



Central Bank of Iceland

Iceland's economic recovery, financial reconstruction and current policy challenges

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Mansion House, City of London, 31 October 2013

The autumn of 2008



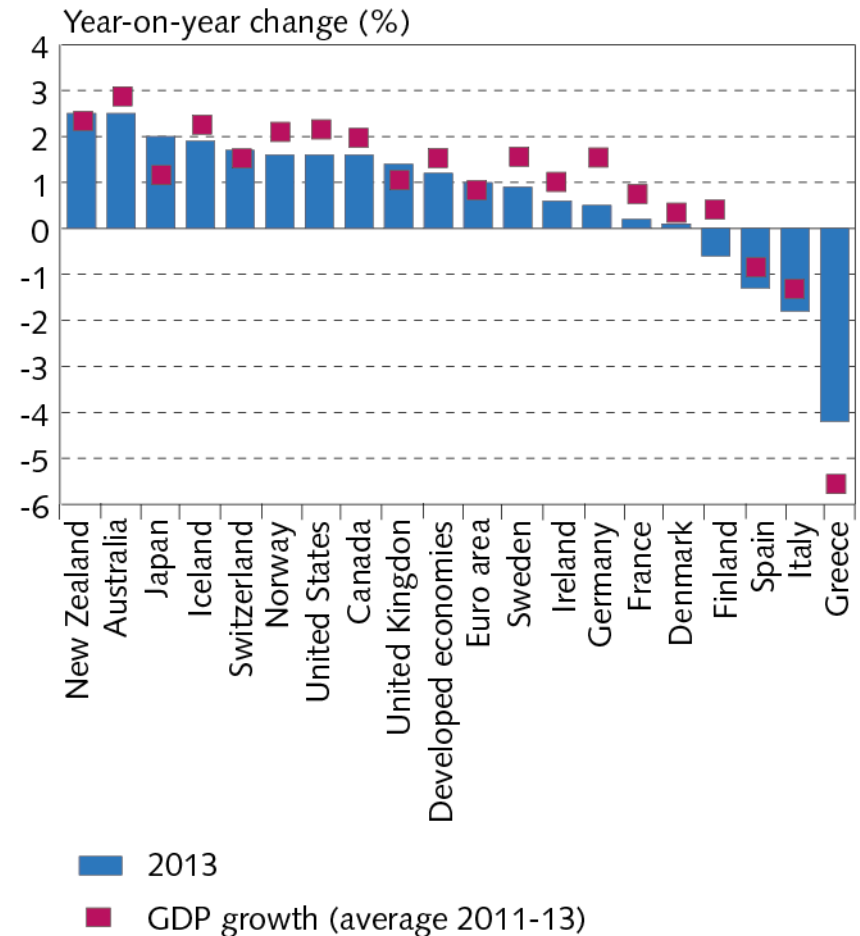
- Almost 90% of Iceland's banking sector failed in the first week of October
- Iceland was at that point already on its way into recession after an unsustainable boom during 2005-2007
- Iceland was suffering from a currency crisis
- Many expected the sovereign to default on its obligations

Where are we now?



- No talk of sovereign default
- Investment grade rating and sovereign has tapped foreign capital markets twice since the crisis
- Economic recovery since the middle of 2010
- Domestically oriented banking system has been rebuilt

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.

Nature of the problem



- Demand imbalances (eg current account deficit) and over-indebtedness
- Overextended sectors (finance and construction)
- Excess demand – temporary effective demand problem came as a result of the crisis, not its cause
- More Fischer and Hayekian elements than Keynesian
- Iceland a very small open economy => internal effective demand problems less of an issue (demand leakages and export led growth)

