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Iceland's Experience May Offer a Lesson

Sir, when all of Iceland's main banks failed in less than a week in October 2008, Iceland imposed capital controls but never closed the banks, not even for a single day. We felt that it was imperative in limiting the damage the financial crisis had on the economy that the payment functions of the banking system continue operating at all times. Even relatively short-term interruption of normal payment functions by banks can lead to a massive cascade of delinquencies across the whole economy greatly magnifying an already dire situation.

To be able to avoid closing the banks when they failed, the Icelandic government passed an emergency law only hours before the first bank failed. This law had two crucial parts. First, it provided the Financial Supervisory Authority in Iceland with sweeping powers to resolve failed financial institutions. Second, it made deposits priority claims which was crucial in safeguarding deposits in the resolution process.

When each bank failed, a well-capitalized new bank was immediately created by moving all critical assets and liabilities into the new entity but making sure to move over many more assets than liabilities. This process was made possible by the fact that a sizeable fraction of the liabilities of the Icelandic banks were non-deposits (and could therefore be viewed as non-critical). This process was crucial in stemming an emerging run on deposits.

The current situation in Greece does seem to call for both capital controls and restrictions on the convertibility of deposits into currency. However, full closure of the banking system is a much more drastic and damaging step that can hopefully be reversed as quickly as possible. Perhaps Greece can learn something from Iceland's experience in this regard.

Jón Steinsson

Associate Professor of Economics, Columbia University and
Advisor to the Prime Minister of Iceland in October 2008