Iceland's response to economic crises: A success story?

Dimitriou, Georgia and Metaxas, Theodore

University of Thessaly, Department of Economics, Volos, Greece

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Georgia Dimitriou
Researcher
Department of Economics, University of Thessaly
28th October 78, 38333, Volos, Greece
Email: georgiedh@hotmail.com

Theodore Metaxas
Assistant Professor
Department of Economics, University of Thessaly
28th October 78, 38333, Volos, Greece
Tel: ++30 24210 74917
Fax: ++30 24210 74772
Email: metaxas@econ.uth.gr

Abstract

The economic crisis that burst in 2007 was one of the harshest-if not the harshest- in the recent history. Companies, households and whole economies were affected. Starting from the USA and later expanding to the western countries, the consequences of the crisis were severe for some countries even within the European Union. Iceland is one of first the countries in Europe that experienced the crisis and its consequences.

On October 2008, the country saw the financial system collapsing. Iceland experienced an economic bubble which can be related and compared to the one that took place in the USA. The great difference, though, was that the enormity of the Icelandic crisis could not be compared to its small size. In a short period of time, Icelanders, as well as British and Dutch, lost their money. No signs were taken seriously in the previous years, leading to a complete disaster of the economy.

The purpose of this article is to examine the factors that caused the 2007 crisis and why Iceland was so badly affected. Were there any signs of the forthcoming disaster? Could it all have been prevented and, if so, in what price? These are the questions that we would like to answer in order to understand this crisis and prevent a future one.

Jel codes: G01, N24, O16

1. Introduction

The economic crisis that appears in 2007 is considered by many as the worst economic crisis since the Great Depression of 1930. The crisis led to the collapse of large companies in both the US and Europe but at the same time brought about an unprecedented imbalance in the economy worldwide (Erkens et al, 2012). Firms, banks, corporations and whole countries were affected within a night. The European Union saw many of her members losing their monetary strength and stability.

One of the countries within the Union that was severely affected by the crisis was Iceland which saw her banking system collapse. Unable to forecast this bad turn of the economy, Icelanders and the whole world watched the fall of a country which took place within a night, drifting with her more countries with the UK and the Netherlands being the first of the list. But what is the economic crisis? What factors create it? Could it have been predicted? Such questions hardly accept a mutually acceptable answer. However, one can find answers in the literature.

The added value of the paper is in determining the reasons behind the crisis that hit Iceland and examining the way this country succeeded in overcoming its problems. Iceland could be an example for all the countries which face a similar situation and in this paper we have tried to analyze the factors behind the crisis, the impacts it had and the solutions that the Icelandic government found and used and which proved to be the right ones.

The next session of this paper presents a theoretical background of the economic crisis and the factors responsible for it. The third session presents the beginning of the crisis, where it started from and the reasons that provoked it while the fourth session presents the financial crisis in Europe and in the fifth session we examine the European reaction. The sixth session of this paper is focusing on the case of Iceland and the reasons why this country was so vulnerable when the crisis hit the European area whilst in the seventh session we try to analyze the consequences of this financial crisis on the country. Finally, the eight session of this paper is about the ways that Iceland managed to get out of the crisis.

2. Define economic crisis and responsible factors

Many definitions have been given to the term of the “economic crisis”. The classic definition of the term "economic crisis" is in fact the problems which are created in an economy by the 'monetary excesses' which lead to an inevitable rise and subsequent decline of the economy (Taylor, 2009). According to Mishkin (1991), there are five factors responsible for a financial crisis: a) increase in interest rates, b) stock market declines, c) unanticipated declines in price levels, d) increase in uncertainty and e) bank panics. More particularly:

Increase in interest rates: when a Central Bank decides to increase the interest rates it is because she is worried that inflation is about to increase. The consequences of an increase in the interest rates affect consumers as well as firms too. The higher the interest rates get the more expensive are the interest payments on credit cards and loans. Thus, people who already have loans to pay off will see their income becoming insufficient due to the higher interest payments they have to make. As a result, consumption will decline, affecting other factors of the economy too.

Stock market declines: a decline in the stock market actually means the decline of firms' net worth. A firm's net worth is essential as it has the role of a bail when it comes to lending. So, as the value of the firm declines lenders become more cautious towards them.

Unanticipated declines in price levels: the net worth of a firm can be declined by unanticipated declines of the prices. In other words, as debt payments of the firms are fixed, a decline in the prices will raise the firm's liabilities but will not raise the value of its assets.

Increase in uncertainty: as uncertainty in financial markets increases, lenders become more cautious and selective. This leads to less lending and, thus, a decline in investments and firms' activities.

Bank panics: a bank panic will occur when many banks suffer bank runs at the same time. This means that depositors decide to withdraw their money, from many banks and at the same time, causing suffocation to the whole system. Banks are unable to give loans since the deposits are reduced. Also, bank panics lead to increase in interest rates with all the consequences that follow and we have mentioned earlier.

3. The beginning of the crisis

The financial crisis which we observed taking place and affecting Europe has its roots in the American banking sector. According to Bernanke (2005), in order to be able to examine the causes and the factors that affected the economic sector of the USA leading it to a recession, it would be useful to divide them in two categories: the first is related to the trade and the US trade deficit and the second is related to investments, savings and international financial flows.

