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Why Financial Collapse Has Been Good for Iceland

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Introduction

What is a banking crisis? What happens if it results in a collapse of the financial system? A systematic banking crisis occurs when many borrowers simultaneously experience difficulties in making their loan payments. Banks suddenly see a spike in nonperforming loans, which lowers the value and quality of their loan portfolios. Typically there are plummeting asset prices as well. When the market comes to the realization that "systemically important financial institutions are in distress," a full-blown banking crisis can occur. (Laeven and Valencia)

When such crises strike, what is the best course of action? During the 2008 global liquidity crisis, countries like the U.S., U.K., and Germany kept their banks afloat by bailing them out. This action was designed to prevent catastrophic harm to the entire system by keeping systematically important institutions, considered too big to fail, from failing. Some observers regard the U.S. government’s decision to let Lehman Brothers fail as a critical mistake that resulted in a national liquidity crisis turning into a global one. Lehman Brothers was just one bank in the U.S., but what would be the consequences if the entire banking sector collapsed in a country? It happened in Iceland.

One of the first and worst casualties of the 2008 global liquidity crisis was Iceland’s banking sector. Within three days, the country’s three largest banks failed, wiping out more than 85 percent of Iceland’s financial system. The government took control of the pieces and created new banks to assure domestic business could continue. Many believed at the time that the collapse of Iceland’s financial sector would lead to long-term devastation for the country. It was assumed that for the foreseeable future, Icelanders would suffer the effects of the collapse and that Iceland would be an example to other countries that a banking collapse would result in unthinkable consequences. However, two years after Iceland’s collapse, none of these consequences has happened. By the time Iceland realized that its banking industry had grown too large to control, the 2008 global liquidity crisis triggered a meltdown. In Ice-
land’s case, the government had trouble securing enough foreign assistance to support the banks, so failure might have been the only option. Contrary to expectations, Iceland is doing relatively well and seems to be on the way to building a stable and sustainable financial system, especially compared with other countries still struggling with debt and inflated banking sectors. In retrospect, other countries with alternatives might have done better to have followed Iceland and allowed their banks to collapse instead of bailing them out.

**Background**

Before the 2008 crash, Iceland was known for its banking sector’s large size relative to the rest of the economy. Iceland’s enormous banking sector was a relatively new phenomenon. After a delayed start in the late 1800s, Iceland was slow to develop a sophisticated banking sector. Once liberalized in the 1990s, growth exploded, bringing with it a painful warning in 2006.

**Slow Development**

Several factors hindered the development of Iceland’s banking system throughout the 1900s. Iceland suffered banking troubles, recessions, periods of high inflation, and restrictive policies. Operating in a small fishing nation, Icelandic banks often lent large amounts of money to individual fishing companies, meaning a bad fishing season occasionally led to bank failures and even economic recession. (Boyes) Iceland has also experienced its share of high inflation. Until 1992, inflation was chronically high, in the double digits.

Even with a volatile fishing industry and chronic inflation, government regulations remained the biggest hindrance to the Icelandic banking industry. Throughout the 1900s, the Icelandic market was tightly regulated, more so than in continental Europe. Large commercial banking operations remained under government control until their privatization in the 1990s, capital controls were in place from 1931 until 1994, and interest rates on deposits and loans were fixed by the government until 1985. (Jónsson, p. 44)

**Rapid Development**

After being stalled for much of the 1900s, Iceland’s banking sector saw tremendous growth during the 1990s. (Jónsson, p. 38) In 1994 Iceland joined the European Economic Area, providing access to the single European market, opening opportunities for expansion, and lowering the amount of money banks needed to keep in reserves. (“New Rules …”) In 1992, the central bank began using monetary policy to bring inflation under control, down to 2 percent to 3 percent annually. The corporate income tax rate was also drastically reduced from 55 percent in 1988 to 15 percent in 2008, allowing a larger proportion of profits to fuel more growth. These developments liberalized Iceland so quickly that the country went from having one of the most sheltered economies in Scandinavia to the freest economy in Scandinavia.

