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Iceland's crisis and recovery and current challenges

Már Guðmundsson, Governor of the Central Bank of Iceland, Speech at a Conference organised by the French-Icelandic Chamber of Commerce; Islande, La Renaissance, Paris, 28 February 2013.

President of Iceland, Ambassadors, Ladies and Gentlemen

Nearly all of you probably know that almost 90% of Iceland's banking sector failed in the first week of October 2008. This fact is well established in the minds of scholars of the international financial crisis. What is probably less well known is that at that point, Iceland was already on its way into a recession after an unsustainable boom and serious overheating during 2005-2007 and a currency crisis in the first half of 2008. The banking collapse and the associated wealth loss and further currency depreciation made the recession worse, of course, but so did the recession that hit the global economy in the fourth quarter of 2008.

That autumn, two separate but interrelated sub-stories of the recent Icelandic saga converged in a tragic grand finale. These are:

1. Iceland's boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies. This is a story that has played out many times around the globe, and many of its elements have been seen before in Iceland. It might have been somewhat more extreme this time around, but it wasn't fundamentally different.
2. The rise and fall of three cross-border banks operating on the basis of EU legislation (the European "passport"). This story was much more unique, as involved the first banking crisis in Europe since the EU single market was formed in the early 1990s.

Today I am not going to talk about the build-up to these events, and I will have little to say about the second story. I have expanded on both in various publications and speeches that I can refer you to. Instead, I am going to talk about what happened to the Icelandic economy afterward – its deep recession and its recovery – and then reflect on some of the policy challenges that still face us.

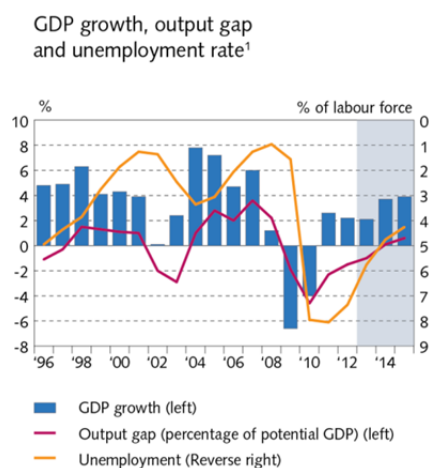
But let us first reflect on the distance that has been travelled since that fateful autumn of 2008. Iceland's financial sector was crumbling, and the authorities had to take extraordinary measures to keep basic domestic banking services up and running, including letting the international part of the banking system go into resolution, wiping out all equity in the banks, and removing their managers. Many expected the sovereign to default on its obligations, which would have left Iceland shut out of international capital markets for years. A key aspect of crisis management was therefore to ring-fence the sovereign from the failing banks and minimise the socialisation of private sector losses. And Iceland was well on its way into its deepest post-war recession, where GDP contracted by 12.5% from its peak in the fourth quarter of 2007 to its trough nine quarters later, in the first quarter of 2010. It fell from an unsustainable peak, of course, but the drop was spectacular nonetheless.

Where are we now, almost five years later?

First, there is hardly any talk of a potential sovereign default any more: the public sector has a primary surplus, the overall deficit is estimated to have been around 2% of GDP last year, government debt as a share of GDP is on a downward trajectory, and Iceland has investment-grade ratings from all three major rating agencies.

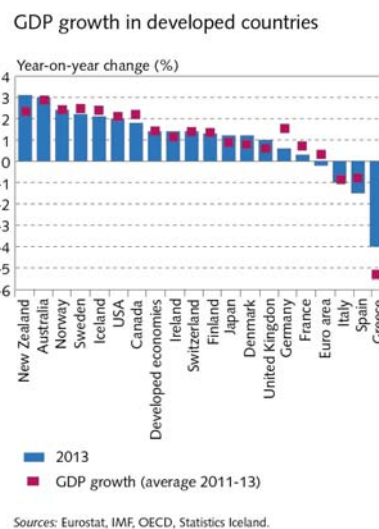
Second, we are far advanced in rebuilding a domestically oriented financial sector. The new domestic banks, which were built on the ashes of the three failing cross-border banks, are profitable, well capitalised, liquid, and with non-performing loan ratios that, although still high due the crisis, are falling to normal levels as private sector debt restructuring progresses and the economy recovers.

Fig. 1a



1. Central Bank baseline forecast 2012-2015. Sources: Directorate of labour, Statistics Iceland, Central Bank of Iceland.

Fig. 1b



Sources: Eurostat, IMF, OECD, Statistics Iceland.