In order for a country to grow and have healthy trades which will bring back profit, the revenues from exports should, at least, cover import costs. So when the US arrives at a point in which the profits from exports do not cover the cost of imports, this difference will be borne by the respective government, businesses and households. Specifically, according to data of 2004, the US imported goods worth US $ 1.76 trillion while exported goods which brought them only $ 1.15 trillion (Bernanke, 2005). Therefore, in order to cover this difference and the deficit in the economy and to meet their obligations, the US is forced to turn to international markets to borrow as much as the difference of imports- exports. The second category of causes and factors affecting the economy and which is also due to recession in an economy are investments and savings. In order for a country to be able to invest, whether these investments concern the banking sector or in manufacturing and business, a surplus is required which comes essentially from commercial transactions.

3.1 The crisis of 2007

So, what caused this financial crisis? Analysts have concluded that these three factors that are responsible for the downturn of the US economy and, thus, the expansion to the Eurozone (Swedberg, 2010): a) Rapid growth and subsequent collapse of the real estate prices in the USA, b) Increase in the rate of administrating mortgage loans, c) The securitization and transfer risk from banks to the public and investors (Swedberg, 2010). At this point, the role of the banking systems in the economy is becoming clear and especially in an economy which starts showing problems, deficits and signs of recession. In order to boost investments, particularly in sectors such as constructions and new technologies, banks lend large amounts of high risk. What is now, however, foreseen is a pressure and an inability to pay back these debts to the banks, given the low financial liquidity (Eichengreen και Mitchener, 2004).

3.2 Real estate prices in the USA

In recent decades, the capital market and property are the sectors in which economists pay particular attention. Especially after the great crisis of 1930s, economists are skeptical about the fluctuation of capital values, assets and real estate market. As shown by the most recent history, during the decades from 1970 to 1990, a sharp increase or decrease in capital values can lead to disastrous consequences, both at microeconomic level and up to macroeconomic level and a n overall imbalance (Gerdesmeir, Reimers and Roffia, 2010).

It is, then, understood that watching and focusing on the prices of real estate is of the greatest importance for the banks. A bank's ability to understand and explain the reasons why a rise or a fall in the real estate prices- and particularly when this happens to a large extent and with great intensity- is a great advantage for it. The greatest benefit, however, for the banks is the ability to recognize when this variation in the real estate market is real and when it is of a "bubble". The "bubble" phenomenon was, in fact, the beginning of the economic crisis which affected the USA and expanded in the European zone later.

3.3 The increase in mortgage loans

With the rise in the US real estate market, it was more than expected from the banks to react accordingly. The rapid growth seen in the construction and housing sector and the increase in the demand for real estate lead the American banks to increase mortgage lending. Here comes the point, then, at which banks grant loans even to those households which were excluded before and which, later, would be unable to repay their debts to the banks (Barrel and Davis, 2008, p.7).

The biggest mistake that the banks made while granting mortgage loans was the fact that the only guarantee they asked for was an expected increase in real estate prices. Furthermore, the interest rates in which they lent started from low prices, in order for the banks to become more attractive to their clients-to-be and, later on, the same rates were adjusted.

However, the increase in the real estate market reaches its peak and then the decline begins. A direct consequence of this is that this decline extends to the banking sector and an uprising crisis is on the verge (Ellul and Yerramilli, 2010). This crisis in the banking sector is due to two reasons: firstly, many high- risk mortgage securities were kept in each bank whereas they could have been transferred, in time, to other financial institutions which would have had a greater ability to manage them. Secondly, the management of the banks which started to suffer felt that a good first move to remedy the situation would be a short-term customer lending (Kashyap, 2010).

3.4 Securitization and risk transfer from banks to customers

In the securitization process, loans are converted into bonds. Thus, the bank has now a portfolio of loans rather than bonds which can be used to negotiate. Then, similar titles are securitized and sold to the European banks with the creation of Collateralized Debt Obligations (Collateralized Debt Obligations, CDOs). What, in fact, occurs during the securitization process is that each bank shows in its balance sheets the liabilities and obligations of the Collateralized Debt Obligations and the assets of the requirements of the loans which it has securitized. Therefore, the bank is able to pay its obligations once it has received the interest on loans.

During the securitization process and along with its portfolio, the bank can now avoid holding a risky and costly capital and is able to sell its products to the investors who, in turn, bear the risk of these new bonds (Achary and Richardson, 2009, p.5). So what is that motivates investors? The answer is the fact that the greater the risk of having a title, the greater will be the profit when making the repayment.

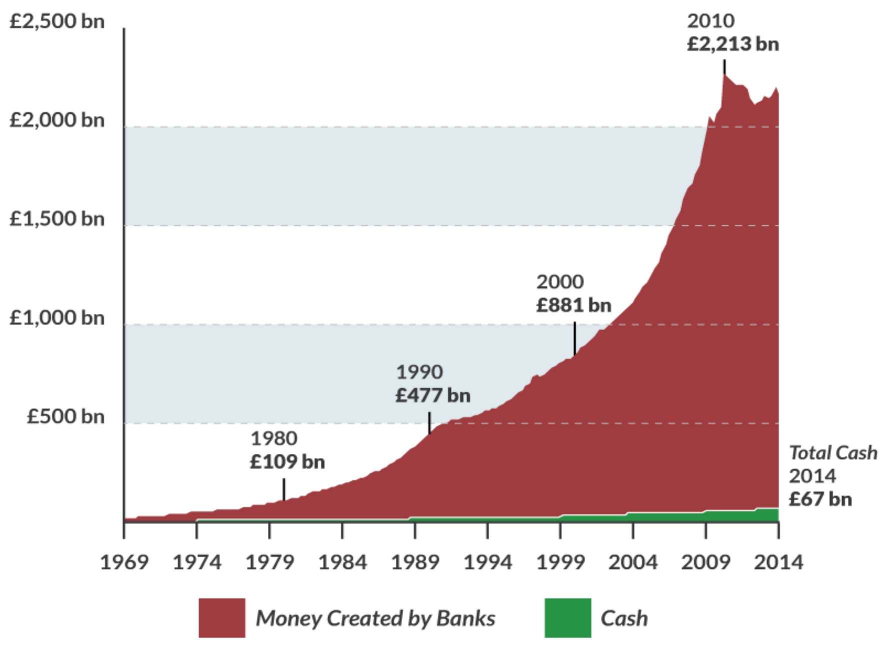
The great advantage that this technique offers to the banks is that they can lend even to non-creditworthy customers as the risk will be transferred to the other investors whereas the bank will be able to obtain additional liquidity. It is, therefore, understood that at a time in which the real estate sector is booming and the demand for property increases, banks lend large sums with the security offered by the technique of securitization. At this point, the reasons and the sequence of the US financial crisis are beginning to show. It is now the turning point in which this crisis will be, subsequently, transferred to Europe.

