Discussion of:

The Rise, the Fall, and the Resurrection of Iceland

by Benediksdottir, Eggertsson, Þorarinsson

Jón Steinsson
Columbia University
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
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
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 supermarket 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

Figure 7: Current Account Balance

![Graph showing the current account balance as a percentage of GDP from 1997 to 2015. The graph includes series for balance on goods, balance on services, balance on income, and current account balance.]
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  1. Emergency Law
2. Housing Policy      2. Fiscal Room
3. Monetary Policy     3. Capital Controls
4. Insured deposits    4. Devaluation