ICELAND: FROM BOOM TO BUST, AND BACK AGAIN

The Chamber of Commerce recommends that Iceland stop comparing itself with other Nordic countries because we are superior to them in most respects.

Iceland Chamber of Commerce, February 2008.

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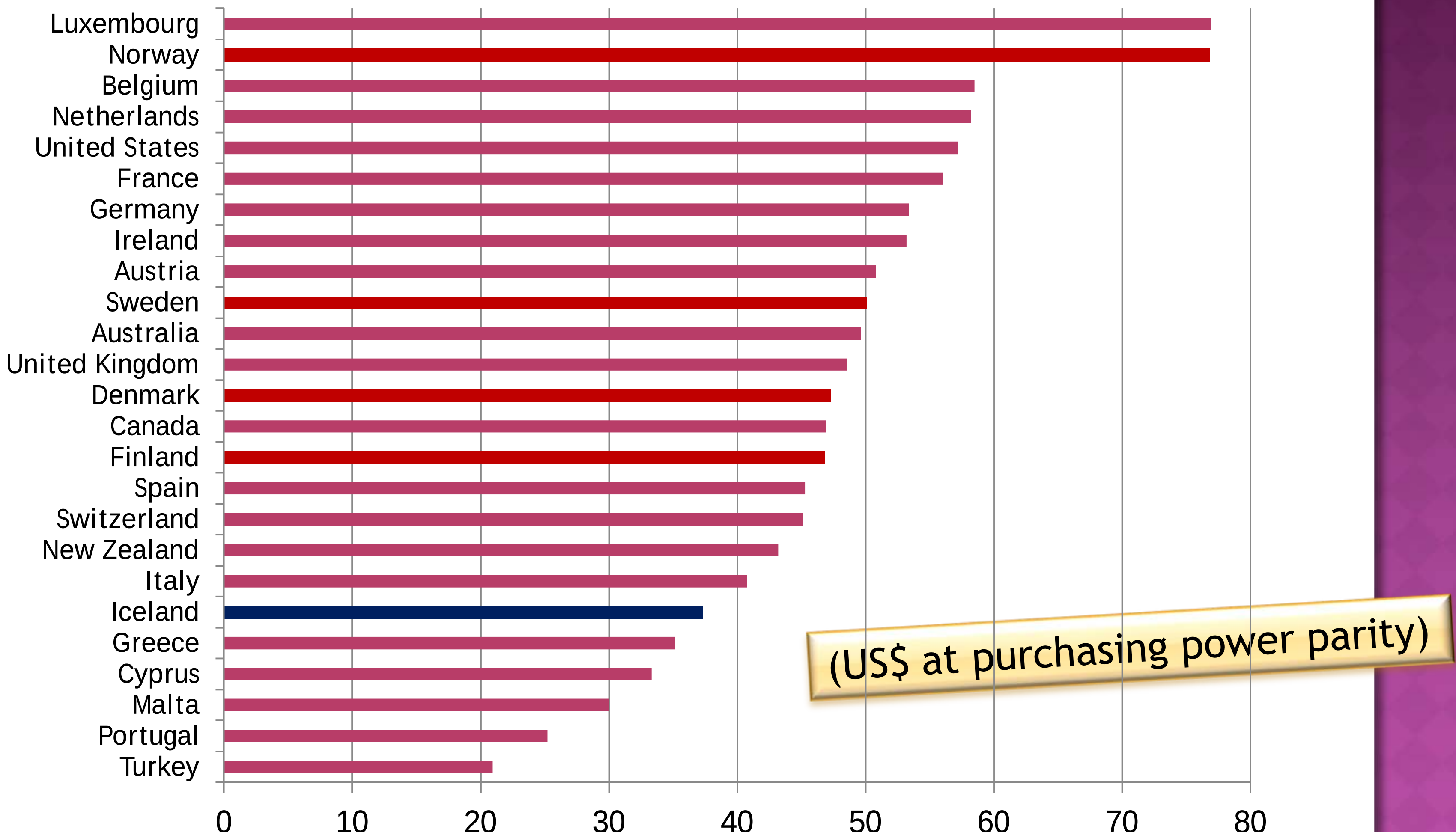
STORY IN THREE PARTS

