Iceland’s Deep Freeze
Observations on an Economic Crisis

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Overview

• Introduction

• 1. What happened?
• 2. Why did it happen?
• 3. Icesave
• 4. How will Iceland recover?
What happened?
Frightening comments from the special investigation commission

- “Probably there is no commission that has had to bring its’ nation as bad news as this commission”
  - Supreme Court Justice Pall Hreinsson, commission chairman, Aug. 8, 2009
- “[I have] at times almost cried and sometimes been very irritated over what [I have] seen. When [I have] realized where things were done and especially where things were not done then [I become] hurt and disappointed”
  - Parliament Ombudsman Tryggvi Gunnarsson, commission member, Jan. 25, 2010
“A systemic crisis, the first in an advanced country”
Economic growth

-10%  -8%  -6%  -4%  -2%  0%  2%  4%  6%  8%  10%

2003  2004  2005  2006  2007  2008  2009  2010  2011
Inflation
Currency: 100 ISK = EUR
State budget

% of GDP

Stock index

OMX Iceland 15
Why did it happen?
Triple B: Bad BANKING, bad POLICIES, bad LUCK

“Recent history of ineffective bank supervision, exceptionally aggressive banks and inadequate macroeconomic policies.”
OECD Sep. 2009
“It appears that the Icelandic financial supervisory authorities had become overwhelmed by the complexity of the national banking system, and had been unable to stop their expansion. In addition, there was a lack of a macro prudential framework that would have reacted to unsustainable developments in credit, leverage and risk. By the end, the size of the banks far exceeded the limited capacity of the Icelandic authorities to rescue them.”

Bad banking

“Seemingly unlimited access to cheap capital, excessive risk-taking and lax standards of risk management.”

Danielsson and Zoega, Feb. 2009
Banks far too big as a ratio of GDP
Bad banking decisions

- Highly concentrated loan portfolio
- Largest borrowers highly leveraged
- Extensive cross-holdings between financial and non-financial firms
- Huge loans to owners and management
- Covert activities to maintain high share price
- Huge loans with sole collateral in own stocks
Bad economic policies

• During period of massive construction in energy sector and heavy industries government followed expansionary policies:
  – Lowered taxes
  – Increased housing loans
  – Increased expenditure

• Central Bank’s monetary policy did not help:
  – Reduced bank reserve requirements
  – Raised interest rates, encouraging households and firms to borrow in foreign currencies with low rates, as well as stimulating currency inflows for carry trade
Growing external debt
Immaturity

• Short experience in running a modern banking system
  – Boards and senior management Icelanders with little international banking experience
• Political favoritism when banks privatized
• Weak supervision in small country with tight political connections between private sector and political superstructure
Weak supervision

• Weak Financial Supervisory Authority with inadequate government support:
  – FSA budget up by 47% while bank assets grew 900%.
• Central Bank appears to have done little to prevent the banking system collapse
• Central Bank highly politicized, unable to assume leadership role in averting crisis
• Government may have known about pending failure of banking system, but did not act
Warnings opposed by positive reports

Negative reports:
• Credit ratings downgraded Feb. 2006
• Danske Bank Mar. 2006
• Aliber May 2008
• Buiter, Sibert July 2008

Positive reports:
Herbertsson, Mishkin May 2006
Baldursson, Portes Nov. 2007
Central Bank April 2008
FSA August 2008
Bad luck: Lehman collapse

• The Lehman bankruptcy triggered a widespread crisis of confidence.

• Global financial markets seized up and entered a new and deeper state of crisis:
  – Credit and money markets essentially frozen
  – Equity prices plummeting
  – Bank access to funding eroded
  – Bank capital shrinking due to accumulating mark to market losses
Iceland: Banking system collapse

• Three major banks collapsed Oct. 7-8, 2008
• Banks no. 4 and 5 collapsed in March 2009
• Banks no. 6 and 7, as well as several smaller savings banks, allowed to stay alive pending finalization of government rescue plans
• Only three small banks did not need support
Private sector and households severely wounded

- Up to 60% of large firms technically bankrupt
- 20% of households in deep trouble or will lose all assets
- 20% of households hurting but surviving
- Comprehensive restructuring procedures absolutely necessary, but not yet available
IMF stepped in, additional loan commitments from other countries

- **International Monetary Fund**, USD 2.1 Billion stand-by facility, USD 665 million already paid, rest subject to Icesave solution and periodic reviews of strict performance criteria, including fiscal and monetary goals
- **Nordic countries**, USD 2.5 Billion, subject to resolution of Icesave dispute
- **Faroe Islands**, USD 50 Million, already paid
- **Poland**, USD 200 Million, awaiting next reviews of IMF
Currency controls weak at first