Third, the economy has indeed recovered, as can be seen on Figure 1a. The economy has been growing since the second quarter of 2010, and unemployment has fallen from a peak of over 9% to around 5½%. And as Figure 1b shows, this year Iceland is projected to be among the world's five fastest-growing advanced economies, with growth estimated at 2.1%, although that is due in part to the recent slowdown in many other advanced countries. And the prediction is that Iceland will grow even faster during the next two years, or in the range of 3½-4% per annum, causing the slack in the economy to disappear and the unemployment rate to fall to around 4%.

Fig. 2a

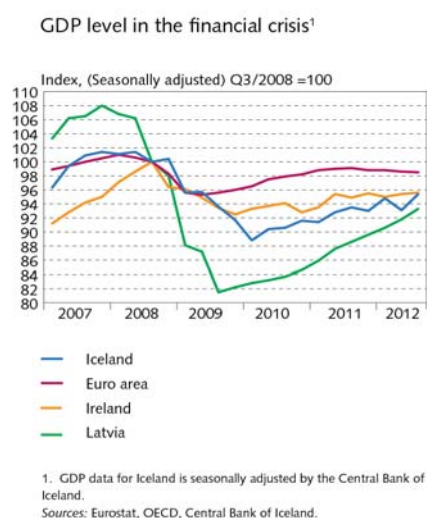


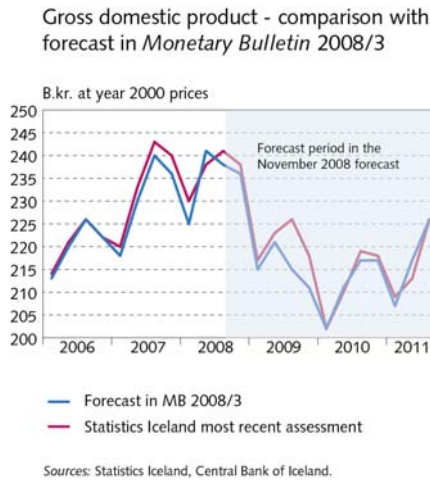
Fig. 2b



So how did we get here?

In answering this question, we need to remember that subsequent developments were not only a function of the negative shocks hitting the economy in 2008 but also a function of the policy responses. In addition to crisis management vis-à-vis the failing banks, which I have already mentioned, the economic programme that the Icelandic authorities developed in co-operation with the IMF played a key role. It provided financing amounting to 5.1 billion US dollars, which helped to build FX reserves. The programme had three key goals: stabilisation of the exchange rate, fiscal sustainability, and reconstruction of the financial sector. Comprehensive capital controls were a key element in the programme.

Fig. 3



The policy responses mitigated the recession but could not stop it from becoming the deepest in Iceland’s post-war history and a severe one in international comparison as can be seen from Figure 2. Iceland was not the hardest hit, however, as can be seen from this slide. Furthermore, developments were more or less in line with previous Central Bank of Iceland predictions (see Figure 3). The result was that Iceland fell significantly down the League of Nations.

Fig. 4a

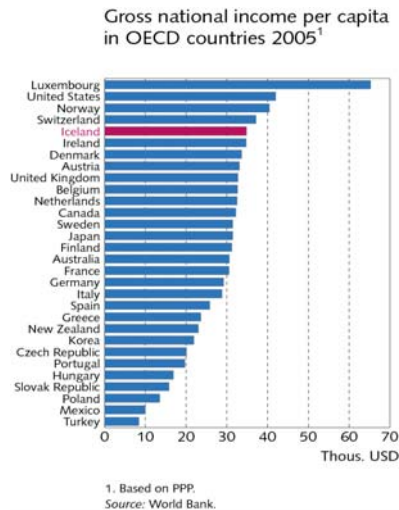
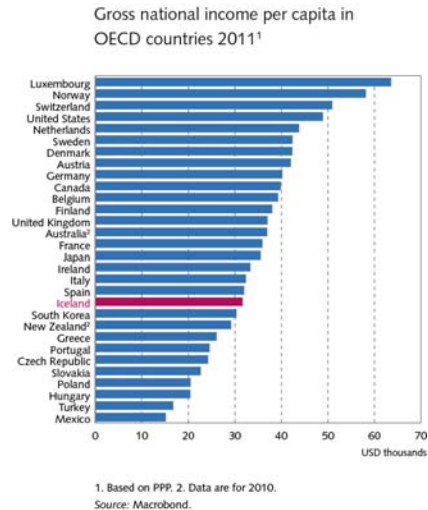