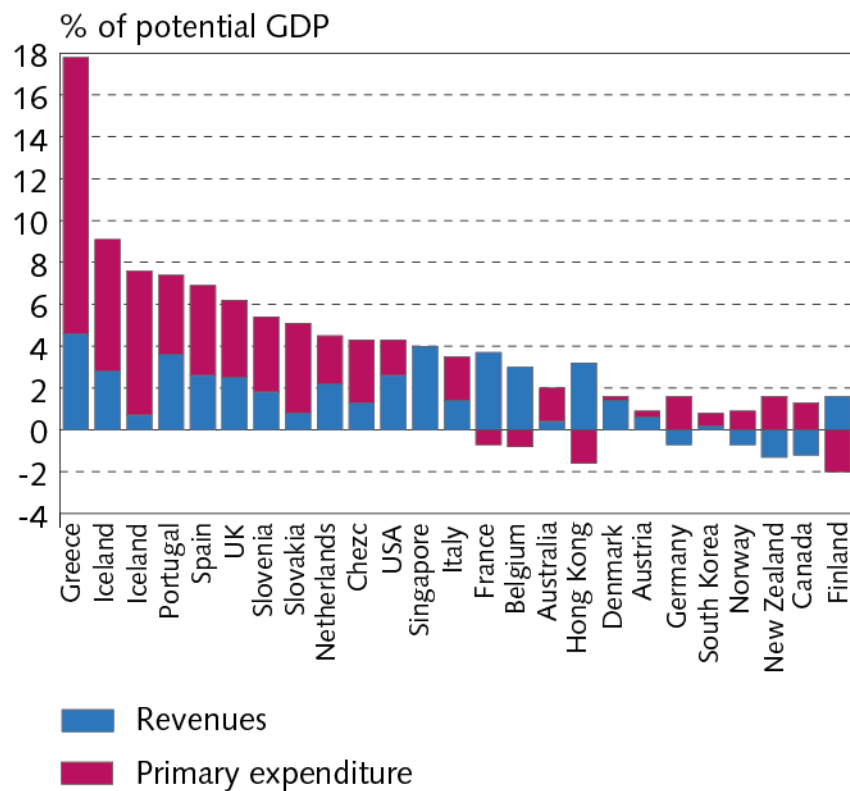
The policy response

- 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 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

