---|---|
| October | 1939 | 100 | 100 | 100 |
| December | 1940 | 127 | 140 | 91 |
| " | 1943 | 375 | 260 | 144 |
| " | 1945 | 480 | 285 | 168 |
| " | 1947 | 630 | 330 | 191 |
| October | 1948 | 579 | 325 | 178 |

However, according to unofficial calculations, the cost of living index has tended to underestimate the actual rise in the cost of living. The adjusted index indicates a less rapid rise in real wages as follows:

| | | |
|---|---|---|
| October 1939 | - | 100 |
| December 1940 | - | 91 |
| December 1943 | - | 136 |
| December 1945 | - | 141 |
| December 1947 | - | 156 |
| October 1948 | - | 143 |

The adjustment downward in 1948 arose from the provisions of the Inflation Act of 1947 which reduced the cost of living index (for the purpose of computing wage increases) to 300. Agricultural and other prices were lowered; the index was reduced from 330 in December 1947 to 320 in May 1948. However, by the end of the year the index was 325 and in May of 1949 it reached 327.

The Government's policy of holding the wage line finally broke down in the last two weeks of June. The unskilled unions (followed by other unions) succeeded in negotiating wage rises of 8 to 10%. Wages have therefore risen to approximately the level they would have attained without the wage stop. The already high cost-price structure of Iceland will be further and deleteriously affected. The state finances will feel the effects; wages of civil servants will rise as will construction costs; the state will also have to pay more for subsidies to the fishing boats and possibly the herring fleets, if the herring season is unsuccessful.

## 3. The Budget and Fiscal Policy

The form of the Icelandic budget is more advanced technically than that of the U.S. It is based on Swedish (and originally Danish) models and was instituted in 1936 on the advice of a Swedish expert. The budget provides for a current budget (covering state operating costs, subsidies, and non-revenue producing capital expenditures) and a capital budget (for revenue-earning capital expenditures). There is, however, no very clear line drawn between these types of capital expenditures. The 1949 budget, for example, provides for the costs of construction of roads in the current budget and a number of other non-revenue producing expenditures (schools and hospitals) in the capital budget.

The budget differs in a number of respects from its Swedish model:

a) with the exception of the State monopolies and one or two enterprises which earn a small return, such as the state printing shop, none of the State enterprises earns a return sufficient to cover interest and amortization,

b) the ordinary budget, which should show a surplus in prosperous times, has until this year, either shown a deficit or only a small surplus, while the capital budgets have shown large deficits and thus the system is used in other than the counter-cyclical fashion which was the original intention of the Swedish budget of 1933,

c) the budget appears "balanced" when the ordinary budget is balanced, while extraordinary budgetary expenditures for various capital expenditures remain uncovered, and the Government has barely met its amortization charges out of existing revenues, though the major part of the debt has been floating and not consolidated since 1945,

d) there are no safeguards in the budget (such as the Swedish system of charging 20% of investment each year in non-productive enterprises to the ordinary budget),

e) there are numerous extra-budgetary expenditures, guarantees and loans which are a part of the State finances, but do not appear in the current or capital budget and result in substantial capital expenditures.

There is no real budgetary control in Iceland. This rather loose fiscal practice of Iceland has facilitated capital expenditures well beyond the financial capacity of the country.

The Government's combined (capital and current) budget was in balance in 1945 and has remained unbalanced since that time. The budgets for 1947 and 1948 and the recently passed (May 17, 1949) budget for 1949 will be found as Table I in the Appendix.

The 1947, 1948 and 1949 Budgets

The 1949 budget as passed by the Althing shows a balance for the first time since 1945. However, the balance is precarious and unlikely to be maintained.

The proposed expenditures on the current budget are expected to yield a surplus of 28 m. kr. which approximately

covers the deficit on the capital account. The budget for 1949 provides for a) decreased expenditures of around 10 m. kr. on internal meat subsidies and b) approximately the following increases in taxes over 1948,

| | |
|---|---|
| Gasoline | 6 m. kr. |
| Sales taxes | 22 m. kr. |
| Licensing tax | 10 m. kr. |
| Auto tax | 5 m. kr. |
| Other taxes | 7 m. kr. |
| | 50 m. kr. |

Counteracting these increases are various expected decreases, notably in the sales of the state tobacco and wine monopolies. Total revenue is expected to reach 285 m. kr., an increase of 26 m. kr. over 1948 while total current expenditures are estimated at 257 m. kr., a rise of 6 m. kr. Export subsidies will be up (which will more than counteract the decline in internal meat subsidies). There are small increases in expenditures for state communications (mainly roads) and health. Around 25% of the State current revenue in 1949 comes from the wine and tobacco monopoly, another 15% from income and property taxes, a further 26% from import duties and the remainder from miscellaneous sources, mainly sales taxes.

In addition to total expenditures by the Government of 332 m. kr., in 1948, district and local income taxes yielded between 80 and 90 m. kr. Together with other local taxes, the Government's share of the national income for 1948 exceeded one-third.

