



Central Bank of Iceland

Crisis and recovery in Iceland and the lessons to be learnt

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Harpa, 19 June 2012



Preamble: 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")

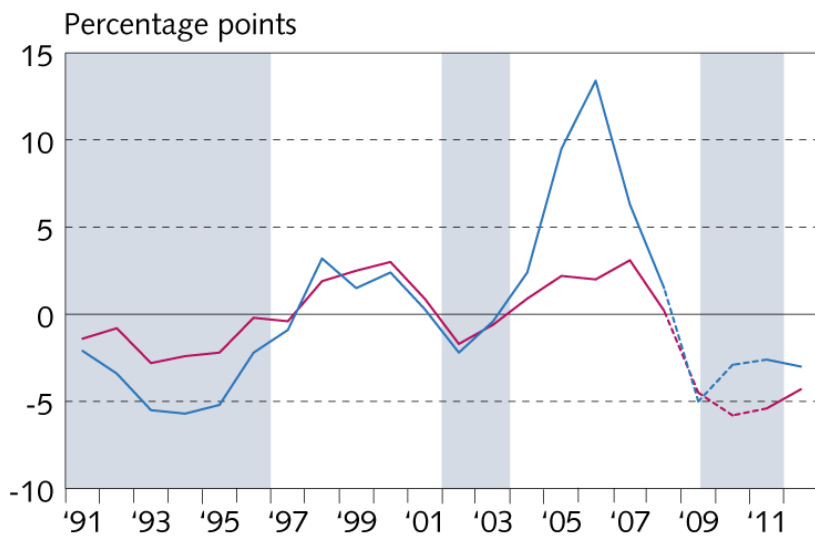
The two converged in a tragic grand finale in early October 2008, when Iceland's three commercial banks failed and were placed in special resolution regimes.

Positive investment shock, followed by overheating



Business investment as % of GDP 1991-2012¹

Deviation from average for 1970-2007

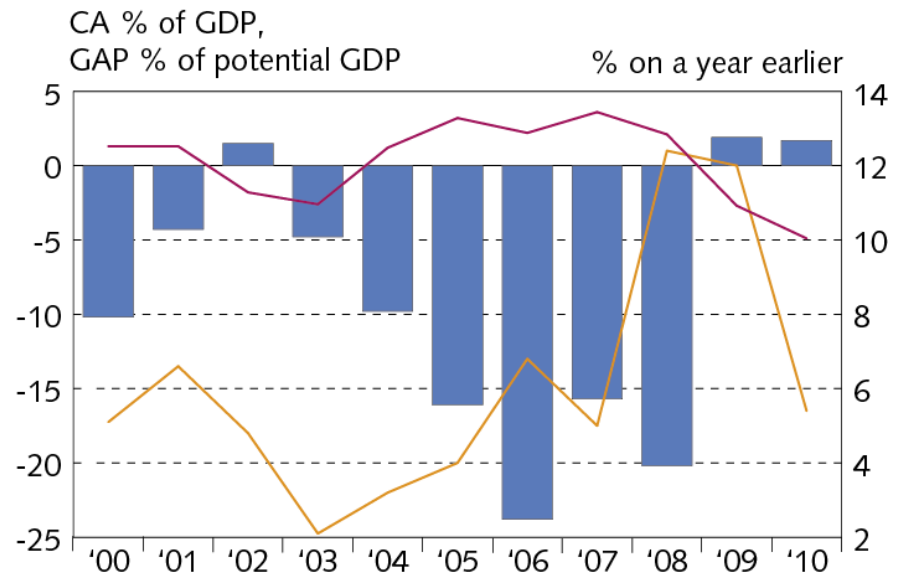


- Business investment
- Business investment excluding aluminium and power stations

1. Central Bank baseline forecast 2009-2012. Shaded areas show periods with negative output gap.

Sources: Statistics Iceland, Central Bank of Iceland.

Current account, output gap and inflation



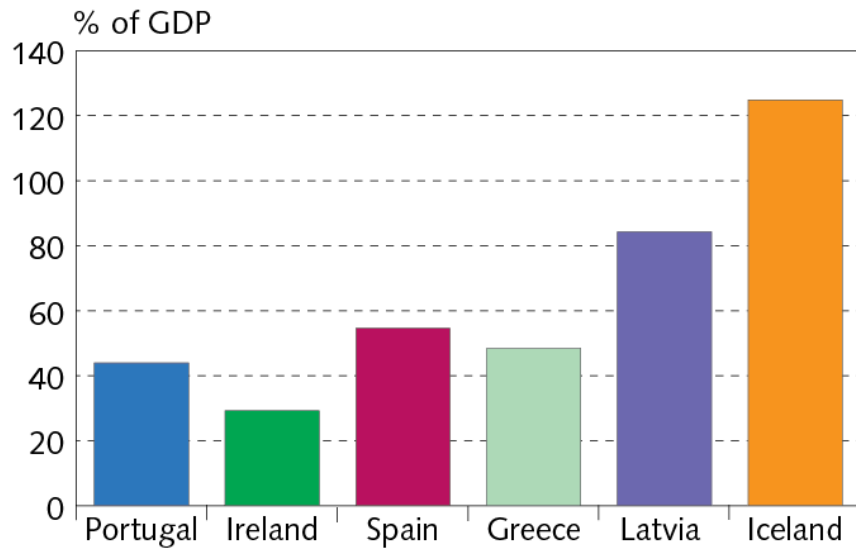
- Current account balance excl. DMBs undergoing winding-up proceedings (left)
- Output gap (left)
- Inflation (right)

Sources: Statistics Iceland, Central Bank of Iceland.

Fuelled by strong capital inflows

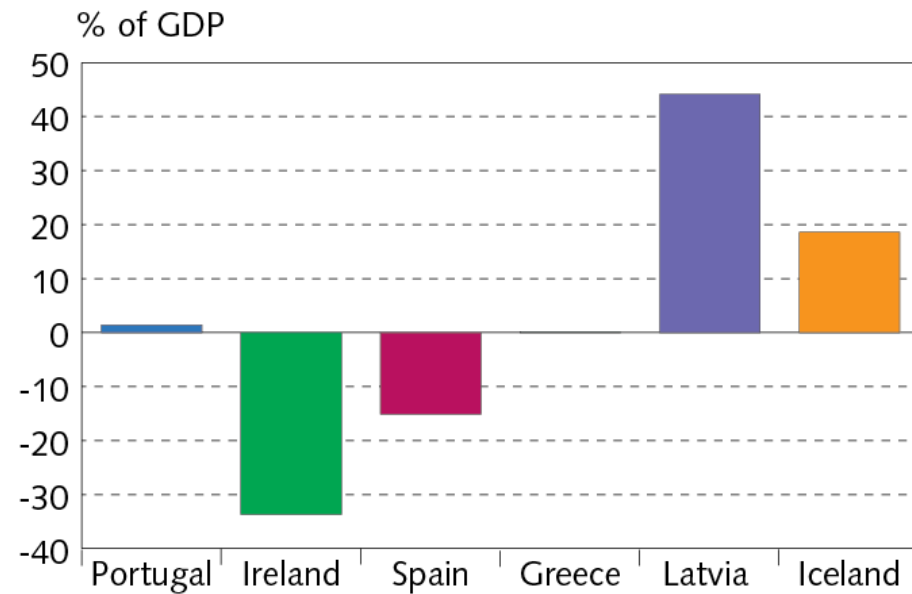


Net private capital inflows excluding FDI, cumulative 2002 - 2008



Sources: Various Central Bank websites.

