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Introduction

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INTRODUCTION

Perceptive is the Guest's Eye

"Perceptive is the Guest's Eye" is an Icelandic proverb. The Guest is one-eyed Odin, wisest of the Norse gods. The Martindale Student Associates' essays fill one with admiration and gratitude for these young people who took the time to reveal the Guest's Eye.

As the Martindale students point out, after World War II Iceland progressed from an underdeveloped society to one of the world's richest countries. Iceland's vast resources, highly literate population, and geographic location all played parts. Yet that was not enough. Iceland wanted to become a global financial hub, a desire enabled by a global tsunami of easy money. The combination of low interest rates, excess international loan capital, and wave of debt securitization that separated credit origination from eventual credit risk seemed to create money out of thin air. Iceland's bankers rode the wave in 2003-2008, taking all of Iceland along.

In this age of easy money Icelanders turned away from high-interest local currency, the krona. Businesses and, more frequently, common citizens obtained loans in low-interest currencies like the yen and Swiss franc. That seemed like Valhalla for the Icelandic people, but Iceland soon experienced the bitter taste of foreign exchange risk. Something was rotten in the state of Iceland and the global financial community soon found out. Iceland's prosperity was not sustainable with an account deficit between 16 percent and 25 percent of GDP from 2005 to 2008. The krona was overvalued due to inflows of foreign capital, resulting in artificial purchasing power of foreign goods and services and a bubble in housing and equity markets.

The Banking Saga

The three major Icelandic banks were privatized in 2002-2003. At that point their combined assets equaled 100% of GDP. But in the age of easy money the banks grew so quickly that by 2008 their assets had increased to a staggering 1000% of GDP. Dark storms of the credit crunch then hit. Lehman Brothers fell and Iceland's banking sector soon went bankrupt.

The impact of the crisis on Iceland's economy gave the government no option other than to assume responsibility for local assets and liabilities by establishing new banks. This process protected domestic depositors, but creditors of the three big banks lost ISK 7,400 billion ($64 billion), hitting bondholders around the world, including high-street retail banks in the U.K.

Icelandic policy was eminently defensible. Banks were private companies and a fundamental capitalist doctrine is that private failure is at the cost of shareholders and creditors. But what about foreign depositors? A significant policy challenge came from time deposits in the Netherlands and the U.K. in the so-called Icesave branch of Landsbanki, one of the banks that failed. Icesave depositors, mainly British and Dutch citizens, were not compensated by Iceland's deposit insurance funds but instead made whole by deposit guarantee funds of the Netherlands and U.K. While this bailed out ordinary depositors of a bankrupt Landsbanki, it did not match the nationality of the deposit insurance with the default. Iceland's government would not guarantee repayments to Dutch and British deposit guarantee funds. It argued that recovery of the bankrupt estate of Landsbanki should cover losses—in other words demanding an eventual solution to an immediate problem. This bankruptcy workout, taken in a methodical manner by Icelandic executives charged with the difficult process of asset recovery, has worked. Today it is evident that asset sales and recovery from the Landsbanki estate will pay back 90¢ on the dollar. Short-term deposit insurance paid by British and Dutch governments seems to have been covered by long-term asset liquidation of the Icelandic bank.

In spite of this solution, the Icelandic government and people are still pressured on the differential treatment of depositors. The Icesave dispute is under review by the European Free Trade Association (EFTA) Surveillance Authority, which will decide whether to take the case to the EFTA Court. On grounds of good asset recovery, Icelandic authorities have strongly opposed that process. One question is what might happen to the flawed European deposit guarantee scheme if governments need to bail out banks' deposits. Would moral hazard result in even riskier operations of the banks?

Iceland's Economy Today

The economic collapse fractured underlying pillars of Iceland's economy:

- The financial services industry's total meltdown means it will be decades before rebirth of a global financial industry in Iceland. Some new banks have established foreign operations in niche markets like fisheries and geothermal energy technology. Banks in Iceland will be based on local products and services and serve local clients. High finance days are over, at least until international markets forget the Icelandic crisis.

- Fisheries are the traditional export industry of Iceland and one of the best performing sectors. This industry is based on some of the richest fishing grounds on the planet, the intersection of the warm Gulf Stream with the rich abundance of the Arctic Ocean. Devaluation of the Icelandic krona increased foreign-denominated liabilities of these companies overnight. Luckily this industry has a natural hedge to foreign exchange fluctuation. Since export income is predominantly in foreign exchange, a rapidly depreciating local currency boosted worldwide demand for Icelandic fish products.

- Fishing-affiliated industries in Iceland, such as food processing, are also major developers of locally produced high-tech equipment. Fisheries-related equipment and technology have become another pillar of the Icelandic economy.

- Iceland is a major producer of renewable energy and renewable engineering and drilling services. Iceland is one of the largest producers of primary energy per capita in the OECD, and energy has developed into a vital export. Through three large energy-hungry aluminum production plants that use foreign-sourced bauxite, Iceland is in effect exporting electricity by serving global conglomerates active in the aluminum industry.

However, the capital-intensive energy industry is heavily dependent on foreign financing. The largest electricity provider, Landsvirkjun, was not heavily affected by the crisis, because its income and accounts are dollar denominated. Unfortunately, other utilities had a majority of their income in Icelandic krona but financed their investments in foreign exchange. The result damaged balance sheets and increased the burden on consumers via price increases.

- The tourism industry was one winner of the crisis. Suddenly a vacation that had been outrageously expensive in Iceland is again affordable to foreigners captivated by Iceland's spectacular nature. This industry has grown in spite of volcanic eruptions.

Fisheries, energy, and tourism share a common attribute: they face short-term fixed capacity. Iceland's fisheries operate under fixed catch quotas with limited opportunities to increase revenues, unless world fish prices increase. The energy industry is currently operating at full capacity, yet further development is dependent on foreign capital to import heavy equipment produced outside the country. These investments, already under pressure from environmental politics, are stymied by Iceland's credit rating. The tourist industry is seasonal, operating at full capacity only in summer. While there are opportunities for expansion if entrepreneurs can utilize wintertime capacity, it is not obvious that a large increase in tourism is available.

Emerging industries are the wild card and future potential of Iceland's economy-example companies are Marel in food processing technology, Össur in orthopedics, deCODE in genetics, and Actavis, a generic pharmaceutical company. Emerging industries include online gaming platforms, IT services, music, geothermal engineering services, data hosting centers enabled by cheap electricity, and the potential for a major oil and gas discovery above the Arctic Circle. Many of these new industries are limited only by the imagination of entrepreneurs. The future can be bright by using the well-educated workforce in an increasingly diverse set of industries, hopefully adding pillars collectively more enduring than the giant financial industry.

It is complex and challenging to analyze causes and consequences of the collapse of Iceland's banks and economy in the autumn of 2008. The Martindale students made tremendous efforts in their analyses of Iceland's history, politics and geopolitical power struggle, industries, and general economic progress. Understanding these issues will inform both the country's future policies and Iceland's debate about joining the European Union.

The Martindale Student Associates are "the Perceptive Guest's Eye" and it is a privilege to read these insightful essays demonstrating economic and political wisdom. As an Icelander to the Lehigh Martindale scholars, please feel free to call me if you see something rotten in Iceland developing in the future.

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