Necessary Adjustments

Már Gudmundsson, governor of the Central Bank of Iceland, explains the lessons of Iceland's recovery

By Jonathan Barnes

After the blowup of Glitnir, Kaupthing, and Landsbanki—Iceland's three largest banks in 2008—90% of Iceland´s financial sector was in ruins and interest rates spiked to 18%. Already down 26% that year, the króna collapsed another 26%. Instead of a bailout, the country let the banks fail, guaranteed deposits in domestic units of the banks (both króna and foreign denominated), and restricted capital flows. Today, less than four years later, much has changed. On the job as governor of the Central Bank of Iceland since August 2009, Már Gudmundsson has overseen the revival of Iceland's economy, with a first quarter 2012 year-on-year growth of 4.5%. In this interview, Gudmundsson discusses the lessons learned from Iceland's crisis and recovery, the ongoing eurozone troubles (including the chances of Iceland joining the EU), and the process of lifting the country's capital controls.

Why did Iceland let the banks fail?
Iceland let the banks fail because it had no other option. If it had attempted to bail out the banks with the government's own resources, it would have bankrupted the country. We are talking about a banking system that was 10 times GDP. In the autumn of 2008, post-Lehman, the nature of the problem was that there was a wholesale run on the foreign currency liabilities of the Icelandic banks.

Becoming responsible for the banks' whole balance sheet, which was still bleeding, was just impossible because their foreign currency balance sheet was 7.5 times GDP, whereas the foreign exchange reserves of the Central Bank were just over a third of GDP. It was not that Icelanders were necessarily more clever than others but that Iceland didn't have any choice in the matter.

The banks had a majority of their operations overseas.

Yes, bear in mind that these banks were truly cross-border banks. They were European in their operations, and to a great extent, they were financing themselves abroad and also *investing* abroad. So, in a sense, they were not just cross-border; they were off-border. Therefore, when the banks failed, the effect was shared throughout Europe and other places and the costs fell mostly on equity holders and foreign bondholders. There was a significant loss in Iceland as well, but it was not as big as you would have thought given the size of the banks.

Also bear in mind that these were private banks and, as such, not guaranteed by the government. It was a private sector default. I would say there were three elements to what we did. One was to ensure that the Icelandic public had access to their deposits; second, to keep some kind of domestic banking system functioning and going forward; and third, to ring-fence the sovereign against the collapse of the banks.

How do you rate Iceland's recovery?

In talking about Iceland and the recovery, one has to be very clear that what happened in Iceland was only partially related to the banks and the banking story. Iceland was on its way to a recession before the banks collapsed. That was because there were huge imbalances in the economy, generated by strong capital inflows and policy mistakes. Fiscal policy was too loose, and monetary policy was overburdened. The authorities did not lean against capital inflows by accumulating foreign exchange reserves.

Then, in addition, we had a currency crisis at the beginning of 2008—that was before the banks collapsed. It hit the private sector, which was very highly indebted in terms of foreign currency. Households had borrowed in foreign currency because they thought it was cheap and, in addition, three-fourths of household debt was indexed to the price level. When the exchange rate fell, the price level rose very quickly because it passed along changes in the exchange rate to inflation.

Of course, the weak króna also stimulated exports to a degree and compressed imports, so the current account deficit turned around very fast. In a matter of one year, we went from a very huge deficit to a very significant surplus. And so, this is one of the reasons why the recession was not as deep as you would have expected.

Looking at it, you would have said, "OK, this is an economy where 90% of the financial sector is collapsing, and that must have terrible consequences." But it didn't to that degree because we were able to keep the domestic part of the banking system up and running through this whole period. Then, the necessary adjustment that had to take place in the economy was allowed to take place. Of course, there was a recession in 2009 and 2010, but we have rebounded well since then.

Why did you guarantee only domestic deposits?

