

**Ragnarök: Iceland's Crisis,
its Successful Stabilization Program,
and the Role of the IMF¹**

Poul M. Thomsen
Director, European Department
International Monetary Fund

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Minister, Governor, friends and colleagues, ladies and gentlemen, it is a great pleasure for me to be here today. Allow me to start by expressing my thanks to my old friend Governor Már Gudmundsson—and other colleagues at the Central Bank of Iceland—for the warm welcome and for putting this event together.

Let me thank all of you for coming here on a Saturday. As you know, this is not just any Saturday. No, this is the day that marks the tenth anniversary of the collapse of Lehman Brothers, an event that sent financial shockwaves around the world. So much of

¹ The views expressed are mine and do not necessarily represent those of the IMF.

what the global economy has lived through over the past ten years has in one way or another been touched by that day.

Everyone recalls that Monday when Lehman went down. AIG would have followed the very next day had it not received \$85 billion from the U.S. Federal Reserve. Then an important U.S. money market mutual fund “broke the buck,” triggering a violent run on the U.S. money fund industry. With a force none could have predicted, wholesale funding markets all over the world froze, trade financing collapsed, goods and services trade fell off a cliff, banks started to drop like dominos, and fiscal coffers were forced open. Within ten days of Lehman filing for bankruptcy, Denmark, Norway, and Sweden—but not Iceland—had joined an expanding list of countries eligible for the U.S. Federal Reserve’s swap lines.

At the end of September 2008, Wachovia, the fourth largest banking group in the United States, needed public support. Two

weeks later, the U.S. government had blanket guaranteed the entire U.S. banking system and was moving to selectively provide capital injections. Other national governments, including in Reykjavík and Dublin, had already done so. Those days ten year ago were tumultuous indeed.

To me, it seems entirely appropriate that I should mark the tenth anniversary of Lehman's collapse with you here in Iceland, in a country that was one of the first in the path of the financial tsunami that followed.

I will not get into why Iceland had become so vulnerable—why the banking system had been allowed to explode in size relative to the Icelandic economy during a very short period, relying on a funding model of aggressive foreign borrowing. Much has already been said about this, and it is clear that there is ample blame to go around—in Iceland and abroad.

Indeed, if I was to get into this, I would have to admit that we at the IMF also have to be

humble. Among several things that we in retrospect might want to have done differently, we had for a while moved Iceland from the standard 12-month cycle for our surveillance missions to a 24-month cycle, reflecting a benign view on vulnerabilities. The same was the case for Cyprus, another small country that would soon be engulfed in a deep crisis.

As to my own personal experience, having been involved almost exclusively in crisis work ever since I joined the IMF in 1982, such work had mostly dried-up during the years of exuberance that preceded the crisis. Instead, I found myself tasked with overseeing a radical downsizing of the IMF's European Department, as part of a broader downsizing of the IMF. During this downsizing, there were those back then who even began to ask if the Fund should be closed. It never came to that, but the decision to undertake large staffing cuts reflected, among other reasons, the view—as one internal memo so memorably put it at the time—that advanced countries in Europe

and elsewhere would in the future only suffer from the “garden variety” of economic problems. This was not the consensus view within the institution, but it says something about the sentiments at the time.

Let me fast-forward to a few months later. I found myself on plane to Iceland—with only 24-hours’ notice—heading a team of young economists, all of whom were very bright, but none of whom had any significant crisis experience. I do remember a few sleepless nights here in Iceland, worrying about what was to come.

Today, I would like to focus my remarks on a number of features of the IMF supported program for Iceland that were somewhat unusual at the time—even controversial—by comparison to other IMF programs. I believe that these features were one of the reasons, among others, for why the program was successful in helping Iceland not only to overcome the crisis, but to do so faster than we had initially expected. I think that being

mindful of these lessons from the Iceland experience can help ensure a more effective crisis response in other cases in the future.

However, let me be very clear about one thing up-front—about what to me is the most fundamental lesson from Iceland. While there were important technical features in the design of the IMF support that helped explain why it is now considered a success, by far the main reason for this success was the broad and strong political commitment in Iceland to determinedly and consistently implement the program. This program had what we in the business call very strong domestic “ownership.”