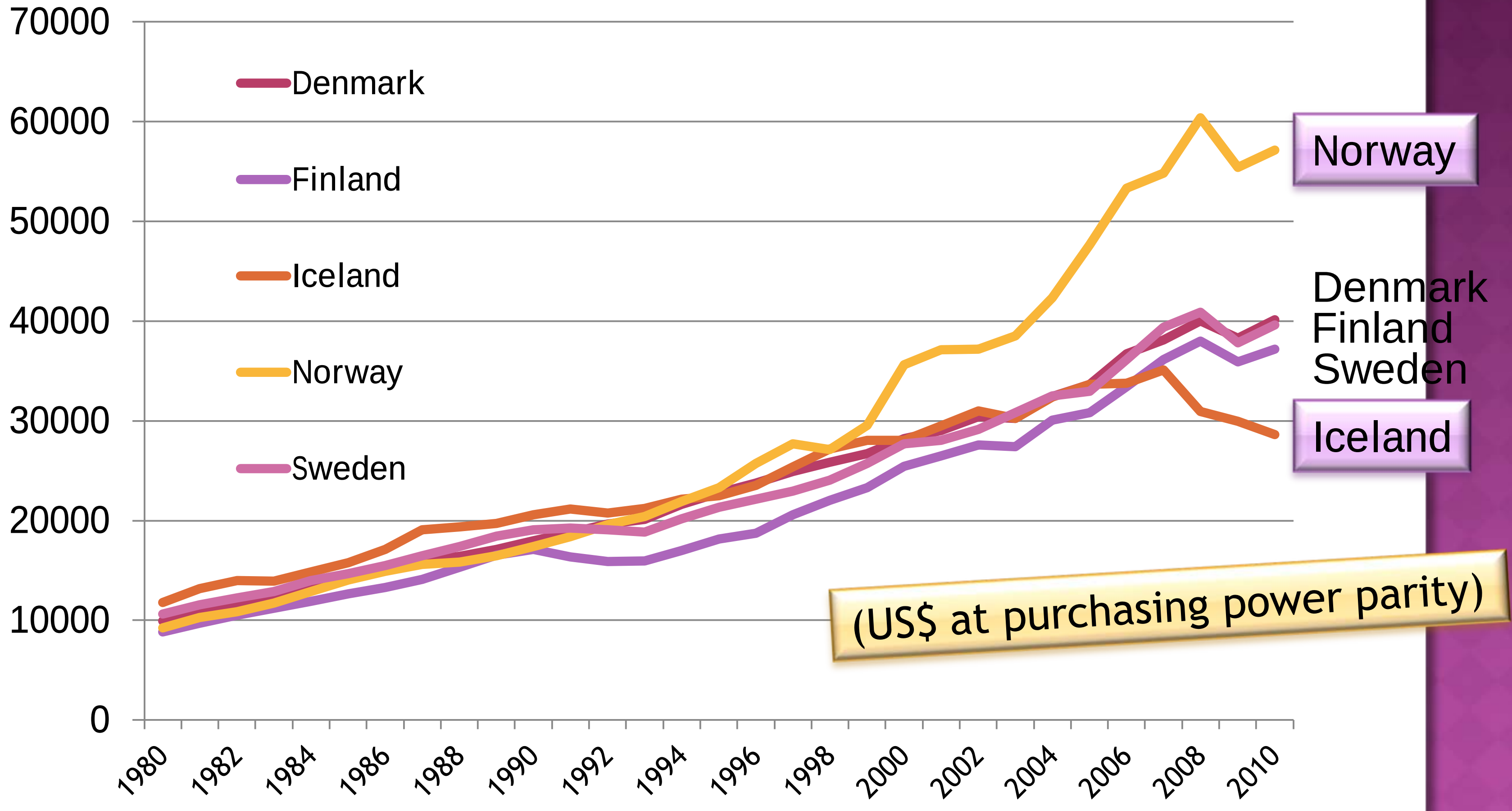
- Background and history
  - Pretty long history
- Collapse in 2008
  - Followed by temporary renationalization and reorganization of banks
- After the fall
  - Twelve lessons from crisis – leave out here
  - IMF-supported rescue operation
  - Prospects

GDP PER HOUR WORKED 2009



Source: The Conference Board and Groningen Growth and Development Centre.

GROWING APART: GNI PER CAPITA



Source: World Bank, World Development Indicators 2011.

BRIEF HISTORY OF THE BANKS I

- For decades, the government owned the banks
  - Political leaders sat side by side on bank boards, representing essentially bankrupt economic interests and dividing the spoils ("*Socialism of the Devil*")
    - With negative real interest rates and an overvalued currency, bankers exercised significant power
- Privatization 1998-2003 ought to have aimed to sever those connections, but did not fully succeed
  - Two largest banks were sold in part to well-connected individuals with close ties to the two governing parties (in their own words, "within calling distance")
    - The two parties maintained their operatives on the banks' governing boards
    - "Buyers" of banks borrowed from one another

BRIEF HISTORY OF THE BANKS II

- Banks were sold both at once at "modest" prices
- No serious attempt was made to attract foreign buyers of banks as was done in the Baltics
- Unlike Nordic and Baltic countries, there is as yet no foreign competition in Icelandic banking
  - More concentration of industry than among Nordics
  - Oligopoly is the rule in European banking
    - Market share of EU's five largest banks is over 50%
      - EU's competition policy is important
    - Iceland: three banks had 85% market share
    - Privatization was supposed to make banks more efficient, enabling them to pay higher deposit rates and charge lower lending rates
      - This did not happen, on the contrary, spreads rose

Brief History of the Banks III

- Iceland’s privatization of its state banks 1998-2003 was mismanaged in ways that contributed to collapse and to weak restraints on bank growth
  - Government ought to have constrained the banks through taxes, but didn’t – you don’t tax your friends
  - Central Bank ought to have constrained them through reserve requirements, but didn’t, on the contrary
  - Financial Supervision Authority ought to have applied more stringent stress tests, tailored to local conditions, but didn’t – it looked the other way
- Besides, several documented earlier episodes of bank problems – scandals, really – when banks were state-owned were covered up
  - No culture of accountability, no checks and balances

BRIEF HISTORY OF THE BANKS IV

- Once freed from government control, the banks kicked up their heels like cows in spring
  - Unprecedented borrowing and lending spree
  - Borrowed short abroad at low interest to make long-term housing loans at home at unprecedentedly low rates
    - Icelandic version of subprime lending
      - Loan pushers from the banks went into overdrive
      - Extended loans indexed to foreign currencies: illegal
    - Extensive insider lending without adequate collateral
      - William Black: *The Best Way to Rob a Bank Is to Own One* (2005)
      - Landsbanki Chairman: $750 million personal bankruptcy, 2/3 of which to Landsbanki that was "happy to have him as a borrower"
  - There was nothing to hold them back, no brakes

GROWTH STRATEGY? GROW, BABY, GROW

How did they grow?

