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 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 “rollover 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.
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 Arna-son 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
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.
Rare is the scholar to inspire a Festchrift—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.


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

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