If there is one overarching lesson from the Iceland program it is that it provides yet more proof of the lesson learned long ago from decades of IMF supported programs that such programs only work if there is domestic ownership. In Iceland, this ownership was very strong. In fact, as you will hear, it was the early indication of such strong ownership that helped justify some of

the unusual technical features in the design of the program.

And let me stress that by “ownership” I don’t just mean that there was a broad political resolve within the Icelandic body politic, but also that the Icelandic authorities were fully involved in the design of the program from the outset. In some key areas—as I will explain below—they took important steps before we got involved. This program was very much a collaborative effort, with the IMF bringing international experience and lessons to the table, but the authorities having strong views on what would work and what would not work in the Icelandic context.

Domestic ownership sowed the seeds of success for the program. Looking back and comparing the main macro aggregates as envisaged when the program was designed with eventual outcomes, I think that on every measure the program can be judged a success.

Inflation spiked largely as envisaged and proved a little more persistent, but it soon returned to near the official target. Economic growth declined sharply, but not as sharply as feared, and the v-shaped recovery came on cue. Importantly, although unemployment rose sharply, it did not reach the extremely high levels seen in other crisis countries, and it came down quickly by international standards. Public debt surged to 95 percent of GDP, but this peak was some 14 percent of GDP less than expected, and debt has fallen fast since then, to some 40 percent of GDP today.

But now, let's go back to Reykjavík ten years ago.

The IMF got involved only after the banking system had collapsed. This was one the few negative features of the Iceland case, although it is one that is very familiar to the Fund from its work in other crisis cases. We tend to only be invited to take a seat at the table very late in the game, often after a

crisis has already begun causing severe disruptions.

We left for Iceland with only 24 hours' notice and—by the time we arrived—the Icelandic foreign exchange market had collapsed and the króna was in free-fall. Foreign currency was already being severely rationed to ensure that payments for priority imports could continue to be made—even the smooth supply of imported food and medicines was not assured. What we witnessed unfolding right in front of our eyes was not only one of the deepest financial crises in modern economic history, but one that was associated with a high risk of becoming severely disruptive to Iceland's real sector and to people's welfare, reflecting the extreme dependence on imports and the significant foreign-currency and foreign-currency indexed debt that households and corporations has incurred in the boom years. This latter fact meant that it was extremely important to contain the extent of the currency depreciation in order

to avoid catastrophic insolvency across the economy.

I subsequently was closely involved in other major programs in Europe where the Fund also was asked to come to the table only late and where there also was a strong sense of urgency—notably the rush to avoid defaults on upcoming debt payments in the case of Greece and Portugal, defaults that could have caused severe contagion inside the eurozone. But only in Iceland did the urgency arise from an extreme and acute threat to the provision of basic necessities. The patient was in acute cardiac arrest and time was of essence.

And we moved fast. I arrived here in full program mode on October 12 and ten days later we had not only finished the diagnostic work—despite no prior engagement in the run-up to the crisis—but also agreed on a program of corrective policies. We announced on October 23 that we were ready to present the program to our Executive Board and release funding as soon

as we had assurances from other countries— notably in the Nordic region—on the comprehensive package of external support necessary to make the program work. Already with this announcement of staff-level agreement on policies the situation began to stabilize.

After another short period of intensive discussions with other creditors and donors, we had the necessary financing assurances. Our Executive Board moved swiftly to approve the release of funding on November 19, having had only three business days to study our report compared to the three weeks it normally requires. Thus, slightly more than one month after the mission had first arrived in Reykjavík, the IMF approved what remains among its largest programs relative to the size of the economy—18 percent of Iceland’s GDP or 1,190 percent of Iceland’s quota in the IMF—with almost half of the funding being disbursed in one go up-front. This was extremely fast and it was on a large scale by comparison to other cases.

One reason for the speed and the scale was the strong support and solidarity from other countries in the region. This allowed Iceland to become something of a model for how the IMF's seal-of-approval can catalyze rapid and broad international support.