Net FDI, cumulative 2002-2008



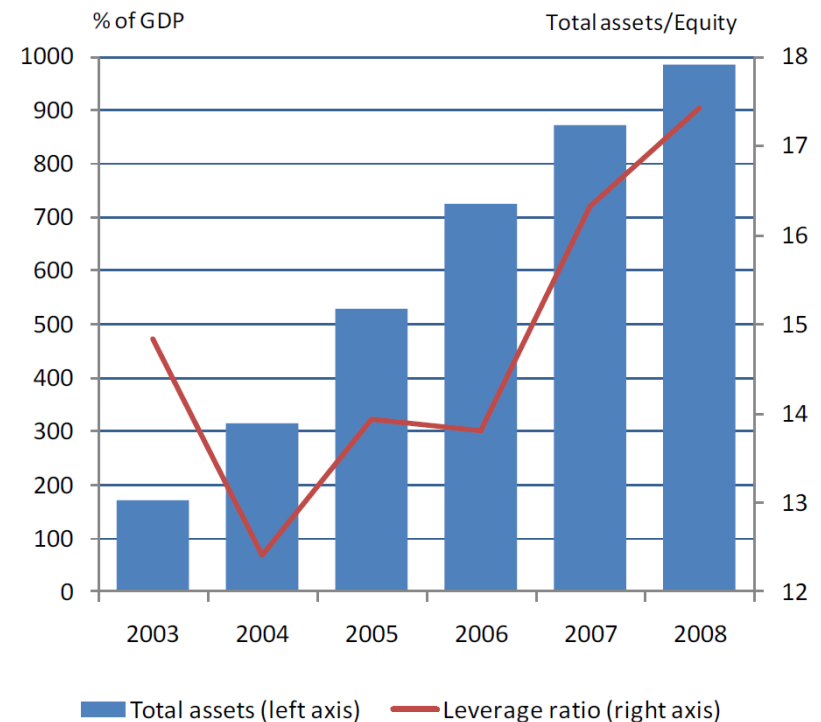
Sources: Various Central Bank websites.

Cross-border banks facilitated by EU framework



- EU “passport” with common legal and regulatory framework...
- ...but national supervision, deposit insurance, LOLR and crisis management, and resolution
- Over $\frac{2}{3}$ of total lending and deposits in foreign currency
- 41% of assets in foreign subsidiaries

Banks' balance sheet expansion and leverage



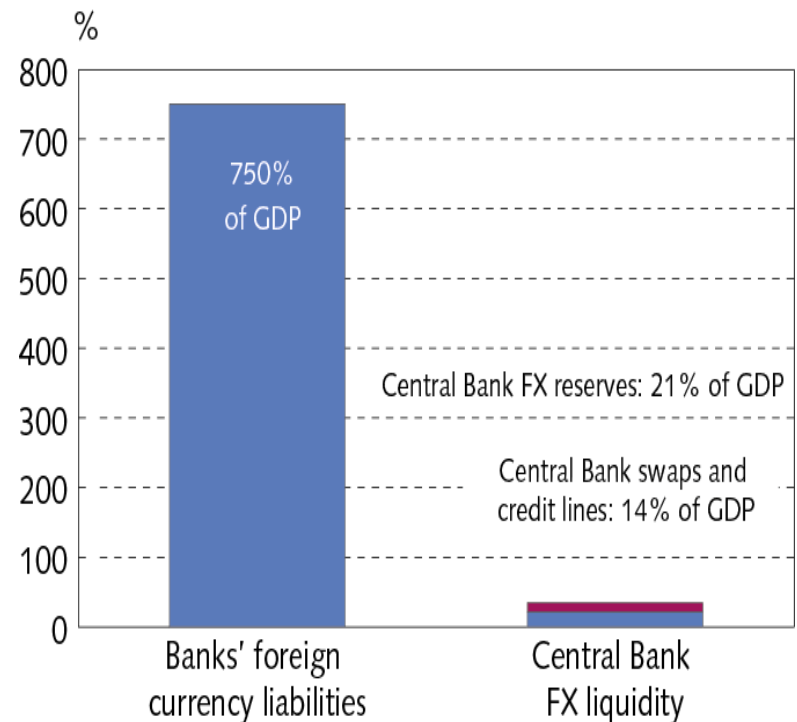
Consolidated accounts of three largest commercial banks. 2008 data is end-June.

Source: Central Bank of Iceland.

A run on foreign currency liabilities

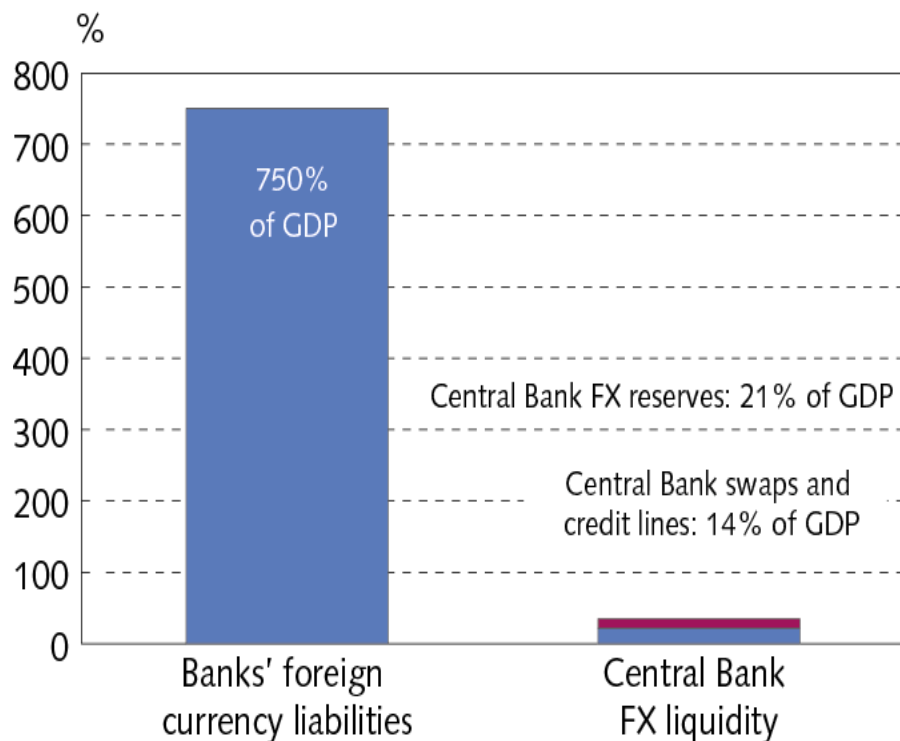
- The Icelandic banks were largely unable to refinance foreign currency liabilities after the outbreak of the international financial crisis in August 2007.
- Run on FX liabilities of banks post-Lehman in late September 2008.

