Iceland’s economic turmoil threatens instability throughout Scandinavia

By Jordan Shilton
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Iceland’s economic future continues to be bleak, with inflation increasing again in May and threatening to precipitate the first recession since the early 90s. An OECD report stated that an economic recession in Iceland now appears “imminent”.

This is despite the best efforts of the Icelandic government and central bank to stabilize the currency, the króna (ISK), which has fallen by around 24 percent against the euro since the beginning of the year.

Last month, an agreement was reached between the Icelandic central bank (Sedlabanki) and three central banks of Scandinavian countries, Sweden, Denmark and Norway. The deal, coming after interest rates had been raised to a record high of 15.5 percent, allows the Icelandic central bank to borrow 1.5 billion euros from the central banks, in order to increase its currency reserves. The measure will almost double the amount of reserves at the disposal of Sedlabanki.

The agreement stemmed from concerns that Sedlabanki would not be able to support Iceland’s main investment banks, Kaupthing, Landsbanki and Glittnir, in the event that they default on their payments. These three banks possess assets nine times the country’s GDP, an expansion which has been funded by borrowing cheaply in international financial markets. As a result of the credit crisis it is feared that the banks will be unable to access the liquidity in international markets they require.

Following the deal, Sedlabanki announced a proposal at the end of May to allow for the sale of ISK500 billion ($6.4 billion) in foreign currency bonds to further expand its currency reserves. Yet it has attempted to insist that both measures are simply precautionary and that it does not intend to utilize all of the funds raised.

Prime Minister Geir Haarde and finance minister Arni Mathiesen have tried to remain positive. While accepting that the economy will slow over the next year or two, Mathiesen stated, “I don’t think we have to be overly worried. As things have developed the downside risks are mainly linked to world developments.”

World economic developments are hardly a source of comfort.

Data released on June 12 confirmed that GDP shrank by 3.7 percent in the first quarter of this year. The reduction meant that Iceland’s economy achieved an annual growth rate of 1.1 percent during January-March as compared with 4.6 percent in the last quarter of 2007. The gloomy outlook was explained by Glitnir analyst Hjordis Vilhjamsdottir who noted, “Our GDP growth forecast for 2008 is zero percent.

“We expect private consumption to contract as the year unfolds, and also investments, after (the) huge investments in previous years in the private sector and aluminium smelters.”

Under such unstable circumstances, sections of the Icelandic ruling establishment have begun considering the possibility of adopting the euro in place of the króna. To adopt the euro would mean joining the European Union which would result in Iceland losing control of its fishing industry. Nonetheless, some companies have declared their intention to begin displaying their shares on the stock exchange in euros rather than krónur. Kaupthing, Iceland’s biggest bank intends to begin keeping its accounts in euros. The bank stated in a recent report, “The main problem of Icelandic banks is a lack of a lender of last resort since the Central Bank of Iceland can only print Icelandic krónur, whereas the Icelandic banks’ liquidity needs are in foreign currency.”

The impact upon the Icelandic population of such a move would be negative. As Joel Sherwood points out in the *Wall Street Journal*, “Iceland would need to go through a lengthy process required of all new members, which involves reducing inflation and budget deficits to levels comparable with countries that use the euro. Many of the Eastern European countries that were admitted to the EU in 2004 have found it difficult to meet those criteria.”

Reducing budget deficits and curbing inflation inevitably means making huge inroads into social spending as well as forcing workers to accept wage freezes and reductions in order to prevent “inflationary pressures”.

Prime Minister Haarde is the leader of the Independence Party, which has opposed adopting the euro, in part because of the party’s close links to the fishing industry but also on the grounds that it fears Iceland losing control of its economic policy.

This state of affairs is already proving tough for Icelanders. Inflation rose again in May to 12.3 percent and private consumption has begun to decrease. Recent months have seen an explosion in the price of fuel as well as increases in basic food prices, reflecting tendencies across the world. As far back as late March, truckers' protests broke out in Reykjavik against increasing fuel prices, with drivers complaining that the situation was unsustainable and calling for government intervention. Over the last year, the price of petrol in Iceland has risen by 37 percent, with the cost of diesel fuel increasing by 50 percent.