Although the liberalization of the markets is often cited as one of the causes of the crisis in Iceland, according to an interview with Icelandic economist Gylfi Magnusson, the manner in which the banks were privatized was the critical element that led to collapse. (Boyes) The Prime Minister at that time, David Oddsson, believed that it was “unhealthy if too much power is in too few hands,” so the Executive Committee on Privatization was tasked with privatizing the banks. The committee decided that one entity or individual could own no more than a four percent share in a bank. Instead, politics soon got in the way and controlling shares in banks were sold off to leveraged holding companies. The concentration of ownership in these companies, burdened by debt, was a recipe for epic financial disaster.

With the banks in private hands and the markets liberalized, rapid expansion abroad commenced. The Icelandic banks quickly discovered that organic growth abroad was a slow process and focused most of their efforts on acquisitions. (Jónsson)
A Painful Warning

With aggressive international expansion and a ballooning carry trade,1 the world began to take notice of Iceland in 2006. Analysts were concerned with excessive lending to related entities, high correlation of assets, dependence on the wholesale markets, and a limited ability of the government to provide support. (Flannery) In what became known as the Geyser Crisis, Iceland received a sharp warning that its system needed to be changed. Debt became more expensive for Icelanders to issue, Iceland Stock Exchange stocks were shorted, and Iceland’s currency was shorted as well. Working together, the Central Bank of Iceland (CBI) and Icelandic banks were able to fend off the crisis and return to business as usual, at least temporarily. This warning should have been enough to convince Icelanders to make changes to their system, but it was not. (Jónsson, pp. 58-82)

Bank Balance Sheets

Before the 2008 collapse, the balance sheets of Iceland’s three largest banks, Kaupthing, Íslandsbanki, and Glitner, provided initial evidence of an impending collapse. By analyzing the assets, liabilities, and owners' equity of the banks, financial collapse is no surprise to a keen observer.

Assets

A majority of banks’ assets are frequently loans to customers, and banks may hold assets in the form of shares of ownership in other companies, which can include acquired banks and their loans. In the case of Iceland’s three largest banks, the quality and makeup of their loan portfolios, systematic risk exposure, and rapid expansion abroad provided a warning that the long-term financial future was not as rosy as earnings reports seemed to indicate for the short term.

In 2006, 74.57 percent of Kaupthing’s assets came from loans to customers and credit insti-

1 Carry trade is when investors borrow money in a country with low interest rates and invest it in a country with high interest rates to make a profit. Because Iceland had very high interest rates, capital poured into the country due to this trading strategy.

2 The Truth Report is a document detailing Iceland’s financial crisis and what happened. It was written by the Special Investigation Commission, which was appointed by the Icelandic government to investigate and analyze the crisis. It is considered to be comprehensive, accurate, and unbiased.
bank balance sheets. In 2008, the banks also kept their stock prices high by buying approximately 45 percent of all automatically matched trades of their shares while selling only 2 percent of automatically matched trades. (“Chapter 2 …,” p. 4) This interrelatedness is not a problem when ICEX stocks are rising in value because everyone is making money, but eventually the bubble bursts. Knowing that bank stock was the collateral for many of the three banks’ loans, the interrelatedness of Icelandic banks became especially troubling when the ICEX began to tumble in mid 2007 (Figure 1). (Flannery) With banks’ share value declining, banks faced declining loan portfolio quality, declining asset values, and a declining ability of their owners to support them.

The last troubling issue was the pace of foreign expansion. From 2004 through 2007, bank assets increased ninefold from 100 percent of GDP to 923 percent of GDP. With a small domestic market, a majority of this asset growth had to come from abroad. After the economic liberalization of the 1990s, bank expansion took off. In Meltdown Iceland, Roger Boyes compares standard acquisition practices to those used by the Icelandic banks. Acquired companies normally invite an acquirer in to show them how the business is run. However, many Icelandic acquirers were not interested in how their newly acquired firms did business. While rapid expansion can significantly strain a system, careless expansion undoubtedly strains more.

