



Central Bank of Iceland

From Crisis to Recovery: What are the Lessons of the Iceland Saga?

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Casgrain & Company, Economic Conference 2013, St. John's, Newfoundland

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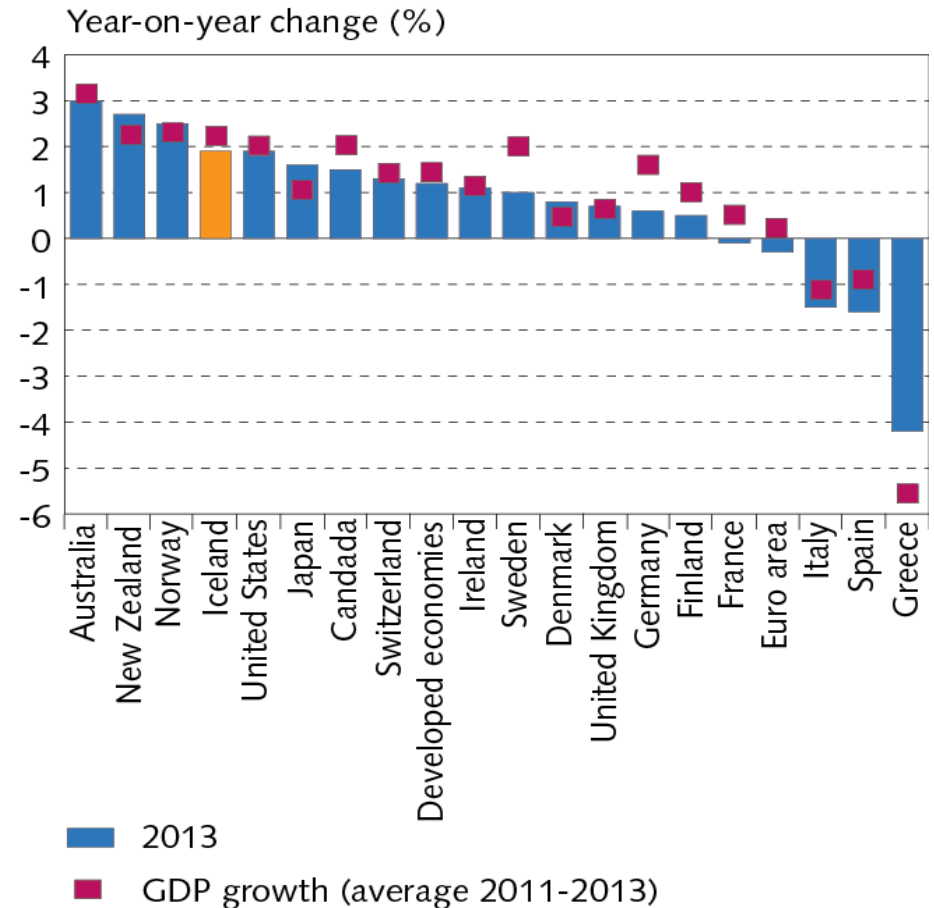
- Almost 90% of Iceland's banking sector failed in the first week of October
- At that point, Iceland was already on its way into recession after an unsustainable boom during 2005-2007
- Iceland was suffering from a currency crisis
- Many expected the sovereign to default on its obligations

Where are we now?



- No talk of sovereign default
- Primary surplus and an overall deficit around 1-2% of GDP in 2013
- Investment-grade ratings from all three major rating agencies
- Domestically oriented banking system rebuilt
- Economic recovery

GDP growth in developed countries



Sources: IMF, Statistics Iceland, Central Bank of Iceland.



The crisis and the policy response



The recent Iceland saga

Two separate but interrelated sub-stories:

1. Iceland's boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies.
2. The rise and fall of three cross-border banks operating on the basis of EU legislation (the European "passport").

The two converged in a tragic grand finale in early October 2008, when Iceland's three commercial banks failed and were placed in special resolution regimes.

Adjustment and three shocks

- Unusually large external and internal macroeconomic imbalances in 2005-2007.
- Their subsiding was bound to be associated with a significant slowdown, if not an outright recession (from 2006 onwards, the CBI consistently predicted a recession in 2009).
- Currency crisis in early 2008 (exchange rate fell by 26% in the first half).
- Collapse of the banking system in October 2008 (exchange rate fell by another 26% to year-end).
- Global contraction in Q4/2008 and the first half of 2009.

The policy response

- Emergency Act: intervention powers, deposit preference, authorisation for capital injections
- Statement that all deposits in Iceland were secure
- Failing banks placed in resolution regimes and domestic banks carved out (1.7 times GDP)
- IMF programme (USD 5.1 bn with bilateral loans) and three key goals: exchange rate stability, fiscal sustainability, and financial sector reconstruction
- Comprehensive capital controls a key element in the programme