We were also able to move fast because the IMF's involvement helped—I believe—catalyze the necessary broad support for policies within the Icelandic body politic. One of the more memorable episodes as far as I am concerned is that on our first working morning in town, labor market representatives told us that they realized that difficult and socially painful measures were unavoidable, but that they would support such measures provided that the IMF was fully on-board.

In the following days—I remember clearly—I was struck not only by the national embarrassment about what was happening, but primarily by a strong and broad willingness to do what needed to be done—by what I before called “ownership.”

This mobilization of a consensus on what needed to be done was admittedly not entirely smooth—as I am sure you remember. In particular, the central bank took a step in the wrong direction when, in the midst of the discussions, it significantly lowered interest rates. However, this step was soon reversed and within days we had agreement on a comprehensive program of difficult and painful but necessary corrective measures, an agreement that in my experience had exceptionally strong domestic support. I still remember vividly sitting waiting in the early morning—I believe it was on October 23—outside the room where the cabinet was carefully studying the agreement. After having waited for quite some time, I was called in to answer some questions and after a short while Prime Minister Geir Haarde looked around the room, nodded, and then said to me “ Poul, we are going to do it.” As I said, I sensed a very strong ownership.

Let me turn to the design and content of the program, to economic policies. I want to

stress three features that I think were important for the success of the program and that were if not unique then certainly somewhat unusual.

First, the program's conditionality—its policy measures—was very narrowly focused on dealing with the acute issues that we were facing. Quite strikingly, compared to most other IMF supported programs at the time, the program with Iceland did not contain any structural conditionality other than what was needed to restore fiscal discipline and rebuild the financial system. There were no broader structural reforms whatsoever.

Here, we certainly heeded one of the lessons from the Asian crisis, where the Fund had been accused of insisting on measures that were not essential for the task at hand. A case in point was the measures regarding the plywood industry and the clove monopoly in one of our Asian programs. While I was not familiar with Iceland's economic history before coming here, we soon realized that

Iceland had a history of quickly adjusting to shocks, not least because of labor market flexibility.

Now, one can of course always find structural weaknesses that ultimately have macroeconomic and financial stability implications. This was certainly also the case for Iceland. But there is a need to prioritize. This is critical to build the broadest possible political support for a program in the midst of a crisis, to avoid triggering resistance from vested interest across the economy. While there are many structural features that one could argue should be changed to improve the long-run performance and stability of an economy, these should be the outcome of the normal political process and not be imposed in the midst of a crisis. This is not to say that crises cannot catalyze broad support for deep structural reforms—witness for instance Spain during the euro crisis.

We decided early on to be extremely nimble—parsimonious if you will—by

focusing on a very narrow set limited to three critical issues: restoring monetary stability; rebuilding the collapsed banking system; and dealing with the huge fiscal deficit that was opening up as a result of the crisis. In fact, to move fast, we initially focused only on the first of the three issues—restoring monetary stability—deferring the tackling of banking sector and fiscal issues to the subsequent reviews of the program.

I believe that the success of the program owes much to having been nimble and fast.

The second feature that I believe was important for the effectiveness of the program was the design of the fiscal program, in particular the phasing of fiscal consolidation.

As in any other case with a serious banking crisis, it was clear that the need for support for Iceland's financial system and the effect of the deep recession would take a dramatic fiscal toll.

We estimated at the time that the direct fiscal support to the financial sector would cost the taxpayers some 75 percent of GDP, despite important measures to limit such costs. Taking into account also the effect of the recession, we estimated that public sector debt would surge from 29 percent of GDP before the crisis to a peak of 109 percent. Thus, the mess in the banking system had overnight changed Iceland's public sector debt burden from very low to very high.

There was thus no doubt that Iceland would need quite dramatic and sustained fiscal adjustment to reduce debt. This was not questioned during the discussions. The issue we confronted centered on timing.

We purposefully avoided building any fiscal consolidation into the first year of the program, instead allowing automatic stabilizers to work in full. A time when private demand is collapsing is not the time to slam the brakes on public spending or raise taxes. Thus, the overall fiscal deficit was allowed to surge from about balance

before the crisis to a deficit of 14 percent of GDP in 2009. Of course, deferring fiscal consolidation is a luxury only affordable if there is pre-existing fiscal space. Such space was available in Iceland, and the program went ahead and used it.

