

THE FINANCIAL CRISIS ON ICELAND – A MACRO PERSPECTIVE

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1. HISTORICAL BACKGROUND

- 1904:** Home Rule, after 600 years under first Norwegian and then Danish rule (compare with 1814 for Norway)
- 1944:** The republic of Iceland is established (compare with 1905 for Norway)
- 1949:** Joins NATO from the start
- 1970:** Joins EFTA, ten years after inception
- 1972-1976:** Cod war with UK – and Iceland carries the day
- 1990:** Individual Transferable Quotas (ITQ) for all Icelandic fisheries introduced
- 1994:** Joins EEA (like Norway, i.e. not member of EU, but almost)



2. HAPPY DAYS

2003-2007: Iceland does exceeding well.

Stock market up by 390 %

Real home prices up by 89 %

The three Big Banks get active in the mortgage market.

At the end, 20 % of house owners financed loans in JPY, CHF, etc.

Why? Because you don't want to look less smart than your neighbor.

Business investments grew at 19 % a year.

Value added in finance sector likewise, 19 % in annual growth.

Construction sector: 14 % growth .

Large inflow of immigrants.

2003-2007: Annual economic growth overall of more than 6 %



3. THE MAKING OF AN ECONOMIC CRISIS

Were it not for the Asian crisis, IMF, Greenspan, Bernanke, etc.....

1997-1998: Asian crisis handled unkindly by the IMF

China, Malaysia, Thailand, Vietnam, Taiwan etc learned a lesson; don't rely on others.
Need a war chest of foreign reserves.

Which necessitates trade surpluses over a number of years.

The US accomodates by running huge deficits.

Savings glut and interest rates bottom out.

Iceland becomes a wonderful place to place your money.

“Carry trade” blossoms.

German dentists get higher return on savings – it seems

Icelandic house owners get cheaper loans – it seems



..... *but Iceland's own bankers also contributed to the crisis*

1994: Capital account liberalized, i.e. can freely import and export capital, making it hard to sustain a fixed exchange rate.

2001: Inflation target for Central Bank of Iceland (CBI), necessitating floating exchange rate. Introduced at the same time in Norway.

2003: The three large banks are privatized, a process that started in the late 1990s. Loan officers were rewarded according to the volume of loans they made

2008: In October the same three banks, 85 % market share, are put into receivership. Quite similar to the Norwegian experience of 1992; three banks with 85 % market share went bust. Why is it so hard to learn from the mistakes of others?



..... and it all smacks of irregular behavior, yet to be sorted out

Fishing quotas given out for free, a market for them is created (1990).

Some people get filthy rich.

Rich and well-connected Icelanders enter the financial sector.

40 % of Landsbanki sold to local investor group (Samson).

OECD (2009): *“The sale was largely a political decision.”*

Financial Supervisory Authority (FSE), grossly undermanned, was overruled.

OECD (2009): *“Widespread accusation of political favourism”.*

OECD: *“... the new owners and the people behind them had the mindset of investment bankers rapid growth and highly leveraged, aggressive deals.”* (Jännäri Report of 2009).

Easy global monetary condition and this strategy could be pursued.



In the aggregate Iceland behaved as an irresponsible hedge fund manager

2003: Balance sheet of Big 3 amounts to 170 % of GDP

2007: Balance sheet of Big 3 amounts to 880 % of GDP

Iceland, with high rates of interests, looks attractive to foreign fund managers in search of yield.

Money lent to Icelandic investment companies (Baugur, Samson),
“typically controlled by the main shareholders of the banks, taking equity positions in foreign firms.” (OECD)

OECD: *“Iceland’s international investment position had come to resemble the balance sheet of a hedge fund, with large debt-financed equity positions.”*



Iceland becomes exposed to global equity market, totally beyond her capacity.

2007 and wholesale funding dries up. “Glacier bonds” hard to sell.
Landsbanki does a clever job in attracting retail deposits.

Icesave is successfully marketed. Branch of Landsbanki, not a subsidiary.
Road show with Prime Minister and Foreign Minister on the road.
(Compare sms exchanges between Rune Bjerke and Jens Stoltenberg.)