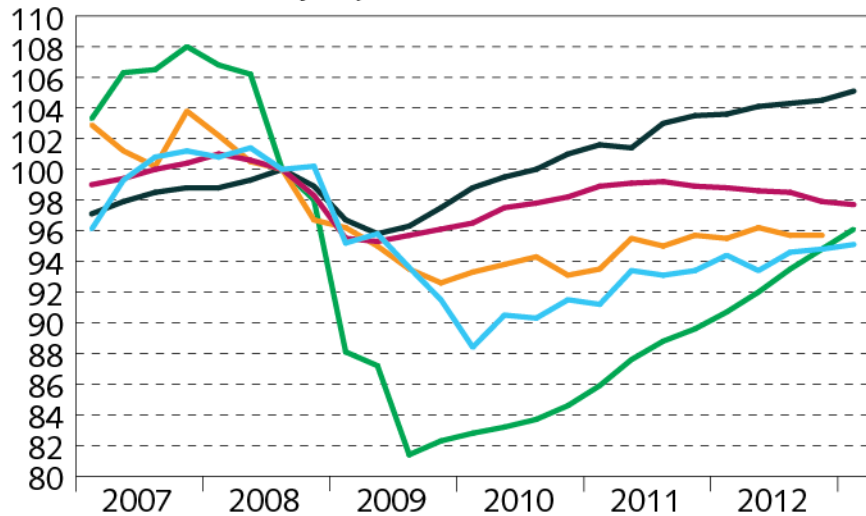
Recession and recovery

The recession was deep, but Iceland has not been the hardest hit



GDP level¹

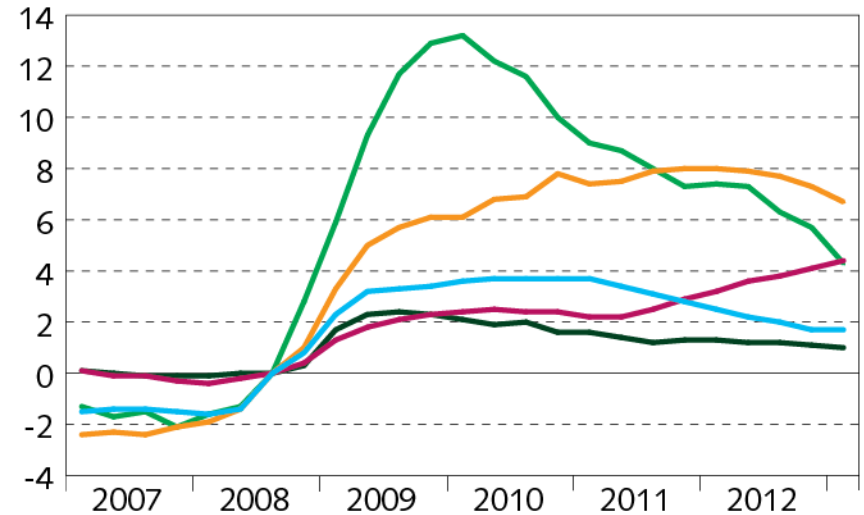
Index, (seasonally adjusted) Q3/2008 =100



- Iceland
- Euro area
- Ireland
- Latvia
- Canada

Unemployment rate¹

% of labour force (normalised at 0 in Q3/2008)



- Iceland
- Euro area
- Ireland
- Latvia
- Canada

1. GDP data for Iceland is seasonally adjusted by the Central Bank of Iceland.

Sources: Eurostat, OECD, Central Bank of Iceland.

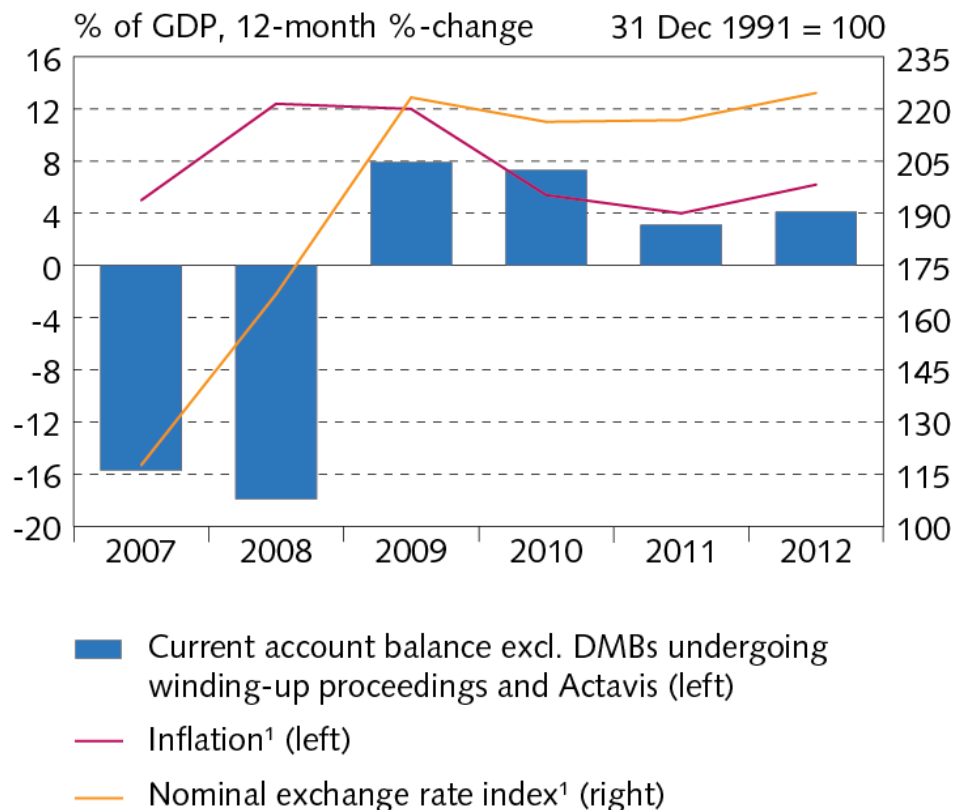
1. Seasonally adjusted harmonised unemployment rate, except for Latvia, as the series are seasonally adjusted by Eurostat.

Source: OECD.

Stabilisation

- Current account deficit of double digits prior to the crisis has swung into a significant underlying surplus
- Exchange rate stabilised in H2/2009 and rose in 2010
- Inflation and interest rates came down

Current account balance, inflation and nominal exchange rate 2007-2012



1. For the year 2012, the exchange rate and the inflation are shown as averages from 1 January - 15 June 2012.

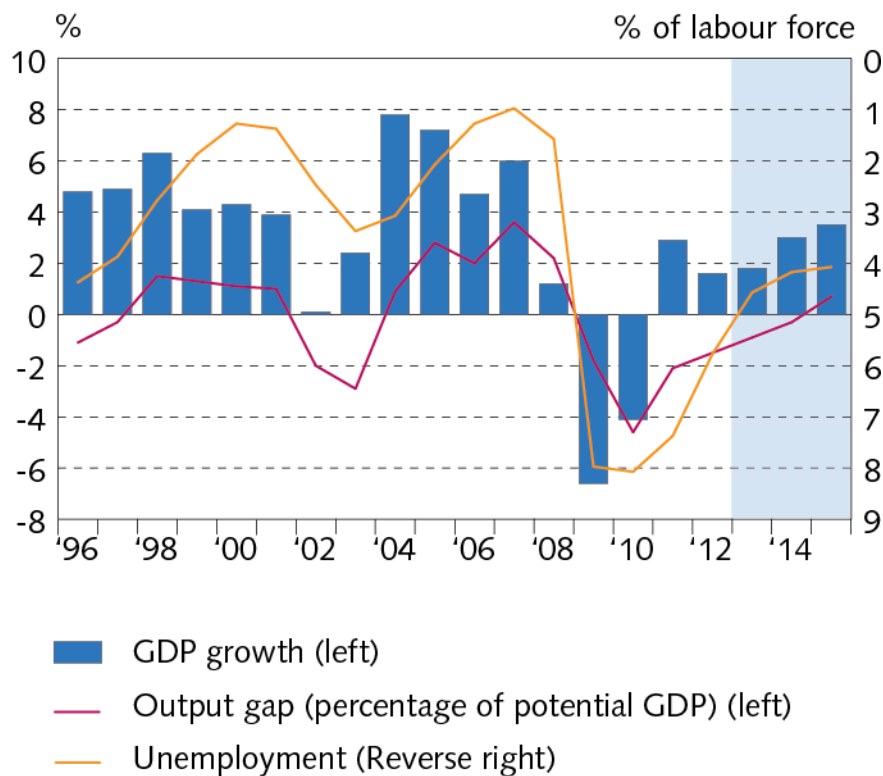
Sources: Statistics Iceland, Central Bank of Iceland.

