Iceland’s boom, bust & “capital outflow management”

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Background

- Based on research with Silla Sigurgeirsdottir, Political Science, Uni of Iceland
- Iceland tiny (320,000 people, area = 42% Great Britain)
- “Small pond, big fish” problem.
- Iceland of wider interest b/c shows in exaggerated form the ideas, interests, institutions that produced huge global imbalances & financial fragility over 2000s.

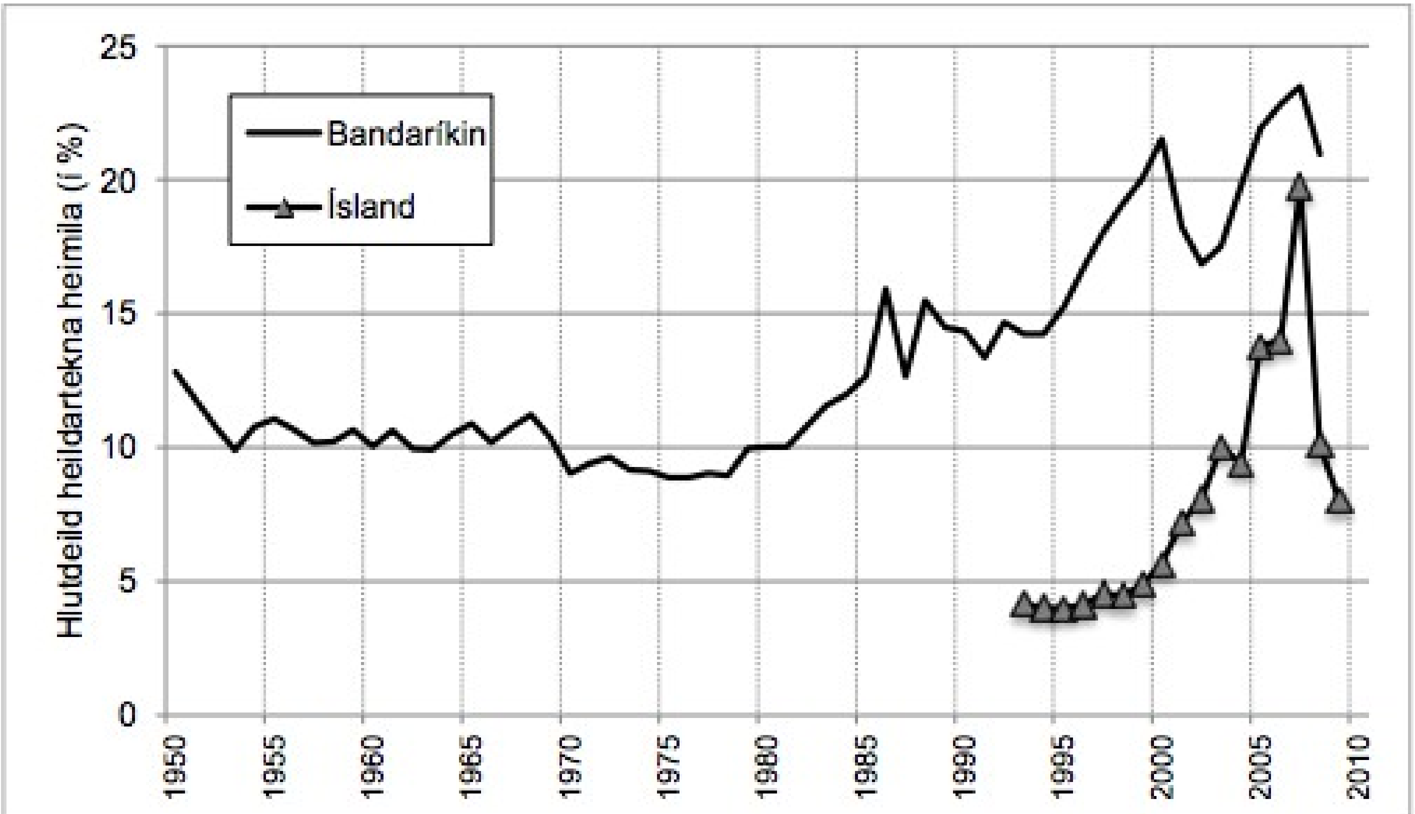
Great Liberalization, from 1990s

- Reagan- & Thatcher-inspired neoliberal reforms in previously regulated, corporatist economy
- By early 2000s 2 big state-owned, domestically-oriented banks privatized, + 3rd big private bank formed from mergers.
- Banks borrowed heavily on short-term K mkts, & lent to largest shareholders. Bought assets in UK, Scandinavia etc., restructured, took profits, repatriated some to Iceland, kept borrowing. Ponzi financing
- **By 2006 Iceland 3 banks assets = almost 10 times GDP, 2nd in world after Switzerland. Amongst world's 300 biggest banks.**

Growth, inequality, politics

- Over 2000 to 2008, fast GDP growth, based on rising household & corporate **debt**, much of it foreign-denominated.
- 2007 Iceland had 6 $ billionaires.
- Share of top 1%: CHART. More inequality than other Nordics
- Population applauded “new Vikings”, & borrowed more.

IN trends: US & Iceland



Mynd 28: Hlutdeild tekjuhæsta 1% heimila af heildartekjum í Bandaríkjunum og Íslandi. Heildartekjur fyrir skatt; allar skattskyldar tekjur meðtaldar.
Heimild: Ríkisskattstjóri og http://g-mond.parisschoolofeconomics.eu/topincomes/

How did Iceland get so much foreign K?

- Ran large CA deficits (15-20% GDP)
- Banks borrowed abroad on implicit assumption of public guarantees
- Inflation high; interest rates high (12-15%), so **large carry-trade inflows**. John X in Canada, World Bank etc., bought ISK bonds to get interest differential
- 2001-2007 **krona appreciated** against $: from 103 to 62.

Euphoria

- **Strategy**: diversify from fish, aluminium & tourism into finance: Iceland as international financial center b/w EU & US, & “one of us”
- Chamber of Commerce, 2006: We should “stop comparing ourselves with the other Nordic countries – after all we are in many ways superior to them”