All deposits in Iceland were fully guaranteed. That was relatively easy to do because they were mostly in Icelandic krónur. What would have ruined the country was if we had tried to guarantee huge foreign currency-denominated liabilities. That is the crucial distinction. For instance, when the U.S. was bailing out its banking system, it was doing that with U.S. dollars, which they issue and can print, but we cannot print foreign currency. We can only print our own currency, and therefore, we had to let the foreign part fall.

How much of foreign-denominated deposits have been repaid?

I don't have the actual numbers. The main issue is that the depositors will get all of their money back, as the recovery rate from the failed banks is proving to be sufficiently good. Significant amounts have already been paid, and there is more to come.

What have you learned from the crisis?

I think we have mostly learned how to avoid getting *into* a crisis. What we did in terms of handling the crisis was not so bad, but there were lots of mistakes made in the buildup to the crisis.

Our crisis management had two elements. One was how we handled the banks, and there again, the key issue was to try to protect the sovereign from failing banks but, at the same time, to keep up the domestic payment system and a minimum domestic banking system.

Second, the role of monetary policy was important in that we wanted the policy to stabilize the exchange rate. And it did so. Then, we used the capital controls to keep interest rates sufficiently low and thus create a space to stimulate the real economy, and we went into significant negative real interest rates for a while. Of course, there was some risk taken with inflation, but still, we were successful in stimulating the real economy. I think the lesson here is to keep a domestic banking system and financial sector running and to stabilize things and then create conditions for recovery. That was made easier by the fact that the shocks hitting

Iceland were more financial than real. There was no collapse of fish stocks or impairment of productive capacity in the aluminum sector. The foundations of the real economy were intact, and therefore, Iceland was able to keep up with export demand and keep the economy going.

What is your biggest challenge right now?

What is unique in our situation is that we are managing capital controls. The reason is that when the currency and, subsequently, the banks collapsed, we had very big offshore króna positions—held by foreign investors—in the form of short-term deposits and short-term government debt, to the tune of one-third of GDP. If all of that had been allowed to just flow out freely, the exchange rate would have collapsed much further than it did. But now we are faced with the challenge of lifting these controls. That has been—and still remains—a very challenging task.

As a result of the banking crisis, the Central Bank is handling a lot of collateral that it took over because of the failure of the banks. Unfortunately, we have had to manage a lot of assets, and so we have an asset management company wholly owned by the Central Bank, which is something that central banks usually don't do. But it is a consequence of the crisis. So, I would say that these two tasks [managing capital controls and managing assets] have been the most challenging ones and the core central banking tasks, such as monetary policy, have been easier. Of course, monetary policy has its own challenges, and there are a lot of disputes. Some people think that the interest rates should be lower and things of that nature. But that just goes with the territory.

With capital controls in place, investors have to invest domestically.

Yes. At the moment, the capital controls are on outflows only. Capital inflows are free, as are all subsequent outflows associated with those inflows. So, foreign investors can come in, invest today, and leave tomorrow, and that is free and was made free in October 2009. But, yes, we have controls on all capital outflows from domestic residents.

Basically, we are still in a situation—a balance of payments crisis, if you like—where the debt position of the country is sustainable, but too much of that debt currently is short-term and in our own currency. Over time, we are working to change that, but we need to progress somewhat more before we can finally lift the controls.

Where are domestic investors putting their money?

They are putting it in the domestic bond market, which has been very lively. There are some incipient signs of the recovery of the domestic equity market.

Because of the controls, it has been very easy for the government to finance its deficit. That has been part of the crisis management strategy. The government is financing the deficit in the domestic market with negative real interest rates, which is something that many countries around us are trying to achieve. Some are successful in doing so, and some are not. And of course, many of the crisis countries cannot do this because they do not have capital controls and do not, in many cases, have their own currency. So it is impossible for them to do. But this was part of our program, and it has been helpful.

In terms of lifting capital controls, what kind of indicators or time frame are you looking at?