Government finances during crisis and recovery

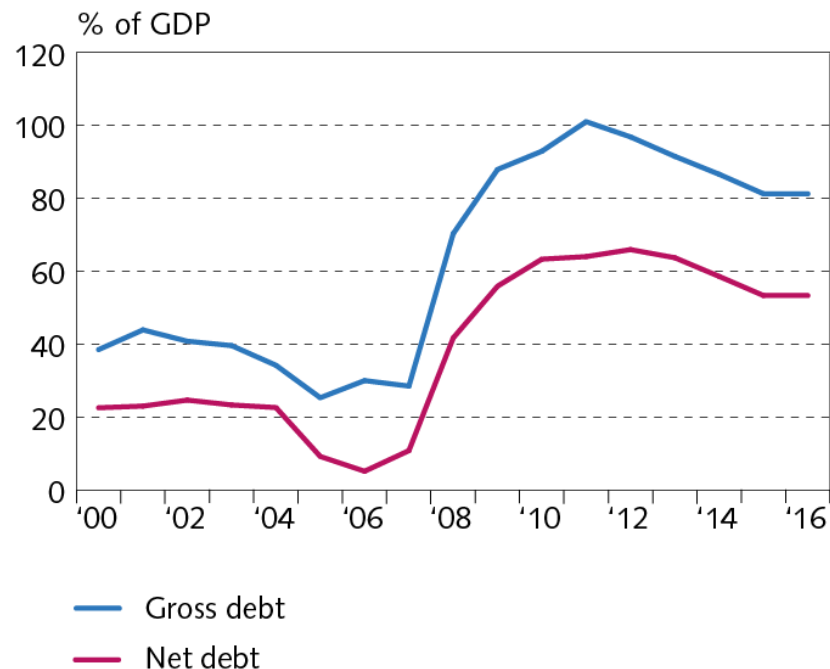


Composition of adjustment in several industrialised countries, 2009-2013¹



1. Adjustment of cyclically adjusted primary balance.
Source: IMF, *Fiscal Monitor*, October 2013.

General government debt 2000-2016¹

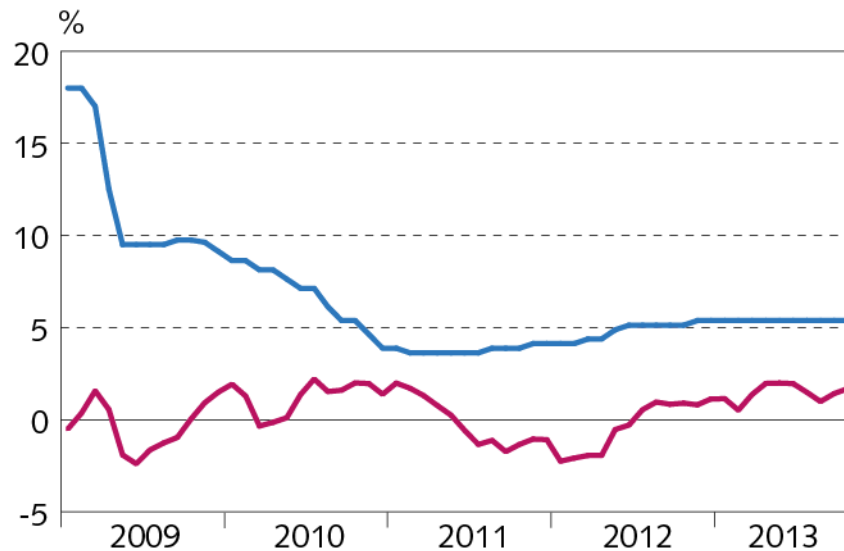


1. Central Bank baseline forecast 2013-2016.
Sources: Ministry of Finance, Statistics Iceland, Central Bank of Iceland.

Monetary policy and inflation



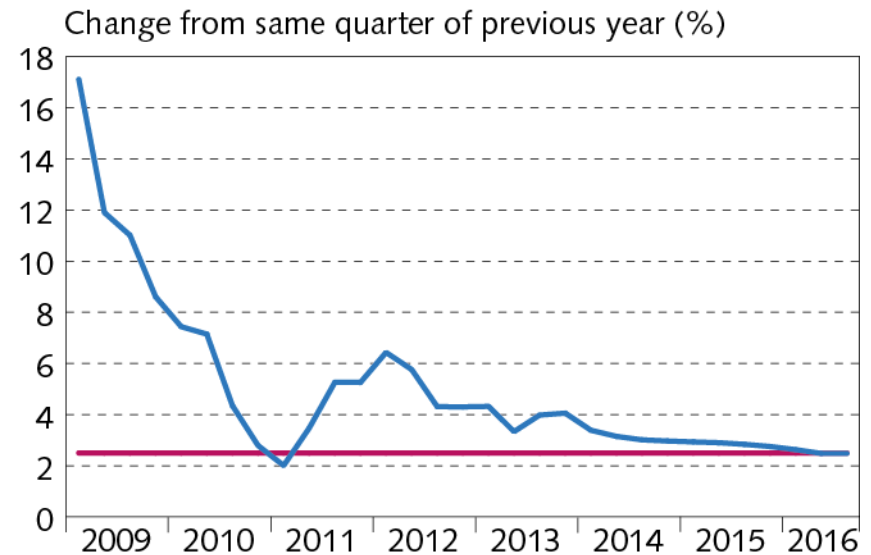
Real and nominal effective policy rates
of the Central Bank of Iceland



— Nominal policy rates
— Real policy rates

Sources: Statistics Iceland, Central Bank of Iceland.

