The Icelandic financial sector and the markets

Richard Portes
London Business School and CEPR
April 2008
Road map

- The Icelandic economy: fundamentals
- Mini-crisis of 2006 and response
- The banks: fundamentals
- CDS market and ratings agencies
- Macro imbalances: a hard landing in prospect?
- Financial volatility and the euro
- The market risk premium on Icelandic banks is excessive – so what is going on?
- How to get out of the vicious circles?
La calunnia
(Aria of Don Basilio)
Gioachino Rossini, *Il barbiere di Siviglia*, act I
Rumours start...

La calunnia è un venticello
un’auretta assai gentile
che insensibile, sottile,
leggermente, dolcemente,
incomincia a sussurrar.

Slander is a little breeze,
a gentle little zephyr,
which, insensibly and subtly,
lightly and softly,
beginns to murmur.

Piano piano, terra terra,
sotto voce, sibillando,
va scorrendo, va ronzando;
nelle orecchie della gente
s’introduce dextramente,
e le teste ed i cervelli
fa stordire e fa gonfiar.

Very softly, quite prosaically,
under one’s breath, with a hiss,
it flows, it buzzes;
into the ears of the public
it deftly introduces itself,
and it stupefies heads and brains
and makes them swell up.
...and lead to crisis -
with an unpleasant dénouement...

Alla fin trabocca e scoppia, 
si propaga si raddoppia 
e produce un’esplosione 
come un colpo di cannone, 
un tremuoto, un temporale, 
un tumulto generale 
che fa l’aria rimbombar.

E il meschino calunniato, 
avvilito, calpestato, 
sotto il pubblico flagello 
per gran sorte va a crepar.

Finally it issues forth and bursts, 
it spreads and redoubles 
and produces an explosion 
like a cannon shot, 
an earthquake, a thunderstorm, 
a general uproar 
that makes the air echo.

And the miserable victim of slander, 
humiliated, downtrodden, 
under the scourge of the public, 
by good luck, drops dead.
The rumours - an example from the British press

Is Iceland facing meltdown?
18 March 2006
Now we have ‘Déjà vu all over again…’

Is Iceland headed for meltdown?
A Northern Rock style crisis is threatening Iceland's entire banking system
5 February 2008
At least they added a sentence at the end: "Results published by the key players in Iceland's financial sector last week helped alleviate fears that the country is on the cusp of a Northern Rock-style bank funding crisis." But that didn’t stop them…

“Iceland shows cracks as the krona crashes”
23 March 2008
The fundamentals: a very small country, highly geared...

- Population 300,000, GDP € 13 bn
- Per capita GDP $ 40,000 (PPP) – 5th in OECD
- Open in trade: \( \frac{1}{2} \) (imports + exports)/GDP = 38%
- *Exceptionally open in finance*: external assets 395% of GDP, external liabilities 517% of GDP (end-2006), significant carry trade
- Non-resident workforce of Icelandic companies approximately equals resident workforce
- From early 1990s: market liberalisation, European integration, privatisation
- Founding member of EEA, so applies all EU legislation
Smallest country with independent monetary policy, floating exchange rate, inflation targeting

*Growth* has decelerated to 2.9% in 2007, zero in 2008 (forecast)

*Current account* deficit fell from 26% of GDP in 2006 to 16% in 2007, with exports up 20% (data controversial – a better estimate of income component would probably cut 2007 deficit to 10%) – projected to fall to levels long sustained by Australia and NZ

And exports should continue to rise (fish, aluminium), imports to fall (exchange-rate depreciation)

*Fully funded pension system*

*Fiscal surplus*, central government *net debt* 6% of GDP, *gross debt* 24%
Net debt of government and municipals

% GDP


Government
Municipals
An advanced institutional and regulatory framework

- Health, education, infrastructure, economic freedom, absence of corruption, press freedom, political stability - all at the top of international league tables
- Financial Services Authority is highly professional, and its budget was recently doubled
- Central Bank of Iceland achieves high standard in its financial stability analyses
- Iceland fully implements directives of EU Financial Services Action Plan - including MiFID (unlike several EU countries!)
Spectacular growth of the banks

- Total assets of banking sector were 96% of GDP in 2000, 800% of GDP in 2006, probably ten times GDP at end-2007

