



Central Bank of Iceland

# Overcoming a financial crisis and taking the road forward: the case of Iceland

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European Economics and Financial Centre, Palace of Westminster, London, 14 March 2013

# The autumn of 2008



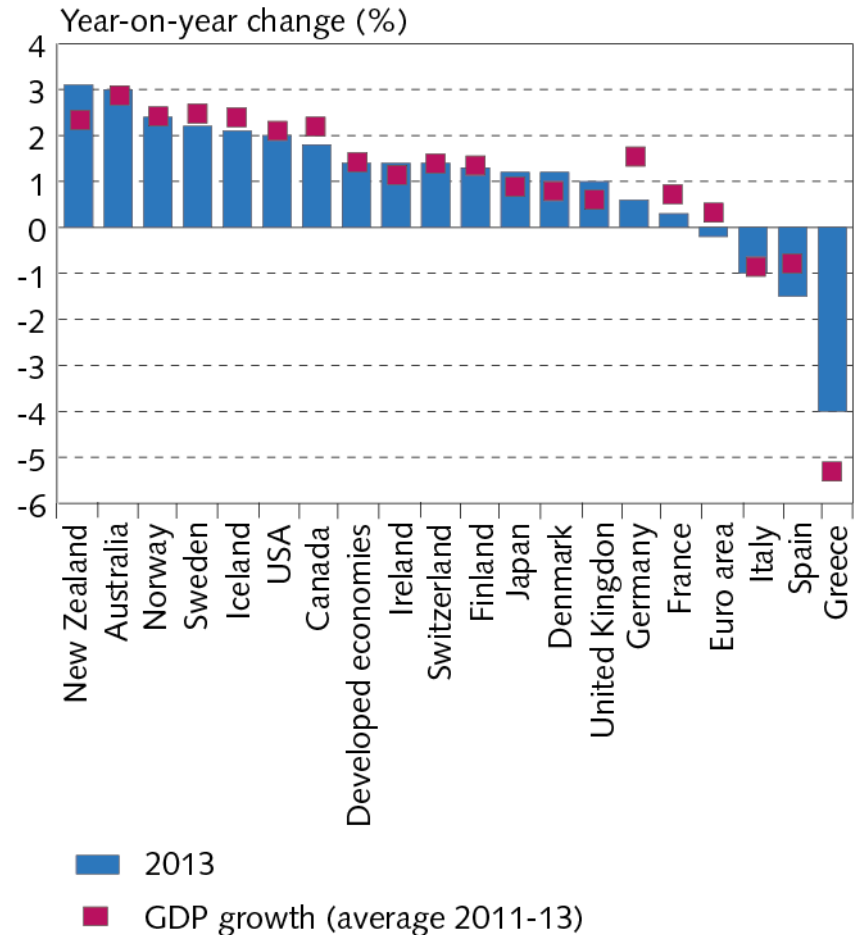
- Almost 90% of Iceland's banking sector failed in the first week of October
- At that point, Iceland was already on its way into recession after an unsustainable boom during 2005-2007
- Iceland was suffering from a currency crisis
- Many expected the sovereign to default on its obligations

