

Comments by Glitnir Research on the Danske Bank report "Iceland: Geysir crisis".

The Danske Bank report looks written with the intent of putting the Icelandic economy in the most unfavourable light possible. What sets it apart from the previous reports is that, rather than just voicing concerns, it actually predicts a coming financial crisis and accompanying severe recession in the next couple of years. There are numerous inaccuracies and errors, which coincidentally all serve to paint a bleaker picture than the facts would warrant.

Highly implausible forecast

Danske Bank forecasts a 30-40% fall in investment and 5-10% fall in consumption. The bank maintains that it could result from a financial crisis and this may well lead to a drop in GDP of 5-10% over next two years. We disagree with this forecast.

Glitnir Research's forecast contraction in consumption and investment in next year, but a stable GDP, as exports will increase dramatically. DB's forecast seems to overlook the growth in exports both as aluminium production increases and devaluation of the krona increases production in the non-sheltered sector. DB's forecast of a deep recession just doesn't square with what is commonly known about the relationship of various economic variables in Iceland.

We forecast 4.3% growth of the Icelandic economy this year and a 0.1% contraction next year. It should be noted that other forecasters predict robust growth in 2007: The Central Bank 4.1%, The Ministry of Finance 2.5%, and OECD 2.5%.

Icelandic recessions are not "usually tough"

DB's assertion that "the recession is coming and it will be tough – as Icelandic recessions usually are" is simply wrong. The last recession, in 2002, was very mild (1% for one year) and the one before that, in 1991-1992, relatively mild as well. Possibly DB is referring to the 5.5% contraction in GDP in 1968 but apart from that, one has to look to the first half of the 20. century for a "tough recession" in Iceland.

It is also false that "deep recessions followed [minimal unemployment] in 1992 and 2001". In fact, GDP grew by 3.8% in 2001 and shrank by only 1% in 2002, followed by 3% growth in 2003. In 1992, GDP contracted by 3.3% but again the recession was replaced by 1.3% growth in 1993 and a further eight years of non-stop growth.

Likewise, the report claims that when the real policy rate exceeded 6% in 1998, a "significant slump" followed. GDP growth was 4.3% in 1999 and 4.1% in 2000; hardly a slump by any measure.

Turning to their forecast of a 5-10% contraction in GDP in 2006-2007, the pattern of erroneous figures combined with dubious interpretation continues. For example, the "Icelandic recession of 2001" actually sported a GDP growth of 3.8%, with the mild recession (-1%) happening the year after. Also, the cited figures from 2001 of a "more than 25%" contraction in investment and 5% contraction in consumption are incorrect (The correct numbers are 2.9 contraction in investment, followed by 19% contraction in 2002, and a 3% contraction in consumption).

Similar errors in economic figures and their interpretation abound throughout the report.

Why Thailand and Turkey?

The repeated comparison with Thailand and Turkey plays down the vast dissimilarities between those cases. To give DB their due, they mention that the ISK floats while the baht and lira were fixed and that contrary to those countries, foreign borrowing has not been used for domestic mortgages, but rather for investment abroad. However, they then proceed to brush these differences aside, when the fact is that they more or less make any direct comparison irrelevant.

Exaggerated concerns over loan portfolios

DB's concerns about deteriorating quality of the banks' loan portfolio in the case of substantial depreciation fails to take account of the fact that the majority of those loans are for investments abroad and thus insulated from changes in the ISK.

Also, their point of the size of mortgage borrowing by households causing problems for the banks overlooks the share of the Housing Financing Fund in those loans (over 40% of the total). The HFF, of course, has a state guarantee. The pension funds account for a further 11%, the share of the banks being less than 50% of total mortgage loans.

Some other examples of errors

- Wage growth, due to a strained labour market, "drove inflation above the Icelandic central bank's upper inflation band of 4% during 2005" – In fact rapid rises in housing prices have been the main drive of inflation for the past 18 months. Inflation, excluding housing, is currently 1.8% in Iceland.
- "The current account deficit is closing in on 20% of GDP." [Q4 05 figures without taking seasonality into account] The deficit was 16.5% in 2005 and will be less this year and decrease dramatically next year.
- "External debt is now nearly 300% of GDP" with no mention of external assets being close to 200% of GDP and the fact that all ratios to GDP are going to be skewed because of the international nature of the bigger Icelandic companies.
- "Unemployment stands at 1%" when in fact it is 1.6% based on registrations and 2.7% according to survey data from Statistics Iceland.

Summary:

The DB report presents a grim view of the economy, contains numerous errors and omissions, assumes a worst case scenario and presents a highly implausible forecast of a financial crisis and subsequent deep recession, even given those assumptions.

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