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SUBJECT: ICELAND: ANNUAL REVIEW: FLYWEIGHT ASPIRES TO GO UP A CLASS

Part 1 of 2

#### SUMMARY

1. A year in which Iceland continued to amaze. Their economy grew and they got richer but remained loyal and steadfast allies. They worried about US attitudes on the base. They turned increasingly to the UK for business. More of the same for 2005.

#### DETAIL


2. It is all too easy to forget that this is a country of just under 300,000 people. But as a Cockney boxer once said of his lighter opponent: "for a little bleeder, 'e don't 'alf pack a wallop".

3. The main issues of the year were: the media bill and its aftermath; Iraq; Afghanistan; the economy; the future of the base; energy and the environment; the 10 week teachers' strike; Europe (much discussed for a subject that we were told was not on the

agenda) the swapping of offices by the Foreign Minister and Prime Minister that ended a 13 year tenure and the political dominance of the PM; the voracious appetite for acquisitions (principally in the UK) of the new Vikings; growth of the banks; tourism; differences with the Norwegians over herring and the Svalbard agreement; whaling and fish (of course).

#### Iceland Internal, Political and Economic

4. The year has seen: growth in GDP of 5.5%; unemployment down to 2.6%; property values up by 15%; 15% more tourists than last year, outnumbering the population for the first time; inflation up to 3.9%, with base rates rising to 8.25% in response, which only strengthened the Krona.

 In an unprecedented move, the President refused to sign the bill and opted "to put it to the people". Rather than do that, the PM withdrew the bill. And set up a committee to review the constitution, focusing on the bit covering the powers of the President. The President went on to be re-elected easily for a third term. But it was by a smaller majority and in a lower turn-out than expected. It was a scrap the PM probably just won on points but before he could savour the victory, he had to undergo operations for cancer, from which he is only slowly recovering. His debilitated state and move from the Prime Ministry has left a vacuum.

6. The government changes and the political mayhem of the summer will make little difference to the implementation of coalition policies in the coming year. Support on Iraq should not waver, unless the US goes much further on running down the base than the Icelanders would like. The same will apply to Iceland's continuing involvement in Afghanistan. They and the Americans will meet in January to discuss the future of the base. What is already clear is that the base will have fewer personnel under a USAF colonel, instead of an Admiral, with the Icelanders contributing more and playing a greater role in running it.

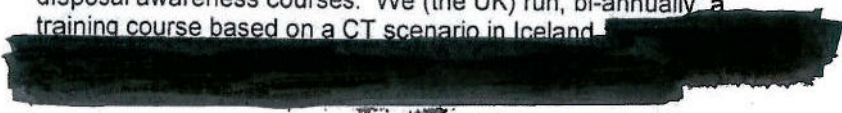
7. The economy will grow by another c5% and inflation and interest rates with it. The basic rate of income tax will be reduced by a further 1%, to 24.75, on 1 January and the property boom will continue because of the availability of 100% mortgages at a fixed 4.5%, as well as the demand from overseas buyers. Local authorities too will continue to be able to borrow overseas at rates significantly below Icelandic ones. While the government's aim will remain to bring down corporation tax to 17% from the present 18%. Iceland Telecom will be privatised (overseen by Morgan Stanley).

8. The banks will build on their rapid expansion (KB Bank went from being the 911th biggest in the world to 260th, the fastest growth of any bank) in the UK and Scandinavia in 2004. And companies such as Baugur, Bakkavor and Actavis will become even better known in the UK as they add to their size and strength. There are now significant numbers of Brits employed in companies owned, or controlled, by Icelanders. Baugur alone employs between 15 and 20,000 and owns over 1,000 retail outlets.

What about our Strategic Priorities?

SP1

9. Iceland has been keen to develop its CT knowledge and capabilities. We have helped by providing UK expertise and training for police and the small CT teams, including bomb disposal awareness courses. We (the UK) run, bi-annually, a training course based on a CT scenario in Iceland.



SP2

10. We meet at regular intervals the director and deputy director of the immigration directorate and the commissioner and deputy commissioner of the state and Reykjavik police to discuss and exchange information on illegal immigration and international crime. The Icelanders look to the UK for guidance and assistance and will always go through the embassy to make contact with UK counterparts. The Minister of Justice has said publicly that Iceland should consider establishing an intelligence service. We can help them.

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