

Credit crisis hits Iceland

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Since the beginning of the year, the Icelandic economy has been in turmoil, as the impact of the growing credit crisis is felt worldwide.

The krona (ISK) is in meltdown, falling by around 30 percent against the euro since the beginning of 2008. Inflation has doubled in just over six months, reaching an 18-year high in April of 11 percent, well above the central bank target of 2.5 percent.

The Central Bank was compelled in April to raise interest rates to 15.5 percent. This represents the highest interest levels in industrialised countries and was the second time in just over three weeks the bank had increased rates.

Speculation has grown of a possible concerted attack by international hedge funds against an economy many presumed to be stable. The Financial Supervisory Authority is in the process of investigating claims that certain hedge funds published unduly pessimistic predictions on the Icelandic economy and then bet heavily on the currency declining. Finance Minister Arni Mathiesen has placed the blame for the economy's troubles on these international groups, claiming that they have been behaving "more like they are betting at a table in Las Vegas than operating financial institutions."

It is quite possible that such practises may have taken place. Nevertheless, it is primarily the result of the credit crisis that Iceland now faces such dilemmas.

With a population of just over 300,000, Iceland is still seen by many as a tiny island in the north Atlantic surviving mainly on its fish industry. In recent history, however, this has changed considerably. The financial sector has grown massively over the course of the last decade, coupled with an economic boom. The privatisation of the banks in 2003 vastly sped up this process.

Iceland is rated the sixth-richest country by the Organisation for Economic Cooperation and Development, and the speculative boom has seen a vast concentration of wealth, particularly in the capital Reykjavík. In some of the richest districts, flats had been reportedly selling for around €2 million. Since 2001, house prices have doubled. As a result, Iceland has been cited by many as a prime example of what a small independent nation can achieve for itself in the world market. Along with countries such as Ireland and Norway, Iceland supposedly "proved" that it was possible in the age of globalisation to have strong national economic development.

Such claims falsified the facts. The situation today is that Iceland's three main banks, Glitnir, Kaupthing and Landsbanki, possess assets valued at 10 times the level of the country's GDP. The only way in which the banks were able to finance such a disproportionate level of growth compared with Iceland's tiny economy was to rely on foreign investment. The three main banks have expanded into Scandinavia and Britain and have opened branches as far away as China.

Thus, the strength of Iceland's booming economy was based entirely on the stability of international capitalism. Given the recent volatility on global stock exchanges, this position no longer holds.

In a process known in financial circles as the "carry trade," the banks took advantage of Iceland's high interest rates by buying up currencies with low interest levels and investing the money in the krona, where they received higher returns. Added to this, the privatisation process, which saw virtually all of Iceland's resources sold off in tandem with a huge expansion in investment, meant that in 2007 Iceland's current accounts deficit stood at 16 percent of its GDP.

In spite of all the evidence to the contrary, some have attempted to maintain that nothing serious will result from the current problems. While accepting that there may be a brief recession in the short-term, they point to the fact that in 2006, when a slight downturn hit the economy, the banks redirected their investments to safer areas and increased their diversity.

The Central Bank supported this outlook in its recent assessment of Iceland's economic development for the coming year. While accepting that international markets had worsened considerably over the past period, it noted that its last report in 2007 "concluded that the financial system was broadly sound. That has not changed."

Analysts base this belief on the grounds that Iceland's government continues to achieve a budget surplus and is virtually debt free. This line of argument forgets one small thing: far from viewing the developments as merely the outcome of policies which can be pursued by the banks in question or the government, the fortunes of these institutions are inextricably bound up with the development of the world economy. As David Teather pointed out in the *Guardian* of April 17, "Ten years ago, Iceland would have been at the tail end of a global downturn. Today, with its companies and banks locked into world markets, it has become a lead indicator."

In the event that the banks do not possess the funds to meet their obligations, serious doubts have been raised over what the government could do. “Investors are worried because the banks have no real access to the markets,” said Paul Rawkins, a senior director and Iceland expert at credit rating firm Fitch. “Their next stop will be the government, which would have to bail them out. But the government doesn’t have the check book to pay for it.”

This perilous situation coincides with the government predicting that the economy will enter a recession in 2009, its first since 1992. While it predicts the economy will shrink by 0.7 percent, the central bank has been even more concerned, threatening a 2.5 percent contraction.

Economists have been forced to admit Iceland is facing difficulties. Glyfi Magnussen, an economist at the University of Iceland, explained: “I think it is fair to call it a crisis. What we have is a country or an economy that has gone a little too far in some respects, especially the banking system. The growth of the banking system was very rapid and until last year the banks didn’t really have trouble financing themselves and rolling over their debt at quite favourable rates, but the international financial crisis has hit Iceland very adversely and made this situation very rapidly almost unsustainable.”

In this environment, the impact on the Icelandic population will be devastating. Prices for cars have already jumped between 25 and 30 percent over the past few months, with dealers reporting that sales have dried up considerably.

Ordinary Icelanders are feeling the pressure. In recent weeks, truckers have been engaged in demonstrations against the price of fuel, which has risen severely as their wages stagnate. With the Consumer Price Index increasing by 3.4 percent in April alone, workers are finding everyday living costs growing dramatically.

Sturla Jónsson, one of the drivers who organised the truckers protests, commented, “It is very tough. Your salary is not moving anywhere and inflation is much higher than the government is saying.”

Protests have been ongoing since late March, with increasing numbers taking part. On April 23, a protest culminated in 20 truckers being arrested for refusing to move their vehicles to unblock one of the main routes in Reykjavík. According to one of the organisers, police initiated the violence by refusing to allow one of the demonstrators to move his vehicle. The demonstration ended with protestors throwing bottles and rocks at police. As Halldór Sigurdsson, a retired truck driver explained to CNN, “This is the first time in a long time we have seen in Iceland violence against protestors. We are not used to violence against groups of people at all.”

Prime Minister Geir Haarde declared, “It is not in consistency with Icelandic traditions to solve disputes with violence, but I believe it is necessary that police use the resources they have to protect public safety.”

Haarde criticised protesters as selfish, stating, “Various

groups have demands for the government and have a cause to fight for, but not everyone can block the traffic by parking large trucks in the street. I think truck drivers are disregarding the causes of other people by their actions.”

His comments were undoubtedly also directed at nurses who had threatened to walk out of the national hospital on May 1, as a result of management decisions to modify their shift patterns. While this dispute was resolved at least temporarily with management backing down, further attempts to change working practises are to be expected.

Haarde is the leader of the Independence Party, the largest in the coalition government, which also contains the Alliance, a merger between the Social Democrats and the Women’s Alliance that took place in 2000. Following elections last year, the right-wing coalition of the Independence and Progressive Parties lost four seats, forcing Haarde to turn to the Alliance as an alternative to strengthen his position in parliament.

The government set out its priorities from the beginning in its policy statement, committing itself to ensuring Iceland’s economic “competitiveness” on the global stage and its position as an attractive haven for foreign investment, by pledging to cut corporate taxes.

In order to provide extra resources for the private sector, the government also wants to keep strict controls on public spending, commenting in its statement that “a tight and cautious fiscal policy is essential and it is vital that the public sector’s share of GDP should not increase.”

Even the Central Bank was compelled on May 9 to issue a warning to the government to put its plans to cut income tax on hold. It pointed out that the measure could cost the public treasury around ISK 47 billion (€393 million) and recommended that the government await a more stable economic situation.



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