

# Iceland faces national bankruptcy

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Iceland's entire banking system is in danger of collapse.

On Wednesday Kaupthing Bank, Iceland's largest bank, became the third financial institution to be taken over by the government, joining Landsbanki and Glitnir, Iceland's second and third largest banks.

Iceland's Financial Supervisory Authority said the move was made to safeguard its domestic banking system. But later that day trading was suspended on the OMX Nordic Exchange Iceland for two days. It will not reopen until next Monday. The move was taken to prevent panic spreading throughout the country's financial markets.

On Monday of this week the government rushed emergency powers through parliament to give it increased power over the financial system. Amongst other things, the adopted provisions permitted a suspension of competition laws, allowed the government to force ailing banks into mergers, and ensured that the government could make credit available to the country's financial institutions.

Also on Monday, in a televised address to the nation, Prime Minister Geir Haarde made clear that the government was close to losing control of the situation. "As recently as last night it looked like the banks could continue operations for a while," he said. "This morning and today, things have totally changed for the worse."

He went on to spell out the potential fate of the Icelandic economy as a whole. Stating that the failure of the banking system would bring "chaos" to the country, Haarde declared, "There is a very real danger, fellow citizens, that the Icelandic economy, in the worst case, could be sucked with the banks into the whirlpool and the result could be national bankruptcy."

Trading on banking shares had already been suspended Monday as they fell dramatically. The Icelandic Krona (ISK) fell by 30 percent against the euro. Over the course of the previous week, the currency had lost ten percent against the euro and its value has declined by half against the dollar this year.

The collapse of the ISK has made the position even worse for many of the country's financial institutions. The institutions have large foreign debts and are struggling to raise funds. Half of Glitnir's debt of €15 billion was due for repayment in the coming two years.

The plummeting currency will also accelerate inflation, already running at 14 percent. The central bank has been

compelled to increase interest rates over the past year to try and bring inflation under control, with interest rates now at 15.5 percent. But the exceptionally high interest rates over the past year have had the effect of attracting currency speculators to the Krona who are keen to profit from the high returns on their investments. The result was a financial bubble with banks holding assets 12 times greater than Iceland's GDP. It is a bubble that has now burst, raising the distinct possibility of Iceland becoming a failed state in the fullest sense of the term.

As the economy became more unstable throughout the first half of 2008, with investors increasingly worried that the country would be unable to meet its debts, credit default swaps on Iceland grew dramatically. With the country on the verge of financial meltdown, Haarde and his government have been forced to seek funds from elsewhere.

But their appeal fell on deaf ears in Europe, with the leaders of the European Union, led by Germany and Britain, rejecting a coordinated European approach in favour of national financial rescue packages. Iceland is not a member of the EU.

On Tuesday morning negotiations were advanced between Iceland and Russia on the terms for a loan of €4 billion to stabilise government finances. Haarde expressed his bitterness towards Europe openly. "We have not received the kind of support that we were requesting from our friends. So in a situation like that one has to look for new friends," he said.

Haarde would not say which countries had refused to help, but added, "In a situation like this it's turning out that it's every man for himself, every country for itself, everybody's taking care of their best interest and that's what we are doing."

The *Financial Times* noted that Haarde was forced to deny that his economic arrangements with Moscow also extended to military co-operation, "refuting the suggestion that Russia might be given access to an airbase vacated by the US air force in 2006."

While Haarde maintained the loan was merely a precautionary step to increase Iceland's foreign currency reserves, without significant assistance the country faces financial collapse. In emergency measures, the Krona was pegged at 131 against the euro in a bid to stabilise the currency. Barely 24 hours afterwards, the central bank reversed its decision and stated it was no longer going to prop up the ISK, citing lack of support for the currency.

Tuesday also saw the government announce that it was taking

control of Landsbanki. It appointed an entirely new executive board to run the bank's operations amid rumours of Landsbanki being declared bankrupt. By Wednesday, the bank had been placed in receivership. As with Glitnir, Landsbanki has significant involvement in foreign markets, particularly Scandinavia and the UK, meaning that the bank's collapse would have severe consequences.

As these events unfolded, the government revealed it was scrapping its planned takeover of Glitnir. Stating that the full extent of the bank's problems had not been appreciated, it instead placed the institution in receivership under the control of the financial supervisory authority.

Kaupthing Bank had been offered a loan of €500 million from the central bank in a bid to allow it to continue its operations.

There were also reports of a loan from Sweden's Riksbank of €500 million to allow it to keep its Swedish operations running. Stefan Ingves, governor of the Riksbank had stated that Kaupthing Sverige had been granted "liquidity assistance" to "safeguard financial stability in Sweden and ensure the smooth functioning of the financial markets." But immediately following this declaration, it was announced that Kaupthing's Swedish operations would be put up for sale. This made Kaupthing's takeover in Iceland inevitable.

Credit rating firm Standard & Poor's has downgraded Iceland's credit rating by three notches to "BBB." It warned that Iceland now faces a deep recession.

In Britain approximately 300,000 savers hold deposits in the online bank IceSave which is controlled by Landsbanki. Following the announced takeover of Landsbanki by the Icelandic government, access to IceSave accounts was frozen. It now appears customers will have to claim compensation from the British and Icelandic governments.

Following the announcement that Landsbanki had been taken over, the Brown government in London stated that it would sue Icelandic authorities over the losses savers had incurred. While Icelandic Prime Minister Haarde issued conciliatory statements that both countries should work together to safeguard the deposits, this is yet another expression of the growing tensions between nations in the current climate.

Alongside the impact on individual savers, the banking failures in Iceland could have a major knock-on effect on the UK economy. Many local Authorities in the UK have invested millions in council taxes in Icelandic banks. According to a detailed report in the *Independent*, London public authorities have investments totalling around £200 million, with at least eight borough councils affected. These include Barnet Council in north London with £27 million, Hillingdon Council in west London with £20 million and Westminster Council with £17 million. Kent County Council has deposited £50 million and Transport for London has a £40 million deposit with Kaupthing Singer & Friedlander, which is now in administration.

Erik Pickles, the opposition Conservative Party's Shadow local government secretary, told the BBC that the sums

involved could exceed £1 billion.

The Local Government Authority has sought a guarantee against losses from central government like that extended to private investors, but Chancellor Alistair Darling did not do so—describing local authorities as being "more of an informed investor."

Major problems could also hit the retail sector in Britain, with House of Fraser, Debenhams, Woolworths, Moss Bros., French Connection and the supermarket chain Iceland all enjoying substantial backing through Icelandic banks. Many jobs in the financial district in London would be lost in the event of the collapse of the Icelandic banks.

The government in Iceland is also attempting to encourage foreign investments to be sold off and brought home. Some of the pension funds have agreed to sell up to 200 billion ISK (€1.2 billion) of their assets and transfer them to the state. This means that vast sums of ordinary people's savings will be put at risk in attempting to stabilise the financial system.

There are reports of queues at banks across Iceland, with savers keen to withdraw their money before it is lost. Rumours that a shortage in petrol would result from the massive drop in the Krona's value on Monday prompted a rush to petrol stations. The cost of loans have jumped by nearly 50 percent and with prices for everyday goods set to rocket, many Icelanders face the prospect of losing their jobs as companies cut costs or go bankrupt.

In his speech on Monday, Haarde sought to appeal to nationalist sentiments to encourage all Icelanders to "stand together" against the economic catastrophe the country faces. The unions have been happy to oblige in this campaign, working together with the government to secure the repatriation of the country's pension funds.



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