# 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: Eurostat, IMF, OECD, Statistics Iceland.



# **The crisis and the policy response**



# The recent Icelandic 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



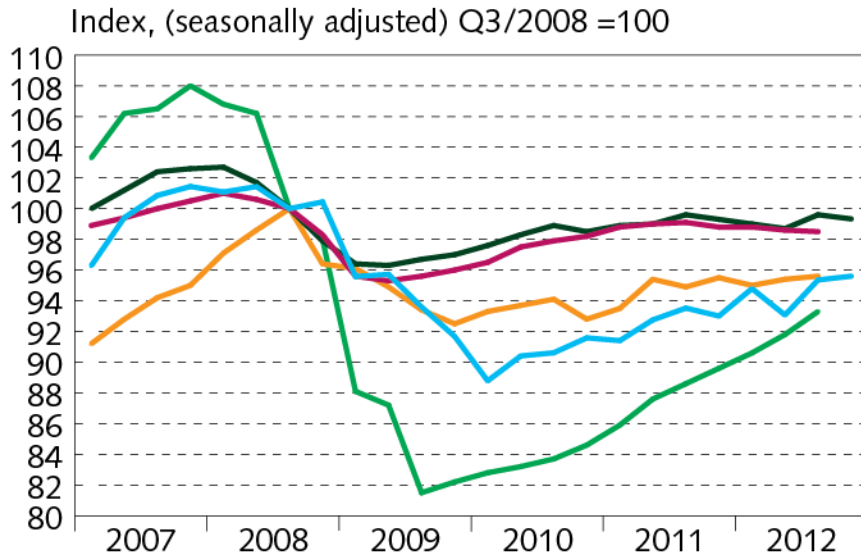
# Recession and recovery



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



Level of GDP<sup>1</sup>

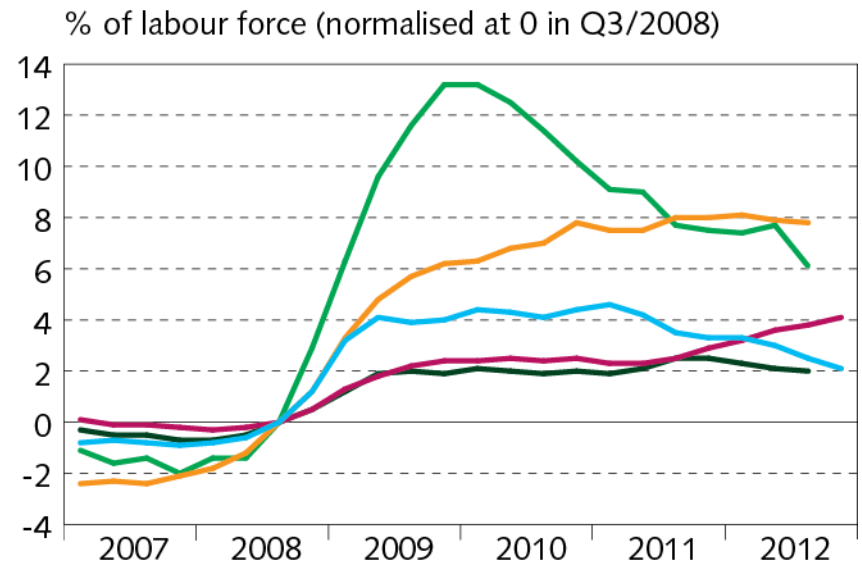


- Iceland
- Euro area
- Ireland
- Latvia
- United Kingdom

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

Sources: Eurostat, OECD, Central Bank of Iceland.

Unemployment rate<sup>1</sup>



- Iceland
- Euro area
- Ireland
- Latvia
- United Kingdom

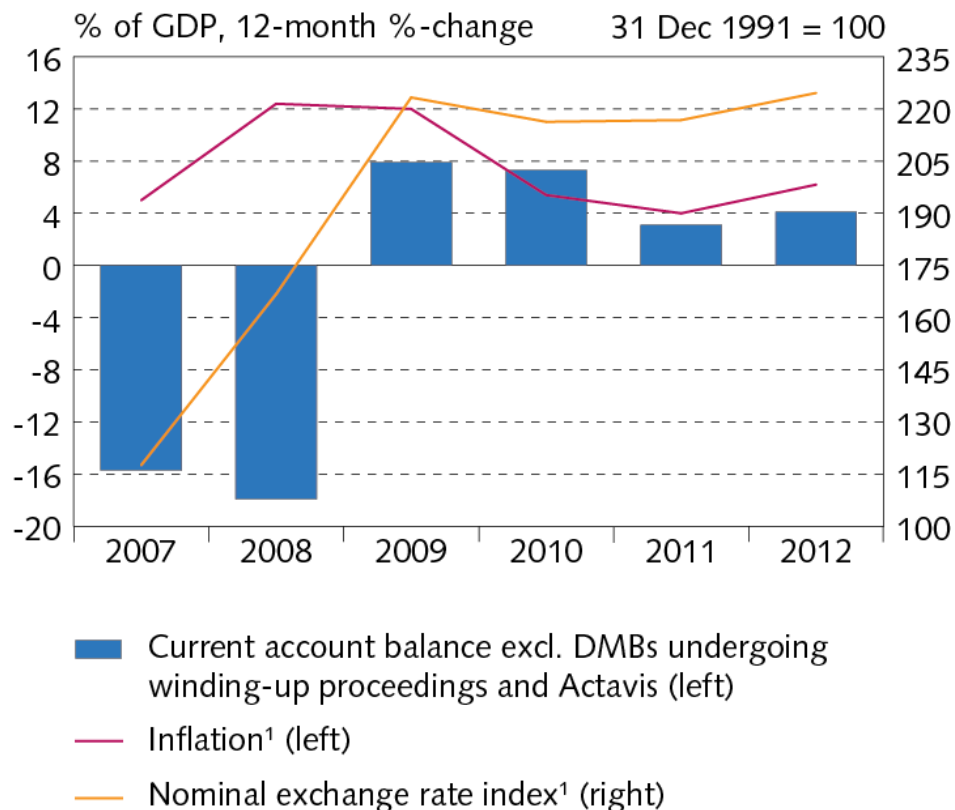
1. Seasonally adjusted harmonised unemployment rate, except for Latvia, as the series are seasonally adjusted by Eurostat.

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 appreciated in 2010
- Inflation fell and interest rates were reduced

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.

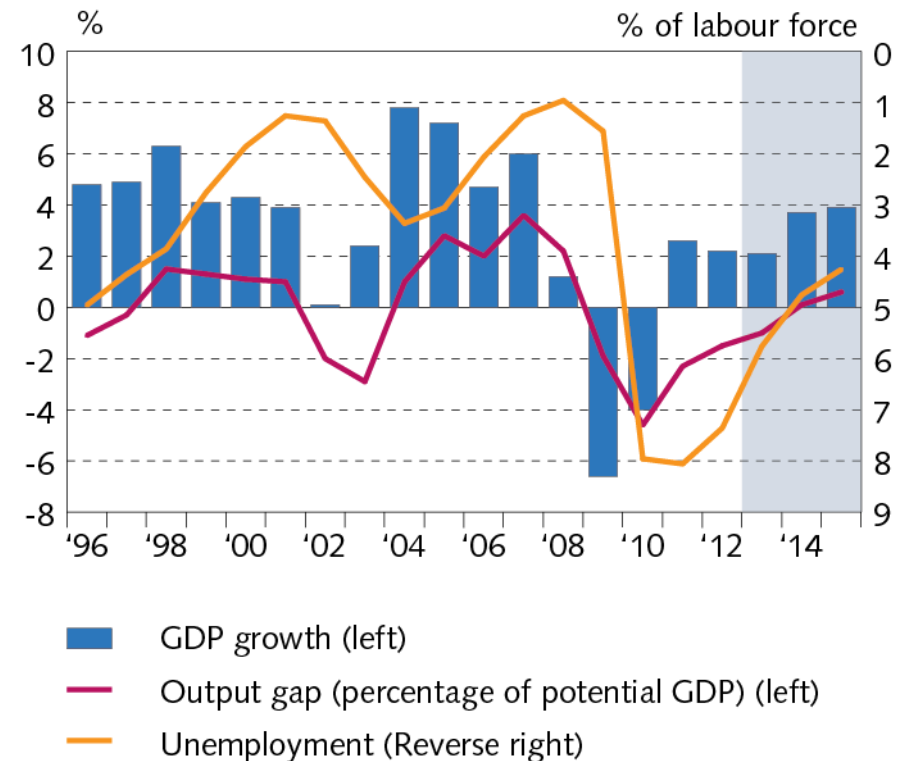
Sources: Statistics Iceland, Central Bank of Iceland.