- Arthur Laffer, end 2007: “Iceland shd be model to the world”

Attracting foreign K

- Only mortgage lender: public Housing Fund
- Escaped micro-prudential regn as “social policy institution”
- 2003 govt allowed 90% mortgages; & **Housing Fund restructured bonds to attract foreign lenders**
- 2004 banks offered more generous mortgages
- Mortgages denominated in foreign currency
- → housing bubble & currency mismatch.

Financial regulation

- Govt established “sound-looking” institutions:
- Eg central bank made “independent” (but governors, who set interest rate, all political appointees)
- Micro-prudential regulatory agency established (but by 2006, total staff 46)
- No macro-prudential regulation
- National Institute Econ Research abolished 2002

By-passing IMF

- IMF Article 4 missions expressed growing alarm.
- Frederic Mishkin, 2006, affirmed stability & “good business model” of Iceland banks (in return for $135,000)
- Richard Portes, 2007, same (but only £58,000)
- Govt ignored IMF, holding up Mishkin & Portes as experts

Crash

- Early October 2008, the **3 giant banks collapsed, entering league of 11 biggest financial failures in history**
- Perfect storm: collapse of Krona (fell 80% against euro) CHECK, stock mkt, house prices, credit.
- **Iceland had biggest fall in GDP of 33 OECD countries**, b/w 2007 and 2010.

Enter IMF

- First developed country rescue since UK in 1976.
- IMF strategy: (1) **stabilize currency**; (2) restructure banks – “old” ex-banks (all assets/liabilities held by foreigners) & “new” real banks (all assets/liabilities held by residents); (3) gradually reduce fiscal deficit, while protecting social spending
- IMF insisted on emergency rationing of foreign exchange with restrictions on both current & capital accounts, so Iceland cld continue to import essentials.
- Flew in team of experts to advise CB

Capital controls

- IMF insisted on legal capital outflow controls
- Foreign Exchange Act amended in all-night sitting of parliament, concluded hours before IMF due to release first tranche.
- Included a “duty to repatriate” foreign exchange earned by exporters.
- Thereafter restrictions on current account transactions lifted, targeted on **capital** account.
- John X etc. locked in – could not sell ISK assets for FX

