ECMI Commentary No. 7
31 May 2006

European Capital Markets Institute

# Iceland: Big lessons from a small country?

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Global monetary policy is tightening. Following Japan's return to an inflationary environment, liquidity is getting scarce and investors are increasingly discriminating risks. So-called 'carry trades', which ensured high return for little risk, are no longer sustainable, as interest rate indicators of the Triad countries are pointing upwards. Such macroeconomic movements pose worrying problems for open economies that financed their external dependence with ease in the environment of excess liquidity that prevailed over the past five years.

Such monetary contraction can be problematic for small open countries that rely heavily on external financing, especially on portfolio investments. In fact, for such economies, the interest rate leverage is rather ineffective in luring foreign investment. Therefore recent evolutions have caused great concern for small economies such as Hungary, New Zealand and Iceland, which traditionally trade a considerable fraction of their GDP and rely heavily on external financing to finance their current account deficits. In stress situations or when the macroeconomic situation unwinds, those countries are among the first to be exposed to external shocks, and face considerable macroeconomic volatility. The experience of Iceland is particularly relevant as some indicators echo to some extent the school-case scenario of a capital account crisis, and furthermore deliver a similar picture to that of the United States' situation.

## Iceland, a small open economy in the twilight of external volatility

Iceland's economic performance is impressive. Unemployment is almost non-existent; the economy has followed a process of economic diversification away from its traditional industries (i.e. fisheries) towards high value added activities (i.e. banking, biotechnology and software industry). Internally, Iceland's latest accumulation of wealth was mainly induced by a credit boom, exponential growth of housing prices and foreign debt accumulation. Icelandic banks' debts have reached the equivalent of 150% of Iceland's GDP and many credits lines will mature over the next two years, suggesting the loom of a banking crisis. Considering that the country's debt reaches 300% of GDP, debt default seems highly probable to some observers. In order to address such internal imbalances, Iceland's central bank wants to slow credit growth and has announced further interest rate hikes.