• Capital flows severely limited
  – Blocked accounts of foreign investors could otherwise quickly drain foreign currency reserves
  – A potentially bigger threat is flight of domestic assets

• Mandatory repatriation of foreign currency

• Lax enforcement at first led to widespread violation of the controls

• Stricter enforcement has led to numerous police investigations, arrests and freezing of assets
ICESAVE
Icesave

• A large Icelandic bank launched an internet banking scheme through its branches in UK and Netherlands

• Icelandic deposit guarantee fund was supposed to guarantee deposits up to 20,887 Euros

• When the bank collapsed the British and Dutch governments funded the guarantee but demanded repayment from the Icelandic state
Political dispute in Iceland

• Governments (present and past) agreed to pay when bank assets have been liquidated

• Widespread criticism of terms
  – Too high interest rates on loan
  – Payments ought to be subject to GDP growth
    • Iceland needs to retain some of the growth to rebuild own economy
  – Estimated cost in excess of 16,000 USD per capita

• Some lawyers maintain that EU directive on deposit guarantees is flawed and Iceland should not pay at all
Presidential veto

• Parliament has passed two bills authorizing state guarantee for Icesave repayment loan
  – Aug. 2009 law signed by President, included conditions the British and Dutch did not accept
  – Dec. 2009 law revised the conditions, but this time the President did not sign, referring to widespread public dissatisfaction
    • He had received a petition signed by 60 thousand voters (more than a quarter of voting population)
Latest developments in Icesave dispute

• UK and Dutch authorities have agreed to new talks on revisions to the agreement next week
  – Precondition: All political parties in Iceland agree on terms

• Iceland proposes earlier repayment of principal, but no interest payments

• Increasing likelihood of Parliament rescinding the law prior to national vote
National referendum on veto

• Only second time in the 65 year history of the republic that the President has not signed
• Law comes into effect but a national vote has to be called
• Voting date set for March 6th
• Recent opinion polls show 66% will say no
How will Iceland recover?
Economic recovery - scenario 1

• Icesave agreement reached
• Foreign loans strengthen currency reserves
• Currency controls gradually lifted
• Foreign funding becomes available (loans and direct investments)
• Capital investment rises, increasing employment and private consumption
• Back in decent shape in 3-5 years
Economic recovery - scenario 2

• No Icesave agreement
• No further strengthening of currency reserves
• Severe reduction of imports to save currency to meet foreign obligations and prevent defaults
• Very little capital investments
• Unemployment remains high, private consumption decreases further
• Recovery takes 10-15 years
Despite crash Iceland still productive

IMF statistics:

• Iceland 12th highest GDP per capita in 2009 (PPP weighted)
  – Similar to Denmark, Sweden and Australia
  – Was ranked no 8 in 2007

• The problem is not our capacity to produce, we are just too deep in debt

• We need more time to honor our obligations
Economy based on strong pillars

- Fisheries
- Green energy
- Tourism
- High-tech industries
- Modern infrastructure in good shape
- Well-educated workforce, widespread use of computers, efficient service sector
Fisheries and energy

• Fisheries
  – World leading in catch per fisherman
  – World leader in fisheries technology
  – Quota system to prevent overfishing

• Energy
  – Abundant hydro and geothermal energy sources
  – Cool climate lowers operating costs for many industries
Tourism and high-tech industries

• **Tourism**
  – 500 K visitors annually (inhabitants 300 K)
  – Unspoilt nature main attraction
  – More tourism revenues per capita than in France!
  – High flight frequency despite small population
  – World-class arts scene and restaurants

• **High-tech industries**
  – IT and biotech industries growing fast
Capital inflows needed

• Direct investment
• Foreign currency loans
• Iceave dispute keeps foreign inflows away
  – Too risky to invest, too risky to lend
Application for EU membership

• Negotiations to start later this year
  – Current membership of EEA (European Economic Area) shortens negotiations, as majority of EU directives and regulations already implemented in Iceland
• Possible entry in 2012, along with Croatia
• Could meet criteria for using the Euro within 5 years
• Current polls show 60% against membership
Conclusion

• Widespread feeling of having been betrayed  
  – by bankers, supervisors and politicians
• However, most Icelanders optimistic about recovery taking approx. 5 years, if outside world gives us breathing space
• If not, we will just fight harder – in the Viking spirit
• A long-standing reputation as “the little country that can....”  
  – Haiti – Icelandic rescue team first to arrive