



Seðlabanki Íslands

“There is nothing new except what is forgotten”

Short history of monetary issues in Iceland

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This presentation is in part based on an ongoing research project in cooperation with colleagues from the Central Bank (Bjarni G. Einarsson, Kristófer Gunnlaugsson, and Thórarinn G. Pétursson):

„The long history of financial boom-bust cycles in Iceland“

- Part I: Financial crises
- Part II: Financial cycles

The title of the presentation is a quotation attributed to Marie-Jeanne Rose Bertin, Queen Marie Antoinette’s dressmaker and confidante

The opinions expressed herein are those of the author and do not necessarily reflect the opinions or policy of the Central Bank of Iceland.

Three development phases of the financial system in Iceland



1870-1930

- Formation of the monetary system within liberalised capital flows and cross-border ownership of banks

1930-1990s

- State-controlled monetary system with severe restrictions on capital (and current account) flows

1990s-2015

- Modernisation of the financial system, expansion and collapse of cross-border banks and currency, and the ongoing re-liberalisation efforts

Historical background



Denmark

- 1736: Kurantbanken
- 1813: “State bankruptcy”
- 1818: Danmarks Nationalbank
- 1830-40: Banknotes again backed by silver
- 1857: **Privatbanken**
- 1873: Nordic Monetary Union (gold standard)
- 1881: **Landsmandsbanken**
- 1908: Banking crisis

Iceland

- 1853: Request for a branch of Danmarks Nationalbank
- 1855: Trade liberalisation
- 1868: First saving bank
- 1871: Separate fiscal account from Denmark
- 1874: New constitution and fiscal powers
- 1886: **Landsbanki**
- 1904: Home rule, Minister and **Íslandsbanki**
- 1918: Sovereign state in a personal union with Denmark
- 1944: Independent republic

Formation of the monetary system



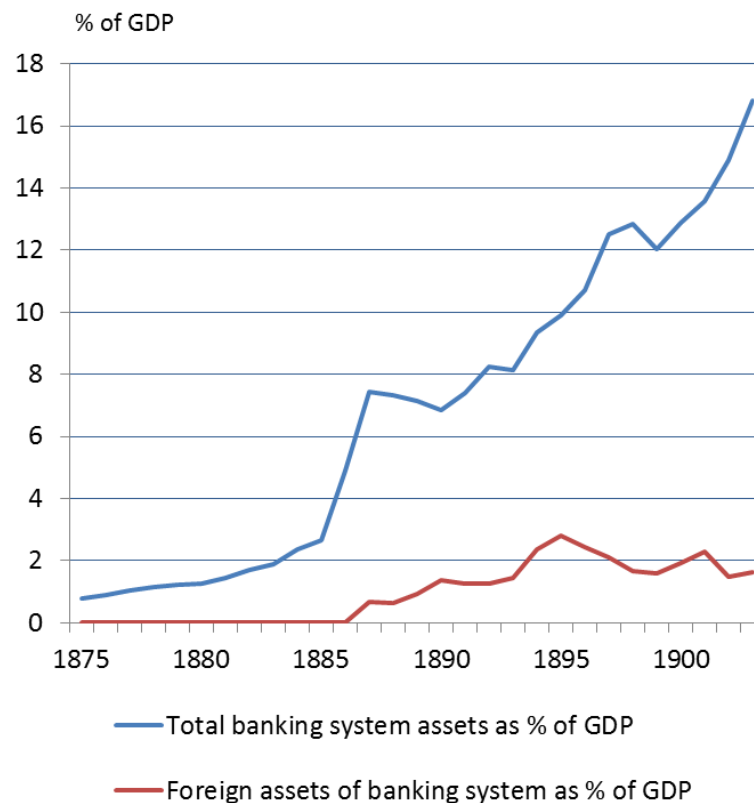
- Money played a very limited role as a medium of exchange in Iceland until foreign trade became fully liberalised in the mid 19th century
 - Also limited use as an unit of account and store of value
- No coincidence that demand for the establishment of banks grew as trade liberalisation brought inflow of foreign money, enhanced trade opportunities which needed financing, and the beginning of urbanisation
 - Enhanced role for money
 - Need for credit

Landsbanki founded in 1886



- State-owned bank with limited right to issue banknotes
 - Guidance from Danmarks Nationalbank
- Bank notes were unbacked by gold, but guaranteed by the Icelandic government
- Limited capacity to finance the needed modernisation and expansion of the fishing industry
 - Saving to commercial bank

Banking system assets as a share of GDP



Source: Einarsson, B. G., K. Gunnlaugsson, T. T. Ólafsson, and T. G. Pétursson (2015). The long history of financial boom-bust cycles in Iceland - Part I: Financial Crises, *Central Bank of Iceland Working Paper*, forthcoming.

