SEÐLABANKI ÍSLANDS

Opening remarks

Macroeconomic stabilisation in small open economies – challenges and lessons: The Icelandic experience

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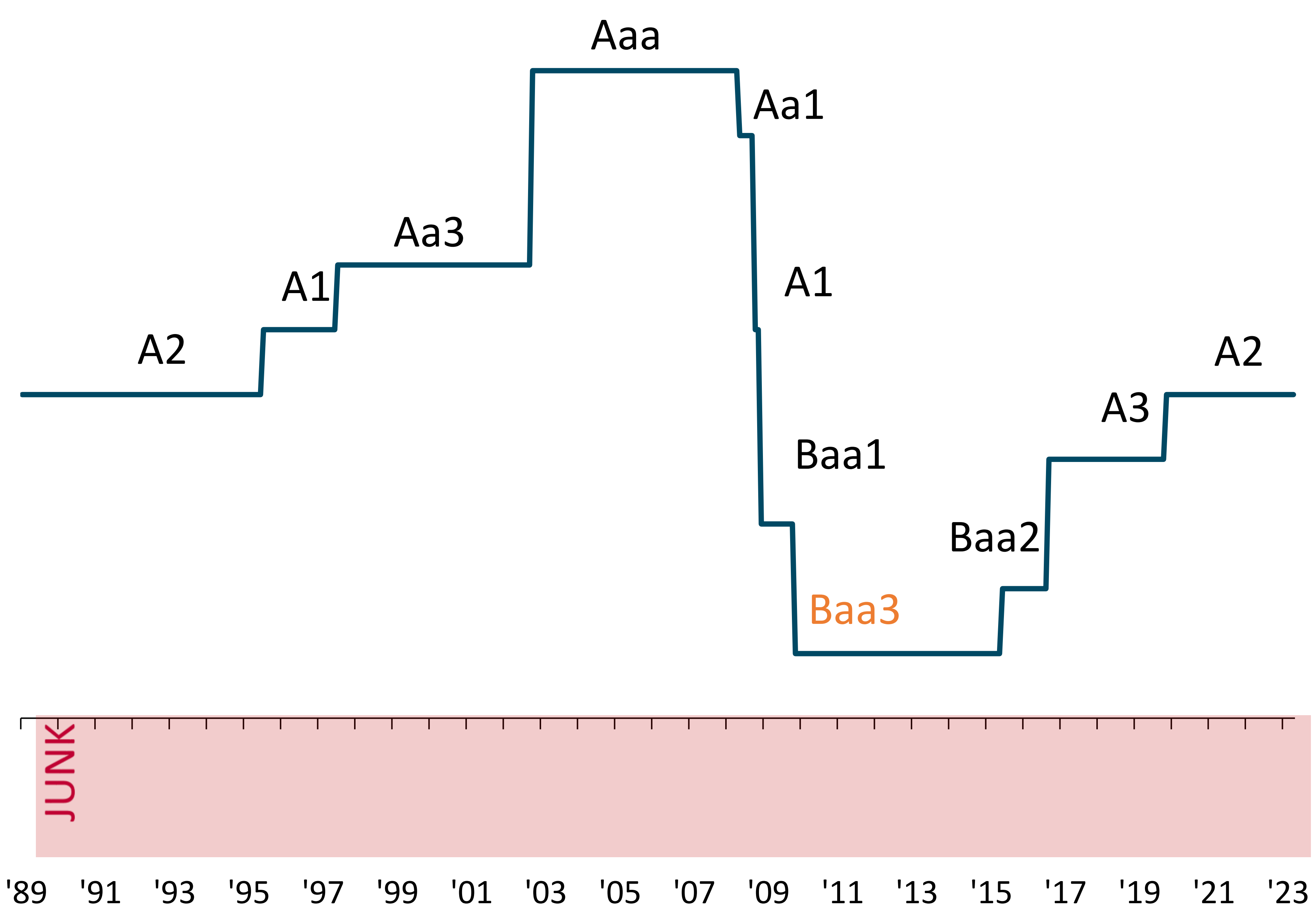
The legacy of the Global Financial Crisis