- Icelandic banks copied each other's business model, and took on excessive risk
  - Fine while the going was good
  - But, if one fell, others were likely to fall as well
- Banks faced an insignificant home market, so their choice was essentially to "evolve (i.e., become international) or die"
- Banks chose the former …
  - They became international, deriving in 2007 half their earnings from abroad
    - 31 subsidiaries in 21 countries (October 2007)
- … only to suffer the latter

BLACK'S RECIPE FOR CONTROL FRAUD

When the title says it all
Article by Akerlof and Romer:
"Looting: Bankruptcy for Profit"

- "The Best Way to Rob a Bank is to Own One"
  - When a senior officer deliberately causes bad loans to be made he **does not defraud himself**
  - He **defrauds the bank's creditors and shareholders**, as a means of optimizing fictional accounting income
  - It pays to seek out bad loans because only those who have no intention of repaying are willing to offer the high loan fees and interest required

Four-point recipe

1. Grow really fast
2. Make really bad loans at higher yields
3. Pile up debts
4. Put aside pitifully low loss reserves

BLACK'S RECIPE FOR CONTROL FRAUD

The script is from Mel Brooks's movie, *The Producers* (1968): A flop pays better than a hit

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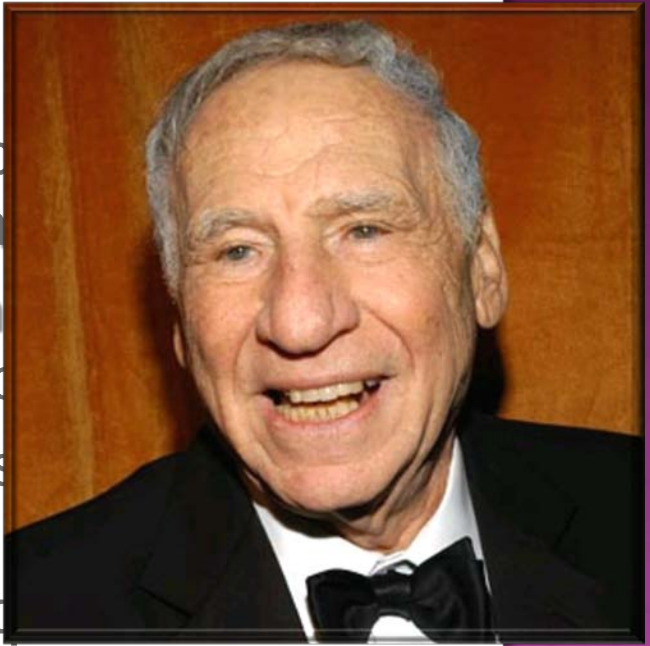

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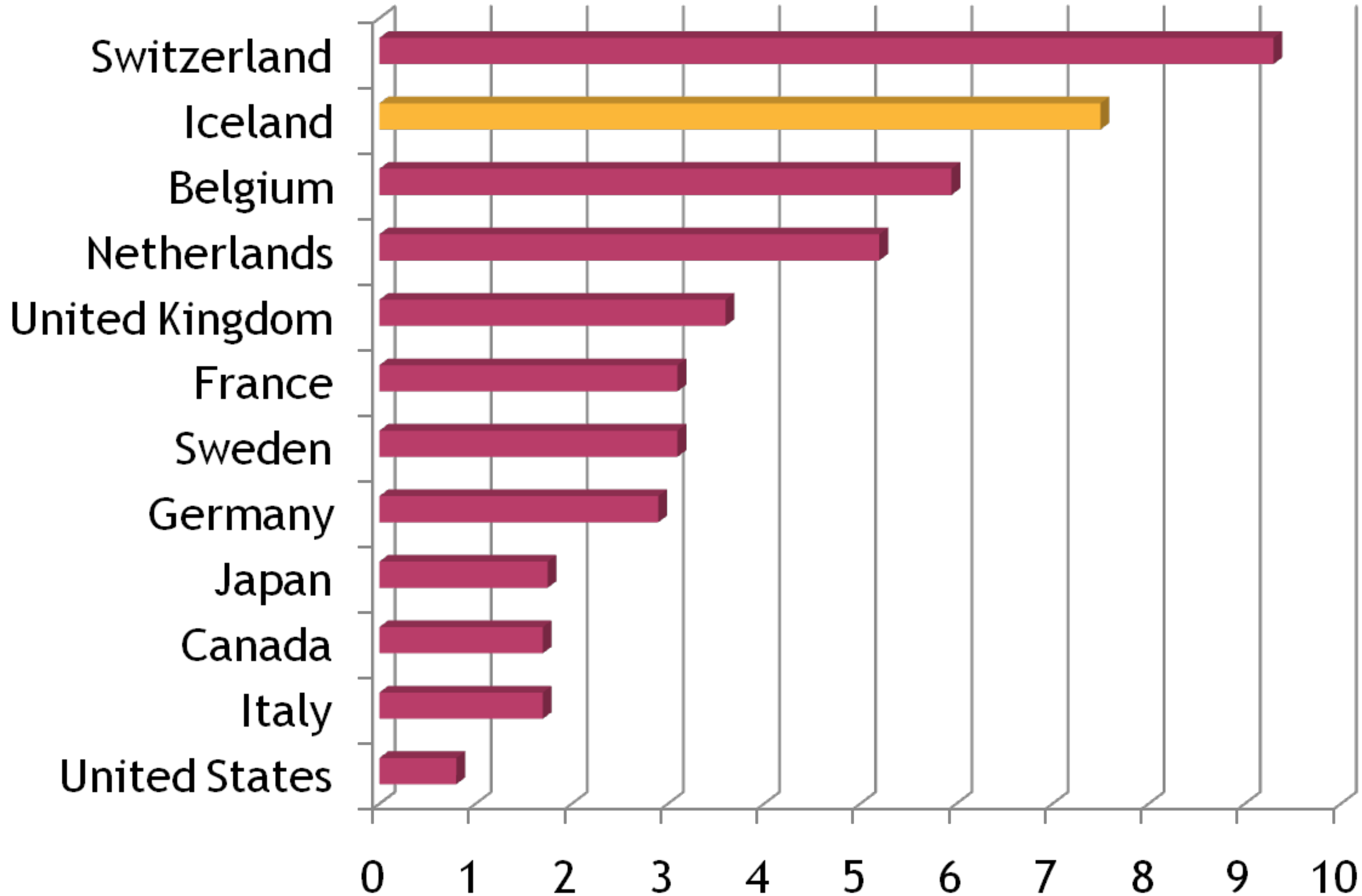
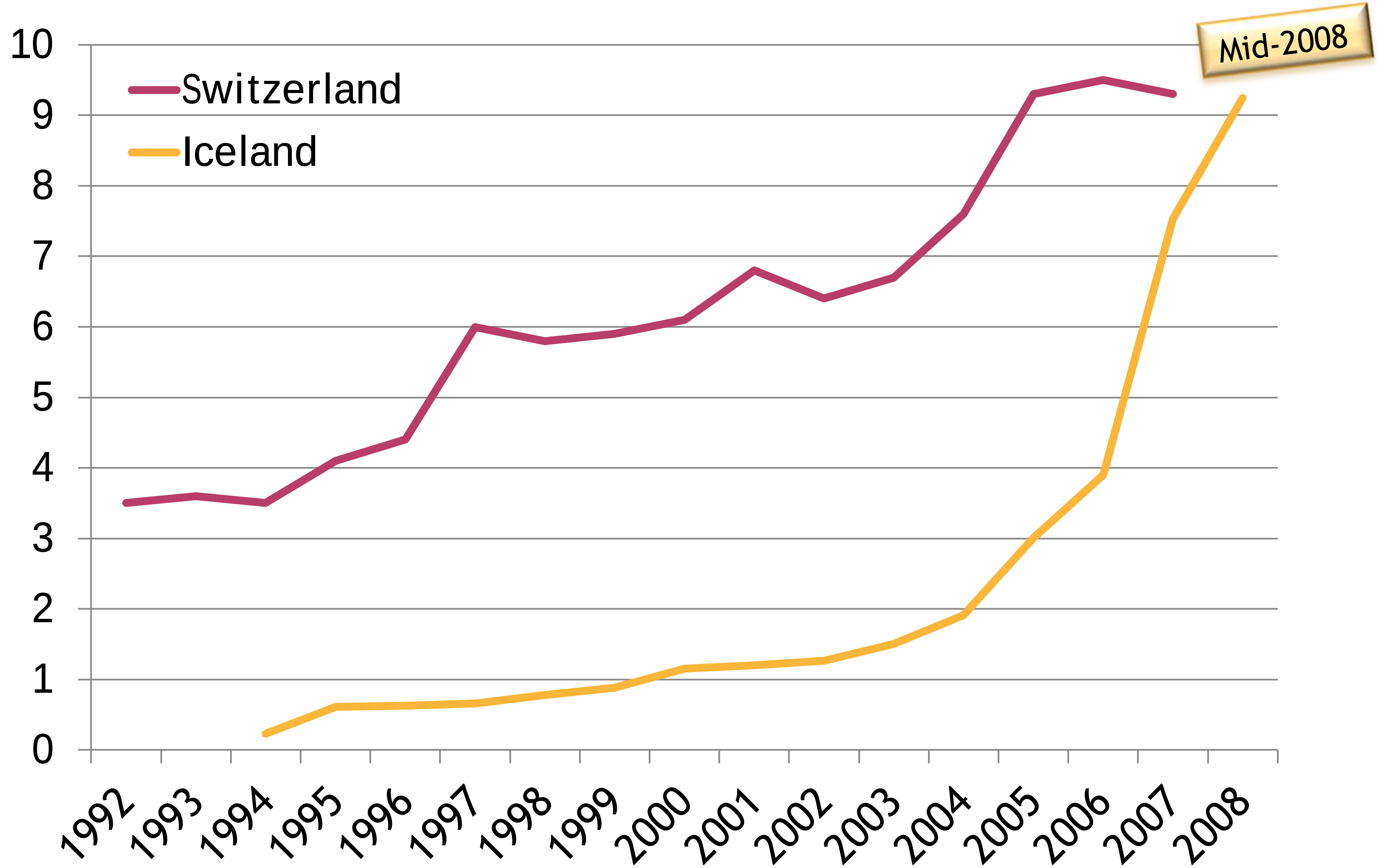
RATIO OF BANK ASSETS TO GDP 2007 (END OF YEAR)