# Recovery



- Economy growing since Q2 2010
- Unemployment down from a peak of 9% to around 5½%
- Slowdown in H2/2012 and beginning of 2013
- Faster growth predicted 2014 and 2015 (3½-4% p.a.)

GDP growth, output gap and unemployment rate<sup>1</sup>

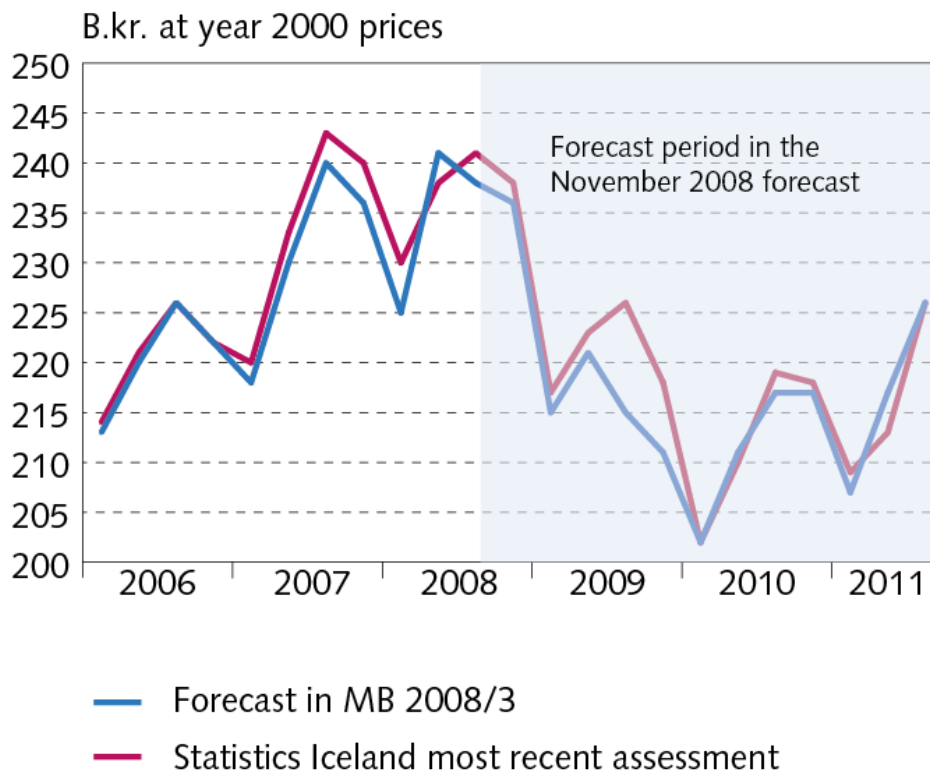


1. Central Bank baseline forecast 2012-2015.

Sources: Directorate of labour, 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.



# Some features of the “Icelandic model”

# Allowing banks to collapse?



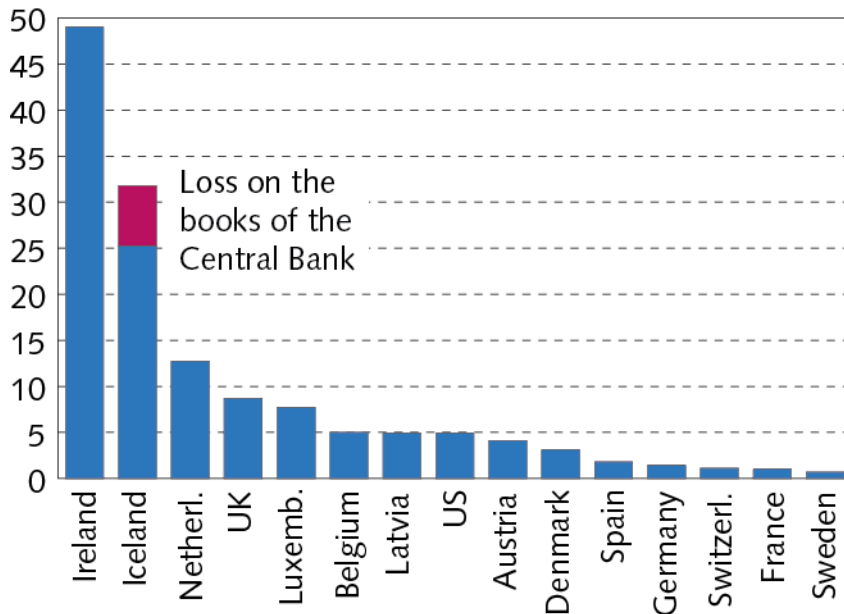
- Iceland did not have the resources on its own to keep the entire banking system up and running
- It would have turned a banking crisis into sovereign default if it had been tried
- Two key considerations:
  - To preserve domestic payment systems and the common citizen's access to his or her deposits
  - To ring-fence the sovereign vis-à-vis the failing banks
- Iceland saved the domestic part of the banking system at significant cost