The road to a financial collapse is always paved with high expectations

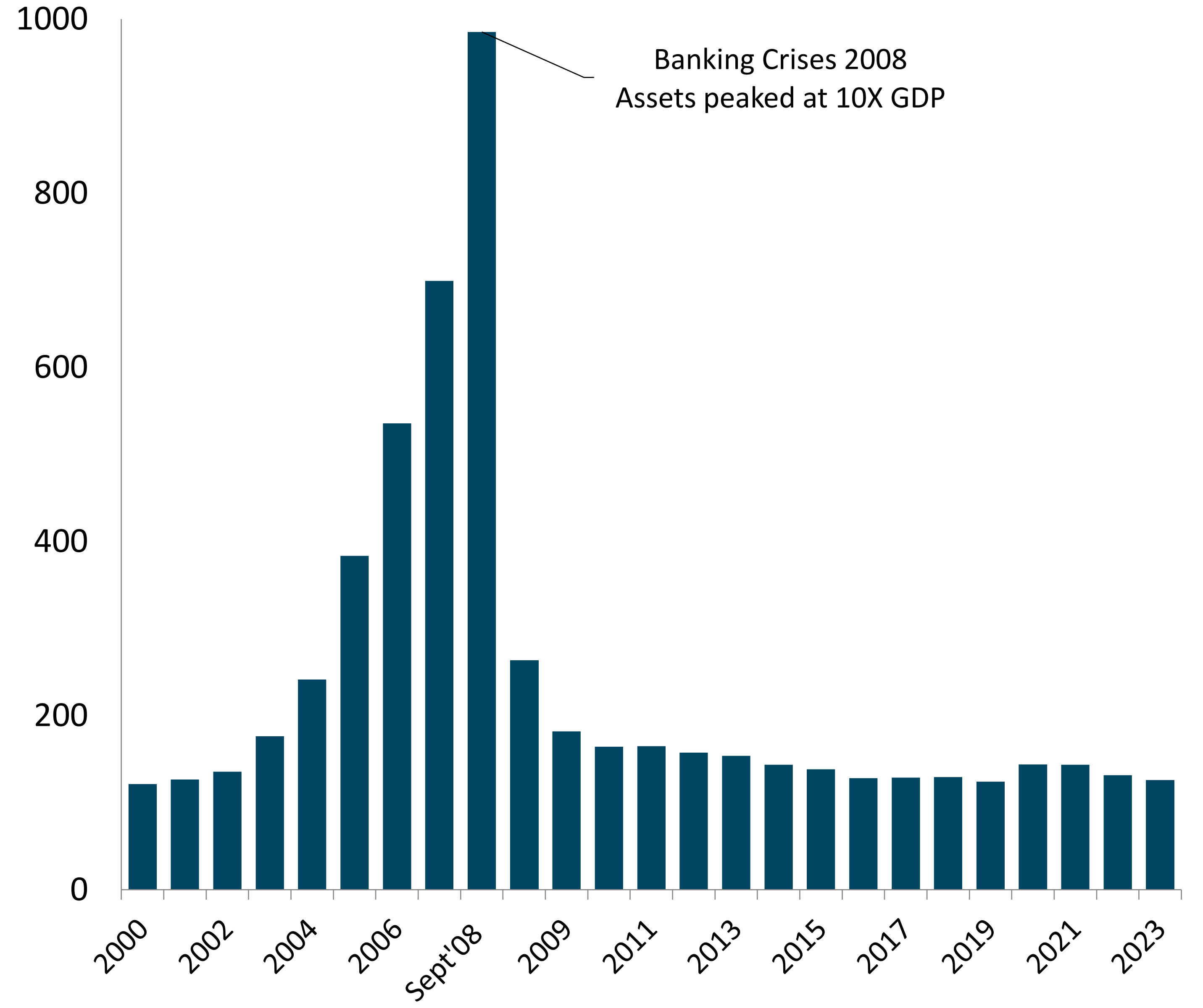
- In 1994, Iceland became a part of the European Economic Area (EEA) – Free movement of goods, services, capital, and labor was of great importance for the Icelandic economy
- In 2002, Iceland received a AAA rating – followed by surge in capital inflows
- In 2007, ratings of the three systematically important Icelandic banks also upgrated to AAA as they were considered too-big-to-fail
- In 2008, the Icelandic banking system had assets 10 times the size of the GDP. It was too-big-to-save

A virtuous cycle of increased external debt and rating upgrades ended in a total collapse in 2008

Moody's rating of the Icelandic Republic



Deposit Money Banks, Assets to GDP (%)