Recovery



- Economy growing since Q2/2010
- Unemployment down from a peak of 9% to just under 5½%
- Slowdown in H1/2012 and beginning of 2013
- Faster growth predicted for 2014 and 2015 (3-3½% p.a.)

GDP growth, output gap and unemployment rate¹

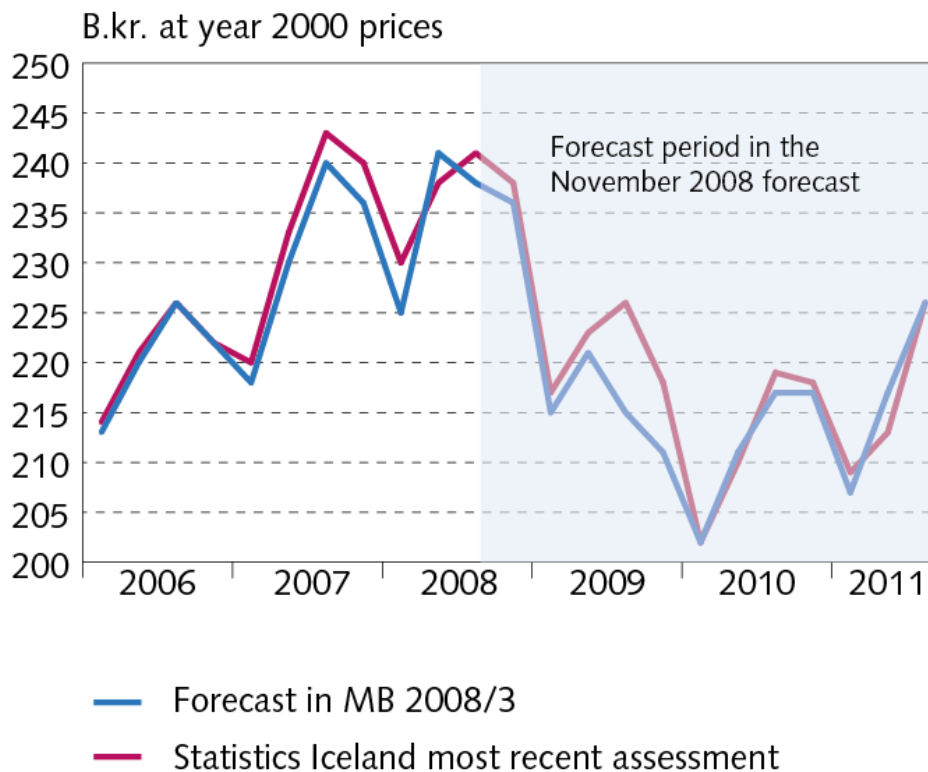


1. Central Bank baseline forecast 2013-2015.

Sources: Statistics Iceland, Central Bank of Iceland.

The pattern of recession and recovery was more or less as predicted by the Central Bank

Gross domestic product - comparison with forecast in *Monetary Bulletin 2008/3*

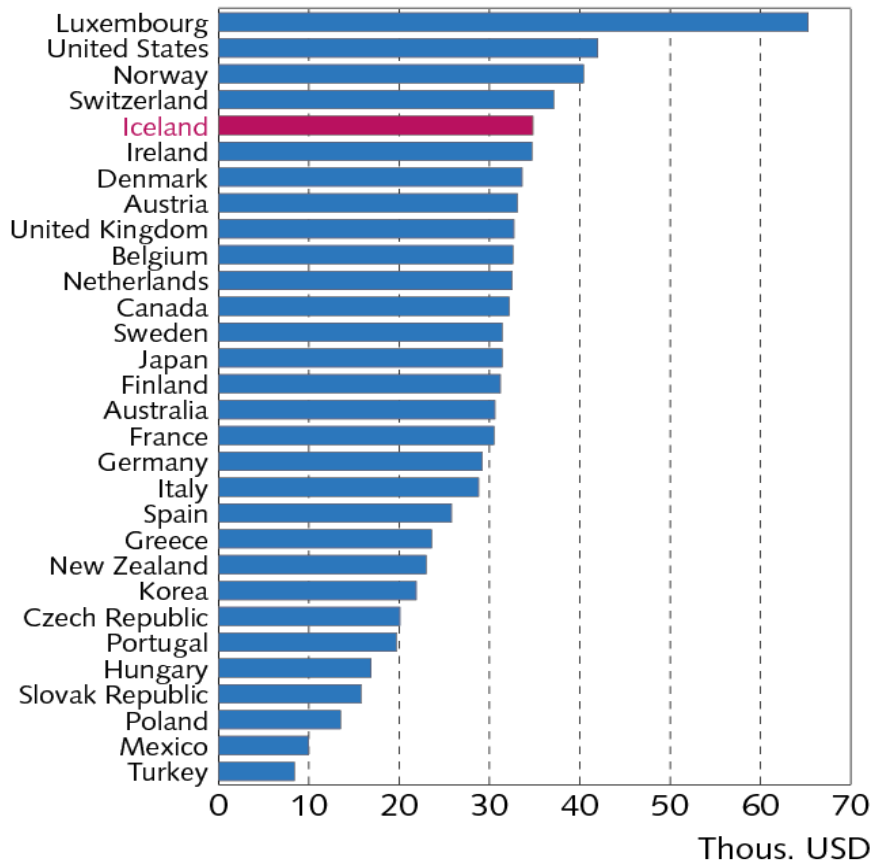


Sources: Statistics Iceland, Central Bank of Iceland.