Examining Icelandic bank assets in terms of the quality of their loan portfolios, levels of systematic risk, and speed of foreign expansion indicates that questions should have been raised about the path of the banks long before the crash of 2008.

Liabilities

Liabilities are obligations that a company must repay in a specified manner over a period of time. Companies looking to raise money can secure funding through various sources, such as getting a loan from a bank or issuing bonds and commercial paper in the market. Just as telling as the assets of the three Icelandic banks were the sources of funding the banks used to support those assets. A majority of their funding was derived from the same source,
which led to questions of whether credit would always be available and whether the Icelandic government could be a reliable backup funding source in tough times.

With the liberalization of its markets and subsequent explosive growth, Iceland needed capital to grow. Conveniently, the global economy was experiencing a period of low interest rates combined with easy access to credit. Much of Icelandic banks' funding needs could be obtained from Europe's medium-term note (MTN) market, debt securities that typically mature within five to ten years. The banks had high credit ratings and the Icelandic government was virtually debt-free, making it easy to access the debt markets.

The MTN market can be a great source of funding, but only while credit remains relatively cheap and easy. At maturity, a bank usually does not have the money to pay off the notes and needs to raise additional money to meet its obligations. If credit gets more expensive or liquidity dries up, it can be risky to fund with shorter-term liabilities because there is a risk that funding costs will go up significantly when those notes come due, or funding could dry up entirely, leaving no market to raise the needed funds.

Banks reportedly learned their lesson from the Geyser Crisis in 2006 and diversified their funding sources by beginning retail deposit campaigns, a source considered less risky than the MTN market. However, retail deposits, although usually more secure than notes, are not risk-free funding. Retail savings accounts are sensitive to interest rate yields. Icelandic banks attracted customers because they offered higher rates than competitors. Money would flee retail accounts if they did not maintain high rates.

Finally, if funding is too difficult to find elsewhere, a home country's central bank is usually a reliable backup funding source to provide the necessary liquidity to a bank until economic conditions stabilize. During the financial crisis of 2008, this is precisely what other central banks did, including the central banks of the U.S. and the EU. But even before the financial crisis, analysts began to question whether or not the Icelandic government could assist its banks should economic times become difficult. Few questioned that the CBI would try to assist the banks, although some wondered if it would be capable. Taking into account the resources of the CBI in comparison to the large size of the banking sector, many analysts believed that the CBI would not be able to save the banks in the case of serious financial trouble. (Flannery)

With funding available from so few sources, the Icelandic banks could not afford to be shut out of international markets or see interest rates skyrocket. Although easy credit made their funding model appear to work well, analysts observed that should economic conditions worsen, Icelandic banks would have a tough road ahead, especially considering their government's limited capabilities to be a lender of last resort in times of need.

**Owners’ Equity**

Owners’ equity in a business is the portion of investment in the company that comes from the owners of the company. In public companies, firms can raise capital by issuing shares that represent an ownership interest in the company. In any small economy, some degree of interconnectedness can be expected, but there is a limit to how much interconnectedness can be considered healthy. In Iceland, the profile of bank owners and the relationship between banks and owners should have been a warning.

Who were the owners of the Icelandic banks? Behind each of the three banks, there was a large holding company. According to an IMF country report in 2008, the average leverage of Icelandic bank owners was greater than the European average, a troubling fact if the banks ever found themselves in trouble and in need of assistance from their owners. Because of their high leverage, the banks’ owners would probably not be able to provide the needed funding support. Iceland also had a great deal of ownership mystification. Outsiders were often unclear exactly who owned what due to fuzzy ownership structures. Before the collapse, many companies in Iceland had ties to at least one of the big banks.