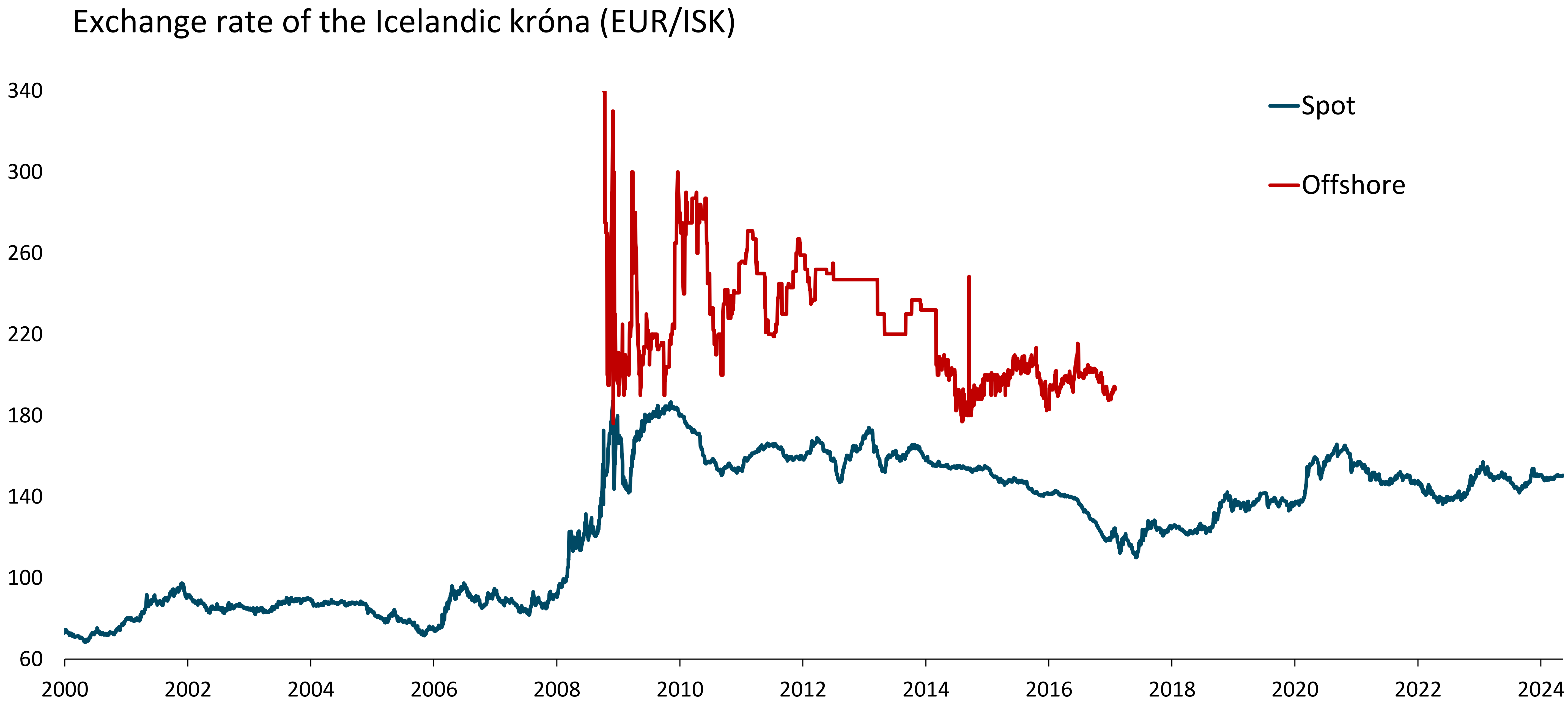


Dealing with the banks - the **Emergency Legislation**

- The Icelandic government responded to the crisis by a force majeure act – severing the link between the banks and the sovereign.
- An emergency legislation gave deposits priority over bonds as well as sweeping authority to the FSA to take control of the banks.
- The banks were divided into two parts; domestic and foreign.
  - Domestic deposits were transferred to “New” banks along with domestic assets. These banks were re-capitalized and are still operating.
  - Foreign assets and liabilities were left at “Old” banks, which were put into liquidation under control of the creditors.