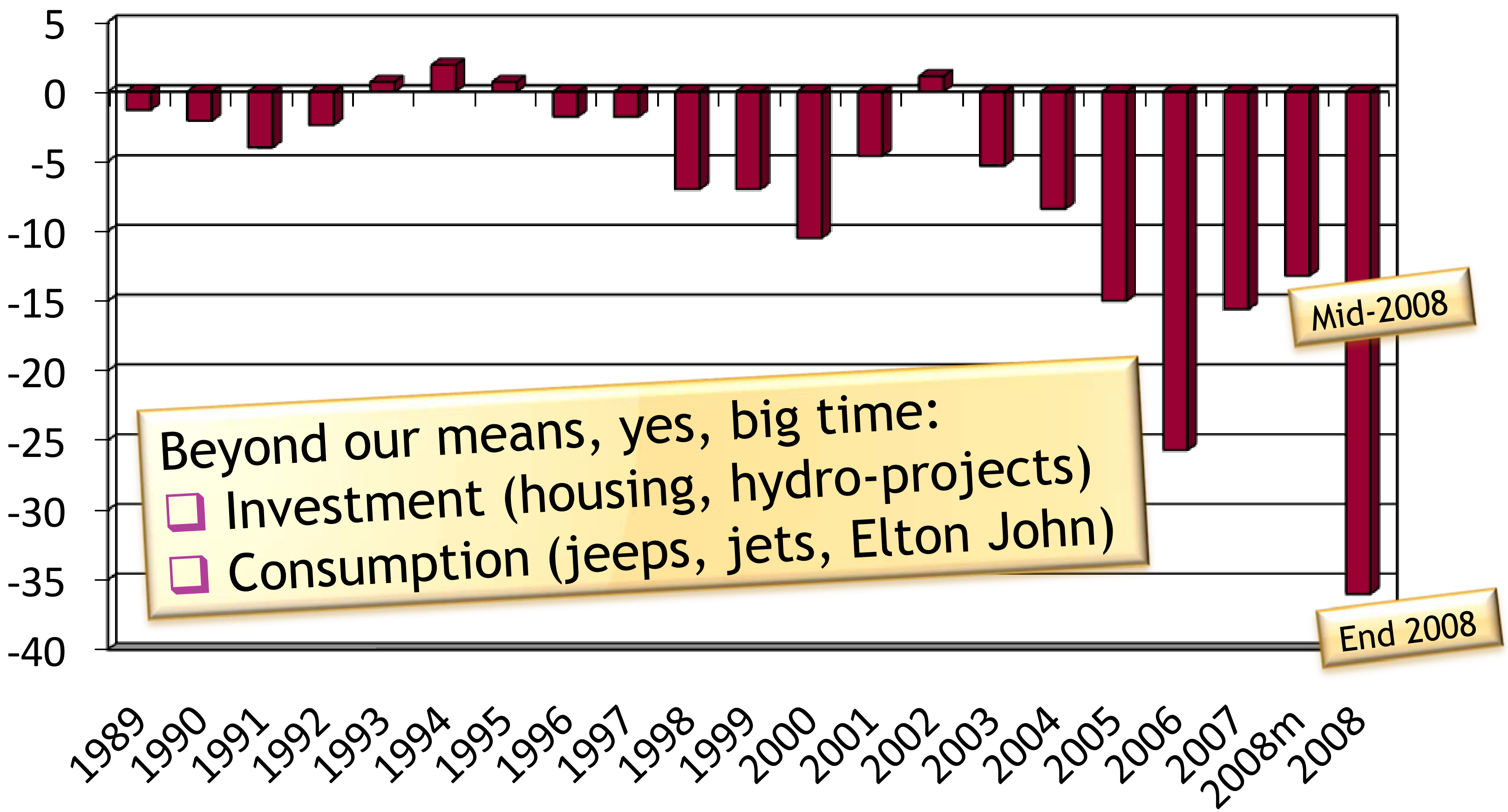


Source: Union Bank of Switzerland

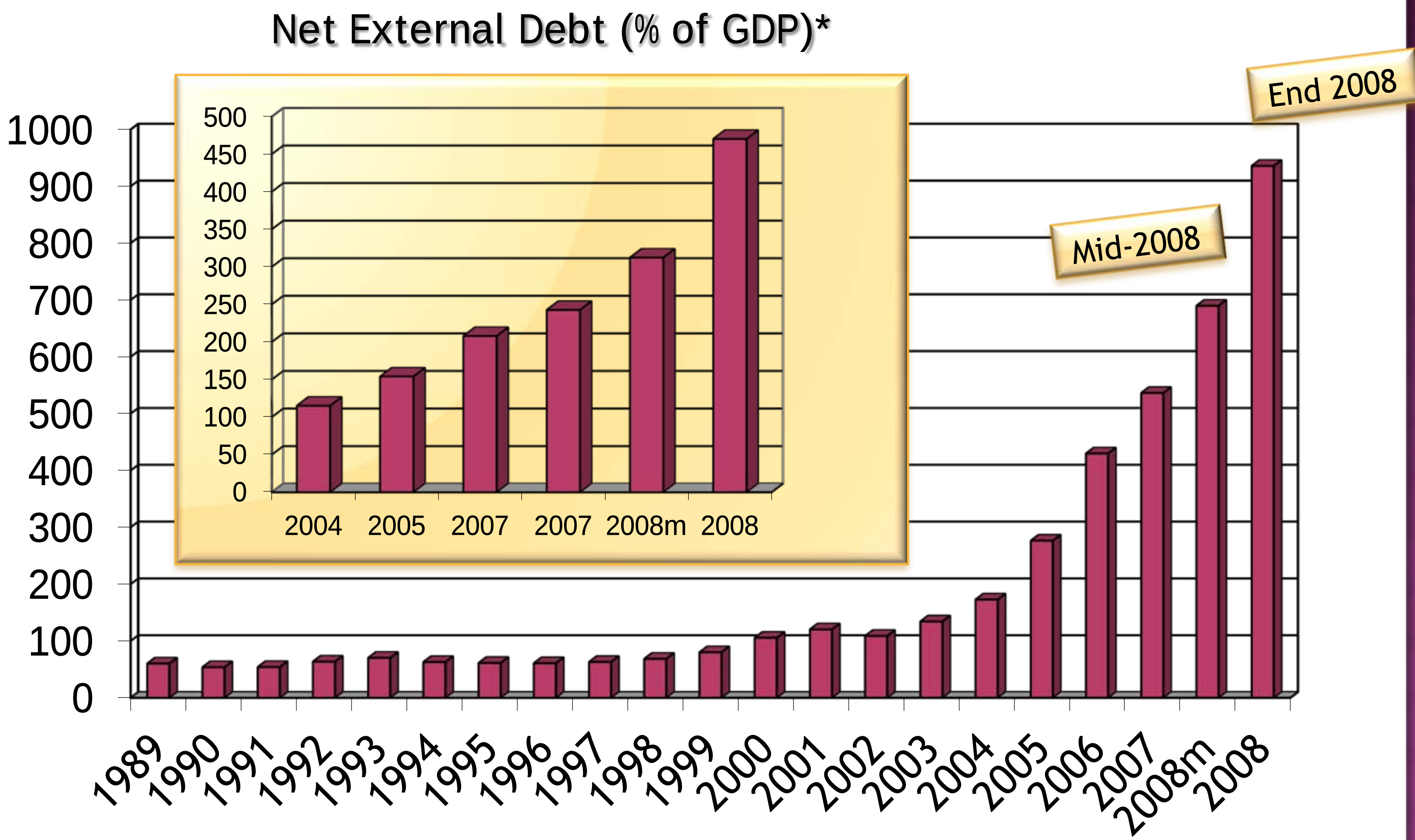
RATIO OF BANK ASSETS TO GDP 1992-2007



CURRENT ACCOUNT 1989-2008 (% OF GDP)