Inflation¹



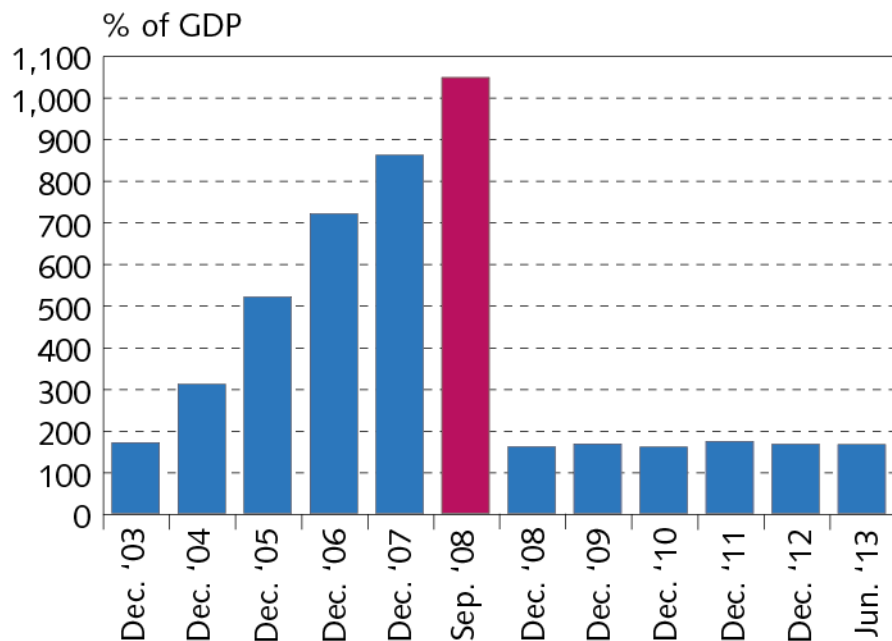
— Inflation
— Inflation target

1. Central Bank baseline forecast from Q3/2013 - Q3/2016.
Sources: Statistics Iceland, Central Bank of Iceland.

Reconstructing the financial sector

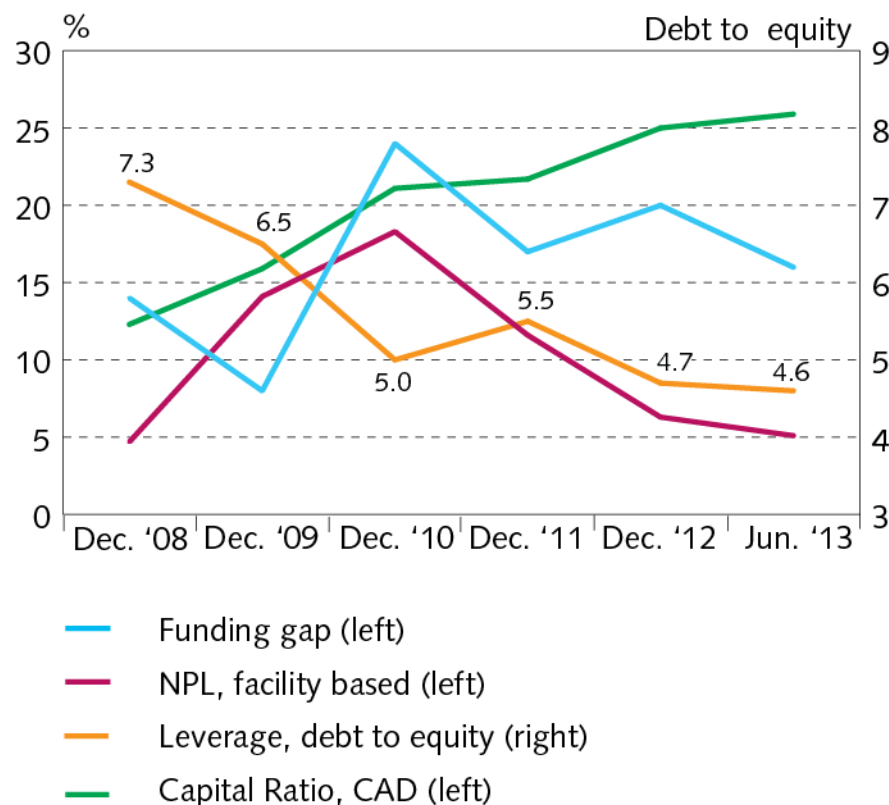


Commercial banks assets¹



1. The three large commercial banks.
Sources: Statistics Iceland, Central Bank of Iceland.

State of the commercial banks¹



1. The three large commercial banks.
Sources: Statistics Iceland, Central Bank of Iceland.

