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NOTES FOR TALK IN REYKJAVIK, 12 JANUARY 2009

INTRODUCTION OF RHW:

RHW is a NZer, who has lived and worked in Britain and US for past 4 decades. Worked as an economist at World Bank, and taught at MIT, Princeton, Brown universities in US, and at Sussex University and LSE in Britain. He won the Leontief Prize in Economics in 2008, which some describe as an “alternative Nobel Prize” for heterodox economists (previous winners include J.K. Galbraith and Amartya Sen). He is a member of The Financial Times’ Economists’ Forum, a group of 50 economists described by the Financial Times as “50 of the world’s most influential economists”.

Ten years ago he wrote several studies of the East Asian financial crisis. He has visited Iceland several times over the past few years. From August 2007 he has been giving public talks and interviews in Iceland about the growing dangers of a major crisis, drawing on his knowledge of what happened in East Asia.

In early July he published an article in The Financial Times titled “Iceland pays the price for financial excess”. In this article he rang the alarm bell even louder than before. The article said little that was new to Icelanders, but because it was published in a highly respected international newspaper, it attracted attention in Iceland. The PM was asked for his reaction to it, and dismissed it as worth no more attention than a letter in DV. His reaction was yet another of many examples where our political leaders failed to pay attention to warning signs at a time when they could have taken action to reduce the damage which Iceland’s society is now experiencing.

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WHY AM I HERE?

I wrote at length about the East Asian financial crisis 10 years ago, and during the past few years I have visited Iceland several times for personal rather than professional reasons. I began to link together my growing knowledge of the Icelandic financial system with my knowledge of the East Asian financial crisis, and from the

summer of 2007 began to worry about Iceland's financial system. I saw that Iceland was running world-record external payments deficits (the gap between imports and exports was bigger than in almost any other country in the world); I saw that the krona was nevertheless *appreciating*, not depreciating as it should have been; and I saw that many of my friends here were loaded up on debt denominated in foreign currency, leaving them vulnerable to a depreciation of the krona. I concluded in the summer of 2007 that Iceland was dynamite waiting to explode – and said so at a public meeting with people from banking, business and government in August 2007. Members of the audience either said nothing or reacted dismissively.

WAS THE CRISIS IN ICELAND INEVITABLE EVEN WITHOUT A GLOBAL CRISIS? YES

There is no doubt that the global financial crisis, which began to spiral out of the US and the UK and go global in the summer of 2008, has made the situation in Iceland worse than it would otherwise be.

But Icelanders cannot console themselves that the crisis in Iceland was just bad luck, or just due to the world crisis of which they were innocent victims. Iceland would have had a major crisis even without a global crisis. For two main reasons.

First, the idea of making Iceland an international banking center was crazy from the start. When Icelanders celebrated the fact that their tiny country had 3 banks in the world's biggest 300 banks, they ignored the dangers of having such big banks domiciled in a very small economy with its own very small currency and unrestricted inflows and outflows of capital. The banks were far too big for the Icelandic central bank to provide lender-of-last-resort support, because Iceland's tax base is far too small. The banks should never have been allowed to grow to that size while remaining domiciled in Iceland. The Baltic economies have also taken on a heavy load of debt, like Iceland; but they were not trying to make themselves into international financial centers, and the banks operating there were mostly foreign owned, and therefore had foreign lenders-of-last-resort.

The second reason why the Icelandic economy would have experienced a major crisis even without a global crisis is that the

economy had come to be based on a phoney, or unviable, growth model. The government set high interest rates and allowed free inflows and outflows of capital; high interest rates attracted in foreign capital, mostly into financial assets; big inflows of foreign capital caused the krona to appreciate; the overvalued krona made imports of all kinds of goods and services relatively cheaper; it also made it cheaper for Icelanders to borrow abroad in foreign currencies. So the combination of high interest rates, capital inflow, and overvalued krona created a boom, and for some years it was bliss to be alive in Iceland. Icelanders borrowed as though there was no tomorrow. Between 2003 and 2007 total foreign debt/GDP shot up like a skyrocket at New Years Eve, to reach between 700 and 800%. But the whole growth model all depended on foreign lenders being willing to keep on lending, and the moment foreign capital stopped coming in the whole pyramid of debt began to unwind. The process became as damaging in reverse as it was good going forward.

