



Discussion of:

# The Rise, the Fall, and the Resurrection of Iceland

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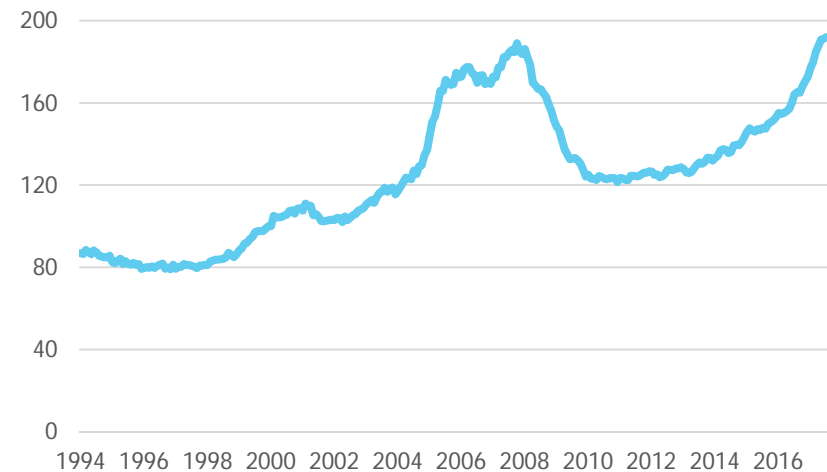
# Policy Failure 1: Banking Supervision

- ▶ Paper covers this very well!
- ▶ Regulators completely captured / incompetent
  - ▶ Related party lending (lack of diversification)
  - ▶ Massive lending to owners of banks (conflicts of interest)
  - ▶ Weak equity / stock price manipulation
  - ▶ Love letters
- ▶ This is what it is like to have a completely unregulated banking system
- ▶ Particularly dangerous when a “Nordic country” behaves so badly

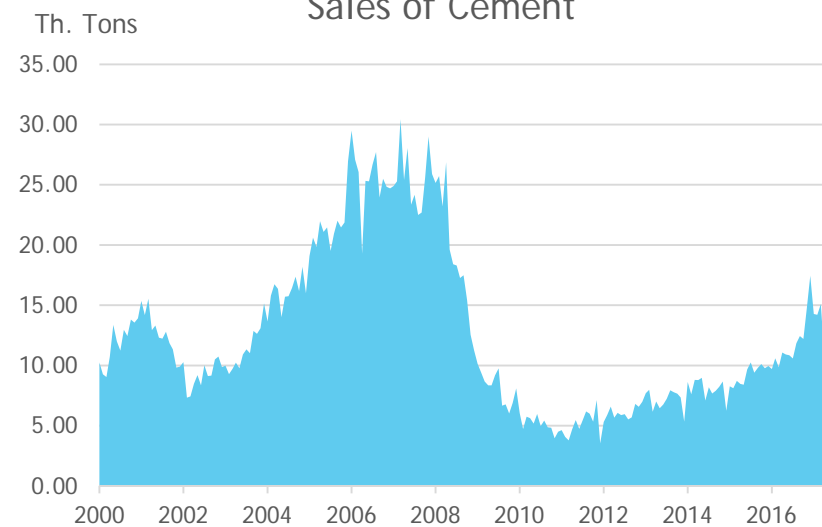
# Policy Failure 2: Housing

- ▶ Recession made much worse due to collapse of housing bubble
- ▶ Fall in employment 2008-9:
  - ▶ Total: 11,100
  - ▶ Banking: 1,000
  - ▶ Construction: **6,600**
  - ▶ Retail/Wholesale: 2,100
  - ▶ Government: 2,400
- ▶ For most normal people, housing shock was big part of the shock
- ▶ Government policy in 2004 contributed to bubble
- ▶ Little done to slow this down