The proposed budget for 1949, introduced in October 1948, called for a budgetary surplus on the current account of 27 m. kr. but without any provision for corresponding revenues. The long delay in the passage of the final budget (until May 17, 1949) arose from the difficulties the Government found in raising new taxes to balance the budget, and in holding expenditures in check. The Government displayed courage in providing for additional and unpopular taxes which are estimated to raise the yield on taxes and duties by 37 m. in 1949 over 1948, and the Government (particularly the cabinet) made efforts to achieve Iceland's first balanced budget since 1945. In addition, the Government's capital budget provided for a relatively low level of investments and the surplus on the current budget is supposed to cover these costs.

However, the balance is, as noted, precarious. A committee is now meeting to consider raising the wages of civil servants and this, if approved, will raise the level of current expenditures for the civil service by 4 m. kr. In addition, there are authorized expenditures annexed to the budget - for which no corresponding revenue is provided - which total at least 23 m. kr. and were approved by the Althing. These include a number of capital expenditures. The Government has already begun expenditures from two groups of authorizations totalling 4,360,000 kr.

The budgets of Iceland have consistently underestimated both expenditures and revenues. It is probable that this will again be the case in 1949, though estimates of revenues are more likely to approximate actual receipts than are estimated expenditures the final outlays. The budget, as nearly as can be determined at the present time, may be underbalanced by between 20 and 30 m. kr. The extent to which the budget is underbalanced will, however, be affected by the summer herring season which, if favorable, will influence incomes, exports and imports upward and Government revenues accordingly. Income tax receipts and particularly customs duties are strongly linked to the value of exports and these at the moment are uncertain. The extent of the deficit will also be affected by the degree to which the Government draws on authorized expenditures.

Underbalance 1949

The extent to which the Government can raise additional taxes is limited by the relatively large number of tax exempt institutions (e.g. the cooperatives which do as much as 60% of the retail business are exempt, as is the Iceland Steamship Company) and the losses which have been suffered by the herring industry and the motor fishing boats. In addition, there are reported evasions of taxes of a not unsubstantial nature. Further, the State institutions (except for the wine and tobacco monopolies) are run at a loss for the most part or at least provide no current revenue to the State.

Not all the State's activities appear in the budget. The State has guaranteed the investments of the district and municipal councils, the investments and losses of the State Herring Board, the purchase of trawlers abroad and savings banks mortgages. Many of these are automatic. The State's contingent liabilities are there substantial.

Growth of State Debt in 1949

The State's floating debt[1/] has increased only moderately during 1949 (around 10 m. kr. from Dec. 31 to May 31). It has been held at this relatively low level because of the fairly successful issues of 5% lottery bonds. The first issue (in November 1948) of 15 m. kr. was almost fully subscribed (14.5 m. kr.) and the remainder was sold in February 1949. A further issue in March 1949 was only partially subscribed (9 m. kr. sold in March and April). The State's total internal floating and consolidated debt has risen around 28 m. kr. since the beginning of the year. These do not cover all the increases in the State's contingent liabilities. The coming summer herring season will require further operating advances for the herring industry, and the State's floating debt is likely to rise during the summer. The repayment of these advances is dependent upon the success of the herring season.

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1/ See Table V.

## 4. Banking and Credit Policy

Banking and credit policy in Iceland has been so intimately linked with the investment and fiscal policy of the Government as to be nearly inseparable. The banking mechanism has been geared almost exclusively in recent years to the financing of the investment program which in turn has been largely Government sponsored. The Central Bank has, within the limits of its powers, endeavored to pursue a moderately independent policy leading to stabilization. The banks are Government owned and the possibility of their pursuing such an independent policy is obviously no greater than that of Central Banks generally these days. Their most effective operations have been in the control of private investment. Since, however, the great bulk of investments have either been government owned, controlled, guaranteed or carried out through loans of the Government, the Central Bank's control of credit to private investment has had a minor (though salutory) effect on the economy.

The changes in the credit position of the Icelandic banks since 1939 will be found in Table V. From the end of 1945 until May 1949, total bank credits increased from 390 to 870 m. kr. or by an amount around 69 m. kr. larger than the precipitous decline in foreign exchange reserves.

The foreign exchange reserves were used to cover the import surplus. Had the exchange been sold to private individuals, the results should have been deflationary since they would have resulted in a decrease in the volume of circulatory money and an increase in the volume of goods. The major part, however of the investment program has been financed on credits, both for imports and the local currency costs of the program. The credit mechanism therefore operated very largely independently of changes in gold and foreign exchange holdings.1/

The origin and reasons for the expansion of credit are entirely clear from the previous discussion of the investment program and its relationship to savings, the level of national income, and consumption standards. Less clear is the exact extent to which the Government directly or indirectly contributed to it. The rather tangled web of Government deficits, Government guarantees and loans (and the activities of local Governments) make it difficult to assess exactly the proportion assigned to the Government. However an approximate picture may be obtained as follows:

a) the Government created a special loan department in the National Bank to establish on very favorable terms loans for the purchase of fishing boats and provided the department with a 100 m. kr. credit,

b) the Government's floating debt to the banks during the period from the end of 1944 to May 1949 rose by 108 m. kr. There was a further very large rise in the State's consolidated debt, a substantial proportion of which was sold to the Banks,

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1/ There are apparently no statutory reserve requirements for the banking system.

c) the State from 1946 to 1948 made direct loans to industries approximating 60 m. kr.,

d) the Government set aside 300 m. kr. in foreign currency for the purchase of trawlers after 1944 and carried through the contracts,

3) other operations of the State involved debts to the Fisheries Bank for guarantee fish prices (10 m. kr.), operating loans by the banks to various enterprises, etc.