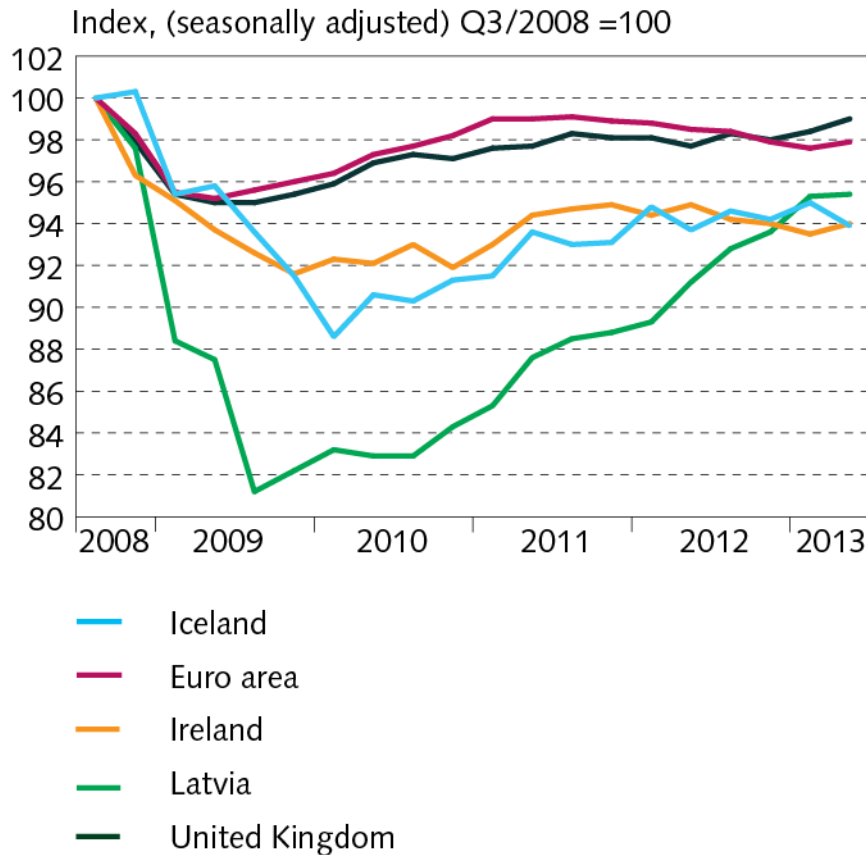


Recession and recovery

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



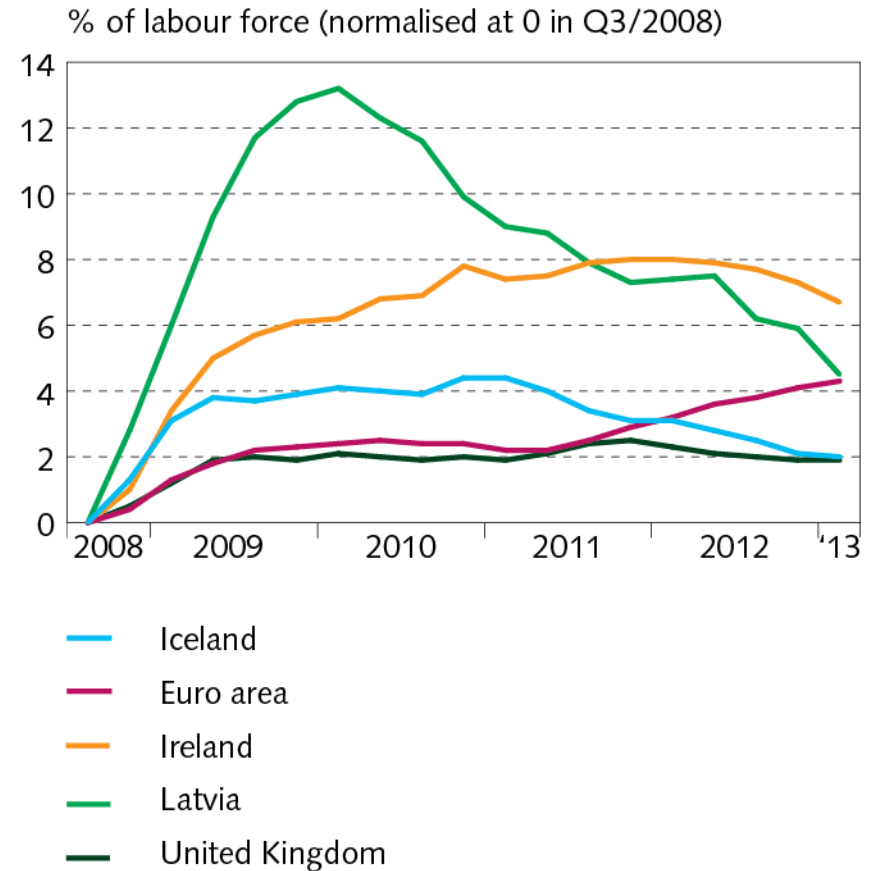
Level of GDP¹



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

Sources: Eurostat, OECD, Central Bank of Iceland.

Unemployment rate¹



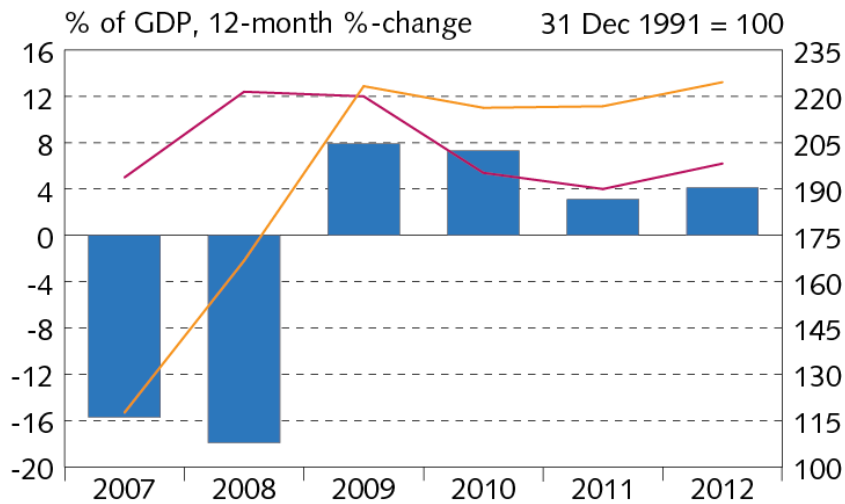
1. Seasonally adjusted harmonised unemployment rate, except for Latvia, as the series are seasonally adjusted by Eurostat.