Real House Prices



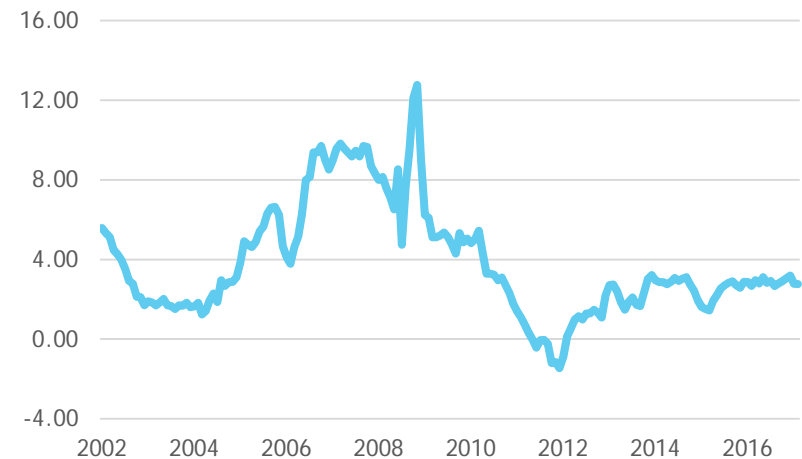
Sales of Cement



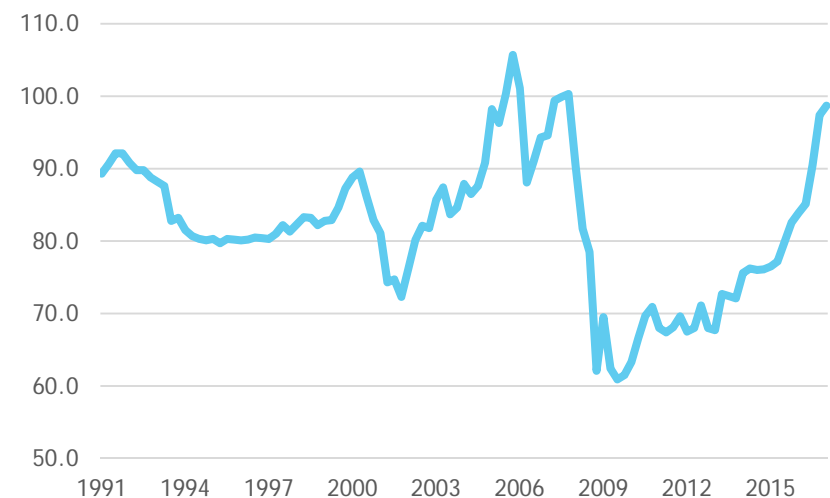
# Policy Failure 3: Monetary Policy

- ▶ Followed conventional wisdom of the time:
  - ▶ One instrument: Very high interest rates
  - ▶ No management of exchange rate
- ▶ Consequences:
  - ▶ Rapidly appreciating exchange rate
  - ▶ Large amounts of carry trade
    - ▶ FX car loans, mortgages
    - ▶ FX financing for non-exporting companies
- ▶ Contrast with policy after the crisis
  - ▶ Heavy exchange rate intervention
  - ▶ Capital controls / Restrictions on carry trade / Restrictions on FX lending

Real Policy Interest Rate



Real Exchange Rate





# Policy Failure 4: Not Making Insured Deposits Super-Priority Claims

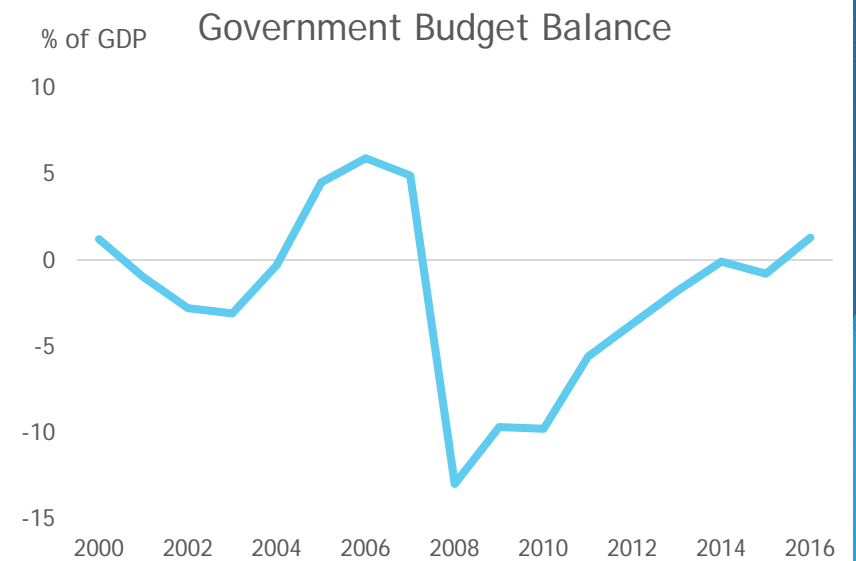
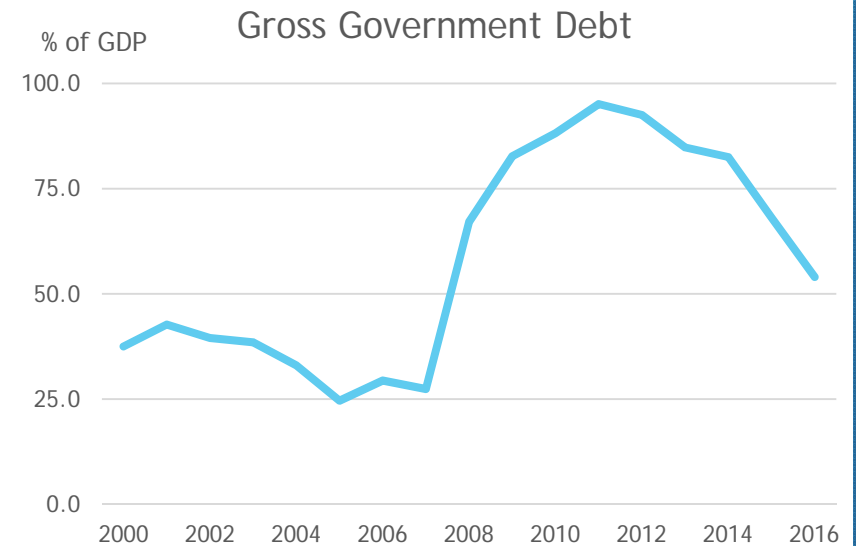
- ▶ Emergency law made deposits priority claims in the banks
  - ▶ As they are in the U.S. but not in Europe
- ▶ We failed however to make **insured** deposits super-priority claims
  - ▶ As they are in the U.S.
- ▶ This would have avoided the infamous Icesave dispute
- ▶ Why wasn't this done?
  - ▶ No one thought of it.