Íslandsbanki founded in 1904



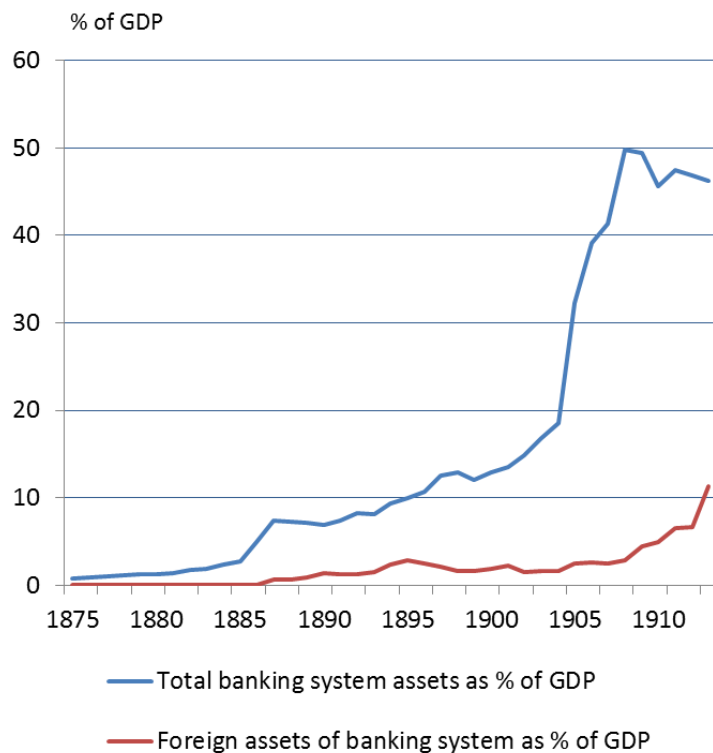
- 1899: Offer from Danish investors to establish a privately-owned commercial bank with certain privileges, including exclusive rights for 90 years to issue gold-backed banknotes
 - Similar to Danmarks Nationalbank
- 1899-1902: Parliamentary disputes with regard to the establishment of such a bank
 - Guidance from Danmarks Nationalbank
- 1902: Establishment allowed by law with some changes to the original proposal
- 1903: Last minute equity financing from Danish and Norwegian financial institutions enabled the establishment in 1904

