Too big to save

Iceland's banking collapse, capital controls and the long way back, 2008-2017

Country decision study | MacroLens Research | Independent desk research - not peer reviewed - not investment advice

ABSTRACT

In one October week in 2008, Iceland's three largest banks - balance sheets near ten times GDP - collapsed, and the government chose not to bail them out. A rescue on that scale, the Bank for International Settlements later assessed, would itself have risked sovereign default. Instead Iceland split the banks into viable domestic institutions and foreign-creditor estates, guaranteed only its own depositors, let the krona lose half its value, imposed capital controls, and signed Western Europe's first IMF program since 1976. The cost was severe: a 13 percent contraction, unemployment near 9 percent, eight and a half years of controls. Then the recovery surprised everyone: growth from 2010, full employment by 2016, controls lifted in March 2017, foreign depositors repaid from bank assets, and 26 bankers sentenced to a combined 74 years. This case study examines what Iceland's refusal bought, and what a sovereign-defaulting Sri Lanka can conditionally use.

WHY THIS CASE FOR SRI LANKA

Sri Lanka's 2022 crisis was different in kind - sovereign, not banking - but the menu was the same: reserves of 7.6 billion dollars at end-2019 had fallen to 1.6 billion by end-2021, external debt service was suspended on 12 April 2022 and the sovereign bonds formally defaulted on 18 May 2022; the rupee lost about 40 percent in three months; an IMF program followed in March 2023. Iceland is a documented modern record of a small economy working through that menu - default-adjacent choices, an IMF program, capital controls, a collapsed currency - and emerging with institutions intact. Its record also separates what is often bundled: refusing a bailout did not mean refusing to pay; protecting depositors did not mean protecting banks; and capital controls were a bridge, not a wall.

THE STARTING POINT: A BANKING SYSTEM BIGGER THAN THE COUNTRY

Iceland's three big banks - Kaupthing, Landsbanki and Glitnir - grew from about 100 percent of GDP in 2004 to 923 percent by end-2007, fed by privatization, investment banking and the European Economic Area's single passport, which let them collect deposits across Europe. By 2008 their combined assets reached roughly ten times GDP, two-thirds of liabilities in foreign currency. The Central Bank of Iceland could not be lender of last resort in euros or pounds; a state bailout, the Bank for International Settlements' post-mortem notes, would have risked sovereign default. When Lehman Brothers failed on 15 September 2008 and wholesale funding froze, the banks had weeks to live.

The first attempt at rescue failed. On 29 September the government announced it would buy 75 percent of Glitnir for 600 million euros; the run accelerated instead, and by 3 October the whole system faced a bank run. On 8 October the central bank abandoned a two-day-old attempt to peg the krona at 131 per euro when no one would sell it foreign currency. The krona went on to lose about half its value against the euro, from around 90 in mid-2007 to around 185 by early 2009. On 8 October Britain, fearing for 300,000 Icesave depositors, froze Landsbanki's UK assets under anti-terrorism legislation - an act Iceland's prime minister called hostile, and one that doomed Kaupthing by freezing its British subsidiary.

THE DECISIONS: SPLIT, GUARANTEE, DEVALUE, RATION

The core decision came in the Emergency Act of 6 October 2008, passed overnight. It did three things: guaranteed domestic deposits in full, empowered the supervisor to seize failing banks, and - the quiet revolution - gave deposits priority over other claims. Over 7 to 9 October the supervisor took over Landsbanki, Glitnir and Kaupthing. Each was split: domestic deposits and loans went into new state-capitalized banks that opened for business within days; foreign assets and creditors stayed in the old estates to be wound down. Foreign bondholders and wholesale lenders were not made whole - losses estimated in the tens of billions of euros stayed where they had been made. On 24 October Iceland applied to the IMF; on 19 November the Board approved a 2.1 billion dollar Stand-By Arrangement, 1,190 percent of quota, covering 42 percent of the financing gap - the first IMF program in a Western European country since Britain in 1976. In November 2008, with IMF support, capital controls went on: residents and the offshore krona overhang - initially some 40 percent of GDP - were fenced in to stop the currency's free fall.

THE DECISION CHAIN: DATES

15 September 2008	Lehman Brothers fails; wholesale funding for Icelandic banks freezes
29 September 2008	Government announces 75 percent stake in Glitnir for 600 million euros; run accelerates; takeover follows within days
6 October 2008	Emergency Act: full domestic deposit guarantee, bank-resolution powers, depositor preference
7-9 October 2008	Landsbanki, Glitnir and Kaupthing seized and split into new domestic banks and creditor estates
8 October 2008	Krona peg abandoned; UK freezes Landsbanki assets under anti-terrorism law; Icesave dispute begins
24 October 2008	Iceland requests an IMF Stand-By Arrangement
19 November 2008	IMF approves 2.1 billion dollar SBA - 1,190 percent of quota, first Western European program since 1976
November 2008	Capital controls imposed with IMF support; offshore krona about 40 percent of GDP
6 March 2010	Icesave referendum: 98.1 percent vote no to a state guarantee of the repayment deal
9 April 2011	Second Icesave referendum: 59.8 percent no
August 2011	IMF program reviews completed
28 January 2013	EFTA Court rejects all claims that Iceland breached deposit-guarantee law
30 November 2013	Household debt-relief action plan announced: about 150 billion kronur (1.26 billion dollars) over four years
2015	GDP regains its pre-crisis level; 26 bankers eventually sentenced to a combined 74 years (by October 2015)
14 March 2017	Capital controls lifted; offshore krona worked down to about 4 percent of GDP