4. The economic crisis in Europe

As globalization of businesses is becoming more intense, the consequences of it are sometimes harsh and can affect a country or, even worse, a whole union. The intensity is mostly seen in finance where events that take place in one part of the world can instantly affect countries in the other side (Arnold and Sikka, 2001; Rotheli, 2010, p120). The closure of the banks, for instance the Lehman Brothers, affected the USA as much as Europe.

The factors behind the European crisis are, in fact, the same as in the USA. First, banks create money. Whenever a bank is granting a new loan, new money is created. Until the financial crisis of 2007, banks created too much money by making loans and without asking for the proper guarantees. So, it can be understood that the money banks have created are not real money but fictitious (Figure 1). Most of the money that the banks created, especially between 2000-2007, stayed in the banking sector and with very little of them going to businesses outside the sector.

Figure 1: Money created by the banks compared to the real cash



Source: http://positivemoney.org/issues/recessions-crisis/

Real estate and financial markets are the sectors that most of the money was used, leaving only a small percent of the money to be used by businesses. Lending money for real estate purposes eventually lead to the rise of the housing prices. Along with the rise of the prices, though, personal debt will rise, too. We reach a point where households are unable to repay the interest of their loans and, even, stop their payments completely.

Banks are now facing the possibility of a bankruptcy. And this is where the crisis begins. Banks are limiting their loans to households and businesses, causing a drop in the prices of the markets. For those who had borrowed a loan and are, now unable to pay it back, things are even worse: they have to sell their assets in order to repay their loan but the prices of the assets are much lower than the prices they had borrowed them with. Economy is now falling into a recession. The banks give less loans and lead to lack of money from the markets. Those who have loans have to pay them but the money used for these repayments don't flow into the markets but, instead, disappear.

5. Europe's response

Europe's response to the economic crisis that affected the US, came somewhat belatedly and without, perhaps, being given the right attention. But, even when Europe got affected by the crisis, the issues that seemed more important to the competent members were a possible depreciation of the euro, the decline in exports from Europe to the US, a continues inflationary pressure and the downward route that the real estate market in Europe starts to show now, as well (Dabrowski, 2010). In September 2008, however, Europe will understand the magnitude of the crisis. It is the month that the company of Lehman Brothers announces its bankruptcy. Before their bankruptcy, the company was one of the largest financial institutions in the US. The reason why such a great company reaches the point of bankruptcy is nothing else than the poor assessment of the market situation and of the real estate market in particular. As mentioned earlier, the uncontrolled granting of mortgage loans, especially subprime loans, led Lehman Brothers to dramatically reduce its credit rating.

This point is crucial for the subsequent course of both the US and the European economy. The bankruptcy of the Lehman Brothers bank instantly froze money markets all around the world. The first problem that the European banks have to deal with is the interbank lending. This means, in terms of real life facts, that the banks will see their cash reserve dropping dramatically. On the same month, Europe will be shocked by the bankruptcy of the Icelandic banks. Within a night, the three major banks of Iceland are going into bankruptcy leaving their depositors unable to react. Iceland, the United Kingdom and the Netherlands are the three countries that feared the most for the losses of their deposits in the Icelandic banks.

5.1 The effects of the economic crisis in the EU

In the beginning of the crisis, some of the European Union members considered the crisis to be a problem only for the USA. Soon they were proven wrong since the European economy started to decline, as well (Jackson, 2009, p. 1).

One of the primary consequences of the crisis is that many EU governments had to make use of their public resources in order to help the problematic banking system of some countries, to protect the depositors and also to improve and boost the markets. Soon, though, this policy would fail as the financial crisis becomes more intense, leading the governments to seek for new ways to protect their economies. In order to secure the economies from a worse decline, the EU governments have to join forces and act as a Union.

In the months to follow, some EU leaders have decided that it was crucial to set some policies and rules that would be common for all the members of the Euro zone. Europe had to be protected from a possible worse consequence of the Icelandic faulty banking system. In February 2009, leaders and Finance Ministers from Germany, the Netherlands, the United Kingdom, Luxemburg, France, Italy and Spain met in Berlin in order to carefully examine the current situation and set some financial rules. From this meeting, a proposition paper was formed which set some goals for the European leaders. These goals were "a) transparency and accountability; b) enhancing sound regulation; c) promoting integrity in financial markets; d)strengthening international cooperation; and e) reforming international financial institutions" (Jackson, 2009, p. 4)

5.2 The European reaction

The policies that the European Union used in order to solve the economic problems that appeared can be described at least spasmodic and erratic. The reaction that the European Union had was chaotic and not carefully organized. Since we are talking about a union, one thing that led to the spread of the crisis in most of the countries was "contagion". The term contagion "refers to a situation whereby instability in a specific market or institution is transmitted to one or several other markets or institutions" (CONSTÂNCIO, 2012, p.110).