4. WHAT DO WE HAVE RATING AGENCIES FOR?

“Love letters” amongst Icelandic banks, i.e. considerable part of collateral of Icelandic banks were against other Icelandic banks.

This nets out when consolidating over all banks.

Lehman bankruptcy in September 2008.

Fitch rating of Iceland 29 September 2008: A+

Fitch rating of Iceland 10 October 2008: BBB-

What do we have rating agencies for?



5. CLEVER HANDLING OF THE CRISIS

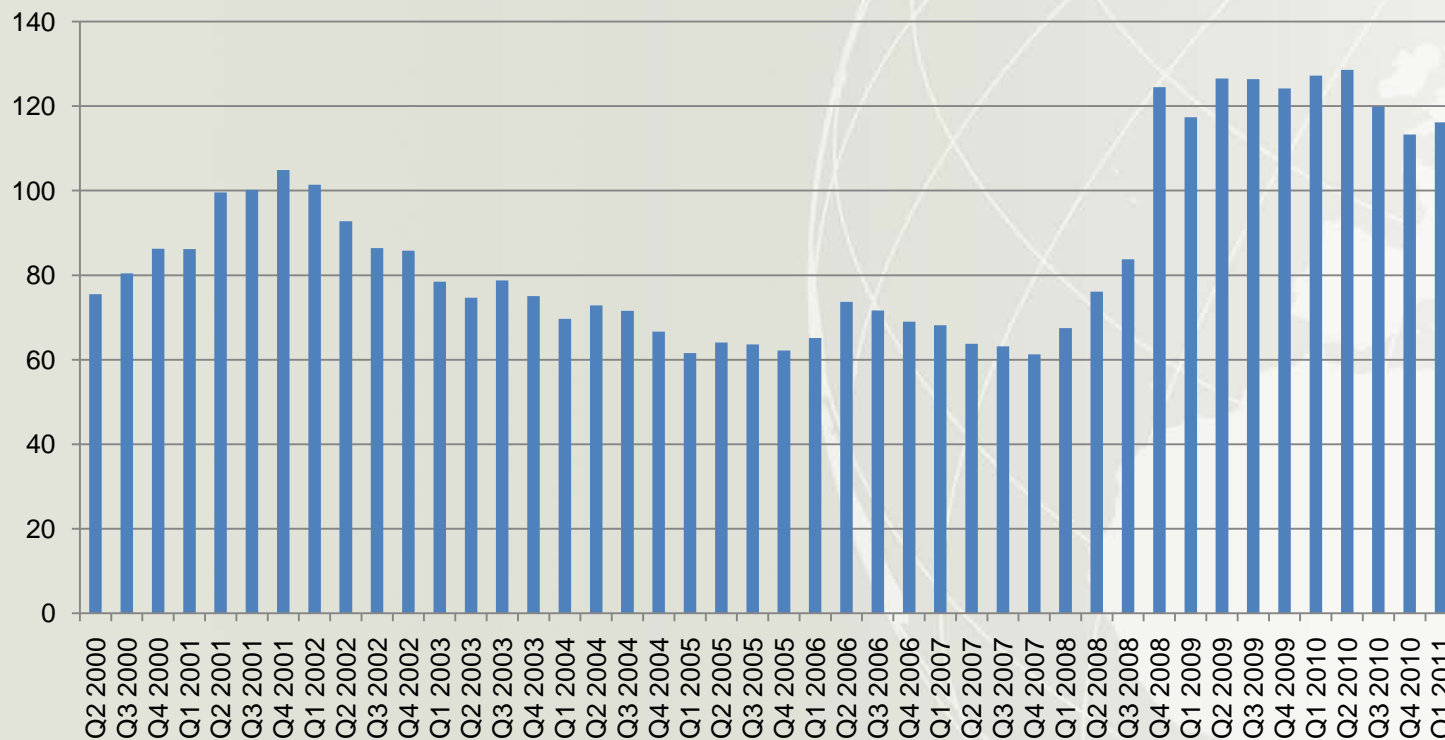
Iceland did the right things:

- The state did NOT take on debts of the banks. Shareholders, bondholders, foreign governments did.
- The exchange rate is a powerful tool that was put to good use.
- Labor markets are flexible.
- Fiscal policy was timed cleverly.



