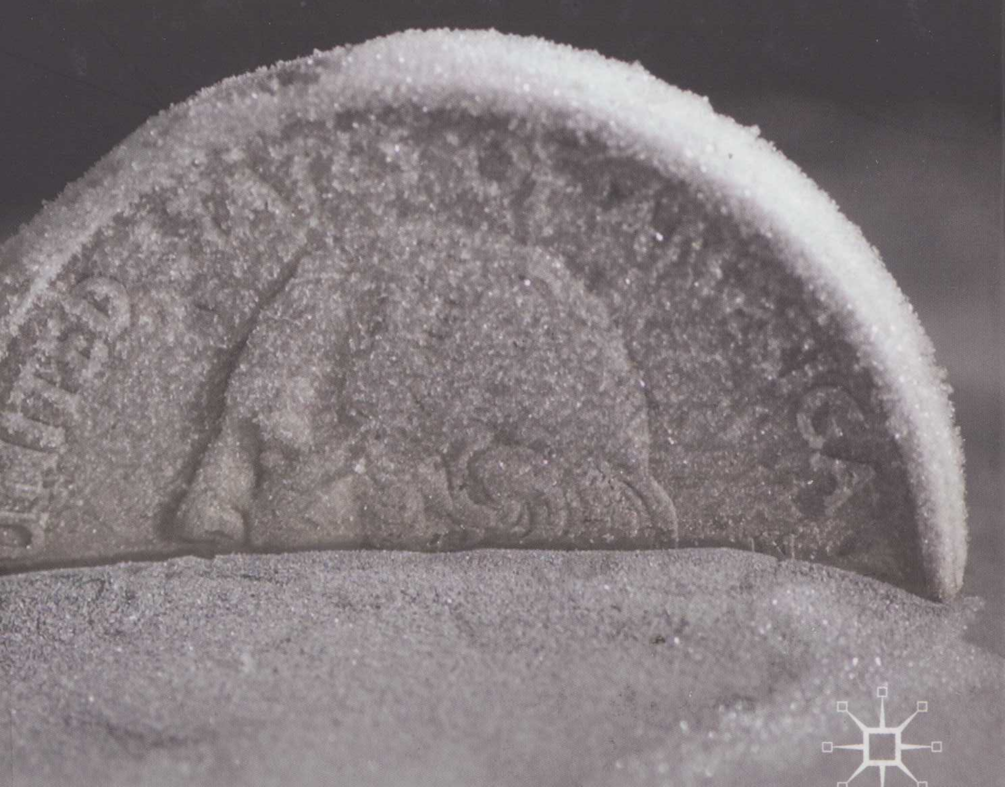
Preludes to the Icelandic Financial Crisis

Edited by
Robert Z. Aliber and
Gylfi Zoega



Preludes to the Icelandic Financial Crisis

Edited by

Robert Z. Aliber
and
Gylfi Zoega

palgrave
macmillan

First published 2011 by
PALGRAVE MACMILLAN

Palgrave Macmillan in the UK is an imprint of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan in the US is a division of St Martin's Press LLC, 175 Fifth Avenue, New York, NY 10010.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN 978–0–230–27692–5 hardback

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

10 9 8 7 6 5 4 3 2 1
20 19 18 17 16 15 14 13 12 11

Printed and bound in Great Britain by
CPI Antony Rowe, Chippenham and Eastbourne

Notes on the Contributors

Robert Z. Aliber, Professor of International Economics and Finance, Booth Graduate School of Business, University of Chicago, emeritus.

Friðrik M. Baldursson, Professor, School of Business, Reykjavik University.

Willem H. Buiter, Chief Economist, Citigroup.

Lars Christiansen, Senior Analyst, Danske Bank.

Daniel Gros, Director, Centre for European Policy Studies, Brussels.

Thorvaldur Gylfason, Professor of Economics, University of Iceland.

Tryggvi T. Herbertsson, Member of Icelandic Parliament and a former Professor of Economics at the University of Iceland.

Frederic S. Mishkin, Alfred Lerner Professor of Banking and Financial Institutions, Graduate School of Business, Columbia University.

Richard Portes, Professor of Economics, London Business School.

Anne C. Sibert, Professor of Economics, Department of Economics, Mathematics and Statistics, Birkbeck College, University of London.

Throstur Olaf Sigurjonsson, Assistant Professor, School of Business, Reykjavik University.

Carsten Valgreen, Chief Economist, Danske Bank.

Gylfi Zoega, Professor of Economics, Department of Economics, University of Iceland.

