



Central Bank of Iceland

Shocks, adjustment, recession and recovery in Iceland

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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.



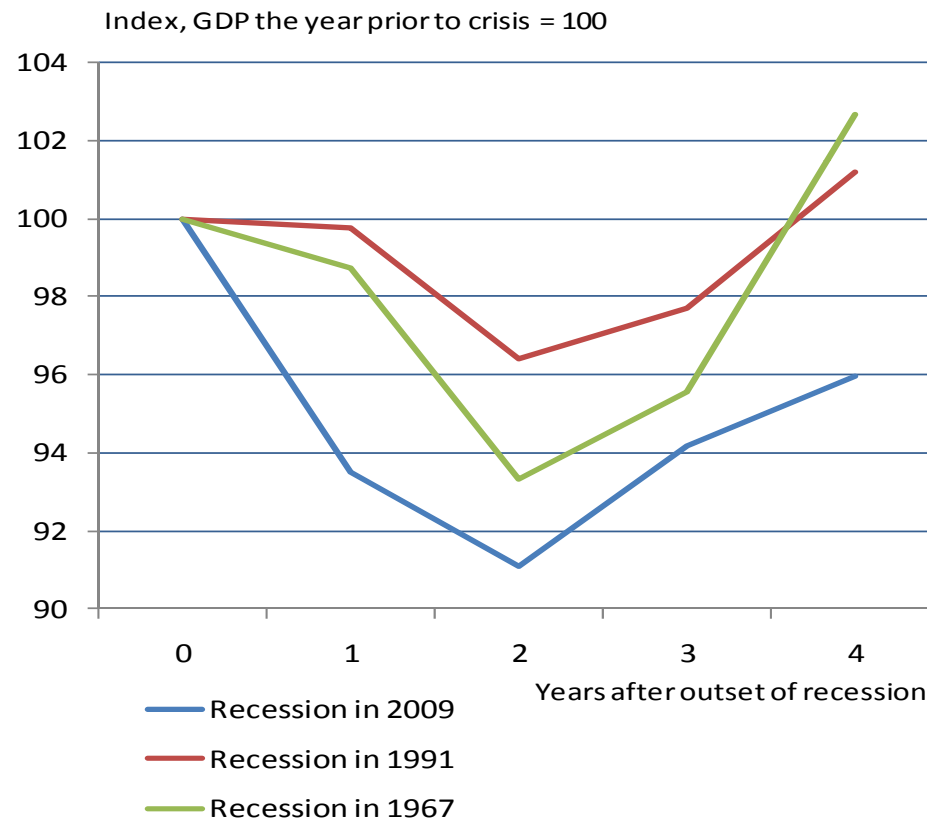
Adjustment and three shocks

- 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 recession is long and deep in historical comparison

Economic recovery in previous recessions

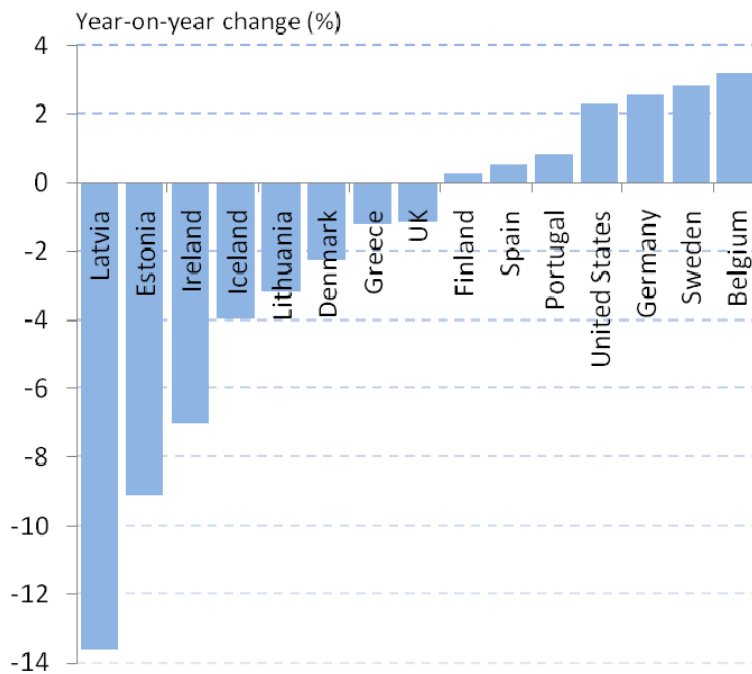


Source: Statistics Iceland, Central Bank of Iceland.