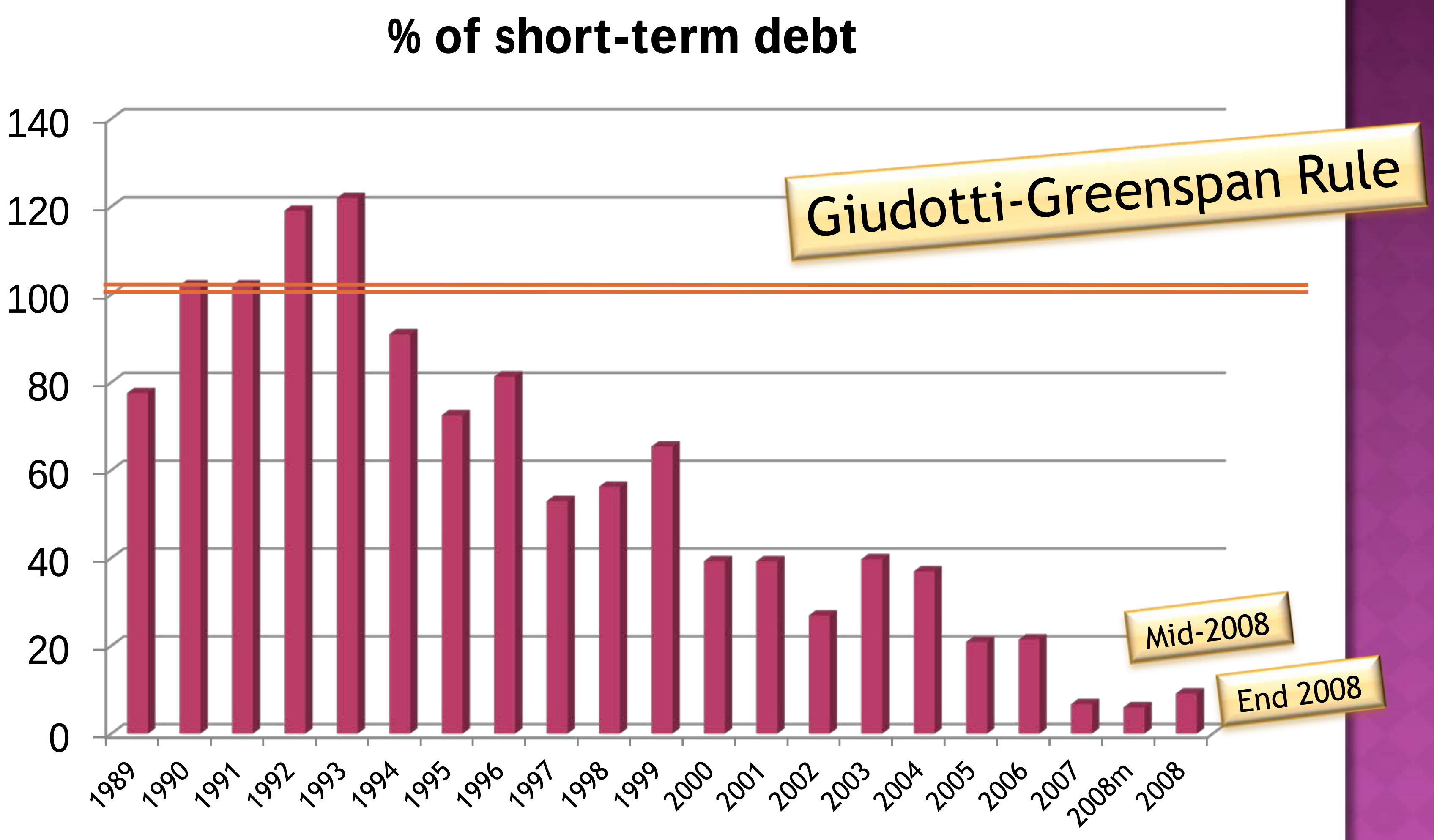


EXTERNAL DEBT 1989-2008 (% OF GDP)