At the time, allowing automatic stabilizers to work in full was if not controversial then by no means normal practice. In part, this reflected the view that up-front fiscal consolidation is critical to the credibility of a program—showing political determination to begin tackling the medium-term fiscal challenges was considered critical to demonstrating commitment, including vis-à-vis foreign donors and creditors.

In view of this, it raised initially some eyebrows back in Washington when not only did we allow automatic stabilizers to operate in full during the first year of the program, deferring the start of the fiscal adjustment to the second year after the initial shock had begun abating, but we did not even specify at the outset the fiscal measures

that would have to be taken in the second year and beyond. Our Executive Board was asked to approve the large financing package without any detail on how the critical fiscal adjustment was to be achieved. We left these measures to be determined at the time of the first review of the program.

It would have been preferable to agree on the fiscal program up-front. But if we had delayed the launch of the program because of the need to do the detailed technical work to identify fiscal measures and build the necessary political consensus, the critical external financing would have been significantly delayed.

Our decision to defer the detailed calibration of the fiscal program was very much influenced by the clear sense on our part that there was a strong political commitment to undertake the necessary fiscal adjustment. This is another example of the critical importance of the strong ownership. As you know, this confidence in the political system's ability to generate support for the

necessary measures was fully justified, as was amply evident from the comprehensive package of measures adopted in the context of the first program review. And, having adopted this package as promised, the authorities went ahead and implemented it faster than agreed.

I firmly believe that the success of the program owes much not only to the fact that we avoided exacerbating the initial shock by allowing automatic stabilizers to work, but also to the fact that Iceland had time to develop its fiscal program through a process of internal debate and deliberation—that this program was not being seen as being imposed under time pressure.

The third distinct feature of the Icelandic program was of course the imposition of capital controls.

Capital controls were initially forced upon Iceland by circumstances—by the collapse of the foreign exchange market—and they were in that sense a *fait accompli* by the time

that we arrived in Reykjavík. The controversial issue was not this, but the fact that the program that we presented to our Executive Board did not foresee lifting the controls, but actually formalized them as a critical part of the toolkit going forward, with no pre-defined timeframe as to when they could be lifted.

Capital controls provided an essential unburdening of monetary and exchange rate policy at a time when the risks of massive foreign exchange drains were overwhelming, not least from glacier bonds amounting to some 35 percent of GDP. Without such controls the depreciation of the króna and the increase in domestic interest rates would have been much larger, taking a much higher toll on growth and balance sheets. In fact, as we gradually managed to strengthen the effectiveness of the capital controls, we could not only progressively liberalize current account controls—which were much more harmful to economic welfare—but also safely relax monetary policy. The later reductions in interest rates owe much to the

success in gradually making capital controls much more effective.

I know that there are those who argue that the economic welfare of Iceland would have been better served over the long run by biting the bullet and lifting capital controls up-front, at the time when the program was launched. I do not belong to that group, and internationally the imposition of such controls under extreme circumstances is today uncontroversial.

But back in 2008, it was unorthodox if not highly controversial—to put it mildly—to contemplate such heavy-handed measures in the context of an IMF program. Back then, hardly anyone recalled that the use of capital controls “as needed” is, in fact, explicitly envisaged in the IMF’s Articles of Agreement. It is difficult for me to convey now just how controversial IMF support for Iceland’s capital controls was at the time.

In fact, when I asked headquarters in Washington to send us some capital control

experts to join the mission in Reykjavík, I learned that we had let most of them retire without any replacements to preserve the institutional knowledge in this area. There was only one person left within the entire institution who was an expert on capital controls. This tells you something about the prevailing wisdom at that time and the surprise that we faced when arguing for capital controls. I still remember having to interrupt my Thanksgiving dinner to conduct a lengthy conference call with analysts and journalists to try to calm sentiments.

Capital controls did not sit well with the prevailing market orthodoxies. But the more serious issue was a concern that such controls could have significant negative spillovers to other vulnerable countries, not least in Eastern Europe. To some extent such concerns were legitimate—in particular amid the very fraught conditions that prevailed at that time—although investors will of course always raise the specter of

contagion and systemic risk in an attempt to get bailed out.