January – October 2008: Effective exchange rate declines by 40 %
To the chagrin of many housowners

Icelandic kronur/US Dollar



Introduce control on capital movements

Foreign investors trapped. Alongside with domestic investors have to put money into Icelandic assets.

15 October 2008 – 3 December 2008: Daily auctions of forex.

Succeeds in keeping the payment systems functioning

Take immediate action to create new banks

Sort out the problem with bad banks later. Still work in progress.
The dispute with UK and NL over Icesave may end in court.
But that is okay.



Call upon the IMF. To get advice. And money. Stand by agreement (SBA) to:

- Prevent further sharp depreciation of ISK
- Fiscal consolidation
- Restructuring the banks

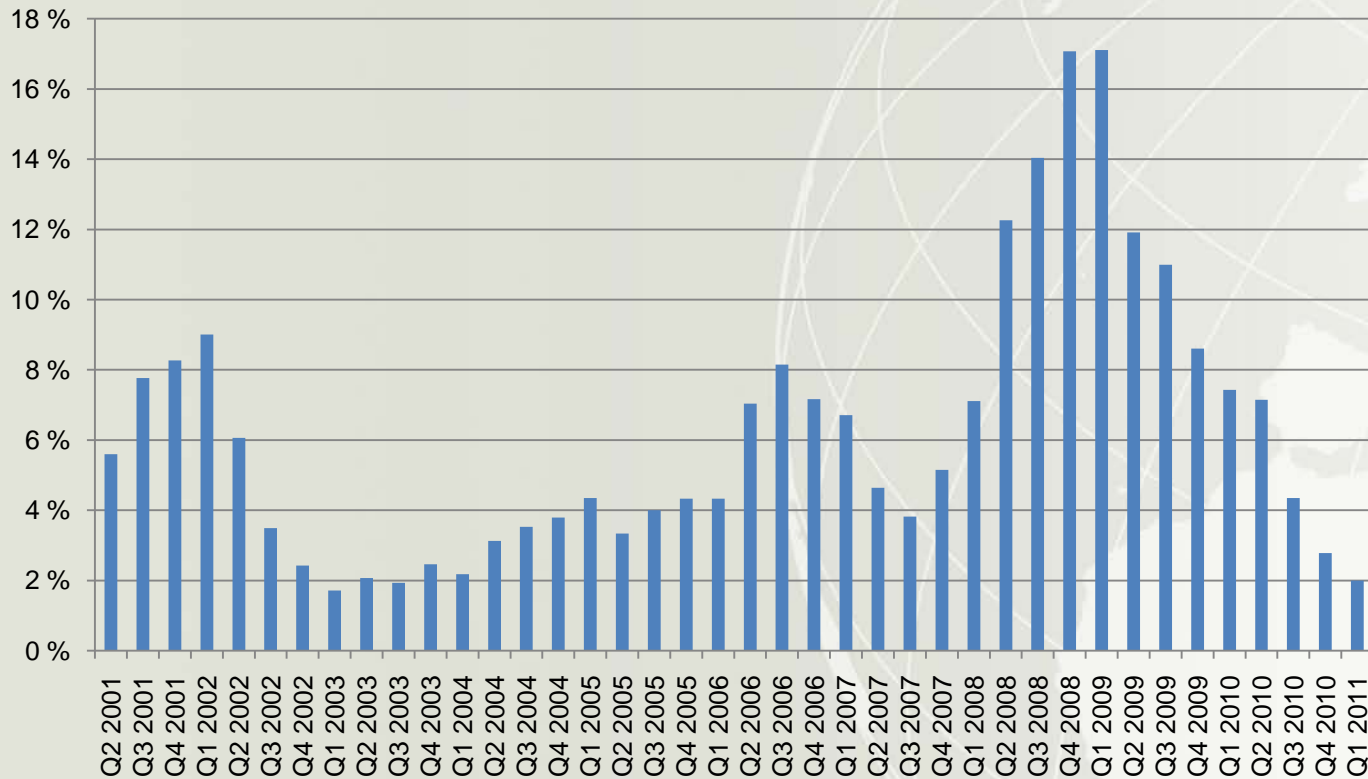
Irish banks were too big to fail (3 times GDP);
Icelandic ones too big to save (9 times GDP).