The results of the contagion among the countries of Euro zone was, in fact, the diffusion of the problems and the imbalances which caused consecutive shocks in the countries. Another significant point of contagion is that it affected the banks, as well.

According to Reisen (2008), contagion can occur through three channels:

- Foreign trade, or also known as "monsoon effect", in which small economies are more vulnerable to being affected due to the trade.
- Financial contagion, which occurs when the money invested from one country return to it. This kind of contagion will cause problems to the countries when currency mismatches appear on the balance sheets of banks and corporations causing a malfunction.
- "Pure" contagion, which occurs when money and bank markets fail and break down. A contagion of this kind occurred in the crisis of 2008 and it was mostly detected in Iceland.

In order to maintain the strength of the monetary system in the Euro zone and to stabilize the credit flow, the ECB made some policies. ECB's first concern was to prevent a further contagion of other European countries and, at the same time, to provide liquidity in longer and looser terms in order to help the most dysfunctional of the economies. Next thing which the ECB did was to join forces with other central banks, not only in the Euro zone but in an international level.

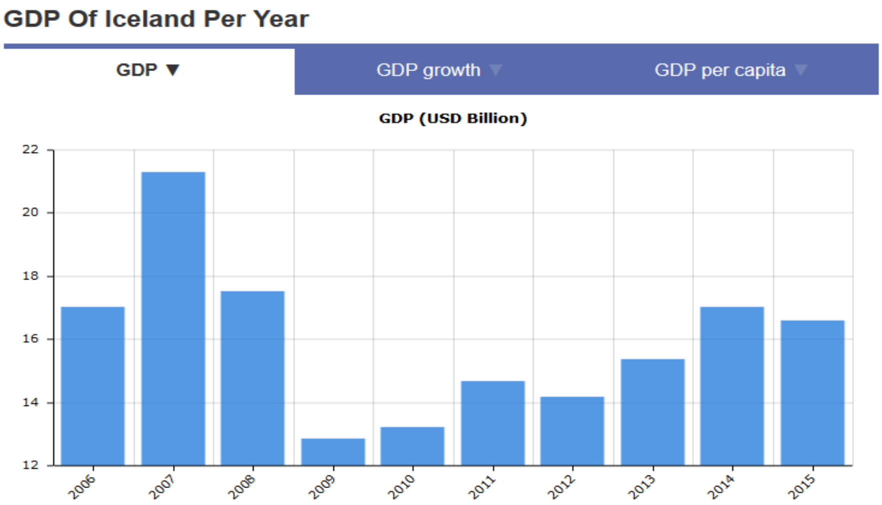
The next thing the ECB did was to launch a policy of "enhanced credit support". This new policy would provide some extra liquidity to the banks and for a period of time which would be extended one more year. Even though Iceland was already on the verge of total collapse, it wasn't the European Central Bank that offered some help but the IMF. Europe is divided over the case of Iceland: since the country is a member of the EU the leaders have to offer her help. But along with Iceland, the UK and the Netherlands had lost money as we will explain later. So, the EU response had to be neutral and to help both sides.

6. The case of Iceland

Iceland was one of the countries in Europe which was hit by the financial crisis. It was, in fact, the first country to face a banking crisis leading to a downfall of the economy. But how did it all start?

Icelandic economy is one of the youngest in Europe. It was only until one century ago that Iceland transformed from a farming country to an advanced economy (Vaiman et al., 2010, p. 260). The country of Iceland has been under the rule of other countries for centuries. First were the Norwegians that ruled Iceland from 1260 until 1380 when it became subject to the Danish crown. Icelanders started seeking for their independence in the mid 19th century and finally gained it in 1944. Iceland's economy was based on farming with the majority of the population working as farmers in 1900 (Wade and Sigurgeirsdottir, 2012, p 131). The economic growth started in the 1990s and especially after Iceland joined the European Union. A large part of Iceland's economy has been due to the fishing activities of the country. This changed in the early 20th century when the country transformed into an "international mini- capital of finance" (Loftsdóttir, 2010). Iceland is the world's 106th largest economy. Its average GDP in the last 10 years is 15.98%, with the highest GDP being recorded in 2007 (21.29%) (Figure 2). Iceland's economic growth is expanding in new sectors like biotechnology, software production and financial services. Also, tourism is another sector which is growing rapidly in the past years.

Figure 2: The Gross Domestic Product of Iceland from 2006- 2015



Source: http://www.worldatlas.com/finance/iceland/gdp.html

The country's economy is mostly export-oriented, with marine products, aluminum and metal, wool as well as equipment for the fishing industry being on top of the list of exported products. The fishing industry only provides 40% of the country's export income. The main destinations for Iceland's exports are the European Union and the European Free Trade Association countries, the USA and Japan. The imports of the country are mostly foodstuff, petroleum products, machinery, textiles and cement.

6.1 The banking sector of Iceland

Currency

The króna is the currency of Iceland, issued exclusively by the Central Bank of Iceland. The country faced a great shock in the 1970's during the 1979 energy crisis, in which it reached an inflation of up to 59% in 1980. It was only until 1994 that things changed for the country as the GDP kept growing until 2004. During these years, inflation was preserved in low levels but in 2006 it reached the level of 8.6%.

