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Iceland's Crash Offers Lessons

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Looking for a good movie?

I highly recommend a documentary that played in theaters titled *Inside Job*. It's about the financial collapse in the U.S. and includes interviews with some key players involved, explaining the incestuous relationships among banks, rating agencies, government officials and paid consultants.

One of the more eye-opening interviews is with Frederick Mishkin, former Federal Reserve governor (2006-2008) and current professor at the Columbia School of Business. In it he is asked about a paper he co-authored in 2006 titled, *Financial Stability in Iceland*, in which he writes in glowing terms about the country's strong and stable financial markets. This was mere months before the country's banks and economy collapsed under enormous debt. He is then asked what, in his research, made him believe Iceland's market was so stable. After fumbling for an answer, he came up with, "You talk to people, you have faith in the central bank." When asked how much money the Icelandic Chamber of Commerce paid him to write the report, Mishkin's response was \$124,000.

This certainly leads one to reconsider how much prescience and practical knowledge those in control of monetary policy really have. But, there's more. The next question the interviewer asked leaves the poor man momentarily speechless. Immediately after the \$124,000 question, Mishkin is presented a copy of his paper, on which the title of the 2006 report has been changed to *Financial Instability in Iceland*. All Mishkin could do was mumble something about a typo.

I bring this up not to attack Mishkin, but to highlight the fact that central bankers can get things wrong. And, in the case of the bailout fever that firmly grips the U.S. and is spreading quickly in Europe, evidence is emerging that our monetary policy chiefs are exactly that: Wrong. Again.

Take Iceland. The country let its banks fail, it didn't use taxpayer money to bail them out, and the country and its currency have paid a heavy price. However, Iceland's budget deficit just a couple of years past the crash will be 6.3% this year and will vanish by 2012, the European Commission (EC) estimates. Contrast this with Ireland, which will leave a 32% deficit as

estimated by the EC. How long will this debt burden the economy? How long will banks be frozen, leading to stagnation? If Japan is any guide, it could be decades.

What Iceland is showing us, however, is that while letting banks and corporations fail produces some short-term volatility, the destruction of bad debt is a necessary precursor to the reformation of capital. Iceland tore off the Band-Aid® in one quick pull. Now it can move on.

Economist Paul Krugman says Iceland may be an example of "bankrupting yourself to recovery."

The ironic part about the whole debate going on between pro-bailout and anti-bailout pundits in Europe and the U.S. is that we have a real life example, in Iceland, to observe and learn from. Perhaps we should give it some weight before we condemn our economies to decades of stagnation, and our children and grandchildren to mountains of our debt.

Just like a good movie, everyone wants a good ending.

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