Fig. 4b



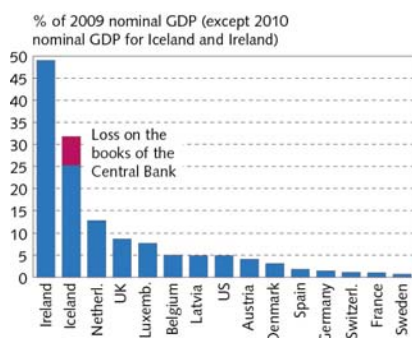
The currency played a significant role, both in the build-up to the crisis and during subsequent stabilisation and recovery. The currency crisis materialised in an over 50% depreciation of the króna over the course of 2008. It hit highly indebted corporate and household sectors, a large share of whose debt was either denominated in or linked directly to foreign currency, or linked indirectly to it through price indexation at a time of strong and rapid exchange

rate pass-through. The contractionary balance sheet effects of the currency depreciation were therefore substantial. Hence the need to stabilise the exchange rate, which was achieved in the middle of 2009.

But the real depreciation – which took the real exchange rate to around 30% below its historical average for a time and left it at the current level of around 20% below that average – compressed imports and provided some stimulus to exports, thus helping to turn a double-digit current account deficit into an underlying surplus. But the stimulus to exports is limited by the fact that Iceland’s major export industries, such as fisheries and energy-intensive metal smelters, face capacity constraints that can only be lifted through investments that have been rather limited so far.

Fig. 5a

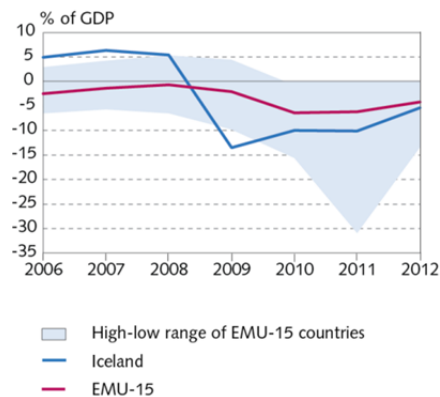
Direct fiscal costs of the financial crisis



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.

Fig. 6a

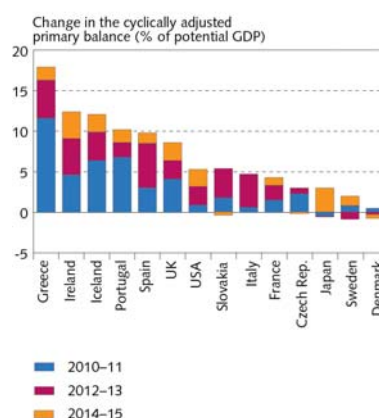
General government net lending in Iceland and EMU-15 2006-2012



Sources: Eurostat, Statistics Iceland.

Fig. 5b

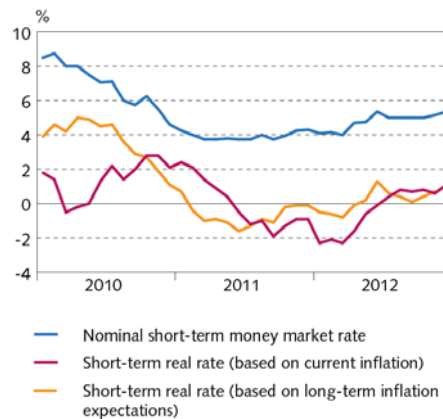
International comparison of fiscal adjustment in advanced economies in the global crisis¹



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.

Fig. 6b

Monetary policy stance 2010-2012



Sources: Statistics Iceland, Central Bank of Iceland.

A very important and somewhat novel element of the successful policy response was the interplay of fiscal consolidation, monetary policy, and capital controls. The crisis dealt a heavy blow to government finances in Iceland, as can be seen from Figure 5. The resulting deficit – 10% of GDP in 2009 – would have been much more difficult to finance in the absence of the capital controls that locked in both foreign financing from before the crisis and new domestic saving. However, there was no escaping the fiscal consolidation needed to put government finances on a sustainable path, as Iceland lacked external confidence and market access. It was a big effort, as can be seen from Figure 6a, and it started in the middle of an economic crisis, which is far from optimal. But monetary policy was increasingly able to give support to the economy after the exchange rate had been stabilised and inflation came down (see Figure 6b). And the scope for monetary policy to support the domestic economy in spite of the balance of payments crisis was in turn enhanced by the capital controls, as can be seen from this slide, which compares short-term real interest rates during the recent financial crisis in Iceland with short-term real rates in Korea during the Asian financial crisis.

Fig. 7



Finally, let me say something about Iceland's current challenges. I will mention three.