- The majority of the banks’ revenues originate outside Iceland
Mini-crisis in early 2006

- Exchange rate depreciated 25%
- Equity prices fell 25%
- An ‘informational crisis’
  - perceived macroeconomic imbalances
  - queries about banks
    - reliance on market funding at short maturities
    - doubts on earnings quality (growth ‘too fast’)
    - cross-ownership
    - lack of transparency
Financial sector responded strongly

- Expanded deposit base
- Extended and broadened maturities and geographical scope of market funding
- Eliminated most cross-holdings
- Emphasized transparency and information dissemination
- ...and continued expansion
### Funding: a good deposit base now

**Deposit ratios** *(Deposits/Loans to customers)*

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Kaupthing</td>
<td>31,5%</td>
<td>29,6%</td>
<td>41,8%</td>
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<tr>
<td>Glitnir</td>
<td>25,9%</td>
<td>24,9%</td>
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<td>Landsbanki</td>
<td>33,9%</td>
<td>47,5%</td>
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<td>DnB Nor</td>
<td>58,9%</td>
<td>57,3%</td>
<td>55,5%</td>
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<td>Swedbank</td>
<td>41,2%</td>
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<td>SHB</td>
<td>41,4%</td>
<td>48,5%</td>
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Funding maturities look good too

<table>
<thead>
<tr>
<th>Maturity profile (EURm)</th>
<th>Glitnir</th>
<th>Kaupthing</th>
<th>Landsbanki</th>
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<tbody>
<tr>
<td>2008</td>
<td>3,276</td>
<td>3,323</td>
<td>749</td>
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<td>2009</td>
<td>2,786</td>
<td>5,484</td>
<td>2,443</td>
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<td>2010</td>
<td>2,889</td>
<td>4,118</td>
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<tr>
<td>2011</td>
<td>2,501</td>
<td>2,222</td>
<td>1,715</td>
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<tr>
<td>2012</td>
<td>2,874</td>
<td>1,845</td>
<td>751</td>
</tr>
<tr>
<td>&gt;2013</td>
<td>942</td>
<td>5,331</td>
<td>1,584</td>
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</table>
# Kaupthing Maturity Profile

**Syndicated Bank Loan & Debt Distribution**

**Search by:**
- Debt Type: Bonds & Loans
- Issuer: Kaupthing Bank Hf
- Include: Current issuer and subs
- Or Ticker: Ticker Type 1 Corp

**Filter by:**
- Curr of issue: All
- Country of issue: All
- Coupon: All
- Date Range: 2/2008 to 12/2058
- Maturity: All
- Sec Type: All
- Loan Type: All

**By Maturity**

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
<th>MM</th>
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<tbody>
<tr>
<td>2008</td>
<td>2,575,782,020</td>
<td>2617</td>
</tr>
<tr>
<td>2009</td>
<td>5,547,702,021</td>
<td>910</td>
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<tr>
<td>2010</td>
<td>4,268,592,022</td>
<td>2,106</td>
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<tr>
<td>2011</td>
<td>2,871,772,023</td>
<td>456</td>
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<tr>
<td>2012</td>
<td>1,859,462,024</td>
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<td>2013</td>
<td>5,109,020,25</td>
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<td>2014</td>
<td>4,589,120,26</td>
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<td>2015</td>
<td>8,827,2027</td>
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<td>2016</td>
<td>12,069,620,28</td>
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<td>2017</td>
<td>4,017,620,29</td>
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<tr>
<td>2018</td>
<td>1,810,2030</td>
<td>3,986</td>
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<tr>
<td>2019</td>
<td>6,532,0231</td>
<td>17,869</td>
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</tbody>
</table>

**Total:** 2,188,867,201 M ISK

**Total # of Issues:** 254

Displays issued amounts of all bank loans disclosed to Bloomberg.
Swedbank maturity profile

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<thead>
<tr>
<th>Maturity</th>
<th>Bonds</th>
<th>Loans</th>
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<td>2009</td>
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<td>2010</td>
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<td>2011</td>
<td>368322023</td>
<td>59</td>
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<td>2012</td>
<td>214432024</td>
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<tr>
<td>2013</td>
<td>30522025</td>
<td></td>
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<td>2014</td>
<td>92932026</td>
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<td>2015</td>
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<td>2017</td>
<td>78742029</td>
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<tr>
<td>2018</td>
<td>292030</td>
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<tr>
<td>2019</td>
<td>&gt;2031</td>
<td>10362</td>
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</tbody>
</table>