Iceland has fallen down the League of Nations but is climbing back

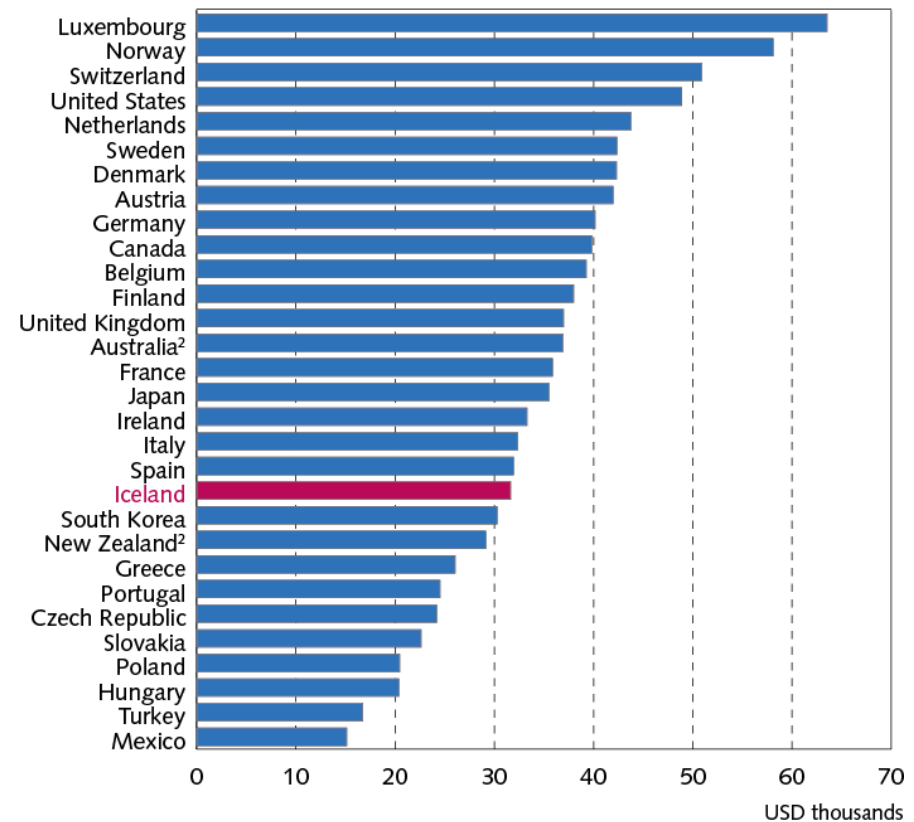


Gross national income per capita in OECD countries 2005¹



1. Based on PPP.
Source: World Bank.

Gross national income per capita in OECD countries 2011¹



1. Based on PPP. 2. Data are for 2010.
Source: Macrobond.



Some features of the “Icelandic model”

- Dealing with failing banks
- Preserving the credit of the sovereign
- Flexible exchange rate
- Capital controls

Ring-fencing the sovereign in the face of private bank failure



- Failure of three-cross border banks: combined bankruptcy the second-largest in history: assets in excess of 10x GDP, with around 2/3 of the balance sheet in foreign currencies.
- Guaranteeing the entire banking system would very likely have resulted in sovereign default.
- In the absence of international cooperation, forced downsizing through resolution and winding-up was the only option.

Allowing banks to collapse?



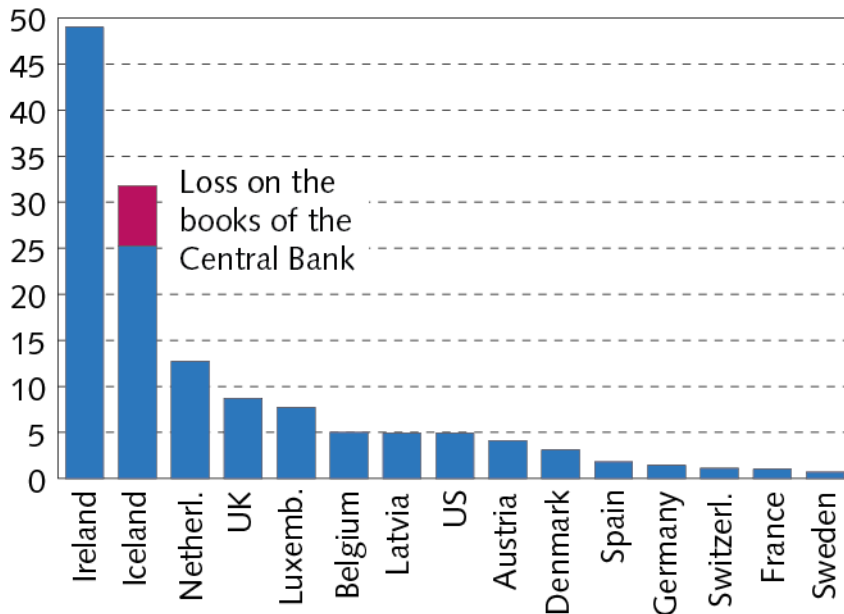
- Two key considerations:
 - To preserve the domestic payment system and common citizens' access to their deposits
 - To ring-fence the sovereign vis-à-vis the failing banks
- Iceland saved the domestic part of the banking system at significant cost
- The international part had to go into resolution
- Associated loss of asset values borne mainly by equity holders (mostly domestic) and foreign creditors (holding 90% of claims)

Crisis hit government finances hard



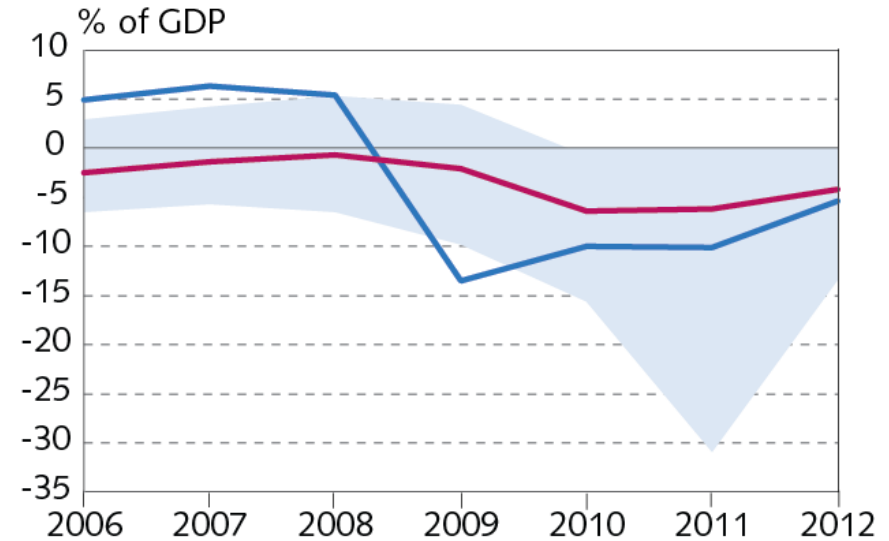
Direct fiscal costs of the financial crisis

% of 2009 nominal GDP (except 2010 nominal GDP for Iceland and Ireland)



Sources: Laeven and Valencia (2010), "Resolution of banking crises: The good, the bad, and the ugly", IMF Working Paper, no. 10/146, OECD (2011), except OECD Economic Surveys: Iceland, and The Icelandic National Audit Office (2012). Fiscal cost of recapitalizing financial and Government institutions following the financial crisis. Report to Parliament, for Iceland and Ireland.

