

## Danske Bank fantasies about Iceland

I believe that the report published by Danske Bank yesterday does not by any means accurately describe the situation in Iceland. **The report has numerous factual errors and is fraught with inaccurate and wrong use of Icelandic economic data.**

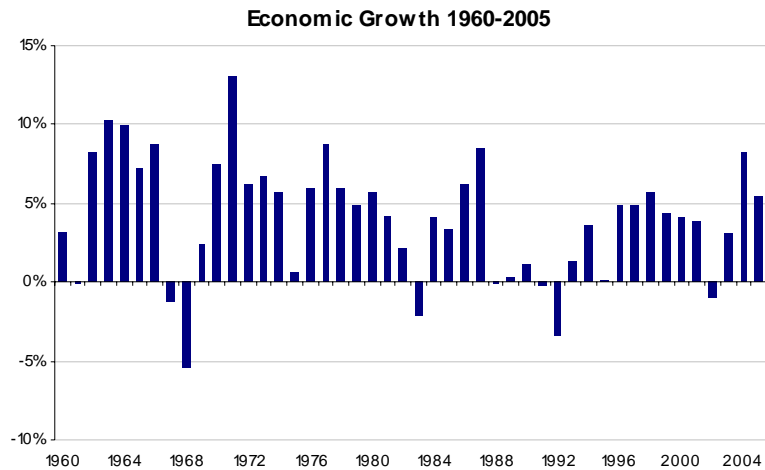
It is stated that every business cycle in Iceland has ended in hard landing, including the one in 1999 and 2001. **This is simply not true, there was no recession in Iceland in 1999 (growth was 4.3%) and in 2002 - not 2001 - the economy experienced a benign contraction with output contracting by 1%.** In fact, exchange rate appreciations, albeit with inflationary side effects, have always resulted in soft landings in the past. This is again according to the textbooks since Iceland is, after all, a small open economy, and about 75% of the revenue of companies listed on the Iceland Stock Exchange, ICEX, was generated abroad.

The report also states that the current account is closing in on 20% of GDP. In 2005 the current account actually stood at 16.5% of GDP and around ¼ of the deficit is due to the large scale investments in the aluminium sector. Kaupthing Research expects the deficit to shrink to around 9.5% of GDP this year and 4.5% in 2007. Moreover, since most consumer goods are imported, Icelandic households respond very strongly to changes in the real exchange rate, which can cause large pro-cyclical fluctuations in the current account. **In 2000 the deficit amounted to 10% GDP but turned into a surplus in just 12 months.**

The authors also inform the reader that high inflation in 2005 can be traced back to pressure in the labour market which has fuelled both wage and price growth. **The fact: inflation in 2005 is due to a boom in the housing market. Inflation excluding housing in 2005 was 1.0%.** More importantly, the Icelandic CPI is highly unusual due to the heavy weight of the housing market. However, according to the harmonized consumer price index – the standard inflation measure – inflation amounted to only 1.3% in Iceland in 2005.

**The report also compares circumstances in Iceland to the situation in Thailand and Turkey before the financial crisis in 1997 and 2001, although very few things seems to be comparable** except for the fact that Icelandic has a large current account deficit and an expanding financial system. More importantly, Iceland does not have a soft currency peg like those countries had and a large unhedged currency position in e.g. housing loans; these two factors were the main vehicle for the crisis in those two countries. The authors state these differences but then choose to ignore them.

The report then goes on assuming a 5-10% contraction of real output in 2006-2007 which seem to have almost no basis. **This scenario is highly unlikely - even absurd** – but both the Central Bank and the Ministry of Finance are forecasting strong growth this year and the next. One has to go back to the year 1968 when the fish stock collapsed to see more than 5% contraction in output (5.5%). Otherwise downswings have been mild and the economy has quickly recovered as can be seen in the figure below.



Source: Statistics Iceland

**In the report the authors state that unemployment is 1% that is not true.** Registered unemployment is 1.6% and according to a survey done by Statistics Iceland unemployment stands at 2.7%.

External debt is now nearly 300% of GDP with no mention of external assets being close to 200% of GDP. The largest part of Iceland foreign debt is due to the Icelandic banks borrowing and re-lending abroad. All comparison of external debt to GDP will be skewed because of this fact. Total assets of the Icelandic banks are e.g. 5 times the Icelandic GDP. The Icelandic banks are giants in one of the smallest economy in the world.

"the krónur has already weakened by around 20% since the start of the market correction". **This is inaccuracy as the ISK has weakened 14.8% since the ISK reached** its strongest value 100.6 the 2<sup>nd</sup> of November and the issuance of the report the 21<sup>st</sup> of March 118.1

In short it is surprised that a bank that takes itself seriously would publish a report of such poor quality. The forecast in the report is based on inaccurate data which seems almost to be willingly misread and on highly questionable comparison with Turkey and Thailand.

Ásgeir Jónsson,  
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