# Crisis hit government finances hard



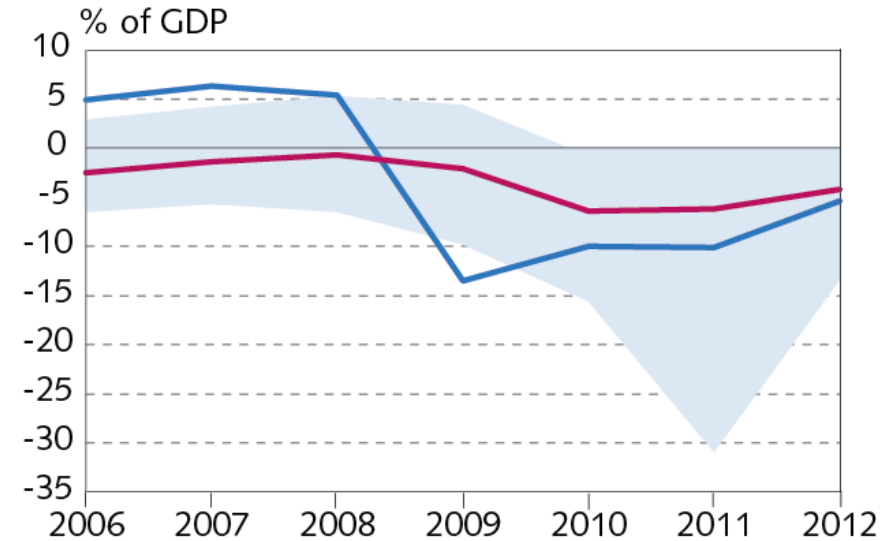
## Direct fiscal costs of the financial crisis

% 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



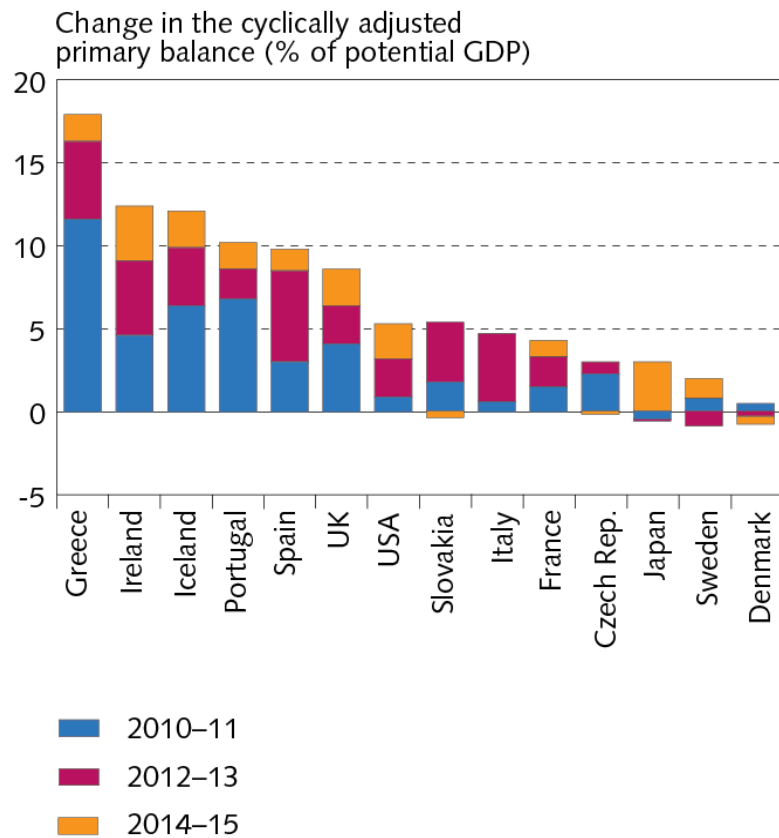
- High-low range of EMU-15 countries
- Iceland
- EMU-15

Sources: Eurostat, Statistics Iceland.

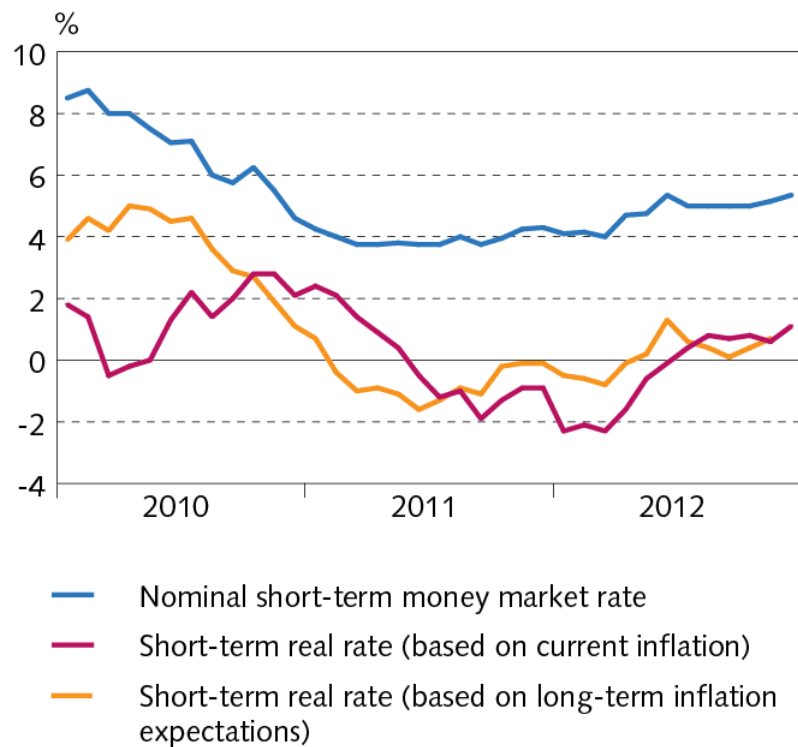
# Fiscal consolidation with monetary support ...