General government net lending in Iceland and EMU-15 2006-2012



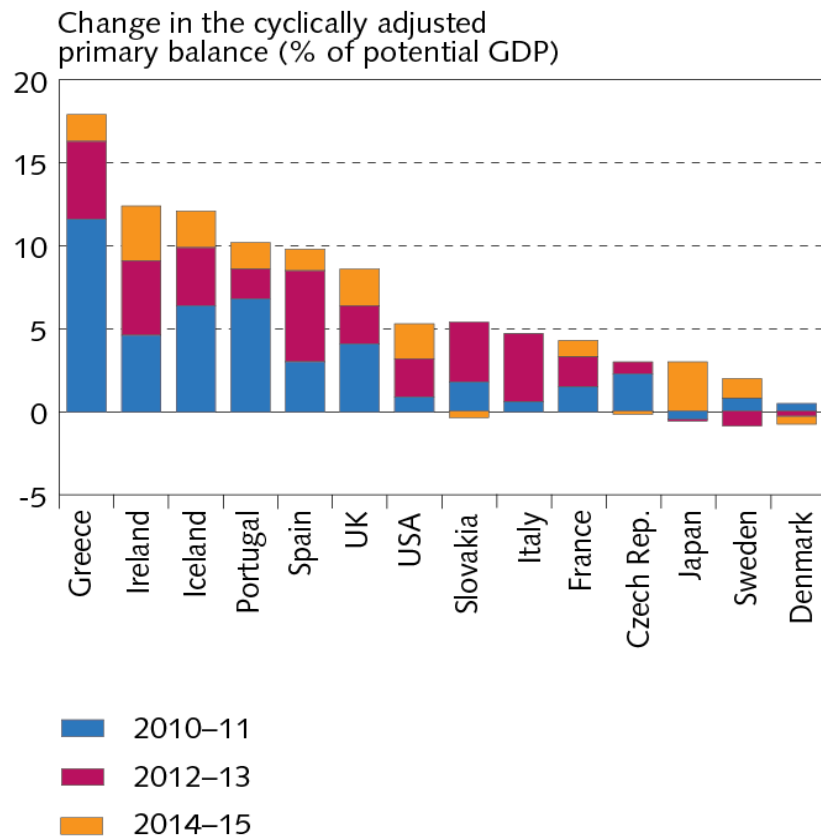
- High-low range of EMU-15 countries
- Iceland
- EMU-15

Sources: Eurostat, Statistics Iceland.

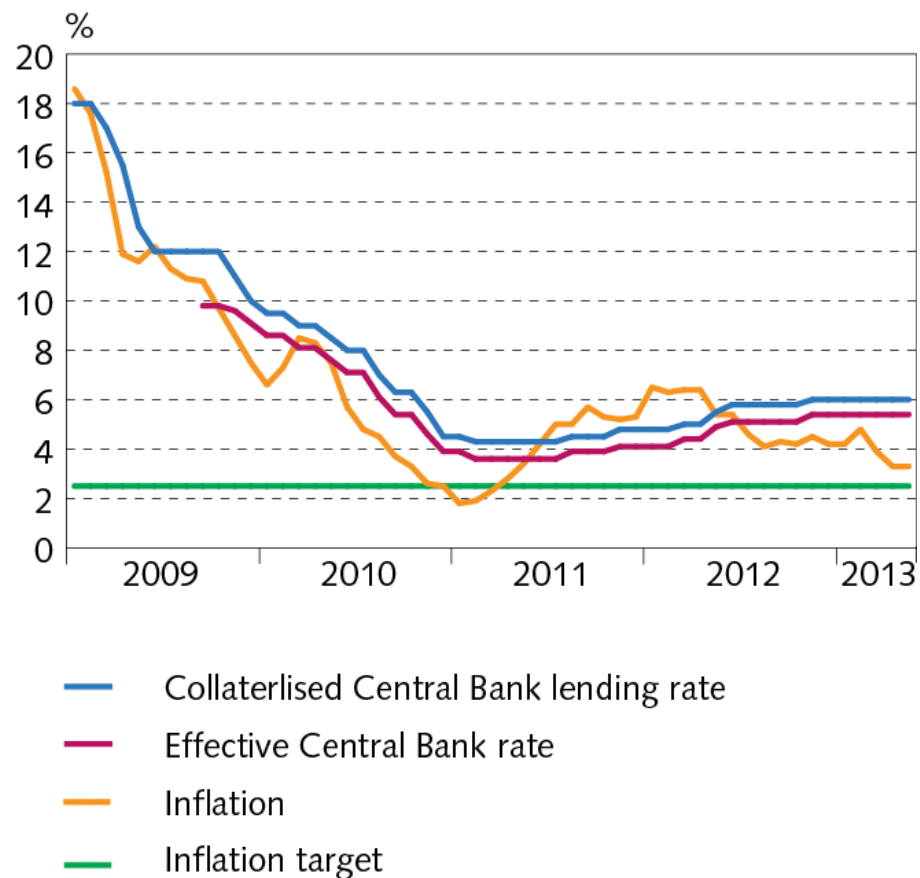
Fiscal consolidation with monetary support ...



International comparison of fiscal adjustment in advanced economies in the global crisis¹



Central Bank policy rate and inflation



1. Fiscal adjustment in 2010-11 refers to changes in the cyclically adjusted primary balance (CAPB) in 2011 compared to 2009; 2012-13 refers to the change in the CAPB in 2013 compared to 2011; and 2014-15 refers to the change in the CAPB in 2015 compared to 2013.