MEASURED OUTCOMES I: THE COST, THEN THE RECOVERY

The contraction was deep and fast: GDP fell 13 percent from the fourth quarter of 2007 to the first quarter of 2010, larger than in any other advanced economy; unemployment rose from 2.5 percent in the third quarter of 2008 to a peak of 9.1 percent in April 2009 - bad, but below the 10 percent the OECD projected; inflation spiked into double digits before slowing to 11.6 percent by May 2009; real wages fell 6.75 percent in the year to April 2009. Then the record turns. Growth resumed in 2010. GDP regained its pre-crisis level in 2015 - six years, protracted, but ahead of the eurozone periphery that could not devalue. Unemployment fell to 2.6 percent by the fourth quarter of 2016. Tourism and exports, repriced by the cheaper krona, boomed; the OECD's 2017 survey called Iceland its fastest-growing economy. The offshore krona was auctioned and negotiated down from 40 percent of GDP to about 4 percent, and on 14 March 2017 the capital controls were lifted - eight and a half years on, without the disorderly outflow they had been built to prevent. The IMF's own later case study treats Iceland as a lending success.

MEASURED OUTCOMES II: WHO PAID

The crisis's signature outcome is distributional. Foreign creditors bore the banks' losses: the estates of the old banks, not the treasury, worked through the claims. The Icesave dispute tested the principle twice. Asked to guarantee repayment of British and Dutch advances, Icelanders voted no by 98.1 percent in March 2010 and by 59.8 percent in April 2011; in January 2013 the EFTA Court vindicated them, ruling that deposit-guarantee law did not oblige the state to pay. Yet the depositors were paid: Landsbanki's estate - whose assets exceeded its priority claims - had already covered over 90 percent of the British and Dutch advance by early 2013, from the bank's own remains. Refusing the guarantee did not mean refusing the debt; it meant the loss fell on the bank's estate rather than the taxpayer. Households got their own reckoning: after court rulings struck down foreign-exchange-indexed loans, the government announced a 150 billion kronur debt-relief plan in November 2013. And accountability was personal: the Special Prosecutor's cases eventually produced 26 sentenced bankers and financiers with combined prison terms of 74 years by October 2015 - a documented record of individual accountability.

The contrast case ran in parallel. Ireland, the same week, guaranteed its banks' liabilities - about 375 billion euros, 200 percent of GDP; the European Commission's post-programme evaluation, quoted in Ireland's banking inquiry, judged that this 'turned the banking crisis into a sovereign debt crisis' - and by November 2010 Ireland was in a 67.5 billion euro EU-IMF program with unemployment headed to 15 percent. Iceland's refusal was not principled bravery: with banks at ten times GDP, a guarantee was simply not available. Ireland's tragedy is what attempting it anyway looked like.

TRANSFER LIMITS: WHAT ICELAND DOES NOT PROVE

First, Iceland's crisis was private debt; Sri Lanka's is sovereign. Iceland could let banks fail because the state's own books were sound - public debt was modest before 2008 - while Sri Lanka's problem was the state's books themselves, so no equivalent "let it fail" exists. Second, the losses were largely exportable: most of the creditors were foreign, which spread the pain outside the voting public; a country whose debt is held domestically has no such release valve. Third, Iceland had a currency to devalue and export sectors - fish, energy, tourism - able to respond to it; devaluation works through tradables, and import-dependent fuel and medicine economies feel the other edge first. Fourth, scale and cohesion mattered: 320,000 people, strong pre-crisis institutions, and functioning courts made depositor preference, estate wind-downs and prosecutions administrable. Fifth, this record's sources are official - the IMF, the BIS, the OECD, Statistics Iceland, the EFTA Court, the Irish parliamentary inquiry - which measure well but were also parties to the program they assess; every figure here is dated and attributed for that reason.

CONDITIONAL LESSONS FOR SRI LANKA

These are design observations, not prescriptions.

1. Match the rescue to the size of the balance sheet. Iceland could not save banks at ten times GDP and said so in a week; Ireland tried at two times GDP and ceded control of budget policy to EU-IMF program conditionality for three years. Sri Lanka's version of the arithmetic ran through its reserves - 7.6 billion dollars in 2019 to 1.6 billion in 2021 - and the same rule held: a guarantee the state cannot honour is not a guarantee, just a larger default.

2. Separate "refusing to guarantee" from "refusing to pay". Iceland rejected the state guarantee twice by referendum and still saw Icesave depositors repaid over 90 percent - from the failed bank's own assets. In restructuring, the fight is over whose balance sheet absorbs the loss, not over whether losses exist.

3. Controls are a bridge, not a wall. Iceland's controls lasted eight and a half years and exited through auctions and negotiated reductions - 40 percent of GDP down to 4 - not through repeal. Sri Lanka's import and FX restrictions of 2020-2022 bought the same kind of time; their exit path matters as much as their imposition.

4. Protect the payments function, not the institutions. Iceland's new banks opened within days because domestic deposits and loans were carved out whole. The instinct to save named banks rather than banking services is the expensive one.

5. Accountability is macroeconomic policy. Twenty-six banker convictions did not recapitalize anything; they established, in open court, who was responsible. Adjustment programs tend to fail politically before they fail arithmetically; visible fairness is part of the financing.

Iceland did not find a painless path - 13 percent of output and eight and a half years of controls is not painless. It found a path where the pain had an assignment: creditors first, currency second, the state last. That ordering, more than any single instrument, is what Sri Lanka can study.

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