

Banks Fail, Economies Adjust: Iceland's Unconventional Path to Recovery

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Abstract

Iceland experienced one of the deepest banking crises of the global financial crisis. Before 2008, its banks grew very quickly. They relied heavily on foreign borrowing and weak regulation. Bank assets became several times larger than the country's GDP. When international funding stopped, the three largest banks failed within days. The Icelandic króna lost much of its value. Inflation increased. The economy went into recession and unemployment rose. Iceland chose a different path from many other countries. It did not bail out the failed banks. Instead, it protected domestic deposits and kept essential banking services running. New banks were created from the failed institutions. Capital controls were introduced to stabilise the currency. Financial regulation was strengthened. Fiscal consolidation came later, once the economy had started to recover. Recovery was gradual but steady. A weaker currency helped exports. Tourism grew rapidly and became an important source of foreign income. Debt restructuring reduced the burden on many households and firms. Over time, the financial system became more stable and less exposed to external shocks. The Icelandic experience shows that there is more than one way to respond to a banking crisis. It also highlights the challenges faced by small open economies in global financial markets. The lessons remain relevant for policymakers and researchers today.

Keywords: Iceland; banking crisis; economic recovery; capital controls