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Iceland's crisis and recovery and the crisis in the eurozone

Már Guðmundsson, Governor of the Central Bank of Iceland, Comments in an international panel of bank governors on the European financial crisis and the Israeli economy, the Eli Hurvitz Conference on Economy and Society, Masada, Israel, 28 June 2012.

Almost 90% of Iceland's financial sector collapsed in the first week of October 2008, after its three private cross-border banks failed. In the panic that gripped global financial markets after the collapse of Lehman Brothers, these banks, like so many internationally active banks around the world, were faced with a wholesale run on their foreign currency liabilities and were therefore heading towards a default on those liabilities in the absence of lender-of-last-resort assistance in terms of foreign currency. However, given the size of the balance sheets involved (10 times GDP overall, with over two-thirds in foreign currency), it was impossible for the Icelandic authorities to provide this assistance on their own. Had the government made a full-scale attempt to save the banks, it would have been at serious risk of defaulting itself. The Icelandic banks' failures were large by any criteria: the largest of them places 4th on the world list of corporate failures, and the three Icelandic banks combined rank 2nd, after Lehman. It was thus an event of systemic proportion in parts of Europe.

At that point, Iceland was already on its way into a recession after an unsustainable boom and serious overheating during 2005-2007 and a currency crisis in the first half of 2008. The banking collapse and the associated wealth loss and further currency depreciation only made the recession worse.

Over the course of that autumn, two separate but interrelated sub-stories of the recent Icelandic saga were converging in a tragic grand finale. These are:

1. Iceland's boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies.
2. The rise and fall of three cross-border banks operating on the basis of EU legislation (the European "passport").

Let us look a little bit closer at the second story. In just five years' time, the Icelandic banking system expanded from a combined balance sheet of under 2 times GDP at the end of 2003 to almost 10 times GDP in mid-2008. Most of this expansion was cross-border, and a great deal of it had very little to do with Iceland, as both financing and investment took place abroad.

There were indeed important domestic factors behind this expansion. One was the privatisation of the Icelandic banking system in the early 2000s, which was carried out in a manner that placed the country's largest banks into the hands of risk-loving investment bankers and the ill-founded promotion of "financial centre Iceland". On the other hand, it is hard to imagine that this scenario could have played out as it did without the worldwide glut of cheap credit in the years before the global financial crisis and Iceland's position as a party to the EEA Agreement, which provides for a legal and regulatory framework based on European Union Directives, including free movement of capital and provision of financial services. The underlying principles are those of home licensing for operation throughout the EEA and a level playing field for competition, where size and location are not supposed to matter. This European "Passport" enabled the Icelandic banks to operate throughout the EEA, including through branches in other EEA countries.

We know now that there were and are deep flaws in this framework: flaws that are important elements in the current eurozone crisis. A key issue here is the dichotomy between European passport rights, on the one hand, and national supervision, national deposit insurance, and national crisis management and resolution regimes, on the other. This is what recent proposals of a banking union are supposed to deal with. But then, for EEA countries outside the euro area, this framework entails potentially enormous foreign currency liquidity risk in the banking system that is not covered by a lender-of-last-resort (LOLR). This was a key element in the Icelandic banking crisis and must be addressed in future reforms of the system.

Let me now say a few words about Iceland's crisis and recovery. The shocks hitting Iceland in 2008 were mitigated by the policy response, which had two focal points. First, immediate crisis management was based on several key goals: keeping domestic payment systems up and running, preserving common citizens' access to their deposits, and ring-fencing the sovereign against the failing private banks. The tools used were to declare all deposits in Iceland safe and to carve domestic banks (1.7 times GDP) out of the failing banks. Second, Iceland went on a programme with the IMF, which had three main goals: stabilising the exchange rate, achieving fiscal sustainability, and rebuilding a sound, domestically oriented financial sector. Comprehensive capital controls were a key element in the programme.

The recession that followed was the deepest in post-war history, with GDP falling by 12% from peak to trough and unemployment soaring from around 2% pre-crisis to a peak of 8-9%. The exchange rate fell by over 50% in 2008, taking the real rate to around 30% below its long-term historical average. That helped turn the huge current account deficit around to an underlying surplus but wreaked havoc on domestic demand and balance sheets, as $\frac{2}{3}$ of corporate debt and 20% of household debt was in foreign currency, and an additional $\frac{3}{4}$ of household debt was indexed to the price level. But the policy measures were successful in turning the situation around: the exchange rate stabilised in 2009,

fiscal consolidation progressed from 2010 onwards, growth resumed in the second half of 2010, the sovereign regained foreign capital market access in summer 2011, and the new banks were profitable and well capitalised. On the other hand, private sector debt restructuring has proven more time-consuming than originally hoped, and lifting the capital controls is a challenging task. According to the latest figures, Iceland's growth rate is 4.5% and the unemployment rate has fallen to the 5½-6% range.

What lessons can be drawn from this story?

1. Excessive and volatile capital flows played an important role in Iceland's crisis, and the capital controls and the underlying balance of payments problem are a legacy of that.
2. To a significant degree, the euro area crisis is also a capital flow – balance of payments problem.
3. The framework for cross-border banking in the EU is deeply flawed. Either there will be a regression of financial globalisation at the EU level, or the freedoms must be matched by public frameworks and policies.
4. In the absence of international or EU-wide reforms, small, open economies like Iceland might have to take action to protect themselves, such as restricting the international activities of home banks and placing much more stringent prudential limits on foreign currency maturity mismatches and foreign currency lending.
5. An independent flexible currency is a double-edged sword. In Iceland's case, it was both part of the problem and part of the solution.
6. We need to think of ways to protect the sovereign from failing banks. Bailing out bondholders is probably not always the best policy.
7. Finally, some elements of the so-called "Icelandic model" merit further consideration as regards wider applicability: allowing banks to fail, using the exchange rate as a tool for adjustment, and using capital controls as a tool for stabilisation. But we need to avoid hype and over-simplification. Some of what Iceland did was due to a lack of other options, and the cost-benefit analysis of allowing banks to fail or imposing capital controls might look quite different in larger countries or countries with different connections with the rest of the world.