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The Icelandic Economic Miracle

WHERE DOES THE MONEY COME FROM?

The normalization or Europeanization of Iceland

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The so-called "Icelandic Economic Miracle" is now receiving increased international attention. The word "miracle" seems to apply both to rampant economic growth and to the rather rapid emergence of Icelandic multinational enterprises. Things are indeed moving at a fast pace on this Atlantic – if not Arctic – island of just 300,000 inhabitants. The GDP has grown about 50% in real terms since 1995, and the recent overseas acquisitions by the island's indigenous corporations do seem to have the appearance of David taking on Goliath with comparatively small Icelandic enterprises – growing at an exponential rate – acquiring much larger companies abroad. This development has left quite many puzzled outside Iceland, especially since it was not until quite recently that any outsiders took an active interest in the affairs of this tiny economy, which so often has been dismissed as a "one trick pony" of natural resource based growth centred on fish and electricity.

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However, the "Icelandic economic miracle" is not a miracle in the sense that Icelandic growth figures are in aberration of economic fundamentals. Nor is it a mystery where the money which the Icelanders are using to buy their way into globalization is coming from. The success during the past years has six distinct roots.

A) Very strong growth fundamentals

Iceland is blessed with ample resources, both human and natural. The country has – along with Ireland – the highest fertility rate and the lowest dependency rate in Europe and a median age of 35. In other words, Iceland is a first world economy with third world demographics, which must translate into a swelling labour force with large new generations entering the labour market while comparatively few are crossing the retirement age. Moreover, very few hands remain idle in the labour market. Iceland has the lowest structural unemployment rate of Europe – around 2% – and the highest labour force participation rate of women, teenagers, and people over fifty since early retirement is almost unknown. The Icelanders also work longer hours than is common in Europe, or about 50 hours a week, which on an annual basis is six weeks longer than e.g. the Danes. In other words, Iceland is a European country with an American labour market. The nation may not have more than 300,000 people, but in terms of the labour force it works like a population of 500,000.

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Moreover, besides the very fertile fishing grounds, Iceland is awash with energy, both geothermal and hydropower, only 17% of whose potential has been utilized. In pure economic terms it means the Icelandic economy has an enormous growth capacity due to its rapidly expanding labour force, although of course it is not immune to overheating as would be expected of a country with almost no structural unemployment. It is therefore no coincidence that the Icelandic economy has expanded by 50% in real terms in the last 10 years, nor is it coincidental that all financial markets have yielded excellent returns in the same period, given the relative dearth of capital to other resources.

B) Free-market reforms paying off

The Icelandic economy used to be fuelled by the rich fishing grounds around the island and thus the nation could afford the luxury of a state-controlled economy. However, when cod stocks were nearly depleted in the late eighties, the country plunged into a six-year recession. During and after these six dark years sweeping free market reforms were enacted. The state retreated from the economy with large-scale privatizations and wide ranging market liberalization, most notably in the financial sector. Corporate income tax has been slashed from 55% to 18% and the tax on financial income is now only 10%. Personal income tax is now 36.7%. The free market reforms have paid off, with fast economic growth since 1995 despite a stationary fishing sector. Most importantly, the spirit of the nation has been fundamentally altered. After decades of being the most anti-market nation in Scandinavia, the Icelanders are probably now the most pro-market with their eyes set on the Anglo-Saxon business model. This mirrors the experience of many other countries which have enacted free market reforms of the type mentioned above and are also endowed with a solid institutional infrastructure for growth.

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C) European integration

In geographical terms, Iceland is one of the most isolated countries in the world and has long been left to its own devices, for better or for worse. The country is economically, though not technically, within the European Union since the country became a member of the European Economic Area in 1993 with a special treaty between the EFTA and EU. Like most other countries on the periphery of the EU, Iceland has benefitted enormously from European economic integration, which has opened up the European heartland for countries long on the margins of Europe. Now for the first time since the outbreak of the First World War in 1914 Iceland has open commercial access to Europe and operates on a level playing field. Icelandic corporations have been taking advantage of the situation and buying their way into Europe with funds from the international financial community. They are usually buying well established foreign enterprises into which they want to merge their operations. They are acquiring connections, know-how, market share and access, which is a typical pattern of an outside business community entering a new market. One may question the individual strategy of each corporation but as a whole this is the only strategy to break out of the small Icelandic market.

