



Central Bank of Iceland

# Lifting Financial Constraints as Recovery Takes Hold

---

Már Gudmundsson, Governor  
Central Bank of Iceland

J.P. Morgan Investor Seminar  
9 October 2010



# Plan of the presentation

- Economic developments and prospects
- Monetary policy
- The financial sector
- Foreign debt and reserves
- Prospects for lifting capital controls

# Adjustment and three shocks



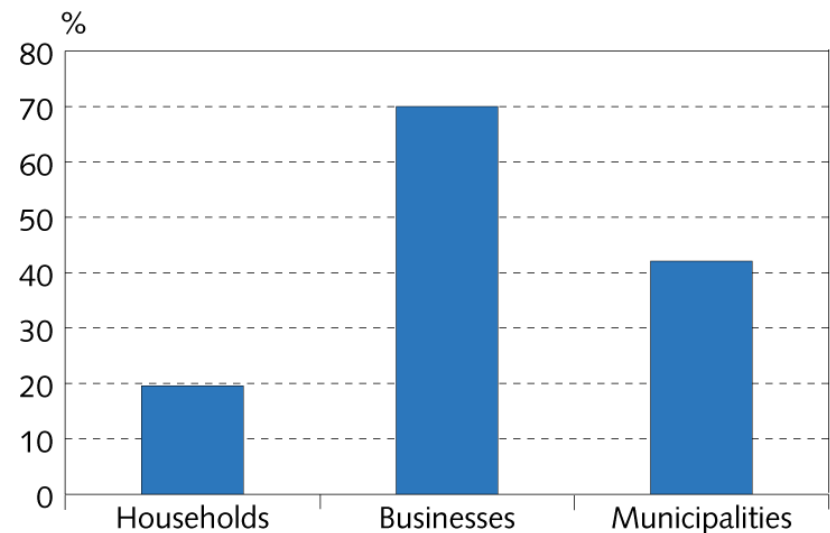
- Unusually large external and internal macroeconomic imbalances 2005-2007 associated with an unsustainable boom
- Their subsiding was bound to be associated with a very significant slowdown, if not an outright recession.
- Currency crisis in early 2008
- Collapse of the banking system in October 2008
- The global contraction in Q4 2008 and the first half of 2009

# Hits a system with very large level of private sector debt



- In relative terms the largest banking system to go through a full scale financial crisis
- One of the most indebted private sector
- With a high share of foreign currency denominated or FX indexed debt

Proportion of total foreign-denominated debt<sup>1</sup>



1. Figures for households and municipalities are as of year-end 2008, and figures for businesses are as of June 2009.

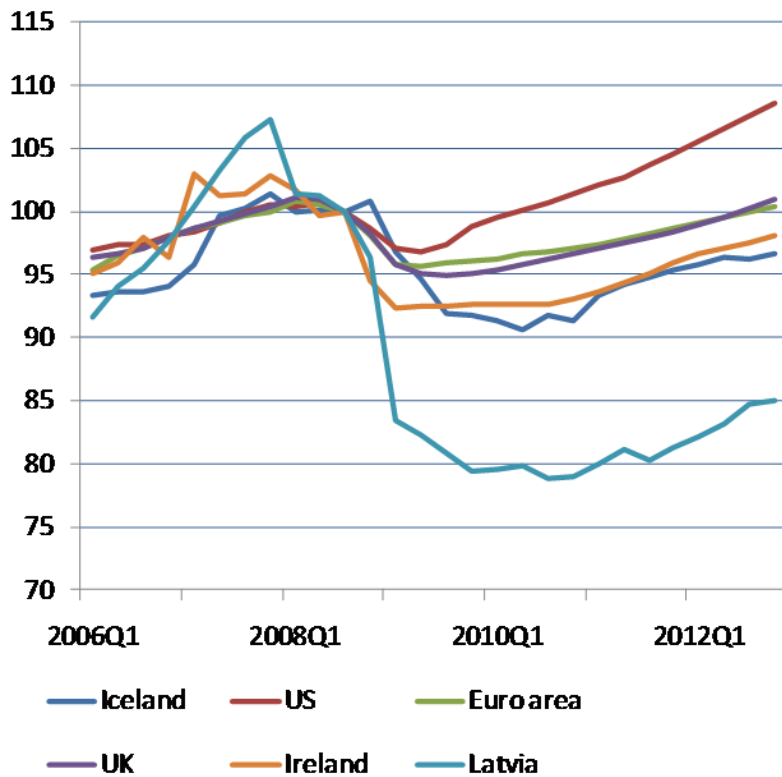
Source: Central Bank of Iceland.

