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## **Northern Europe's Argentina Imitator**

*Iceland tells bondholders to take a severe discount, sending a chilling message to foreign investors.*

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When Iceland's Parliament voted May 22 to coerce U.S. bond investors into accepting discounts of about two-fifths on their holdings in the country's currency, the krona, investors' thoughts turned immediately to another, sunnier country, 7,000 miles south.

Argentina, after the largest sovereign default in history, spent 14 years stiffing creditors until finally settling in March after the defeat of President Cristina Kirchner's preferred successor. Argentina's refusal to abide by court orders, negotiate, or even recognize its obligations caused serious harm to the economy as private investors, fearful of receiving the same treatment, stopped lending money. But Argentina has a history of poor governance and serial defaults. You would expect Iceland to be different.

Instead, this prosperous member of the European Economic Area and NATO, with an unemployment rate of 2.5% and income per capita of nearly \$50,000, is adopting the old Argentine playbook, even hiring the same law firm. The consequences to Iceland's recovering economy could be similar.

You can't blame investors, including small shareholders in mutual funds advised by such U.S. firms as Eaton Vance and Loomis Sayles, for being confused and angered by the latest turn of events. Iceland's policy toward foreign investment suddenly shifted and, it appears, the new law violates Iceland's Constitution as well as the Agreement of the European Economic Area, which prohibits discrimination based on nationality and bars restrictions on the free movement of capital.

Iceland's economy collapsed during the global financial crisis of 2007-09. By offering high interest rates to foreign investors, mainly from the Netherlands and the U.K., Iceland's three largest banks acquired assets 10 times the size of the nation's economy and then got burned when the downturn hit.

Iceland allowed its banks to fail and convicted 26 bankers of crimes. Unemployment rates quadrupled, almost all businesses went bankrupt and the stock market fell 95%. With foreign investors shunning the island, the International Monetary Fund kept the economy afloat with a \$2 billion loan. The currency was devalued, and Iceland rebuilt.

Sounder government policies helped the economy grow, and Iceland's central bank now holds about \$6 billion in foreign reserves, or about one-third of GDP. The IMF loan was repaid in October, ahead of schedule, and Iceland's credit rating from Standard & Poor's, which had plunged five levels to BBB- in 2008, has been raised to BBB+.

So Iceland is in decent shape. But now, rather than pursue a policy of trying to attract and retain foreign investment, the government has decided to kick it out, brutally.

The legislation passed last month gives foreign holders of about \$2.3 billion in bonds denominated in Icelandic kronur two unappetizing options. They can either sell their bonds by June 16 at an exchange rate severely below the current market, or hold the bonds until maturity and have the proceeds locked up inside Iceland in a savings account paying 0.5% interest.

The exchange rate today is about 122 krona to the dollar, so one million krona should be the equivalent of about \$8,100. The legislation orders conversion at between 190 and 210 krona to the dollar, so one million krona becomes as little as \$4,800.

Major victims of Iceland's unilateral decision to default are U.S. investors, including retirees who participate through retail mutual funds. Loomis Sayles Bond Fund, which requires a \$2,500 minimum investment, owns three series of Republic of Iceland bonds, with a total market value as of April 30 of \$96 million. Two series of Icelandic debt securities are the fourth- and fifth-largest holdings of Eaton Vance Diversified Currency Income Fund, which requires an initial investment of just \$1,000. Other U.S. investment firms, including hedge funds, also own these so-called "glacier bonds."

Iceland has suffered through a terrible decade. The prime minister, Sigmundur Gunnlaugsson, stepped down in April after revelations in the Panama Papers led to accusations that he improperly concealed millions in family assets. "The mood of society is still fairly dismal," Stefan Olafsson, a professor of sociology at the University of Iceland, told Bloomberg.

Following a reckless path in dealing with foreign investors will make that mood more dismal still. Iceland was moving in the right direction, but degrading a major asset—respect for the rule of law—will be certain to discourage future investment. The last thing Iceland needs is a reputation as a frosty version of Cristina Kirchner's Argentina, a rogue actor, defying global financial norms.

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