

# Financialisation and Financial crisis in Iceland

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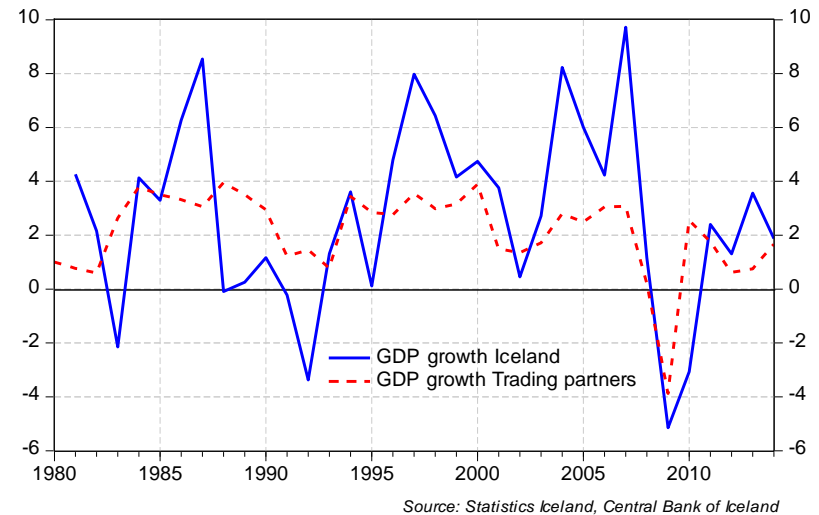
University of Iceland and Statistics Iceland



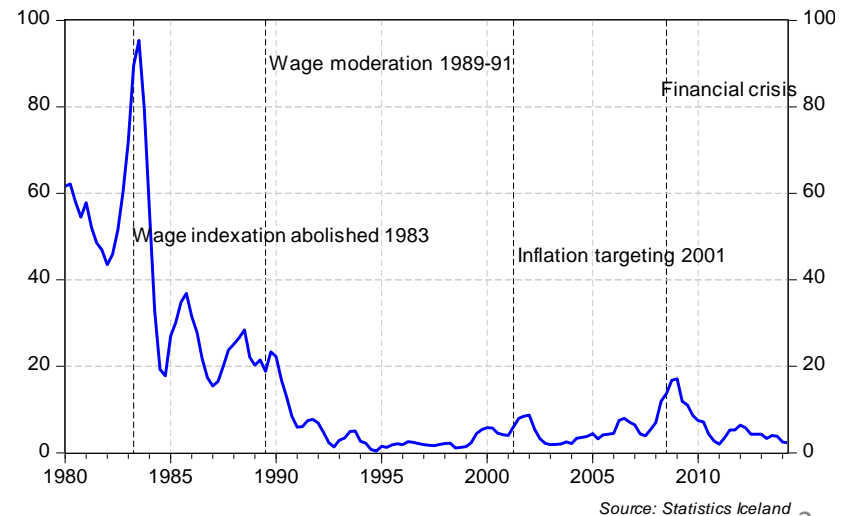
# Balancing volatile economy

- Abundant access to natural resources, high population growth and favorable geo-political position after WW2 contributed the high growth.
- Supply side disturbances, particularly in the fisheries sector and terms of trade shocks, have been important drivers of short term fluctuations of GDP.
- The traditional policy tool used to be exchange rate policy with a strong devaluation bias, leading to high and volatile inflation

Real GDP growth 1980 - 2014



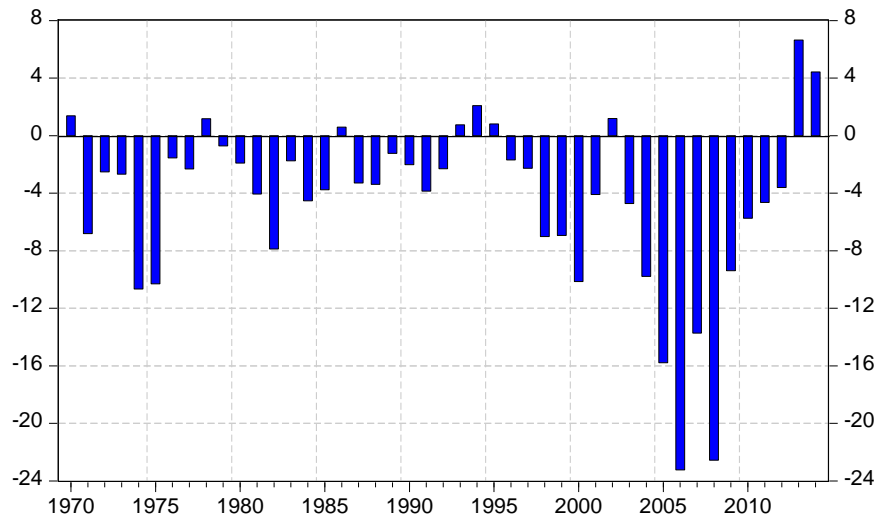
Inflation in Iceland 1980-2014



# External imbalances and exchange rate volatility

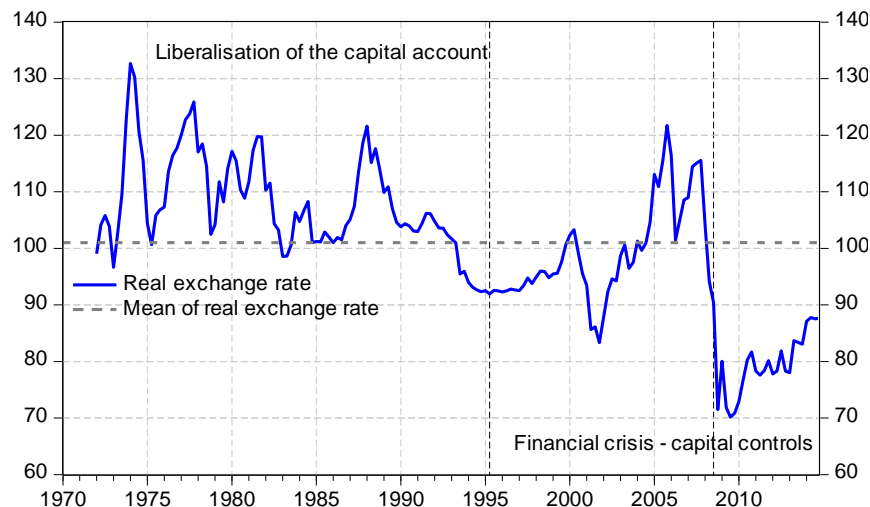
- Despite underdeveloped domestic financial markets, Iceland has had access to international capital markets to finance real sector growth.
- The current account was constantly negative indicating accumulation of sizable foreign debt.
- Real exchange rate volatility has been high driven by high inflation to begin with and nominal exchange rate volatility later on.