It is apparent that the great bulk of the credit expansion has arisen from Government operations. Although exchange reserves have declined to the vanishing point, total deposits (savings and demand) have increased only moderately in the past five years. There was a shift in earlier years from demand to savings deposits because of changes in bank regulations. Note circulation has shown a slight declining tendency. It is the exchange reserves which have borne the burden and the Government which has been the major influence in the credit expansion.

Private credit (non-government-guaranteed) has been for at least a year scarce and difficult to obtain. During 1948 the discount rate was raised by the Central Bank from 5 to 6% and the rate on overdrafts from 6 to 7%. The Government now pays the latter rate on its overdrafts with the Central Bank. The rates on savings deposits were also raised. The Banks have endeavored therefore to raise the price of borrowing, to encourage savings, and to restrict credit to private persons. The Banks, in this way, have operated as effectively as they could, within the framework of Government control, to restrict the credit expansion.

## 5. The Economic Board

The Economic Board, established in July 1947, with extensive controls over capital investments, price control, foreign exchange and rationing, has done quite effective work, under difficult political conditions, to control the volume and direction of investments in Iceland. It has not been completely effective because a) it has no authority to establish complementary credit and monetary controls, b) the Althing has authorized, by law, guarantees and loans, both to municipalities and private enterprises, for capital investments which cannot be fully controlled by the Economic Board, c) many large capital investments had already begun when the Board was instituted and could not be stopped, d) the largest capital expenditures in recent years - for the trawling fleet - have been outside the direct control of the Board and e) the losses of the fishing fleet and herring industry were covered by law and, though a financial burden on the state, have not been, strictly speaking, capital investments.

Nevertheless the Board has been the most effective single instrument for reducing the level of capital investment in Iceland to more reasonable proportions. It has concentrated on reducing the volume of a) large-scale housing b) commercial buildings and c) postponable Government and municipal building. The level of gross investment in 1948 was down by 30% from the high of 1946 and in 1949 it will be down below

1946 by a further 15%. The level of gross investment is still well above the level of savings plus the estimated import surplus (by 110 - 125 m. kr.) and there is therefore still a further way to go before investment can be brought down to a safe non-inflationary level.

It is the Economic Board which carries out the Government's policy of holding imports of consumption goods to a low level in relation to investment goods imports. The Board makes periodical adjustments of its import licenses, in accordance with the exchange situation (usually, January, May and September). Out of planned imports this year of 387 m. kr., the Board had, in June, issued licenses only to the amount of 260 m. kr. of which consumers goods thus far amount to around 60 m. kr. and capital goods to 117 m. kr. [The remainder is fuel and raw materials.] Further adjustments will be made in September, according to the results of the herring season. If the season is not successful, imports will be held to around 300 m. kr. If the season is successful, import licenses will rise close to the original plan and additional consumers goods - particularly textiles - will be admitted. Because of the severe winter, the Board will be forced to import additional foodstuffs than was originally estimated.

In the absence of adequate credit and monetary controls in Iceland - and the Government is the largest factor in

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bank credit expansion - and the very low level to which consumers goods imports are held, it has not been possible for the Board to do more than reduce moderately the inflationary gap. Since the Board has acted at the same time a) to reduce consumers goods imports and b) to reduce the balance of payments deficit, while the gap has remained high, the inflationary factors at work in the Icelandic economy continue relatively large.

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# PART II

## THE EXTERNAL POSITION

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### 1. Foreign Exchange and Foreign Debt

Iceland's net foreign exchange holdings continue at a low level. From 563 m. kr. at the end of 1944, they dropped to 39 m. kr. at the end of 1947 and have held, with minor fluctuations, at approximately the same level since that time. However, the position has deteriorated fairly rapidly in 1949.

Foreign : Exchange :

Net holdings of foreign exchange have dropped during the first five months of 1949 from 46 m. kr. to 14.4 m. kr.[1/] and have reached a rather dangerously low level ($2.2 m.). The relative position is even worse than indicated, inasmuch as ECA loans covered some imports and the conditional grants provided a further coverage of 14.2 m. kr. Substantial trade deficits with Poland, Denmark and Czechoslovakia (as well as the U.S.) have been in part the cause. Iceland has exceptionally small reserves to meet any possible crisis.

ECA aid has been of substantial importance to Iceland's foreign exchange position this past year. It has enabled her a) to dispose of large amounts of iced fish to Germany for conditional aid in dollars, b) to dispose of fish oil to the U.K. - both items totalling $5.2 m. - in addition to loans and grants totalling $5 m. During the first four months of 1949, 77.8% of Iceland's imports from the U.S. were financed by ECA aid.[2/]

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1/Plus gold holdings of $1 m. and 16.55 m. kr. in ECA grants which is now being utilized.

2/Statement of Minister of Commerce to the Althing, May 20, 1949.