## International comparison of fiscal adjustment in advanced economies in the global crisis<sup>1</sup>



## Monetary policy stance 2010-2012



Sources: Statistics Iceland, Central Bank of Iceland.

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.

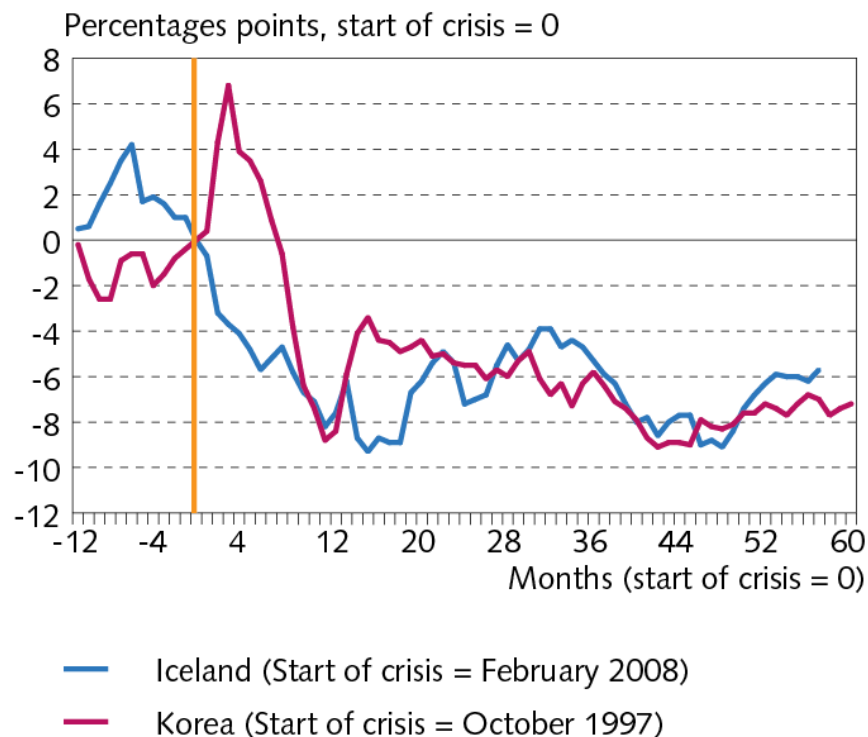
Source: IMF.



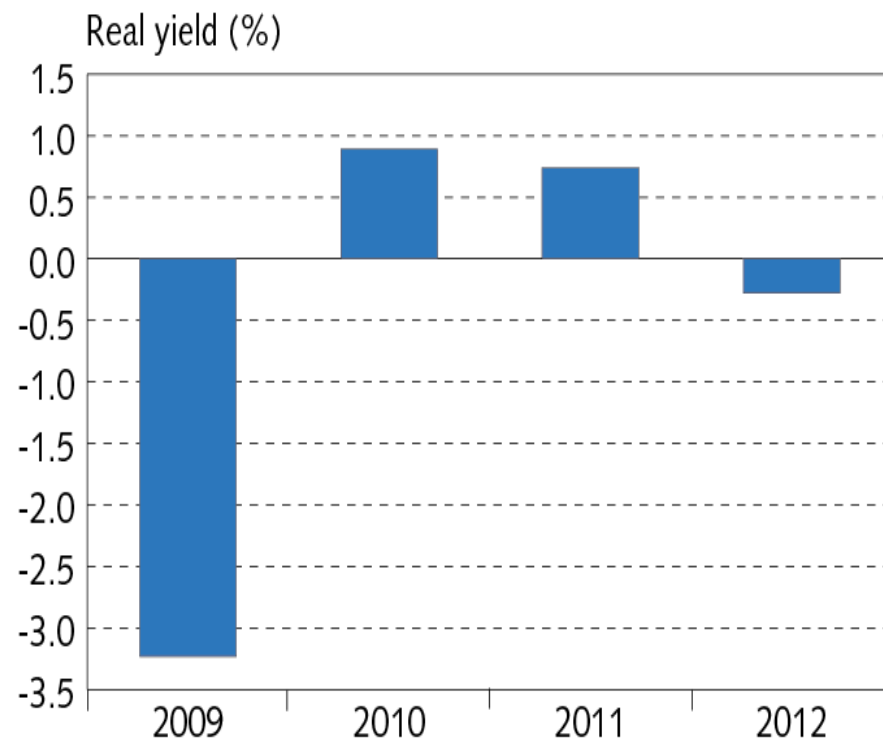
# ... and helped by capital controls



Real short-term interbank interest rates in two twin-crises - Iceland and Korea<sup>1</sup>



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.