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D) A fully funded pension system

The Icelandic pension system dates back to the 1960s and is semi-private with representatives of unions and employers' federations sitting on the governing boards. The system is fully funded and about 12% minimum of each employee's salaried income is mandatorily put aside. In addition to this many wage earners have extra fully private pension schemes. The same demographic parameters that expand the labour supply also swell the pension funds. New contributions are accumulating fast but very little is paid out in accrued benefits. The pension funds now have assets totalling 120% of Iceland's GDP and growing. (The funds can be compared to the Norwegian oil fund which comprises 65% of total GDP of Norway). The funds are now charged with the task of putting that money into work and earning interest while they wait for the retirement of eventual recipients. They have been investing in the stock markets of Europe and America and about 30-40% of their assets are now foreign and growing. However, they are also very heavy in the domestic stock market and have provided a large proportion of equity used by Icelandic corporations in their overseas acquisitions.

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E) Low world market price on capital

Iceland has been a net importer of capital with a constant trade deficit ever since modern growth took root in the country in the late 1800s. This is in a strict accordance with classical growth theory. A country with a rapidly expanding labour supply and ample natural resources should draw on foreign savings and import capital until domestic interest rates – net of the country specific risk premia – are equalized to match those of the outside world. What matters in the long run, in macroeconomic terms, is that the rate of economic growth is greater than real world interest rates, which has indeed been the case in Iceland. Therefore, the current low world interest rates, especially in the euro zone, are a bonanza for a capital importing country like Iceland and have provided an added impetus for growth.

"Icelandic foreign debt for the last 5 years has mainly been the result of expanding activities abroad…"

The influx of capital to Iceland has somewhat accelerated after the capital account was opened in 1995, while at the same time real domestic interest has dropped significantly. The level of foreign private debt has risen while foreign public debt is vanishing. The increase in private debt can almost exclusively be attributed to business activities, since Icelandic households carry almost no currency-linked debt on their books. At first, Icelandic enterprises, especially export industries with a natural currency hedge, were eager to capitalize on lower foreign interest by swapping domestic debt for foreign. In 2000 currency linked loans counted for about 35% of the domestic loan portfolio of the banking system but that ratio has been stable since that time. The rapid increase in Icelandic foreign debt for the last 5 years has mainly been the result of expanding activities abroad, especially the banks, whose multinational lending and activities have placed large foreign liabilities – compared with GDP of Iceland – on the national balance sheet. However, these external liabilities are serviced abroad, have matching foreign assets and are actually generating foreign earnings through returns on Icelandic equity and thus constitute a currency inflow or foreign revenue into the country.

F) Scale economies - do or die

"The fishing sector has now reached a plateau and Iceland must repeat the success for other selected sectors…"

It was once said that Prussia was not a country with an army but rather an army with a country. Similarly, Icelandic success in the fisheries is not only due to the rich fishing grounds but also the scale economics involved in being a small country that is big in fish. Icelanders became not only good at fishing but in everything involving value creation in the sector, including marketing and technological innovation. In fact, technology developed for the Icelandic fishing sector is now being exported, e.g. for chicken processing in the US. Although still successful, the fishing sector has now reached a plateau and Iceland must repeat the success for other selected sectors. Currently there are several initiatives under way. Many of the upstart Icelandic multinationals began as successful spin-offs from the marine sector. Others are rooted in other traditionally strong sectors in Iceland, such as the airline industry, biotech or health related services. Still others are the creation of successful entrepreneurs, in areas such as banking, retail and multimedia production, which have used the skills base of the country in their projects. Naturally, not all of these initiatives will flower but some of them will provide the scale effects which Iceland needs to prosper. International trade today is chiefly what has been called "intra-industry" trade built on scale economics, specialization and spillover effects stemming from one large multinational company or large exporting sector. True enough, the economy of the Scandinavian nations is not driven by forestry exports but external effects of companies like Ericsson in Sweden or Nokia in Finland.

G) Investment banking

Companies operating in small island economies do not have the luxury of a piecemeal approach to their expansion. After having tested the limits of their own domestic markets they either have to take a giant leap forward and expand overseas or sit and be satisfied at home. However, having a business plan is not enough. The aspiring multinationals have to have access to both equity and debt financing. Investment banking has been instrumental in the success of almost all Icelandic corporations taking this jump. The process is usually as follows. At the beginning there is a well rooted company or a group of entrepreneurs with a business plan. They come into contact with one of the three banks which drafts up a war plan for the expansion, secures a loan and then buys a stake in the unlisted business. Thirdly, at the first sign of success, the bank arranges for an IPO on the Icelandic stock market and even sells its stake at a profit. Since all Icelandic companies are small by international standards, comparatively small operations have been able to raise funds in the public market without the small cap premium that exists on larger markets. However, it has to be kept in mind that this strategy is only a vehicle for putting good business ideas into a practice but not an end in itself.