Financial Crisis far the biggest crisis in our history

Exchange rate depreciated by 50% and output contracted by 10%



Capital Controls introduced in November 2008

Private capital transaction were forbidden: Transactions related to the current account allowed, i.e. ISK floating based on trade flows with frequent interventions from the Central Bank

The advantage of the capital controls:

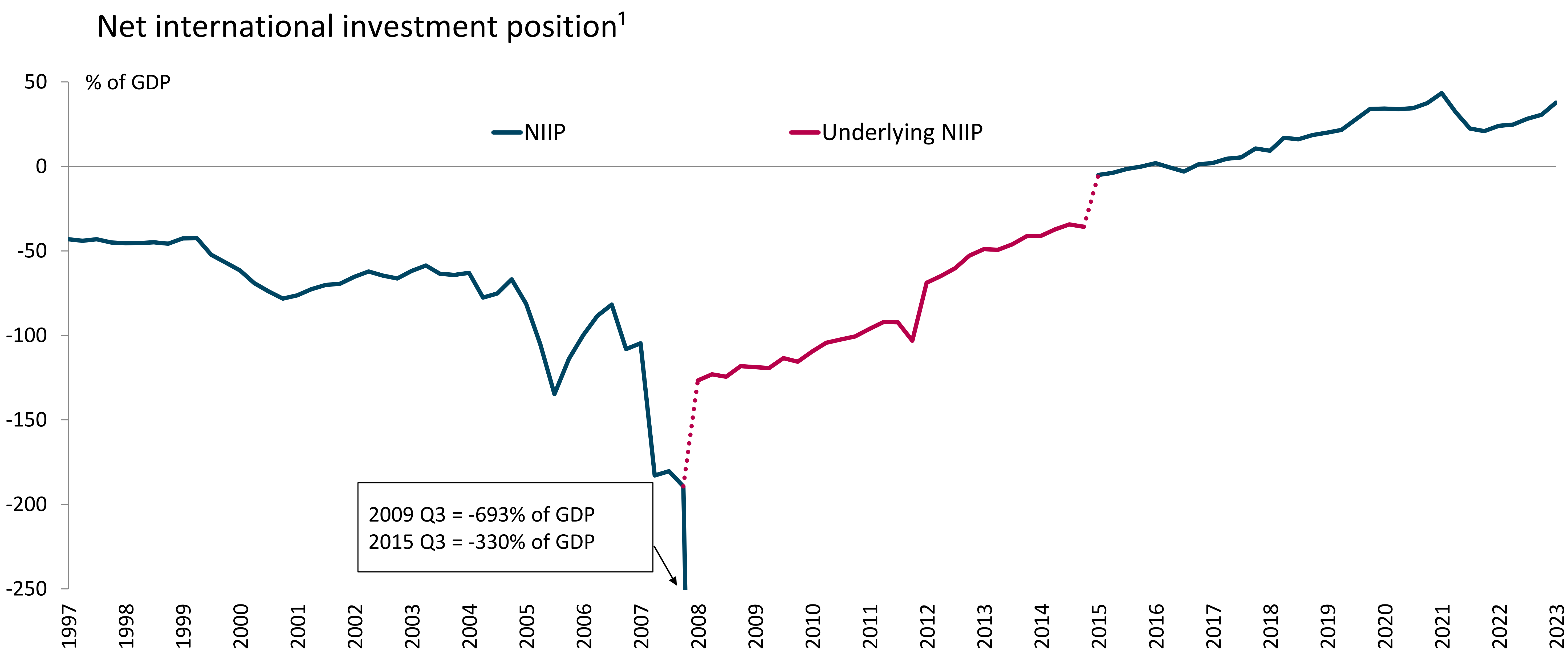
1. The capital controls allowed Iceland to restructure the banking system and lower interest rate without the risk of capital flight or bank run.
2. The controls allowed the Icelandic government to refinance itself at a much-reduced rate after the crisis.
3. The controls gave the Central bank bargaining power against the hedge funds which owned large off-shore ISK assets in the estates of the defaulted banks.

Never let a “good” crisis go to waste

- The Icelandic Central Bank did not have the printing power to serve as the lender of last resort to a banking system with liquidity needs in foreign currency
- The Icelandic Treasury did not have taxing power to re-capitalise a banking system 10 times the Icelandic GDP
  - Thus 98% of the Icelandic banking system defaulted
- The best thing about the systematic collapse – is that it gave an opportunity to build a new resilient institutional structure under the auspices of the IMF with all the proper guidelines in place
- This is a short description of the new stories that have been written on the blank page left by crisis

The visible result from Iceland's new policies

Iceland went from being one of the most heavily indebted country in the world to having almost no debt



1. Based on underlying position from 2008 through end-2015; i.e., adjusted for the effects of settling the failed banks' estates and assuming equal distribution of assets to general creditors. At the end of 2015, the estates of the failed financial institutions reached composition agreements entailing the write-off of a large portion of their debt. As a result, there was no difference between the NIIP and the underlying NIIP.