Iceland proved that other governments are wrong to say there is no alternative to paying for banks' losses. Why is it that such a view prevails?



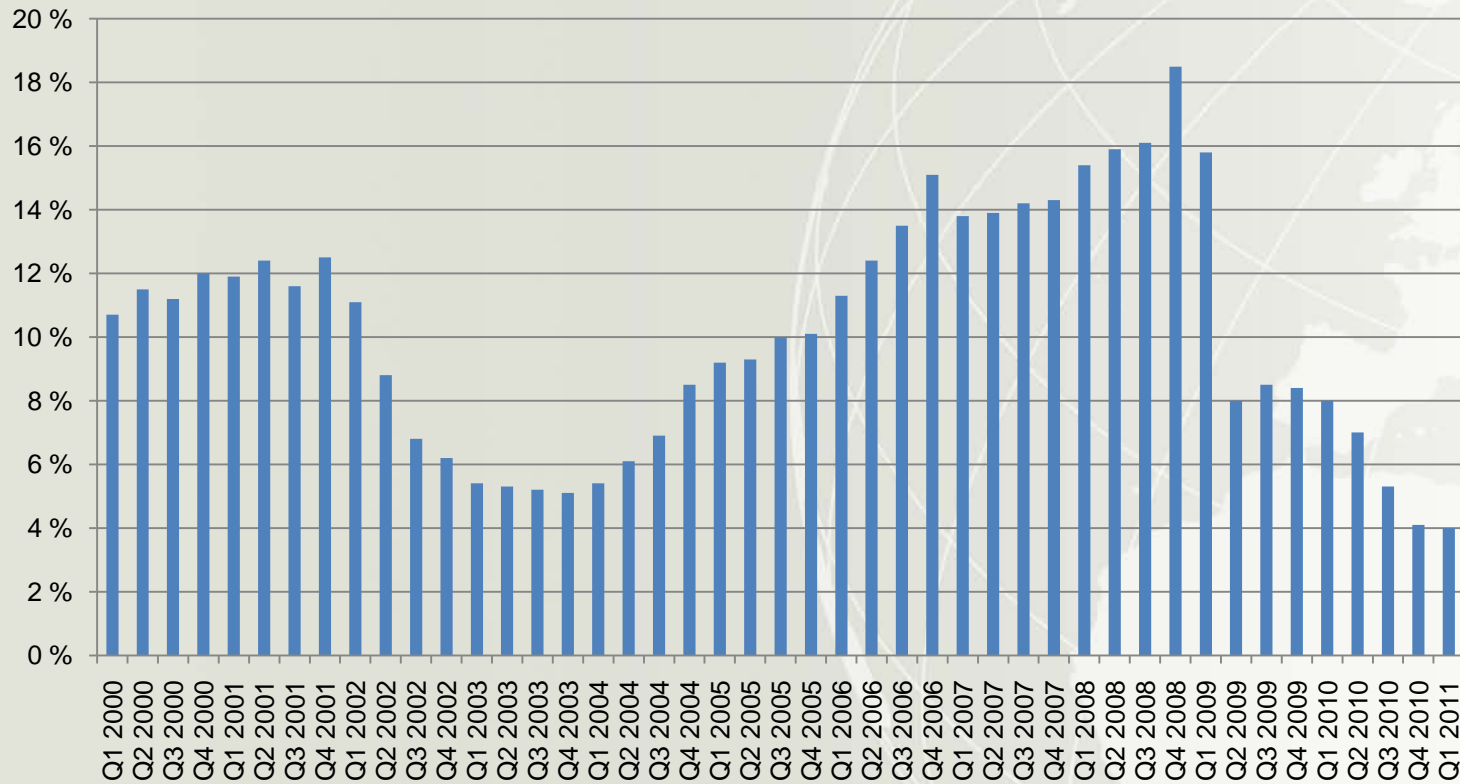
Inflation soars as the external value of ISK declines sharply