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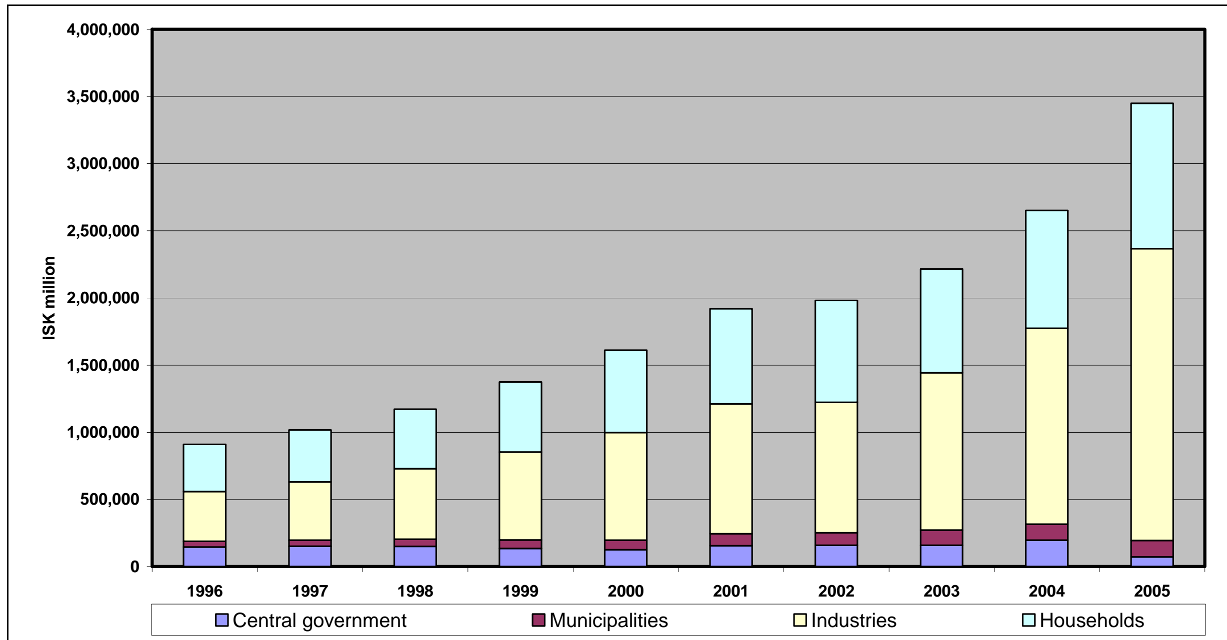
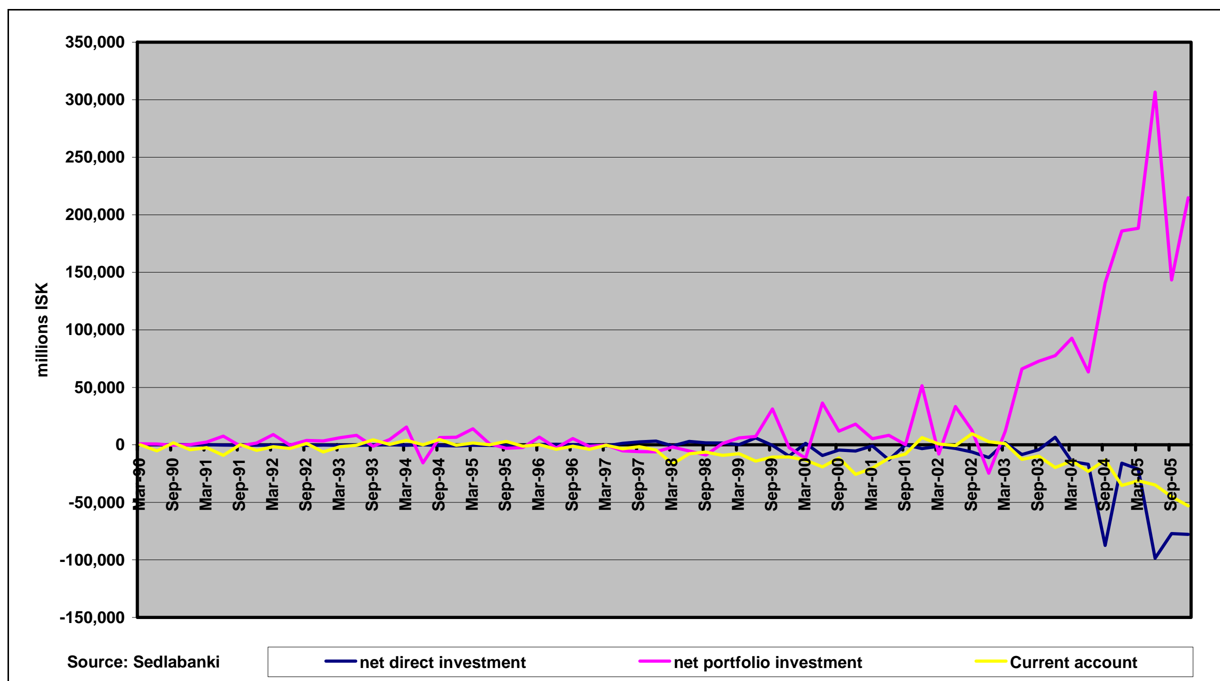
*Figure 1. Credit activity in Iceland*




Externally, Iceland is highly exposed. Being the paradigm of a small open economy, Iceland faces a structural current account deficit, which causes the country to be dependent on external financing. In fact as Figure 2 illustrates, Iceland finances its trade dependence through foreign investment, especially portfolio investment.

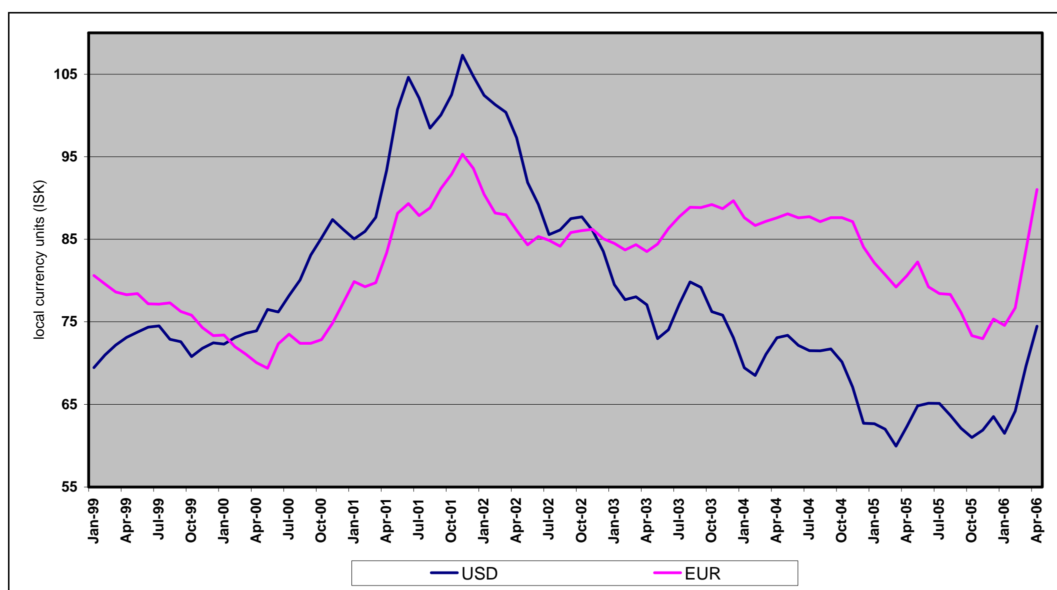
*Figure 2. Iceland: A small open economy*