Iceland has not been the hardest hit

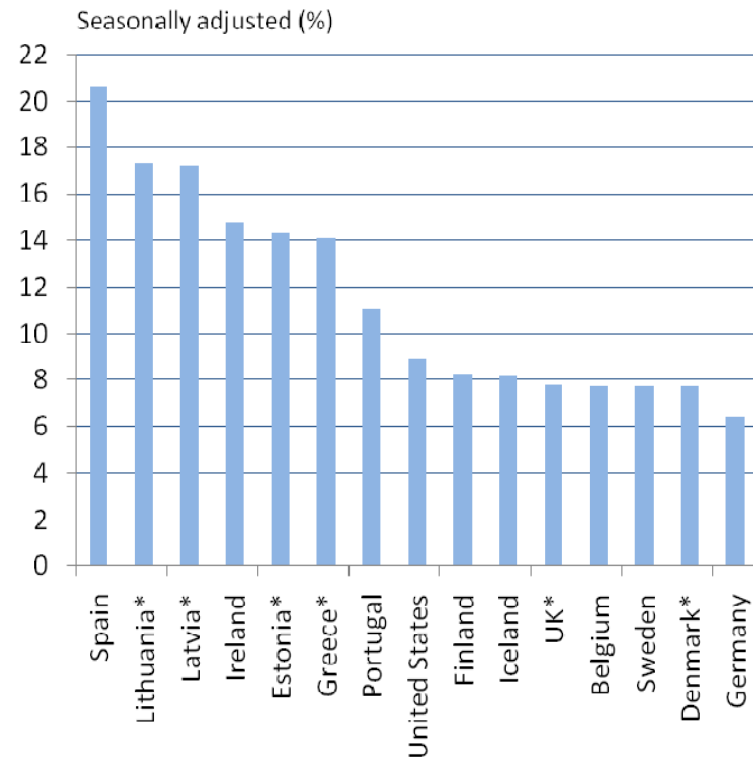


Percentage change in GDP from the average of 2005-2007 to 2010



Source: Eurostat.

Unemployment rate Q1 2011¹



1. Data for countries with an asterisk are only available for Q4/2010.

Source: Macrobond, Central Bank of Iceland.



Stabilisation

- The underlying current account has swung into a significant surplus (around 8% GDP in 2011 and 2012).
- This contributed to stabilisation of the exchange rate in the second half of 2009 and then appreciation in 2010 (12%).
- Exchange rate still 20% below 30-year average in real terms.
- Inflation has been close to the 2½% target recently.