Current account balance, % of GDP 1970 - 2014



Source: Central Bank of Iceland

Real exchange rate 1970 - 2014

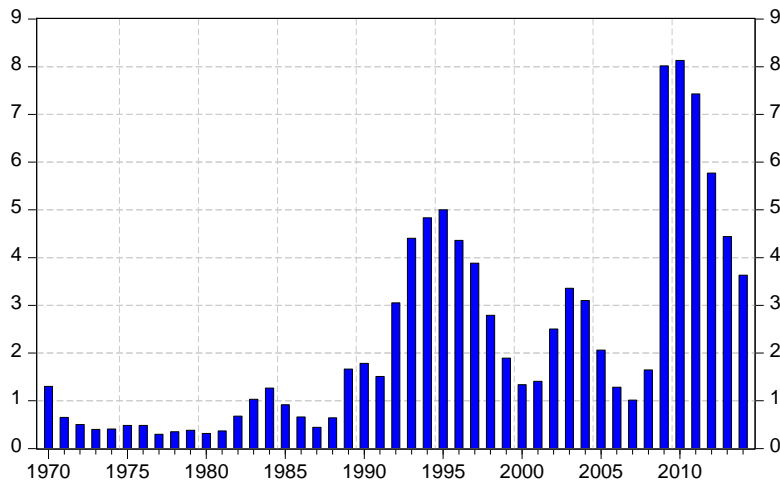


Source: Central Bank of Iceland

# ...but high employment and participation

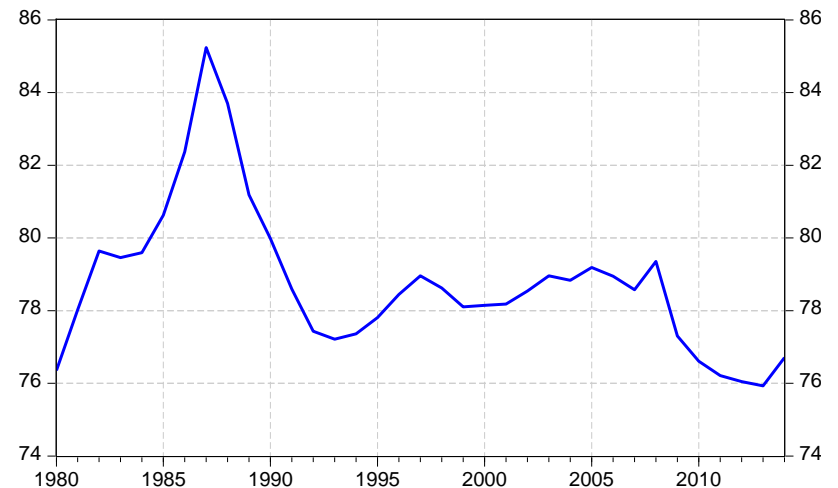
- Strong domestic demand has delivered high employment overall with exceptionally low unemployment. Lately unemployment has been increasing.
- The same story can be seen regarding labor market participation, it remains high relative to most OECD countries, but seems to be declining.
- Labor market flexibility is partly explained by international integration which goes in both directions.

Rate of unemployment (registered) 1970 - 2014



Source: Statistics Iceland

Participation rate in Iceland 1980-2014



Source: Central Bank of Iceland

# Policy agenda in the 90's and 2000's

- Macro instability, high inflation, current account deficits – What can be done ?
- Iceland more or less followed the school book recipe. Go for market liberalization / privatization / globalization.
- Following liberalization trend in the 1980's, Iceland copied the institutional design of the EU by participating in the EEA.
- Monetary and credit institutions lagged behind until early 2000's when traditional Inflation Targeting framework was put in place in 2001.
- Privatization policies played an important role as family-style capitalism, co-operatives and public ownership gave way to corporate capitalism.
- On the domestic front:
  - Implement market oriented reforms in the fisheries sector
  - Promoting new export industries by FDI projects in the energy sector
  - Developing institutional framework around bargaining about functional income distribution
  - Public sector reforms

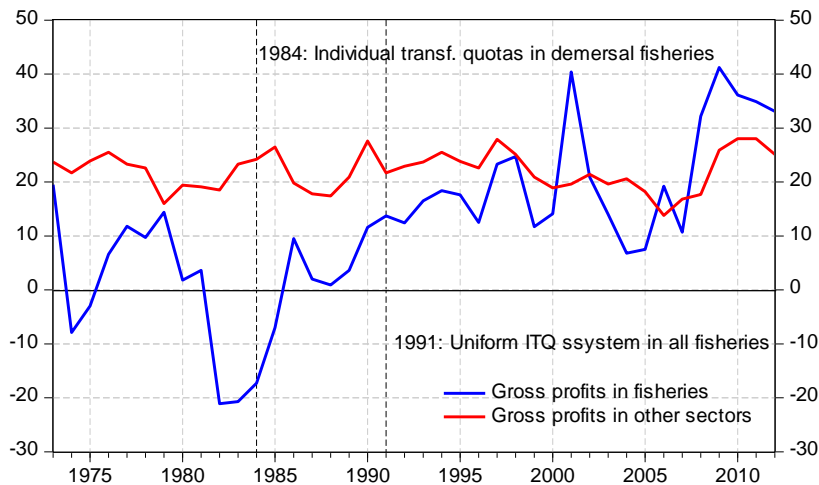
# Fast track to financialisation

- As the legal and institutional framework became more receptive to market oriented structures, the conditions for expanding the financial sector slowly became more and more favorable.
  - Stock market established in early 1990's
  - Capital account liberalization in mid 1990's
  - Privatisation policy with strong emphasis on financial sector liberalisation
- Three areas can be identified as particularly important preconditions for the consecutive build up of the financial sector
  - Successful application of market solutions in the fisheries sector
  - Build up of the occupational pension fund sector
  - Fiscal policy measures in the early 1990's
- Build on the success in these areas, Iceland was well placed to embrace the financialisation tsunami in the late 1990's and early 2000's.

