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THE ICELANDIC MELTDOWN

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Icelandic Prime Minister Geir Haarde's resignation this year marked the first political casualty of the current financial crisis that resulted in the collapse of all major banks, a run on deposits, a stock market drop of 90 percent, empty grocery shelves, plus a severe recession.

Many commentators misidentify the true source of Iceland's meltdown, resulting in prescribed cures that fall short of the necessary actions.

Peter Gumbel writing for *Fortune* argues that previous Prime Minister Davíð Oddsson's free-market reforms during his 1991–2004 years in office are what ultimately gave rise to the bust.

Likewise, the IMF's mission chief sent to Iceland to survey the nature of the problem, Poul Thomsen, commented in an interview that the root problem in Iceland was an unregulated environment that allowed an oversized banking system to develop.

It's true that the post-privatization banking experienced in Iceland resulted in a banking sector that saw assets increase to over 1,400 percent of GDP. What analysts and authors commonly miss is the *reason* the banking sector could expand so rapidly. The incentive structure of the Icelandic economy was manipulated through government guarantees, artificially low interest rates, and monetary spigots opened wide, allowing liquidity to be flushed through the economy.

In addition, Iceland's homeowners were offered tantalizingly low interest rates through the "Housing Financing Fund" (HFF), a state agency that enjoyed *explicit* government guarantees on its debt, resulting in reduced interest charges for homeowners. Interestingly, while the Fund's *merely* implicitly guaranteed American counterparts—Freddie Mac and Fannie Mae—have been the center of much controversy, the HFF has remained relatively unscathed.

The policy prescriptions in the wake of the crisis have called for more interventions, which will prove to exacerbate the situation if put into effect. Only by gaining a true understanding of the unsustainable and artificial nature of the boom of the past ➡



decade may we arrive at effective solutions to navigate the bust that engulfs the country.

Iceland's crisis shares a common bond with those that have infected other developed economies recently: all have banking systems heavily engaged in the practice of maturity mismatching. In other words, Icelandic banks issued short-term liabilities in order to invest in long-term assets.

The banking system had to continuously roll over (renew) their short-term liabilities until their long-term assets fully matured. If an event arose whereby Icelandic banks failed to find new borrowers to continue rolling over their liabilities, they could face a liquidity crisis and, more importantly, spark the collapse of the Icelandic financial system; recent events have borne out this exact scenario.

Considering these recent events, the question that immediately comes to mind is, why did Icelandic banks engage in such a risky practice in the first place? First of all, maturity mismatching can turn out to be a very profitable business, involving a basic interest arbitrage.

Normally, long-term interest rates are higher than their corresponding short-term rates. A bank may then profit the difference—the spread between short- and long-term rates—through these transactions. Yet, while maturity mismatching can turn out to be profitable, it is very risky as the short-term debts require continual reinvestment (i.e., a continual “rollover” must occur).

As in other countries, Icelandic banks enjoyed guarantees by the government to bail them out should their bets on the market turn erroneous. However, while

this guarantee is merely implicit in most developed economies, the Central Bank of Iceland committed to it explicitly. The CBI effectively functioned as the “roller-over of last resort,” providing fresh short-term debt as the market required it. Indeed, the three main Icelandic banks—Kaupthing, Glitnir, and Landsbanki—were so big in comparison to the GDP that they could regard themselves as too big to fail.

This led to moral-hazard problems: If we have rollover problems threatening our solvency, someone—be it the government or the central bank—will come to help us, lest a detrimental shock reverberate through the financial community. The result of this explicit guarantee was excessive maturity mismatching.

This represents a financially unsound practice and may lead to banking-system instability. However, another even more important effect of excessive levels of maturity-mismatched loans is that it leads to distortions in the real economy by distorting the capital structure, as demonstrated by Austrian business cycle theory.

By expanding credit, banks create demand deposits (zero maturity) in order to invest in loans issued to the public (longer-term maturity). A similar maturity mismatch occurred, as we shall see, when Icelandic banks borrowed in (mainly international) wholesale markets (via short-term interbank loans and repurchase agreements, asset-backed commercial paper, etc.) in order to invest in long-term loans, such as commercial and residential mortgages.

Maturity mismatching deceives both investors and entrepreneurs about the available amount of real long-term savings.

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Hence, by borrowing short and lending long, long-term interest rates are artificially reduced. Entrepreneurs think that more long-term savings are available than really exist and accordingly engage in malinvestments that must be liquidated, once it becomes obvious that there are not enough *real* savings to sustain them to completion.

In the Icelandic case, the malinvestments were made mainly in the aluminum and construction industries. Both aluminum mines and residential and commercial housing represent long-term investment projects that were financed by short-term funds and not by savings of an equal term.