Contents

List of Figures

List of Tables

1
Introduction

Robert Z. Aliber

Introduction

Iceland was one of the first countries to experience the collapse of its banks in the fourth wave of financial crises since the early 1980s. Each of these waves has involved the failure of a large number of banks in a country at about the same time. Each of these waves has followed a wave of credit bubbles, when the indebtedness of a group of borrowers, usually the buyers of real estate, increased at an annual rate of 20–30 per cent a year for two, three, or more years. Most of these credit bubbles have followed an increase in the flow of money to a country that led to an increase in the value of its currency, to an increase in its current account deficit and to increases in asset prices. (The principal exception is that the credit bubble in Japan in the second half of the 1980s occurred when its current account surplus was declining, however at the same time that the Japanese yen appreciated. The other exceptions are that the credit bubbles in Ireland and Spain occurred when they were members of the European Monetary Union.)

Iceland is the smallest country with its own currency. Between 2002 and 2007 real estate prices increased sharply while prices of stocks of Icelandic firms increased by a factor of seven, one of the most rapid increases ever in any country. During this period real estate prices in the United States, Britain, Ireland, Spain, South Africa, Australia, and New Zealand increased rapidly.

Iceland gained its independence from Denmark in 1944, and its financial history is relatively short. While the quality of the human capital is extremely high, the managerial structure in the public and private sectors is thin because of the small population.

In the late 1990s Iceland participated in the global moves toward the privatization of government-owned firms. The privatization of the three Icelandic banks began in 1998, and was completed in 2002. The banks were acquired by industrial conglomerates – family firms that owned several different businesses.

My initial encounter with Iceland – and the event that led to this book – was in April 2006; a friend invited me to participate in the first class of the term at London Business School. One of the other participants was a young banker from Iceland who had recently graduated from LBS; he described the increases in stock prices in his country. Listening to his presentation was eerie because it seemed as if I could complete – figuratively – most of his sentences; his description of changes in stock prices complemented a model that I had been developing of the impact of an increase in money flows to a country on the value of its currency and on the prices of its assets. At the time I made a mental note, 'Visit Iceland on the first possible occasion.' The intuition was that the processes that lead to asset price bubbles would be more readily apparent in a small open economy than in a Mexico or a Britain or a Japan.

In the previous years I had been chasing bubbles in several different countries. There were numerous visits to Mexico in the early 1990s in the effort to understand the impact of privatization, liberalization, and macrostabilization on the nominal and real values of the peso. A newspaper headline about property prices in Hong Kong in February 1997 prompted a visit to several of the countries in South East Asia, where there had been dramatic increases in the prices of stocks and of real estate. A visit to South Korea in December 1997 occurred during a presidential election and a sharp depreciation of the won that was associated with the failure of many banks. The surge in nominal and real interest rates in Moscow in the spring of 1998 prompted a visit in the early summer in the effort to learn the source of the returns that enabled the lenders to pay such high rates. While there had been several visits to Japan in the late 1980s, it was only after the property prices had begun to decline that I began to use the term 'bubble' to describe the surge in property prices and stock prices. A few years later a taxonomy of bubbles was developed – 'credit bubbles' were distinguished from 'asset bubbles' – most but not all asset price bubbles follow from credit bubbles, and most but not all credit bubbles lead to asset price bubbles. The increase in the bank loans to the governments and government-owned firms in Mexico and ten other developing countries in the 1970s was a credit bubble; the indebtedness was increasing at a rate that was too high to be sustainable. The increase in US stock prices in the late 1990s was an asset price bubble but not a credit bubble.

In 2002 I 'inherited' *Manias, Panics, and Crashes* from Charles Kindleberger, who had brought out the first four editions. Kindleberger had developed a stylized view of the five stages of a bubble and examined these stages across many bubbles across several centuries. I prepared the fifth edition in 2003 and 2004; one of the innovations was a new chapter that focused on the three 'waves' of credit bubbles since the mid-1970s. The first centred on Mexico and about ten other developing countries in the 1970s.

One of the chapters in *Manias* centred on the supply of fraud and corruption, which seem to increase exponentially when a country experienced a bubble. Several chapters highlighted the range of responses of governments when a bubble was under way and after it imploded – should the government intervene to stabilize asset prices or should the government instead allow asset prices to decline?

My first visit to Iceland was in June 2007, in response to an invitation for a presentation at one of the workshops of the Ronald Coase Institute. Iceland seemed 'very expensive'; the prices of non-tradable goods – restaurant meals, hotel rooms, and taxis – seemed high. Ballpark estimates of purchasing power suggested that the Icelandic krona was overvalued by 30–40 per cent. There were 10 or 12 visits with economists in the Central Bank of Iceland, in the commercial banks, and at the University of Iceland. These conversations reinforced the impression that Iceland was sitting on top of a massive asset price bubble. My presentation at the Coase Institute was on the three earlier waves of global credit bubbles since the 1970s and only tangentially on the asset bubble that was then under way in the country – although several students asked about my impressions of the recent economic developments in Iceland.