# Fish and finance

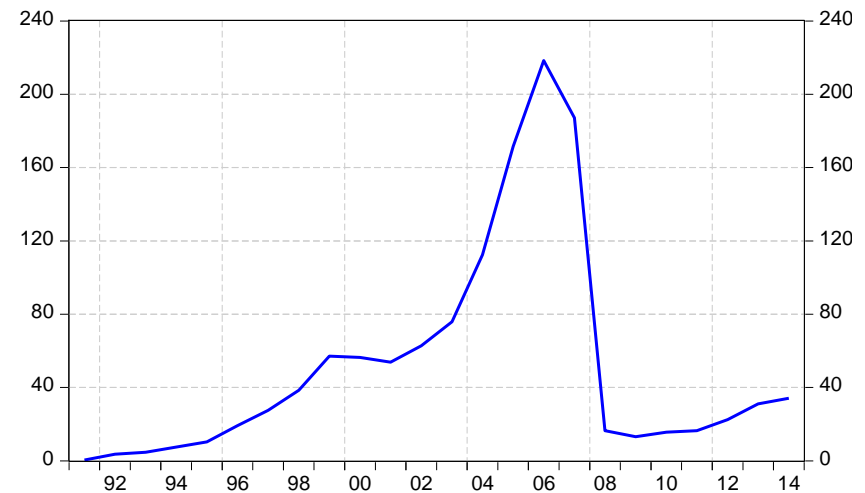
- Following expansion for fishing limits to 200 miles in 1976, a policy of quantitative restrictions was implemented by a system of transferable fishing quotas.
- Wealth created by the quota system allowed fishing companies to raise financial capital as the implicit market value of fishing quotas was 40% of GDP in late 1990's.
- Firms in the fisheries sector played a key role in the early build up of the stock market as their share in total stock market capitalization rose from 5% in 1994 to 40% in 1999.

Gross profits in fisheries and other sectors - share of value added



Source: Statistics Iceland, R. Ámason, 2008

Market capitalisation, Nasdaq Iceland, % of GDP

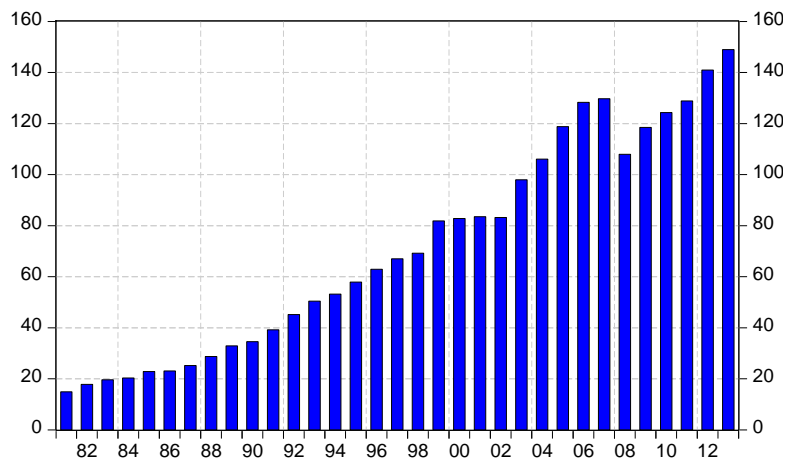


Source: Nasdaq Iceland

# Pension funds and financialisation

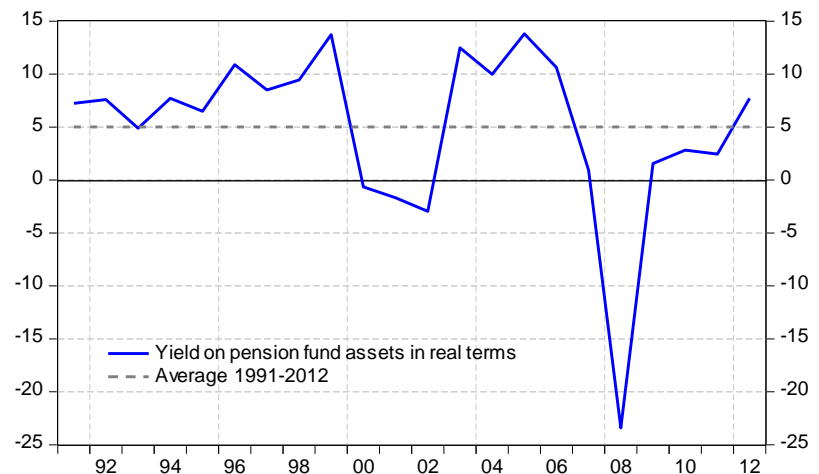
- Pension funds is an other success story regarding the build-up of financial wealth. Since late 1960's, pension funds have accumulated financial assets in excess of 150% of GDP, among the highest in the OECD.
- Asset accumulation of pension funds supported financialisation in many ways, directly and indirectly, and provided an important FX hedge in the crisis through FX assets.
- Currently, pension funds are the by far the most important institutional investment force in the country.