Sources: Eurostat, OECD.

Stabilisation and recovery

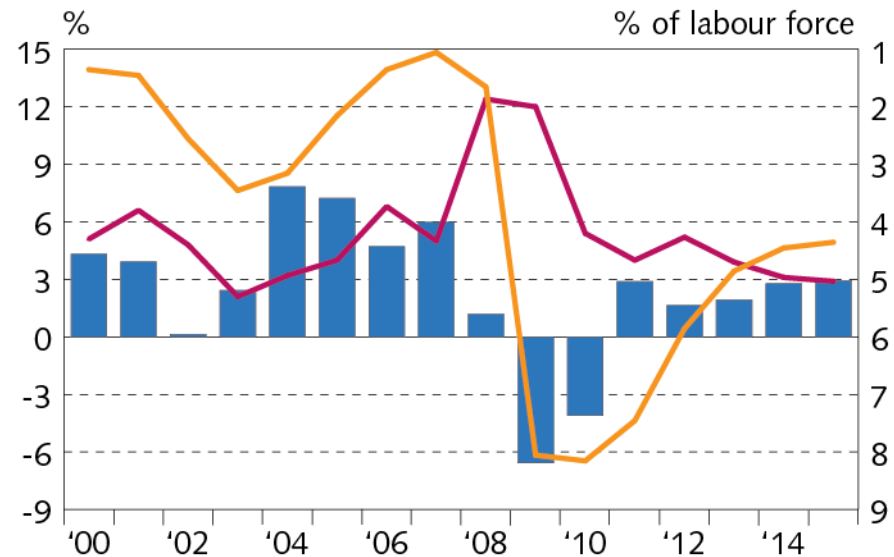


Current account balance, inflation and nominal exchange rate 2007-2012



- Current account balance excl. DMBs undergoing winding-up proceedings and Actavis (left)
- Inflation¹ (left)
- Nominal exchange rate index¹ (right)

GDP growth, output gap and unemployment rate¹



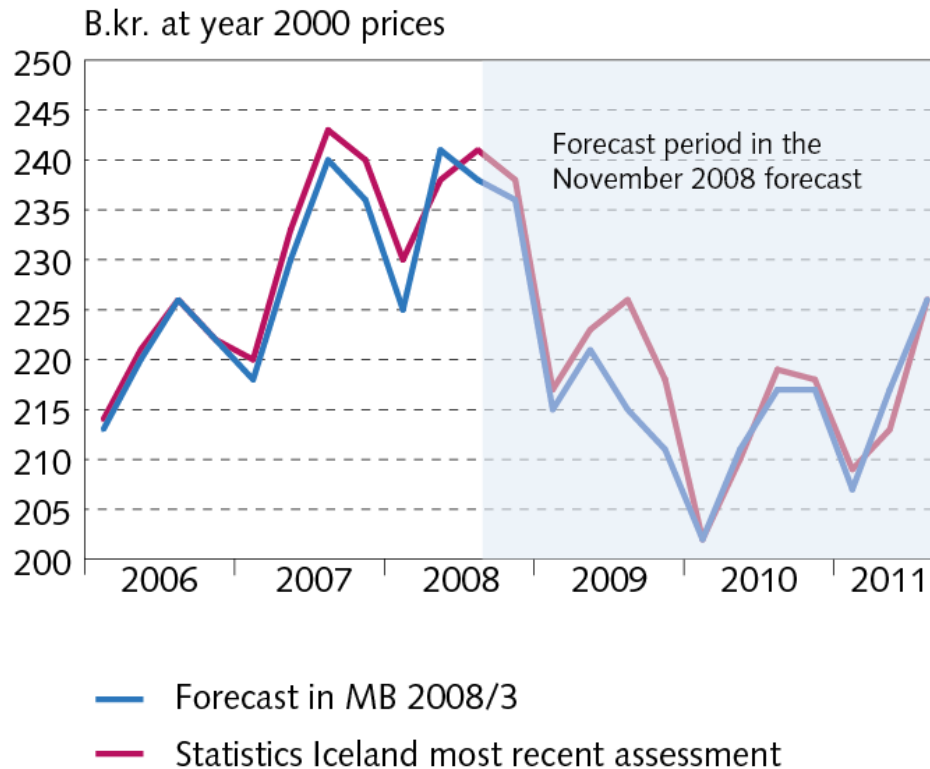
- GDP growth (left)
- Inflation (left)
- Unemployment (reverse right)

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.

