Már Guðmundsson: The financial crisis in Iceland and Ireland – what are the lessons five years later?

Opening address by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the half-day Central Bank of Iceland conference "The financial crisis in Iceland and Ireland: What are the lessons seen to be five years later?", Reykjavík, 28 November 2013.

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President of Iceland, excellencies, ladies and gentlemen,

On behalf of the Central Bank of Iceland, I would like to welcome you all to this morning meeting, held five years after the collapse of Iceland's three cross-border banks, the enactment of the emergency legislation, and the beginning of the Icelandic authorities' economic programme with the IMF. And incidentally, it is exactly five years ago today that Iceland's Parliament, Alþingi, passed legislation on comprehensive capital controls.

At this short conference, which we call *The financial crisis in Iceland and Ireland: what are the lessons five years later?* the focus is on the situation that faced these and other small countries with big banks in the autumn of 2008, how we managed the first phase of the crisis, and the policies that were put in place to mitigate the effects of the shocks that were hitting us. Joining us today are three highly distinguished speakers who will take the floor after my opening remarks. First is Patrick Honohan, Governor of the Central Bank of Ireland, who took office in September 2009 and has played a key role in dealing with the crisis in Ireland. Then we will hear from Geir Haarde, Prime Minister of Iceland in the autumn of 2008, who oversaw both crisis management during the banking collapse and the design of the economic programme with the IMF. Our final speaker is Franek Rozwadowski, who until recently was the resident representative of the IMF in Iceland.

It is well known, both in this country and among scholars of the international financial crisis around the world, that almost 90% of Iceland's banking sector failed in the first week of October 2008. What is probably less well known is that 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 made the recession significantly worse, of course, as did the recession that hit the global economy in the fourth quarter of 2008.

That autumn, two separate but interrelated sub-stories of the recent Icelandic saga converged 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. This is a story that has played out many times around the globe, and many of its elements have been seen before in Iceland. It might have been somewhat more extreme this time around, but it wasn't fundamentally different.
2. The rise and fall of three cross-border banks operating on the basis of EU legislation (the European "passport"). This story was much more unique, as it involved the first banking crisis in Europe since the EU single market was formed in the early 1990s.

The combined balance sheet of these banks was 10 times Iceland's GDP, and their combined bankruptcy, measured by the size of balance sheets, ranks third in size in the international history of corporate failures. And this happened in a country that ranks among the smallest in the world! We are still dealing with the repercussions of it, as can be seen in our overblown and unbalanced IIP and the controls on capital outflows.

Before the collapse, the banking system had expanded very rapidly, growing in just five years from a combined balance sheet of less than 2 times GDP at the end of 2003 to the aforementioned 10 times GDP. Most of this expansion was cross-border, and a significant part of it was really off-border, having little to do with Iceland, as both financing and investment took place abroad. Around two-thirds of the balance sheet of the three cross-border banks was denominated in foreign currency. As is typical for banks, the FX part of the balance sheet had a significant maturity mismatch. However, there was no safety net of the type that we have in a national setting to back it up. This turned out to be the fatal flaw in the whole setup, although we now know that these banks were also undercapitalised, which might have done them in at a later stage. But so were also several European banks that were considered solid at the time!

In the panic that gripped global financial markets after the collapse of Lehman Brothers, Iceland's big banks 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 LOLR assistance in foreign currency. However, given their size, it was impossible for the Icelandic authorities to provide such assistance on their own.

Liquidity risk was generally underestimated in the build-up to the crisis, both by the financial industry and by supervisors. This applied even more to FX liquidity risk, which can be more lethal due the lack of backstops and safety nets. For example, before the crisis, European banks had built up huge USD-denominated balance sheets that were balanced to a large extent – except, of course, in terms of maturity. This became a major problem when there was a run on such dollar-denominated bank liabilities post-Lehman, and many big European banking names might not be with us today had it not been for the USD swap lines granted to the European Central Bank, the Bank of England, and the Swiss National Bank.