In most cases, the banks’ owners (i.e. holding companies) were the biggest clients of the banks. The holding companies brought business and fees to the banks, and the banks con-
continued to lend them money, often to purchase more stock in the banks themselves. (Jónsson, p. 97) However, this extensive symbiotic relationship between the banks and their owners is not healthy. In 2008, Iceland's three banks’ combined lending portfolio had more than 23 individual exposures, each consisting of more than 10 percent of that bank’s equity. (Jónsson, p. 129) Glitner’s owner, the Bauger Group, owed €5.5 billion to the three banks, which was 11 percent of the banks’ entire lending portfolio and 53 percent of their aggregate capital. (“Chapter 2 …,” p. 2) When Kaupthing tightened lending in 2002, the group moved on to Landsbanki, and when they also tightened lending, the Bauger Group moved on to Glitner. An owner’s failure could take down the entire system, so the banks were forced to do everything in their power to keep these holding companies afloat.

In short, a review of the assets, liabilities, and owners’ equity on the balance sheets of Iceland’s banks shows that change was needed. Icelandic banks would not be able to continue business as usual without making significant changes to integral parts of the system.

Iceland’s Financial System Collapses

By September 2008, it became clear that the global financial system was in turmoil and Icelandic banks were having trouble staying afloat. Liquidity had dried up and credit was hard to come by. Icelandic officials soon found themselves enacting emergency legislation, arguing with the U.K. and the Netherlands, and asking the IMF for assistance.

On October 6, 2008, the Icelandic government passed emergency legislation that gave the government extraordinary powers to deal with the impending financial demise of the country. This emergency legislation, the Wall of Shields Act, gave the Financial Supervisory Authority the power to take control of a company’s decision-making process, to control a company’s assets, and to demand that a company apply for a moratorium on payments to creditors. The Act also gave the Minister of Finance the power to finance the creation of new firms or take over existing firms. (“Act Providing …”) In the months leading up to October 2008, Icelandic banks found it increasingly difficult to find funding sources. When money began to flow out of Internet savings accounts, the banks ended up in real trouble. They turned to the CBI, which, although able to provide some funding, did not have the funding to save all three. So on October 7, 2008, Landsbanki and Glitner were brought under government control.

On the next day, due to a domino effect, Kaupthing was brought under government control, meaning that a total of 85 percent of Iceland’s financial system had just collapsed. (Jónsson)

The new emergency legislation divided each of the three banks into two banks, an old (bad) bank and a new (good) bank. The new banks each received all of the domestic assets and liabilities contained in the corresponding failed bank, so that banking inside the country would continue. Bank customers would be able to access their savings accounts, make payments, and continue business within the country. Everything else, including all derivatives and foreign assets, was relegated to the old bank. Each of the three old banks was left with frozen assets that would need to be valued and gradually sold off. The new banks would need to compensate the old banks for the fair value of the assets that had been taken from them and put into the new banks. (“The Icelandic Government’s…”) A later agreement was reached that the creditors of the old banks would become the owners of the new banks.

The Wall of Shields also secured domestic deposits, placing domestic depositors above bondholders and foreign depositors. This crucial change was one of the catalysts that sent the Icelandic-British relationship into turmoil. Landsbanki’s Icesave accounts were retail deposit accounts in the U.K. and Netherlands backed by an Icelandic guarantee. When Landsbanki collapsed, the British and Dutch governments guaranteed and paid out deposits to avoid panic in their own systems. Questions then arose about Iceland’s legal responsibility to repay the British and Dutch governments, because the deposits were backed by an Icelandic deposit guarantee. To add to the tension between the countries, the U.K. used antiterrorist legislation to freeze all Icelandic
assets in the U.K. (Jónsson, p. 179) This move was the final straw that took down Kaupthing bank the day after Landsbanki fell. Icelanders were left feeling offended that Britain had effectively declared their nation a terrorist state, and the British were left wary of Icelandic creditworthiness, even though Iceland promised to fulfill its obligations.