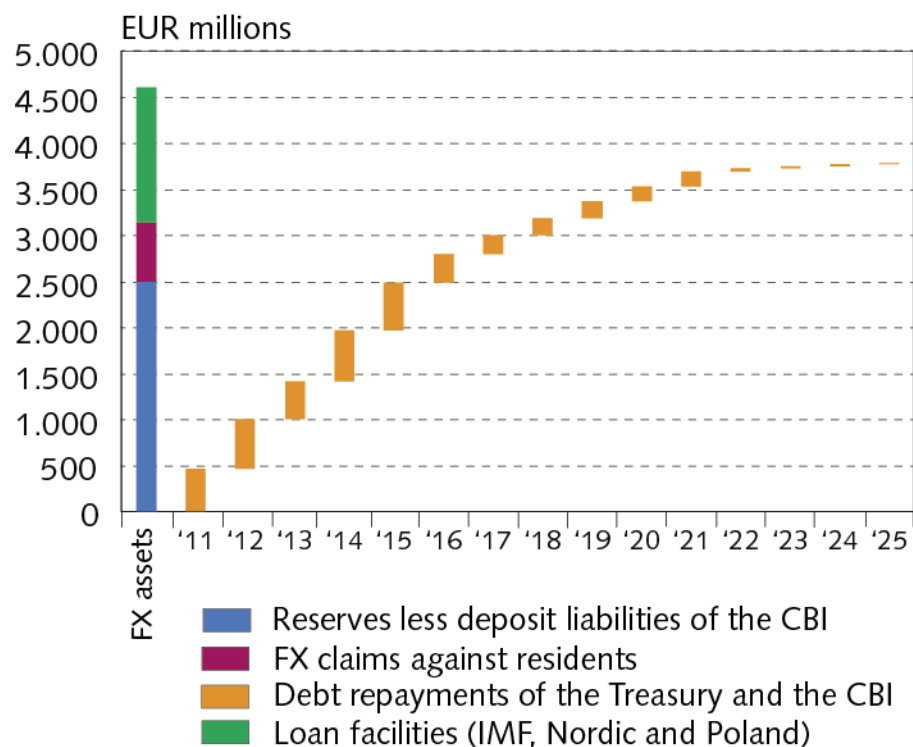


Recovery

- GDP seems to have begun growing again in Q3/2010.
- The recovery is still weak, however, and unemployment is still close to peak.
- Investment rate is at a historical low.
- Iceland faces the task of re-integrating into global capital markets.
- Lifting capital controls and demonstrating market access of the sovereign are important elements in the process.

FX reserves

Developments in FX reserves and repayment profile for foreign loans



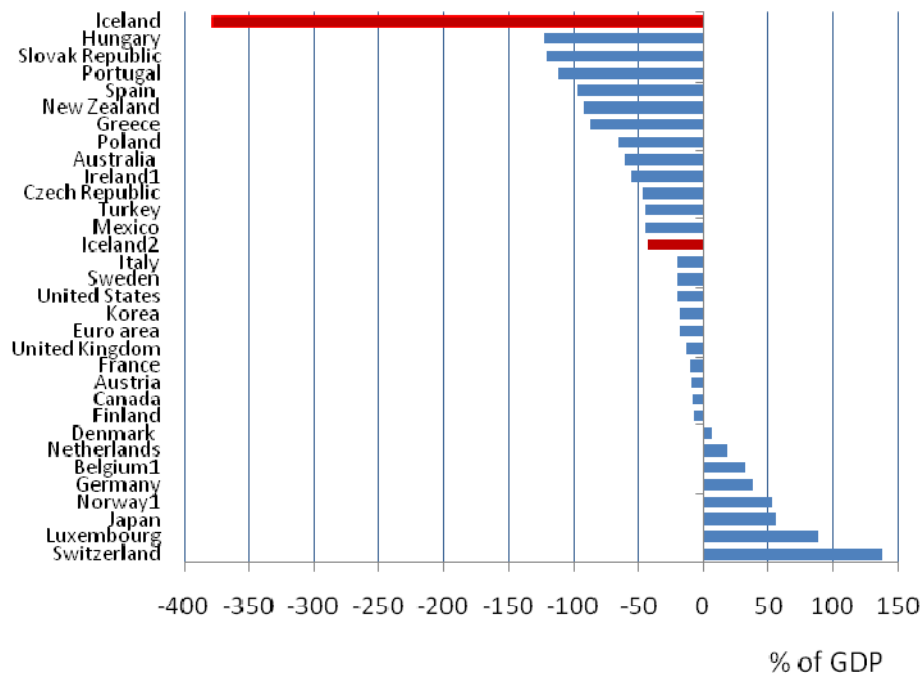
Source: Central Bank of Iceland.

- Current foreign exchange reserves are the largest in the history of Iceland (46% of GDP)
- FX reserves net of deposits cover repayments of Treasury and Central Bank FX debt well into 2015



International investment position

International investment position of OECD countries 2009



- When the failed banks have been wound up, Iceland will not be an outlier in terms of net foreign debt.
- Further excluding one private international company takes the net IIP to around $-\frac{1}{4}$ of GDP.

1. Figures are for 2008. 2. IIP excluding DMBs undergoing winding up proceedings.
Sources: IMF and various central bank and statistics websites.