# Capital controls?



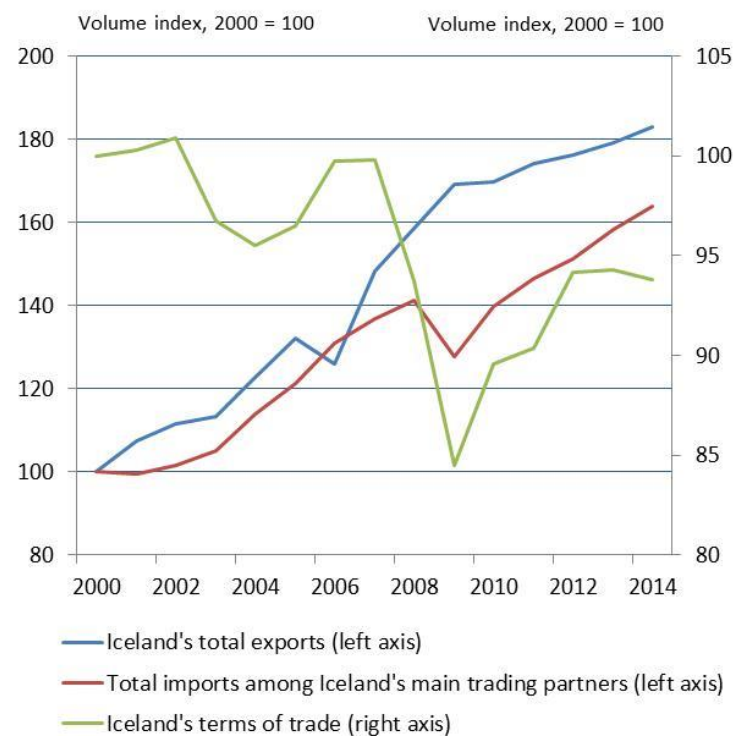
- Capital controls were helpful in stabilising the economy and supporting recovery
- But microeconomic costs accumulate over time  
...
- ... and capital controls might be more difficult to introduce and manage in larger, more complex, and more connected economies, and the costs will be higher
- Lifting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

# 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 non-traded goods sectors

Figure 8 Export volumes and terms of trade 2000-2014



Sources: OECD, Central Bank of Iceland.

# Three interrelated key challenges

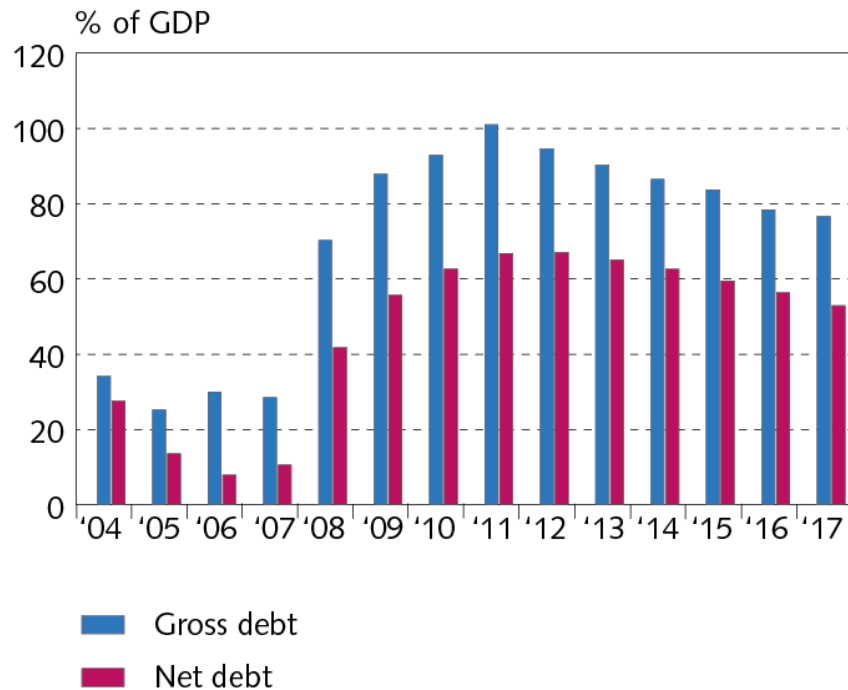


- Managing balance sheet risk
- Dealing with the balance of payments crisis
- Lifting capital controls