1. Central Bank baseline forecast 2013-2015.
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.

Current challenges



- **Balanced sustainable growth with low inflation**
 - Deteriorating terms of trade and a shrinking current account surplus
 - Low investment and national savings rates
 - Inflation and inflation expectations persistently above target
 - Capital controls are putting obstacles in the way of real economic cross-border integration
- **Iceland's balance of payments crisis and the task of lifting capital controls**

Iceland's balance of payments crisis

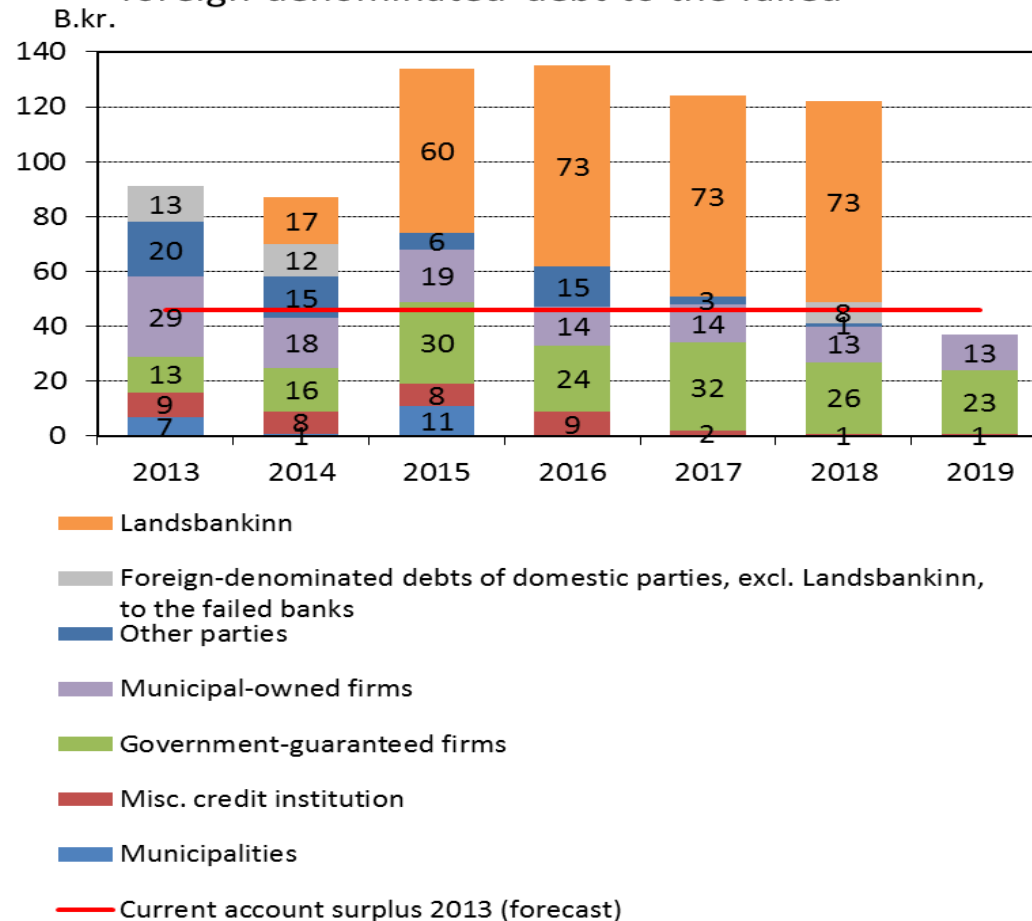


- Three elements:
 - Contractual foreign debt repayment burden is heavy in coming years and far in excess of reasonable estimates of the current account surplus
 - The current overhang of off-shore krónur: 20% of GDP
 - Unwinding of old banks: 95% of claims foreign but around third of recoveries are domestic
- Potential addition to krónur overhang from unwinding of old banks is 25-30%
- => around a half a GDP – compare to UK after the WWII