Inflation YoY



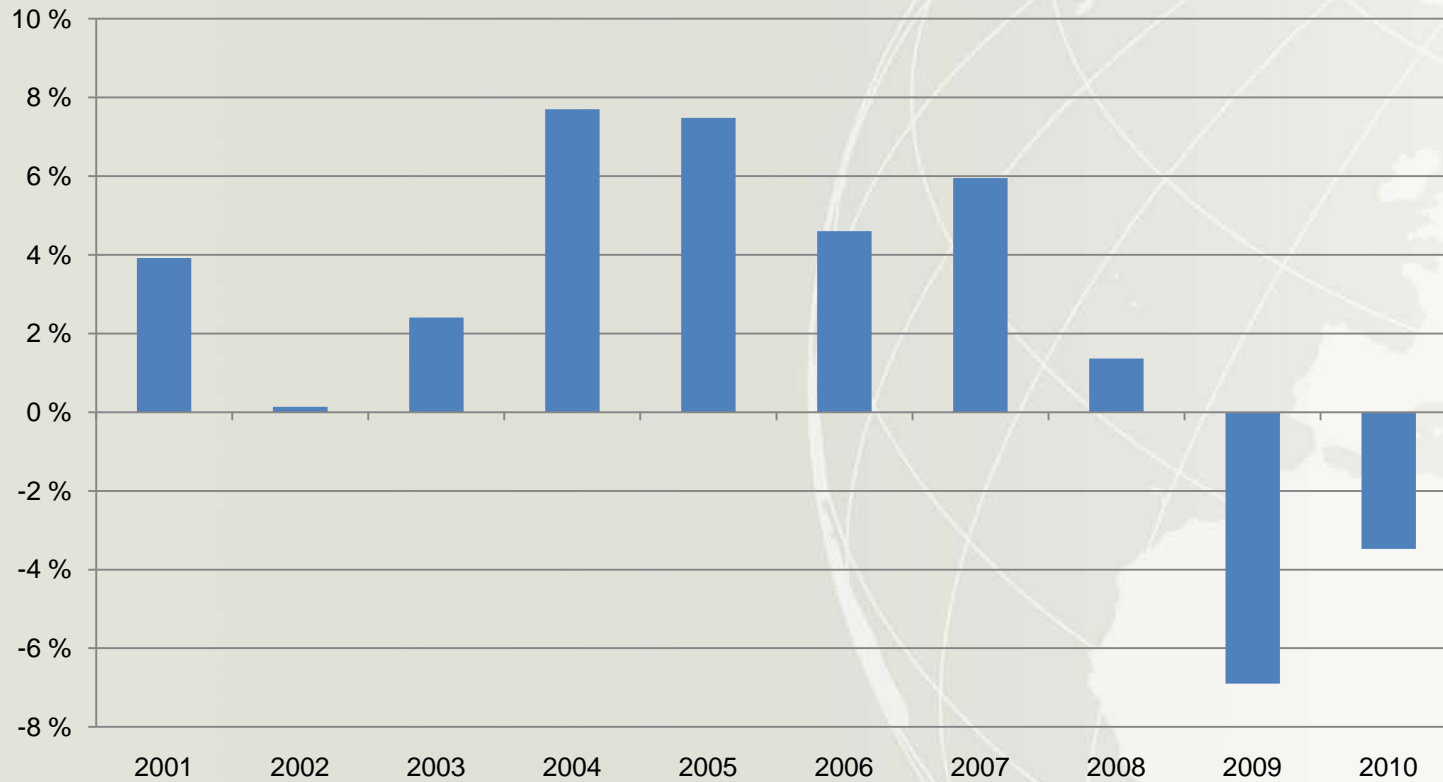
As inflation picks up, so does the rate of interest

3-month interbank rate (REIBOR)