Think of it this way: If my tailor lends me the money with which to buy his suits I will keep buying his suits with his money. For a time I will be very happy and I will be admired by all my friends for my growing collection of suits. The problem comes when my tailor insists that I repay the credit he has given me. Then I will not be so happy and I may have to sell all my suits at firesale prices.... Icelandic society now faces a long period -- several years at least -- of having to repay the tailor for years of past excess consumption.

In a sense, then, the “problem” is not the current crisis. The problem is how to scale down from the phoney consumption standards of the past decade to sustainable living standards for the next decade. Icelanders have been enjoying something like a free lunch, and at the end of the day, there is no free lunch.

COULD THE GOVERNMENT HAVE TAKEN PRE-EMPTIVE ACTION TO SOFTEN THE CRISIS? YES

The problems facing Iceland's banks were already well known to the wholesale money markets, or bond markets, by the summer of 2006, when conditions in the global financial market were still healthy. The government could have paid attention to the warning signs and acted to protect the economy from a banking crisis, but did not.

By the summer of 2006 Icelandic banks found it difficult to sell bonds in order to borrow money, because potential buyers of their bonds (or lenders to them) became aware that the banks' balance sheets were unbalanced, that the banks were taking on far too much debt. By the summer of 2006 the Icelandic banks were closed out of the wholesale money markets.

This should have sent a clear message to the owners of the banks, to the boards of the banks, to the central bank, and to the Financial Services Authority that something was seriously wrong, and that the banks had to cut back their borrowing and their acquisitions.

Instead, the banks went to the retail money market, by opening Icesave internet accounts and Singer and Friedlander accounts. They proceeded to suck up retail deposits by offering a slightly higher interest rate to UK, Dutch and German depositors than those depositors could get from their own banks.

This allowed the Icelandic banks to avoid taking action to make their own banks and the banking system safer; indeed, their success in attracting UK, Dutch and German deposits encouraged them to take even bigger gambles and to further disregard prudential limits.

In short, it is true that the crash of the Icelandic banking system in September-October 2008 was a direct reflex of the global crisis. But a crash of the banking system would surely have come anyway.

A crash was all the more likely because the expansion of the banks and investment companies was probably propelled by fraudulent practices, including fraudulent valuation of assets; and because the financial regulators displayed a level of incompetence which is difficult to believe.

In particular, the government, the central bank, and the Financial Services Authority ignored repeated warnings of dangers ahead. For example, when Robert Aliber, one of the world experts on financial systems and financial crises, came to Iceland in 2007 and again in 2008 and warned of big dangers ahead, his warnings were widely dismissed by Icelandic economists and officials. In

2007 Aliber drove around Reykjavik counting the number of building cranes, and said, in a public speech, “You’ve got a year before the crisis hits”. Aliber was asked what should be done to get the government to take the warnings seriously. He replied, “Those who can see what is happening just have to keep shouting, louder and louder”.

WHAT THE GOVERNMENT SHOULD DO NOW

The bonds of the Icelandic banks are currently trading at between 1 and 7% of their face value – that is, buyers of the bonds will pay only between 1 and 7% of the face value. This is a measure of the catastrophe. The road to recovery will be long, because it will be a long time before participants in money markets will take the Icelandic banks seriously, their reputation has been so thoroughly damaged.

But for the next few months, up to about May 2009, Iceland has some breathing room; after that, a large amount of debt has to be refinanced, and whether or not it is refinanced, and at what cost, depends on what the government of Iceland does over the next few months.

Action by the government is all the more urgent because there is now a high probability that the world economy has entered not just a recession but a depression. Paul Krugman, who won the Nobel Prize in economics in 2008, said just a week ago, “This looks an awful lot like the beginning of a second Great Depression”.[□] He went on to say that

“recent economic numbers have been terrifying, not just in the United States but around the world. Manufacturing, in particular, is plunging everywhere. Banks aren’t lending; businesses and consumers aren’t spending”.