The Banking Sector

The banking sector has had an important role in the country's economic bloom. Iceland has three major privately owned commercial banks: NBI (formerly Landsbanki), Arion Bank (formerly Kaupthing Bank) and Islandsbanki (formerly Glitnir). In the years preceding the crisis, these three banks- Landsbanki, Kaupthing and Glitnir- expanded and multiplied in size due to the banks' access to credit in international financial markets. Nonetheless, when the international financial crisis broke out and started expanding, trust in these Icelandic banks was lost.

Since Iceland has been a small finance market, the only way the country's banks could have expanded would be through interbank lending. Also, one more reason for their expansion was the deposits from outside Iceland and, especially, the Netherlands and the United Kingdom. Iceland's major commercial banks were Kaupthing, Landsbanki and Glitnir and it is estimated that, by 2008, those three banks only held a foreign debt in excess of 50 billion € given that the country's GDP was 8.5 billion €.

In the years between 2001-2007 Iceland's borrowing from the international credit markets was so big that it provoked a great expansion of the banking sector. A direct result of this borrowing, as well as, from the deposits the banks had attracted, was the buy-out of foreign companies and assets, too (Zoega, 2008, p. 19). At this point starts the problem for Iceland and the country's banks. As the banks expanded more and more, the government of Iceland should have taken the right measures in order to restrict this expansion. The growth of the banking sector was so great that it transcended the central bank of Iceland and its ability of lending.

Icesave

One of Iceland's private banks, Landsbanki, founded an online savings account brand, Icesave. It operated from 2006-2008 in two countries, the United Kingdom and the Netherlands, while the bank's initial purpose was to operate in more countries in the following years.

Icesave's operation in the UK, offered three types of saving accounts: an immediate-access savings account, Individuals Savings Account (ISA) and a range of fixed- rate bonds. At the time Landsbanki collapsed, Icesave already had 300.000 customers and over €5 billion deposits. The interest rates that Icesave offered were over 6% meaning that they were among the best rates that were offered to customers from online banks in the UK. In the Netherlands, Icesave operated only for five months. However, in this short period of time, it managed to attract more than 125.000 customers with deposits reaching to €1.7 billion. It offered only one type of account: an immediate- access savings account. The interest rate in Netherlands was 5% but it later increased in 5.25%.

Kaupthing Edge

Like the case of Landsbanki's Icesave, Kaupthing Bank founded "Kaupthing Edge", an online savings brand, as well. It offered two types of accounts: a savings account and a fixed-term deposit account. Kaupthing Edge was available in ten countries: United Kingdom, Germany, Austria, Luxemburg, Norway, Sweden, Finland, Switzerland, Belgium and Isle of Man. Unlike Icesave, Kaupthing Edge accounts were under the responsibility of regulation from the host countries and not Iceland.

The collapse

Since 2001, Iceland saw a great boom as foreign capital was flowing into the country (Asgeirsdottir et al, 2015, p 92). But the frivolous behavior of the banking system and the loose management of the government led to a downturn of the economy. 2008 was a crucial year for Iceland. There was some great concern on the matter of Iceland through 2007, mostly, due to the fact that the three major banks had a combined debt which was five times the Icelandic GDP. At that point, the debt of all three banks was estimated to be € 50 billion compared to the €8.5 billion of the Icelandic GDP. In terms of policy mistakes that have contributed to the financial crisis of the country, monetary policy is of great importance and is one of the factors to blame for the later country's situation. Icelandic economy and its banking sector appeared too expansionary and without paying attention to the symptoms that portended the upcoming disaster.

Following the bankruptcy of Lehman Brothers, Iceland was then facing the fear of watching its banking system fail. The once "too-big-to-fail" system is now "too-big-to-save"; within a few days 85% of the banking system had collapsed (Growiec et al, 2012; Jonsson et al, 2016, pp 289). In the first week of October, matters became worse when the foreign press started writing about the Icelandic banks, the lack of stability and the difficulty of paying off their debts (Wade and Sigurgeirsdottir, 2012, p 136). These rumors, combined with the depreciation of the ISK, the Icelandic króna, which took place earlier the same year (from January to September the value of the króna dropped 35%) led to a run on the deposits, first in the UK and later in Netherlands and the other markets.

On 7 October, just a few days later of the British concerns on a possible failure of the Icelandic banks, Landsbanki was placed by the FME on a state of receivership. On 9 October, all the Icelandic assets and the liabilities of the bank were transferred to a new bank under the name Nýi Landsbanki (now Landsbankinn). The bank was established by the Icelandic government and until today it is state-owned.

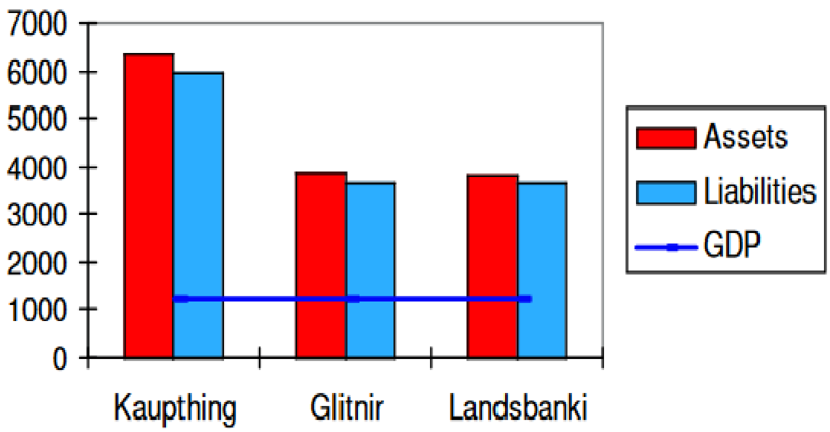
6.2 So what caused the crisis?