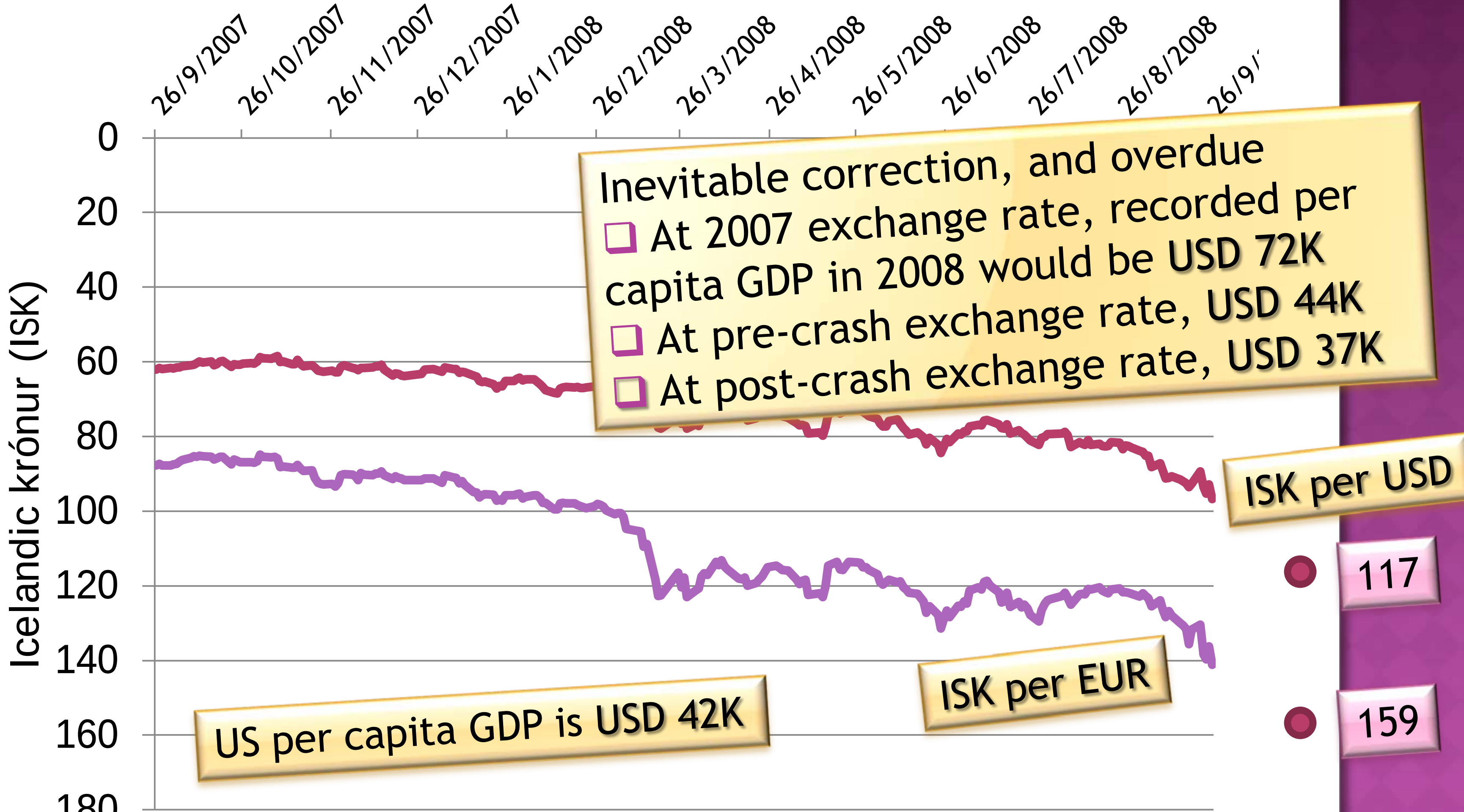


*Excluding risk capital

Central Bank Foreign Exchange Reserves 1989-2008



DEPRECIATION OF KRÓNA BY HALF SINCE FALL OF 2007



Inevitable correction, and overdue

- At 2007 exchange rate, recorded per capita GDP in 2008 would be USD 72K
- At pre-crash exchange rate, USD 44K
- At post-crash exchange rate, USD 37K

US per capita GDP is USD 42K

TWIN BUBBLES

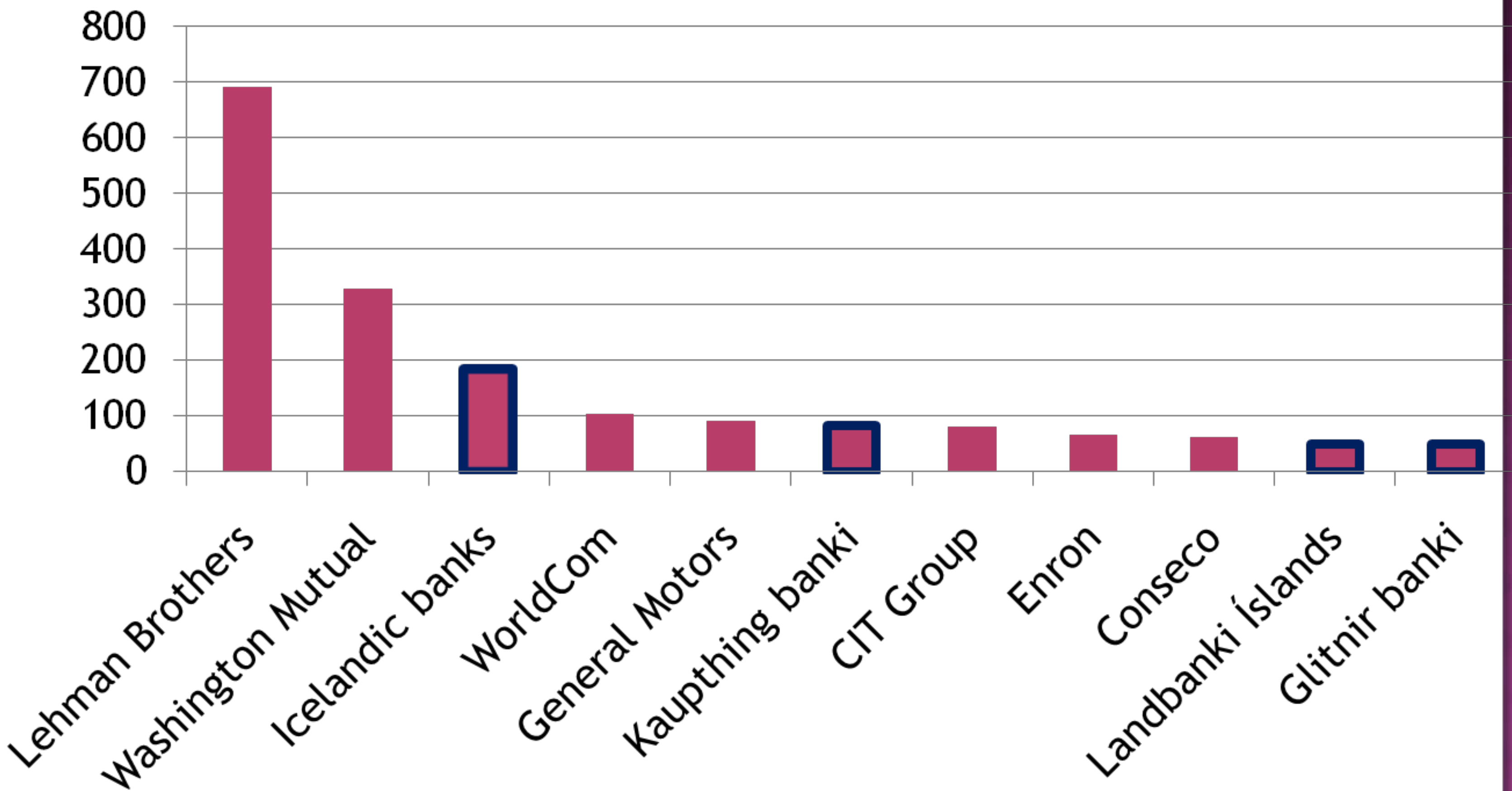
- Stock market rose by a factor of 9 from 2001 to 2007
  - 44% average annual increase six years in a row
    - World record
  - Clearly a bubble, and hence unsustainable
    - Even before bank collapse, stock market fell by more than 50% from 2007
- Real estate prices rose by a factor of 2.5 from 2001 to 2008
  - 11% per year on average
  - Led to construction boom
    - Count the cranes! (Professor Robert Aliber)
  - Also, a bubble, unsustainable
  - Accident waiting to happen

Too Big to Fail? Too Big to Save?

