



Reflections on the “Icelandic model” for crisis management and recovery

Már Guðmundsson
Central Bank of Iceland

Adam Smith Seminars
Paris, 7 March 2012

The Icelandic model?



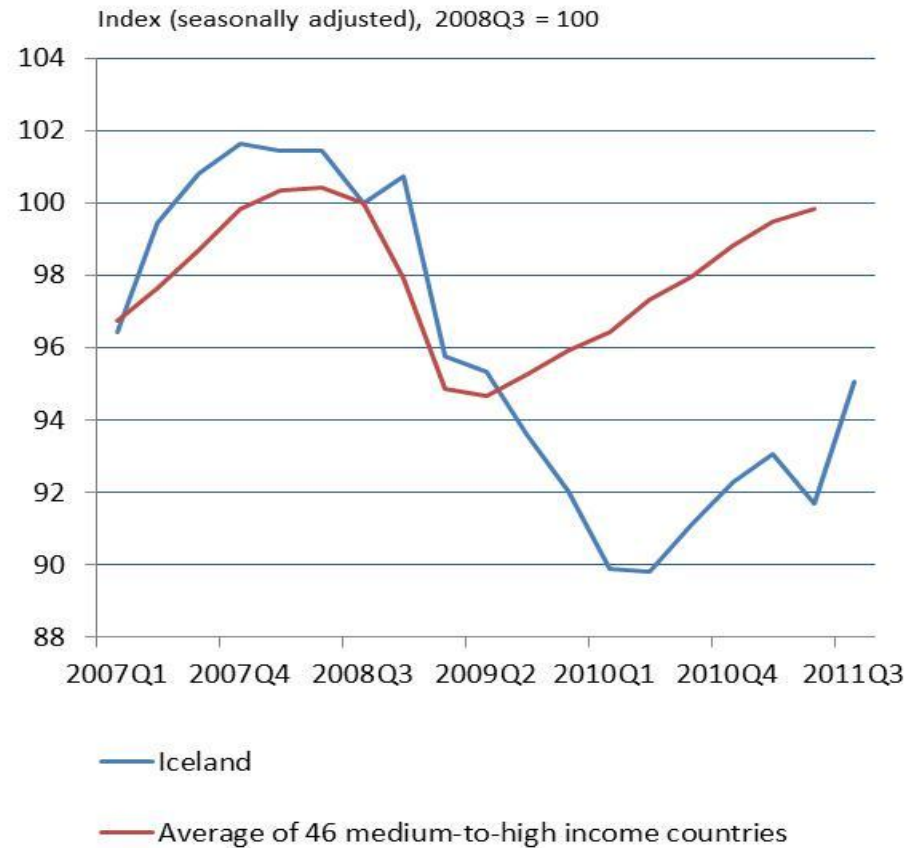
- Allowing private banks to fail
- Protecting retail depositors, not bond holders
- Ring-fencing the sovereign against the failing banks – limiting socialisation of private sector losses
- Flexible exchange rate
- Short-term demand support and medium-term fiscal consolidation
- Private sector debt restructuring
- Capital controls

The recession



- GDP contracted by almost 12% from its 2007Q4 peak to its 2010H1 trough

Figure 12 GDP level

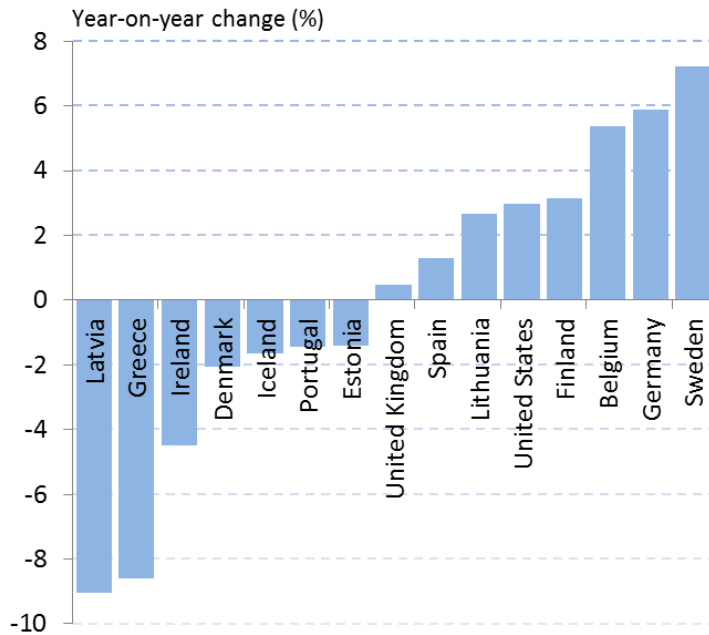


Sources: Macrobond, Eurostat, Central Bank of Iceland.

