



Central Bank of Iceland

Half in – Half out

What are the risks for small, open, and financially integrated economies (SOFIEs)?

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EEA Policy Seminar: Inside the Internal Market, Outside
the Banking Union

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Outline of the talk



- Iceland's pre-crisis relationship with the single market provides a dramatic example of the risks of being half in and half out (*in* regarding the freedoms and *out* regarding the backstops and safety net)
- Discuss Iceland's and other SOFIEs experience
 - Iceland's cross-border banks
 - Capital inflows and carry trade
 - Global financial integration and SOFIEs
 - Prudential rules and regulations after capital controls

Bottom line

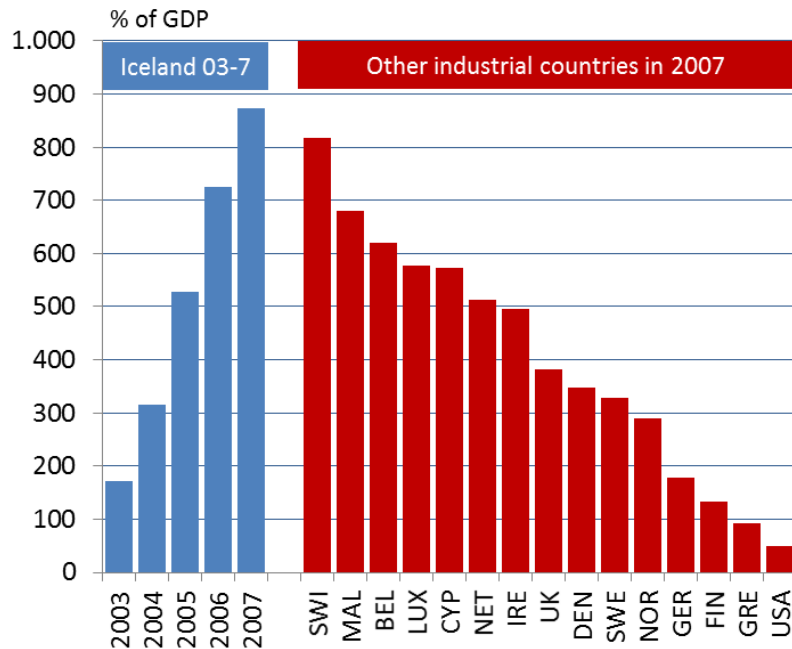


- Single market or European Economic Area (EEA) rules and their interpretation must be flexible enough to accommodate mitigating measures to deal with the relevant risks
- Before the crisis, the balance was tilted too much towards competition concerns and a level playing field, and financial stability risks were grossly underrated
- Do not have the expertise to say whether it requires changes in rules or interpretation – my relevant expertise here is in risks to monetary and financial stability

Big banks in small countries



Banking system size in the run-up to the international financial crisis in selected industrial countries¹

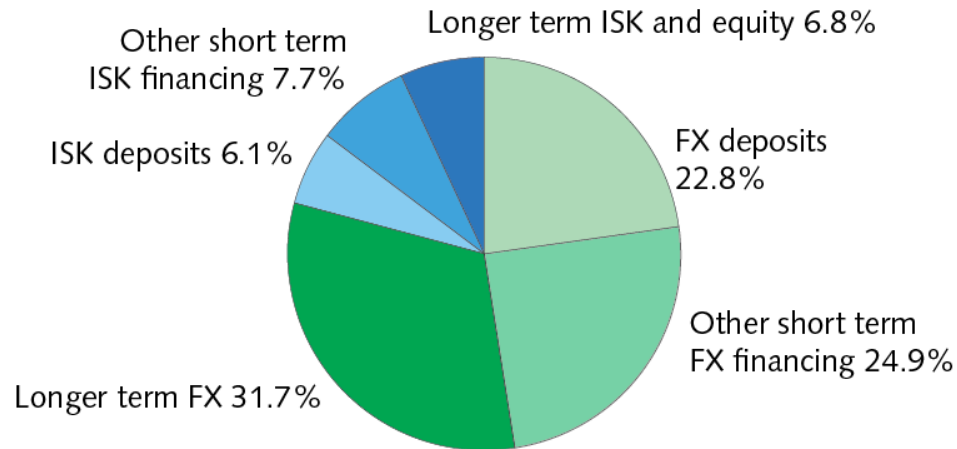


1. The figure shows the development in Iceland in 2003-2007 but the position in 2007 in other countries.

Sources: Central Bank of Iceland, Thorvarður Tjörvi Ólafsson and Thórarinn G. Pétursson (2011). Weathering the financial storm: The importance of fundamentals and flexibility. In *The Euro Area and the Financial Crisis*. Editors M. Bablavý, D. Cobham and L. Ódor. Cambridge University Press.

