After the Crash: How Iceland Recovered from a Banking Collapse

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Abstract

The collapse of Iceland's banking system in 2008 was one of the defining events of the global financial crisis. In the years before the crash, the country's banks expanded at an extraordinary pace. Easy access to international borrowing, together with limited oversight, allowed the banking sector to grow to several times the size of Iceland's economy. When global credit markets froze, the three largest banks failed within days. The króna lost much of its value, inflation surged, economic activity fell sharply, and unemployment increased. Iceland responded differently from many other countries. Instead of rescuing the failed banks, the government protected domestic deposits and ensured that basic banking services continued to operate. New banks were created from the domestic operations of the failed institutions, capital controls were introduced to stabilise the economy, and financial regulation was strengthened. Fiscal tightening followed later, after the immediate crisis had passed. Recovery was neither immediate nor effortless, but it proved remarkably resilient. A weaker currency boosted exports, tourism expanded rapidly, and debt restructuring reduced financial pressure on many households and firms. Within a few years, economic growth had resumed, unemployment had fallen, and the banking system had become more stable and less vulnerable to external shocks. The Icelandic experience shows that there is no single blueprint for dealing with a banking crisis. For small open economies in particular, it demonstrates how policy choices can shape both the speed of recovery and the long-term resilience of the financial system.

Keywords: Iceland; banking crisis; economic recovery; financial stability; capital controls.