Sources: Statistics Iceland, Central Bank of Iceland.

How to create resilience in a small open economy?

"Independent monetary policies are possible if and only if the capital account is managed, directly or indirectly, regardless of the exchange-rate regime"

-Héléne Rey

Three ways of managing balance of payments

1. Impose restrictions on inflows to prevent exchange rate from drifting above equilibrium and large external imbalances
2. Use foreign exchange reserves to prevent disturbances in the FX market
3. Use macroprudential tools

Building the future – six lessons

6 lessons from **100 years** of Iceland's experiment of being an open economy and remaining stable: Framework for financial resilience

1. **One actor in charge** The Central Bank has to accept responsibility for monetary policy, financial stability and supervision

2. **Managing the balance of payments** is the blueprint for resilience

3. **Integrating Macroprudential and monetary policy** in managing credit growth and leverage ratios is best recipe for economic stability

4. **Transparent and pro-active supervision** is the key to public trust and the prevention of fat-tail events

5. **Consensus with the labor market** Improves policy trade-offs between output and inflation

6. **Political support is needed** for monetary policy to succeed

First lesson: One actor in charge

The Central Bank of Iceland merged with the FSA in 2020 and is now the sole institution responsible for **price stability, financial stability and supervision**. Policy decisions are taken by **three committees** with external members

1. The Monetary Policy Committee takes decisions on the application of the monetary policy instruments aiming at price stability defined as 2½% inflation rate
2. Macroprudential decisions are taken by Financial Stability Committee with focus on preserving financial stability and containing systemic risk in the financial sector
3. Major FSA decisions are taken by Financial Supervisory Committee with the aim of securing sound and secure financial sector

The Governor of the Central Bank chairs all three committees and has just one vote

Second lesson: Managing the balance of payments

a) Maintain adequate international reserves – manage the foreign exchange market through limited but strategic interventions

Macro-pru

b) Limit the ability of domestic entities to accumulate short-term external debt e.g. by capital flow management measures, NSFR

c) Limit the scope for FX futures to be used as vehicles for speculative carry-trade by placing caps on the maximum net positions on the books of the banks.

Third lesson: Integrating Macroprudential and monetary policy – limiting leverage

Macro-pru

a) Maintain high capital ratios of banks with capital buffers – around 20% - with the additional 2,5% countercyclical capital buffer

b) Employ borrower-based measures; capping both leverage and debt service burden for household borrowing,

c) Limit foreign-denominated currency lending to non-export companies and households

Fourth lesson: Transparent and pro-active supervision - the key to public trust.

a) All supervisory actions are subject to a full disclosure and transparent due process.

b) Important to draw both <u>systemic</u> and <u>systematic</u> conclusion from supervisory data – not get lost in the details

c) Strict rules on bonuses are enforced, including caps on bonuses

d) Restrictions, including cap, on loan to related parties

- Strict fit and proper requirements for board members and managers and detailed qualification assessment
- Additional capital requirements due to loans to holding companies categorized as risky

Fifth lesson: Consensus with the labor market - Improves the policy trade-offs

a) The Scandinavian approach is to have a general centralized wage bargaining where the government participates in the negotiations. Through this process every worker gets the same annual pay-rise throughout the economy.

b) This has not worked well in Iceland. Icelanders do not agree on the relative wage differential between skilled and unskilled, between doctors or workers or etc. There have been frequent labor disputes.

c) Wage rises in excess of productivity growth are bound to erode the competitive position, increase domestic demand and cut into export, resulting in a current account deficit and external indebtedness, devaluations and economic and financial instability.

Sixth lesson: Monetary policy needs political support

a) No monetary policy will be successful – at least not in the long run – without a broad-based political support and appropriate fiscal policy

b) Following the IMF program, Iceland set up a rule based fiscal framework. Unfortunately, this framework was set aside during the Covid pandemic and has proven to be difficult to re-establish

c) Establishing a credible monetary policy is a long and hard process, but credibility can be lost overnight. Like happened in Iceland in 2008

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2. **Managing the balance of payments** is the blueprint for resilience

3. **Integrating Macroprudential and monetary policy** in managing credit growth and leverage ratios is best recipe for economic stability

4. **Transparent and pro-active supervision** is the key to public trust and the prevention of fat-tail events

5. **Consensus with the labor market** Improves policy trade-offs between output and inflation

6. **Political support is needed** for monetary policy to succeed

Thank you