Pension fund assets as per cent of GDP



Source: Central Bank of Iceland

Rate of return on pension fund assets in real terms

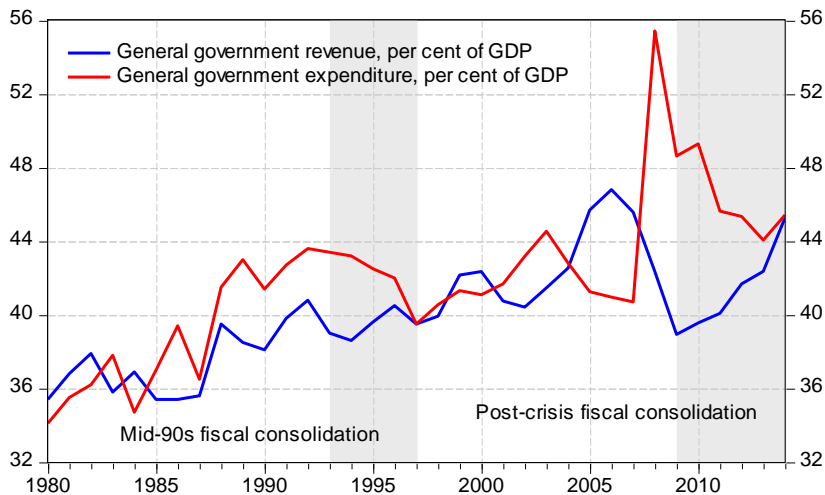




# Fiscal space for financialisation

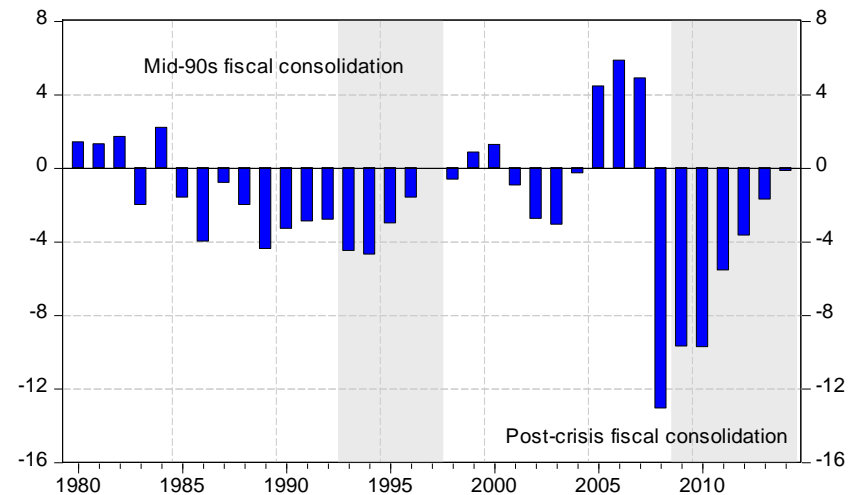
- Icelandic authorities responded strongly to fiscal policy challenges in the early 90's when austerity measures and fiscal consolidation was in vogue in the OECD area.
- At the time public sector finances has been showing deficits for several years. Already in 1997 the deficit has been eliminated and a small surplus emerged.
- The successful fiscal consolidation improved Iceland's reputation in international financial market and eventually resulted in high credit rating for the sovereign
- These high ratings were subsequently "over taken" by the banks following the privatization in the late 90's and early 2000's

General government revenue and expenditure, % of GDP



Source: Statistics Iceland

General government financial balance, % of GDP

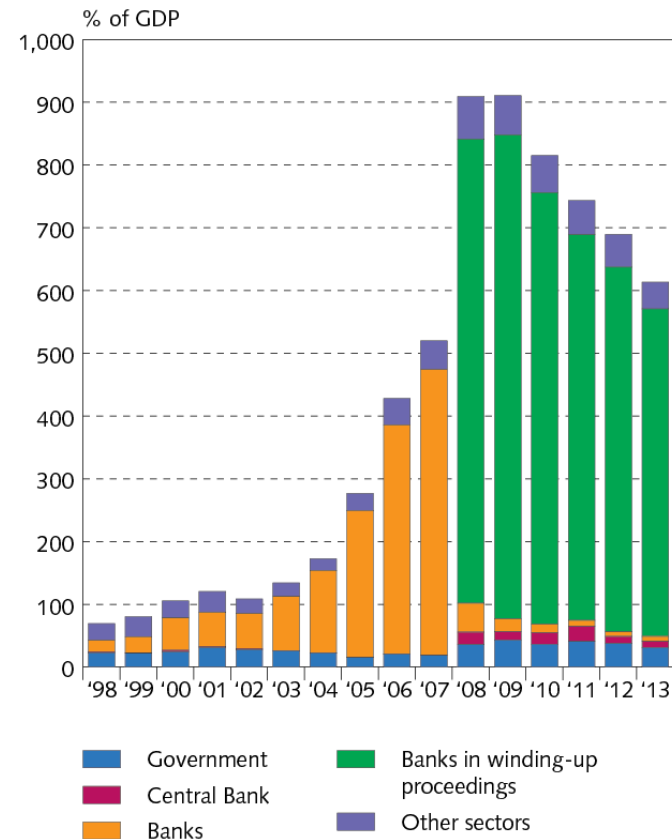


Source: Statistics Iceland 9

# Rise and fall of the banks

- In the late 90's and early 2000's conditions for building up international banking in Iceland were exceptionally positive.
- Build around a group of aggressive investors that wanted to expand their activities beyond Iceland, to move into finance seemed only natural.
- Privatization policies has already been on going for a decade and the domestic banking sector was next in line.
- Strong political support mixed with nationalistic nostalgia accelerated the financial expansion and promoted euphoric behavior in the run up to the financial crisis
- Applying the EEA agreement clauses at a time when global credit conditions were extremely loose turned out to be lethal.

Estimated foreign debt by sector 1998-2013<sup>1</sup>



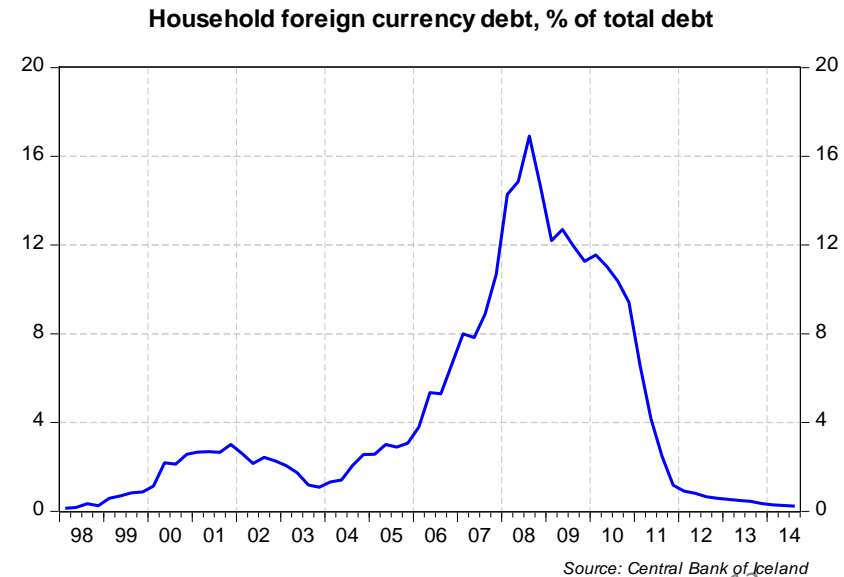
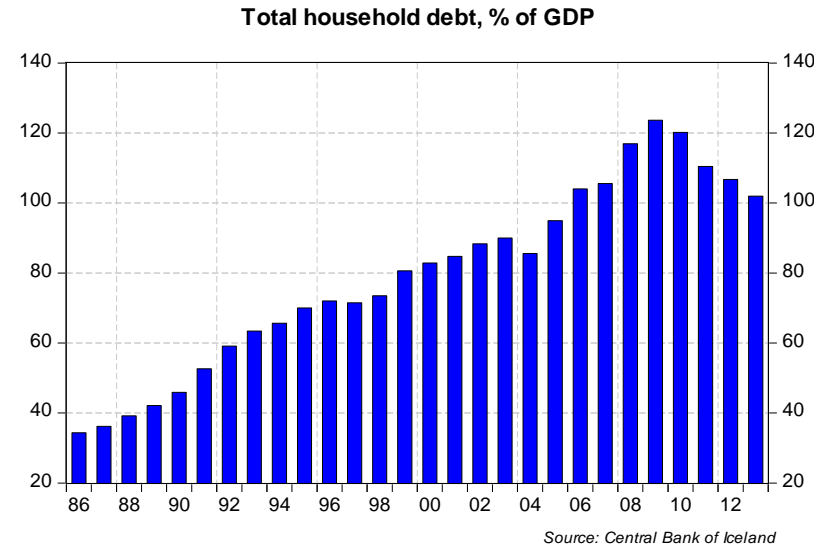
1. External debt position, excluding FDI and portfolio equities.  
Sources: Statistics Iceland, Central Bank of Iceland.