Importance of Íslandsbanki

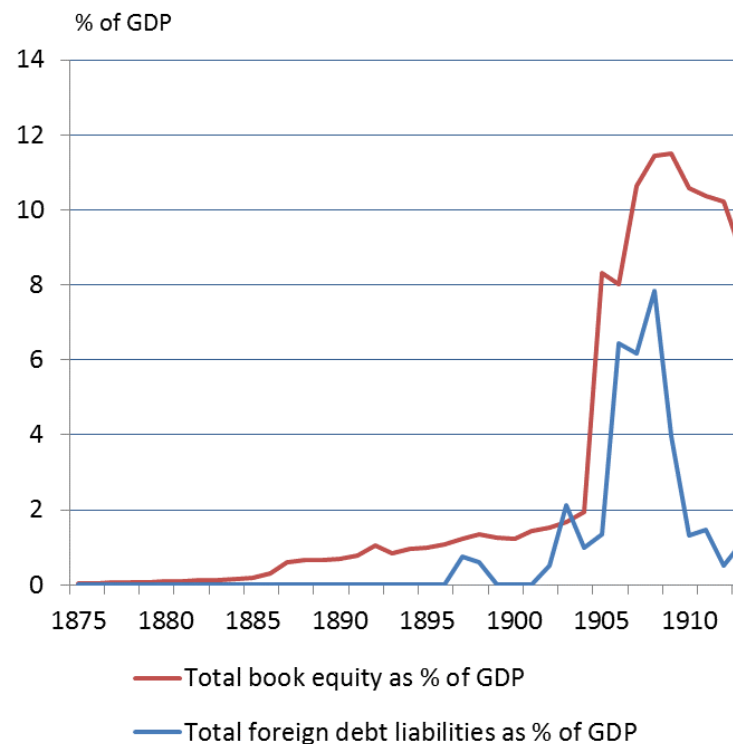


- Parliamentary disputes centred on the question of whether a foreign bank should be given exclusive rights to issue banknotes and whether foreign financing should rather be sought through government loans to strengthen the state-owned Landsbanki – long lasting issues
- The importance of Íslandsbanki can be seen from the degree of foreign financing it brought

Banking system assets as a share of GDP



Banking system equity and liabilities as a share of GDP



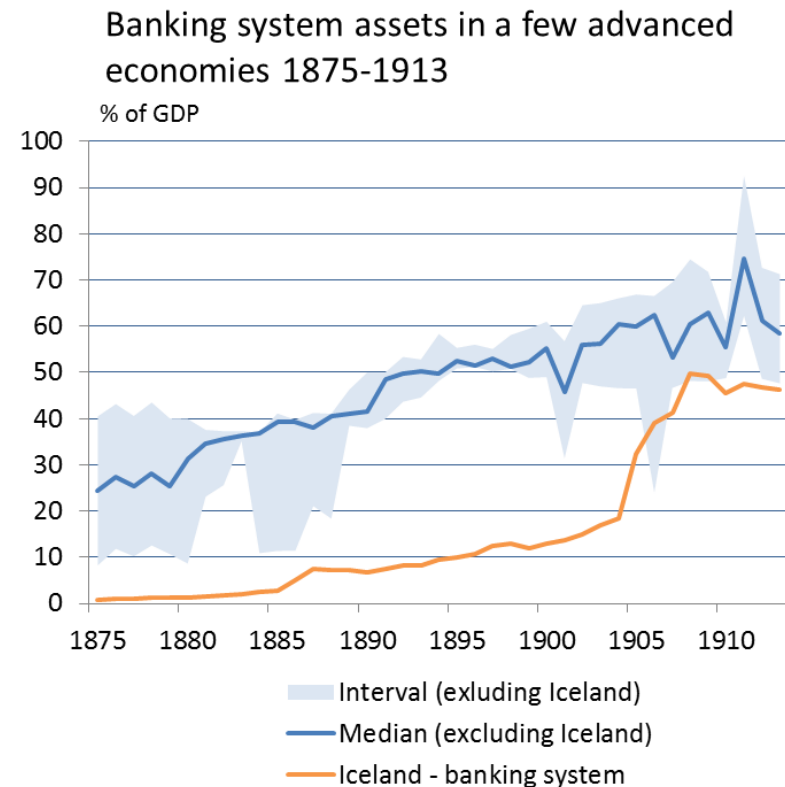
Source: Einarsson, B. G., K. Gunnlaugsson, T. T. Ólafsson, and T. G. Pétursson (2015). The long history of financial boom-bust cycles in Iceland - Part I: Financial Crises, *Central Bank of Iceland Working Paper*, forthcoming.

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Iceland's (first) financial catch-up



- Iceland's banking system grew very rapidly in the first decade of the 20th century through increased external financial integration
- The global banking panic of 1907-8 hindered planned increase of foreign equity issuance and decreased foreign debt funding of Icelandic banks
 - Similar story as in the early 2000s, but then with less foreign equity financing



1. Total bank assets is defined as the year-end sum of all balance sheet assets of banks with national residency (excluding foreign currency assets). Countries included are Canada, Denmark, France, Germany, United Kingdom, United States. *Sources:* Schularik, M. and A.M. Taylor (2009). "Credit Booms Gone Bust: Monetary Policy, Leverage Cycles and Financial Crises, 1870-2008", *NBER Working Paper* No. 15512; Einarsson, B. G., K. Gunnlaugsson, T. T. Ólafsson, and T. G. Pétursson (2015). The long history of financial boom-bust cycles in Iceland - Part I: Financial crises, *Central Bank of Iceland Working Paper*, forthcoming.