# Policy Success 1: Emergency Law

- ▶ Two key elements:
  - ▶ Ex-post reordering of priority of bank liabilities (deposits moved up)
  - ▶ Resolution authority
- ▶ Consequences:
  - ▶ Sovereign did not assume liabilities of banks / Owners-credits bore losses
  - ▶ Banks remained open for business throughout
  - ▶ Minimal disruption for real economy (given enormity of shock)
    - ▶ No lines at ATMs, no stockpiling of food, everyone got wages paid on time, etc.
  - ▶ Very successful restructuring of corporate sector
    - ▶ Most major companies were bankrupt after crisis (e.g., major airline, major shipping company, major super market chain, etc.)
- ▶ This was handled well (many things were not)

# Policy Success 2: Fiscal Room

- ▶ Iceland's experience highlights the values of fiscal room
- ▶ Very little debt going into crisis
- ▶ Could run massive deficits to smooth out the shock
  - ▶ 2008 deficit: 13% of GDP
  - ▶ 2009 deficit: 10% of GDP
  - ▶ 2010 deficit: 10% of GDP
  - ▶ 2011 deficit: 6% of GDP





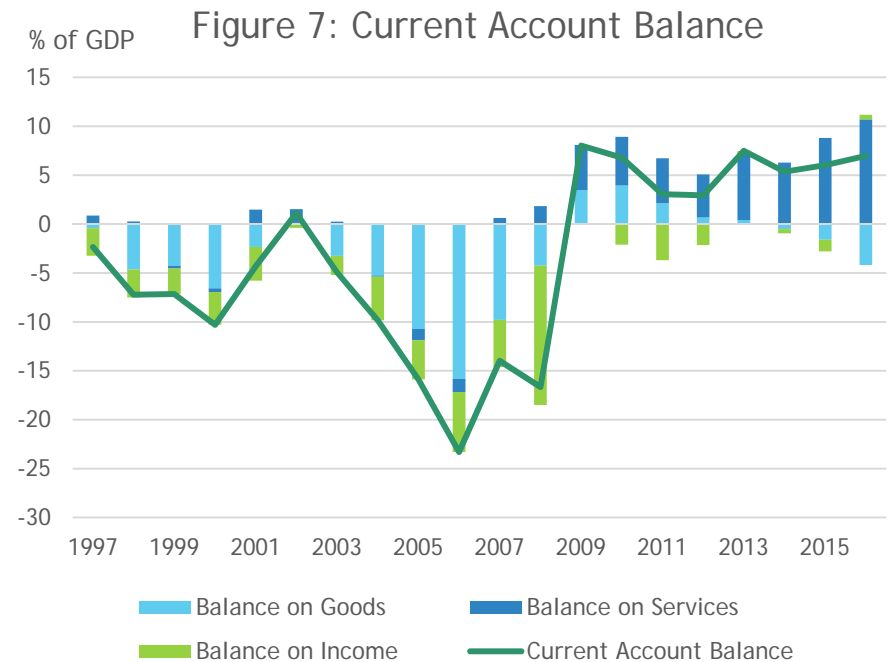
# Policy Success 3: Capital Controls

- ▶ Iceland imposed capital controls after crisis (with strong prodding from IMF)
- ▶ I opposed this at the time
  - ▶ We had already defaulted on most foreign liabilities
  - ▶ Why not let scared foreigners exit at fire-sale prices?
- ▶ I have changed my mind
  - ▶ Lowered government financing costs
  - ▶ Massive deficits perhaps not possible without this
  - ▶ A way of taxing the wealthy / Leverage against bank creditors
  - ▶ Controlling inflation without capital controls could have been difficult politically