# Financialisation – What to expect ?

- Effects of financial factors on key economic variables: consumption, investment, income distribution and the current account.
- Effects on household's consumption
  - Focus on the link between wealth, consumption and debt. In the short/medium run rising debt increased consumption with the highest impact on low income households stimulating demand and growth
  - In the longer run these effects are reversed as debt service burdens rise.
  - Wealth effects on consumption are significant and positive
- Effect on firm's investment
  - Focus on 'Owner – Management conflict' which is inherent in large corporations and the trade-off between growth and profit
  - As firms become larger managerial oversight becomes difficult allowing shareholder short-term profit motives to gain control and longer term growth objectives loose ground
  - Negative overall effect of business investments
- Effects on income distribution
  - Focus on functional distribution of income between gross profits (retained profits, dividends, interest) and wages
- Effects on the current account
  - Focus on external imbalances and foreign debt

# Consumption leading the way

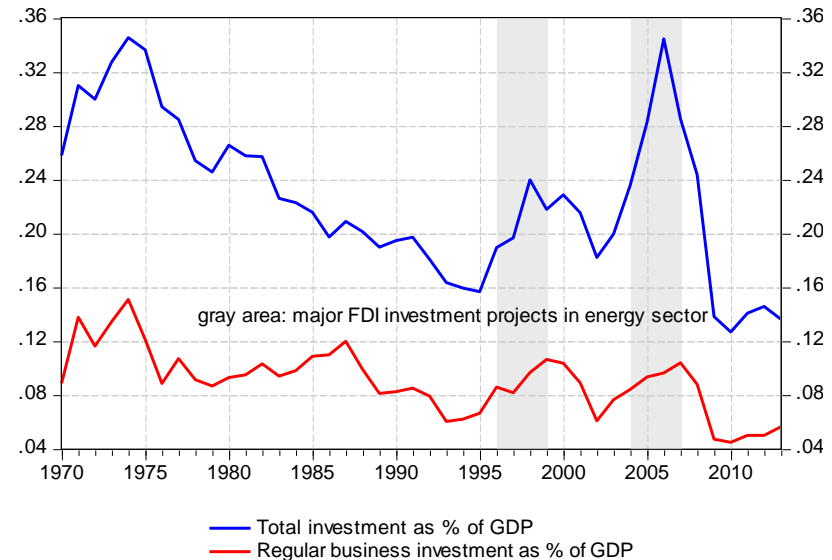
- Private consumption has historically been volatile in Iceland. Financialisation did not change much on that front.
- However, availability of credit did drive up consumer activity before the crisis, making consumption growth exceptionally strong.
- Rising consumer debt was partly related to households taking on FX debt and engaging in “carry trade”.
- In the aftermath of the crisis private consumption has declined rapidly in line with previous experiences making the adjustment process relatively rapid.



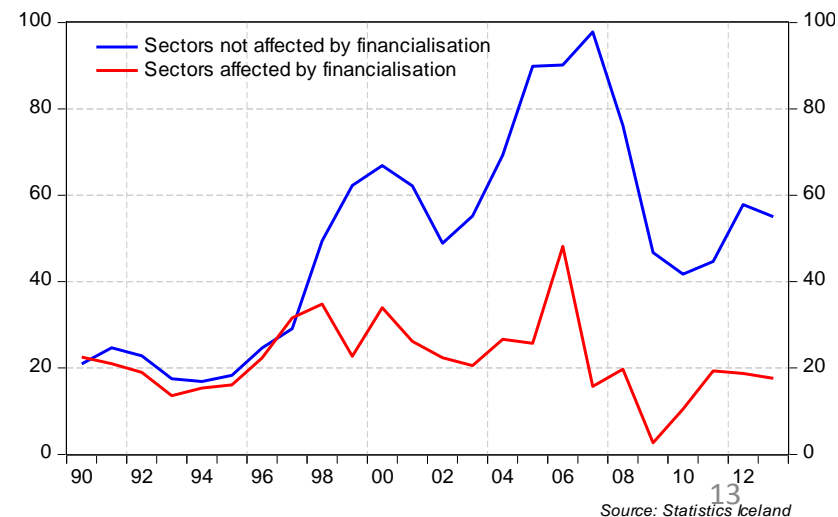
# Effects on investment

- Iceland has experienced secular decline in investments in recent decades.
- Apart from extremely large FDI projects in the energy / metallurgical industry, business investment is now at a historical low.
- Investments in housing have also fallen significantly except during the financial boom years. Same goes of public sector investment.
- It seems that investment in non-financial private sector that were most affected by financialisation were particularly hit.

Investment as % of GDP 1970 - 2013



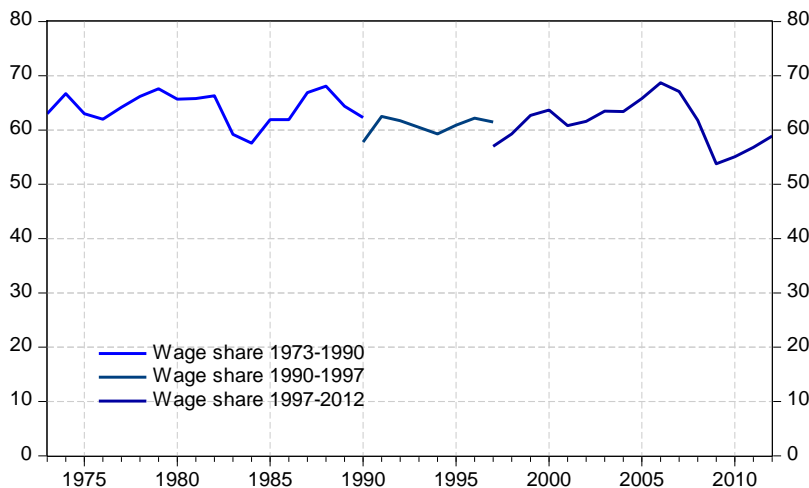
Impact on financialisation on NFS-investment, (2005 prices)