Iceland's foreign debt is, fortunately, extremely low. 1/

**Foreign Debt:** At the end of 1939 it amounted to 49.2 m. kr. or to around one-third of the national income. At the end of 1949 it amounted to 18.2 m. kr. (practically all of the ECA loan) or to around 1½% of the national income. However, negotiations are now going on with the U.K. for an additional trawler loan of £1.25 m. (20 years, 4½%, price 99) which will raise Iceland's external debt by a further 32.7 m. kr. 2/ While this will bring it up to the prewar level, it is obvious that Iceland is in much better position than pre-war to finance an external debt at least in currencies other than dollars.

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1/ See Table VII.

2/ This issue was placed on public sale in London on July 21, 1949.

## 2. Foreign Trade Position

Iceland's exports in 1948 reached an all time high of 396 m. kr. - a per capita export of $445, higher than that of any other country. The trade deficit of 229 m. kr. in 1947 was reduced to 61 m. kr. in 1948.[1/] The unusually high export of 1948 was aided by the following factors: a) the winter herring season of 1947/48 was successful and herring oil and meal exports in 1948 reached 109 m. kr. against 17 m. kr. the previous year b) the 28 new trawlers in service doubled the catch of fish (on ice) and exports increased from 43 m. kr. to 90 m. kr., c) cod liver oil exports increased from 23 m. kr. to 34 m. kr. in part because of ICEF purchases.

The sales of herring oil and iced fish in particular, were facilitated through ECA conditional grants and offshore purchases for a total of 81 m. kr. In addition, Government subsidies, direct and indirect, on exports of frozen and salt fish aided exports as did trade agreements with high export price countries (e.g. Czechoslovakia).

Exports for the first five months of 1949 have been running at an annual rate of 325 m. kr. Total exports have been 135 m. kr. as compared with 155 m. kr. the first five months of 1948. Exports for the whole of 1949 will depend primarily on the herring season, and secondarily on marketing difficulties Iceland is facing.

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1/ The dollar deficit (Canada and the U.S.) declined from 125 m. kr. to 80 m. kr.

The lower rate of exports in 1949 is affected by several factors, but primarily by the high cost-price structure of Iceland in the face of declining world prices. Iceland had difficulty in disposing of fillets and salt fish at the Government guaranteed prices in 1948 and is even less favorably placed in 1949. The recent trade agreement with the U.K. which takes 30% of Iceland's exports, resulted in lower prices for herring oil and meal as well as frozen fish. Wet salt fish in 1948 was sold in most cases below and in some cases well below the Government of 2.25 kr. per kilo. Frozen fish was also sold below the Government price in the U.S. The exports of cod liver oil to the U.S. have dropped sharply during 1949.

An adjustment of the exchange rate would improve Iceland's marketing possibilities in many of the products. Herring meal and oil is still in sufficiently short world supply to find a ready market. The question of the supply of raw material, however, is still open.

## 3. Balance of Payments

Iceland has submitted its balance of payments for 1948 to OEEC and ECA in detail.[1/] It will therefore be necessary here to cover only the salient features.

Iceland's balance of payments deficit on trade account was small in 1948 - \$2.5 m. - compared with \$35.3 m. the previous year. The over-all picture was thus quite good. The dollar deficit, however, was large - \$13 m. - while the surplus with other countries came to \$10.5 m. Around \$4.4 m. of this latter surplus was provided by surpluses with Eastern Europe under trade agreements which resulted frequently in Iceland paying more for imports than would have been the case with convertible currencies.

The bulk of the invisibles concern transport. The Keflavik airport provided net earnings of \$2.55 m., and this more than offset dollar fuel imports of \$1.8 m.

The main function of the Icelandic merchant marine has been as a foreign exchange saver rather than earner. In consequence it appears in the balance of payments schemata formulated by OEEC only in part. Gross freight earnings amounted to \$7.10 m. which slightly more than offset net disbursements abroad of \$6.55 m. Other freight paid to foreign vessels (probably including charter fees, though this point is not clear) together with tanker charter fees brought

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1/ See Table VIII for Summary

the deficit on shipping account to $2.22 m. according to the Icelandic statement. This appears prima facie to be rather large since the bulk of Icelandic exports were carried on Icelandic ships (or were delivered in trawlers directly from the fishing grounds to foreign ports). Charter fees however were relatively large ($4.7 m. in 1938 according to Eimskip). They will disappear in 1949 because of the growth of the merchant marine.

Even in July of 1949 it is impossible to predict the balance of payments for the year inasmuch as the herring season, if it is successful, will add as much as $9.m. to Iceland's exports for the year. In consequence imports will be effected as will all invisible shipping receipts and expenditures. In all probability Iceland will (assuming the herring season is unsuccessful) have a somewhat larger trade deficit and a smaller shipping payment deficit in 1949 than in 1948. The two items should approximately offset with a net deficit of roughly the same order of magnitude as last year's - e.g. $7.5 m. The dollar deficit of last year, $11.9 m., may be even larger since additional imports of foodstuffs will be required, and Icelandic exports to the U.S. have been well below those of 1948.

In the longer run, it is apparent that Iceland can bring its international accounts fairly quickly into over-all balance by curtailing its heavy capital investment program which will aid internal financial stability. It would in fact be desirable for the country to do more than balance its accounts and build up a surplus of at least 25 m. kr. a year as a reserve against future fluctuations in exports by volume and price. There is little prospect, however, of the country's balancing its dollar account by 1952.