Another consequence of malinvestment was that resources were drawn into the financial sector, which expanded enormously. Thus, resources were redirected from consumer goods' industries into the financial sector. As Ragnar Arnason of the University of Iceland noted, fishermen became investment bankers to meet the insatiable demands of the newly profitable financial sector. As a result, Iceland became an exporter of financial services and an importer of goods.

This distorted structure of production threatened to "starve" the population during the currency breakdown last fall when Iceland had problems obtaining foreign exchange to pay for the imports the country had become so reliant on consuming.

However, maturity mismatching alone does not explain the Icelandic case sufficiently. Over the past decade, the Icelandic financial system had accumulated a significant portion of its funding requirements in foreign currencies. From 2001 to 2008, there was a 2,300 percent increase in foreign liabilities that occurred over the seven-year period. Domestic liabilities, in contrast, also saw a significant 600 percent increase—the result of low nominal interest rates, which hovered near zero when factored for inflation.

The evolution of bank assets may seem reserved by comparison with Icelandic foreign assets, now only approximately the

same size as domestic assets. However, looking at the relative positions from just seven years ago, we see the much more "normal" position financial institutions prefer to be in—large asset holdings in the domestic currency to minimize risks from exchange-rate shocks. Indeed, foreign assets become the asset class that ballooned as much as any other, increasing a staggering 10,600 percent over the period!

One main source of external funding was Japanese-yen-denominated loans. The Bank of Japan has pursued a loose monetary policy for many years to combat an extended period of recession. As a result of these artificially low borrowing rates, yen-denominated loans could be obtained for historically low yields—sometimes as low as 1 percent per annum. As a result of these attractive yields, an ample amount of short-term liquidity was available, which in turn was invested in the now-famous maturity mismatch. As long as the liquidity remained high, Icelandic banks faced no problem continually obtaining new short-term funding. However, as the interbank lending markets dried up last year after the collapse of Lehman Brothers, Icelandic banks found themselves unable to cover the shortfall.

One problematic area this foreign borrowing filtered into was the domestic mortgage market. While in many other countries, state-controlled mortgage-assistance schemes were reserved for those deemed most in need, Icelandic society—one that prides itself on treating everyone equally—saw no need to discriminate between those who should receive assistance and those who should not.

Iceland's newly privatized banks, led by the big three, found themselves unable to compete with the state-supported system based on low interest rates alone. Instead, they increasingly were forced to reduce the quality of the collateral posted on their mortgages, an occurrence that resulted in a general underpricing of risk.

Mortgage market lending was further exacerbated by two central-bank

policies. First, a central-bank reduction in the reserve requirements in place in the country's fractional-reserve banking system caused a sudden availability of liquidity in the financial market, resulting in many banks requiring a place to park the extra liquidity.

Second, an extremely accommodating monetary policy—both domestically and internationally—made ample quantities of liquidity available to be borrowed and invested. In Iceland's specific case, broad-based monetary aggregates such as M1, grew at a rate of 20–30 percent per annum every year between 2002 and 2007.

Additionally, about half of the borrowing in Iceland carried short-term flexible interest rates, made at appealing low interest rates, artificially reduced by the central bank. With a bountiful quantity of liquidity available at historically low prices, the outlets of this monetary expansion saw their values rise to ever greater heights. The average house price in Iceland saw its value increase almost 30 percent in domestic króna, and every year between 2003 and 2007 saw a greater-than 10 percent annual price appreciation.

When the house of cards finally came tumbling down, this boom sustained on foreign currencies soon came to an end. With the bankruptcy of American financial-service provider Lehman Brothers, the banks that had engaged in maturity mismatching—the essence of the Icelandic model—found themselves in a squeeze to roll over the necessary funds to maintain liquidity.

Unfortunately, unlike many other areas of the world where quantitative easing by the central bank has provided short-lived relief, Iceland was forced to suffer a much more dire fate. The island's currency—the króna—plunged in value, making bankers, both private and central, unable to raise the cash necessary to continue funding their liabilities.

In the end, a banking system once thought to be “too big to fail” was quickly seen as the white elephant it was—“too big to bail.” The holders of the liabilities

of the banking system had been induced to make a shift from domestic to foreign assets, which bred detrimental misallocations in the real economy.

Furthermore, the relative increase in profit in the banking sector caused many Icelandic resources to shift from the real economy—once dominated by marine activities—to the more modern world of banking and finance. These imbalances will take time to repair themselves, as the real economy must revert back to a sustainable structure, conducive to the desires and preferences of consumers.