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



Footnote deposits in foreign branches markets

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



- CBI FX amounted to €2½ bn in September 2008, and access to foreign capital markets was closed.
- FX deposits in UK and Netherlands branches of Landsbanki amounted to €11½ bn.
- Paying out EU minimum deposit insurance would have required €4½ bn.

Adjustment and three shocks

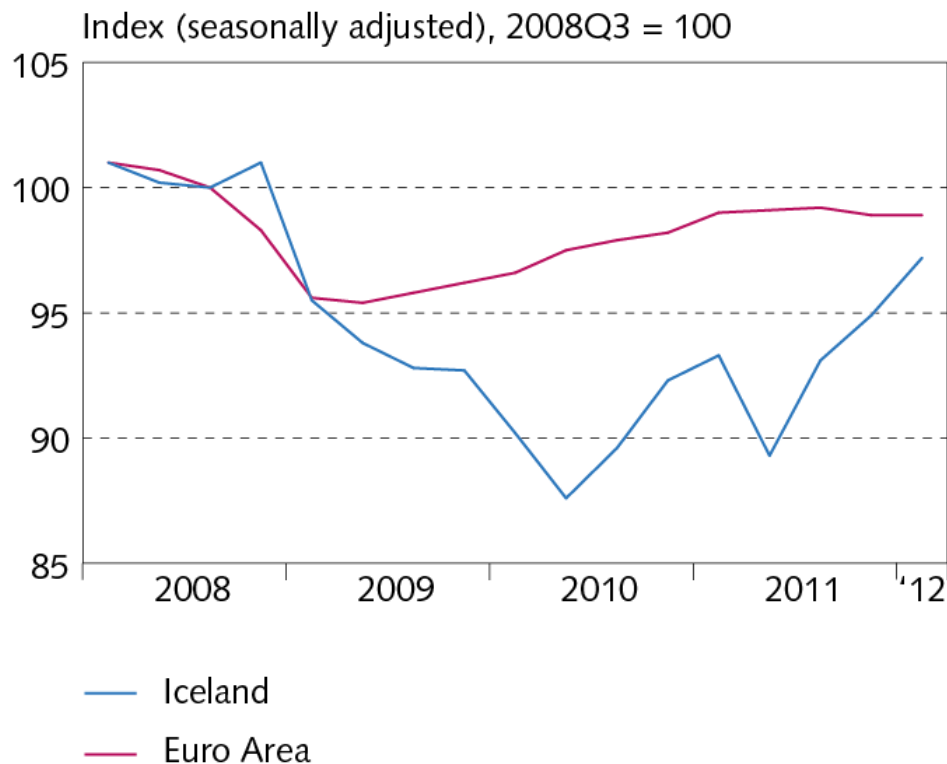
- Unusually large external and internal macroeconomic imbalances in 2005-2007.
- Their subsiding was bound to be associated with a significant slowdown, if not an outright recession (from 2006 onwards, the CBI consistently predicted a recession in 2009).
- Currency crisis in early 2008 (exchange rate 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

The recession was deep in international comparison

GDP level
Q1/2008 - Q1/2012



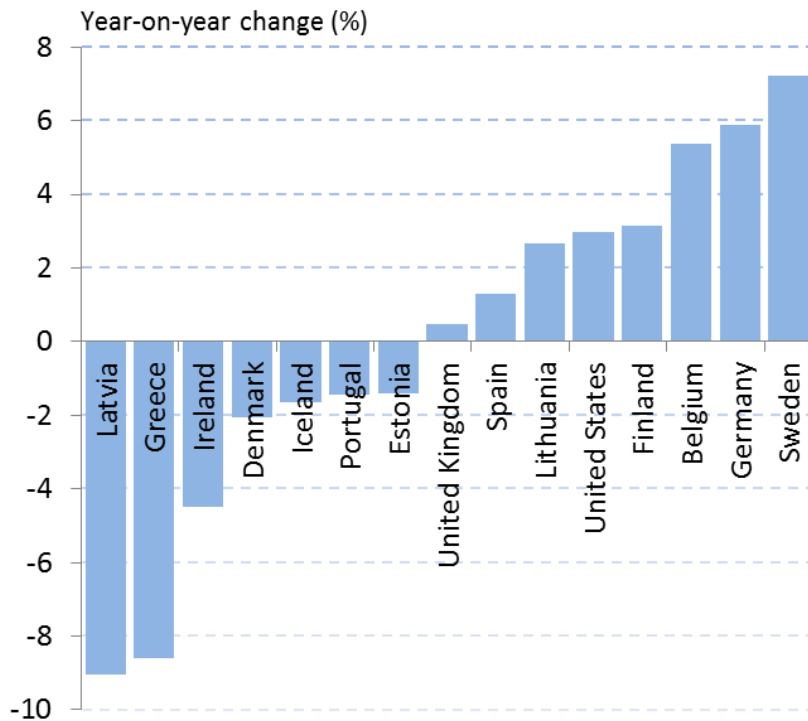
Source: Eurostat.

- GDP contracted by almost 12% from its peak in Q4/2007 to its trough in H1/2010
- But that was a decline from an overheated level

But Iceland was not the hardest hit



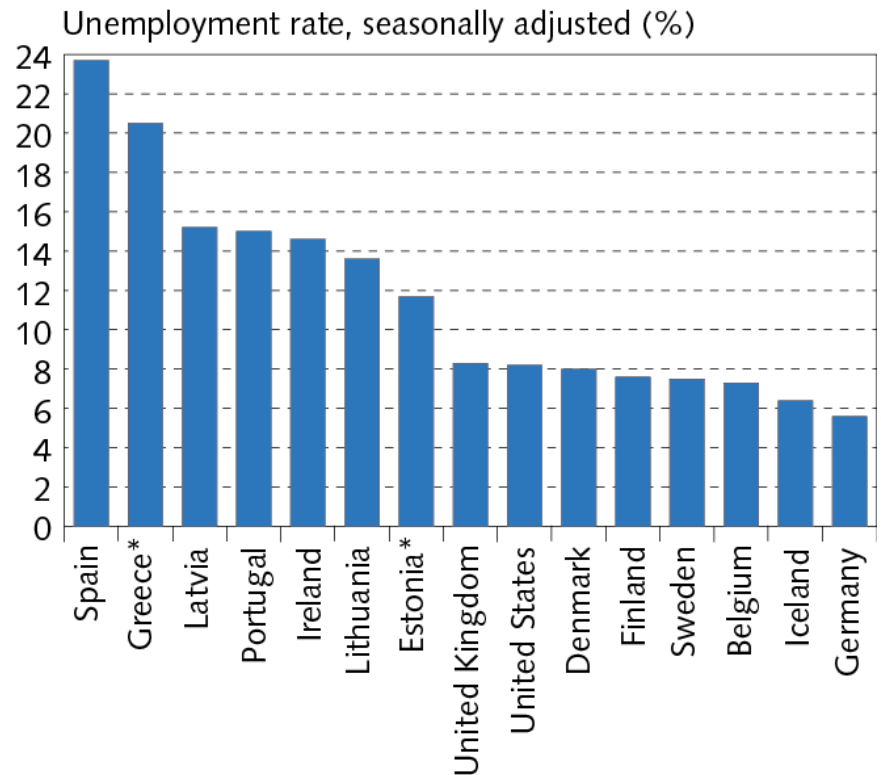
Percentage change in GDP from the average of 2005-2007 to 2011¹