This type of investment banking has not only been successful in Iceland but has also been successfully exported to small and medium sized businesses in northern Europe, most notably in the case of Kaupthing Bank. Icelandic bankers maintain that the times are changing. Bankers in nice suits can no longer walk into a firm, leave behind an excel spreadsheet and then send a hefty bill. The bank has to show concretely that it has the right incentives and believes its own advice by taking equity risk in the business.

The two miracle economies – Iceland and Ireland

The Icelandic growth miracle is fully comparable to the much publicized Irish "miracle". Both countries are islands in the North Atlantic which for centuries were dominated by a much larger neighbour. (Britain in the case of Ireland and Denmark for Iceland.) Iceland is not catholic – although the Icelanders held out against Lutheranism longer that any other nation in northern Europe until brought under subjugation by a Danish/German army in 1551 – but has nevertheless long been an outsider in Europe given its distance from the continent. These two literary nations are moreover blood related – the ancestry of Icelanders is about 40% Celtic – and have very similar demographic parameters, fertility rate etc., that allow for rapid economic expansion. Both Iceland and Ireland have been handsomely rewarded for free market reforms, tax cuts and labour market flexibility. They have also benefited from the European integration which has opened up the continental heartland for them. They also have been importing capital to enhance growth. Ireland has drawn large sums from EU structural funds as well as attracting massive FDI from US multinationals. Iceland on the other hand is drawing a line of credit in the major financial markets of Europe to finance its expansion but has been the source rather than a receiver of FDI. The countries differ in that Iceland was already – despite a six-year standstill in growth 1988-1994 – among the wealthiest countries of the OECD before reforms and integration took place. Therefore it has been able to use its own pool of savings in lieu of the pension funds as a source of equity to foot its own multinationals. Both nations, however, are coming in from the cold and simply ask their fellow Europeans to put aside the old stereotypes.

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Conclusion

One consequence of high growth is that the Icelandic economy has been quite cyclical. This might be expected given the small size and homogenity of the population and the resulting correlation of consumer decisions. Moreover, since most consumer goods are imported, Icelandic households respond very strongly to changes in the real exchange rate, which can cause large pro-cyclical fluctuations in the current account. This cyclical tendency poses a significant challenge to economic stabilization policy, although adjustments in the exchange rate, albeit with inflationary side effects, have always resulted in soft landings in the past. This is again according to the textbooks since Iceland is, after all, a small open economy, and about 75% of the revenue of companies listed on the Iceland Stock Exchange, ICEX, was generated abroad. Moreover, economic life in Iceland has in many ways adapted to these fluctuations. The financial system is, for example, more or less index-linked which means that inflationary shocks can move through the system without causing as much harm as in other countries. Approximately 87% of household loans are index-linked with fixed real yields, which means that the burden of payment hardly changes even if inflation increases. Moreover, unlike other countries, the banking system actually gains from rising inflation as its outgoing loans are largely index-linked and deposits are not. Thus, the elasticity of the Icelandic economy is greater than in its larger counterparts in Europe, although it would be preferable if it were less stretchy at times.

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During the past few years, much has been made of how unusual Iceland is. Hence, the phrasing: "the Icelandic economic miracle". In reality this is really turning things upside down. Iceland was already highly unusual, beyond the radar screens of Europe with its strong anti-market policies and oversize fishing sector. The process that began with market liberalization after the cod stocks failed in the late eighties gathered steam after the advent of European integration in the early nineties and it now reaching its zenith with the rising Icelandic multinationals, is the process of normalization, Europeanization or even the Scandinavianization of Iceland. This is, of course, not without risks or potential downsides. However, the risks involved are idiosyncratic, not systematic. The new Icelandic upstarts are a heterogeneous lot but not a single entity that stands or falls together. Some will fail and some will succeed. The Icelanders are not putting all their eggs in the same basket and stand a good chance of developing a handful of multinational enterprises that will prove to be pillars of growth in the near future.

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