I think it very likely that the world economy will hit another tipping point – similar to the one in September 2008 – around March-April 2009. The tipping point will be caused by the rise of general awareness throughout Europe, America and Asia that hundreds of millions of people in rich and poor countries are experiencing rapidly falling living standards; that the crisis is becoming worse, not better; and that it has escaped the control of public authorities, national and international. Governments have

[□] Paul Krugman, “Fighting off depression”, International Herald Tribune, 6 Jan 09.

to use the time between now and March-April 2009 to equip themselves to cope with a surge of unemployment, a collapse of capital-funded pension funds, and fierce anger directed at them by their citizens, which may take the form of large-scale civil protest. I doubt whether there will be significant recovery of economic growth in the world economy at large – or in Iceland -- until late 2010.

On the other hand, the good news about the crisis is that it has undercut, or delegitimized, the neoliberal or free market ideology which has dominated economic thinking for the past 30 years, in Iceland and elsewhere. Governments are having to “intervene” in the economy much more than in the past, and not just in finance, because of the spectacular “failure of markets to regulate themselves” represented by the crisis.

IMMEDIATE STEPS

The first immediate step towards financial recovery in Iceland is for a team of highly qualified and foreign (non-Icelandic) forensic accountants and experts in sovereign debt restructuring to do a serious investigation of where the money is, and to map out a possible road to recovery. This should have been done immediately in September-October, straight after the crash (as I said in an interview on Icelandic TV at the time). Instead, we have seen a series of almost random responses, with the central bank and the Finance Ministry seeming to drive all over the road, partly because there has been no good basis of knowledge about the assets and liabilities of the banks and the investment companies.

The second immediate step to recovery of reputation is to invite the governor of the central bank to seek employment elsewhere; in other words, to dismiss him for gross dereliction of duty. It is clear that the governor understands little about international finance. If he did, he would not have tried to peg the krona against the euro in October 2008 at a time when Iceland had hardly any foreign exchange reserves left, a decision the governor made himself without consulting the central bank’s chief economist. It was about the shortest lived currency peg on record. Every foreign commentator on the Icelandic situation – including Willem Buiter and Richard Portes – has called for the dismissal of the central bank governor. Dismissal would send a signal to global

financial markets that Iceland was serious about getting back on track.

The third immediate step is for the PM to apologize to the nation for the calamity which the country has fallen into during his government's stewardship of the economy. It is indeed strange that no senior politician has offered anything close to an apology – with the partial exception of the leader of the Social Democrats, who came into government long after it should have been clear to the previous government that the Icelandic banking system was unstable. The best way for the Icelandic government to demonstrate its democratic accountability would be to call new elections.

ALMOST-IMMEDIATE STEPS

Employment

The Icelandic government should actively learn from what other governments are doing in order to protect employment and minimize unemployment. Possible measures include:

- (a) subsidize employers to offer apprenticeships to school leavers (rather than giving the subsidy to private training providers);
- (b) subsidize employers to place employees on short-time working instead of firing them, by paying employees their missing days;
- (c) provide public work programs, doing real work for the minimum wage, from social work to construction. □

The aim should be to minimize the number of people obtaining unemployment benefit, for that way risks creating a lost generation of mainly young people with little work experience for when recovery begins.

Pensions

The government should intervene to protect pensions of those already drawing pensions, and to provide a means of slowing down the collapse of pension funds. **HOW??**

□ Polly Tonybee, “The prospect of another lost generation is a chilling one”, Guardian, 20 Dec 08.

Financial regulation and restructuring

The government must tighten regulation of the financial sector. Coming out of the crisis, there will be a general move around the world towards treating finance more like alcohol, drugs, explosives, and gambling – all activities where the unrestricted distribution of the product creates large “external” costs for the society, so the market for the product is restricted in line with political decisions.

More specifically, all governments must clarify which kinds of financial firms can expect lender-of-last resort facilities, and ensure that those within the safety net are subject to close prudential regulation – such as a ceiling on the amount of debt, or leverage, they can carry relative to their equity. Second, governments should insist on a separation of commercial banking and investment banking, as was the case in the US before the repeal of Glass-Steagall in 1999.