When I was still at the Bank for International Settlements, I gave a speech here in Iceland on financial globalisation to an audience of high-level European bankers. In that speech I discussed the risks associated with the internationalisation of banking and said: " … emergency liquidity assistance will be complicated or even impossible for central banks to deliver when internationally active banks face liquidity problems in currencies other than that of their home country. Iceland is a case in point".[1] That is essentially what happened in the autumn of 2008. But this was in May 2007, before the international financial crisis emerged in August that same year. Then it became gradually more obvious and the Icelandic authorities tried to build defences and seek international support, but with limited success.

Given the lack of international cooperation, the Icelandic authorities were forced to consider radical solutions. Although they were probably not articulated fully at the time, these solutions entailed several goals: preserving a functioning domestic payment system, ring-fencing the sovereign in the case of bank failures, limiting the socialisation of private sector losses, and creating the conditions for the reconstruction of a domestic banking system.

In essence, the adopted solution saved the domestic operations of the banking system and let the international part to go into a resolution process. The new banks were created by carving the domestic assets and liabilities out of the old, failing banks. The new banking system amounted to 1.7 times GDP.

On the whole, these measures were successful, which was a key factor in mitigating the effect of the banks' failure on the economy. The domestic payment system functioned more or less seamlessly throughout, and there was continuous access to deposits and basic banking services in Iceland. International payment flows were seriously affected, however, not least because of the freezing order imposed by the British authorities on Icelandic banks, but also because of a general distrust among foreign counterparties. Normal payment flows were restored through a concerted effort by the Central Bank in the ensuing months.

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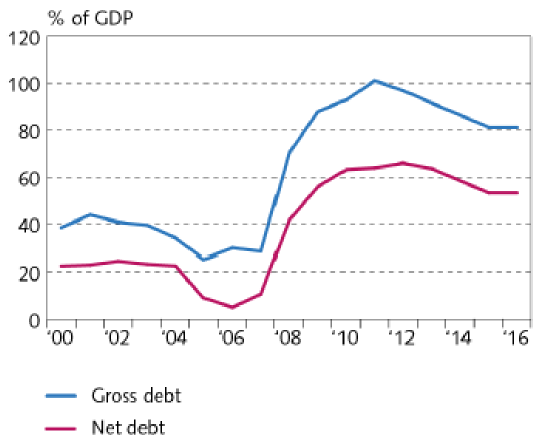
[1] See : "*Financial globalisation and challenges for prudential policies and macroeconomic management*", 18 May 2007, http://www.bis.org/speeches/sp070525.htm

I have painted the banking crisis and the immediate policy responses with a broad brush, but I expect that Geir will give you a fuller story. It will also be interesting to hear from Patrick what the essential features of the Irish banking crisis unfolding around the same time are seen to be now, five years later.

Let me turn now to the macroeconomic part of the saga. I do not have time to discuss the macroeconomic build-up to the crisis, as the focus of this short meeting lies elsewhere. But to set the stage, let me say very briefly that all the usual suspects were present: very strong capital inflows fuelling a credit and asset price boom that subsequently turned into a bubble at the same time as the economy overheated and an unsustainable external position developed, as could be seen in a double-digit current account deficit. And macroeconomic and prudential policies were not up to the task. Quite the contrary: there was a policy conflict between monetary policy and the demand levers pulled by the Government, and the risks inherent in capital flows, FX balance sheets, and credit and asset price booms were left under-regulated and insufficiently supervised.