Size of the K outflow problem

- 2013 IMF estimates: (1) stock of krona assets held by foreigners who want to sell for $ or E = abt 2/3 of GDP (2011).
- (2) ditto, held by residents (abt half in pension funds), who want to diversify portfolio investments out of krona = abt 30-40% GDP
- **Total likely outflow to be managed: abt 100% GDP** (cld be much larger)
- FX reserves = 30% GDP (mostly **borrowed**)

Reactions to KCs: exit & voice

- **Exit: Circumventing controls**: transfer pricing – eg fishing exports.
- **Voice: Demands to lift KCs** from fishing barons, politicians,   Confederation of Employers, pension funds
- Eg employers in IT say ability to recruit foreign experts hamped by KCs
- Eg commentators say low investment/GDP since 2008 due to KCs.
- Eg commentators say KCs violate European 4 freedoms

Govt strategy: first tighten, then lift

- Though KCs declared to be “temporary”, govt kept tightening them, by raising penalties & strengthening enforcement.
- → much criticism that govt reneging
- But govt very worried abt exchange rate, inflation, mortgages
- Stuck to gradualist approach: first, reduce foreigners’ claims; then allow residents to diversify out

Govt strategy: attract more FX

- CB trying to attract in more foreign K for long-term investment, offering E = 230 ISK, in contrast to official (onshore) E = 162.
- **Costs**: (1) Income & wealth inequality growing b/w residents with foreign currency to sell and those with only domestic currency.
- (2) Many wealthy Icelanders with money abroad buying ISK at offshore rate & investing in real estate – pricing average locals out

Enforcement

- KC unit in CB increased to 16 experts. It began to see need for much more “outreach” to persuade people of necessity for temporary restrictions.
- Financial Supervisory Authority (FME) also beefed up to police the controls. CHECK

Why KCs remain, 5 yrs on

- CB, IMF, finance minister still worried abt further ISK collapse, rise in inflation, rise in mortgage debt.
- Finance minister worries abt financing govt budget deficit: locked-in capital makes it cheaper
- **Election of April 2013**: Agrarian Party shot from minor to biggest party with promise which depends on continuing KCs:

Making foreign creditors take "haircut"

- One new bank owned by the state
- Other two new banks owned by creditors to the 2 failed ex-banks
- These creditors are 50% hedge funds (US, Luxemburg, Irish, Cayman, etc), wh bought out original bondholders post-Crash for a song, expecting appreciation). Eg Davidson Kempner Capital Management LLC
- KC legislation kept capital of foreign owners of banks behind the controls, locked in ISK.
- Assets of failed banks increasing in value; now abt 30% pre-crash value. Hedge funds stand to make BIG profits – if they can escape KCs.

Election of Apr 2013

- Agrarian P promised that if it became dominant party it wld arrange “biggest mortgage write-down in world history”, by negotiating with hedge funds & others to take “haircut” in return for escape from KCs.
- Haircut to be used to finance mortgage write-down – assuming state can sell shares at high price & use difference for mortgage relief.
- In election Agrarian P became dominant party. Now must deliver on promise. Keeping KCs is necessary.

Govt wants to find buyers for 2 new banks

- At present: one new (domestic) bank owned by state; two half owned by hedge funds
- Govt wishes to find buyers (not hedge funds!). Who?
- (1) Pension funds plus a few big Iceland companies. They are unwilling as long as KCs in place.
- (2) Foreign banks: but only foreign bank to indicate interest is **People's Bank of China**. This wld fit China's long-term plan to secure stake in development of Far North.
- (3) The state becomes majority owner. If state becomes majority owner of all three, it becomes responsible for 70% of outstanding debt (including Housing Fund, Student Loan, etc.)
- Bank ownership by China or the state would be surprising outcome of The Great Neoliberal Experiment!

Government’s dilemma

- Domestic & foreign entities unwilling to buy banks till KCs lifted.
- Residents (electorate) want to diversify out of ISK
- They can’t get out till large part of foreign claims dealt with.
- Govt must keep KCs in place till hedge funds et al. agree to take big “haircut”
- So, new government will face rising criticism from companies & electorate for keeping KCs. But will be wiped out by mortgage-holders if it reneges on write-down.