Third, governments should aim to create a banking system which gives more emphasis to stability and prudence and less emphasis to “innovation”. We may see “mixed” national banking systems emerge with a significant component of banks which operate like “public utilities” rather than as shareholder-profit-maximizing private firms.

In Iceland, specifically, the mandate and competences of the central bank and the Financial Services Authority need to be substantially upgraded, now that the theory that financial markets can more or less regulate themselves has been so discredited.

Civil service reform

The crisis has exposed some serious deficiencies in Iceland’s public administration, and as the government becomes more involved in the economy over the next several years it is all the more important to upgrade the civil service.

As an outsider I am amazed that there is nothing like a civil service commission, which exercises an independent check on the quality of people recruited to the civil service and promoted to high positions. Without such an independent check, two things happen. First, people are recruited because they are friends of friends, or members of the same political party, without much attention to

“meritocratic” criteria; and you do not have spend much time here before you learn that Iceland’s civil service has a great many people in senior positions who could not possibly survive the application of a meritocratic test. The second effect is that well-qualified people are *not* recruited or promoted to senior positions because the underqualified insiders feel threatened by their superior qualifications and do not want to be made to look underqualified or incompetent. Both effects damage the effectiveness of the public sector.

Creating a civil service commission and giving it real power could bring substantial improvements.

Eurozone entry

Iceland has to give up the idea of restoring itself as a center of international banks. There are too many alternative international banking centers which are not tarnished by having had a great crash. The country must urgently develop other kinds of economic activity than finance.

But a “normal” national financial sector does have to be re-established, and for this purpose there are big advantages to joining the eurozone. It is true that a lot of discussion going on in Rome, Madrid and Dublin about leaving the euro, because of the adverse consequences of loss of sovereignty over the exchange rate and monetary policy. If this discussion is taken at face value, it suggests the possibility of the break-down of the eurozone – which suggests that Iceland would be unwise to try to join it. However, the discussion about these countries leaving the euro should not be taken at face value. They will stay in, because they know that if they dropped the euro their currencies would be chronically vulnerable to speculative attacks – as also would be the Icelandic krona.

Iceland could not join the eurozone before first demonstrating several years of currency stability and a real foreign exchange market. It has to start immediately to create these conditions, and shadowing the euro – at a greatly devaluated exchange rate compared to before the crisis -- is one way to do so.

However, an alternative to joining the eurozone, or a prelude, might be an agreement with Norway that the Icelandic krona will be managed so as to shadow the Norwegian krona, and that the

Norwegian central bank will stand ready to provide currency swap support to the Icelandic central bank. This would have substantial advantages for Iceland; but also the disadvantage that Norway, as an oil economy, has an overvalued exchange rate, and its interest rates diverge significantly from the eurozone where rates reflect broader economic conditions.

What would be the advantage of such an agreement for Norway? For one thing, Norway would be less isolated in the European Economic Area if Iceland stays out of the eurozone. For another, Norway would be better placed to defend its fisheries policy against the destructive EU fisheries policy if Iceland did not adopt the EU fisheries policy, as it would probably have to do if it joined. So Norway might be interested in helping Iceland to stay *out* of the eurozone/EU.

On the other hand, Norway may wish to see Iceland negotiate EU membership in the hope that the combination of Iceland's reputation as one of the few countries which has managed fish stocks sustainably, plus Iceland's much greater dependence on fish, post-crisis, will lead the EC to moderate its insistence that Iceland accept the disastrous EU fisheries policy. If the EC did not insist on Iceland adopting the EU fisheries policy, then it may also grant Norway more autonomy if Norway were later to join; and there are many powerful Norwegians who wish Norway to join but who are obstructed by the fisheries issue. In short, the fisheries issue might encourage Norway to support Iceland's EU membership rather than oppose it.

Clearly these are important issues to clarify with the Norwegian government. And clearly, the Icelandic government – hopefully with a fresh mandate from the electorate – has a difficult decision ahead of it on EU and eurozone membership. END