

The Financial Crisis in 2008-2009: Case Iceland

Comments by Tom Berglund

The insights that Throvaldur Gylfasson's knowledgeable and well explained survey of the run-up to the full blown financial crisis in Iceland in 2008, and the lessons learned from that crisis are thought provoking¹. How is it possible that almost everyone in an, at least formally, open society were willing to close their eyes to the massive excessive risk taking that went on in the Icelandic banking sector?

According to Gylfasson the roots of the mayhem stretch back to the privatization of the banks around the turn of the millennium. Instead of auctioning the state owned banks to interested foreign banks Iceland settled for a domestic solution, with entrepreneurial individuals, that lacked deeper banking experience, taking up the challenge of developing the banks into competitive entities. The three main banks that were built up in the process adopted a similar strategy of high risk exposure in the domestic and particularly in the international markets where the Icelandic banks launched an aggressive buying spree of foreign firms in financial services.

The Icelandic government, the central bank, and the Icelandic financial supervision miserably failed in their tasks of curtailing the aggressive risk taking of these aggressive banks. Lack of experience together with the fact that the Icelandic banks rapidly grew to become substantially bigger than the Icelandic economy as whole contributed to the lack of ability and willingness on behalf of government controlled

¹ A relatively extensive text version of this presentation can be found in Gylfasson (2010).

institutions to take a tough stand against the excesses in the Icelandic banking sector. On the contrary, the evidence that Gylfasson refers to shows that Icelandic officials were actively engaged in suppressing the critical voices that spoke out against the reckless speculation.

On the basis of the Icelandic experience Gylfasson sets up twelve lessons to help avoid similar crises, some of them perhaps more specific to the Icelandic experience and some of them of a more general nature. Below I will comment on them one by one:

1. Legal protection against predatory lending

Predatory lending is likely to be more of a problem when consumers have been dealing with bureaucratic state owned banks and haven't been exposed to commercial banking before.

2. Rating agencies to be paid by investors

The problem with this, rather universal lesson, is in its implementation.

3. More effective regulation

The problem with this, very universal, lesson is what actually constitutes more effective regulation.

4. Read the warning signals

The problem with this lesson is that regulators face two types of potential errors: the one that Gylfasson talks about, which is that warning signals are

disregarded, and the opposite problem which is that events that characterize a healthy economy are interpreted as warning signals with a premature tightening as a consequence.

5. Banks not to outgrow Central Bank's capacity to handle them.

This is perhaps the most obvious lesson of the Icelandic version of the financial crisis. Banks must be controlled by bodies which have enough fire-power to impact the banks' behavior. Large banks being active in a large number of countries require supervisors with similar reach.

6. Banks not to operate branches abroad but subsidiaries.

This is one way to split up the role of lender of last resort between the countries in which the bank is active. The Icelandic case shows that the branch structure can be problematic not just in the countries that host the branches but also in the banks' home countries, in particular if the home country is small.

7. Rapid credit growth not acceptable even if inflation low.

This is a fairly universal lesson where the issue is how to draw the line between excessive and acceptable credit ex ante.

8. Erect firewalls between banking and politics.

A very important lesson in particular for emerging markets with ambitions to create a well functioning financial system.

9. When things go wrong, do not cover up!

A general lesson which seems extremely hard to follow while the in the heat of the events.

10. When banks collapse use massive monetary or fiscal stimulus.

The verdict is still partly open on this lesson.

11. Shared conditionality should be more common

A sensible goal.

12. Stay cool!

The main corollaries of this lesson being that too little and too much regulation will be costly, and that a country should be prepared to accept help from abroad. This is certainly an important lesson to remember when public outrage calls for rapid and decisive action, and clear signals are called for by the public that those in charge are able to sort out the mess themselves.

In general terms the Icelandic case points to the dangers of “group think”, that is lack of diverging views on what goes on in the economy². A small relatively homogeneous country like Iceland is probably more exposed to a pressure towards conformism than a large country like the USA, but the danger exists everywhere.

Being active in the academic sector myself I would personally like to emphasize the

² For an interesting study applying a network approach to the broad based condemnation in Iceland of a critical report on the Icelandic Economy produced by Danske Bank in 2006, see Sigurjonsson & Schwarzkopf (2011). The study was not able to identify any specific origins for the rejection of the report.

role of university education in building up a fundamental respect for diverging views and an open discussion in which alternative interpretations of ongoing events are allowed to confront each other on equal terms.

References

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