One of the surprises during the visit was several sets of comments that Iceland was becoming an 'international financial centre'. These comments reflected the surge in the foreign assets and the foreign liabilities of the Icelandic banks relative to the country's GDP. The hallmark of a financial centre is that investors accept lower rates of interest because of some other pecuniary or non-pecuniary advantages, including a low inflation rate, relatively low tax rates, financial stability, and secrecy. The uniqueness of Iceland's role as an international financial intermediary is that the counterpart of the increase in its indebtedness was an increase in equity investments in other countries by Icelandic firms and banks.

In December 2007 I was invited to present a public lecture at the University of Iceland, which occurred in May 2008. The preparation involved a review of the Icelandic economic and financial data available in *International Financial Statistics* and of several of the IMF country consultation reports. The lecture was based on an essay titled 'Monetary Turbulence and the Icelandic Economy' that is Chapter 15 in this book.

The imbalances in the Icelandic economy were staggering. The current account deficit was more than 20 per cent of the country's GDP, much higher than that of any other country. While foreign firms had financed a massive enclave investment in a hydroelectric generating plant and an aluminium smelter, the inflow of real resources associated with this joint project accounted for 3–4 per cent of the country's GDP – about 20 per cent of its current account deficit. Most of the Iceland's current account deficit reflected a household consumption boom, including imports of automobiles and other durables.

A second imbalance was that the market value of the stocks of the 15 or so Icelandic firms was exceedingly high relative to Iceland's GDP. Between 2002 and 2007 the US dollar value of Iceland's GDP had increased by 80 per cent, during the same period the market value of Icelandic stocks had increased by 700 per cent. One of the idiosyncratic features of the Iceland experience is that the increase in stock prices was much larger in percentage terms than the increase in real estate prices, at least after 2003; in most other countries the percentage increases in the prices of real estate and stocks have been in the same ballpark.

A third imbalance was that in 2007 the total assets of the three Icelandic banks were seven or eight times Iceland's GDP, whereas in 2002 these assets had approximated the country's GDP. Hence bank assets had increased by more than 50 per cent a year during this period. By the end of 2007 the foreign assets of the banks were three times larger than their domestic assets.

The logic was that the rapid increase in the assets of the banks could have occurred only if there had been a comparable increase in the capital of the banks. The intuition was that the likelihood that the increase in capital of the banks could have been obtained from interest rate spreads or fees was trivially small; instead the increase in bank capital must have occurred as a result of capital gains on stocks and real estate owned by the banks, much as in Japan in the 1980s.

Another intuition was that the massive imbalances in Iceland must be systematically related; the question is whether the sharp increase in stock prices induced the money inflow or whether instead the money inflow led to the increase in stock prices. Again the intuition was the increase in stock prices could not have been spontaneous. Instead the inflow of money had led to both a sharp increase in the value of the Icelandic krona and a large increase in imports relative to exports. The balance of payments accounting identity is that if Iceland experienced an increase in its capital account surplus, adjustments must have occurred to ensure there was a corresponding increase in its current account deficit.

The increase in the flow of foreign money to Iceland led to the appreciation of the Icelandic krona and contributed to the increase in imports relative to exports. Moreover the increase in net imports resulted from the surge in household wealth. The foreign money that went to Iceland 'had to go someplace'; the only possible place that it might have gone was to one of the asset markets – the stock market, the real estate market, and the market for government debt. The debt of the Icelandic government was small, and hence the foreign money did not go to this market. The money went into the markets for stocks and real estate and the dramatic increase in household wealth led to a consumption boom and a sharp increase in the demand for foreign goods.

The extraordinary increase in the price of stocks would have led to a sharp increase in the capital of the banks if the ratio of the market value of bank-owned stocks to their total assets was in the same ballpark as the capital requirement of the banks as a share of their total assets. Because the rate of return to owners of stocks was so high, it was plausible that many of the loans made by banks were to those who bought stocks. During the Japanese bubble of the late 1980s, many industrial corporations used the money obtained from bank loans to buy stocks and real estate because the anticipated rates of return on these assets were so much higher than on the investments in plants to produce steel and autos and electronic products. Moreover it was also plausible that the surge in the value of Icelandic stocks owned by investors would lead some of them to increase their purchases of foreign assets to maintain diversified portfolios.

It was also obvious that Iceland would experience a crash like the ones observed in Mexico and Thailand, since a 'limit theorem' applies to the external indebtedness of a country, which cannot increase relative to its GDP for an extended period. Inevitably the increase in the external indebtedness of Iceland would slow and its current account deficit would decline and the krona would depreciate, perhaps suddenly and sharply because the prospect of this change would immediately deter further money inflows.