Foretold of things to come



- In 1909 there were widespread parliamentary discussions regarding the government investing in Íslandsbanki but at the same time political turmoil surged in relation to firing of Landsbanki's management
 - International financial integration and domestic politics would prove to be important driving factors of the system



An ominous bank of dark clouds is upon us in Iceland in many ways. ... The inflow of money, which was beginning to bear fruit in terms of increased employment, culture and investment, has turned into outflow. The country's credit and reputation has been shattered for an uncertain period of time and other country's goodwill and compassion with regard to the rebirth and restoration of the Icelandic people has turned into pitiful disbelief.

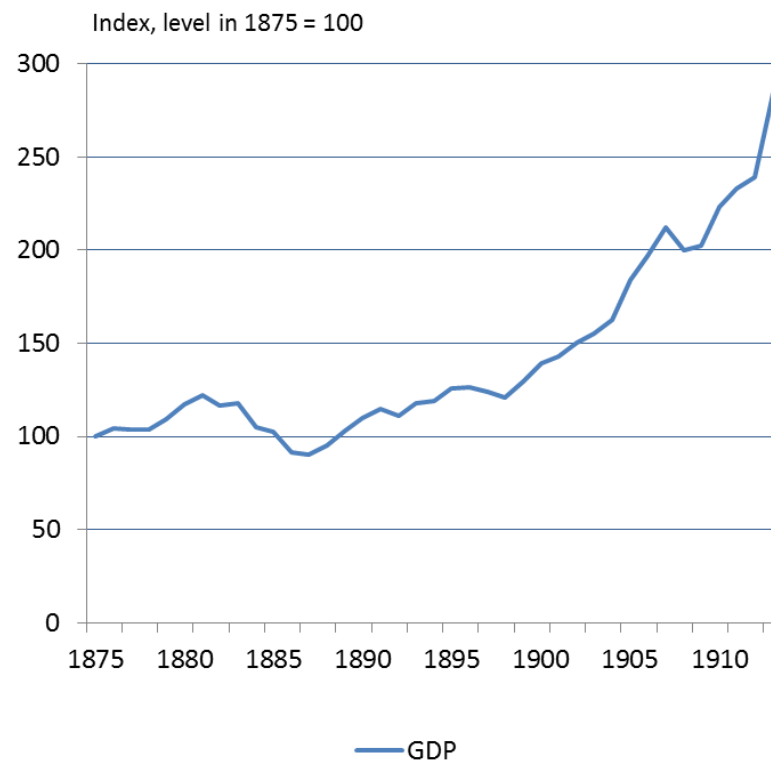
Hannes Hafstein, 1909

Progress towards the outbreak of WWI



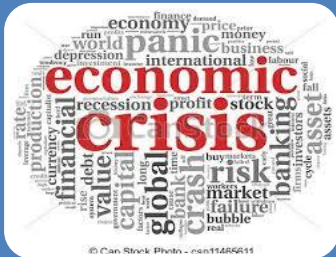
- By 1913, the modernisation of the Icelandic economy was progressing rapidly
 - Financial integration with Denmark and Norway, both through foreign equity and cross-border debt
 - (Mostly) gold-backed banknotes within the Nordic Monetary Union
 - Technological improvements within the fishing industry and beneficial terms of trade led to Iceland having one of the highest export ratios in Europe
 - Most of the manufacturing goods and approximately half of food consumption were imported
 - Living standards were rapidly (and finally) improving

Gross domestic demand 1875-1913



Source: Einarsson, B. G., K. Gunnlaugsson, T. T. Ólafsson, and T. G. Pétursson (2015). The long history of financial boom-bust cycles in Iceland - Part I: Financial Crises, *Central Bank of Iceland Working Paper*, forthcoming.

Sequence of crises in relation to WWI and the post-WWI global financial crisis*



Economic downturns and demand disasters

- GDP downturns: 1914-1918
- Domestic demand disasters: 1914-15, 1918, 1923-24



Inflation and currency crises

- Inflation crisis 1916-18
- “Sudden stop” currency crisis 1919-1920



Banking crisis

- Systemic banking crisis 1920-1921

* For definitions of different types of crises see Einarsson, B. G., K. Gunnlaugsson, T. T. Ólafsson, and T. G. Pétursson (2015). The long history of financial boom-bust cycles in Iceland - Part I: Financial Crises, Central Bank of Iceland Working Paper, forthcoming.