1. Based on forecasts for 2011.

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

Unemployment rate Q1 2012¹



1. Data for countries with an asterisk are only available for Q4/2011.

Source: Macrobond.

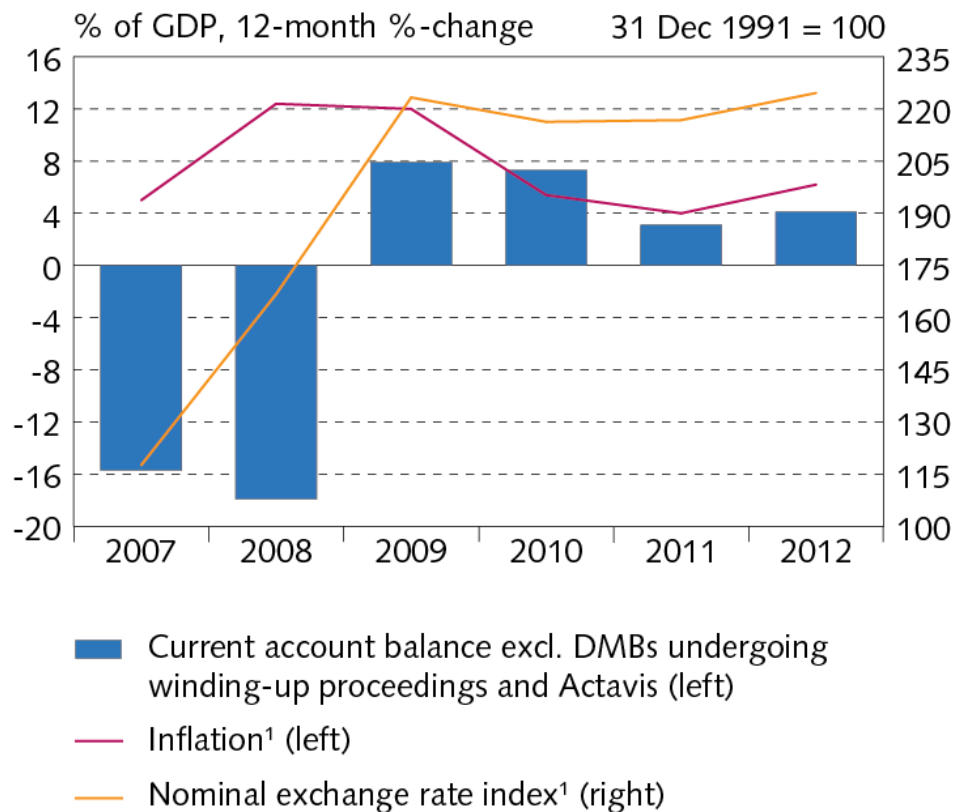


Stabilisation and recovery

Stabilisation

- Pre-crisis current account deficit in double digits has swung into a significant underlying surplus
- Exchange rate stabilised in H2/2009 and appreciated in 2010
- Inflation and interest rates followed down

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



- Recovery of GDP began in H2/2010
- Growth 3.1% in 2011 and 4.5% in Q1/2012.
- GDP in Q1 was 5.7% below the previous peak in Q4/2007.
- Unemployment has been declining (5½% in May).

GDP level and unemployment
Q1/2005 - Q1/2012

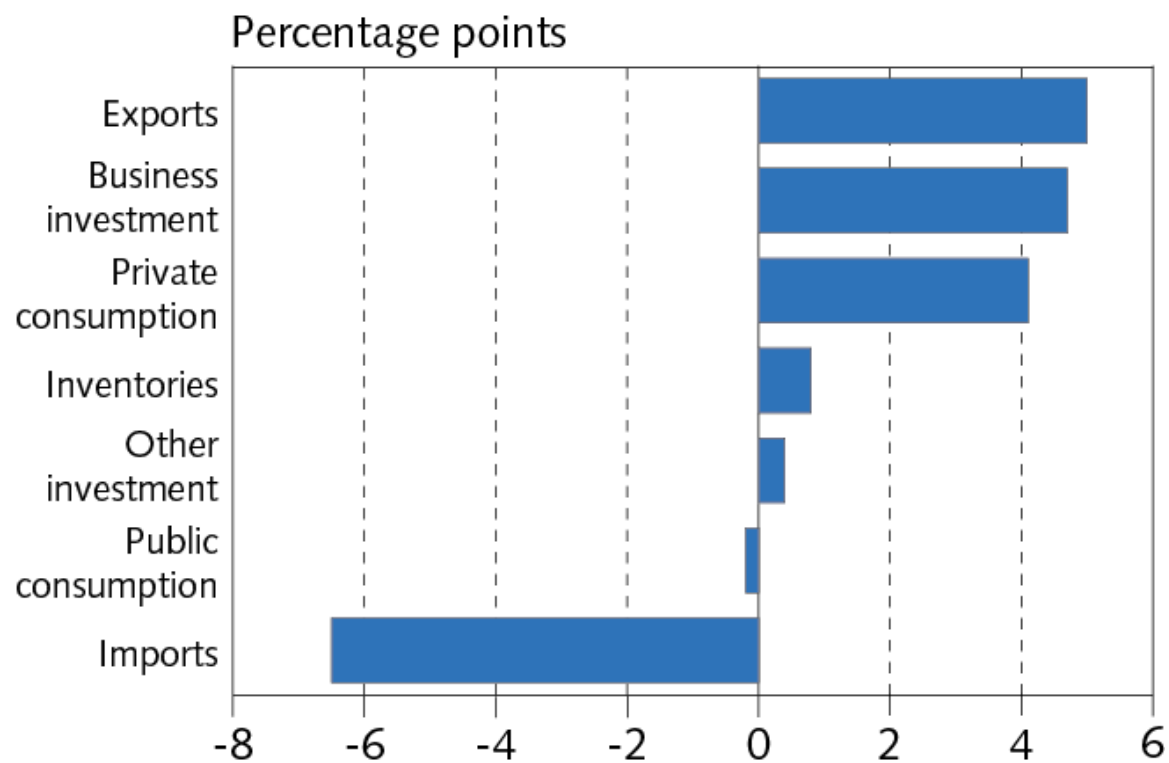


Sources: Directorate of Labour, Statistics Iceland.