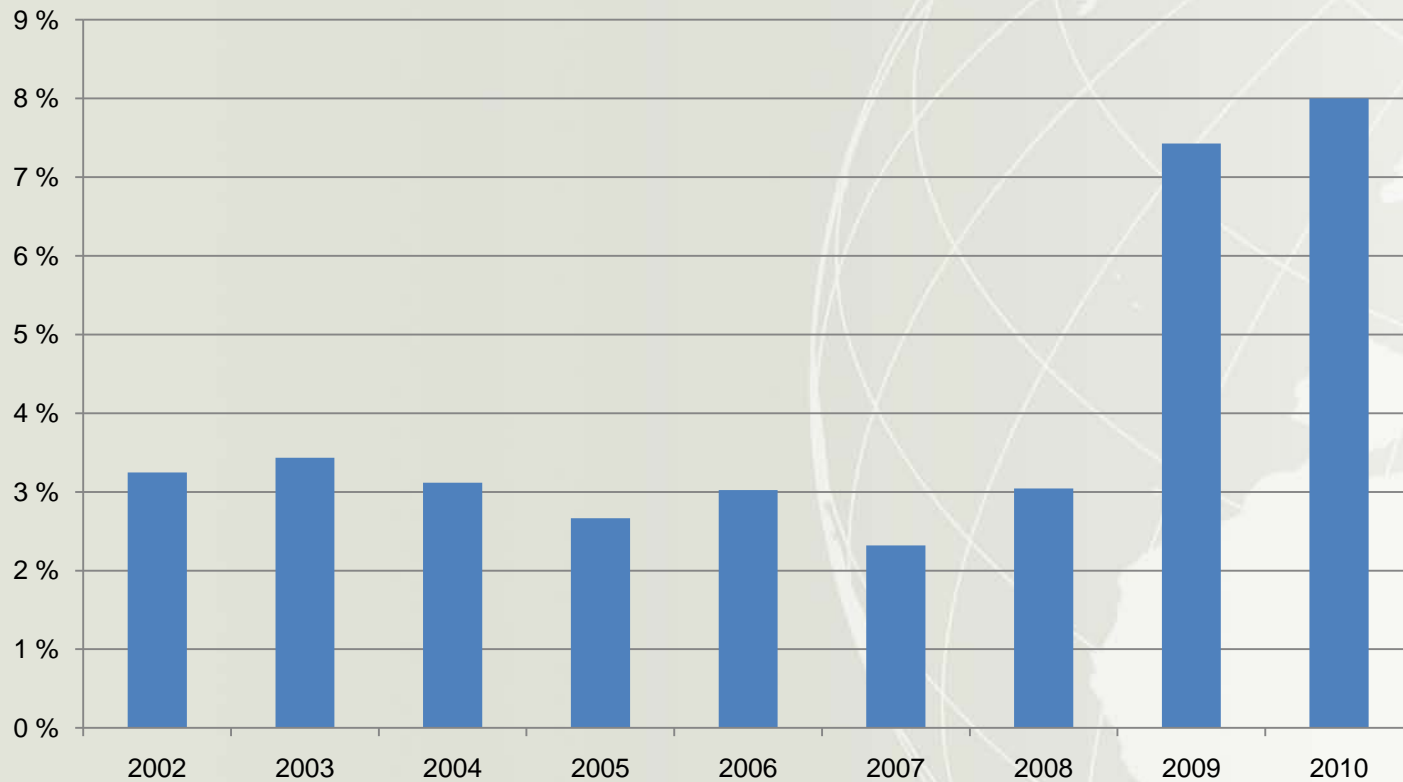
Economic growth takes a solid beating

Real GDP growth



And the rate of unemployment more than doubles from 2008 to 2009

Unemployment rate



6. EURO FOR ICELAND?

Euro – a trap for countries wanting to regain competitiveness.

- Taking away policy instruments (interest rate and exchange rate) without taking the consequences of it. When a country cannot default by devaluation, debt restructuring is needed.
- Teaching other countries German fiscal policy and wage policy should have been on top of the agenda before launching the euro.
- German avoids paying fine in 2004-2005.
And whatever discipline that might have been there, evaporates.

Capital controls were introduced in Iceland in November 2008.

And may remain in place for longer than anticipated.

Within the IMF – discussing the case for permanent controls.

Remember Keynes took that as his point of departure in 1944.



7. CONCLUDING OBSERVATIONS

Public debt from 30 % of GDP to 115 % of GDP

- Needed to recapitalize the banks
- Expansionary fiscal policy to avoid a more severe downturn

Like the Americans, the Icelanders may make ROW pay part of its obligations

- USA through inflation
- Iceland through deposit insurance being picked up abroad

Primary surplus already, i.e. government budget in the black before interest payments.