Was Iceland just a victim of external events or do they have to blame themselves for the situation they got into? Could this crisis have been restricted by the right government policies? Are the banks the only to blame or were the policies of the government a cause of the crisis? It will take time to understand to full extent all the causes that brought Iceland into crisis but we can tell for sure that the most important factor of the crisis was the "bad behavior on the part of the financial system" (Stiglitz, 2010, p 322).

The expansion of the banking sector

In the years before the crisis, the Icelandic banks showed some great expansion and rapid growth (Flannery, 2009, p 95). With the buy- outs of foreign companies and assets, the banks had tremendous assets on their balance sheets. For a country whose economy is properly administrated and the necessary safeguards are offered by the government, this wouldn't be a reason to worry. But in the case of Iceland, this great banking expansion should have been stopped by the government on time. The banks reached a point at which the worth of the assets they had on their possession was much bigger than the Icelandic GDP (Danielsson, 2008, p. 11) [Figure 3]. In fact, until the first half of 2007, the worth of the assets of the three major Icelandic banks was 14,069,370 million krónur which means eleven times the GDP of the country (1,319,200 million krÛnur) (Buiter and SIbert, 2008, p. 4). In the aftermath of the 2008 crisis, we can tell that this financial crisis was incubated and driven by the Western Economies and especially the USA which motivated economies at taking more risks through financial instruments (derivatives, CDOs) (Sikka, 2009, p 868).

Figure 3: The size of the three major Icelandic banks compared to the GDP



Source: Buiter and SIbert, 2008, p. 4

So why would that be a problem for a country? A country's relation with its banking system means that the state offers guarantee for the banks' assets, as well as liquidity. In Iceland's case, it didn't follow this pattern. In fact, the banking sector became too big for the country's size and ability to offer guarantees. This was a sign that the Icelandic government should have payed attention to and not pass by. The capacity of the Central Bank of Iceland was much smaller than this of the three commercial banks combined and, thus, the CBI could no longer operate and be used as "a lender of last resort" (Zoega, 2008). At this point, it is already obvious that the decisions taken by individual banks can put entire economies at risk. The growth strategies that the three banks pursued made them much greater than the whole economy of the island and leading, eventually, to their downfall. In addition to this, it provoked a political crisis to the country, apart from the financial.

One more thing that made matters worse was Icesave and the fact that it operated as a branch of Landsbanki. This means that in a difficult situation in which liquidity was necessary, Icesave could not turn to the Bank of England for help but instead, only the Central Bank of Iceland could offer help. Another policy mistake that the Icelandic government made was the decision to nationalize Glitnir. The government intended to take a 75% share of the bank for €600 million. This acquisition of the government could have an unfortunate turn for Iceland by turning a financial crisis into sovereign crisis (Beirut and Sibert, 2008). Fortunately, this acquisition as never completed as the Financial Supervisory Authority takes control of the bank.

Central Bank governance structure

Apart from the size of the banking sector, one more thing that proved to cause problem to the economy of the country was the banking governance. The governance structure of the Central Bank consists of 3 governors, from whom one or even more are former politicians.

It would be expected from someone, then, to draw the conclusion that the Central Bank has always been, somehow, connected to the central government of the country. This relation between the government and the Bank reduces the reliability of the bank, as it isn't totally independent from the political part of the country. In order to raise the reliability of the Bank, its governor/s should be chosen according to their knowledge and experience and they should be politically impartial.

Also, one more disadvantage which is caused by choosing former politicians as governors of the Central Bank is the fact that, most likely, they will not have the necessary knowledge or expertise to manage the Bank.

Inflation

The interest rates that were held by the banks of Iceland were high. As figure 4 shows, the Central Bank of Iceland held interest rates up to 15% whereas, the UK 's interest rates were 5.5%, for example. This resulted in many depositors choosing the Icelandic banks and Icelandic króna for their deposits. The first assumption that one can make at this point is that all these deposits would lead to monetary inflation. And this is exactly what happened in the case of Iceland. Apart from the monetary inflation, the country will now face inflation in general. Consumers will see a rise in the prices of goods up to 14% within a year.

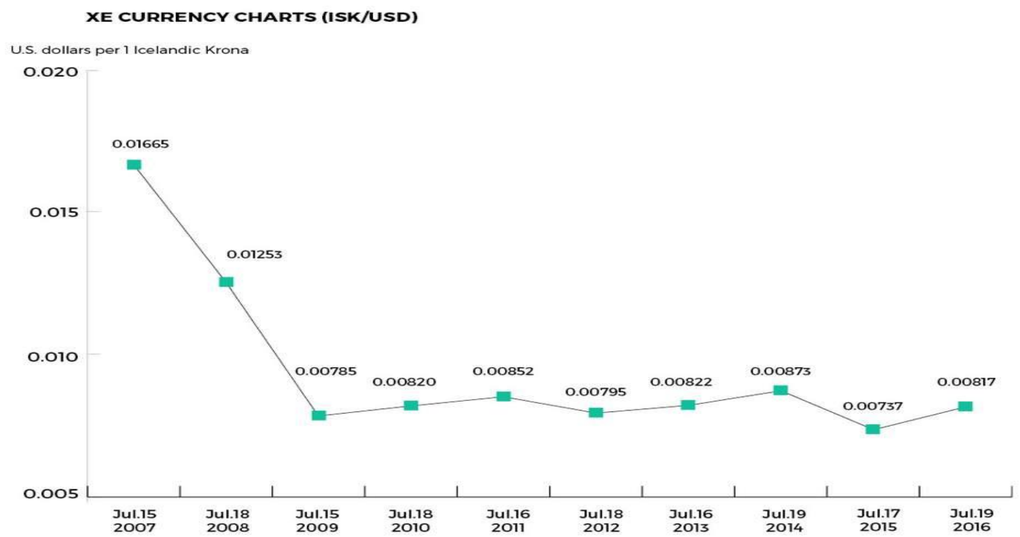
Figure 4: The interest rates of the Icelandic banks from 2008- 2016