Drivers of the recovery



Contribution of GDP components to economic recovery¹



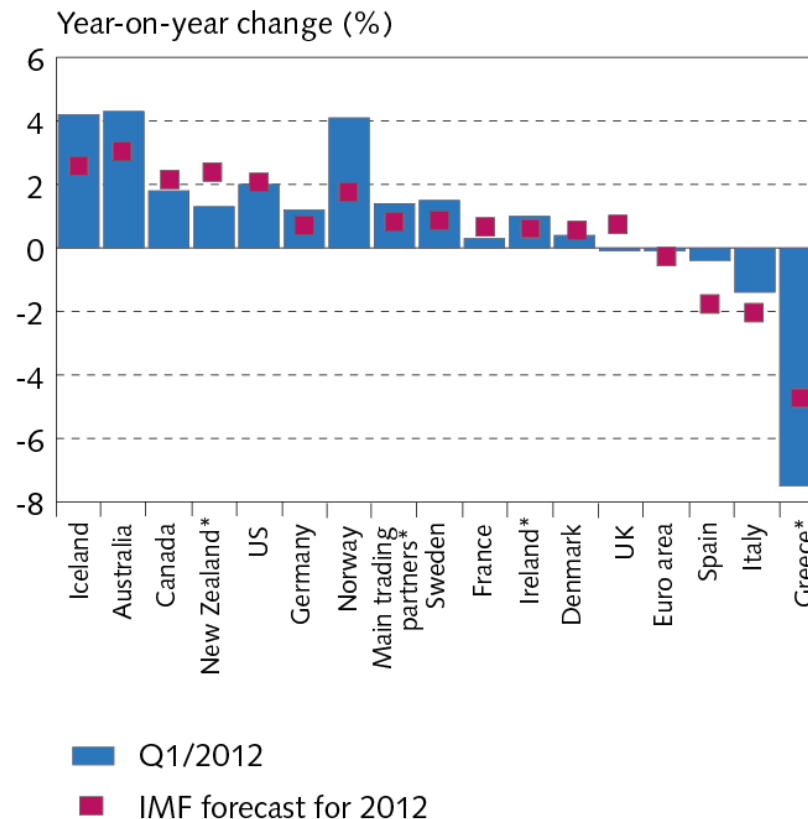
1. From Q2/2010 - Q4/2011.

Sources: Statistics Iceland, Central Bank of Iceland.

Latest GDP growth and prospects for 2012 in international comparison



GDP growth on Q1/2012 and outlook for GDP growth in 2012



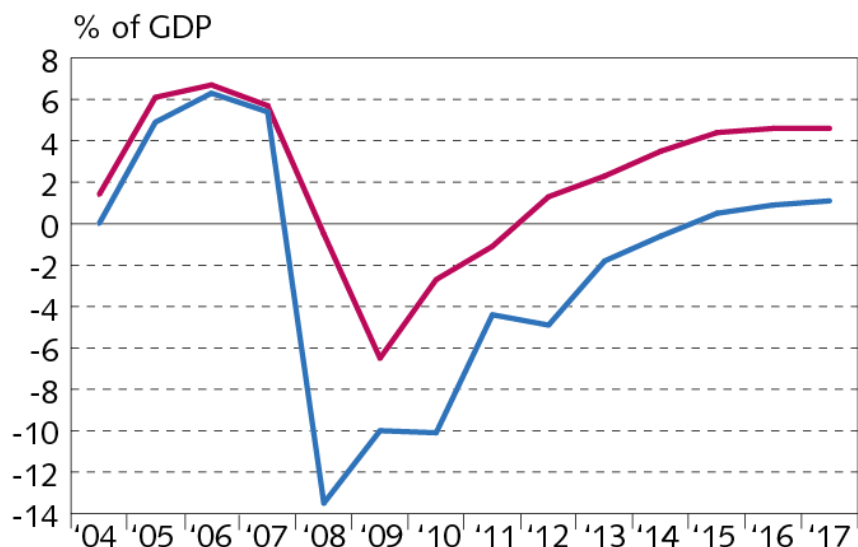
Data for countries with an asterisk are only available for Q4/2011.

Sources: Eurostat, IMF, OECD, Statistics Iceland.

Fiscal consolidation is progressing



General government balance 2004-2017

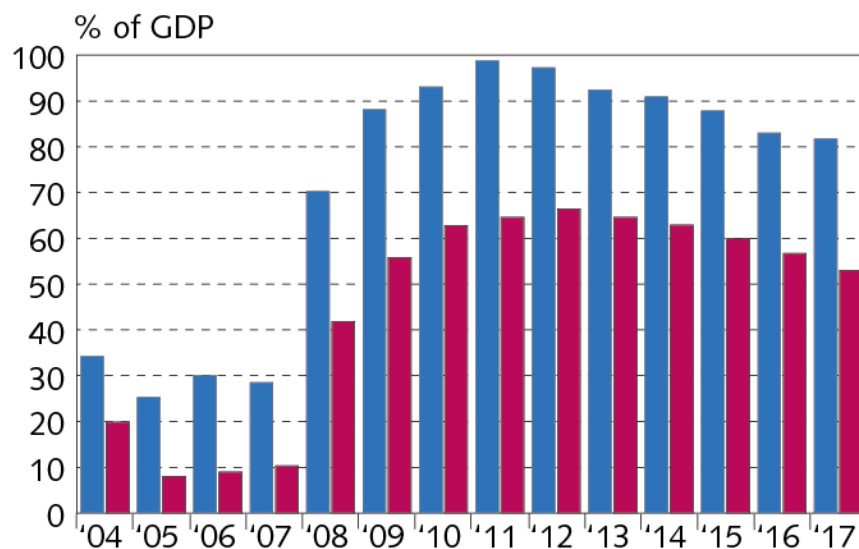


— General Government overall balance¹
 — General Government primary balance

1. Including Write-offs. IMF forecast for 2012-2017.

Sources: IMF, Statistics Iceland.