Total: 470,392,386.55 M SEK
Total # of Issues: 266
Banks perform well in comparison with Nordic peers

- *Deposit ratios strong*, market funding *maturities relatively long*, overall and core *profitability high*
- This is despite *high capital adequacy ratios* with which they counterbalance high equity exposure
- *Negligible exposure to US subprime market, structured finance products*, related financial vehicles
- FSA stress tests indicate they could withstand quite extreme movements in market variables specific to Iceland
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<tbody>
<tr>
<td>Kaupthing</td>
<td>7.9</td>
<td>9.5</td>
<td>1.51</td>
<td>1.43</td>
<td>19.0%</td>
<td>15.0%</td>
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<td>Glitnir</td>
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<td>Landsbanki</td>
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<td>1.82</td>
<td>1.54</td>
<td>23.9%</td>
<td>19.0%</td>
<td>-1.2%</td>
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<td>Nordea Bank</td>
<td>8.3</td>
<td>8.8</td>
<td>1.46</td>
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<td>17.5%</td>
<td>15.2%</td>
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<td>-5.1%</td>
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<td>Danske Bank</td>
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<td>7.7</td>
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<td>1.40</td>
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<td>-10.8%</td>
<td>5.8%</td>
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<tr>
<td>DnB Nor</td>
<td>8.8</td>
<td>8.7</td>
<td>1.39</td>
<td>1.29</td>
<td>15.8%</td>
<td>14.8%</td>
<td>5.6%</td>
<td>1.1%</td>
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<td>18.9%</td>
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<td>Okobank</td>
<td>11.0</td>
<td>10.6</td>
<td>1.24</td>
<td>1.19</td>
<td>11.3%</td>
<td>11.3%</td>
<td>10.6%</td>
<td>3.8%</td>
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<tr>
<td>Swedbank</td>
<td>7.4</td>
<td>7.5</td>
<td>1.30</td>
<td>1.17</td>
<td>17.7%</td>
<td>15.7%</td>
<td>4.5%</td>
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<td>Average</td>
<td>8.7</td>
<td>8.6</td>
<td>1.52</td>
<td>1.39</td>
<td>17.6%</td>
<td>16.3%</td>
<td>-0.2%</td>
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<td>Median</td>
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<td>15.0%</td>
<td>4.5%</td>
<td>0.6%</td>
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</table>
Icelandic banks and their peers: return on equity
Icelandic banks and their peers: capital adequacy ratios end-2007

<table>
<thead>
<tr>
<th></th>
<th>Kaupthing</th>
<th>Glitnir</th>
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<th>SHB</th>
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<td>CAD Ratio</td>
<td>11,8%</td>
<td>11,2%</td>
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<td>Tier 1</td>
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<td>10,1%</td>
<td>6,5%</td>
<td>6,2%</td>
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</table>
But the ratings put Icelandic banks below Nordic peers

<table>
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<th></th>
<th>Kaupthing</th>
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<td>Moody's</td>
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<td>A2</td>
<td>A2</td>
<td>Aa1</td>
<td>Aa1</td>
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<td></td>
<td>Short term</td>
<td>P1</td>
<td>P1</td>
<td>P1</td>
<td>P1</td>
<td>P1</td>
</tr>
<tr>
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<td>Individual</td>
<td>C-</td>
<td>C-</td>
<td>C-</td>
<td>B</td>
<td>B</td>
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<tr>
<td>S&amp;P</td>
<td>Long term</td>
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<td>n/a</td>
<td>A-</td>
<td>AA-</td>
<td>A+</td>
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<tr>
<td></td>
<td>Short term</td>
<td>n/a</td>
<td>n/a</td>
<td>A-2</td>
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<td>Long term</td>
<td>A</td>
<td>A</td>
<td>A</td>
<td>AA-</td>
<td>A+</td>
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<tr>
<td></td>
<td>Short term</td>
<td>F1</td>
<td>F1</td>
<td>F1</td>
<td>F1+</td>
<td>F1</td>
</tr>
</tbody>
</table>
And despite the data, Icelandic banks’ CDS spreads have risen dramatically.
Even Iceland’s sovereign spread has exploded, despite remarkably good fiscal position.
The risk of European banks defaulting rose higher than their clients for the first time in four months as credit-market losses spread, according to credit-default swaps traders. Contracts on the Markit iTraxx Financial index of banks and insurers jumped to as high as 153 basis points today, surpassing the Markit iTraxx Europe index by 3.5 basis points, according to JPMorgan Chase & Co.’ Bloomberg, 7 March 2008
Lex on Icelandic banks’ CDS spreads (FT 1 April 2008)