Iceland's balance of payments crisis



Estimated payments by parties other than the Treasury and CBI on foreign loans and foreign-denominated debt to the failed



1. All figures as of year-end 2012 and exchange rate of 29 August 2013.

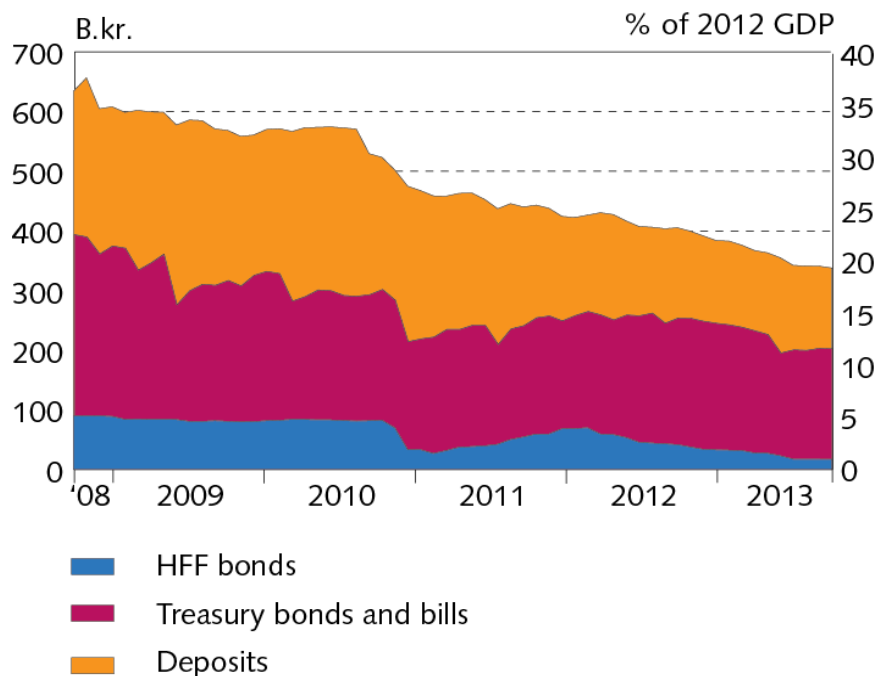
Source: Central Bank of Iceland.

Iceland's balance of payments crisis



Short-term króna assets held by non-residents

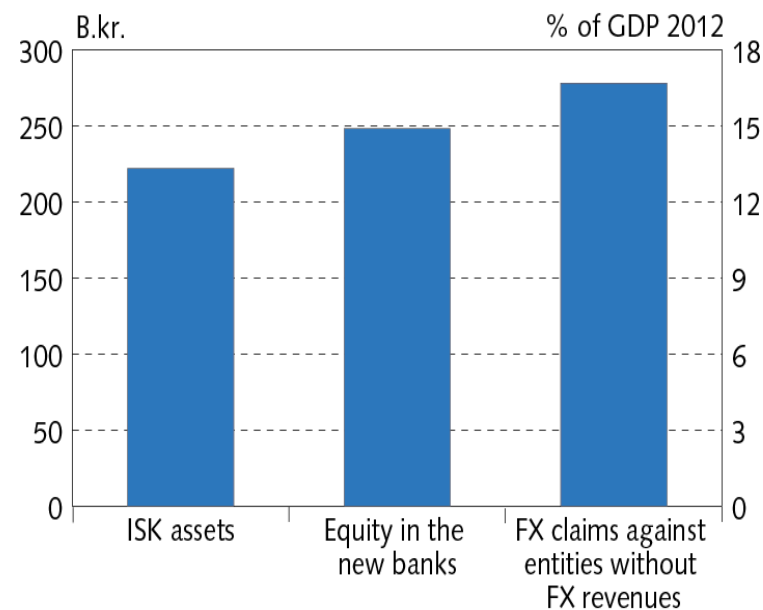
October 2008 - September 2013



Sources: Statistics Iceland, Central Bank of Iceland.

Domestic assets of the failed banks which need to finance

Book value 30.06.2013



Sources: Financial informations Glitnir, Kaupthing and LBI, Statistics Iceland, Central Bank of Iceland.



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 of the foreign debt service profile and realistic valuations in terms of FX of the offshore króna positions and króna recoveries of the failed banks.