In the end, we managed to convince other stakeholders that Iceland would be seen as an extreme outlier and that markets would understand that the use of capital controls was unavoidable in this case and did not foreshadow their imminent imposition in other vulnerable countries.

Let me reiterate that the successful application of capital controls in the case of Iceland has helped in making the use of such controls much more acceptable internationally. Capital controls are no longer a taboo and are now much more accepted globally as part of the toolkit in the event of crisis. In fact, the possibility of imposing capital controls is explicitly acknowledged in the IMF's *Institutional View*, which discusses the prevailing view on the toolkit. There are important caveats—notably that controls should not substitute for warranted macroeconomic adjustment—but the option is not ruled out. In this respect

as in others, the Icelandic experience has helped change a world view. This is another area in which Iceland became something of a trailblazer.

In addition to these three features—the narrow focus of the program, the deferred fiscal adjustment, and the capital controls—the Iceland program contained a fourth distinguishing feature, namely the way that the authorities dealt with the collapsed banks. I mention this separately as this feature of the program had been adopted by the time we got involved.

The challenge facing the authorities was staggering. After the collapse of the currency, total assets of the banking system had peaked at some 900 percent of GDP. If ever there were a situation where the old adage might hold that from extremes there comes clarity, this may have been it: the system was not too big to fail, it was too big to save. The challenge was nothing short of reconstructing an entire banking system—putting public money in where essential

while maximizing asset recoveries. There was a strong agreement between the Icelandic and IMF teams—both when the program was initially designed and throughout the program reviews—that it should be an overarching priority to limit the cost to the public sector.

The Icelandic authorities had decided to split the banks in an unusual way. Rather than the traditional good bank–bad bank split, the cut was made between the failed banks’ domestic operations and their much larger foreign operations, a move that was designed to allow taxpayer support to focus on shielding the domestic economy. This approach was—as you know—controversial, but it withstood legal challenges.

The strategy was novel in at least three ways:

- First, the pervasiveness of external bank borrowing before the crisis meant that, even after severe markdowns to asset values, the new banks came into being with more domestic assets than

domestic liabilities; their balance sheets needed to be balanced by additional funding, and the bank estates—which inherited massive external assets, many of them still good—were made to provide that funding, initially as bonded claims.

- Second, although the revaluations followed the independent advice of reputed international audit firms, a range of uncertainty shrouded the new asset values. The somewhat ingenious solution, for two of the three banks, was to swap their estates' bond claims for equity stakes, thereby allowing the estates to share in any future upside.
- Third, distributions of asset recoveries by the estates to their predominantly foreign general claimants—including substantial dividends from the new domestic banks they owned—became forbidden for balance of payments and supervisory reasons. This restriction was not lifted until the winter of 2015—

16, after the estates made a series of stability contributions to the Icelandic state to ensure that the subsequent payouts of króna-denominated domestic recoveries to private claimants abroad would not drain official foreign exchange reserves. Impressively, the stability contributions amounted to a fiscal windfall of some 20 percent of GDP.

In 2016, we took a fresh look at the direct costs of the banking crisis. Our team counted four categories of recoveries to the state on the direct support it had provided: bank equity and subordinated debt taken as consideration for the recapitalizations; dividends on that equity; the stability contributions; and profits and interest payments to the central bank by the asset management subsidiary it had established in 2009 to hold its seized collateral. Total recoveries as of early 2016 were estimated at 43 percent of GDP.

In other words, recoveries exceeded direct fiscal support costs, with the state making a net gain of over 9 percent of GDP. Making a net fiscal gain from bank support operations is a remarkable achievement, in my view, a testament to the authorities' determination to keep bail-outs to a minimum. Only a few other countries can claim this, with some calculations suggesting the United States is among them. Of course, these fiscal sums do not count the vast indirect economic costs of the banking collapse in terms of lost output and lost jobs.

A brief comment on IceSave. As you know, the IceSave issue turned into a major dispute between Iceland, on the one side, and the U.K. and the Netherlands, on the other side, about compensation to British and Dutch retail depositors. The discussions on how to resolve this issue had not yet gotten underway when we presented the program to our Executive Board and the dispute was not yet evident. This, and the fact that the initial program had set aside an amount for compensation, meant that there was no

objection from the U.K. and the Netherlands at the time of Board approval.