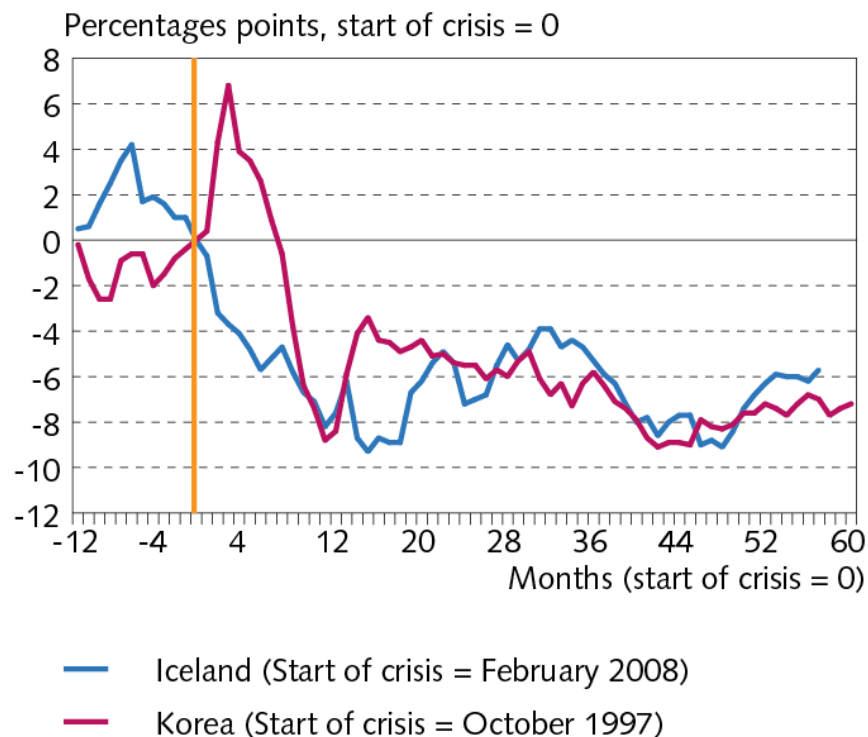
Source: IMF.

Source: Statistics Iceland, Central Bank of Iceland.

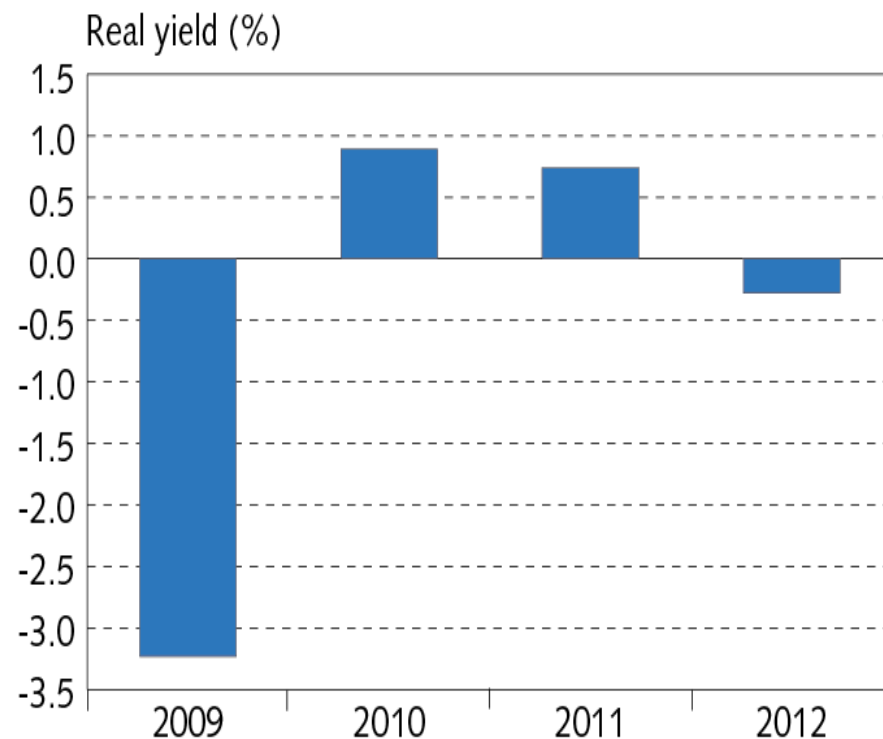
... and helped by capital controls



Real short-term interbank interest rates in two twin-crises - Iceland and Korea¹



Treasury's real interest rates on domestic issuances



1. The currency crisis in Korea is assumed to have started in October 1997 when pressures on the won started to escalate. The currency crisis in Iceland is assumed to have started in February 2008 when the foreign exchange swap market collapsed.

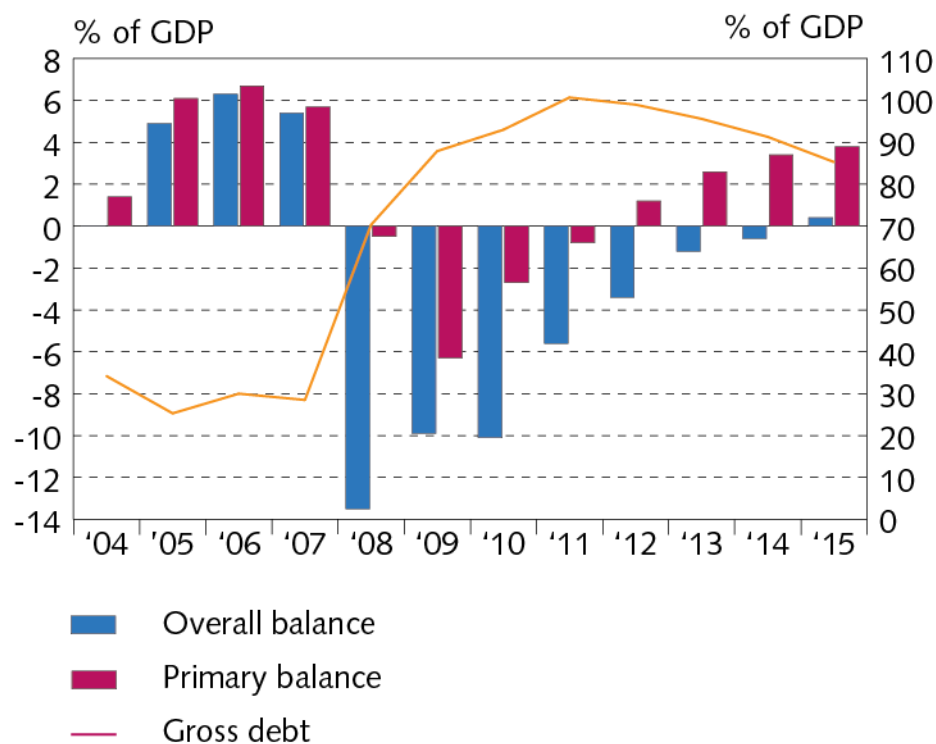
Sources: Macrobond, OECD.