‘Kazakh banks now command a lower risk premium...The apparent panic is not mirrored in equity markets, where all three banks are on bullish price/earnings ratios...Technical reasons explain much of the gulf. The great unwinding of CDOs and leveraged hedge funds is affecting spreads of Icelandic banks more than most, as many funds were overweight with this high-yielding debt. This exacerbates price swings in an illiquid market...Meantime, tracking CDS prices on Icelandic banks may remain more of a sport than a science. As a simple indicator of default probability, spreads seemed to lose touch with reality a long time ago.’
CDS spreads: what do they mean?

- If current level of CDS spreads accurately estimated probability of default, then Icelandic banks (and many others) would be pronounced dead.
- But CDS market is highly distorted:
  - Started as credit protection, then became also a vehicle for speculation (volume is 10 times the underlying).
  - Now everyone wants to hedge the banks, but no one wants to write protection – with very limited supply and rumours fuelling demand, price has gone way up, trading is thin and volatile.
- Irrationalities: cost of protection against Lehman Bros default rose 15% the day after the Bear Stearns bailout demonstrated that the Fed would rescue any LCFI
- And possible market manipulation.
A dysfunctional market creates a vicious circle

‘This year banks began to unwind complex structured products through the CDS markets by bulk-buying insurance. This sent CDS spreads to record highs, totally divorced from the underlying riskiness of the companies.’ Financial Times, 7 March 2008

‘Liquidating structured credit instruments requires buying large amounts of protection using credit default swaps. This...drives the cost of protection higher, potentially triggering a chain reaction...The markets are so illiquid that a few trades can lead to sharp movements, producing violent price swings and knock-on effects.’ Financial Times, 10 March 2008

‘Many CDS sellers were highly leveraged. They’re now being forced to close positions, and prices are rising fast.’ Breaking Views, 10 March 2008
The abnormally high CDS spreads are a major problem for the banks...

- ...because new issues have been priced by reference to (so above) CDS spreads
- At such prices, the markets are effectively closed
- The only way around this is to find investors who will ignore CDS spreads – e.g., Kaupthing issued privately at an (undisclosed) level well below its CDS spread, others too
- Hedge funds may be ‘playing rough’ – if you buy CDS at 200 bp (say), you would want to make things look worse and drive spreads up further
- Even more opportunities: short banks, drive up CDS spreads
- How will HFs eventually close their CDS positions? – by writing them – so it may be just a matter of time before the market self-corrects – meanwhile, however...
A second CDS vicious circle

CDS spreads widen

Investors demand higher yields

Balance sheet deteriorates

Cost of capital goes up

Exacerbated when ratings agencies follow CDS spreads - and CDS spreads follow ratings
And a second dysfunctionality: the (dis)credit(ed) ratings agencies

- The agencies have been erratic and misleading on Iceland...
- ...but this is just one aspect of a C-rated performance
- Consider Moody’s, which has just downgraded the banks and put Iceland’s sovereign rating on negative watch
Moody’s ratings rollercoaster
Why this reversal? - according to Moody’s

- For the banks:
  - a possible ‘hard landing’ for the Icelandic economy, leading to deterioration of bank loan quality
  - related lending and cross-shareholding
  - they may be ‘too big to rescue’ for the central bank and government

- For the sovereign: Moody’s have downgraded the banks, which are contingent liabilities for the government

- But this is obviously circular! Supposed bank weakness → government financial weakness → bank weakness…
The ‘opinion’ doesn’t fit the facts

- **The CBI has the resources to act as LLR** - the banks’ total external liabilities exceed CBI foreign exchange reserves, but
- the banks’ market funding is assured for the coming year
- the maturity profiles are favourable – a relatively small part of the foreign currency liabilities are liquid short-term
- banks’ net foreign exchange assets are positive by € 6 bn, and they are well hedged against ISK fluctuations
- deposits in foreign branches and subsidiaries are insured by host countries on same terms as domestic institutions

- **The potential deterioration of domestic loan quality is overstated** – only Landsbanki has over one-third of its loans to domestic borrowers (and it is the one with least reliance on market funding)
Then there is Fitch...