# Public and private debt is on a declining path ...

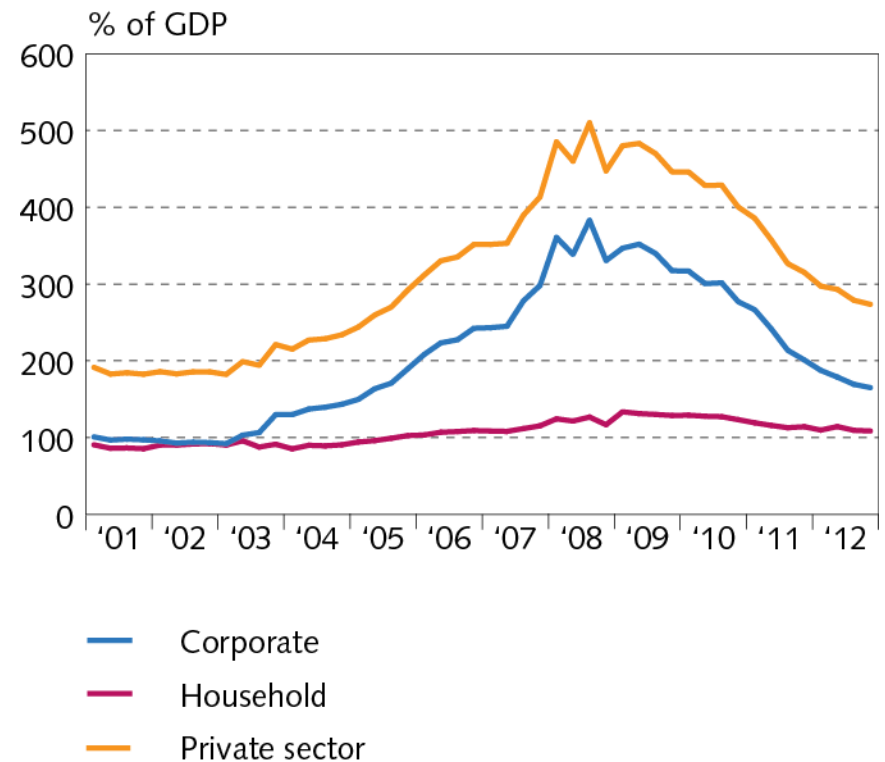


General Government debt ratios 2004-2017<sup>1</sup>



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

Private sector debt  
 2001-2012

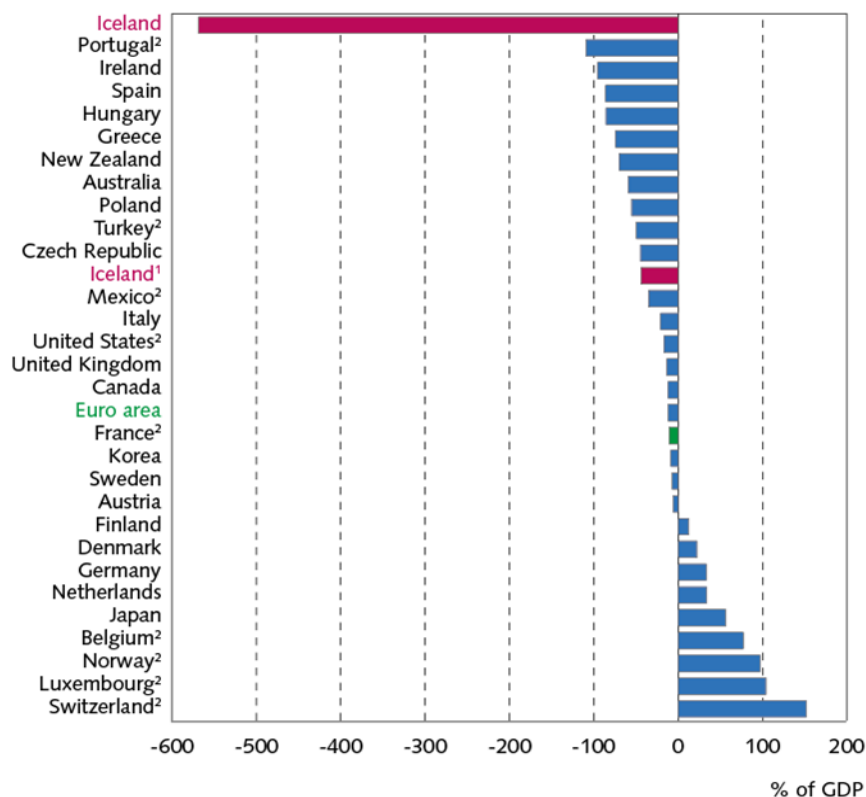


Source: Central Bank of Iceland.

# ... which, along with the resolution process, is reflected in Iceland's IIP



International investment position  
of OECD countries 2011



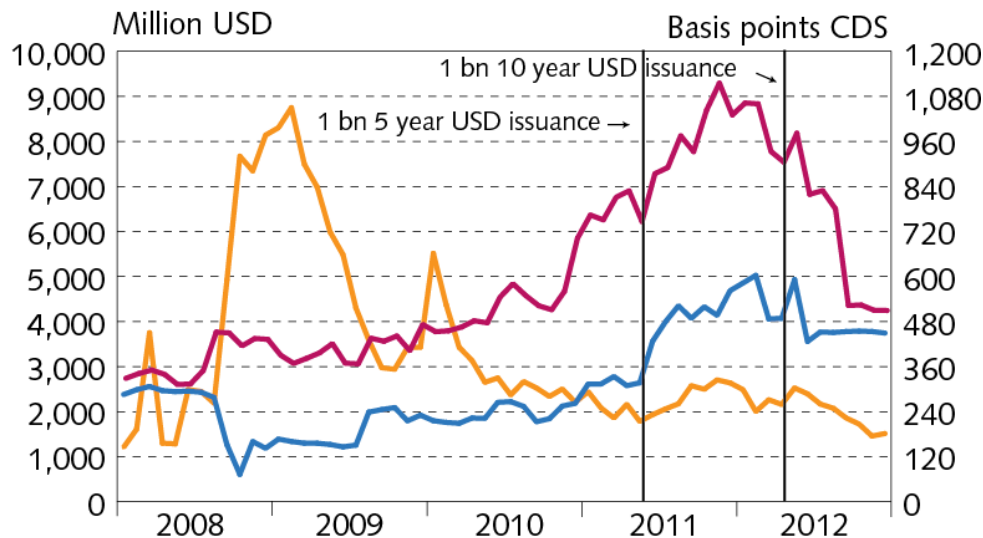
1. IIP based on calculated settlement of DMBs undergoing winding-up proceedings, and excluding Actavis. 2. Figures are for 2010.

Sources: IMF and various central bank and statistics office websites.