Inflation is, actually, one of the causes of Iceland's crisis. As the Icelandic money supply increased up to 56% in just one year and with the increase of the deposits at the country's banks along with the high rates that were offered created the illusion of wealth. The more depositors would choose Icelandic banks for their money the more these banks would keep rates high. This currency inflow is what encouraged the economic growth and inflation (Danielsson, 2008, p. 10) [Figure 5].

Figure 5: The inflation rate of the Icelandic economy between 2008- 2016

As the number of foreign depositors increased so did the inflow of foreign- currency in Iceland. As a result of this, the exchange rate got higher. The foreign- currency became part of the country's economy and this lead to a depreciation of the local currency (Figure 6).

Figure 6: Exchange rate of the Icelandic Krona and the US Dollar between the years 2007- 2016.



Source: https://skift.com/iceland-tourism/

7. Consequences of the Crisis

7.1 Depreciation of the Króna

One of the first impacts of the crisis was on the Icelandic currency. As soon as the banking crisis hit Iceland and the three most important commercial banks went on bankruptcy, the first sector that was affected was the currency –króna- which was instantly depreciated. The reason why the króna lost its value was the fact that investors in the Icelandic banks- during the banking crisis- would convert their Icelandic assets into foreign currencies.

Consequently, the currency depreciation affects households and, thus, consumption. Households are the first to be affected leading to a reduction in their consumption since their balance sheets are now changing. As a result of the household reduction in demand, corporate profits will be reduced.

One more problem for the firms, which is created due to the depreciation, is the uncertainty in most sectors of the economy. According to IMF, investment is also expected to be reduced “by 30% points below the baseline”. However, in the paper that the IMF published in 2015, it is issued that the situation of the country in 2015 is better and less uncertain compared to the crisis of 2008.

7.2 Capital controls

Iceland is familiar with capital controls, as for the most of the twentieth century international capital movements were strictly restricted. This changed when the country became a member of the European Union in 1994 and capital liberalization started between Iceland and the other members of the EU. As the crisis was becoming more intense, many investors decided to exit the króna, leading to its depreciation. When the banks went down and the króna was even more depreciated, “capital-flow management” measures were necessary in order to avoid the negative consequences (Forbes et al, 2013). In 2008 capital controls were imposed to Iceland in order to obstruct further loss of money from the country and a collapse of the exchange rate (Baldursson and Portes, 2013, p.42). Capital controls were imposed with a prospect of being removed shortly after. In 2011, the Central Bank of Iceland suggested a plan for lifting them but until today they have not succeeded in overcoming the boundaries in order to get monetary liberalization. According to the central bank governor, Mar Gudmundsson, and an interview he gave to Reuters on October 2016, capital controls and all the remaining restrictions could be fully gone by the end of 2017.

7.3 Foreign demands from the Icelandic government

As mentioned before, Icelandic banks had deposits from foreign countries, with the greatest depositors coming from the UK and the Netherlands. When the banking crisis started in 2008, the foreign deposits, as well as the Icelandic ones, were no longer secured by the banks and thus, UK and Netherlands depositors lost access to their money.

The Icelandic banks faced a major difficulty when their creditors insisted and asked for their payment. The British and Dutch authorities demanded from the Icelandic state a guarantee of €20.887 per account. The situation faced by Iceland is much worse than they could previously ever believe. The interbank market is of no help for Iceland at this point since the loans the banks own are worthless and no bank is willing to offer new loans to the Icelandic banks. In any other healthy economy, the solution would be given by the Central bank of the country which would lend to the privately owned banks. But in the case of Iceland, the government can’t offer any help since the banking sector is much larger than the economy of the country. Thus, the government and the Central Bank of Iceland cannot guarantee for the banks’ debts.

Iceland’s failure to reassure the British people on the security of their deposits leads the British government to resort to anti- terrorism legislation against Iceland. The purpose of this was to freeze all the assets that Kaupthing had in the UK. With this move of the British government starts the downturn of Kaupthing, which by that time, was the largest and most important commercial bank of Iceland.

8. Getting out of the crisis

Once the Iceland’s economy was severely hit by the crisis, Icelandic authorities had to find solutions to deal with the failing banks. At this point, Iceland is on its own facing a great unwillingness for help or co-operation from other countries. Nevertheless, Iceland has to come up with the ways to protect the country from generalized consequences of the banking crisis.