The first is to bring inflation back to the 2½% target. It is currently running at 4.8% and is fuelled by the weak currency and wage increases in excess of productivity growth, which in turn are driven by good conditions in an export sector that benefits from the low exchange rate. Inflation is predicted to fall back to the target around the middle of next year, although this will depend on exchange rate developments.

Fig. 8a

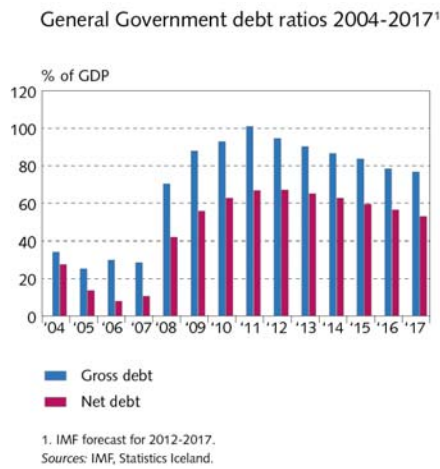
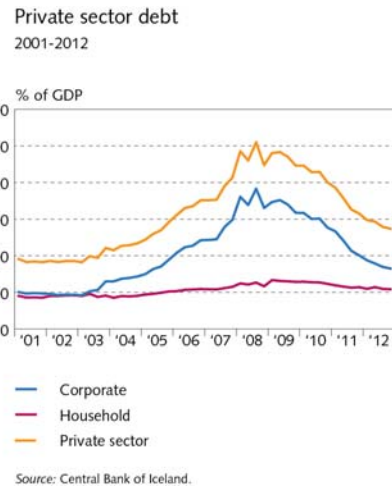


Fig. 8b



The second relates to deleveraging, or reduction of debt levels. Public and private debt levels are on a declining path, as can be seen from Figure 8. In the case of businesses in particular, a significant part of this takes the form of debt restructuring and write-downs. That, along with the resolution process of the failed banks, will reduce Iceland's net external debt to a sustainable level over time (see Figure 9). This is a good thing, of course, but the deleveraging process has two short- to medium-term side effects that must be managed. The first one relates the negative effect of deleveraging on domestic demand. The second relates to its negative effect on the exchange rate, as economic entities with foreign debt, little or no foreign-currency income, and no access to foreign credit are forced to repay foreign debt faster than is optimal for them and the economy. This is part of our balance of payments problem.

Fig. 9a

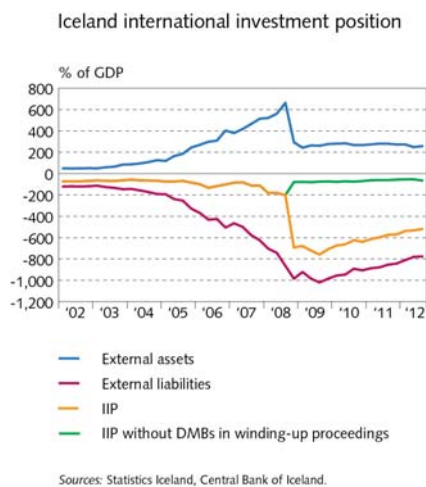
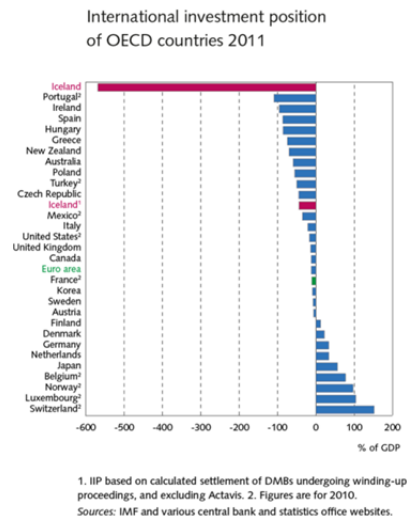


Fig. 9b



That brings me to the third challenge, which is to break out of Iceland's balance of payments crisis and lift the capital controls. Through fiscal consolidation and reinforcement of its FX reserves (see Figure 10a), Iceland has seen a steep drop in the perceived risk of the sovereign as reflected in CDS spreads. Furthermore, the sovereign has been able to tap foreign capital markets twice, for a total of 2 billion US dollars, and use part of the proceeds to repay a significant part of the loans associated with the IMF programme ahead of schedule. FX reserves and other Central Bank FX assets currently cover scheduled sovereign foreign debt repayments beyond 2022 (see Figure 10b).