Source: Central Bank of Iceland.

Fiscal consolidation has been successful so far



General Government
Gross debt, Overall and Primary balance
2004-2015



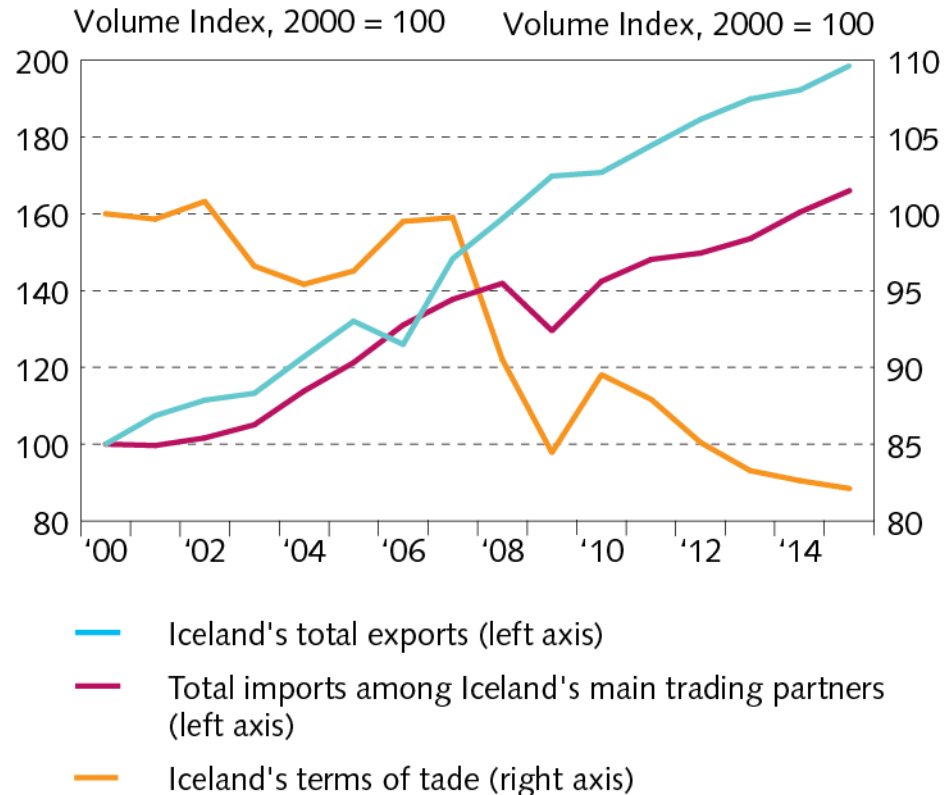
Sources: Statistics Iceland, Central Bank of Iceland.

Flexible exchange rate?



- Part of the problem and part of the solution!?
- Supply constraints in the export sector
- Private sector debt directly and indirectly connected to the exchange rate
- Disequilibrium between the traded and non-traded goods sectors

Export volumes and terms of trade



Source: OECD, Central Bank of Iceland.

Capital controls?



- Capital controls were helpful in stabilising the economy and supporting recovery
- But microeconomic costs accumulate over time ...
- ... and capital controls might be more difficult to introduce and manage in larger, more complex, and more connected economies, and the costs will be higher
- Lifting them has also proved challenging
- The jury is still out!

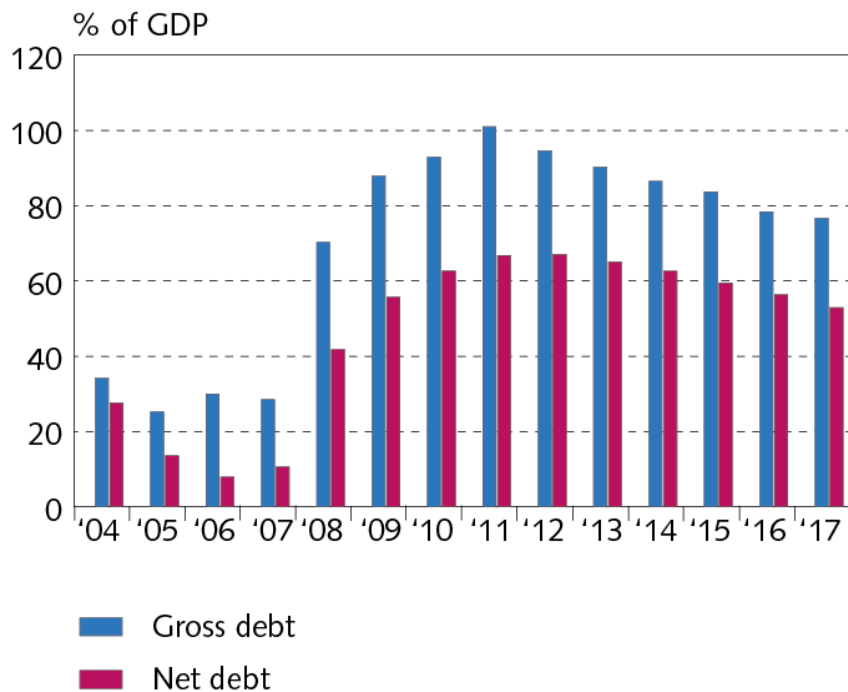
Challenges ahead



- Resolving the balance of payments crisis and lifting capital controls
- Hitting inflation and fiscal targets
- Maintaining responsible policies for the longer term