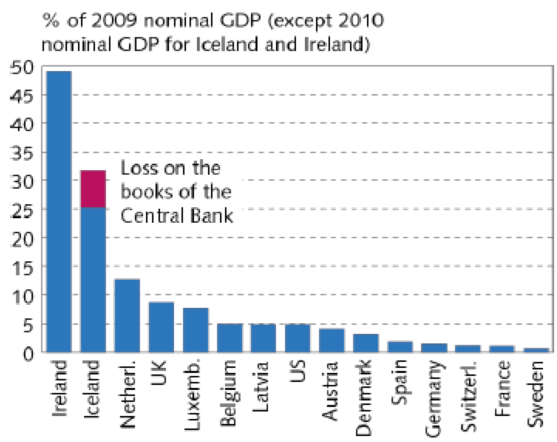
But as so often before in this country, we dealt more effectively with the crisis than the build-up. There were two key elements to this. The first was crisis management vis-à-vis the failing banks, as embodied in the Emergency Act submitted by Prime Minister Geir Haarde to Parliament shortly before the banks failed. The second was the economic programme developed by the Icelandic authorities in co-operation with the IMF. The programme had three key goals: stabilisation of the exchange rate, fiscal sustainability, and reconstruction of the financial sector. Comprehensive capital controls were an important element in the programme, but their rationale was to help to stabilise the exchange rate in a situation where the currency had fallen more than 50% in 2008, where foreign króna positions that were a legacy of carry trade and capital inflows amounted to around 40% of GDP, and where a large fiscal deficit that had to be financed in the domestic market had developed. The capital controls therefore gave monetary policy more scope to help stabilise and turn around the real economy once inflation came down.

General government debt 2000-2016[1]



1. Central Bank baseline forecast 2013-2016.
Sources: Ministry of Finance, Statistics Iceland, Central Bank of Iceland.

Direct fiscal costs of the financial crisis

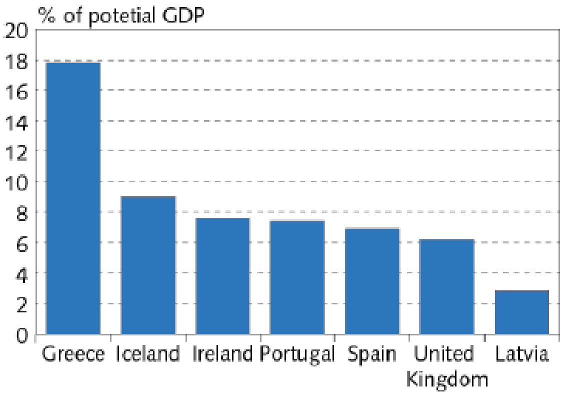


Sources: Laeven and Valencia (2010), "Resolution of banking crises: The good, the bad, and the ugly", IMF Working Paper, no. 10/146, OECD (2011), except OECD Economic Surveys: Iceland, and The Icelandic National Audit Office (2012). Fiscal cost of recapitalizing financial and Government institutions following the financial crisis. Report to Parliament, for Iceland and Ireland.

Franek will discuss the IMF programme in more detail, but I would like to make one more remark regarding fiscal consolidation, as it is such an important part of the story. The crisis hit Government finances hard, as can be seen from this slide.

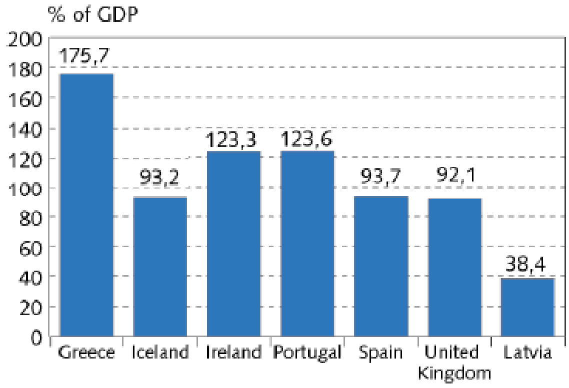
It was therefore of vital importance that Government debt was relatively low immediately before the crisis. However, fiscal consolidation was needed earlier than some considered optimal at the time from a demand management perspective, in order to regain internal and external confidence and open market access.

Change in cyclically adjusted primary balance as a percentage of potential GDP, 2009-2013



Sources: IMF, Fiscal Monitor October 2013.