Since 2003, foreign investors financed Iceland's current account deficit by purchasing Icelandic bonds, inducing an increased exposure of the Icelandic economy to exchange rate fluctuations. The low-yield environment that prevailed in global markets has awakened investors' appetite for the higher-yielding Icelandic bonds. Two factors on the

supply side are at the root of investors' attention for Iceland's securities market. Firstly, in July 2004, the Housing Financing Fund (HFF), a fully state-controlled agency, has initiated the issuance of HFF bonds to finance HFF's mortgage loans. Secondly, foreign financial institutions issued in August 2005 non-indexed ISK Eurobonds.[2] Those funds turned out to be successful, and the amount outstanding in December 2005 largely overshadowed the amount of government securities as well as the amount outstanding of treasury notes.[3] As a consequence, the total market value of Iceland's fixed income securities at the end of November 2005 roughly equals the year's GDP. The issuance of those financial products has safeguarded the financing of Iceland's external dependence.
Additionally, the dynamism of the Icelandic economy lured many investors to invest their equity capital in the Icelandic stock market, which outperformed all European stock exchanges over the past four years. Nowadays, since the buoyancy of the credit expansion has to be tamed, most analysts agree that Iceland faces a recession for the time to come. The response has been a sudden massive selling of Eurobonds issued by non-residents (for the first time since 2002 the net figure is negative), which is primarily due to the economic outlook but also to the anticipation of exchange rate depreciation. The central bank's data underscore the fact that most outflows in March 2006 were equity capital.

*Figure 3. Iceland: Foreign exchange*

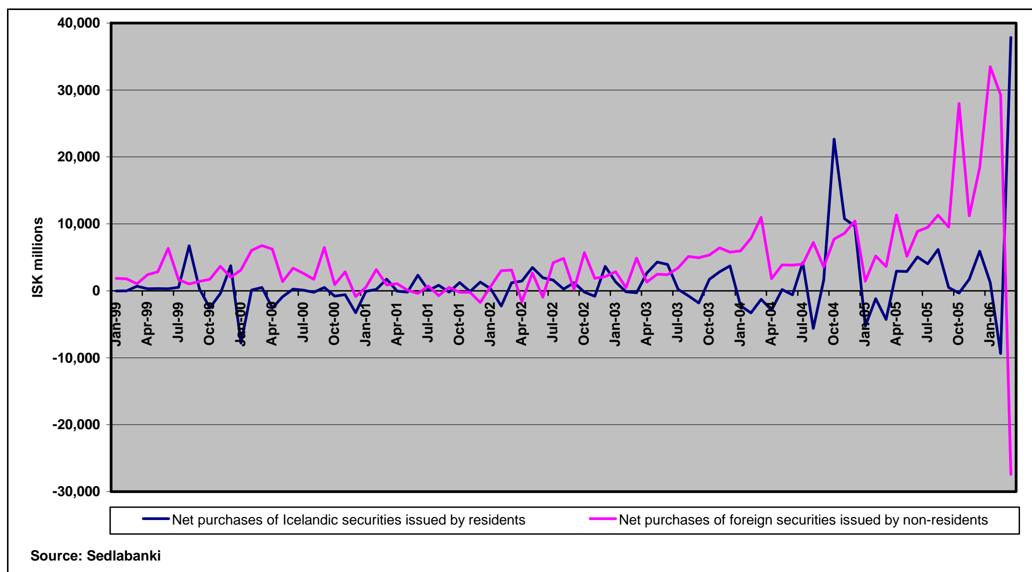



Despite the loss of confidence from foreign investors, net purchases of Icelandic securities by residents largely compensated for the outflow, averting in the short term concerns about a potential current account crisis. Nevertheless, the sustainability of such an outflow is highly doubtful, and the Icelandic central bank reacted by revising its interest rate upwards (11.5%), in order to temper the capital outflow by rewarding investors who stay put.

[2] Also called 'glacier bonds'.

