Panel remarks

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I would like to cover three issues in my remarks. First, I will reflect a bit on the title of the seminar and some of the more specific questions directed at this panel. Second, I will discuss the nexus between sovereign risk and banking fragility, using Iceland as a case study – after all, the Icelandic experience is probably the reason that I am taking part in this interesting seminar in the first place. Third, and again with reference to the Icelandic case, I will reflect on the connection between sovereign ratings of advanced countries and actual sovereign defaults.

The title of this seminar is *Sovereign risk: a world without risk-free assets?* As has been repeatedly pointed out, there is, strictly speaking, no such thing. The default probabilities of even the strongest sovereigns are not zero, and they increase as the horizon gets longer. Furthermore, the real income stream of nominal government bonds is uncertain. The same applies to the FX income stream facing foreign investors, and then there are risks such as the possible introduction of capital controls, which will not count as defaults as long as debt is serviced on time in the domestic currency of the sovereign without discrimination between domestic and foreign investors.

Although it is important to bear all this in mind, it is nothing new. Furthermore, it does not constitute a major problem for the functioning of capital markets as long as the default probabilities of sovereigns seen to be providing so-called risk-free assets are perceived to be so low at the relevant maturities that they can largely be ignored. The question we are faced with is whether this is still the case and what the future will bring in this regard, given that both the market and the rating agencies perceive an increase in sovereign risk. The jury is still out, but my current prediction is that, in the foreseeable future, the supply of risk-free assets according to this definition will be very significantly greater than zero.

Advanced countries with grade-A ratings are and will be issuing a lot of debt in the near term, and the high price that the best-perceived sovereign debt is carrying is a reflection of strong demand rather than weak supply. In spite of everything we have gone through, there has been no sovereign default of any advanced country apart from Greece since the interwar period. Yes, many of these countries have been downgraded lately, but what that means in terms of actual default probabilities is not clear to me at this point, although it might be somewhat clearer after the next session. The fact of the matter is that advanced countries have both considerable means and strong incentives to avoid default. Even Iceland was able to avoid a default after the collapse of 90% of its financial sector and its deepest recession since the interwar period. So, for the post-war period, Walter Wriston has been largely right so far, in saying that “countries don’t go bust” – as far as advanced countries are concerned – although he was wrong as regards all countries. And what holds for advanced countries in this respect does so increasingly for the more important and advanced EMEs.

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I am not denying that sovereign risk has increased, more broadly speaking. Higher deficits and debt levels and weaker growth prospects bear witness to this. But the degree to which this translates into higher default probabilities in the narrow sense is not clear. My prediction is that default probabilities will remain low for most advanced countries.

What, then, about the reaction of rating agencies and markets? Here again, we have the question of what rating agencies are actually trying to measure. I have long experience of dealing with them in my current and past jobs, and I have the sense that they are measuring something more than default probabilities. Partly, therefore, a downgrade by one or two notches within an investment-grade category could be consistent with my view. Then, on top of that, there is a significant amount of evidence to suggest that ratings do not see through the cycle. So the rating agencies and the markets are probably overestimating sovereign risk at the current juncture, in the same way that they underestimated it prior to the crisis. There is one important proviso to this statement, however: the negative feedback loop between sovereign risk and bank fragility, which in historical terms has been particularly severe in the recent period. Thus, for some countries, the markets might be factoring in further socialisation of private sector losses. Therefore, in addition to medium-term fiscal consolidation, a weakening of the nexus between sovereign risk and banking fragility is key. And that is where Iceland comes in.

The collapse of Iceland's three cross-border banks in early October 2008 was the most noticeable event in the unfolding of the financial crisis that hit the country that year. The combined balance sheets of these banks was 10 times Iceland's GDP, and their combined bankruptcy, measured in terms of balance sheets, ranks second in size in the international history of corporate failures, only after Lehman Brothers. And this happened in a country that ranks among the smallest in the world. We are still dealing with the complications that this entails, 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 almost 10 times GDP (in mid-2008). Most of this expansion was cross-border, and a significant part of it was really "off-border", having very little to do with Iceland, as both financing and investment took place abroad.

In the panic that gripped global financial markets after the collapse of Lehman Brothers, these 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 the size of the balance sheets, it was impossible for the Icelandic authorities to provide such assistance on their own, and it could have been catastrophic for the credit of the sovereign if they had made a full-scale attempt to do so.

The Icelandic authorities' actions were based on the assumption that the banks were solvent, which in turn was based on published financial accounts and the analysis of the supervisor. On that premise, the authorities tried to build defences against potential foreign currency liquidity problems at the banks by negotiating swap lines and tapping foreign capital markets, in both cases with limited success. Now, however, we know that there were hidden vulnerabilities in the banks' capital positions.

