Iceland: Government bank takeover increases threat of state bankruptcy

Jordan Shilton
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On Monday, Iceland's financial supervisory authority was forced to step in and assume control of Straumur, the island's fourth-largest financial institution. The move came after the bank's liquidity had dried up, meaning it could no longer meet its obligations to creditors. The takeover means that the state now owns Iceland's four main banks.

Straumur was the country's only major financial institution to avoid a state takeover in the aftermath of the financial collapse that hit last October. The investment bank had operations in a number of European countries, including Finland, Sweden, Denmark, Poland, the Czech Republic and Britain, and in Iceland itself. At the end of 2008, the bank had a balance sheet worth US$3.4 billion and had been attempting to scale down its operations.

Revealing the state takeover of the bank, a statement said, "In spite of its strong capital position and the support of funding banks, Straumur believes its liquidity position is no longer strong enough to sustain activities."

As with the three banks that fell into state ownership last October, Straumur saw a rapid expansion in recent years into new markets throughout Europe. During 2006, its loan book increased by 160 percent, whilst in the following year it nearly doubled. Due to the restrictions of the size of Iceland's internal market, the bank raised fully three quarters of its income outside Iceland. The collapse of many of these markets, particularly in eastern Europe, Denmark and the UK, has been the main cause of its problems.

The Financial Supervisory Authority announced the suspension of the bank's entire board, adding that a "resolution committee" would be appointed to run the bank's operations, with the aim being to wind them down. Straumur's chief executive, William Fall, tendered his resignation.

In another sign of the continuing instability of the financial system, last month saw investment firm Baugur put into administration. The firm held stakes in a number of high street chains, particularly in Denmark and the UK, where it partly owned fashion outlets and the food supermarket Iceland. However, the company owed its creditors more than €1 billion, and although a deal had been attempted with nationalised bank Landsbanki, negotiations broke down.

Baugur founder Jón Asgeir Jóhannesson accused the former Independence Party-led government of deliberately seeking to put him out of business, declaring in the days prior to Baugur entering administration, "The plan that we put to Landsbanki was a good offer. Other holding firms have received positive treatment from the banks so one comes to the conclusion that there are some strange things happening here."

Such claims have received little sympathy since Jóhannesson was one of the most prominent figures during the years of economic growth, making billions out of his investment business.

Straumur's demise was also bound up with debts to the country's other three nationalised banks, Kaupthing, Glittnir and Landsbanki. The bank suffered losses of more than €0.5 billion euros in the fourth quarter of 2008. Just a week prior to Monday's nationalisation, Landsbanki had reclaimed €200 million of funds from Straumur as a result of market exposure. The final straw for the bank on Monday was the inability to access €33 million to meet its obligations, with the bank possessing only €15 million of disposable funds.

The takeover of another bank only increases the danger of Iceland going bankrupt. While the government maintained that all deposits in Straumur would be protected, there is considerable doubt as to whether the state possesses the necessary finances to meet its obligations. As Thomas Haugaard of Handelsbanken pointed out, "The risk of an actual state bankruptcy has moved closer. The government is now assuming responsibility for more deposit guarantees, and the question is whether the Icelandic state is big enough to bear the burden."

With the nationalisation of Iceland's three main banks last October, the state was compelled to assume responsibility for the debts of institutions that held assets worth ten times Iceland's GDP. Although an IMF-backed loan package worth approximately $10 billion was negotiated in

November with support from a number of European states, much of this was directed towards repaying depositors whose funds had been frozen in Landsbanki and Kaupthing accounts. The IMF loan of US$2.1 billion is being paid to Iceland in instalments and is linked to the implementation of austerity measures by the government.

The assumption by the government of yet more debt compounds its precarious position. With an economy in freefall, whoever forms the new administration after upcoming elections next month will be compelled to launch drastic cuts in government spending in order to make the necessary funds available to the financial elite.

The current interim government, a coalition between the Social Democrats and Left-Green Movement, has been in power since the beginning of February and will continue until elections, which have been moved forward to April 25.

At the end of January, the former government, led by the Independence Party and Prime Minister Geir Haarde, was forced out after ongoing popular protests outside parliament in Reykjavik.

Conditions have not improved since then. Iceland's economy is forecast to contract by 9.6 percent this year, with unemployment already up sevenfold in the past 12 months. Many of those who were laid off last October and November are only now beginning to feel the effects, since employers must give 90 days notice to employees who are made redundant. According to government officials, unemployment could reach 20,000 this year, in a country of only 319,000 inhabitants.

Even prior to the nationalisation of Straumur, it was estimated that government debt was well in excess of 100 percent of GDP. This level could prove even higher when a full accounting of the collapsed banks' liabilities is completed. The problem has been compounded by the sharp slide in the value of Iceland's currency, the krona.

In this regard, there is growing pressure from the IMF and other international financial organisations for the government to lift capital controls on the trading of the krona. This would exacerbate further the plight of many ordinary Icelanders who have seen prices for foodstuffs and other essentials shoot up in recent months as the krona collapses. The currency lost two thirds of its value in 2008 against the euro, and in the event of the abolition of capital controls it is clear that a further devaluation would occur.

Since taking power following the mass protests that brought down the Haarde government, the coalition of the Social Democrat-Left Greens has made some cosmetic changes whilst maintaining the fundamental policies of the previous administration. At the end of February, after several weeks of acrimonious debate within ruling circles, chairman of the central bank David Oddsson and the remaining governor were persuaded to resign from their positions.

In their place, Prime Minister Johanna Sigurdardóttir has appointed an interim central bank governor, in preparation for the selection of a permanent head of the central bank. Rather than the political appointments that have characterised the selection of central bank governors previously, Sigurdardóttir has insisted that only economic "experts" will now be considered for the position.

Meanwhile, the government has pledged to continue implementing the IMF restructuring programme negotiated by the previous Independence Party-Social Democrat coalition. Despite posturing as a real alternative willing to renegotiate terms with the IMF, the Left-Greens and their leader Steingrimur Sigfusson have proven to be nothing of the sort. Sigfusson is now the finance minister in the interim administration and has stated that economic policy will be based on the IMF's terms. The likelihood is that his party will emerge from the upcoming elections as the largest party, although it will need coalition partners to form a new administration.

Regardless of who assumes power in Reykjavik, the first priority of the new administration would be to increase the pressure on ordinary people through spending cuts whilst making available ever-larger amounts of public money available to prop up the financial system. As the current business minister, economist Gylfi Magnússon, commented, "We have to make very hard decisions because we do not have any good options."

As this reality becomes increasingly apparent, ordinary Icelanders will once again come into conflict with their government. Sooner rather than later, the mounting social tensions brought on by the economic crash will raise the necessity of workers waging an independent struggle against the ruling establishment in order to defend their living standards.