# Functional income distribution

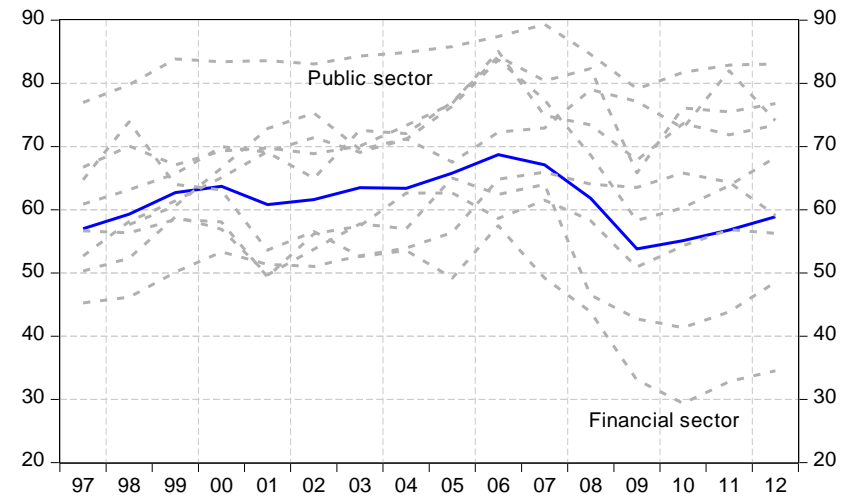
- Data on functional income distribution is available since 1973, with two breaks in 1990 and 1997.
- Overall there is a strong pro-cyclical pattern with the wage share rising during upswings and bottoming out in recessions.
- No clear long run trend in either direction but strong decline in wages after 2008
- Similar pattern is observed until the expansion of the financial sector and following the financial crisis in 2008.
- Strong decline in wage share in the financial sector and higher spread overall

Share of wages in factor income 1973-2012



Source: Statistics Iceland

Share of wages in factor income 1997-2012

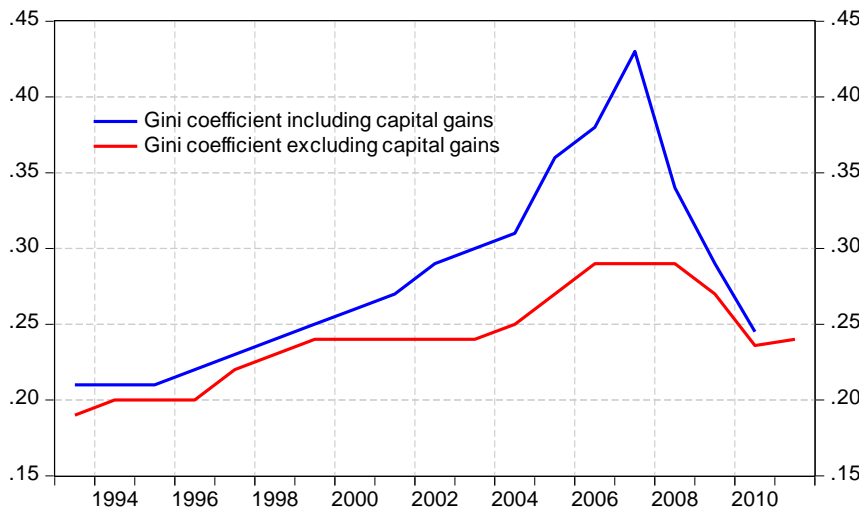


Source: Statistics Iceland 14

# Personal income distribution

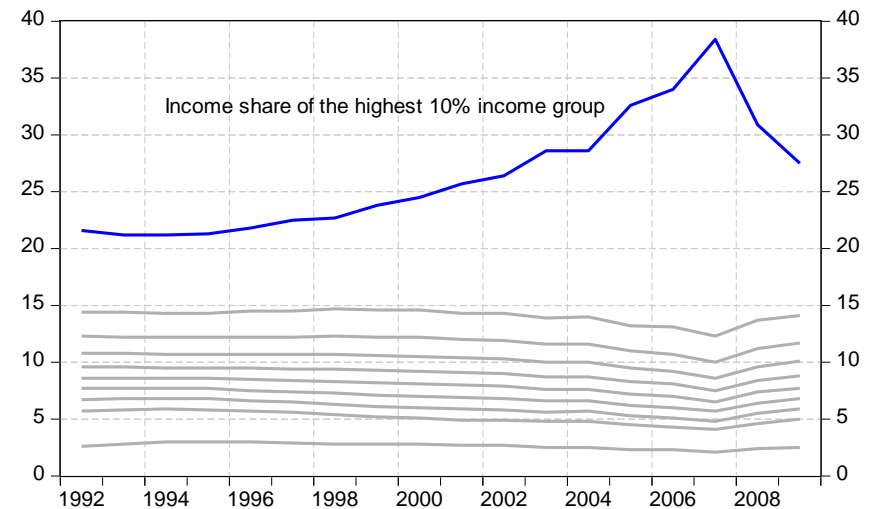
- Income inequality measured by the Gini coefficient, excluding capital gains, rose from around 0,2 in 1993 to around 0,3 in 2007. Including capital gains the Gini in 2007 rose to 0,43.
- Acceleration of rising inequality around 2003-2004 when financial sector expansion gained momentum.
- Strong concentration of personal income among the highest income earners until 2007.
- Following the financial crisis, income inequality has been scaled back significantly.

