Arev

Arev verðbréfafyrirtæki hf.
Bankastræti 5
101 Reykjavík
Iceland

Tel: 00 354 551 2500

www.arev.is
info@arev.is

An Excerpt from the Editorial of the Weekly Courier

May 3rd, 2015

Clouds are gathering over Iceland's rather resilient economy.

The *biggest cloud* is that a great deal of the country's currency and assets, including the nation's banks, are owned by foreign hedge funds. They acquired these assets by picking up most of the bonds of the Icelandic corporate sector including the bonds of the banking system during the 2008 – 2009 crisis. The bonds were acquired at a hefty 80-90% discount. At the moment, the hedge funds own about 60-70% of GDP of domestic assets. For this reason, the country still has strict currency controls as there simply are not enough reserves to pay out the hedge funds.

The Icelandic government has vacillated and hesitated. It has given itself seven long years to deal with the hedge funds and it has still not executed a coherent plan. The Weekly Courier has long held the view that deflating away the claims of the hedge funds might be the most sensible solution. The country has issued much more Icelandic local currency than there is demand for at current exchange rate and we believe that exchange rate is bound to adjust at some point. Successive governments have not been willing to devaluate the currency to the extent needed. The government has also broached a plan whereby hedge fund assets are heavily taxed, thus mitigating the need for devaluation.

The other major cloud is a collapse in the current wage negations between the labor unions and the confederation of industry. The reason for this is a rather simple one. Earlier in the year doctors of medicine sensed an arbitrage opportunity. After the collapse of the local currency they have been paid 30% percent less than their colleagues elsewhere. Many had emigrated and even more were threatening to do the same so that the hospital were short of doctors. During a bitter fight they pushed through an unpresented 30% wage hike.

The labor unions that represent practically everybody else are incensed and they are now demanding 30% wage increases for the remaining workers. This demand has no economic merit as country's GDP is only growing at 2% per annum and its merchandise account balance has actually been contracting. Wage increments of this order will only lead to runaway inflation. Strikes have already begun and it is possible that within a month most of the workers in the country will have stopped working.

Unsurprisingly, there is an enormous pressure on the local currency, ISK. The yield of the benchmark 10 year government bond is already at 7.1% in April and The Weekly Courier expects it to keep on increasing. Comparing the yield to the similar indexed bond shows that the market has factored in a 4% inflation premium.

Getting Iceland out of this mess will not be easy. The government will now have to deal with the hedge funds while facing a revolt from the labor unions.

By definition, crisis occurs, when more or less random and seemingly unrelated events take control over society and the government and its citizens are left to watch as they run their course. This is what happened in 2008 in Iceland and most of the western world. It is also what is happening in Greece at this moment.

By hesitating and not dealing with the hedge funds sooner the government is running the risk of this happening again in Iceland this summer.