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Use the globalEDGE website (globaledge.msu.edu) to complete the following exercises:

1. The *Global Financial Stability Report* is a semi-annual report published by the International Capital Markets Division of the International Monetary Fund (IMF). The report includes an assessment of the risks facing the global financial markets. Locate and download the latest report to get an overview of the most important issues currently under discussion. Also, download a report from five years ago. How do issues from five years ago compare with financial issues identified in the current report?

2. An important element to understanding the international monetary system is keeping updated on current growth trends worldwide. A German colleague told you yesterday that *Deutsche Bank Research* provides an effective way to stay informed on important topics in international finance from a European perspective. One area of focus for the site is emerging markets and economic and financial challenges faced by these markets. Find an emerging market research report for analysis. On which emerging market region did you choose to focus? What are the key takeaways from your chosen report?

CLOSING CASE

The IMF and Iceland's Economic Recovery

When the global financial crisis hit in 2008, tiny Iceland suffered more than most. The country's three biggest banks had been expanding at a breakneck pace since 2000 when the government privatized the banking sector. With a population of around 320,000, Iceland was too small for the banking sector's ambitions, so the banks started to expand into other Scandinavian countries and the UK. They entered local mortgage markets, purchased foreign financial institutions, and opened foreign branches, attracting depositors by offering high interest rates. The expansion was financed by debt, much of it structured as short-term loans that had to be regularly refinanced. By early 2008, the three banks held debts that amounted to almost six times the value of the entire economy of Iceland! So long as they could periodically refinance this debt, it was not a problem. However, in 2008, global financial markets imploded following the bankruptcy of Lehman Brothers and the collapse of the U.S. housing market. In the aftermath, financial markets froze. The Icelandic banks found that they could not refinance their debt, and they faced bankruptcy.

The Icelandic government lacked the funds to bail out the banks, so it decided to let the big three fail. In quick succession the local stock market plunged 90 percent and unemployment increased ninefold. The krona, Iceland's currency, plunged on foreign exchange markets, pushing

up the price of imports, and inflation soared to 18 percent. Iceland appeared to be in free fall. The economy shrank by almost 7 percent in 2009 and another 4 percent in 2010.

To stem the decline, the government secured \$10 billion in loans from the International Monetary Fund (IMF) and other countries. The Icelandic government stepped in to help local depositors, seizing the domestic assets of the Icelandic banks and using IMF and other loans to backstop deposit guarantees. Far from implementing austerity measures to solve the crisis, the Icelandic government looked for ways to shore up consumer spending. For example, the government provided means-tested subsidies to reduce the mortgage interest expenses of borrowers. The idea was to stop domestic consumer spending from imploding and further depressing the economy.

With the financial system stabilized, thanks to the IMF and other foreign loans, what happened next is an object lesson in the value of having a floating currency. The fall in the value of the krona helped boost Iceland's exports, such as fish and aluminum, while depressing demand for costly imports, such as automobiles. By 2009 the krona was worth half as much against the U.S. dollar and euro as it was in 2007 before the crisis. Iceland's exports surged and imports slumped. While the high cost of imports did stoke inflation, booming exports started

to pump money back into the Icelandic economy. In 2011 the economy grew again at a 3.1 percent annual rate. This was followed by 2.7 percent growth in 2012 and 4 percent growth in 2013, while unemployment fell from a high of nearly 10 percent to 4.4 percent at the end of 2013.

Sources: Charles Forelle, "In European Crisis, Iceland Emerges as an Island of Recovery," *The Wall Street Journal*, May 19, 2012, pp. A1, A10; "Coming in from the Cold," *The Economist*, December 16, 2010; Charles Duxbury, "Europe Gets Cold Shoulder in Iceland," *The Wall Street Journal*, April 26, 2012; "Iceland," *The World Factbook 2013* (Washington, DC: Central Intelligence Agency, 2013).

Case Discussion Questions

1. What were the main causes of Iceland's economic troubles in 2008?
2. Was Iceland facing a classic currency crisis, or was this a banking crisis?
3. How did Iceland recover from its 2008–2009 crisis? What are the important lessons to draw from this case?
4. Iceland did not implement the austerity policies that are so often associated with IMF loans, and yet the economy recovered. Does this suggest that austerity policies do not work?

Endnotes

The argument goes back to economist David Hume. See D. Hume, "Of the Balance of Trade," in *The Goldsmiths' Company*, pp. 88–91.

Source: © Chris Wedel/Corbis/Bettmann Images

5. ...
6. ...
7. The argument is made by Stanford University economist ...

markets have become in the modern world. The public offering of a fast-growing company on the Shanghai or the Hong Kong Stock Exchange, which seemed highly unlikely in the 1990s, is now a common sight. Today, it is not unusual for a company to list its shares on foreign exchanges, and the sources of capital, whether from investors or lenders, are the most attractive. We have moved from a world in which the capital market is segmented from each other by regional boundaries to a world in which the capital market is becoming