Measures of income inequality in Iceland



Source: S. Ólafsson, A.S. Kristjánsson, 2013

Disposable income shares by deciles groups 1992-2008

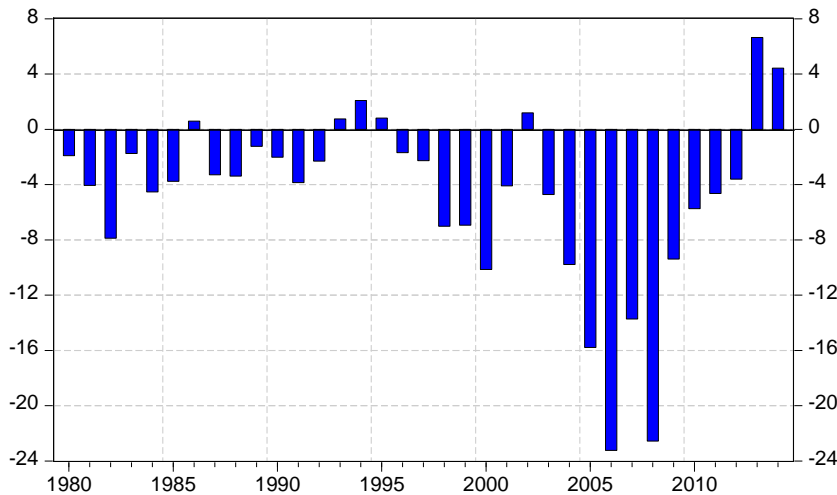


Source: S. Ólafsson, A.S. Kristjánsson, 2013

# Current account and financialisation

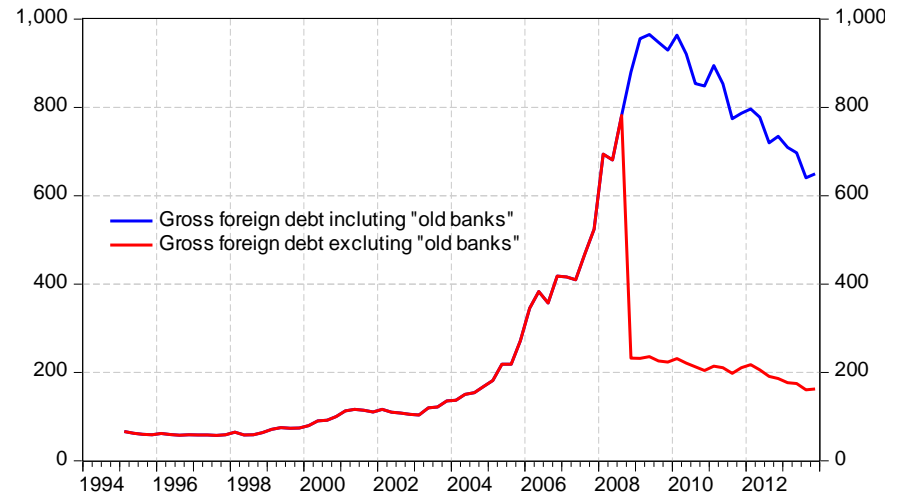
- Iceland has for the most part been a current account deficit country due to classical “Dutch disease” issues coming from the fisheries sector through an upward pressure on the real exchange rate.
- The expansion of the financial sector added a new layer of push-factors taking the current account deficit to new heights adding carry trade and other speculative elements to the picture.
- Foreign debt accelerated around mid-90’s mostly related to the expansion of the banking sector.
- Sharp fall in foreign debt following the financial crisis.

Current account balance, % of GDP



Source: Central Bank of Iceland

Gross foreign debt, % of GDP



Source: Central Bank of Iceland 16



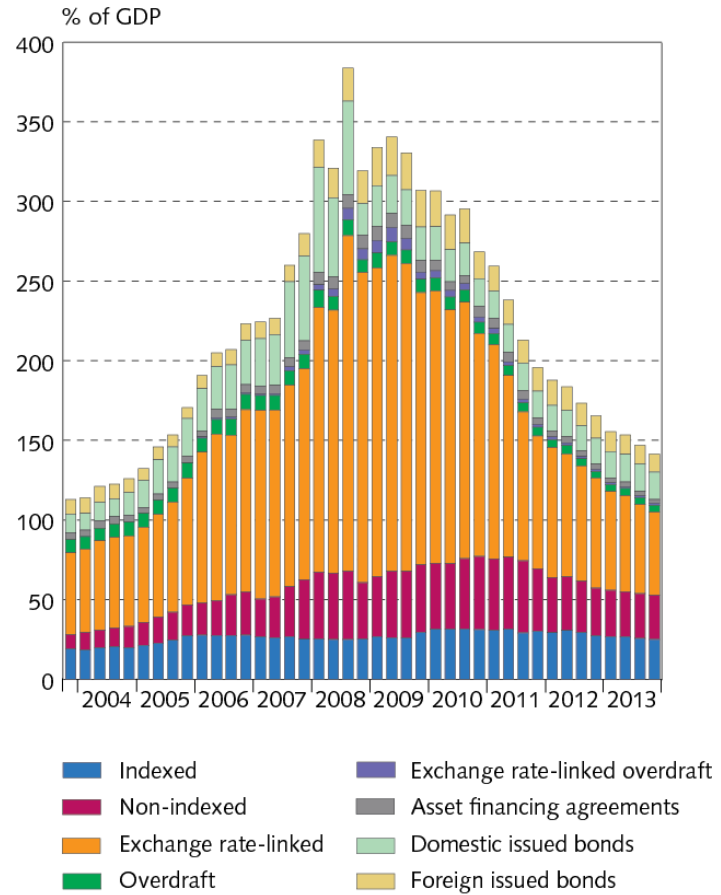
# Effects on debt

Private sector debt as % of GDP  
Q4/2003 - Q4/2013



Sources: Statistics Iceland, Central Bank of Iceland.

Composition of corporate debt<sup>1</sup>  
Q4/2003 - Q4/2013



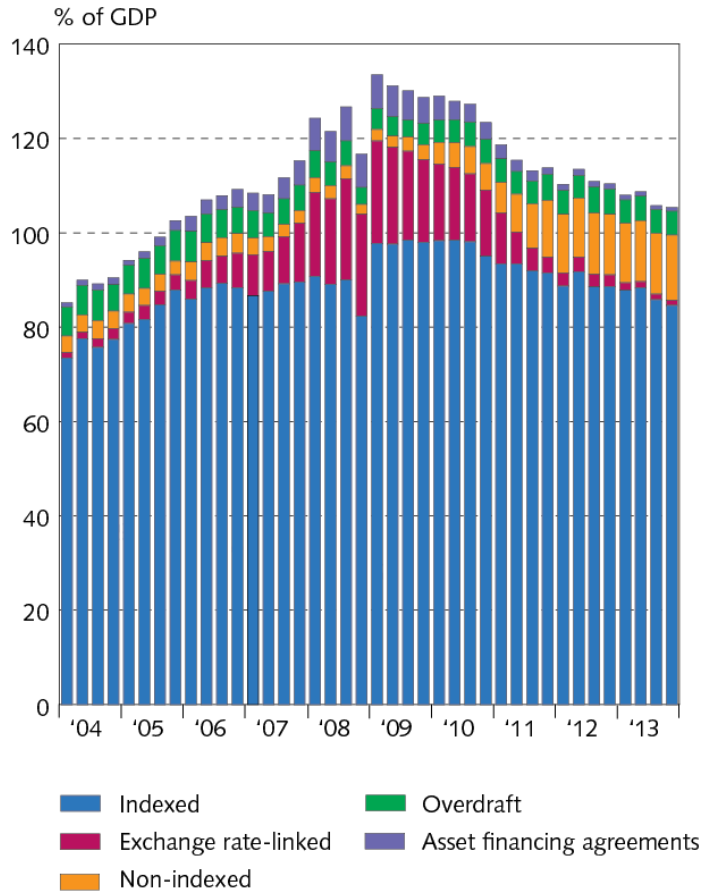
1. Debt to domestic and foreign financial institutions and issued marketable bonds.