General government debt ratios 2004-2017¹



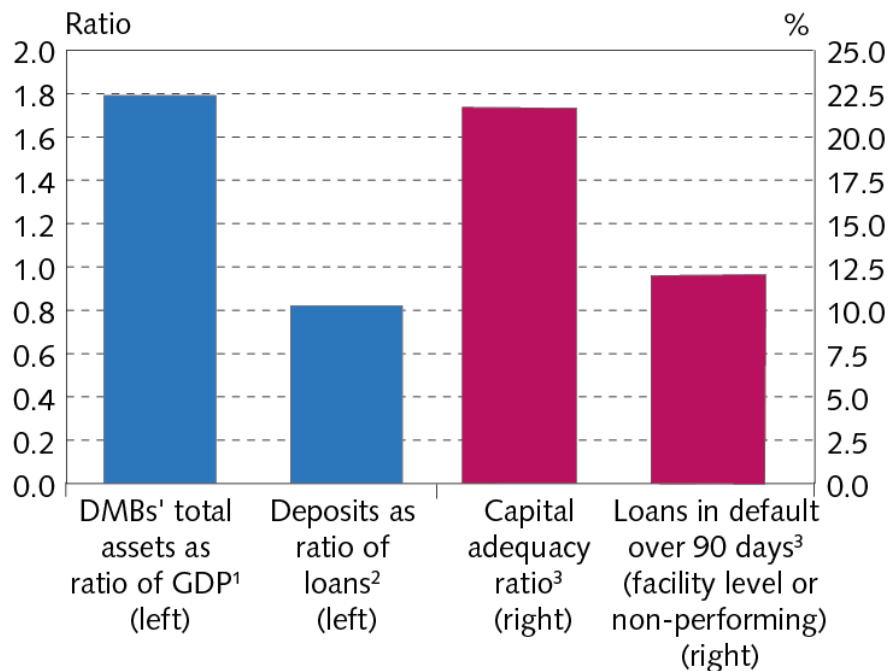
■ General Government gross debt
 ■ General Government net debt

1. IMF forecast for 2012-2017.

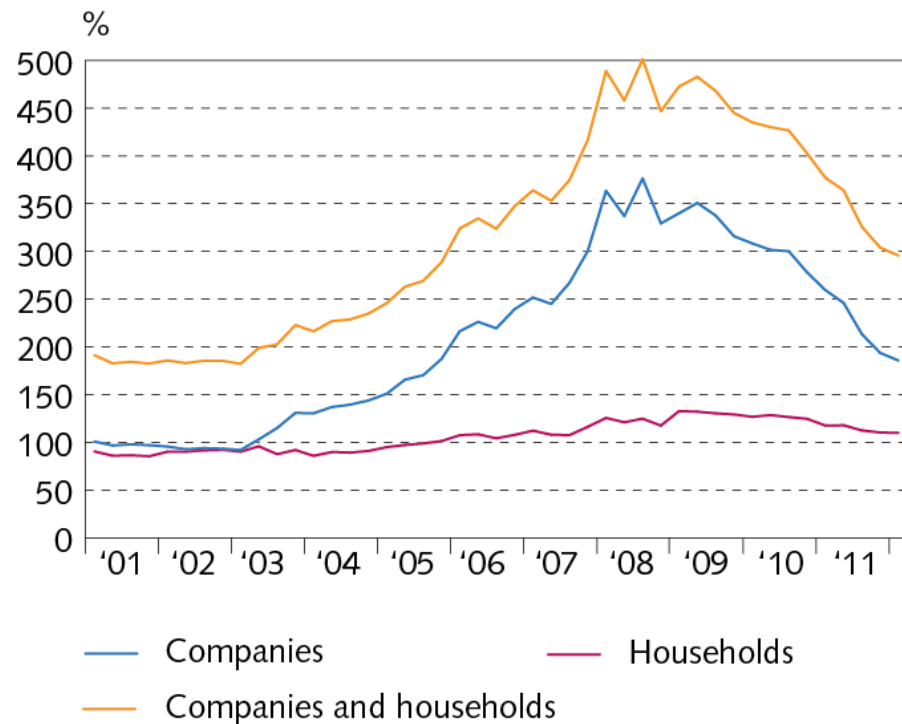
Sources: IMF, Statistics Iceland.

The domestic financial sector has been rebuilt and private sector debt restructuring is underway

Key metrics of the banking system year-end 2011



Private sector debt

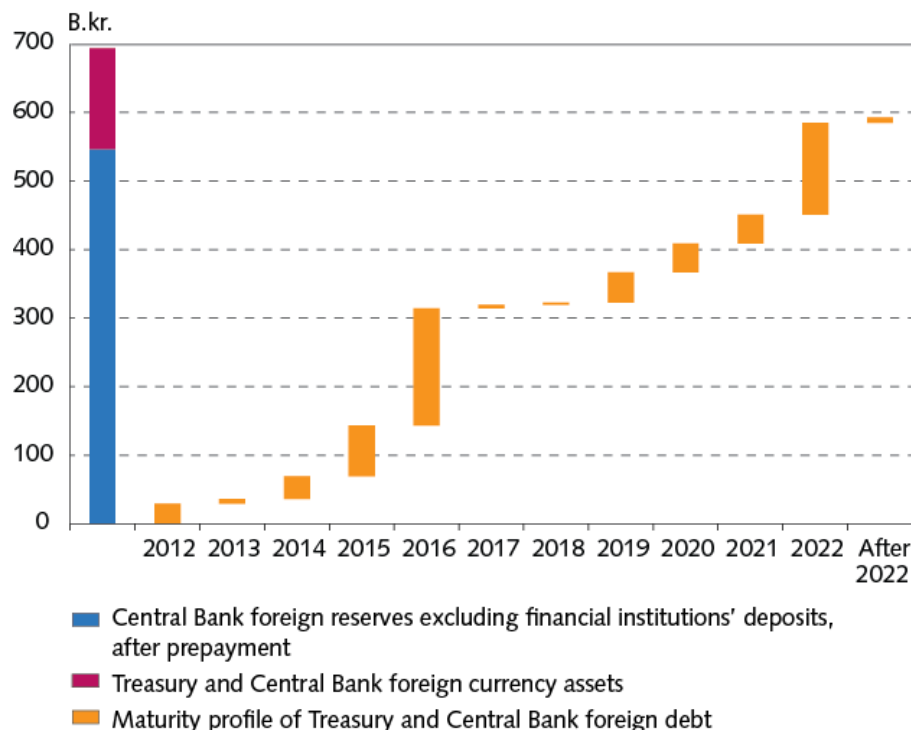


1. Includes commercial banks and savings banks.
2. Includes all commercial banks.
3. Includes the three largest commercial banks.

Source: Central Bank of Iceland.

