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The Icelandic Banking Crisis and What to Do about it: the Lender of Last Resort Theory of Optimal Currency Areas

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Summary

“Iceland has, in a very short period of time, created an internationally active banking sector that is vast relative to the size of its very small economy. Iceland also has its own currency. This chapter argues that this ‘business model’ for Iceland is not viable. With most of the banking system’s assets and liabilities denominated in foreign currency, and with a large amount of short-maturity foreign currency liabilities, Iceland needs a foreign currency lender of last resort and market maker of last resort to prevent funding illiquidity or market illiquidity from bringing down the banking system.
Iceland therefore has two options. First, it can join the EU and the EMU, making the Eurosystem the lender of last resort and market maker of last resort. In this case it can keep its international banking activities domiciled in Iceland. Second, it keeps its own currency. In that case it should relocate its foreign currency banking activities to the euro area.”