Basically, our strategy of lifting the controls can be divided into two phases. In the first phase, we try over time to reduce this overhang of offshore króna assets through auctions and bilateral deals and other methods. We want to move these assets from the hands of those who don't want to hold on to their exposure to Iceland into the hands of those who do want to invest in Iceland, either in government paper or in businesses, thus making this debt more long term. In the process, we hope to see the offshore króna rate move closer to the onshore rate.

In this first phase, we will also make all kinds of preparations in terms of imposing prudential rules on the banks, so they can live with free capital movements. We want to make sure that their liquid position is strong enough and make sure that the government is well financed, so it also can live with the capital movements.

The second phase is basically to lift the remaining controls on domestic residents, and that could happen rather quickly when we are ready. It is not given it will be quick, but conceptually, that could be a fast process. We have a legal mandate for the controls until the end of 2013. We are trying to work within that framework, but we cannot be sure how it will go. We say this strategy is not a timed one; it is condition based and depends on how much capital is flowing into Iceland and the degree of risk aversion around the world. The lower the risk aversion and the more capital inflows we get, the easier it will be.

What can other European countries learn from Iceland?
I am always very careful because I haven't made the necessary comparative study, and I have always highlighted that our situation was special. What I do think is that the costs of imposing capital controls was less in our case than it would be for a medium-sized country that is very well integrated within a monetary union, for example.

But having said that, I think that a policy of trying to reduce the socialization of private sector losses that the financial sector has created is a valid one. How you do that precisely would vary from country to country. But it is also a lesson that you should not try to make bailing out the bondholders to the full degree into some kind of religion. That is something that has to be justified in each case. So, yes, maybe there are some lessons for others.

What are your thoughts on Iceland joining the EU?
Nobody knows how this will evolve because nobody knows how the euro area is going to look when Iceland might be ready to answer the question whether it wants to join or not. If it were to happen today, I would predict that the nation would say no in a referendum. But again, it all depends on whether the EU is able to make the necessary reforms so that the euro area can become stronger and more stable. If not, then the likelihood of Iceland joining becomes less.

One of the lessons drawn here in Iceland was that if you are part of a bigger monetary union, you cannot have a currency crisis, by definition. You can still have a banking crisis. But if the area-wide framework for banking is sound (which it has not been up to now), then the probability of having one is reduced. Having access to a common safety net, especially a credible lender of last resort in the main operating currency of the banks, would also mitigate a banking crisis.

The safety net in the eurozone and the European Union has flaws, clearly, but those flaws are now being worked on. We will see how that goes, but going into some kind of a banking union for cross-border and systemically important banks would agree very well with the lessons of the banking crisis in Iceland. There are pros and cons, and the pros and cons will evolve through time. People might say something and have a position now, but the situation might be totally different when it becomes relevant. We will have to wait and see.

The Central Bank of Iceland is targeting inflation at 2.5%, and current inflation is around 5.4%. How are you managing inflation?
Yes, this is a challenge that we face at the moment. Of course, this is not a result of the crisis but more a result of the recovery because the inflation here is now driven by very strong wage growth. Also, the exchange rate, because of the currency crisis and the banking crisis, is currently 20% below its historical average in real terms. We always knew that the exchange rate would be weak while all of these positions, such as the offshore positions and the positions within the banks, were being unwound.

But inflation is now beginning to trend down again, and we have increased interest rates by something like 1.5% since August 2011. It is a key goal of ours to get inflation under control again, but that is a challenging task because of the weakness of the exchange rate, which is related to overshooting on the downside and the unwinding of pre-crisis positions, and because inflation expectations have for the moment become unstuck from the target. It makes this rather complicated, but we will be steadfast in geting inflation back to target.

What kind of foreign investment are you seeing?
We would like to have much more foreign direct investment. That would help us to solidify the recovery and to lift capital controls.

There are plans being made in the metal smelters, data centers, and tourism. Some of our software companies are also attracting foreign investors. What seem to attract investors are, among other things, our hydro and geothermal energy resources and our motivated and educated labor force.

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