But Iceland was not the hardest hit



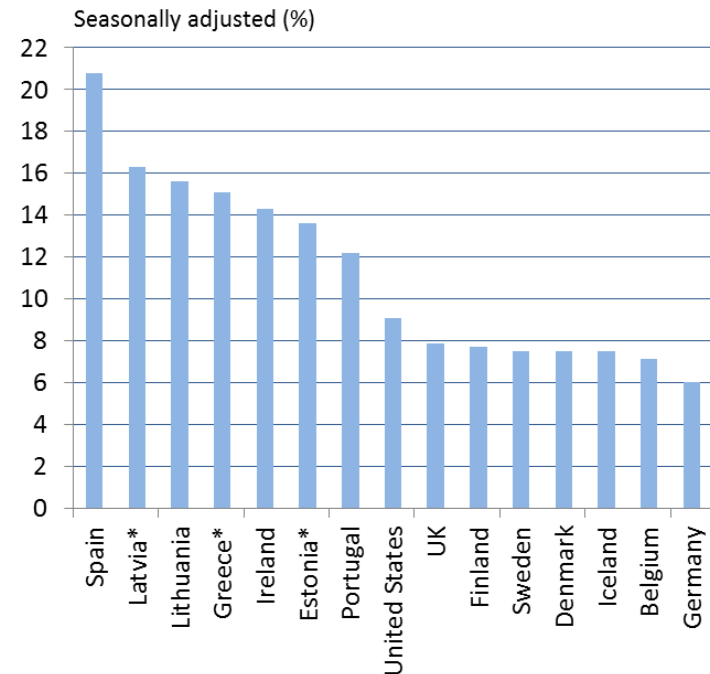
Percentage change in GDP from the average of 2005-2007 to 2011¹



1. Based on forecasts for 2011.

Source: Eurostat, Global Insight, Statistics Iceland, Central Bank of Iceland.

Unemployment rate Q4/2011¹



1. Data for countries with an asterisk are only available for Q3/2011.

Source: Macrobond, Central Bank of Iceland.

Stabilisation and recovery



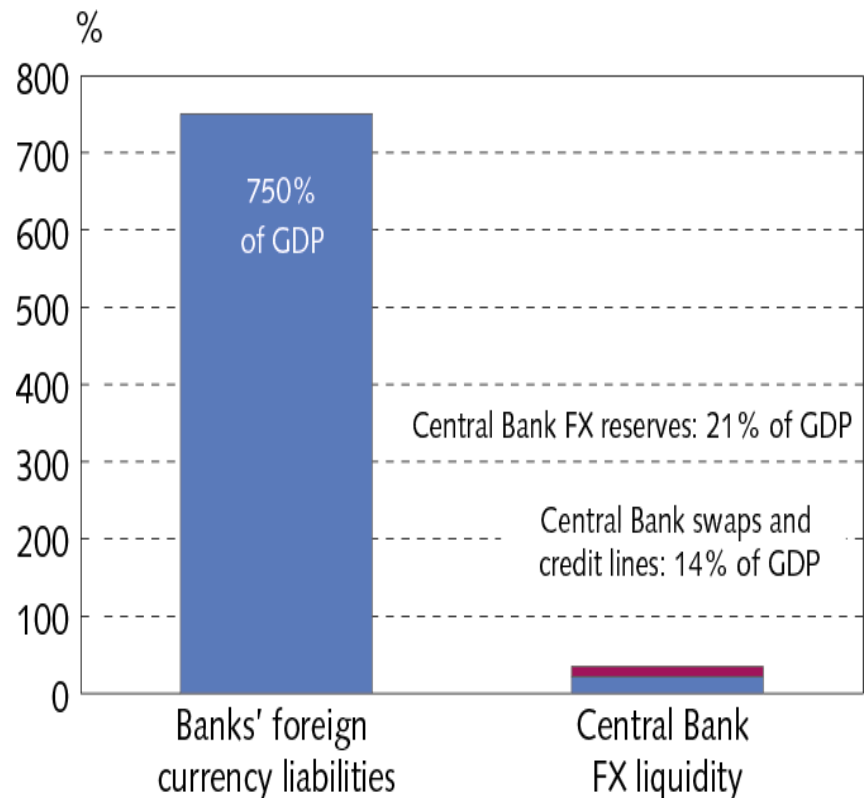
- IMF programme in November 2008:
 - Exchange rate stabilisation
 - Medium-term fiscal consolidation
 - Financial sector reconstruction
- Current account deficit of 25% of GDP in 2007 swung into a significant underlying surplus
- Exchange rate stabilised in 2009H2
- IMF programme completed in August 2011
- Recovery began in 2010H2, 3%+ in 2011 and 2½% (forecasted) in 2012

Allowing banks to fail?



- The banks were 10+ times GDP
- 60% of lending was to non-residents
- Too big for Iceland to save
- Co-operative action of the countries involved was not forthcoming

Banks' foreign currency liabilities and Central Bank FX reserves, September 2008



Allowing banks to fail?