Indeed, as one fisherman-turned-banker recently commented, “I think it is easier to take someone in the fishing industry and teach him about currency trading, than to take someone from the banking industry and teach them how to fish.” Disruptions to this essential process will cause undue duress and prolonged hardship for the Icelandic people.

Government interventions are at the root of the problem as they disrupt the incentive structure that bankers face, limiting their propensity to abide by this sensible practice. The *explicit* guarantee by the Central Bank of Iceland altered bankers' risk preferences, and resulted in the risky undertaking being gingerly assumed to be sustainable. The continual liquidity injections by the central bank ensured that rolling over short-term loans would not pose a significant problem. Finally, the collaborative effort of all central banks over the past decade to reduce interest rates to historically low levels had ingrained in individuals' minds that cheap credit could drive a boom toward ever greater heights. The events of the past year have demonstrated conclusively the fallacy of this viewpoint.

The fatality of the banking practices of mismatching assets and liabilities has been exposed. Let's hope that the calls of some do not exacerbate the situation by allowing it, indeed prompting it, to flourish further. ■

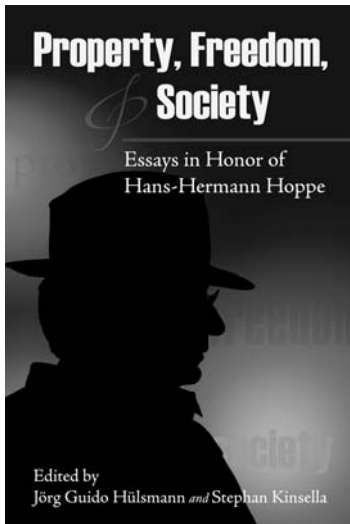
Property, Freedom, & Society

ESSAYS IN HONOR OF HANS-HERMANN HOPPE

Rare is the scholar to inspire a *Festschrift*—a volume of papers written by top specialists in honor of a major thinker—but this one is very special. It is sure to grow in importance as the years move on, for it contains phenomenal contributions written in the tradition of the work of Hans-Hermann Hoppe.

Hoppe is one of the most important scholars of our time. He has made pioneering contributions to sociology, economics, philosophy, and history. His important books include *Handeln und Erkennen* (1976), *Kritik der Kausalwissenschaftlichen Sozialforschung* (1983), *Eigentum, Anarchie, und Staat* (1987), *A Theory of Socialism and Capitalism* (1989), *The Economics and Ethics of Private Property* (1993, enlarged 2nd edition 2006), *Democracy—The God That Failed* (2001), and *The Myth of National Defense* (editor, 2003).

He is the founder and president of the international Property and Freedom Society, which promotes scientific debate in combination with intransigent libertarian radicalism.



Now Professor Emeritus of Economics at UNLV and Distinguished Fellow with the Ludwig von Mises Institute, Hoppe and his writings have inspired scholars around the world to follow in his footsteps and to provide a scientific foundation for individual freedom and a free society. The *Festschrift* honors the occasion of his 60th birthday. It contains personal testimonies and essays in Professor Hoppe's preferred research areas, such as political philosophy, democracy, and economics.

The contributors are colleagues, collaborators, and former students from all over the world, including Llewellyn H. Rockwell, Jr., Sean Gabb, Jesús Huerta de Soto, Robert Higgs, Frank van Dun, Paul Gottfried, Joseph T. Salerno, Walter Block, and Thomas J. DiLorenzo. The 400-page *Festschrift* was presented to Professor Hoppe on July 29, 2009.

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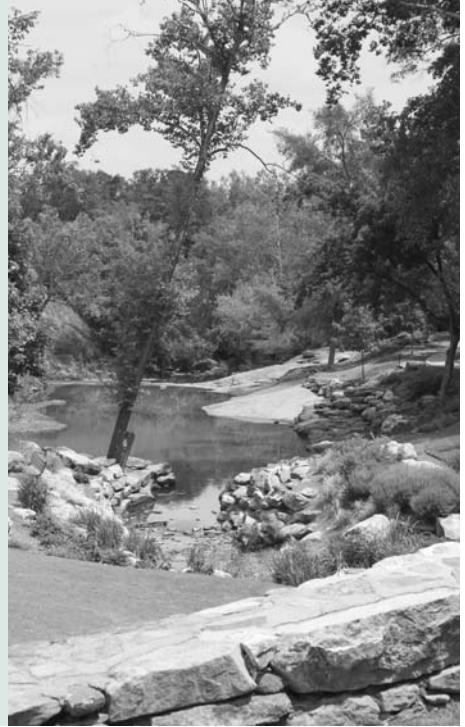
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