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Capital flows and systemic risk in Iceland

Már Guðmundsson, Governor of the Central Bank of Iceland, panel comments in Norges Bank's 200th Anniversary Symposium, 16 June 2016, Oslo.

In my short introductory remarks, I would like to discuss what I consider to be one of the key factors behind the financial crisis in Iceland: the interaction between capital flows and systemic risk. I will focus in particular on those aspects that have more general relevance and herald unsolved problems for economic management and financial stability in small, open, and financially integrated economies (SOFIEs), such as Iceland was before the crisis and now strives to be again, at least up to a degree.

The saga of Iceland's experience during the Great Financial Crisis had two separate but interrelated sub-stories.

The first story was related to Iceland's boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies. This is a story that has played out many times around the globe, and many of its elements have been seen before in Iceland. It might have been somewhat more extreme this time around, but it wasn't fundamentally different. Strong capital inflows that met with an insufficient policy response and contributed to huge imbalances in the domestic economy were a key part of the story. I will come back to this later.

The second story was the rise and fall of three cross-border banks operating on the basis of EU legislation (the European "passport"). This story was much more unique, as it was part of the first banking crisis in Europe since the EU single market was formed in the early 1990s. Taking advantage of this framework and the prevailing international conditions of ample and cheap credit, these banks grew phenomenally, in less than five years, to almost ten times Iceland's GDP, with most of the expansion being cross-border – or maybe more aptly put, off-border, as the bulk of both financing and investment took place abroad. The result was very big FX-denominated balance sheets

with the usual maturity transformation that banks, as we know them, are all about. However, the safety net that we have in national settings to back them up, including LOLR facilities, was not there. It was an accident waiting to happen, and so it did.

I will be very brief on how the failure of these cross-border banks was dealt with and the lessons learned from it. It is now more widely known in our circles than it was to begin with and less controversial. For more, I can refer you to various publications and speeches of mine and others. But the main reason is that, as far as Iceland is concerned, the problem is solved for the near future: we are simply not going to do it. We are not going to establish international banks headquartered in a very small country with its own currency without an access to a sufficient regional or international financial safety net. This does not preclude that we, as well as others, will with time forget the lessons of the crisis and find ways to create problems or even failures of our banks, but it should be a much more domestic and contained affair.

So what did we do? Deposits were given priority over unsecured bond holders prior to the failure of the banks. At the point of failure, smaller domestic banks were carved out of the failing private cross-border banks, which went into resolution governed by law. It was not a clean split, which later became a major impediment to lifting capital controls; however, that impediment has now been removed. Although they were not necessarily clearly articulated at the time, these measures were guided by the following goals: to preserve a functioning domestic payment system, ring-fence the state in the case of bank failures, limit the socialisation of private sector losses, and create the conditions for rebuilding a domestic banking system.

I have already alluded to some of the lessons learned, which relate to large, internationally active banks in small countries and the flaws in the framework for cross-border banking. This is by now well accepted and is partly what a banking union is all about. But it will not fix the problem for EEA countries outside the eurozone, due to potential FX risks on banks' balance sheets.

Let me now turn back to the other story about macroeconomic management and financial stability in SOFIEs. Here the issue is that, with ongoing global financial integration, the interest rate channel of monetary transmission weakens in SOFIEs, as longer domestic rates increasingly co-move with longer rates in the big countries. Inflation targets could still be reached through the exchange rate channel, but exchange rates are not necessarily smooth reflections of underlying fundamentals. Instead they tend to be excessively volatile and are sometimes misaligned for protracted periods. UIP does not hold, except

at long horizons, and even then, often through sharp and disorderly corrections.

This, in turn, gives rise to two concerns: first, regarding detrimental effects on the traded goods sector (for example, New Zealand and Iceland prior to the crisis), and second, regarding financial stability, where volatile capital flows, currency mismatches, and rollover risk of foreign currency debt are among the key players. Adverse effects on financial stability can be particularly severe when a blocked interest rate channel and an erratic exchange rate channel interact badly with other economic and financial risks that can face SOFIEs – such as the global credit cycle, domestic financial vulnerabilities, policy conflicts, and asymmetric shocks. This was the case in Iceland.

This is a more difficult problem to solve than the one of international banks in small countries. There are problems with completely free capital movements, but there are substantial potential efficiency gains as well. You can enter a monetary union, of course, and thus stop being small in a monetary sense, but that has its own pros and cons, which I will not discuss here. We are therefore faced with a situation where the traditional triangle of the trilemma is shrinking and sometimes seems to collapsing into the straight line of a dilemma. I still think it is a trilemma, but the trade-offs facing SOFIEs can be severe.

In principle, there are three ways to mitigate the problem. The first is to adjust macroeconomic policy frameworks and improve execution and policy co-ordination. The second is to use prudential regulation and supervision aimed at reducing potential vulnerabilities and increasing resilience in the face of volatile capital flows. The third is to introduce targeted tools aimed directly at the financial integration part in order to regain greater monetary independence and shift the effects of monetary policy more to the interest rate channel and towards the non-traded goods sector.

In Iceland, this issue is very much on the agenda as the country prepares to lift the comprehensive controls on capital outflows that were introduced at the peak of its financial crisis. We have been working through all of the avenues that I have just mentioned. Very recently, we introduced a CFM tool in the form of a special reserve requirement on portfolio inflows excluding equity. It is constructed in such a way that the bite is biggest for short-term flows. Although it has already been activated due to the special situation we find ourselves in regarding the process of lifting capital controls, for the longer term we see it very much as a third line of defence after macroeconomic policies, and micro and more usual macropru. It is no panacea and comes with distortions.

All of this remains a work in progress, and history will tell whether it will be sufficient to preserve monetary and financial stability in the rougher seas of freer capital movements that we intend to embark upon.