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Classified By: Economic Section Chief Fiona Evans for reasons 1.4 (b)

and (d).

1.(C) Summary: During the October 24 visit of U.S. Treasury Department Acting DAS Eric Meyer and Iceland desk officer Larry Norton, the visiting International Monetary Fund team in Reykjavik announced it had reached an agreement with Icelandic officials on a 2.1 billion USD loan deal. With this agreement on the table, the GOI focused its conversations with Treasury on plans to move forward, including discussing the obstacles to floating the krona, and finding the additional cash loans to supplement the IMF funds. The Prime Minister and Finance Minister traveled to Helsinki on October 26 to meet with their counterparts to ask for additional funding. No Icelandic official asked for USG funding support. However, DAS Meyer indicated that USG would support the IMF deal within the IMF. Several officials took the opportunity to complain about British



actions at the outset of the crisis (including freezing the banks' U.K. assets under an anti-terrorist law), with Central Bank Head David Oddsson going to the extreme of comparing Gordon Brown to Mussolini. The Russian loan still seems to be a possibility, but the IMF deal has pushed this prospect to the back burner. Everyone acknowledged that the road ahead would be painful, but maintained a sense of cautious optimism. End Summary.

2. (C) Central Bank Governor of the Board David Oddsson opened his meeting with the Treasury visitors by asserting that the Financial Times had misquoted him in saying he blamed the Fed and other Central Banks for the Icelandic collapse; he had said only that he was "disappointed in them." He emphasized the need for a show of strength and predicted that the IMF loan would be small and would be disbursed incrementally. Oddsson and Director of International Markets Sturla Palsson warned of investors hedging "against us" and the need to show strong reserves so that "we can stand a speculative run against the Icelandic krona." Palsson said they were prepared to use a tight monetary policy and the priorities were to 1) create the new banks, 2) get the payment systems in order, and 3) get the bond market up and running. They were cautiously optimistic on the economic outlook, and Palsson asserted, "the time to normalcy will be shorter than the textbooks tell us." He was confident the krona could be floated sooner than the IMF estimate of six months to a year.

3. (C) Oddsson was clearly bitter about the UK's freezing of Icelandic assets and compared Gordon Brown's actions to Mussolini's Ethiopian venture in 1935 in which a large country brought about the ruin of a defenseless small one. Oddsson said they were doing their utmost to respond to creditors in a "fair and open way" and cited the hiring of known specialists to ensure there is no favoritism. He said that the government's new emergency law prioritizes depositors over other creditors and that the law lumps all depositors together (retail and wholesale). Oddsson said that the EU Directive on banking establishes a bank fund to serve as a guarantor of the deposits. This works well in a system in which hundreds of banks contribute, but obviously is not a good system when there are only three banks. The Icelandic bank fund isn't sufficient to guarantee the losses that have been incurred by the bankruptcy of the three Icelandic banks. The legal question now is whether the state is the back-up institution when the bank fund is exhausted. The UK argues yes, but Iceland sees it completely differently. This is a question that must be settled in court. Regarding the bond holders, Oddsson said that creditors will be surprised when they receive much more than what is currently being traded. Both Oddsson and Palsson reiterated how important it is to restore trust in the system.

4. (C) At the Financial Supervisory Authority (FME), Head of Foreign Operations Hlynur Jonsson gave a technical description of recent events. He said that the three new banks (New Glitnir, New Kaupthing and New Landsbanki) had been formed from the Icelandic deposits and internal business of the old banks; the old banks would receive a bond, which would be evaluated by an international evaluator within 90 days, for the new banks. The state will have to capitalize the



new banks with bonds issued by the old bank to cover the difference. Jonsson said they needed to liquidate the old banks without ruining Iceland's international reputation. Jonsson said the foreign operations were left in the old banks and are limited because of the authorities in various jurisdictions. He said the situation is most complex in the UK and in Luxembourg, "where huge repos with the European Central Bank and the mother company owing subsidiaries might make it possible to save the subsidiaries." Jonsson said that they are talking with their counterparts in other countries and that everything is going well except with the U.K. When asked about the long term impact of what has happened, Jonsson and Gudrun Jonsdottir, Head of the Securities Market, said they were still putting out fires and were not able to answer just yet.

5. (C) Finance Minister Arni Mathiesen said the IMF deal was not complicated; its focus was on banking structures, monetary policy (key to restoring some confidence in the currency) and fiscal policy (how the government manages the very high debt it will incur as a

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result of the crisis.) Mathiesen said in his mind, there were no areas of disagreement. He said he would travel with the Prime Minister on October 26 to Helsinki for two days of meetings with their Nordic counterparts where they anticipate raising further funds. When asked whether Iceland had approached the EU, Mathiesen said he had talked to French Finance Minister Lagarde and that it seems the EU does not have a structure to tackle these kinds of financial problems and that the assistance would likely be in post-program. He said Foreign Minister Kouchner and Lagarde may be coming to Iceland at some point. He expected the krona to plunge when it is floated but hoped it would stabilize at more or less the current level (115 ISK to 1 USD).

6. (C) The Permanent Secretary of the Prime Minister's Office, Bolli Bollason, said the formal decision to seek IMF assistance had been approved in a Cabinet meeting earlier in the day (Oct. 24.) Bollason understood the size of the IMF package was unusual relative to Iceland's size (as a percentage of Iceland's IMF quota, the program will be bigger than most in IMF history) and said that it was fundamental to restore stability in Iceland. He said that the main concern is passing the hurdle of floating the ISK. He said that the Prime Minister was preparing for the Nordic Prime Ministerial meeting in Helsinki on Monday with his Nordic counterparts, to request funds or swap lines or both. Asked about how Iceland would fill the 4 billion USD gap between the IMF funding and the purported 6 billion USD necessary, Bollason said they asked Central Bank Governor Oddsson to call his counterparts in the Nordics and ask how far they are willing to go. Bollason said in his personal opinion, he didn't expect the Russians to contribute money, that Iceland had not been in contact with the Russians since the Icelandic team left Moscow, but said "let's see how things develop."

7. (C) Director of the Institute of Economic Studies at the



University of Iceland Gunnar Haraldsson told Meyer and Norton that the repercussions of the crisis would be painful. He predicted inflation, mass layoffs, business bankruptcies, and a brain drain. He described the hardships that many Icelanders now face with their payments on foreign currency loans (on their houses and cars) resetting with the krona's depreciation. He saw the IMF as the only way out, and even with their help, it would be a rough 6 to 12 months ahead.

8. (U) This cable has been cleared by Treasury.

VAN VOORST