Later, when the disagreement erupted, it became an issue for discussion at our Board. IMF management and staff took the view that this was a dispute between member states and that Fund support could proceed considering that a good-faith effort was underway to resolve the issue. Thus, this dispute was not holding up the program.

However, some of the countries participating in the financing package had concerns about the unresolved issue, which in turn caused uncertainties about whether the program still had the necessary financing assurances. As our rules do not allow us to proceed with a program that is not fully financed, this uncertainty caused some delay of the subsequent reviews of the program.

After some analysis, staff took the position that the uncertainty did not affect the 12-month forward-looking financing assurances—which is what matters under

our rules—and the reviews went ahead. Thus, at no time was the program held up by the Fund taking any sides in the dispute.

The debate about bail-in versus bail-out continues, but there is no doubt that there has been a shift in views, reflected in a much stronger political determination to shield the taxpayer through various measures to facilitate bail-in. While there is no doubt that the Icelandic approach ten years ago is still somewhat controversial, I do think that the Icelandic experience has been one important reason for this shift.

I have focused here in some details on four key features of the program—features that I believe were important for the success. There are others, like the flexibility of the Icelandic economy and the fact that a history of good fiscal policies meant that Iceland had significant fiscal space when the crisis hit—both features that I have mentioned only in passing, but that were crucial. One point that I did not mention was the role of the social welfare system. My personal

view—and here I probably reveal my Danish origin—was that it was critical for the social and political support for the program.

While I have focused on the features of the program that helped it to be successful, this is not to say that there are areas where we could have done better and where program outcomes fell short. One area that I would regard as unfinished business is the vital task of fixing financial sector oversight so the whole mess cannot happen again. Let us not forget that the bulk of the imbalances that brought Iceland to crisis had built up in the space of only five years after the banks were privatized in 2003.

It is a disappointment, therefore, to see that as recently as 2014, IMF experts assessed banking supervision in Iceland to still lack the requisite teeth and independence. That expert assessment may be somewhat dated by now—and I am told real progress is being made—but Iceland would be well advised to consider institutional reforms.

There is a need to ensure that the banking regulator has all necessary independence, rulemaking and enforcement powers, and resources. One concern in this regard is that having a supervisory agency that is part of the executive branch of government can fundamentally limit independence and effectiveness. Creating a truly arm's-length oversight function becomes doubly critical when state ownership of banks is pervasive, as is currently the case in Iceland.

Iceland is a very small country. I remember, in the program days, it was quite difficult to find independent local experts to help restructure the financial system that had not been intimately involved in the risk-taking that preceded the crisis. Given this smallness, the current arrangement, which fragments banking supervision across two bodies, one responsible for liquidity oversight and the other for solvency oversight, might not be an efficient or effective solution. The IMF's advice, therefore, is that Iceland should consider unifying banking regulation and supervision in one entity, potentially the

central bank. Such a reform would eliminate unnecessary divisions and overlaps, capitalize on the established independence of the central bank, and harness basic synergies between the banking oversight, lender-of-last-resort, and resolution functions. Importantly, this might also better support a fully integrated approach to micro- and macroprudential policy. In any case, whether or not you embrace all aspects of our recommendation, let me close by issuing a call to seize this, the tenth anniversary of the collapse of Lehman and the Icelandic banking system, as a time to fix financial sector oversight. Let this be a time to get the job done.

To conclude, while it today all seems much less dramatic, the Iceland program did in some ways help break new ground. Today, core features of Iceland's emergency response sit as well-accepted pieces of the standard crisis management rulebook, notably: be parsimonious and well-focused in crisis management policies; allow automatic stabilizers to work to a

considerable degree if the fiscal space is available; be pragmatic about the use of capital controls; and insist on bail-in to the maximum extent feasible. Above all, the Icelandic experience has confirmed yet again that success in crisis management hinges of strong domestic ownership.

Friends, let me congratulate you for a successful program, one that has so evidently laid the ground for a blossoming economic recovery.