

COMMENTS ON THE LONG HISTORY OF FINANCIAL BOOM- BUST CYCLES IN ICELAND

BY

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COMMENTS BY DELANO S. VILLANUEVA


- This paper is carefully written and well researched, and I highly commend the four authors.
- I see three main issues.

COMMENTS


I. There's room for the study to relate the statistical results and materials on p. 27, Table 12, and elsewhere in the paper to Iceland's economic and financial development.

- The paper will be helped by relating the story of the financial cycles with reference to the following key financial events and characteristics:**
- ✓ The expansion phase, peaking in 1908, in the context of the exuberance following Home Rule granted to Iceland by Denmark in 1904.**
- ✓ The 1930 bank crash which, while home-made, coincided with the onset of the Great Depression.**
- ✓ The 1939 separation of the Icelandic króna from the Danish krone (since that year, the ISK has lost 95.95% of its value vis-s-vis the DKK!).**

COMMENTS

- ✓ **The long financial cycle of 1969-1983 may be viewed in the context of the inflation binge of the 1970s and 1980s.**
 - ✓ **There were huge write-offs of bank loans around 1990 when Iceland had a banking crisis just as large in terms of write-offs as in Finland, Norway, and Sweden.**
 - ✓ **The 1990 banking crisis was paid for by a large spread between lending and deposit rates---a permanent fixture of Icelandic banking from the outset due to a complete lack of foreign competition.**
 - ✓ **Since 1930, Iceland is the only country in Europe disallowing foreign banks to offer competition to Icelandic banks in Iceland, which explains the large interest spread through which the banks continue to benefit from Icelandic customers.**
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COMMENTS

- ✓ **The financial cycle of 1995-2006 may be viewed in the context of Iceland's entry into the European Economic Area in 1994, involving full capital account liberalization followed by the botched privatizations of the banks in 1998-2003.**
 - ✓ **“Botched” in the sense that banks were taken over by politically connected individuals who took only a few years to run them into the ground.**
 - ✓ **The crash of 2008, by some measures the largest such crash on record (Laeven and Valencia (2012), “Systemic Banking Crises Data Base: An Update,” IMF Working Paper WP/12/163).**
 - ✓ **In sum, Iceland's past failure in monetary and financial management should be acknowledged (whether academically or officially) in the country's monetary and financial history, which has been the same story in many financially repressed economies.**
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COMMENTS

II. The second issue relates to the comparisons of the lengths of cycles across variables and periods without any reference to statistical significance.

- **It would strengthen the paper if differences and correlations presented in several of the tables starting with Tables 3 and 4 are statistically significant and which are not.**
- **This is straightforward to do with correlations, but a bit more involved vis-a-vis differences; at least in principle, it can be done by statistical testing.**
- **A smaller point involves the comparison of US and Icelandic cycles in Section 5.**
- ✓ **Iceland's trade over the past few decades has been overwhelmingly with Europe rather than the US; using the US as a foreign reference at the present time is no longer as obvious a thing to do as it used to be.**
- ✓ **For example, Icelandic banks' main foreign creditors last time those banks failed were European banks, mostly German, rather than American banks.**

COMMENTS

III. The third and final issue concerns implications for deleveraging and monetary policy.

- **In general, household and corporate debt restructurings are critical steps in addressing financial crises—combination of debt forgiveness, maturity lengthening, and low interest rates that results in lower, affordable monthly amortization and interest payments. In the U.S., only the big multinational corporations (both financial and non-financial), not household mortgage debtors, were given cash infusions by the government (through share purchase).**
 - **The bankruptcy procedures, even when mortgage lenders were legally found to have engaged in predatory lending, were too slow and cumbersome to make a dent on household deleveraging.**
 - **Final objective should be that household and corporate debt levels be set at sustainable levels, so that economic growth can recover at sustainable rates.**
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COMMENTS

- **The monetary policy issue relates to Iceland's inflation targeting (IT) framework, introduced around the same time (2001) as in the Philippines.**
- ✓ **The authors make key references to the influential papers by Claudio Borio et al. (2014) *The financial cycle and macroeconomics: What have we learnt?* Journal of Banking & Finance, 45, and (2016) *Monetary policy, the financial cycle and ultralow interest rates*, Bank of Finland Research Discussion Paper, 24/2016.**
- ✓ **The Borio et al. (2016) paper argues for the augmentation of the IT policy interest rate rule to include financial stability (however measured, e.g., bank credit growth, house price inflation, term/yield spread) as a third argument besides the output gap and deviation of inflation from target.**
- ✓ **This is problematic and unsettled both in theory and empirics. In practice, no modern central bank, with the exception of Riksbank, has implemented an augmented IT interest rate rule that includes financial stability as an argument.**

COMMENTS

- ✓ In Sweden (Svensson, 2010, official dissenting statement following Riksbank board meeting on November 24, *Some problems with Swedish monetary policy and possible solutions*, Riksbank), in order to counter household leveraging, Riksbank raised policy rates at a time of inflation below target and unemployment above NAIRU (Case VII, Table 1, Villanueva 2015, *Challenges for Inflation Targeting*, SEACEN Centre, WP 10/2015).
- ✓ Riksbank DG Svensson contends that in the case of Sweden, research indicates that higher interest rates to dampen house prices and household indebtedness have had small effects, but had sizable effects on production, jobs, and unemployment.
- ✓ Svensson argues that direct macro- and micro-prudential measures, such as lower LTV ratios, are much more efficient and effective.

COMMENTS

- ✓ In Villanueva (2008), Ch. 1, *Strategies for Financial Reforms, Macroeconomic Policies for Stable Growth* (World Scientific), pp. 11-12, I argue that in an unstable macroeconomic environment, such as occurred in the 2008-09 financial crisis, the problem of moral hazard intensifies when macro- or micro-prudential supervision is either weak or not effectively utilized.
- ✓ In these circumstances, banks have an incentive to provide risky loans at higher interest rates (Stiglitz and Weiss 1981, *Credit rationing in markets with imperfect information*, *American Economic Review*, 71, pp. 393-410). Household leveraging continues unabated when interest rates are raised. Only direct action on lowering LTVs dampens leveraging.

COMMENTS

- ✓ I have argued in Villanueva (2015) that in the 2008-09 financial crisis, the US failed because of the lack of a coordinated and the presence of a diffused financial regulatory infrastructure, while neighboring Canada successfully weathered the storm because of a mono-regulatory framework that was strong, nimble, and effective.
 - ✓ To minimize the probability of recurrence of the 2008 -09 financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act became law in 2010.
 - ✓ Better to have a strengthened and coordinated financial regulatory structure in place to promote sound balance sheets, and a Consumer Financial Protection Bureau to prevent predatory lending and promote transparency in financial disclosures.
 - ✓ This concludes my comments. Thank you.
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