Twin currency and banking crisis in 1920s



- In our research paper we identify the period 1914-21 as one of six multiple crisis episodes over the period from 1875-2013
- Here, I want to focus on the twin currency and banking crisis, which was rampant in 1920-21
- Later on I will return to this episode in comparison with the two other systemic twin crises in the 1930s and the latest one in 2008

Twin currency and banking crisis in 1920s



External factors

Post-WWI recovery, recession and commodity price boom-bust

Post-WWI financial crisis, widespread in Scandinavia

Domestic factors

Large increase in money and inflation relative to main trading partners

Political disputes with regard to the banks

Effects

Credit and export price boom-bust, sudden stop of capital flows

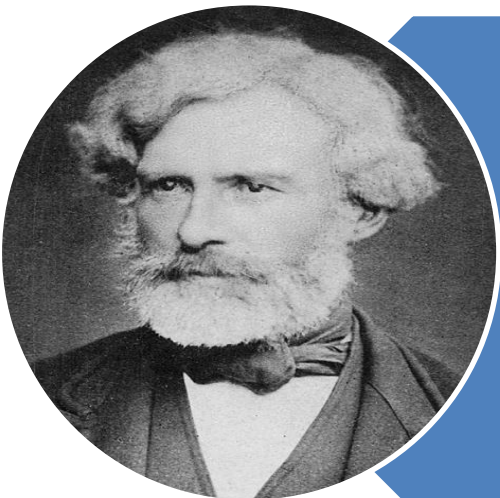
Unofficial FX market, banks' loss of FX funding and cross-border payment disruptions

Twin currency and banking crisis in 1920s



“The key issue is that Íslandsbanki ... does neither have Danish krónas or other “liquid” currency. This has resulted in Icelandic merchants not being able to make payments in Denmark ... The situation is now getting serious and something has to be done to open people’s eyes – The banks need foreign currency and cannot at this stage expect to have any credit.”

Interview with Luvig Kaber, director of Landsbanki in Mbl. 25.8. 1920



“Whatever absurd reasoning some may provide to feed common misconceptions, it can not be denied that too much money has been issued ... And what will it result in for the bank and the value of the Icelandic currency when the accumulated liabilities suddenly have to be sold in the money markets by the millions?”

Article by Eggert Briem in Mbl. 12.4 1921

Twin currency and banking crisis in 1920s



Suggested policy response

- Import restrictions and no official listing of the currency deviating from the Danish parity
- Increased bank note issuance by Landsbanki
- Íslandsbanki should over a few years redeem its notes and sell its metal reserves (at a discount) to Landsbanki
- Structure of bank note issuance to be resolved
- Government foreign financed equity injection into Íslandsbanki

Actual policy response

- The planned equity injection never took place
- The government took a large 30 year foreign loan (the English loan) and split it between the two banks and itself– Íslandsbanki also borrowed from Denmark
- Import restrictions were short-lived and the currency split was officially acknowledged in 1922
- The question of the structure of the banknote issuance, the currency framework and the banking system in general remained unresolved for years

Twin currency and banking crisis in 1920s



“[The actual exchange rate depreciation of the Icelandic currency] has taken place as foreigners, who held claims here that they could not receive, offered others to buy those claims abroad and when this became common, the banks became unwilling to sell foreign currency for Icelandic krónas, even though it existed, unless the exchange rate would deviate from parity. ... I think that we cannot completely escape from this exchange rate deviation until our finances with other countries is such .. that the value of our exports exceed the value of imports by far... ”