General government gross debt 2013 as a percentage of GDP

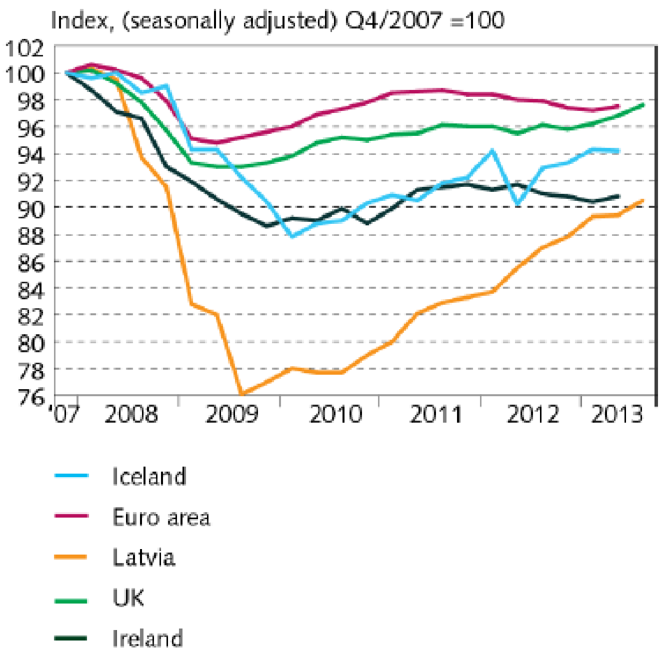


Source: IMF, Fiscal Monitor October 2013.

The effort was huge, as can be seen from this slide, but back-loaded, as automatic stabilisers were mostly allowed to work in 2009. And it did not derail the recovery that began around the middle of 2010.

The policy responses mitigated the recession but could not stop it from becoming the deepest in Iceland's post-war history and a severe one in international comparison, as can be seen from this slide.

Level of GDP[1]



1. GDP data for Iceland is seasonally adjusted by the Central Bank of Iceland.

Sources: Eurostat, OECD, Central Bank of Iceland.

But Iceland was not the hardest hit, as can also be seen from the slide, and this would be still clearer if we were to look at the labour market. Iceland lost 12% of GDP from peak to trough, slightly more than Ireland. However, as was probably also the case in Ireland, that peak was unsustainable and was associated with a significant positive output gap. Iceland has regained 7½% since, which is significantly more than Ireland but less than Latvia, which suffered a much deeper recession.

Finally, I would like to mention selected lessons that I think can be drawn from this experience.

First, dealing with failing big banks in small countries: Guaranteeing the entire banking system in Iceland's case would probably have resulted in sovereign default and the bankruptcy of the country. In general, taking such a step with big banks in small countries is risky, especially if a significant part of their balance sheets are in foreign currencies. The alternative is to save only key infrastructure elements, such as the domestic payment system.

Second, dealing with volatile capital flows: Deal with the inflows if you want to avoid having to take drastic measures to deal with the outflows. That includes adopting correctly aligned macroeconomic and macroprudential policies, leaning into the wind by buying part of the inflows into foreign exchange reserves and, in the limit, deploying selective capital inflow management tools. The FX risks of banks and private sector entities need close monitoring and prudential limitations.

Third, the design of the financial sector in small, open economies: The financial sector has to be smaller than it has been in countries like Iceland, and international activities must be restricted as long as such countries are not part of a credible multilateral safety net. The idea of building international financial centres in countries like Iceland and Ireland is dead – for the time being, at least – as it is not safe under the current framework.

Fourth, the EU framework for cross-border banking: It was very much this framework that facilitated the cross- and off-border expansion of the Icelandic banks through the so-called European passport. It was and is deeply flawed, and it contributed in a significant way to both the Icelandic banking crisis and the crisis in the eurozone. The basic problem is that the freedoms are not matched by public action and frameworks at the EU and EEA level. Bank size relative to country size was tacitly assumed to be a matter of no concern, and FX risk was largely ignored. Based on the Icelandic experience, a banking union makes perfect sense, but only fully for the eurozone, and even then it has to include all three elements in order to break the deadly embrace of banks and sovereigns. In the interim, I think small countries will have to impose their own prudential measures in order to defend themselves against the risks they face.

Let me conclude here and give the floor to Patrick Honohan.