Iceland’s economy during the credit crunch

Iceland's economy used to be based on fishing and high-energy industries such as aluminium until it experienced a sharp boom period in the late nineties. Money flooded into Iceland's economy creating enormous growth rates and unemployment fell to almost zero. The three major banks in Iceland *Landsbanki* , *Glitnir* and *Kaputhing* used this money to leverage debt and invest heavily abroad. They bought everything from Hamley's to the Somerfield supermarket chain to West Ham United Football Club. However, towards the end of this decade Iceland's economy was becoming increasingly reliant on debt and once the credit crunch arrived their banks were fatally exposed. They had made the same mistake as Lehman Brothers and the other large, now defunct, US investment banks. They had borrowed short-term cash to make long-term investments. Iceland's economy was hinged on the continuous rolling over of debt, which had posed no difficulties in the boom years. However once the credit became more difficult to acquire, then the situation of the banks became perilous and so did that of Iceland's economy. The bank's share prices began to fall as did the exchange rate of Iceland's Krona currency. The more difficulty the banks experienced, the more Iceland's economy looked to be built on an unsustainable debt bubble. The banks funding was rapidly drying up and in 2008 the Icelandic government began nationalising them as depositor's were panicking and taking their money out. But it did not stop there for Iceland's economy; foreign reserves began to dry-up as the government now also found it difficult to borrow money because the international markets didn't believe the government could rescue the banks as well as repay their own debt. One economic commentator said that it was not just a case of it being a run on a bank; it was a run on Iceland's economy! Just how serious it is has been for Iceland’s economy can be seen from the fact that the government announced in early Oct 2008 that they were going to attempt to get a loan from the Russian government. This is a shock move considering that Iceland is a member of NATO. In the end however Iceland’s economy was saved, in the short-term at least, by a loan from the Swedish government. It is hoped that this will help support Iceland’s economy but there are fresh fears that they are facing a sovereign default. The government confirmed this when the Prime Minister stated in a TV broadcast that Iceland’s economy faced ‘ a real risk of bankruptcy’ due to the credit crunch.

It is worth elaborating on the discussion on Iceland’s economy during the credit crunch by looking at the impact it was, and is, having on real consumers in the country and then on those living outside the country who might think that what happens in Iceland’s economy will have no impact on them. During the height of the credit crunch in Iceland, the BBC interviewed a number of people to assess their sentiment. One young woman spoke of the rapidly rising prices because so much of the food was imported and with the Krona falling, prices on the shelves were soaring. People were even bulk buying food and hoarding it according to this interviewee. Iceland’s economy had gone from being one the wealthiest countries to this dire situation very quickly. Another Icelandic resident said he had bought his house for 13 Million Krona last year but because of the credit crunch causing higher interest rates, he now owed 16 Million Krona on it! He said Iceland’s economy had been built of debt and many people had borrowed at low interest rates not thinking they could rise – but they did. Another couple who had recently moved from the UK to live in Iceland said they were considering moving back. They could not access their savings because their bank had been nationalised and they were panicking. They thought Iceland's economy was prosperous and wealthy but now they realised it was heading for an enormous recession and they did not want to stay there to experience it. Those living in the UK might believe they are immune from problems with Iceland's economy but on Oct 7 th, they realised they were not. On that day, the online savings bank, Ice Save declared they had suspended withdrawals in the UK because their parent bank Landsbanki, had run out of cash. It is estimated that 300, 000 UK residents had a savings account with Ice Bank. Those who believed that problems with Iceland's economy would stay in Iceland were seriously misinformed.

It is also worth looking at some background information on what precisely caused the difficulties with Iceland's economy and why the credit crunch impacted them particularly. The question most people might ask were why Iceland's economy was so affected and the simple answer to this is size. Size really matters when it comes to economic problems. The UK and US economies were big enough and diversified enough to be able to move in and recapitalise their banking systems with national resources. Iceland has a population of only 400, 000 people and their banks had ballooned in size. Iceland's economy, no matter how productive it was, could never bail out their banks which had been investing huge sums outside of Iceland's economy. Yet the Icelandic government was caught in a trap; without a functioning banking system, it knew an economy cannot function and so they were determined to prop up their banks. However, the government poured too many of the national reserves into its banks before it realised it was all in vain. Iceland’s economy was destroyed during the credit crunch because it ultimately lacked a big enough central bank like the Bank of England or Federal Reserve. In fact, some individual Iceland’s banks were far bigger than Iceland’s economy itself and so could never have been rescued. The lesson to learn from the experience of Iceland’s economy during the credit crunch is to ensure that banks are well regulated and that their loans do not grow beyond the capacity of the government to rescue them should the need occur.