[3] As of December 2005, the amount outstanding of ISK Eurobonds = 152 billion ISK; the amount outstanding of treasury notes = 64 billion ISK and the amount outstanding of government securities = 101 billion ISK, according to Landsbankinn, January 2006.

*Figure 4. Iceland: Portfolio investment*




More recently, concerns about the short-term sustainability resurfaced as the two latest offerings of Icelandic government bonds were cancelled by the Icelandic National Debt Management Agency, because investors were demanding too high yields. This cancellation does not amount to a lending crisis, since the treasury didn't need the debt issuance to balance its accounts, but rather aimed at offering a more continuous yield curve with the planned issuance.

### 1998 in the head, credit bubble in the legs

The scenario recalls to some extent the Asian situation of an increasingly integrated economy in the financial world that has to face considerable 'imbalances'.[4] Some alarming reports have been written by *Danske Bank* announcing a "geyser crisis" and a hard landing for 2006-07. On the other hand, some argue that the consequences will not be as harsh as in Asia because the currency depreciation was largely anticipated.[5] Apart from this remark, it must be stressed that the most obvious differences that must be taken into account in comparing and extrapolating the Asian crisis to Iceland's situation are the exchange rate regime on the one hand, and the banking structure, on the other, the latter being the most crucial. In fact, a flexible, well-functioning inter-banking market could indeed absorb the external shock that has just hit the country, and prevent internal credit bubble from bursting as they did in Thailand.

Systemic bank risk will rise in the next six months, and efforts have to be made by Icelandic banks to discriminate risk appropriately. As Figure 1 emphasised, lending activity in the Icelandic banking sector has grown exponentially. The problem faced by the banking sector is the huge build-up of credit lines on banks' balance sheets because of sustained low interest rates of equity and property bubbles. Nevertheless, stress tests performed by the central bank suggest that the Icelandic banking sector can in its current configuration withstand large shocks. Furthermore, the worst being announced for Iceland over the past months, risks in the banking sectors seem to be identified and banks have taken steps to meet their funding needs in the short term. Careful liquidity

[4] Or rather deficit to be economically correct, since from an accounting perspective, an economy's accounts are always balanced.

[5] "Is something rotten in the state of Iceland?", Insight, Landsbankinn, 22nd March 2006, p. 1.

management, the reduction of cross-holdings of equities and increased vigilance of credit quality are the issues to be addressed in the short-term policies of the Icelandic banking sector, in order to safeguard a smooth adaptation to the new macroeconomic environment prevailing in world financial markets.

**Is Iceland willing to trade a stable exchange rate for its economic dynamism? 'Small and exponential' or 'big and linear'?**

In the wake of the above-described external volatility, some observers have asked whether Iceland should join the eurozone. For a small open economy, joining the eurozone would greatly reduce the external dependence and deliver a stable currency that fosters its externally-led development. Membership of the European Monetary Union (EMU) has in fact greatly benefited small open economies that fostered their trade relying on the strength of the euro, but less clearly the bigger countries, which have faced large difficulties to grasp the benefits of the euro. Thus for Iceland it could seem pertinent to explore to what extent its small open economy in the twilight of external volatility could consider eurozone accession in order to avoid external macroeconomic stress. Last month, in fact, Mr Asgrimsson, the Prime Minister of Iceland, predicted that Iceland would become a member of the EU by 2015.[6] Furthermore, the Ministers for Commerce and Industry are eager to push the economy towards euroisation.

The first economic benefit if Iceland would enter the EMU would be that the scenario sketched out above could be avoided. In fact, 70% of its imports and exports would henceforth be issued in euro, considerably reducing uncertainty about future payments and preventing adverse effects on the forex market to cause major disruptions on the financial sector.

Nevertheless, public opinion remains split between two equally weighted groups, and hopes that the current tensions could tip the balance in favour of adopting the euro seem unrealistic, in light of the rather stagnant public debate on the euro issue. In order to avoid a Norway-like scenario, a long-term debate needs to be initiated. The newly emerging need for a stable currency is in fact the most persuasive argument for joining the EU, and could potentially convince the traditionally eurosceptic Iceland to seriously consider adhesion.

On the other hand, considering that Iceland's greatest current economic advantage is the fact that it is a small, flexible (but albeit volatile) economy, the prospect of trading this advantage for the heavy weight of European regulation with its linear economic path, is worth a cost-benefit analysis. For Iceland the deal would be to swap its status of dynamic economy and the legislative measures that lured foreign investors as well as hedge funds, in exchange for European regulation and adopt a monetary policy that doesn't necessarily reflect the internal economic situation of the country.

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[6] "Euro dreams", The Economist, 2 March 2006.