Financing of the three largest commercial banks in Iceland

June 2008



Sources: Banks interim consolidated accounts.

Iceland's cross-border banks



- Part of the first banking crisis in Europe since the EU single market was formed in the early 1990s
- Facilitated the cross-border expansion of the Icelandic banks
- In less than five years, from end-2003 to mid-2008, the combined balance sheet of these banks went from less than two times GDP to almost ten times GDP, topping other small European countries with international financial centres

Iceland's cross-border banks



- Towards the end, around two-thirds of the combined balance sheet of the three cross-border banks was denominated in foreign currency.
- On the liabilities side, the share of FX-denominated debt was actually higher, as can be seen on the right side of the slide, with almost half of the financing in the form of FX deposits and other short-term FX financing.
- The FX part of the balance sheet therefore had a significant maturity mismatch. However, there was a very limited safety net of the type we have in a national setting, in the form of liquidity provision and lender of last resort (LOLR) to back it up. It was an accident waiting to happen – and so it did.

Flaws in the EU/EEA framework for cross-border banking



- European freedoms were not matched by public action at the European level (supervision, deposit insurance, LOLR, crisis management and resolution) => banking union (for EU?)
- FX risk was largely ignored (and still is?)
- Country size and bank size relative to countries matter for risk and the viability of bailout options (Iceland is a clear example)
- There was a built-in vulnerability/risk in this setup, especially for small countries outside the euro area