If a bank is too big to fail, it is too big

- End of September 2008: Collapse
  - First, Glitnir collapsed
    - Glitnir asked Central Bank for $600 million loan to meet due date 15 days later as foreign credit line had closed; Central Bank refused
  - Within a week, Landsbanki and Kaupthing also collapsed
    - The three accounted for 85% of the banking system
    - Most of the remaining 15% went under a little later
- Government passed emergency laws and put all three banks into administration
  - Deposits were granted priority over other claims on the banks
  - Bank shares became worthless overnight
  - New bank/old bank approach
    - New state banks took over deposits and provided domestic banking services, injected new capital into them, also into Central Bank
    - Old private banks were left with their dodgy assets and foreign debts
    - Resolution committees were appointed to liquidate old banks
- In effect, temporary renationalization
  - Based on Nordic good bank/bad bank approach, worked well in crisis of 1988-1993
  - Glitnir and Kaupthing have now been reprivatized with new names by exchanging their debts for equity, now owned by US hedge funds with no plans to stay
  - State maintains 81% share in Landsbanki, now biggest of the three
  - Winding-up committees at work

TEN LARGEST CORPORATE BANKRUPTCIES OF ALL TIME (USD BILLION)



Source: Financial Supervisory Authority of Iceland.

IMF PROGRAM IN NOVEMBER 2008

- Two-year stand-by arrangement, extended to three
  - IMF provides $2.1 billion, with $0.8 billion up front and the rest in eight equal installments subject to quarterly reviews
    - Exceptional access to Fund resources, amounting to nearly 1,200% of Iceland's quota
    - Second installment, scheduled for February 2009, was delayed for months due to delays in implementation
  - Fund money covers 42% of total financing gap of $5 billion during 2008-2011
  - Remaining $2.9 billion is provided by
    - Denmark, Finland, Norway, and Sweden (conditional, 2.5)
    - Russia (conditional, but withdrew)
    - Poland (conditional, 0.2)
    - Faroe Islands (unconditional, 0.05)
    - EU (macro-stabilization loan, 0.15)

Shared conditionality:
Fund needs to listen to
concerns of other creditors

MAIN FEATURES OF IMF PROGRAM

- Monetary restraint (18% policy rate, 0% real)
- Transparent bank restructuring (takes too long)
- Floating exchange rate
  - Supported by strict but **temporary capital controls**
    - Delays of program implementation caused controls to last longer than envisaged (perhaps 5-7 years, not 2-3)
- Fiscal space provided in 2009, with government budget deficit of 14% of GDP; turned out at 9%
  - Fiscal restraint kicked in from 2010 onward
    - Cut spending from 50% of GDP in 2009 to 40% in 2016
    - Keep revenue at 41% of GDP from 2009 to 2016
    - Adjustment equivalent to 10% of GDP in 7 years; tough
- Different from Asian programs 10 years ago
  - IMF tolerates capital controls, grants fiscal space

EXPECTED RESULTS OF PROGRAM

%	2009	2010	2011	2012	2013	2014	2015	2016
GDP growth*	-7	-3	2	3	3	3	3	3
Unemployment**	8	8	7	6	4	4	4	4
Inflation*	12	5	4	4	2.5	2.5	2.5	2.5
Gross foreign debt***	266	279	252	188	178	169	158	147
Net foreign debt***	140	147	141	85	85	76	73	64

* % per year

** % of labor force

*** public and private, % of GDP

Measured in krónur, GDP will recover by 2014
In euros, recovery of GDP will take longer

Source: IMF, August 2011.

PROSPECTS I

- Two views
  - **Pessimists** initially warned that debt burden might threaten to match that which the allies imposed on Germany at **Versailles** after World War I, with predictable economic and political consequences
    - France, UK, US, Italy imposed war damages on Germany equivalent to 80% of GDP, then reduced their claim by half
    - Victors also took land, reducing Germany by more than 10%
    - Claim was not paid in full, was settled peacefully in 1932
  - **Optimists** emphasize that the **Faroe Islands** emerged from their deep financial crisis in early 1990s with an external debt to Denmark equivalent to 120% of GDP, and were able to repay with interest within 6-8 years, with relatively minor forgiveness
    - Long-term loss to Faroes despite recovery in other respects
      - Net emigration of about 10% of population
      - This Iceland (pop. 320,000) must avoid

PROSPECTS II

- Successful recovery rests on two pillars
  - Must effectively implement IMF program and supplement it with further reforms
    - Decision by Parliament in July 2009 to apply for EU and EMU membership was intended to send an encouraging signal to international community
  - Must also uncover the causes of the collapse, including massive failure of policy and institutions
    - Rather than appoint an international Commission of Enquiry, Parliament appointed a domestic Investigation Committee, risking a deepening crisis of confidence should the committee fail to convince the public
      - In 2010, committee produced a damning report, proposing possible legal proceedings against 3 cabinet ministers and 4 public officials, including 3 central bank governors

PROSPECTS III

A number to remember

99.95%

- What next?
  - Successful completion of IMF program needs to be carried forward by local authorities
  - By applying for EU membership, Iceland has indicated its readiness to share its sovereignty with other EU members as required by rules of the game, including the adoption of the euro
    - But then: havoc in Europe puts strategy in jeopardy
  - EU membership will ultimately be decided in a national referendum when terms of accession have been laid down through negotiations
    - With Europe in good shape, the result may be Yes
    - With Europe in a mess, the result may be No

THE END