ECONOMIC WORRIES IN ICELAND

On April 10th the Central Bank of Iceland raised its core lending rate to a record 15.5%. In recent years Iceland's central bank has kept its core lending rate higher than those in larger European economies, but this latest increase looked less like standard procedure and more like a reaction to recent economic turmoil in the Icelandic economy.

At the beginning of 2008, the krona began to plummet in value relative to the euro and in the following months the Icelandic economy has been in full retreat, with inflation at 6.8% and rising and many economists now projecting the economy to fall into recession by 2009.

Two related factors have contributed to the slowdown: the effects of the global credit shortage on Iceland's exposure to foreign debt and an unexpected drop in the value of the krona.

Risky borrowing

In early April the Fitch Ratings agency placed Iceland's three largest banks on a negative credit watch. The agency said it thought the banks' current liquidity was sufficient to cover demands against them, but it said the banks could become insolvent if diminishing consumer confidence caused a run on the banks.

The market's outlook for the banks is indeed negative. Seafood.com reports the rates paid by Iceland's largest bank Kaupthing for "credit-default swaps" – essentially insurance banks buy to protect them from a borrower defaulting on a loan – rose to 16.5% up front and 5% annually for 10 million euros of bonds. This makes lending extremely expensive for Kaupthing, threatening its ability to earn enough profit to stay solvent. A JP Morgan valuation model predicts that at these credit-default swap rates, Kaupthing has a 59% chance of defaulting on its commitments within five years.

We have all read about the multi-billion dollar writedowns of nonperforming "sub-prime" mortgage securities by major US and European banks, how that has tightened credit markets worldwide and how it may precipitate a worldwide recession. Ironically, Iceland's banks are suffering despite little to no exposure to the "sub-prime crisis." In general they decided against participating in these risky investments.

Instead, the "sub-prime crisis" has hurt Iceland's banks because of the foreign loans they used to fund overseas expansion activities. After the Icelandic government privatized its banks in 2000, the banks have grown beyond the confines of the country's relatively small economy. The largest banks have bought foreign banks and now have operations in Scandinavia, the UK, China and Canada. The total assets of Icelandic banks are now 10 times the country's Gross Domestic Product (GDP).

The banks funded most of this expansion with cheaper foreign loans.

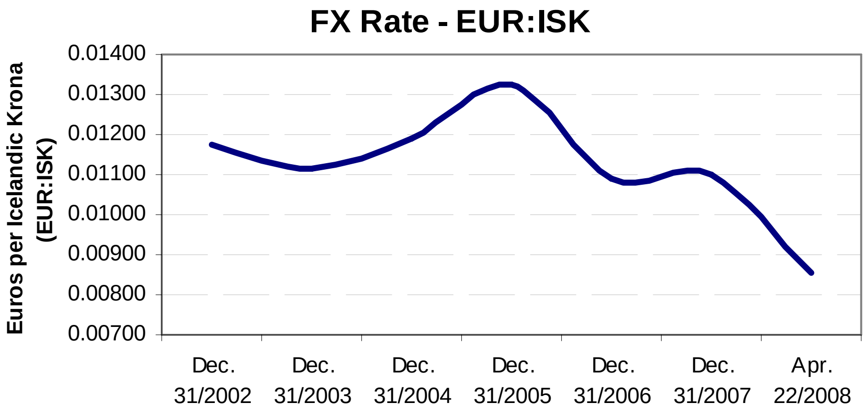
Like the banks, Icelandic consumers have used foreign loans to increase consumption. Loans from domestic banks have been relatively expensive throughout Iceland's boom, so many consumers and businesses funded their spending with loans from overseas banks.

The Icelandic government is experiencing the same crunch as its banks and consumers. During the country's recent boom, the government consistently posted large spending deficits, with the shortfall financed largely with foreign debt. According to the International Herald Tribune, the deficit in 2007 was $2.7 billion, or 16% of Iceland's GDP that year. "By comparison, the much-criticized current-account deficit of the United States is 5.3% of total output."

For these three players in the Icelandic economy (banks, consumers, government), foreign debt worked well so long as the krona remained strong and borrowing costs remained low. But when the krona's value tumbled in early 2008 and the worldwide cost of credit rose with the "sub-prime crisis," Iceland's foreign debt became much more expensive. Debt-financed consumption disappeared, halting the country's economic growth.

The faltering krona

Although among the world's richest, most developed economies per capita, Iceland's economy as a whole is relatively small. Its currency has therefore shown more volatility than those of larger nations with comparable per capita output. The following chart shows the value of the krona in euros for the post-2001 boom years:



For the past couple of years observers of Iceland's currency have predicted a downward correction. They argued that Iceland's recent boom was built mainly on debt-financed consumption, not on growth in Iceland's core export industries such as seafood. Since Iceland imports much of what it consumes, the demand for imports was growing faster than for exports, meaning lower demand for the krona would cause a downward correction.

The krona lost approximately 20% of its value in 2006, which was largely expected, meaning the market took it in stride. The 2006 correction was accompanied by a slowdown in growth, but this was temporary and the economy quickly resumed its recent growth trend.

The krona suddenly began to slide on January 1, 2008, falling 22% by April 22. This current slide was unexpected and it has caused more erratic behaviour on the market.

Officials in Iceland's government and central bank have accused foreign currency speculators such as hedge funds of conspiring to use their trading clout and rumors to profit from a run on Iceland's currency and banks.

There is undoubtedly some currency speculation behind the krona's decline, but it is unlikely traders have moved their money out of krona-based investments on a whim or as part of a conspiracy. If these profit-seeking traders saw continued opportunities in these investments, their money would stay.

More likely is that big investors saw an increased risk in their krona-based investments and looked to minimize the risk by selling. Economic behaviour is often emotional rather than rational, so when smaller investors saw money fleeing Iceland, the herd followed, not wanting to be left holding worthless paper. Justified or not, these large flows had a disproportionate effect on Iceland's small economy, as evidenced by the 22% drop in the krona since January 1, 2008.

Cod quotas contributing to economic slowdown

In July, 2007 the Icelandic government announced 2007-08 cod quotas of 130,000 metric tons (MT), a 30% drop from 2006-07 quotas of 180,000MT. It said it would maintain the lower quotas for at least three years to allow the stocks time to consolidate before higher quotas are reintroduced. Scientists at the International Council for the Exploration of the Seas (ICES), which monitors and provides quota advice on European fisheries, had for several years called for lower quotas in Iceland, but this latest quota cut went even further than ICES advice.

The Atlantic cod stocks within Icelandic waters are the second most important source of global cod supplies after the Barents Sea stock. Seafood, especially cod and haddock, is also among Iceland's most important exports.

Economic theory suggests that when a country's currency falls in value relative to world currencies, that country's exports become cheaper for foreign buyers and demand rises. This increase in demand helps bring the affected currency back to equilibrium. But in Iceland's case, the opportunity for increased exports will be limited by the reduced supply of cod over the next three years.

Sources: International Herald Tribune, Guardian, Washington Times, Urner Barry, Seafood.com, Central Bank of Iceland, UN Statistics Division, Wikipedia, Independent Online

Implications for frozen seafood buyers:

- European buyers may see some bargains for Icelandic seafood.
- Savings on cod purchases from the 22% drop in the value of the krona will likely be offset by the 30% drop in supply.
- Icelandic seafood companies and the Icelandic banks that finance them have a big footprint in the world seafood industry: any turmoil they experience as a result of Iceland's economic difficulties will likely be felt in the wider industry.

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