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REFS: A) Reykjavik 213

B) Evans-Norton email 10/01/08

1. (SBU) Summary: Counter to the hopes of the Icelandic government, saving Glitnir Bank has not saved the economy, as the krona has fallen by 15 percent over the last two days and Iceland's credit ratings have dropped. In the midst of the bad news, the first budget deficit since 1996 was announced and banks are trying every means possible to shore up their holdings. Politically, the government's visibility has somewhat been dwarfed by David Oddsson, the Chairman of the Icelandic Central Bank Board of Governors and former Prime Minister. Prime Minister Haarde's annual "State of the



Union"-equivalent address on October 2 had difficulty getting attention over reports that Oddsson is calling for a unity coalition. While Haarde's Political Advisor dismissed these rumors, the government is struggling to give the impression that it is in control of events here. End Summary.

2. (U) After the Icelandic Government's purchase of a majority share in the country's third-largest bank on September 29 (ref A), many had hoped the economic situation would stabilize and the krona's slide would stop. In this atmosphere, the October 1 presentation of the 2009 government budget bill offered little comfort. For the first time since 2003, the government anticipates a deficit (approx. ISK 56.9 billion, or \$517 million). Earlier forecasts had predicted a deficit of ISK 20 billion, or \$182 million, for 2009, but estimates have changed in the last few weeks. Further, the last time a budget bill was presented with a deficit was in 1996. For the past three years, the state treasury has delivered a total surplus of ISK 283 billion, or \$2.57 billion. Further doom and gloom comes from the fact that the budget proposal was completed for printing prior to last weekend's banking crisis and therefore does not account for the GOI's purchase of a 75 percent stake in Glitnir Bank and the further depreciation of the krona. The changed economic situation will probably be considered in the parliament's handling of the bill. After the nationalization of Glitnir on September 29, Standard & Poor's and Fitch Ratings downgraded Iceland's sovereign credit ratings.

3. (U) After the credit rating downgrades, the Icelandic krona tumbled nearly 15 percent from September 29 to October 3 to ISK 112.99 against the dollar, which is the the weakest since the Central Bank of Iceland quit restricting its movement in March 2001. Over the last five days, the krona has come under heavy selling pressure, also falling 12 percent against the euro. In addition, credit default swap (CDS) spreads for Icelandic banks have soared. A wider CDS spread means that yields on riskier debt rose sharply, while those of safe government bonds fell. The krona's sell-off was precipitated by turmoil in the overleveraged banking sector, which in turn is posing serious risks to Iceland's overall financial stability.

4. (U) The three major Icelandic banks are rapidly trying to shore up cash. On October 1, Iceland's number two bank Landsbanki said it will reverse its recent expansion and sold the majority of its overseas corporate finance and brokerage platforms to Reykjavik-based Straumur-Burdaras Investment Bank for 380 million euros, or \$525 million. The deal strengthened Landsbanki's capital position and leaves it focused on commercial and corporate banking. Nonetheless, Fitch cut its long-term rating on Landsbanki from A to BBB, and Moody's put its A2 long-term rating of Landsbanki up for a possible downgrade. Meanwhile, Kaupthing, Iceland's biggest bank by value, said in February it would sell its asset finance and commodity trade finance businesses in Britain. It sold part of this in August. On October 2, the spokesman of Kaupthing's Danish unit, FIH, Jonas Sigurgeirsson, said the bank had no plans for further sales. He added that Kaupthing had been very successful in raising



deposits, meaning it was less reliant on wholesale funding, which has become very difficult to find and very expensive for Icelandic banks in the current market climate. "The liquidity and the position of Kaupthing is very strong," Sigurgeirsson said. Additionally, Kaupthing is still pressing ahead with its recent plan to acquire a major Icelandic savings bank in order to add to its deposit holdings.

5. (SBU) Adding to the government's headaches, on October 2 newspapers reported that David Oddsson, the Chairman of the Board of Governors at the Central Bank of Iceland (and previously PM and Independence Party chair from 1991-2005), has mentioned twice in the last few days in meetings at the Central Bank and at the Prime Minister's Office that forming a unity government (including all parties in the parliament) should be considered in light of the serious economic situation in Iceland. This has raised eyebrows, while pundits have pointed out that the current coalition government

REYKJAVIK 00000217 002 OF 002

enjoys a strong parliamentary majority and would be unlikely to yield to such a coalition. The general public is increasingly calling for action, while PM Haarde and the government, in press statements and interviews, maintain that the economic situation will get better. In a conversation with PolOff, Haarde's Political Advisor put the Oddsson rumors down to a group within the IP that wants to sow discord and possibly rid themselves of their Social Democratic Alliance coalition partners. This group supposedly has never liked the current coalition and would rather re-form an alliance with the Progressive Party. Haarde's Advisor cautioned that this was an "extremely dangerous time" to be playing politics and said Haarde would be pressing ahead regardless.

6. (U) Haarde's annual policy address to the Althingi (parliament) went forth against this backdrop on the evening of October 2, and while offering little in the way of policy specifics was praised by leading daily Morgunbladid for showing optimism and determination in the face of the current challenges. While the opposition parties unanimously criticized the PM's lack of specificity, Left-Green Chair Steingrimur Sigfusson was notable in his cheerleading for the Icelandic people to rely on their strengths and the country's resources (something of a departure for the often-critical Sigfusson). Perhaps inspired by Oddsson's comments about a unity government, Sigfusson also encouraged the PM to call the leaders of all major elements of society together to hammer out a national consensus on a way forward.

7. (SBU) Comment: The general public listened anxiously to Haarde's speech to hear what proposals the government might have. Though Haarde's cautious optimism may have offered a calming effect, he will have to work hard to overcome the image -- eagerly reported by the media here -- of an inactive government shell-shocked by recent events. Results in securing outside guarantees or added cash reserves to back up the krona would do much to calm anxieties here,

and Haarde and his team appear to know that the pressure is on. End
Comment.

VAN VOORST