# External liquidity and sovereign credit access



Development of Iceland's FX Reserves and CDS

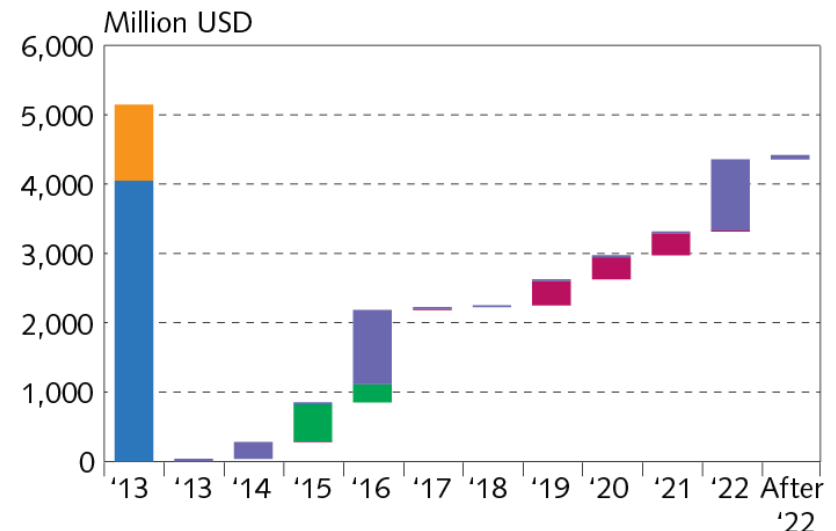


- Net reserves<sup>1</sup> (left axis)
- Gross reserves (left axis)
- 5 year CDS of Iceland (right axis)

1. Net reserves, that is short term liabilities deducted from foreign assets.

Sources: Bloomberg, Central Bank of Iceland.

Projections of principal payments of the Treasury and Central Bank foreign loans against foreign currency assets



- Central bank foreign reserves excluding financial institutions' deposits
- Bilateral loans
- Treasury and Central Bank foreign currency assets exclusive of reserves
- IMF loan
- Marketable loans

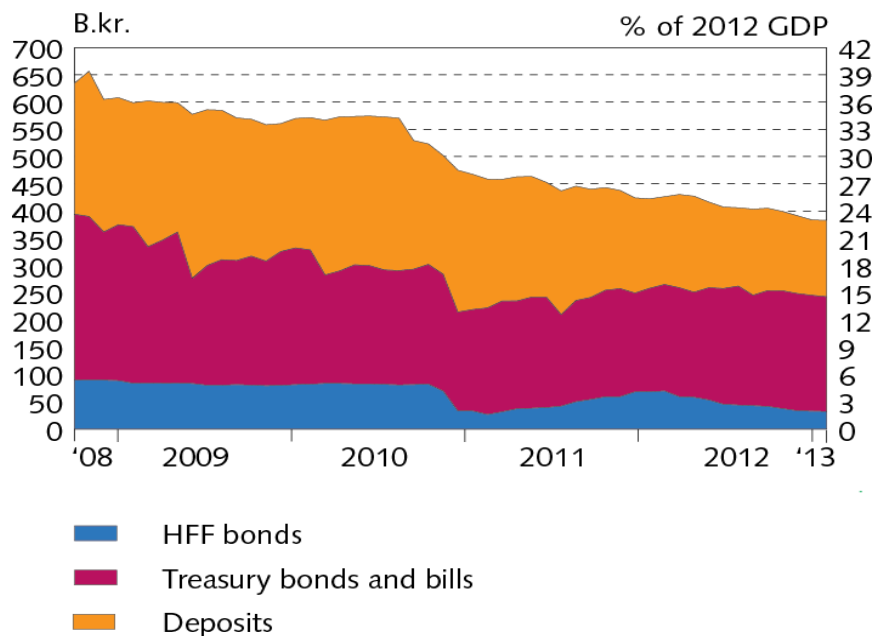
Source: Central Bank of Iceland.

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



Liquid ISK assets held by non-residents

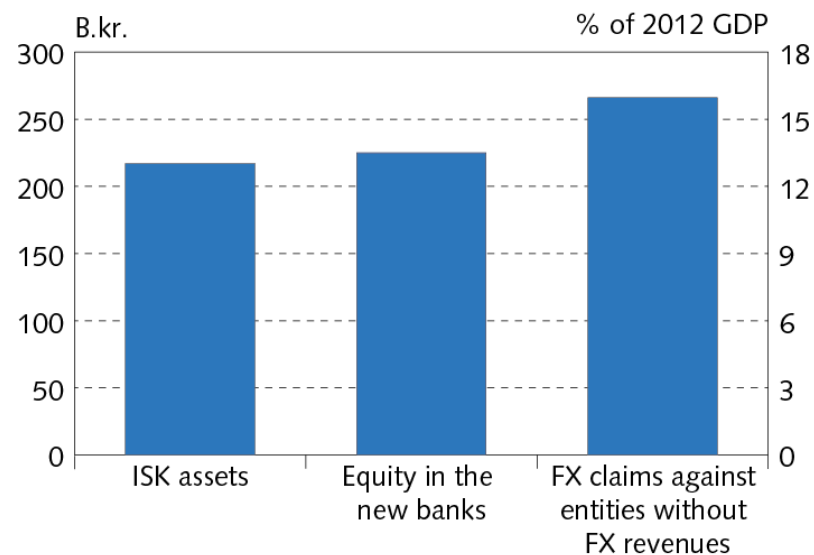
October 2008 - January 2013



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 at the same time as private sector FX debt servicing will increase during the next few years.





# Lifting capital controls will be challenging

- Iceland does not face a sovereign debt problem
- Iceland's net external debt position is sustainable in the traditional sense
- But to lift the controls requires smoothing the foreign debt service profile and realistic valuations in terms of FX of the offshore ISK positions and ISK recoveries of the failed banks.