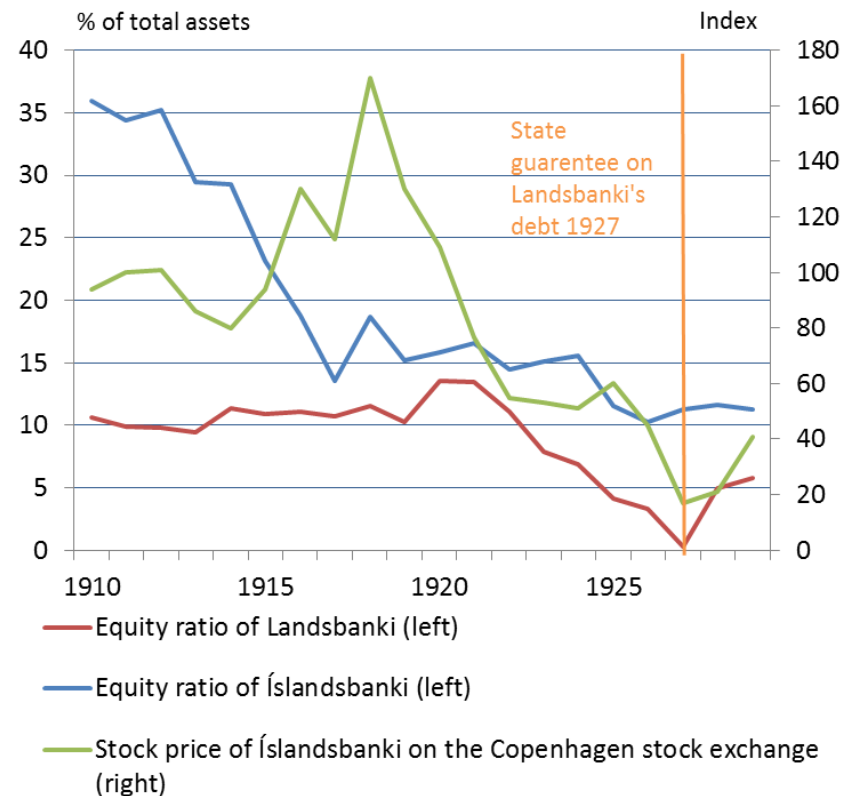
*Speech by Magnús Guðmundsson,
finance minister in Althingi 17.02 1922 (reprinted in Mbl. 19.2 1922)*

Banking and currency reform in 1920s



- Floating exchange rate 1922-25, then fixed against Sterling due to political disputes
- Íslandsbanki's gradual deleveraging and "dismantling"
 - Privatbanken resurrected in 1928
- Private sector distress – high real interest rates
- Landsbanki becomes a national bank in 1927 with state guarantee and central bank division

Bank equity ratios and Íslandsbanki's stock price developments 1910-1929¹



1. Stock prices as reported in Björnsson (1981), which are not annual averages for all the years.
Sources: Björnsson, Ó. (1981). *Saga Íslandsbanka hf og Útvegsbanka Íslands 1904-1980*. Reykjavík: Útvegsbanki Íslands.

Twin banking and currency crisis in 1930s



External factors

Great Depression, trade restrictions and price collapses

Banking failures and gold standard abolished

Domestic factors

Banking sector vulnerabilities but decreased fiscal debt

Political disputes with regard to the banks

Effects

Collapse of exports and domestic demand

Systemic banking crisis as Islandsbanki collapses

Twin banking and currency crisis in 1930s



- Íslandsbanki seeks assistance from Landsbanki in light of heavy debt repayments, but is declined – then limited assistance is provided by the bank and the government but it is insufficient and the bank closes in early February after Althingi fails to agree on further guarantees
 - Main foreign loans of Íslandsbanki reflect response to 1920s crisis: the English loan (guaranteed by the Icelandic government), loan from the Danish government, and Privatbanken in Denmark

Twin banking and currency crisis in 1930s



Issues heftily discussed

- To what extent the state should rescue the bank or whether it should be put into bankruptcy proceedings
- How the government's credit would evolve in case of different solution approaches
- How other domestic banks, firms and households would be affected by Íslandsbanki's failure
- To what extent the government should allow foreign creditors to get the bank's state guaranteed liabilities in a worst case scenario
- Currency denomination of some balance sheet items

Twin currency and banking crisis in 1930s



“The situation of Íslandsbanki is very seriously regarded in London and elsewhere owing to the constitution of its board. Credit of government and all Icelandic institutions are affected. Do most strongly urge you in interest to country’s credit to take strong measures immediately to reopen bank and reassure foreign creditors.”