- ...an example of sheer irresponsibility
- Financial Times 24 November quoted Paul Rawlings (Senior Director) as saying, ‘If you look at their [Icelandic banks’] loan to deposit ratio, it is still 300%, which shows their dependence on the wholesale markets’
- Brian Coulton (Head of Global Economics) admitted that the data cited were from *end-2006*, although the banks’ 2007Q3 results appeared at end-October
- The correct number at end 2007Q3 was 200% - similar to Nordea (177%) and Danske Bank (208%)
And the sovereign is in exceptionally good fiscal health

- Fiscal surplus (overall, not just primary surplus)
- Very low debt/GDP ratio
- But what about the ‘contingent liabilities’? Aside from the banks, they are the Housing Finance Fund and the National Power Company – both backed by very substantial collateral!
- Even Moody’s have to streeeeeeetch to find any significant vulnerability, even if there were a full-scale run on the banks
The agencies should now be ignored

Not an original thought! ‘By now no one should care what the ratings agencies think.’ *WSJ* 26 February 2008

- They were notoriously behind the curve in Asia in 1997
- Their disastrous performance in rating structured finance instruments is a major source of the current capital market turmoil
- And now they are (characteristically) reacting with indiscriminate downgrades, again behind the curve, again *exacerbating market instability*
- They are understandably running scared, trying to convince policy-makers not to break them up, change their revenue model, or eliminate the barriers to entry that have made them so profitable
What about *macroeconomic imbalances* - a ‘hard landing’ that would hurt the banks?

- Economy has been running at very high pressure of demand – unemployment negligible, inflation now at 8.5 % (4 % above CBI target), housing market boom.
- *High current account deficit* and highly negative net international investment position.
- But *fiscal position enviably strong*. 
NIIP deteriorated sharply in 2005-2006

An article in the latest Monetary Bulletin of the Central Bank of Iceland, however, re-estimates the NIIP at market values. He finds that it is -27% of GDP, rather than the -122% figure seen here and often quoted.
Still, external position is sustainable

- Current account deficit was 25.5% of GDP in 2006, 16% of GDP in 2007, likely to fall to around 10% this year (growth slowdown and exchange-rate depreciation) – as officially measured
- Real exchange rate was somewhat overvalued, not any more
- And *factor income and NIIP are mismeasured*
- Official data indicating that Iceland’s investments abroad are substantially less profitable than foreigners’ investments in Iceland…
- …are inconsistent with high profitability and growth of Iceland’s international banks and corporations
- Capital markets will finance deficits of a healthy economy (cf. New Zealand, Norway in 1970s)
Factor income deficit down sharply, trade deficit falling as growth falls
Overall, macro picture not bad

- Interest rate increase to 15.0 % (125 bp) made macroeconomic sense – CBI credibility was on the line, slowdown needed anyway, and a long way to go before rates become really painful
- Tight monetary policy unlikely to provoke deep recession
- Some exchange-rate depreciation was desirable – ISK somewhat overvalued as of November 2007 – but it’s right to try to stop overshooting
- There are technical reasons, however, why even the latest increase to 15.5% (10 April) is unlikely to bring the carry trade back in the short term*

*The swap markets aren’t functioning – the CDS spread plus the swap rate is approximately equal to the CBI interest rate, and volatility has increased, so the Sharpe ratios of carry trade have fallen dramatically
Bottom line: ‘hard landing’ improbable

- Current account deficit on sustainable downward track (mismeasurement should be cleared up)
- Central bank reserves substantial for a floating exchange rate regime
- Fiscal soundness is a key ‘buffer’ – zero probability of default on sovereign debt (because there is so little!)
- Indeed, calculations suggest that in the worst case scenario of a government bailout of the banks, its gross debt as a percentage of GDP would rise to approximately the level of Belgium – without the linguistic discord and political instability
- Yet ratings agencies and markets seem to disagree
Financial *volatility not a threat*