## 4. F$_u$ture Dollar Position

One of the regrettable features of Iceland's extraordinary post-war investment program has been the rapid disappearance of her irreplaceable dollar reserves. These amounted at the end of 1945 to $26.3 m. and at the end of 1948 were down to $3.1 m. net (excluding $3.5 m. in ECA conditional grant).

The future dollar position of Iceland does not appear bright. There is a declining secular demand for cod-liver oil, which provided 46% of Iceland's exports to the U.S. in 1948, because of the competition of synthetic vitamins. The pressure of American fish producers in regard to Iceland's fish fillets may result in restrictions on such exports to the U.S.

The main possibilities of expanding exports to the U.S. in the future rest on exports of a) stickwater protein b) canned fish products c) spiced and processed herring. No estimate can as yet be given on the prospects for such exports; a supplemental memorandum is in preparation. Small dollar receipts will arise from the international weather station as well as the sales of fuel oil at Keflavik. The extent to which the latter will produce dollars is contingent entirely on Iceland's continued imports of dollar fuel.

Iceland's future dollar position appears at present to depend entirely on future sterling convertibility. Her dollar position after 1952 is therefore most uncertain. For that

## TABLES

reason, it would be undesirable for Iceland to assume any very sizeable additional dollar debt.

## 5. Exchange Rate of the Krona

Since the question of the devaluation of the Icelandic currency is primarily one for the International Monetary Fund it will be discussed only briefly here. There are two factors to note a) Iceland has had increasing and serious difficulties in disposing of its exports because of its high wage cost - price structure which has forced the country increasingly to engage in subsidies of its exports (24.7 m. kr. in 1948) together with bilateral trade negotiations with other high export price countries (e.g. Czechoslovakia and Poland) b) Iceland is completely within the sterling area (as a "Scheduled Territory") and the adjustment of the currency is inseparable from that of the pound.

If the devaluation of the pound does not take place during 1949, it will be preferable for Iceland to postpone its own adjustment until other measures of monetary and fiscal reform have led to internal financial stabilization, before the krona is devalued. If however, the pound devaluation does take place, it will be necessary for Iceland to adjust its currency before such measures can successfully take place. From the political point of view - since the question of devaluation is, unfortunately, a political issue in Iceland - it will be easier for the Government to take action along with the U.K., since the necessity will arise from external action. Devaluation, to be successful, preferably requires internal reform measures before the final step is taken. If these measures are taken on a sufficient scale, it would be possible, and desirable, for the Government to adjust the currency during the course of the coming winter, independently of the action of other European countries.

The extent of the devaluation required will need further study. The adjustment, in terms of the dollar, should be between 45 and 55%, and in terms of sterling, in accordance with the future sterling-dollar rate. It would be preferable for Iceland to have a slightly undervalued currency since the country cannot influence world prices and Iceland will always face somewhat precarious market conditions abroad because of fluctuating prices and fish catches. The undervaluation will tend to help the country to maintain markets and will act as a slight barrier to imports which will help the country to build up vitally needed exchange reserves which can act as a cushion against adverse price conditions or fish catches.

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# PART III

## THE INVESTMENT PROGRAM

## III. The Investment Program

### 1. The Attainment of Financial Stability

The extent of Iceland's investment, as well as its mechanism of financing, have brought serious dislocations to the country's economic, social and financial structure. It is this aspect of the program that is particularly open to question. Nonetheless the productive apparatus of the country has been greatly strengthened, and the investments have, on the whole, been carried out effectively and rationally from the point of view of the country's most urgent requirements.

Iceland's few questionable investments have been in a) overlarge and overelaborate house construction, a program now largely halted and b) road and port construction in response to local pressure rather than national needs. Some doubt has been expressed in Iceland as to the capital investment in the floating herring factory and the extent of the new trawler program. It is difficult to say whether the investment in the herring industry was justified; if the herring reappear, the entire investment would be covered in a single year's exports.

The Government, fully supported by the country generally, has carried out with considerable courage and foresight, a program to transform and modernize the economic structure of the country. The development of the economy in a few years has been remarkable. Whatever index is taken in comparison with pre-war - volume of exports (up 88%) real national income (up 82%) real wages (up 50%) power consumption (up 55%) - will attest to Iceland's progress. Iceland's productivity is probably at least four times pre-war. Its foreign debt is low. Iceland is in a far stronger position than before the war, given reasonably favorable world conditions, to maintain not only its present position but to continue with a long-range development program. It has survived the bad luck of successive failures of the herring catch. The country has, however, reached a critical financial stage with its foreign exchange gone, its exports declining and strong inflationary factors still at work while a moderate world deflation has set in. It is time that the country tailor its program to fit a shrinking cloth.

The inflationary gap for 1949 is in the nature of 100-125 m. kr. To restore equilibrium to the economy will require a series of measures. The Government, as long as two years ago, undertook measures successful in themselves, but insufficient in extent, to restore equilibrium. Further measures are now needed. It will be possible, given these measures, for Iceland to attain financial stability relatively quickly. The extent of the measures required is dependent to an unusual degree upon the herring season. The closing of the gap will be greatly facilitated if exports can be expanded of herring oil and meal.