Destabilising capital flows

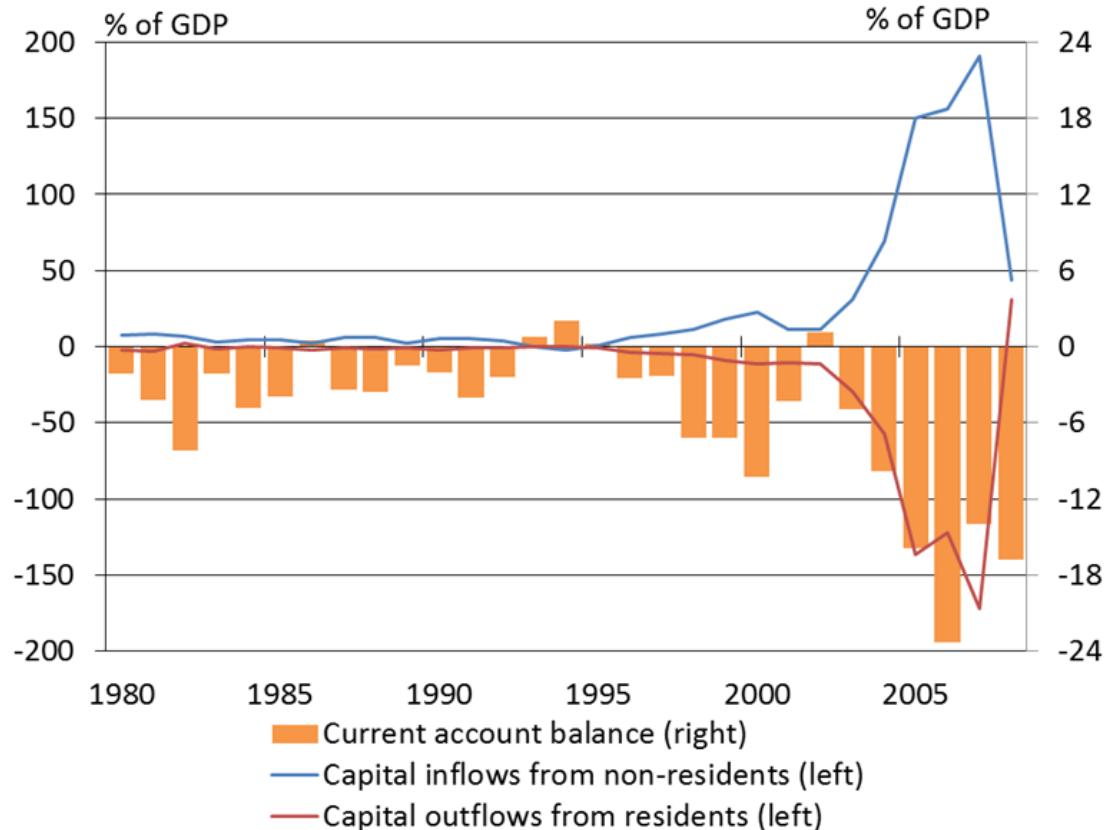


- Huge capital inflow surge (both gross and net) in the years leading up to the crisis
- Driven by perceived high growth potential, expected return on capital, carry trade, and search for yields
- Facilitated by the cross-border banks and the prevailing international conditions of abundant cheap credit
- Resulted in accumulation of risks to financial stability (credit and asset price boom, currency mismatches, etc.) and a build-up of macroeconomic imbalances (e.g., big current account deficit)
- Ended in sudden stop, financial crisis, and economic recession

Destabilising capital inflows



Iceland's sudden floods and stops in capital flows 1980-2008¹



1. The current account in 2008 is based on estimated underlying current account.

Sources: Broner, F., T. Didier, A. Erce, and S. L. Schmukler (2013). Gross capital flows: Dynamics and crises. *Journal of Monetary Economics*, 60, 113-133, National Economic Institute, Statistics Iceland, Central Bank of Iceland.



Global financial integration and scope for IMS and FS in SOFIES

- Longer-term interest rates in SOFIES reflect global rates more and more – there is a global financial cycle driven by financial conditions among core rate-setting countries
- Flexible exchange rate sufficient to hit an inflation target through the exchange rate channel
- But:
- Exchange rates do not smoothly reflect fundamentals: UIP does not hold except in the long run and then with sharp and disorderly corrections – carry trade
- Interaction with financial vulnerabilities; e.g., domestic currency mismatches and international activities subject to regulatory gaps of domestically headquartered banks

Trilemma versus dilemma



- Independent monetary policy means the ability to have a different interest rate than the rest of the world
- This is becoming increasingly difficult for SOFIEs
- But it varies with time and conditions
- It is still a triangle combined with trade-offs, but sometimes it becomes very small

What can SOFIES do about this?



- Increase resilience and ability to live with exchange rate fluctuations (reduce fear of floating) – regulate FX risk on bank balance sheets, currency mismatches, etc.
- Use more tools, some of which actually reduce the level of financial integration (but hopefully where it matters less for efficiency and growth) – Macropru – FX intervention and capital flow management tools – IT+
- Give up on independent monetary policy:
 - Monetary union
 - Monetary policy follows global monetary policy, and other policies have to take care of domestic economic stabilisation – but will they?
- Increasingly difficult to keep your own house in order

Prudential regulations or tools after capital controls in Iceland



	Regulation or tool	Status
a)	LCR and NSFR in FX	Implemented
b)	Restrictions on deposit-taking in foreign branches	a) restricts – future issue
c)	Limits on FX imbalances	In progress – depends on d)
d)	Restrictions on FX lending to unhedged borrowers	Before Parliament
e)	Capital flow management tool for capital inflows	Implemented

What does this mean for reform of the IMFS?



- Institutionalisation of CB swaps?
- Accommodate but monitor unilateral use by SOFIEs of additional tools (in particular CFM tools) – rules of the game
- Reduce financial regulatory flaws and gaps at the global and regional level



Reforms of the EU/EEA framework

- Match EU passport with EU supervision, resolution, and safety net (LOLR and deposit insurance)
- Banking union makes perfect sense based on Iceland's experience – But only for the eurozone, and then it must include all three elements
- Only solves part of the problems for EU countries outside the eurozone and EEA countries – leaves currency and LOLR problems unaddressed
- Accommodate the SOFIE problem within prevailing rules: e.g. CFM, macropru, restrictions on FX borrowing by unhedged agents, etc. – but there is also a need for critical peer review and development of rules of the game

Inside the internal market and outside the banking union?

- It is a very risky proposition
- Either countries are part of both the freedoms and the associated safety net
- Or they are forced to take unilateral action, openly or covertly, to adjust the freedoms to reflect the risks
- As I see it, Iceland should have a domestically oriented banking system as long as it is not a part of a credible multilateral financial safety net
- If sensibly managed on all sides, this should not preclude participation in the internal market, which confers substantial benefits in many areas