Eric Hambro, chairman of Hambrosbank, a major foreign creditor in early February 1930 (Here taken from Mbl. 16.2. 1930)



“I pointed out the risk to Iceland’s credit from Íslandsbanki’s failure already in the beginning of Althingi’s night session on 3 February. The finance minister claimed to totally disagree and believed that our status and credit would improve. ... There is considerable risk that [the failure of Íslandsbanki] would overburden Landsbanki.

Speech by Jón Thorláksson in Althingi 15.2. 1930 (reprinted in Mbl. 16.2. 1930)

Twin banking and currency crisis in 1930s

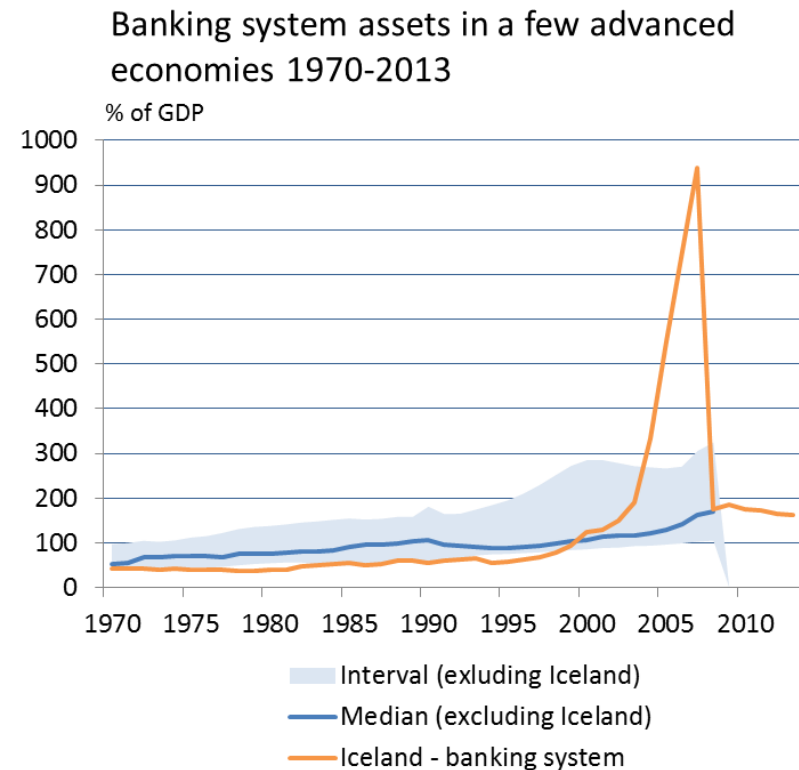


- After a few months negotiations, Íslandsbanki was resurrected as Útvegsbanki
 - Foreign creditors and the government swapped some of their debt claims into equity
 - Widespread current account and capital flow restrictions were introduced and subsequently made more stringent
 - The banking system became fully state controlled
 - The currency was not depreciated against Sterling until 1939 but then WWII broke out and the economy recovered and grew with leaps and bounds

From an enduring state-controlled system to a liberalised and integrated system



- The state-controlled financial system within capital controls was by and large kept in place until the 1990s
- Then Iceland, again liberalised its financial markets and institutions and integrated with global financial markets
- Over a course of just a few years, the newly privatised banks converted from local, typically-sized and relatively dormant entities into large, complex, intertwined, risk-seeking, cross-border financial institutions that rode the wave of abundant international liquidity



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Twin banking and currency crisis in 2008



External factors

Great Recession

Systemic financial crises in several countries

Domestic factors

Sizeable banking sector vulnerabilities but decreased fiscal debt

Macroeconomic imbalances

Effects

Collapse of imports and domestic demand, offshore FX market

Systemic banking and currency crisis of exceptional magnitude

Twin banking and currency crisis in 2008



Issues heftily discussed

- To what extent the state should rescue the bank or whether it should be put into bankruptcy proceedings
- How the government's credit and would evolve in case of different solution approaches
- How other domestic banks, firms and households would be affected by Glitnir's failure
- Foreign creditors' role in bank resurrection, Icesave and currency denomination of some balance sheet items
- Role of capital controls and banking reforms

Hence, the conclusion ...



“There is nothing new except what
is forgotten”