The methods by which the gap can be closed are very flexible; there are many alternatives open to the Government. Assuming there is an inflationary gap of 100-125 m. kr. (which could be reduced automatically as much as 50 m. kr. by a successful herring season which would provide a longer national income, increased tax revenues, and increased imports) a possible pattern for the restoration of financial stability would be:

| | | |
|---|---|---|
| 1) | Budget equilibrium, or surplus of 10 m.kr., instead of deficit of 20 m. kr. | = 20-30 m.kr. |
| 2) | Reduction of level of investment, other than level reduced in budget, by 30 m.kr. | = 30 m.kr. |
| 3) | Sterilization of counterpart funds | = 25 m.kr.1/ |
| 4) | Shift of investments goods imports to consumers goods imports (-15 investment goods and plus 30 consumers goods) | = 45 m.kr. |
| | | 110-120 m.kr. |

There are many variants which can be applied - a larger budget surplus or a further curtailment of investment. If consumers goods imports were to come in largely under ECA grants, for example, a very substantial additional counterpart fund would be built up. A successful herring season of itself (provided additional exports were used for imports of consumption goods) would act to close a large part of the gap. It would be possible to close the gap, even with a slightly underbalanced budget, provided there were additional controls over investments and a further shift from investment goods to consumer

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1/ While these will yield only 16 m. kr. in dollar equivalent, sales in the Icelandic market, including duties will be higher.

goods. Sound fiscal practice, however, calls for a budget surplus, no further credit expansion by the banks, and a reduction of investments to a level consonant with the available national resources.

The successful attainment of the objective of financial stability will pave the way for an adjustment of the external value of the krona.

## 2. F$_{u}$ture Investment Program

The extent to which Iceland can continue an investment program within the framework of financial stability is still very large, particularly in comparison with the pre-war rate of capital formation. The financial resources available will be determined by the level of national income and exports, and the level of voluntary savings plus such balance of payments deficits as can be financed through loans or credits. In monetary terms, at the present level of national income, Iceland should be able to finance an investment program of 200-225 m. kr. The previous calculation assumes a reduction of investments to a level of 260-270 m. kr. (which includes a 1949 balance of payments deficit of around 50 m. kr.). As a percentage of national income at the present level of the latter, this would mean 15 to 20%. In real terms, Iceland can afford an investment program nearly four times pre-war, a rate of progress that compares favorably with that of any western European country. It is within this framework that the Icelandic Government will be able to determine the most urgent requirements of the economy over the next four years.

While there are differences of opinion in Iceland as to the requirements over the next four years, there is almost unanimous agreement that hydroelectric power and agriculture deserve first and second place. Iceland's power facilities have been strained to absolute capacity; power is basic to the further development of the country. The program of agricultural development - land drainage and reclamation and mechanization - also is necessary, the former in view of the relatively rapid growth of population which requires additional food and the latter because of the decline in the rural population.

There was not complete agreement on further developments. Those which seemed to have most favor include:

a) the stickwater plant, particularly if the herring return, and reports on possibilities of U.S. markets are favorable,

b) additional construction of smaller dwelling units and apartments to meet the acute shortage of dwelling space,

c) increased mechanization of the fish fillet industries to reduce costs,

d) the famous hotel is probably an urgent requirement. [It should be noted that Iceland had not planned to use ECA funds for its construction. The hotel would be generally desirable and if Iceland can finance it within the framework of a non-inflationary program, there can be no reasonable objection. In this connection, Iceland might well consider encouraging foreign private investment to undertake the risk under transfer guarantee].

# Report on Iceland

This report presents the results of a mission for ECA to Iceland from June 21 to July 5, 1949. In view of the brevity of the mission the report does not attempt to give either a complete survey of ECA operations to date in that country, nor the structure of the economy.[1/] The report summarizes the current trends in investment, savings, the national income, fiscal policy, foreign trade and the balance of payments. The report also evaluates briefly the past and proposed investment program of the country and contains recommendations to the Economic Cooperation Administration on measures to achieve internal financial stability.

The American Legation at Reykjavik was cooperative, helpful and courteous in a degree far beyond any required level of duty. In particular thanks are due to the Minister, Mr. Richard P. Butrick, the ECA Program Review Officer, Mr. John A. McKesson III, the Assistant Commercial Attache, Mr. William S. Krason, and the Second Secretary, Miss Mary Olmsted. The Icelandic Government was fully cooperative and rather more than ordinarily interested in the results of the survey.

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1/ These are covered in comprehensive reports of the American Legation at Reykjavik.

e) Nitrogen fertilizer plant. This is supported by many persons, though its necessity to the economy requires further information,

f) The cement plant seems prima facie to be a preferable investment to nitrogen. Recent discoveries of shell sand may provide domestic raw material for its manufacture.