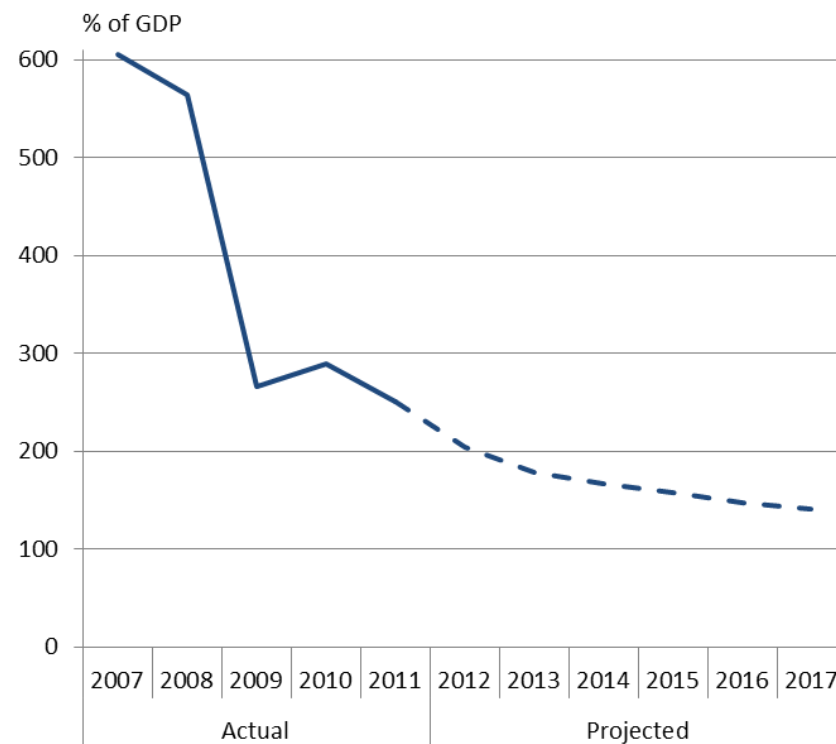
FX reserves cover sovereign debt service beyond 2022 and foreign debt is on a declining path

Maturity profile: Treasury and Central Bank foreign debt



Source: Central Bank of Iceland

IMF External Debt Baseline Projection



Source: IMF Article IV Review, 2012



Current policy challenges

Policy challenges



- Maintaining the momentum of fiscal consolidation through the political cycle
- Bringing inflation back to target
- Lifting controls on capital outflows

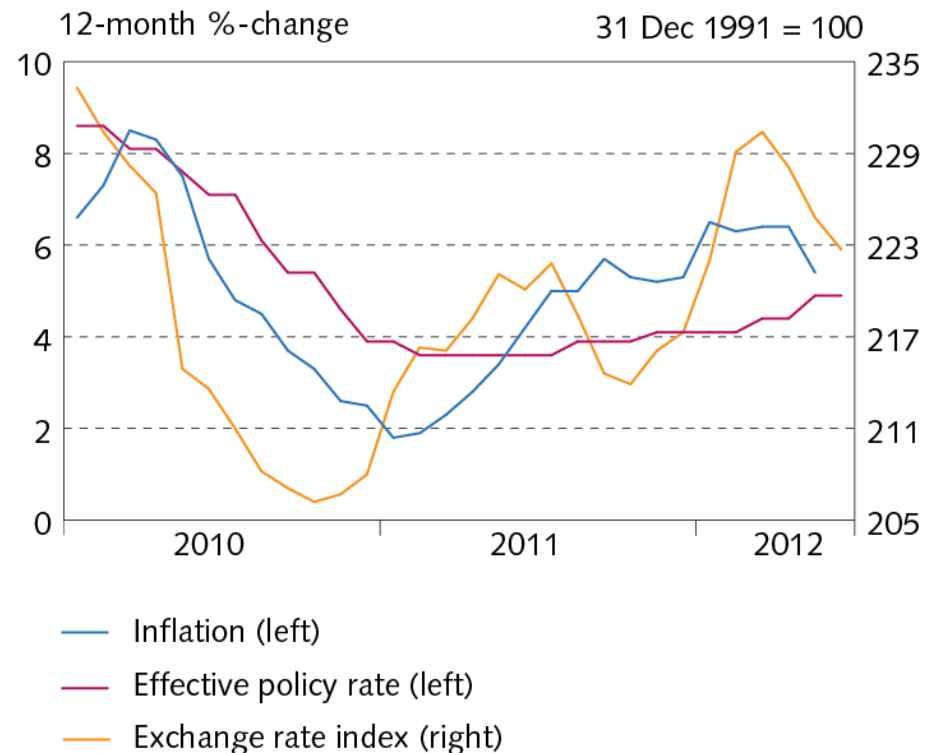
Monetary policy and inflation



- Inflation has increased significantly since reaching target in early 2011
- Fuelled by exchange rate weakness and high wage increases, which in turn are fuelled by the strong position of export sectors
- Monetary policy has responded by raising the policy rate by 1.5 percentage points since August 2011
- Negative real rates supported the recovery

Inflation, exchange rate index and effective policy rate

January 2010 - June 2012



1. For June 2012, exchange rate is shown as an average from 1 June - 15 June.

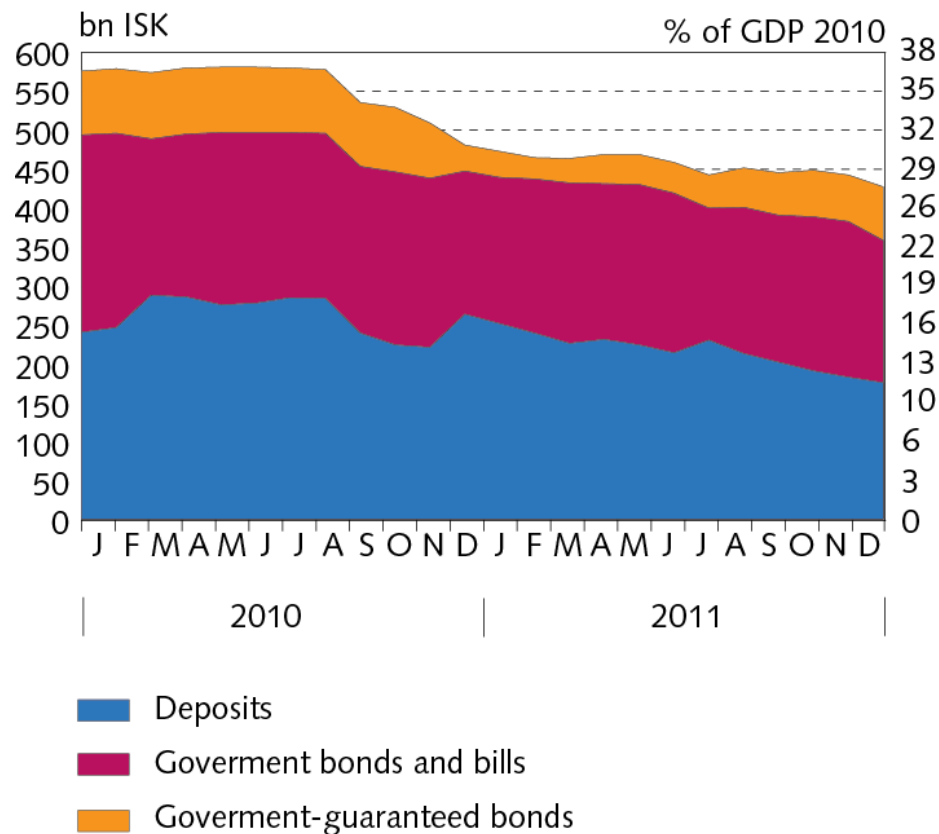
Sources: Statistics Iceland, Central Bank of Iceland.