Finally, as Iceland sought help, it found itself repeatedly directed toward the IMF for assistance in stabilizing and rebuilding its financial sector. On October 24, 2008, the IMF announced a program with Iceland that included a $2 billion loan. The Faroe Islands, Norway, and Poland also agreed to supply loans to Iceland. (“Factsheet: The Icesave Issue”) The IMF included conditions that Iceland needed to meet in order to satisfy three main goals. Two initial goals were to create a functioning banking sector in Iceland and to stabilize the króna. The last goal, more long term, was to reduce the public debt burden on the country to ensure a manageable repayment plan. To fulfill these goals, Iceland has been implementing reforms to manage the new banks, restructure corporate and individual debt, and set up a new financial framework. To stabilize the króna, Iceland implemented a capital control program to prevent large amounts of money from fleeing the country and further devaluing the króna. Finally, various changes to fiscal policy and the government budget were made to bring public debt under control, with an additional reduction coming from the proceeds of the sale of assets in the failed banks.

In sum, the October 2008 liquidity crisis was the tipping point in a string of systemic problems that caused Iceland’s financial collapse, which then led to emergency legislation, tensions with the U.K. and the Netherlands, and finally to IMF assistance.

Analysis

More than two years after Iceland’s financial collapse, the effects that the collapse has had on the financial sector can be examined. At the height of the global crisis, bank failure was looked on as a worst-case scenario. Many governments took drastic steps to assure their countries’ systems remained intact. Iceland found itself at a point where bank failure was the only option available.

However, post failure, Iceland has found itself in a favorable position compared with other countries that opted to bail out their banks. Iceland has found that many of the severe consequences assumed to be a result of collapse were either nonexistent or not as severe as expected. Analyzing the outcomes of Iceland’s financial collapse reveals that allowing a banking system to collapse when it gets too big to be managed may not be the worst outcome. Perhaps other countries can consider following Iceland’s example when looking for a plausible way to handle an unmanageable banking sector.

Opportunities

Unlike other countries struggling to bring their economies out of distress, Iceland has seen positive developments since its financial collapse. Iceland did not drag out a long period of turmoil and trouble; instead, it deleveraged itself quickly so that future generations would not be dealing with an overinflated system. In the process, it was able to completely redefine its banking and financial policies.

By January 2011, two and a half years after the financial crisis, there were still countries struggling to keep their financial systems afloat. Ireland asked the IMF for support after being unable to fix its ailing financial sector, Greece and Portugal suffered through serious debt problems, and the sustainability of Spain’s financial sector, the fifth largest economy in Europe, was coming under question. (Stelzer) Iceland, on the other hand, reported growth in the third quarter of 2010. (Ward) After failing in 2008, Iceland was able to quickly get the assistance it needed to restructure and rebuild its financial sector, unlike other countries that dragged out the pain before finally calling for help. To save ailing financial systems, the accepted method during the crisis seems to have been government bailouts of banks. This strategy greatly increases the debt burden on taxpayers. In contrast, Iceland did not bail out its banks. It promised to meet obligations in full to domestic depositors and the minimum requirement to foreign depositors, but in essence told shareholders and creditors that they were out of luck and needed to wait until the banks’ assets were unwound to get any money back. Iceland’s action caused gross
public debt to soar from approximately 30 percent in 2007 to a peak of 115 percent in 2010 due to “a recession on public finances, need to recapitalize, crisis related central bank losses, and foreign deposit requirements.” (Thom森 and Roaf, p. 4) However, as assets are recovered from banks, the economy rebounds, the currency appreciates after a sharp decline, and external debts are expected to shrink. By 2015, the IMF estimates that Iceland’s gross government debt will be down to a manageable level of 76 percent. Figure 2 illustrates that after Iceland’s debt peaked in 2010, expected debt declines sharply compared with the expected public debt of other countries, which show a slow and steady climb after an initial spike. (“World Economic Outlook Database”) Perhaps this is because Iceland forced shareholders and creditors to absorb bank losses while other governments took on the burden of bank losses as public debt.

