Icelandic households suffered severe financial shocks in the prelude to and aftermath of the banking and currency crisis. The króna depreciated by more than half from its peak in mid-2007 to its trough shortly after the collapse of the domestic banking system. Prices skyrocketed thereafter, and inflation soared to a high of 18.6% in January 2009. All of this hit Icelandic households especially hard, not least because they had accumulated substantial debt during the pre-crisis period (see Section III). The rise in inflation- and exchange rate-linked debt, the plunge in real house prices by about a third, and the collapse of money market funds and the stock market severely damaged many households' balance sheets. Moreover, nominal wages did not rise in tandem with prices, and unemployment increased from 1% in 2007 to over 9% early in 2010. As a result, households' solvency and debt sustainability problems were greatly exacerbated, and household demand contracted sharply.[1] The contraction in private consumption measured nearly 8% in 2008 and about 15% in 2009, and private consumption as a share of GDP fell to about 51%, some 6½ percentage points below its 30-year average.[2] Private consumption has gradually recovered since mid-2010, although it is still somewhat below the long-term average as a share of GDP.

It is clear that the contraction in private consumption could have been even more severe and the crisis even deeper if various supportive measures had not been undertaken. Many neighbouring countries stepped up public spending and cut taxes. In Iceland, however, the steep rise in public sector debt following the crisis placed strict limitations on the authorities' scope to take such action. A number of measures were adopted by the Government and other parties, however, with the aim of supporting household demand. The measures included expanded entitlement to unemployment benefits, the Government-sponsored "Back to Work" initiative and the third-pillar pension savings withdrawals. Offsetting this, however, were cutbacks in payments from the Maternity/Paternity leave Fund and the social security system, as well as a reduction in child benefits in 2010 and 2011. The reduction in child benefits will expire this year.

Third-pillar pension savings withdrawals

One of the most important post-crisis measures did not strain public sector finances but actually generated fiscal revenues: the temporary authorisation for withdrawal of third-pillar pension savings. Under this measure, households with supplementary pension savings were authorised to withdraw a portion of those funds, subject to a specified maximum, thereby enabling them to respond to the economic shocks accompanying the crisis.[3]

By end-March, nearly 66,000 individuals had applied to withdraw 84.5 b.kr. of their third-pillar pension savings. The authorisation for such applications expires on 1 January 2014, although pay-

1. See, for example, Thorvardur Tjörvi Ólafsson and Karen Áslaug Vignisdóttir (2012), "Households' position in the financial crisis in Iceland", Central Bank of Iceland *Working Paper*, no. 59, June 2012.
2. The Central Bank forecasts published before the financial crisis materialised assumed that domestic consumption was markedly above the level that was sustainable in the long term and that some sort of adjustment in consumption spending was inevitable. The crisis expedited and exacerbated that adjustment.
3. A large portion of Icelandic households' savings is invested in pension funds and housing and is therefore inaccessible at short notice if households should suffer temporary shocks. Because a significant share of households had limited access to financial markets and their assets lost collateral value in the wake of the crisis, they had difficulty responding to a temporary reduction in income by borrowing money in order to smooth their consumption spending, even though their expected permanent income had been reduced very little. Without access to such savings, even though it was their own, households would probably have had to curtail private consumption even further.

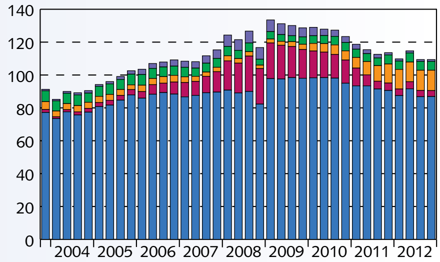
Box IV-1

Payments to households in the wake of the financial crisis

Chart 1

Household debt as a share of GDP

Q4/2003 - Q4/2012

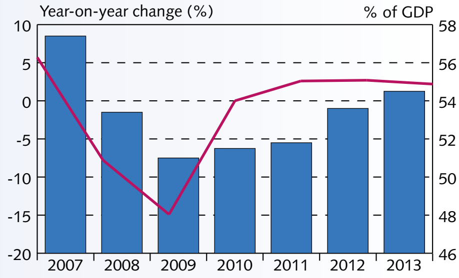


CPI-indexed loans
Exchange rate-linked loans
Non-indexed loans
Overdraft loans
Asset financing agreements