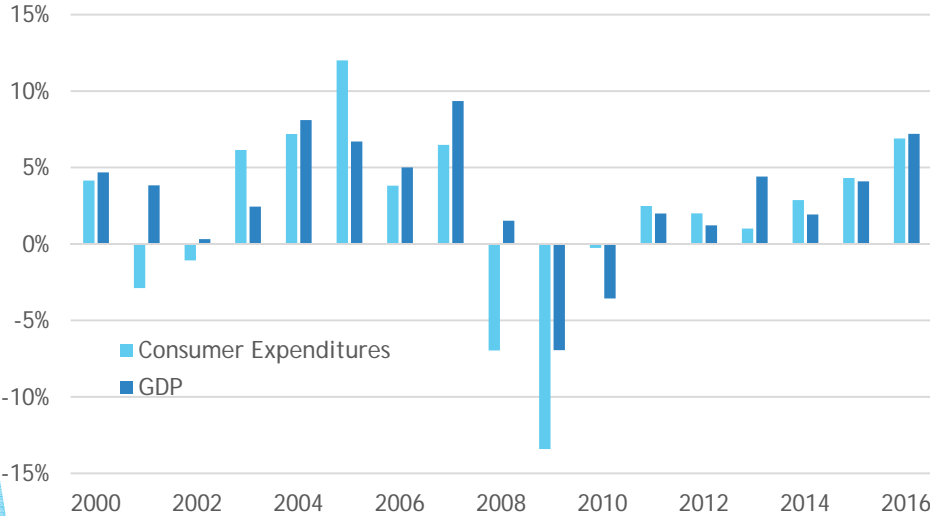
# Policy Success 4: Devaluation

- ▶ Icelandic krona depreciated by over 50%
- ▶ Allowed for inflation and reductions in real wages “without bloodshed”
  - ▶ Important for government budget
- ▶ Allowed for expenditure switching towards Icelandic goods
  - ▶ Short term adjustment mostly on durable goods imports
  - ▶ Exports mostly capacity constrained (fish and aluminum (electricity))
  - ▶ Longer term, tourism has been important

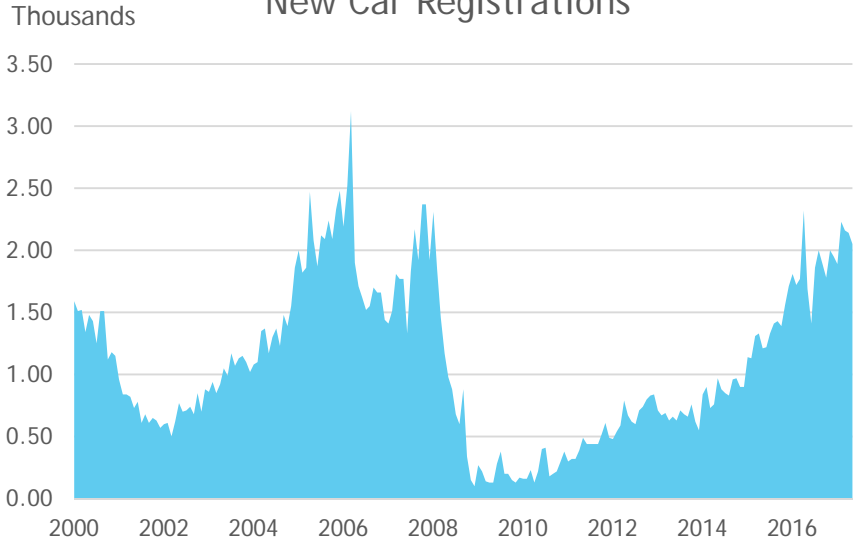


# Policy Success 4: Devaluation

### Growth in GDP and Consumer Expenditures



### New Car Registrations



# Policy Success 4: Devaluation

- ▶ Does this mean Iceland is an “optimal currency area”?
- ▶ Exchange rate flexibility is like insurance
  - ▶ Valuable in bad times
  - ▶ But you pay a premium in good times
    - ▶ Very high interest rates (low demand for currency)
    - ▶ Massive fluctuations in the exchange rate
- ▶ Is the premium in good times worth the benefit in bad?
  - ▶ Hard to say



# Policy Failures Policy Successes

1. Banking Supervision
2. Housing Policy
3. Monetary Policy
4. Insured deposits

1. Emergency Law
2. Fiscal Room
3. Capital Controls
4. Devaluation