By deleveraging, Iceland has saved future generations from dealing with an oversized financial system. Five years earlier in 2003, the system’s assets amounted to less than two times GDP. (Flannery) Before the collapse in 2008, the assets in Iceland’s banking industry amounted to a phenomenal nine times GDP. Figure 3 shows how large this is compared to other economies. The only country with a system of similar size is Switzerland, and the next largest system is the U.K.’s at 4.5 times GDP. The question remains, How big is too big? For Iceland, nine times GDP was not sustainable, and the collapse has allowed the country to bring the system under control. In addition, external debt (the debt owed to foreigners) had reached 605 percent of GDP in the pre-crisis period. This figure fell to approximately 300 percent of GDP two years into the post-crisis period. By 2015, external debt levels are expected to drop to 190 percent of GDP. (Thom森 and Roaf) Again, this is an example of how the collapse helped bring debt under control. The banking collapse has removed the extensive web of interrelated ownership and reduced inflated asset prices. Despite the crash, the average person likewise has not suffered as harshly as expected. Unemployment rose from around 1.6 percent in 2008 to a peak of 9.4 percent in January 2009 and GDP fell by nearly 6.8 percent in 2009, but both measures have since begun to rebound. (“World Economic Outlook Database”) In essence, Iceland is one of the only coun-
tries that can claim to have "solved" its banking problems, because the banking industry as it formerly existed is no longer in operation. (Jónsson, p. 200)

Another advantage resulting from the financial collapse is an opportunity to completely redefine the financial regulatory framework with fewer hindrances. Without the influence of private banks to lobby against changes, Iceland has a more straightforward task at hand. Iceland can also redefine monetary policy and more easily implement temporary measures to help get the country back on track.

The same advantage has also allowed Iceland to bring down its interest rates and stabilize its currency. Before the crisis, foreign funds poured into the country to take advantage of Iceland's high interest rates and perceived low risk. This influx of capital in turn drove high growth and currency appreciation. Iceland's policy officials followed a generally accepted standard for monetary policy management. To keep inflation from rising above certain targets during times of high growth, policymakers raised interest rates to make borrowing the capital necessary to continue the unsustainable growth more difficult. In Iceland's case, this plan continued to backfire, bringing more foreign funds into the country to take advantage of higher interest rates. Lowering interest rates would cause large amounts of capital to flee the country, leaving Iceland unstable and exposed to deflation. With the previous financial system still in place, Icelandic officials were finding it difficult to fix these problems. (Jónsson)

After the collapse, through the use of capital controls that restrict the flow of funds in and out of the country, Iceland has brought interest rates down from a peak of 19 percent to less than 4 percent in October 2010. In addition, the króna has begun to appreciate as interest rates have been brought down to be more in line with similar economies. Also, the government has been using a primary trade surplus to acquire foreign currency reserves and is working at

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\(^{3}\) For more information about financial regulation, see article by Giglia in this issue.

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Figure 3

Banking Group Assets as Percent of GDP in the Global Financial Crisis

Notes: Total consolidated assets from domestically held owned banking sector only. Includes assets of domestic banks held abroad. End-2007 except UK (end-2008) and Iceland (June 2008).
Source: Bank of England; Central Bank of Iceland.
removing the capital controls as soon as possible. (Thomsen and Roaf) Without the financial
collapse, interest rates might be at 19 percent
or higher in Iceland.

Initial Pitfalls

In the immediate aftermath of Iceland’s
financial collapse, economists and former
bankers worried that Iceland’s reputation in
international markets would be damaged
beyond repair. Icelanders worried that the col-
lapse would leave an onerous financial burden
on future generations. There was fear that Ice-
danic banking failures would trigger a global
chain of events, leaving banks and investors
holding worthless Icelandic assets or at least tied
up in bankruptcy proceedings for years. How-
ever, a review of these perceived pitfalls reveals
that in the long run, the benefits outweighed
the negatives.