There was also a failed attempt to nationalise one of the banks in late September 2008. It was indeed fortunate that it did fail, as nationalising the bank would have turned a bank foreign currency refining problem into a sovereign problem, with the serious risk that the sovereign might have defaulted on such foreign currency payments.

In this light, and given the lack of international cooperation, the Icelandic authorities were forced to consider radical solutions. Although they were not necessarily 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 rebuilding a domestic banking system.

In essence, the adopted solution saved the domestic operations of the banking system by splitting up the banks and allowing the international part to go into a resolution process. Furthermore, in order to stop an incipient run on domestic deposits, all deposits in Iceland were declared safe and all deposits in Icelandic-headquartered banks were given priority over other unsecured claims. As a result of these measures, the domestic payment system functioned more or less seamlessly throughout, and common citizens had continuous access to their deposits.

There are still a number of misconceptions about this process in international discussions. There have been claims that Iceland allowed its banking system to collapse, with what now seem reasonable results, and that others should consider doing the same. The fact is that Iceland kept the domestic part of its banking system running throughout; otherwise, the consequences would have been dire. Some have claimed that the banks were nationalised. They were not. The old banks are private companies. They are in winding-up proceedings governed by law; they are not under the control of the Government. The Government has a majority stake in only one of the new banks. Others have claimed that Iceland defaulted and got away with it. The opposite is true. The credit of the sovereign was preserved, and all debt obligations have been paid on time. Moreover, the investment-grade credit ratings from Moody's and S&P were preserved throughout the crisis. This is why the sovereign has been able to tap international capital markets twice so far since the crisis struck.

So the bottom line is that a sovereign default was avoided in spite of an almost unprecedented financial collapse and the worst economic recession since the interwar years. A key to that result was the ring-fencing of the sovereign from the collapse of the private banks. All debt service payments on sovereign debt, in both domestic and foreign currencies, have been made in full and on time. But the avoidance of default during a crisis does not come without the willingness to use the means available to avoid that outcome, even in very adverse situations, and the ability to endure the temporary hardship that comes with it. In addition, Iceland – like Ireland, probably – was helped by a relatively good fiscal position prior to the crisis. The fiscal consolidation that began in 2010 and has already resulted in a significant primary surplus was subsequently an important factor in restoring external confidence, which fell to what, in retrospect, seems an unjustifiably low level. In Iceland's case, the overall effort was made easier by the outside assistance of the IMF, the Nordic countries, and Poland. The same consideration applies to the hardest-hit EU countries and should be kept in mind when assessing their probability of default.

Finally, let me say a few words about credit ratings and market perceptions in the Icelandic saga, which broadly conforms to more general patterns. Both the sovereign and the private Icelandic banks were assigned triple-A ratings by Moody's for a period prior to the crisis (the sovereign from October 2002 to May 2008 and

Kaupthing Bank from February 2007 to April 2007). In the case of the banks, the stated argument was that the Government would stand behind them in times of difficulty. We now know that this was nonsense, given the size of the banks and the scale of their international activities. In the case of the sovereign, this rating was not so bad after all!

The bank ratings then started to fall in early 2008 and then plunged to sub-investment grade after the banks had collapsed. The sovereign rating, however, although it fell over the course of 2008, never fell to sub-investment grade with Moody's and S&P, and it only fell below investment grade with Fitch Ratings after the president sent the so-called Icesave deal to a referendum in January 2010. It is now back to investment grade with all three agencies.

It is interesting to see how both ratings and market perceptions evolved around two key dates in September/October 2008, when decisions were taken that could drastically affect sovereign risk. The first date was 29 September, when an announcement was made of the Government's intention to take a 75% ownership stake in one of the three cross-border banks, an action that should increase sovereign risk. The other date was 6 October, when Parliament passed the so-called Emergency Act, which severed the nexus between the sovereign and the private banks and drastically reduced objective sovereign risk. Both the rating agencies and the market got the sign of the first event right: S&P downgraded the sovereign by one notch and Glitnir by one notch the day after; Fitch downgraded them the next day by two and three notches, respectively; and Iceland's sovereign CDS spread shot up to almost 600 in the first two days after the announcement, from just over 300 in the days prior. But both the rating agencies and markets got the sign of the second event completely wrong, with further downgrades and the CDS peaking at 1473 on 10 October. It took them a while to correct this, and the CDS was down to around 180 by the end of 2012. To be sure, there were other things going on at the time, but still!

Let me conclude by saying that the Icelandic case seems to support the conclusion that it is premature to state that we are in or heading towards a world without risk-free assets in the narrow sense. It will take policy mistakes of gigantic proportions in several parts of the world to get there. But the risk is not and never has been zero.