Lifting capital controls: the overhang



- Liquid króna positions held by non-residents are a legacy of pre-crisis capital inflows and carry trade
- They are a key obstacle to removal of controls on capital outflows
- Have been reduced through auctions and bilateral deals
- 12% of GDP will be added by estates of failed banks but will be offset by somewhat larger FX payments to residents

Non-residents' ISK assets

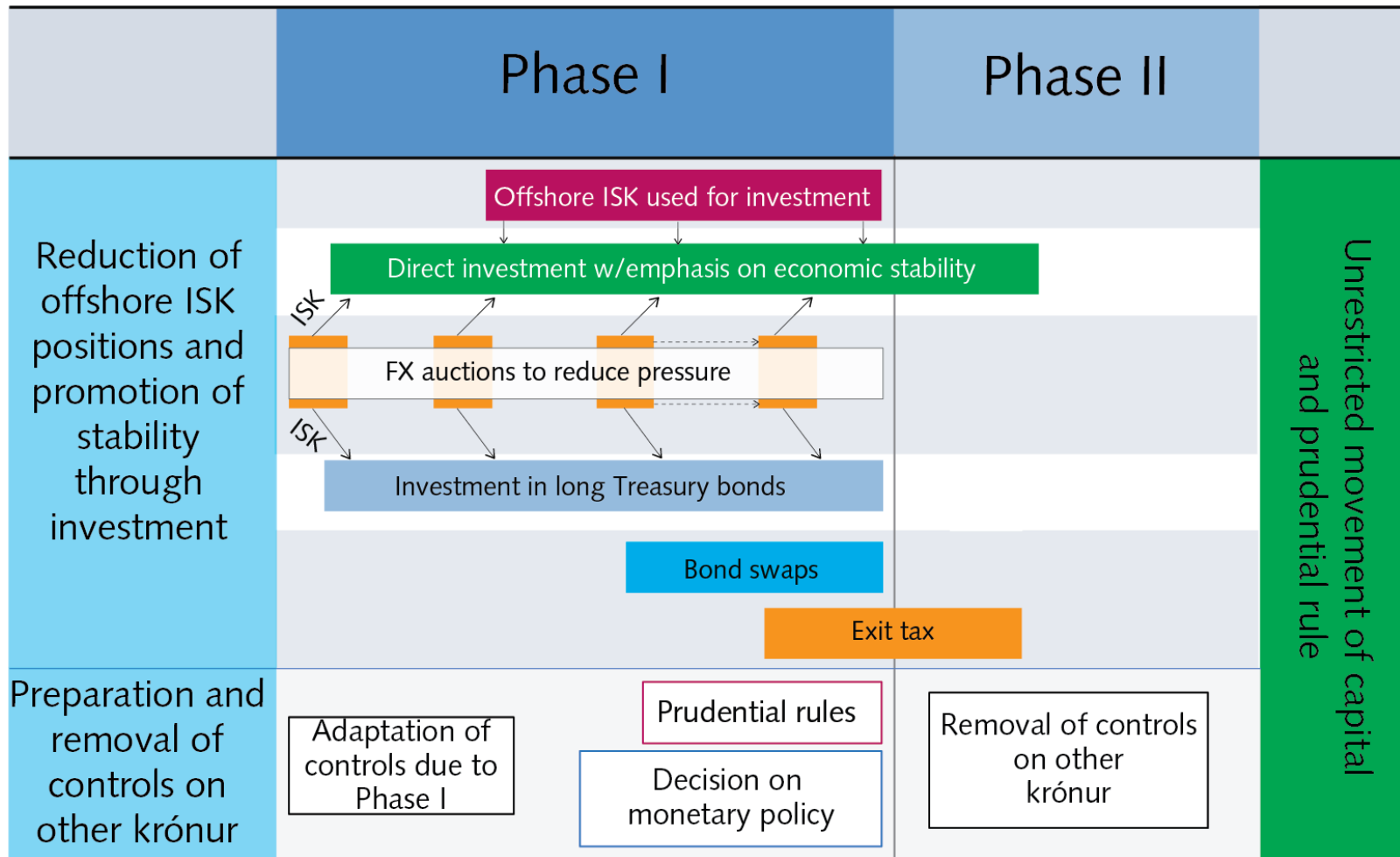


Source: Central Bank of Iceland.

Strategy for removing the capital controls



Capital account liberalisation: Phases and steps





Lessons to be learnt and reflections on the “Icelandic model”

Macroeconomic management in small, open economies



- Policy conflicts are very dangerous in small, open, and financially integrated economies.
- Do not be afraid of large government surpluses during booms.
- Traditional government balances only tell part of the story – look at all channels through which government policy affects demand.
- Current account deficits matter.

Cross-border banking

- Cross-currency risk and maturity mismatches in terms of foreign currency (=> rollover risk) was underestimated prior to the crisis =>
- Under-regulated and insufficiently backed by capital or safety net facilities (e.g., LOLR).
- EU/EEA framework is flawed and poses particular risk to small countries outside the euro area.
- We need to move towards EU supervision, deposit insurance, crisis management and resolution regimes for cross-border banks. Domestic banks could remain within the national safety net.

Exchange rate regime

- In Iceland, the floating exchange rate contributed to the problem but is also part of the solution.
- Membership in the euro area would have prevented the currency crisis and greatly reduced the problem of FX balance sheets without LOLR => the banking crisis would have been less severe.
- This is a key factor behind Iceland's EU application.
- But you can still have a banking crisis and a sovereign debt crisis, as recent experience has demonstrated!

The Icelandic model?

- Useful recipe for others
- Allowing private banks to fail but protecting retail depositors, not bondholders, and ring-fencing the sovereign from the failing banks (limiting socialisation of private losses)
- Flexible exchange rate as a tool for adjustment
- Capital controls as a tool for stabilisation



Allowing banks to fail?

- Private banks that were too big for the Icelandic authorities to save
- In terms of loss of 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 will look different in larger countries
- But it makes sense to ring-fence sovereigns from private banks as much as is feasible
- And bailing out bondholders 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 tradable and non-tradable goods sectors

Figure 8 Export volumes and terms of trade 2000-2014



Sources: OECD, Central Bank of Iceland.

Capital controls?



- Capital controls were a key in stabilising the exchange rate, facilitated the financing of the sovereign and the banks, and provided fiscal and monetary policies the room for manoeuvre to support the domestic economy.
- But they might be more difficult to introduce in larger, more complex, and more connected economies, and the costs might be higher.
- Lifting them has also proved challenging, and the microeconomic costs increase with time.
- The jury is still out!