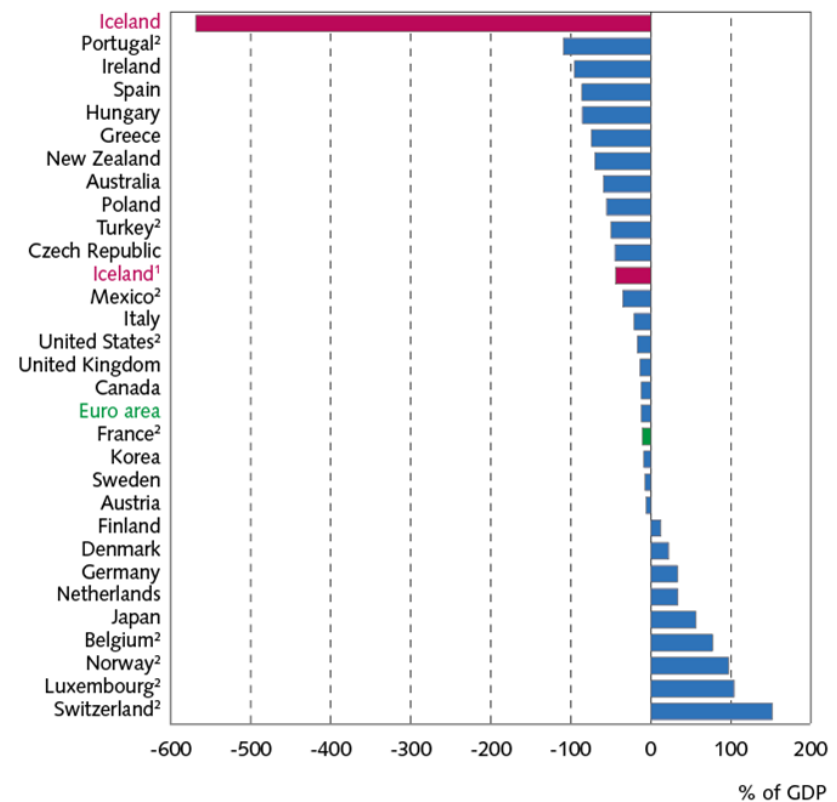
Not a sovereign debt problem, and foreign debt is sustainable

General Government debt ratios 2004-2017¹



1. IMF forecast for 2012-2017.
Sources: IMF, Statistics Iceland.

International investment position of OECD countries 2011



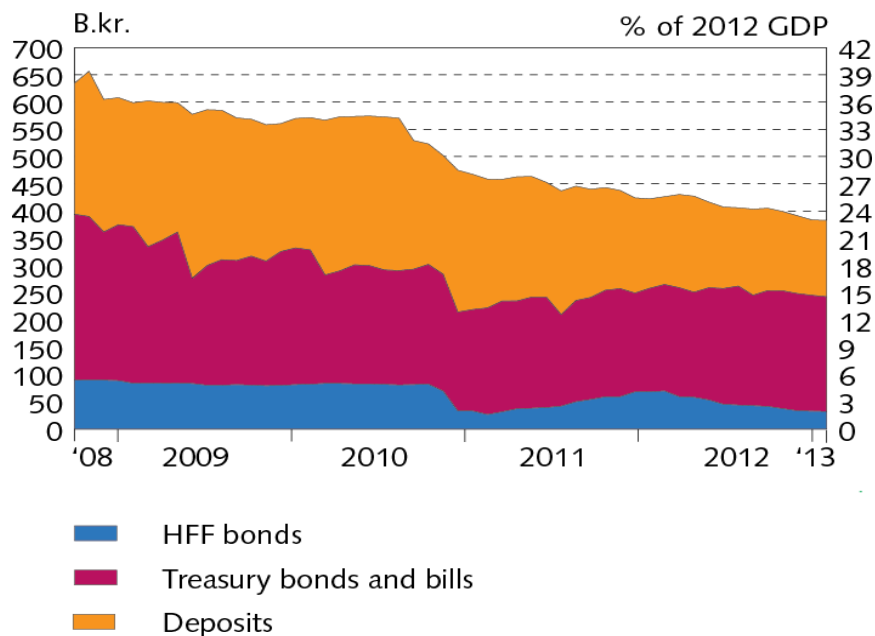
1. IIP based on calculated settlement of DMBs undergoing winding-up proceedings, and excluding Actavis. 2. Figures are for 2010.
Sources: IMF and various central bank and statistics office websites.

The problem is offshore positions and FX debt service, excluding the sovereign



Liquid ISK assets held by non-residents

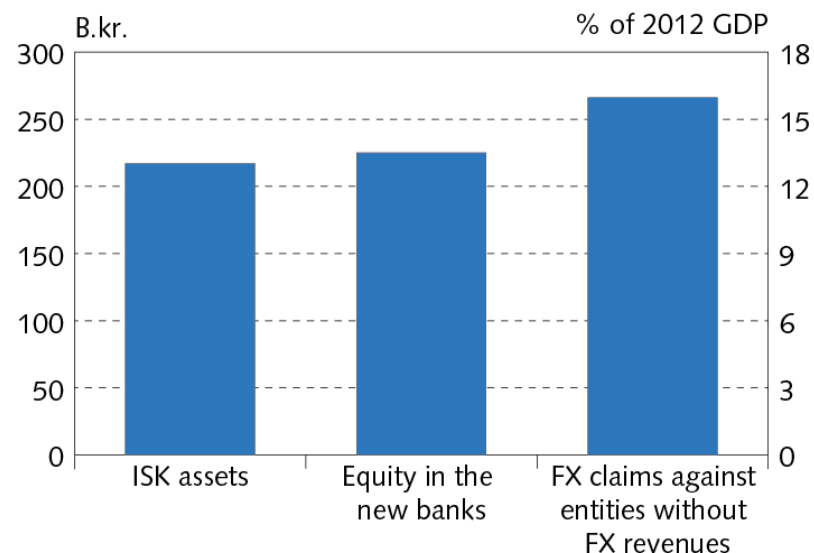
October 2008 - January 2013



Source: Central Bank of Iceland.

Direct and indirect króna assets of banks in resolution

Book value 30.09.2012



Source: Central Bank of Iceland.

Underlying current account surplus is 3-4% of GDP but is falling, whereas private sector FX debt service will increase over the next few years.



Lifting capital controls will be challenging

- Lifting the controls requires a smoother foreign debt service profile and realistic valuations in terms of FX of the offshore ISK positions and ISK recoveries of the failed banks.

Why Iceland's relatively successful recovery?



- Shocks hit frothy sectors (finance and construction), but the export base and many other fundamentals were intact.
- Flexible economy – particularly the labour market
- Flexible exchange rate
- Fiscal prudence: good initial position, limited socialisation of liabilities of private banks, and medium term financial consolidation

But the jury is still out!



- Reintegration into the world economy:
 - Level of new foreign direct investment is still low
 - Lack of capital market access
 - Capital controls
 - Icelandic companies face limitations on cross-border activities
- Longer-run perseverance and sustainability of policies?