According to *Morgunbladid*, there has been a noticeable reduction in traffic activity on Iceland's roads. Sigurdur Ingi Jónsson, the CEO of a company which operates a tunnel on one of the main routes out of Reykjavík, noted that for the first time since the tunnel opened in 1998, traffic through it has declined.

The intervention of the Scandinavian banks confirms that a collapse in Iceland would result in broader economic consequences for the region and the international capitalist system.

According to a report from Statistics Sweden, the consumer price index (CPI) rose in May by 0.4 percent compared to April, giving Sweden an annual inflation rate of 4 percent, exceeding the central bank (Riksbank) target of 2 percent. It is the seventh month in a row in which inflation has exceeded expectations.

The unexpectedly high increase has been put down to growing energy and food prices impacting upon consumers. Some analysts have predicted an interest rate hike by the Riksbank later in the year. Typical was the reaction of Peter Kaplan, head of strategy at Handelsbanken.

"The level (of inflation) probably doesn't surprise the Riksbank when considering what has happened with energy prices and much else. But it's a level which is quite worrying for the Riksbank.

"There will be headlines that inflation is at historically high levels. If we look ahead to the autumn we'll see even higher figures, probably close to five percent."

Together with this, there are signs that production in Sweden is slowing. Industrial output in May declined by 0.3 percent from the previous month, and in April, retail sales were at their lowest in ten years. Some in financial circles have pointed to these conditions as symptoms of "stagflation", where the economy stagnates but prices continue to grow.

Danish inflation has also been higher than expected, at 3 percent and more, according to recent figures. This compares with a target of 2 percent in the euro zone. Although Denmark does not use the euro as its currency, the Danish Króna (DKK) is tied to the euro and the central bank is unable to adjust interest rates but follows the ECB (European Central Bank).

A recent investigation in to the rate of inflation in Denmark demonstrated that the increase was almost entirely due to rising food and energy prices. The Economic Council of the Labour Movement in a report in March stated that inflation had reached 3.1 percent, up from 2 percent a year earlier.

On top of this, Sweden and Denmark are suffering from labour shortages, with unemployment levels in both countries dropping to historically low levels. Sweden's unemployment levels reached their lowest since 1991 with around 2.6 percent of the population being officially out of work. In Denmark, unemployment reached 1.8 percent, prompting the head of the Danish national bank to call for workers to pay for new efforts to defend Danish corporate profitability.

Niels Bernstein commented, "If unemployment doesn't increase within the coming year, then it will come at us from outside and we will get it the hard way, namely that we will lose our competitive edge in relation to the outside world."

Meanwhile in Norway, in spite of a temporary pause in inflation in May, economists are still anticipating prices to rise. Referring to May's inflation figure of 2.3 percent, slightly above the central bank (Norges Bank) target of 2.2 percent, Nordea Markets economist Erik Bruce said "All in all, we see today's figures as a temporary drop and continue to believe that core inflation will increase further."

Norges Bank has increased interest rates 12 times since late 2005 in order to keep Norway's economy in check due to vastly expanding prices for its oil and gas stocks.

For these countries, instability in Iceland could quickly spread, creating new economic and social tensions throughout the region. The recent strike wave across Scandinavia in the public sector, covering healthcare workers and teachers amongst others, demonstrates that there are already mounting social pressures.

Some analysts have speculated that if the situation becomes extremely critical, the Bank of England could be drawn in to provide support, since Icelandic business and the three big Icelandic banks have extensive interests in the British economy.

Regardless of these measures, virtually everyone has been forced to accept that Iceland faces a recession. Some have admitted that the measures taken will do nothing to avert the crisis. As Lars Christensen, an economist at Danske Bank pointed out, "Economically, this changes nothing. Iceland is one of the most indebted countries in the world."

Iceland's external debt has reached $97 billion, according to Paul Rawkins of Fitch ratings, an amount five times the size of its economy. This precarious situation led one analyst to comment that Iceland could become an "offshore Northern Rock", in reference to the British bank which had to be bailed out by the intervention of the Brown government. It is the possibility of such an eventuality which has driven the Scandinavian central banks to take such drastic action.