TABLE I

Icelandic State Budget
(m. kronur)

Current Account

| Revenue: | 1947 | 1948 | 1949 |
|---|---|---|---|
| 1) Taxes and Duties | 165 | 175 | 212 |
| 2) Revenue from State Institutions | 73 | 80 | 70 |
| 3) Share of Bank Profits and Miscellaneous | 5 | 4 | 3 |
| Total | 243 | 259 | 285 |
| **Expenditure** | | | |
| 1) Interest on Public Debt | 3 | 6 | 7 |
| 2) Government and Civil Service | 28 | 29 | 27 |
| 3) State Communications | 45 | 35 | 40 |
| 4) Church and Education | 38 | 32 | 32 |
| 5) Research, Libraries and Culture | 6 | 7 | 6 |
| 6) Social Security | 27 | 26 | 26 |
| 7) Pensions | 6 | 6 | 6 |
| 8) Health | 13 | 11 | 14 |
| 9) Subsidies | 60 | 67 | 72 |
| 10) Agriculture, Fisheries, and Power | 21 | 23 | 27 |
| 11) Miscellaneous | 8 | 10 | - |
| Total | 255 | 251 | 257 |
| Surplus or deficit | -12 | 8 | 28 |

Capital Account

| Receipts | 1947 | 1948 | 1949 |
|---|---|---|---|
| 1) From revenue above | 243 | 259 | 285 |
| 2) Depreciation and Miscellaneous | 11 | 1 | 2 |
| Total | 254 | 260 | 287 |
| **Disbursements** | | | |
| 1) To expenditures above | 255 | 251 | 257 |
| 2) Amortization and Payments on Guarantees | 9 | 11a/ | 21 |
| 3) Loans and investments | 54 | 70 | 10 |
| Total | 318 | 332 | 288 |
| Deficit | -64 | -72 | - 1 |

a/ estimated.

TABLE II

<u>Index of Electricity Production in Iceland</u>

(1938 = 100)

| | |
|---|---|
| 1929 | 30 |
| 1938 | 100 |
| 1945 | 415 |
| 1946 | 466 |
| 1947 | 570 |
| 1948 | 656 |

Source: Hagtidindi, May 1949

TABLE III

National Income Per Head

(Dollars in 1938 Prices)

| | 1938 | 1947 | 1948 |
|---|---|---|---|
| Iceland | 271 | 537 | 489 |
| Denmark | 316 | 276 | 307 |
| Norway | 255 | 248 | 253 |
| Sweden | 367 | 413 | 413 |
| United Kingdom | 378 | 363 | 401 |
| Belgium-Luxembourg | 275 | 255 | 278 |
| France | 236 | 207 | 228 |
| Netherlands | 323 | 219 | 250 |
| Switzerland | 367 | 451 | 441 |
| U. S. A. | 521 | 665 | 683 |

Source: ECE Report, except for Iceland

TABLE IV

National Income, Consumption and Investment in Iceland
(m. kronur)

| | 1945 | 1946 | 1947 | 1948 | 1949 (planned) |
|---|---|---|---|---|---|
| Gross Investment | 280 | 500 | 530 | 420 | 360[a] |
| National Income | 960 | 1220 | 1320 | 1220 | 1200 |
| Percent of Investment | 29.2 | 41.0 | 40.2 | 34.4 | 30.0[b] |
| Balance of Payments Deficit | 50 | 185 | 240 | 50 | 70[c] |
| Investment Domestically Financed | 230 | 315 | 290 | 370 | 290 |
| Percent Domestically Financed | 24.0 | 25.8 | 22.0 | 30.3 | 24.2 |

a/ Will probably be lower, perhaps 330 m. kr.

b/ If (a) is reduced, (b) will be down to 28%.

c/ This is probably too high. There is no evidence as yet that the deficit will be this large in 1949.

Note: These are corrected figures prepared since the General Memorandum of Iceland was forwarded to OEEC.

TABLE V

Changes in Credit Position of Icelandic Banks

| End of Year | Total Bank Credits a/ | Floating Debts of State Treasury and State Enterprises b/ | Net Foreign Assets c/ | Notes in Circulation | Savings Accounts | Current Accounts |
|---|---|---|---|---|---|---|
| 1939 | 119 | 3 | -12 | 14 | 56 | 20 |
| 1941 | 121 | - | 165 | 51 | 121 | 101 |
| 1943 | 229 | - | 447 | 145 | 272 | 192 |
| 1944 | 278 | 2 | 563 | 167 | 363 | 254 |
| 1945 | 390 | 16 | 464 | 177 | 398 | 220 |
| 1946 | 579 | 33 | 217 | 167 | 385 | 156 |
| 1947 | 739 | 55 | 39 | 107 | 394 | 178 |
| 1948 | 841 | 101 | 46 | 175 | 420 | 174 |
| April 1949 | 849 | 110 | 24 | 150 | 444 | 168 |
| May 1949 | 870 | n.a. | 14(est.) | 152 | 443 | n.a. |

a/ Including bills, overdraft credits, long-term obligations and National Bank's credits to Fisheries Loan Department. Includes 1.8 m. kr. for that share of IBRD and IMF contribution payable in foreign currency.

b/ Proceeds of State Lottery Loans totalling 23.9 m. kr. were deposited in State's Current Accounts from November 1948 to April 1949. These have held the State's floating debt at a fairly stationary level since October 1948 (109 m.). These debts include operating loans to cover operating losses (e.g. State Herring Plant). The trawlers loans are not included; they amount to a further 86.5 m. kr. (end of May 1949).

c/ Commercial guarantees not included.