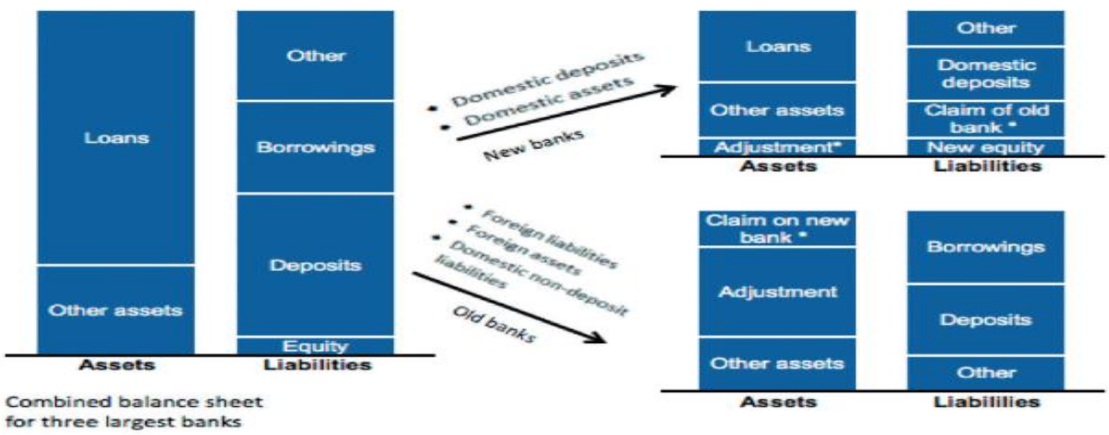
The solution was given by the government of Geir H. Haarde and passed by the parliament on October 6 2008. It was called Emergency Act. Through this emergency legislation the Icelandic government managed to minimize the impact of the crisis on the country by giving permission to the Financial Supervisory Authority of Iceland to undertake the operations of the three major commercial Banks. One more factor that helped in the recovery of the country was the IMF and the economic aid it offered through the IMF Stand-By-Arrangement.

8.1 Restructure of the banking sector

Due to the liquidity problems that the three banks faced, their control was passed to the Icelandic regulator (FME). The result was the separation of the banks into "Old" and "New" Banks with assets being transferred from one to another. Both foreign assets as well as debt obligations remained to the "Old" bank whereas domestic assets and deposits were transferred from the old to the new banks. The deposits of the Icelandic branches were now in the property of the New banks whereas the deposits of foreign branches remained in the Old banks but with high priority (Figure 7). Following the deposits were the bondholders of the banks. Figure 3 shows the separation of the banks. The reason behind this split of the three banks was the improvement of the recovery rates, as it would be an outcome of the residual value of the remaining assets in the "Old" banks and the realizable value of the bonds issued by the "New" Bank (J.P.Morgan, 2009, p.2).

The issue of the "Old" and the "New" banks was questioned and doubted a lot. Many rushed and claimed that the "New" banks were nationalized. The truth is that these "New" banks belonged to the private sector as did the "Old" banks. The Icelandic government proceeded and fully recapitalized only one of the banks, Glitnir. The rest two banks remained as a property of the old banks.

Figure 7: The separation on the banks into "New" and "Old" and the sharing of assets and liabilities



Source: Baldursson and Portes, 2013, p. 46

8.2 The IMF Stand-By-Arrangement

The IMF Stand-By-Arrangement (SBA) was applied in November 2008 and managed to restrain a wider spread of the crisis in Iceland.

The first step of the SBA was the adoption of a program which would offer fiscal consolidation. The way to do that was through austerity measures and increase in taxes, leading, though, to the stability of the Central Government debts. The second step of the SBA was the protection of a banking system which would be much smaller but viable. As mentioned before, the existing banking system was too large for the size of the country, making it impossible to save when needed. Downsizing the banks and creating a new system out of the ruins of the old, proved to be salutary for the country. The third step of the SBA was the re-establishment of the capital controls. I have already mentioned that the Icelandic economy was under capital controls for most of the twentieth century and in the recent history, since the October of 2008, they were imposed again on the banking system.

8.3 Icelandic EU Accession bid

On 16 July 2009, the government of Johanna Sigurdardottir applied for membership in the EU. Formal negotiations started on 27 July 2010 and continued until September of 2013, when Iceland suspended the application for membership.

The timing when the application was made couldn't have been more appropriate as it gave Iceland some more help with the resolution of the crisis. With this action Iceland has succeeded in gaining trust and enhancing the credibility of the country on the international financial markets. Even though applying for the membership was important for the course of the country, the governments that followed suspended the negotiations. On 12 March 2015, Foreign Minister of Iceland Gunnar Bragi Sveinsson stated that he had withdrawn the application for membership, whereas the EU stated that no formal withdrawal of application had been made.

9. Conclusions

Iceland can be regarded as a recovery success story. Facing a major and sudden banking crisis and leading the way out of it within a few years is a great achievement for a country, especially of the size of Iceland.

Choosing to let the banking system of a country fail is against the normal but it was a decision that Iceland took and proved to be the right one. Bankruptcy, capital controls and austerity measures didn't stop Iceland from regaining the status it had before all these. The country was left to find the way out of the crisis and this is exactly what happened. Beating the odds, Iceland's model of economy seemed to work.

Here lies a great advantage that the country had: its currency. Making the economy more competitive, while reducing the wages was necessary and to help the country to improve its place. Instead of cutting on the wages and payments, Iceland decided to devalue the króna. Through the devaluation, export revenues increased, with fish being the top exports. Also, tourism was another sector that benefited from the situation. Iceland is, now, seen as a cheap travel destination and creating some really promising revenues.

Iceland is an example of how a whole country can be a victim to a financial trap. Icelanders were made to believe that they were in place to support such a huge banking system, investing on it more and demising the other parts of the economy. But Iceland did something unexpected that no other country would have: let the banks fail. Coming as a surprise, this actually worked and helped the country develop again.

Right now, Iceland is growing at fast rate and is even paying back the huge loans it had. This country can become an example of how it can rise from the ashes, going against the norms and finding revolutionary solutions in order to save an economy. Iceland has made its way to the top on her own- with only the help of the omnipresent IMF- doing the things on its way getting itself out of the destruction, creating the infrastructure for a promising future and proving everyone wrong.

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