- Volatilities of exchange rate, equity prices, and bond yields are not exceptionally high.
- The krona (ISK) is not much more volatile against major currencies than the currencies of New Zealand, Sweden, and Australia.
- Carry trade significantly influences exchange rate.
- Banks are fully hedged against ISK volatility.
- Many firms have high foreign revenues, so borrowing in foreign currency is a natural hedge – others can pass on exchange rate effects into prices.
- Households borrow increasingly in foreign currency – still only 7-8% of debt, but risk requires watching.
Past exchange rate volatility low, with 3 spikes
Exchange rate closely correlated with other carry trade targets
Shift towards use of euro

- ISK is a problem for OMX ICE listed firms, because equity prices rise when ISK appreciates, so exchange rate volatility accentuates stock market volatility.
- Hence ISK-denominated shares are unattractive to all but risk-loving foreign investors.
- Large banks and companies moving to adopt euro as listing currency and as their ‘functional’ currency (in accounts, denomination of equity).
Equity volatility spikes much higher in euros than in ISK
But Iceland outside EU, can’t enter EMU

- Still, could unilaterally adopt euro
- Although EU and ECB oppose unilateral euroisation for countries that might end up as candidates for EMU, that’s not a block now
- The issue requires extensive political as well as economic debate
- There are, however, possible destabilising consequences of *gradual* shift towards using euro domestically*

*see R. Portes, ‘ISK or euro: not both!’, presentation to Icelandic Chamber of Commerce annual meeting, Reykjavik, 13.02.08
Market risk premium on Icelandic banks is excessive

- The banks are aggressive and entrepreneurial
- But they exploit *strong competitive advantages*:
  - careful risk control
  - flat management structures and very capable management
  - unusual and strong business models

*They didn’t buy CDOs etc.*

- Fully hedged in FX market (have made € 1 bn from ISK depreciation!)

- Even if there were a ‘hard landing’ domestically, banks are not heavily exposed to specific Iceland risk

*Economy and financial sector are flexible and highly resilient* – effective response to mini-crisis of early 2006
So what is going on?

- Market and ratings agency doubts
  - reliance on market funding
  - doubts on earnings quality
  - cross-ownership
  - lack of transparency

  Sound familiar?

- Unwinding of carry trade
- (Dis)credit(ed) ratings agencies
- Classic speculative attack, with a twist: short the currency and equities, while driving CDS spreads up
- Abetted by press and market analysts
- And by rumours…
‘La calunnia’ continues…

- Recall *The Guardian* saying in October 2006, ‘Viking invaders return undefeated to Britain’s financial territory.’
- Now the Vikings are in trouble, so the British should worry – ‘British savers have billions in Icelandic accounts, but its banking system is looking shaky.’ *Sunday Times* 10 February 2008
- ‘Could Kaupthing Edge be the next Rock?’ *This is Money*, 22 February 2008
- And they are pretty suspicious characters: ‘The origins of Iceland’s wealth are still something of a mystery.’ *Telegraph* 5 February 2008
Why? Again, a British perspective

- A natural suspicion, even hostility towards ‘upstarts’
- Worse when they come from a tiny island (to whom we lost the last of the ‘cod wars’ in 1976), buy up our firms (including West Ham United FC!), and then compete aggressively – and successfully
- Schadenfreude provoked by the Northern Rock disaster
- And of course, bad journalism – scare stories always sell papers, so suggest ‘Your money really isn’t safe in IceSave’…
- …a rumour that just might be spread by competitors, too
How to get out of the vicious circles?

- Join EU and EMU! – not for a while...
- Short term: lender of last resort (LLR) usually prefers ‘constructive ambiguity’, but that’s dangerous now
- Both central bank and Ministry of Finance should overcome reticence, ignore moral hazard
- They must state explicitly that the banks could not be allowed to fail, so any speculation to the contrary will be unprofitable
- And they must back this up with a clear account of the data and the measures available to them
What measures?

- How to beat the speculative attack?
  - orthodox methods – interest rate defence
  - heterodox methods – e.g., the Hong Kong bear trap

- Meanwhile, the banks will have to retrench somewhat for the time being and focus on ensuring that the assets they have acquired are good assets
Then the rumours will turn around!