TABLE VI

Government Subsidies[1]
(m. kronur)

| | 1947 | 1948 | 1949[2] |
|---|---|---|---|
| Cost of Living | | | |
| Meat | 26.3 | 23.5 | |
| Milk | 3.6 | 4.7 | |
| Butter | 1.8 | 6.9 | |
| Margarine | 2.2 | 4.0 | |
| Potatoes | 1.8 | 2.0 | |
| Salt Fish | .2 | .7 | |
| Sugar | .1 | - | |
| | 35.9 | 41.9 | (32?) |
| Exports | | | |
| Meat | - | 4.5 | |
| Wool | 3.1 | .3 | |
| Fish | 21.0 | 18.6 | |
| Fish oil | | 1.3 | |
| | 24.0 | 24.7 | 39 (?) |
| Total | 60.1 | 66.6 | 71.1 |

1/ Numbers rounded

2/ Budgeted

TABLE VII

National Debt of Iceland
(m. kronur)

| End of Year | Internal | External | Total |
|---|---|---|---|
| 1939 | 7.4 | 49.2 | 56.6 |
| 1940 | 5.8 | 45.8 | 51.6 |
| 1945 | 21.7 | 10.1 | 31.8 |
| 1946 | 35.3 | 8.1 | 43.4 |
| 1947 | 101.1 | 6.2 | 107.3 |
| 1948 | 160.9 | 18.2 | 179.1 |
| June 1949 (est.) | 188.4 | 18.2 1/ | 206.6 |

Note: See Table V for portion of internal debt which is floating. (101 m. kr. at end of 1948)

1/ Negotiations now under way with the U.K. on additional external debt of £1.25 m. (32.7 m. kr.)

TABLE VIII

Iceland's Balance of Payments
1948
(in m. $)

| | Receipts | Payments | Balance |
|---|---|---|---|
| Merchandise, F.O.B. | 60.86 | 63.33 | -2.47 |
| Transport, non-maritime | 3.25 | .70 | +2.55 |
| Transport, maritime (freight) | 7.85 | 11.50 | -3.65 |
| Transport, maritime (oil) | - | 1.12 | -1.12 |
| Other invisibles | 3.15 | 5.95 | -2.80 |
| | 75.11 | 82.60 | -7.49 |

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# PART I

## The Internal Position

## I. INTERNAL POSITION

### 1. Social Changes and the War.

The changing economic status of Iceland as a result of the war has resulted in abrupt and far-reaching changes in the social structure of the country. The capital city of the country has gained in nine years the equivalent of seventeen percent of the present population. The capital, in fact, has absorbed more than the entire increase of the Icelandic population in this period and the strain on the city's transportation, school, power and housing facilities has been enormous; this has been one of major contributing factors to the enormous investment requirements of Iceland in the post-war period. The other "urban" areas have also had a growth though by no means at the rate of Reykjavik. The rural population has fallen abruptly, perhaps by 7,000 persons (or 15% of the 1940 rural population). Many of the least prosperous areas or villages are stripped of young people. Some rural schools are used at only a small fraction of their capacity. The shortage of farm labor has been sufficiently serious for the country to import several hundred German farm laborers, the first immigration to the country in many centuries.

National income since before the war has nearly doubled; real wages are now around 50% above pre-war. Standards of diet and health have greatly improved. The house construction program has made Reykjavik a modern city in a few years.

Iceland, which had no road across the island as late as 1930, now has modern airports throughout the island. Power consumption is six and a half times pre-war. The non-existent (before the war) merchant marine has been built up to a small but modern and efficient service. The country has jumped from primitive methods of salting and drying fish to modern quick freezing plants and herring factories.

In seven years Iceland has attained goals that would perhaps have taken her fifty years at the pre-war rate of development. The development has been so rapid as to place a severe strain on Iceland's internal finances and external exchange resources. Inflation, though now diminishing, as the investment program is slowing down, is still serious. Iceland's cost-price structure is pricing her out of world markets. Although its economy is basically far stronger than in the thirties, Iceland is not adequately prepared to adjust to rapidly changing world market and price conditions. Its rigidities in the face of flexible world conditions, may result in unfortunate social repercussions within the country unless the country moves rapidly to greater internal financial stability.

## 2. The National Income

### A. Income per Capita

The per capita national income of Iceland may now be the highest in Europe. For comparative purposes, the data available from Iceland was calculated 1/ as closely as possible in accordance with the calculations of per capital national income of the Economic Commission for Europe. 2/ There is a possibility of error inasmuch as the full recalculation was not possible (in terms of an adjustment of the currency according to 1929 purchasing power parity) but it is not believed that this invalidates the conclusion. Such a calculation would probably raise further the level of per capita income.

The results will be found in Table III. According to these data, Iceland's per capita income in 1938 ranked seventh among the western and northern European countries. The per capita income slightly exceeded Norway and France. By 1948 because of several factors including the most extensive investment program in Europe, favorable terms of trade and large deficits in the balance of payments financed out of accumulated exchange reserves, Iceland had moved into first place with a per capita income of $489 in 1938 prices which exceeded that of Switzerland ($441).

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1/ By the Statistical Division of the International Bank.
2/ "Economic Survey of Europe", Table E, Appendix A.
The adjustment was made on the basis of 1938 prices, according to the unofficial but reasonably reliable "corrected" Iceland price index which probably represents most closely the otherwise non-existing wholesale price index of Iceland. In 1948, the corrected index was 405 compared with the official cost of living index of 325.