Fig. 10a

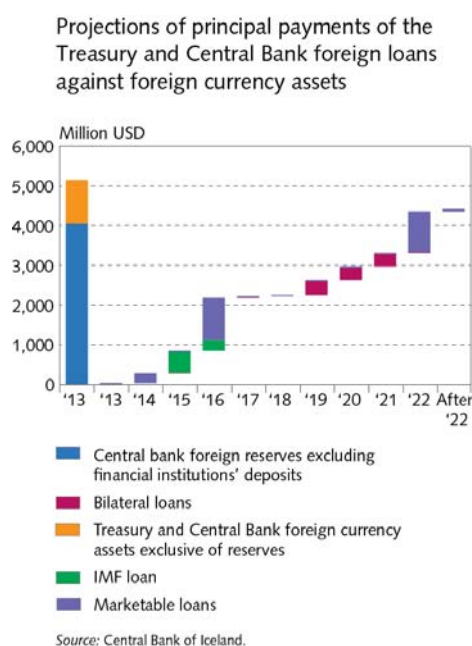
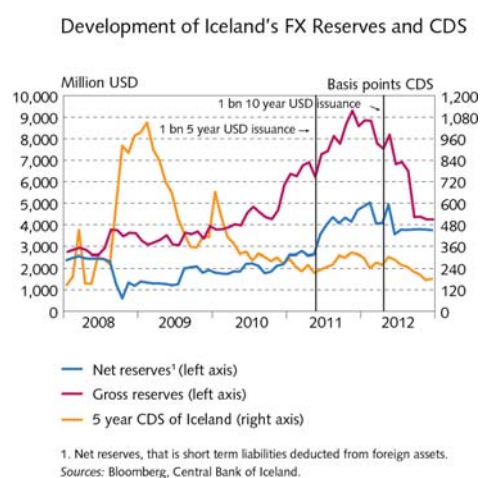


Fig. 10b



The balance of payments problem that the current controls on capital outflows are intended to address therefore lies elsewhere. It is best demonstrated by Figure 11, which shows, on the one hand, liquid ISK assets held by non-residents, which amount to 22% of GDP, and the old banks' ISK assets, which will, in the absence of other action, accrue mostly to foreign residents and may be added to the overhang of potentially liquid offshore krónur. Given that the underlying current account surplus is in the region of 3-4% of GDP and that there are a lot of other debt repayments laying claims to it, it is clear that if these amounts were to be released overnight, we would be at risk of another currency crisis, with potentially significant financial stability implications. That is why these assets must be released after significantly reduced valuations in terms of foreign currency or must flow out over a much longer period. The more their value is reduced in terms of foreign currency, the faster can the controls be lifted.

Fig. 11a

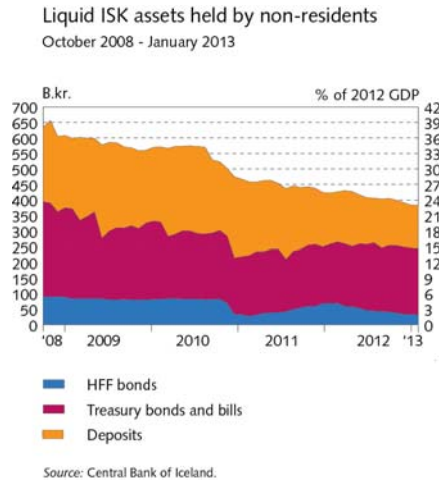


Fig. 11b



The Icelandic authorities have a strategy in place to lift the capital controls gradually, as conditions permit, without unduly undermining exchange rate and financial stability. The strategy is currently under review. It is clear that the process will be significantly affected by how the króna problem associated the winding up of the old banks is dealt with, as an amicable solution could greatly expedite the removal of the controls.

But the basic thinking will remain the same. The first element is to secure the framework conditions for lifting the controls, such as at least balanced public sector finances, an underlying current account surplus, and adequate FX reserves. All of this is either in place or well on its way. The second element is to put in place the economic policy frameworks and prudential rules that will make it possible for Iceland to deal with the risks associated with free and volatile capital movements. That is also underway. The third element is to reduce the overhang of liquid offshore krónur to a safer level, either through release at a discount or by tying the offshore krónur up in longer maturities and real investments. That is underway as well, although some are of the view that the process is too slow. The fourth element is to open market access and, through other means, generate longer-term inflows to replace the capital that wants to leave. History shows that those who jump early on such a bandwagon have a lot to gain.

Let me conclude by saying that Iceland has made great strides since the autumn of 2008. The next major task is to re-integrate Iceland financially into the global economy, but hopefully in a safer way this time.

Thank you very much.