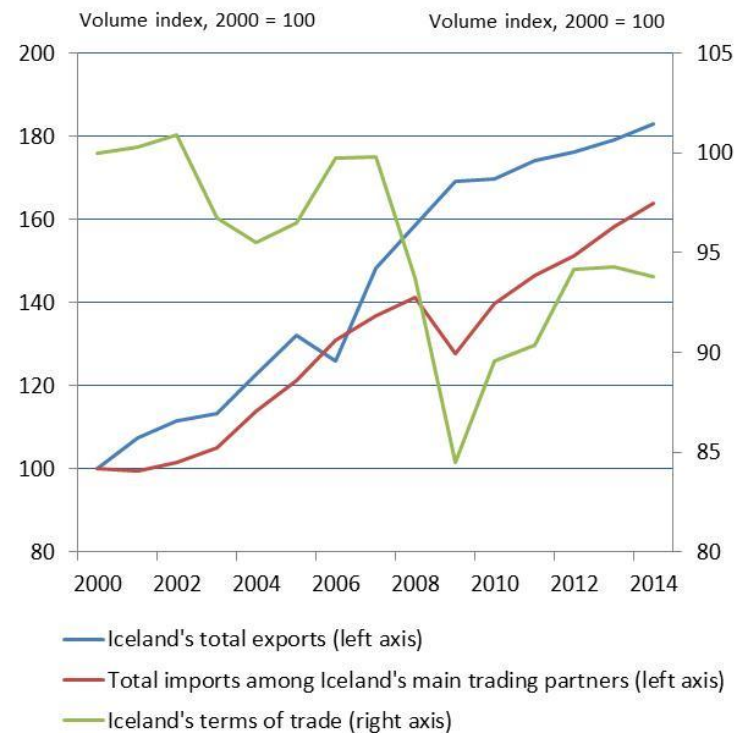
- Seen in terms of lost asset values, the burden of the banks' collapse was borne mostly by foreign creditors (currently holding 85-90% of claim values on the old banks)
- The option would look different in larger countries
- But it makes sense to ring-fence sovereigns from private banks as much as is feasible
- And bailing out bond holders is certainly not a sacred principle!

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 goods and the non-traded goods sectors.

Figure 8 Export volumes and terms of trade 2000-2014



Sources: OECD, Central Bank of Iceland.

Fiscal consolidation



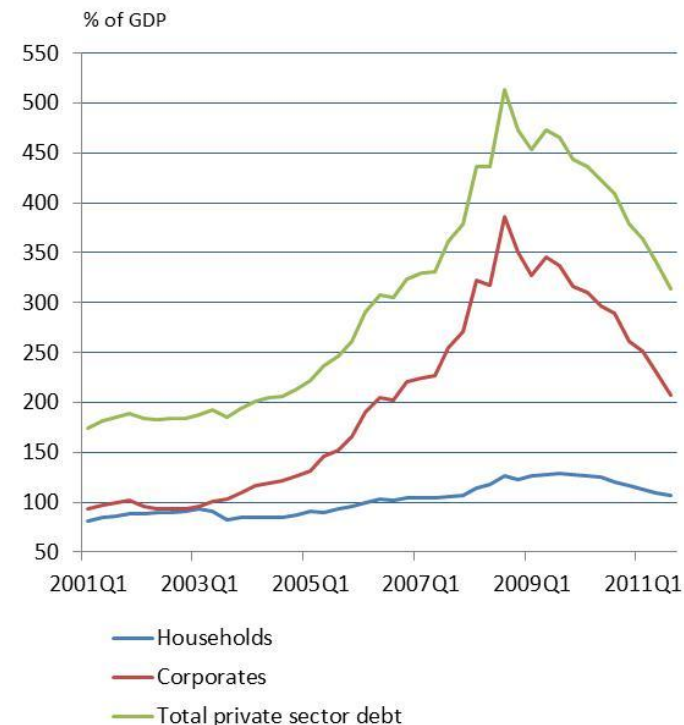
- Automatic stabilisers mostly allowed work in 2009
- Fiscal consolidation from 2010 onwards
- Overall surplus in 2014
- Key to recovering external confidence
- Investment-grade ratings with three major CRAs
- Iceland tapped the US market for USD 1 bn last summer
- CDS below 300 points

Private sector debt restructuring



- Icelandic private sector one of the most indebted
- Debt restructuring facilitated by transfer of assets from old to new banks at a deep discount
- Significant progress

Figure 5 Private sector debt 2000Q1-2011Q3



Sources: Statistics Iceland, Central Bank of Iceland.

Capital controls



- Króna positions of foreign residents estimated at over $\frac{1}{3}$ of GDP at the time of the crash
- Comprehensive controls on outflows created shelter for the financing of the banks and the sovereign (non-residents hold $\frac{1}{2}$ of short-term government securities)
- They also created shelter for domestic macroeconomic policies at a time when exchange rate stabilisation was of key importance
- Microeconomic costs small initially but accumulate over time

Removal of capital controls



- Two-phase strategy published March 2011
- Implementation underway
- A complicated operation involving risks to economic and financial stability
- The future evaluation of the “Icelandic model” will depend in part on the success of this process