Sources: Statistics Iceland, Central Bank of Iceland.

# Effects on debt

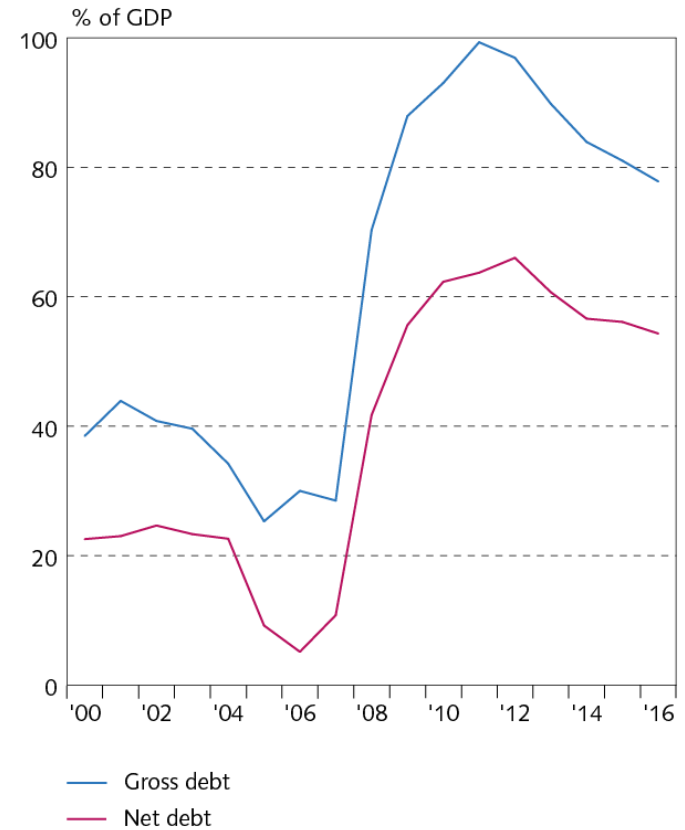
Household debt as % of GDP

Q1/2004 - Q4/2013



Sources: Statistics Iceland, Central Bank of Iceland.

General government debt 2000-2016<sup>1</sup>



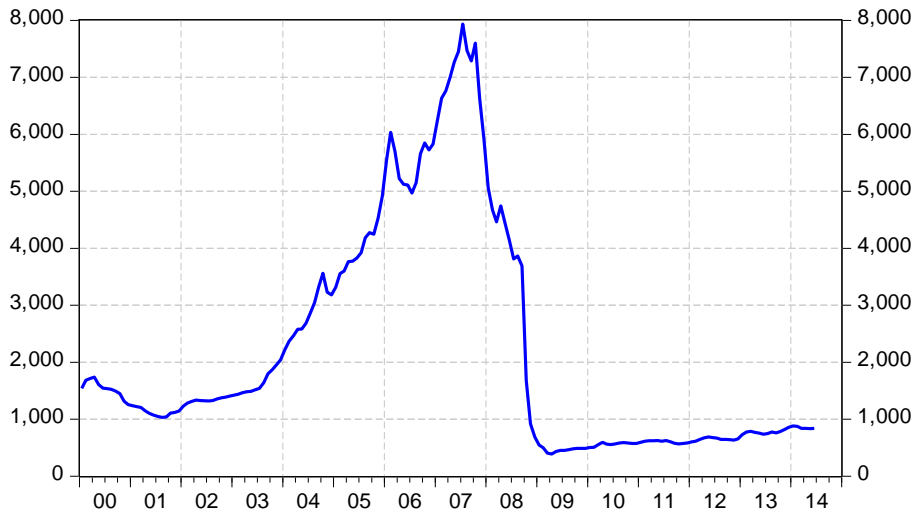
1. Central Bank baseline forecast 2014-2016 from *Monetary Bulletin* 2014/3. Gross debt according to Maastricht criteria.

Sources: Ministry of Finance, Statistics Iceland, Central Bank of Iceland.

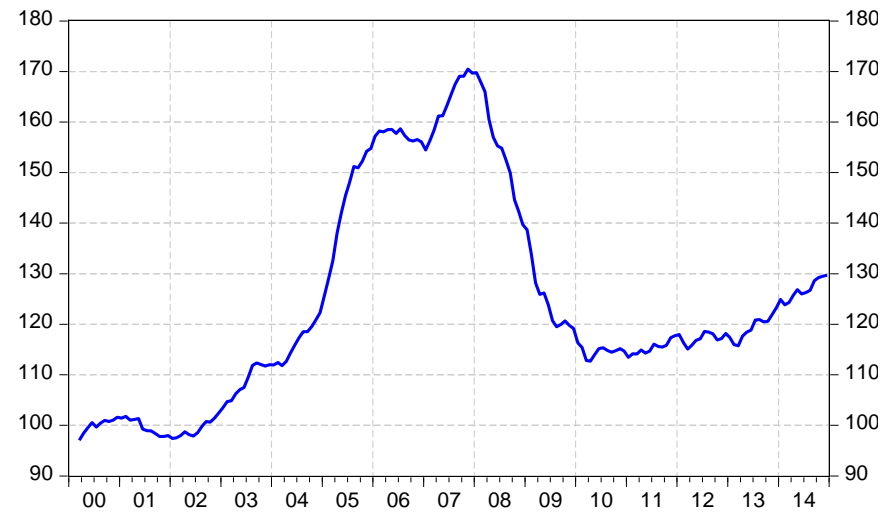
# Effects on Asset Prices

- The two major classes of real assets, shares and housing have followed predictable patterns.
- Share prices increased very rapidly in early stages and then falling exceptionally low during the financial crisis. (Banks dominance on the stock market).
- Housing prices did also rise substantially but have gained some ground again.

Stock Market Prices



House prices in real tems, 2000=100



Source: Statistics Iceland

# From finance induced to export induced growth

- Following rapid financialisation in the early 2000s, GDP growth picked up again after slump in 2002-2003.
- After the financial crisis, a new export led growth regime seems to have emerged as low real exchange rate increased competitiveness.



# Conclusions

- In the past imbalances in the Icelandic economy were mostly related to supply side shocks leading to unstable growth.
- At the same time domestic demand was kept high leading to high unemployment and current account deficits.
- The drive towards financialisation was promoted by political forces supported by economic and financial integration in Europe.
- Iceland's financialisation is one of the most spectacular example of the rise (and fall) of financial sector activity.
- Effects on investment, income distribution, debt and asset prices have been more or less in accordance with current literature on financialisation.
- Following the financial crisis, an export led growth regime has emerged which seems to be locking in negative effects on income distribution.