Typically, countries bail out financially trou-
bled banks to avoid diminishing their global
credit rating. A fear that debts will not be repaid
means that lending stops or that the price of
debt skyrockets. Greece and Ireland are two
countries that have recently seen a significant
rise in the price of issuing debt, signaling the
global hesitancy to lend money to the countries.
In contrast, Iceland’s image in the global mar-
ket is on the rise. (Martin, Ward) Icelanders have
brought their currency under control and are
nearing plans to allow it to freely float. They
have implemented the IMF’s program goals
for restructuring and brought in financial
experts to redesign their financial sector. The
resolution of the Icesave dispute with the U.K.
and the Netherlands will further boost Iceland’s
reputation by demonstrating its creditworthi-
ness and desire to repay its debts. (“Icelandic
Voters …”) So, while a damaged reputation that
could cut a country off from the global mar-
kets may be a good reason to avoid collapse,
in Iceland’s case, this fear was exaggerated.

Careful attention has been taken in Ice-
land to assure that the fallout from the finan-
cial crisis does not become a burden for future
generations, and so far officials are addressing
this concern. As discussed previously, although
Iceland’s gross public debt increased from 30
percent to 125 percent, it is expected to come
down in the coming years to a range in line with
other advanced economies. Although an official
agreement has not yet been reached, negotia-
tions between Iceland, U.K., and the Nether-
lands for the repayment of Icesave deposit insur-
ance obligations also reflect this sentiment. In
2009, a tentative agreement was reached
whereby Icelanders would pay a 5.5 percent
interest rate on their obligations. A year later,
a new tentative agreement was reached to assure
a more manageable debt burden. The average
interest rate for the new agreement is 3.2 per-
cent, with a ceiling on payments of 5 percent
of treasury revenue and a minimum of at least
1.3 percent of GDP. After assets are recovered
from the banks, it is expected that the Icelandic
treasury will be responsible only for the inter-
est payments. (“Summary of the Negotiating
Committee…”) These terms imply a cost that is
only one-third of the original agreement.4

Regardless of how beneficial the banking
collapse has been for Iceland, it may not be
the solution in every case. The global chain of
events that can occur from bank failures is a
critical consideration. When Lehman Brothers
failed, its interconnectedness within the entire
system left other banks with worthless assets
and struggling to find necessary liquidity or
credit to maintain operations. Luckily for Ice-
dland, its financial system was small enough in
comparison to the global economy that,
although its failure caused alarm, it did not
set off a global chain of events.

Although a financial collapse can be diffi-
cult to accept, in Iceland’s case, the benefits that
arose from the collapse have had favorable, if
unexpected, consequences. Many of the per-
cieved consequences turned out to be less severe
or even nonexistent as events played out.

Conclusion

In the wake of its financial collapse, Ice-
land has proved that there is more than one path
to recovery. Having made a late entry into the
banking world, Icelanders attempted to make
up for lost time as their banking system bal-
looned into one of the largest systems in the
world relative to country GDP. The industry was

4 In a vote on April 9, 2011, the Icelandic public again
rejected this agreement. Iceland, the U.K., and the Nether-
lands will now likely proceed to court to settle this dis-
pute.
fraught with irresponsible practices before and after the industry was liberalized in the 1990s. Before the collapse, Iceland’s three largest banks maintained balance sheets suggesting that the system could not continue to sustain current business practices. The Icelandic banking system’s collapse has allowed for the financial rebirth that Iceland needed to mend its system.

Iceland’s success story may be an example for other countries with unsustainable banking systems, although financial collapse is not a strategy that should be considered lightly. Only by understanding the circumstances surrounding Iceland’s financial collapse is it possible to estimate whether this approach can work for other countries. One lesson from Iceland’s experience is that financial collapse does not necessarily lead to horrific consequences.
REFERENCES