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2

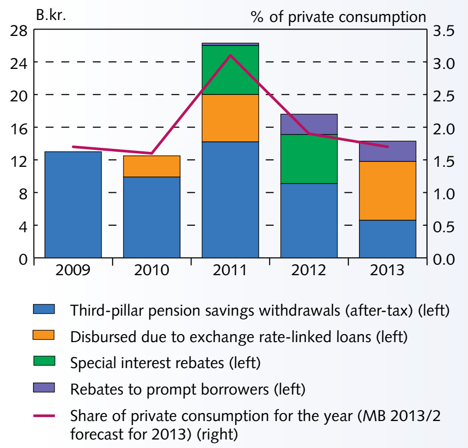
Pre- and post-crisis developments in private consumption[1]



Private consumption (% of GDP, right)
Private consumption (percentage change from previous year, left)

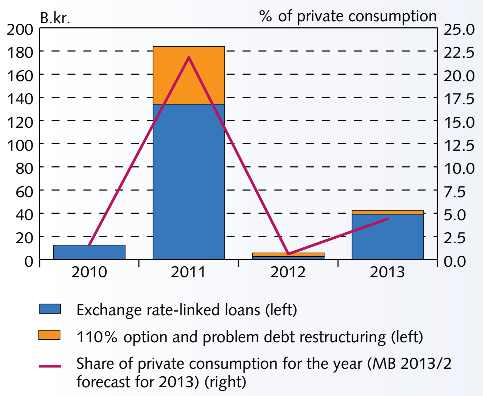
1. Central Bank of Iceland forecast for 2013.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 3
Special post-crisis disbursements to households



Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4
Post-crisis write-downs of household debt



Sources: Icelandic Financial Services Association, Statistics Iceland, Central Bank of Iceland.

ments will be remitted for up to 15 months thereafter. From 2009 through end-2012, pension savings withdrawals totalled 46 b.kr. after taxes, or an average of 2% of private consumption per year. Although the pace of withdrawals has slowed down, payments are still substantial, totalling an estimated 4.6 b.kr. after taxes this year. Third-pillar pension savings withdrawals therefore generated some 51 b.kr. after taxes during the period 2009-2013, the equivalent of 5.2% of estimated year-2013 private consumption, or almost 3% of GDP.[4]

Other special payments to households

Furthermore, households have received special interest rebates in the amount of 12 b.kr.[5] They have also been reimbursed for overpaid interest and instalments on exchange rate-linked loans, with payments totalling an estimated 15.6 b.kr., including this year's reimbursements. Commercial bank customers whose mortgage payments are up to date have received roughly 5.3 b.kr. in interest rebates, including this year's payments. These payments amount to a total of 32.9 b.kr., the equivalent of just over 3% of estimated year-2013 private consumption, or nearly 2% of GDP. Including post tax third-pillar pension savings withdrawals, disbursements in accordance with these measures totalled 83.7 b.kr. during the period 2009-2013, the equivalent of nearly 9% of estimated year-2013 private consumption, or almost 5% of GDP.

Write-downs of household debt

It is estimated that the principal amount of exchange rate-linked loans that have been deemed illegal by court rulings will be written down by over 39 b.kr. this year.[6] This is in addition to the more than 149 b.kr. in write-downs in 2010-2012, as a result of court judgments on the illegality of numerous loans linked to foreign currencies, and a reduction of 56 b.kr. in debt in connection with the special problem debt restructuring programme and the so-called 110% option. Included in these figures is the recently concluded memorandum of understanding between the authorities and the Icelandic Pension Funds Association, which authorises borrowers with guarantor mortgages from pension funds to apply for debt reduction in accordance with the 110% option. The Treasury will reimburse the pension funds for the bulk of the expense involved. The write-downs could equal an estimated 3 b.kr. Since the crisis struck, household debt has been reduced by over 244 b.kr. as a result of these measures. This is equivalent to one-fourth of estimated year-2013 private consumption, or nearly 14% of GDP. Not included in these figures are the write-downs implemented by some credit institutions before official measures were introduced and exchange rate-linked loans deemed illegal.

4. It can be assumed that most of those who withdrew a portion of their third-pillar savings continued to make contributions to third-pillar funds, prompted by tax advantages and matching employer contributions. In spite of the authorisation for pension savings withdrawals, the total balance of households' third-pillar pension savings has continued to grow year by year and is now some 33% higher than at year-end 2008.
5. These are payments in addition to regular mortgage interest subsidies.
6. It is assumed that the legal uncertainty surrounding the recalculation of the loans will be eliminated by end-2013. It is possible that some write-downs and reimbursements of overpaid interest will be deferred until 2014.