# Recession deep in international and historical comparison



Economic recovery in various countries

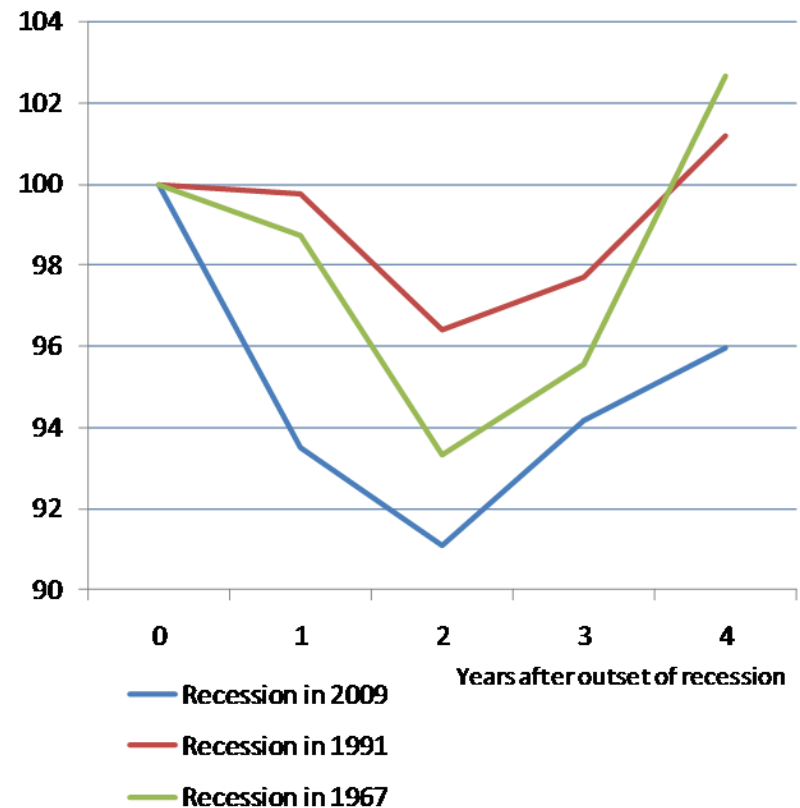
Seasonally adjusted GDP, index Q3/2008 = 100



Source: Global Insight, Central Bank of Iceland.

Economic recovery in previous recessions

Index, GDP the year prior to crisis = 100



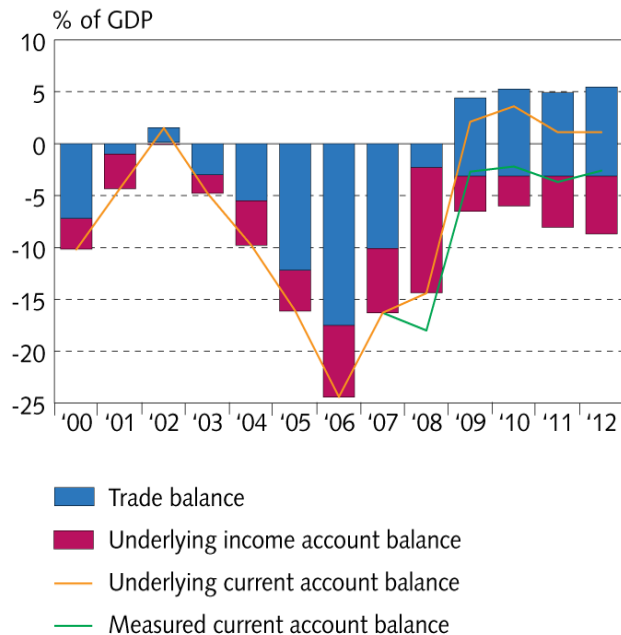
Source: Statistics Iceland, Central Bank of Iceland.



**The economy has now stabilised!**

# Stabilisation: Current account

Current account balance 2000-2012<sup>1</sup>



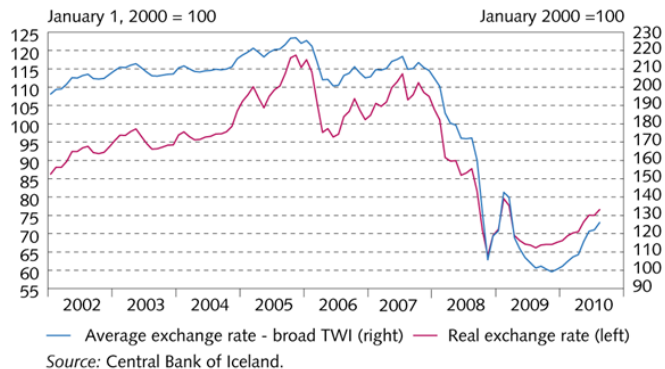
1. Net current transfer is included in the balance of income. Central Bank baseline forecast 2010-2012.

Sources: Statistics Iceland, Central Bank of Iceland.

- Substantial improvement in the current account balance from -18% of GDP in 2008 to -2.7% of GDP in 2009
- The underlying current account (i.e. excluding accrued interest of failed banks) is already in surplus

# Stabilisation: Exchange rate

Nominal and real exchange rate of the króna



Real exchange rate



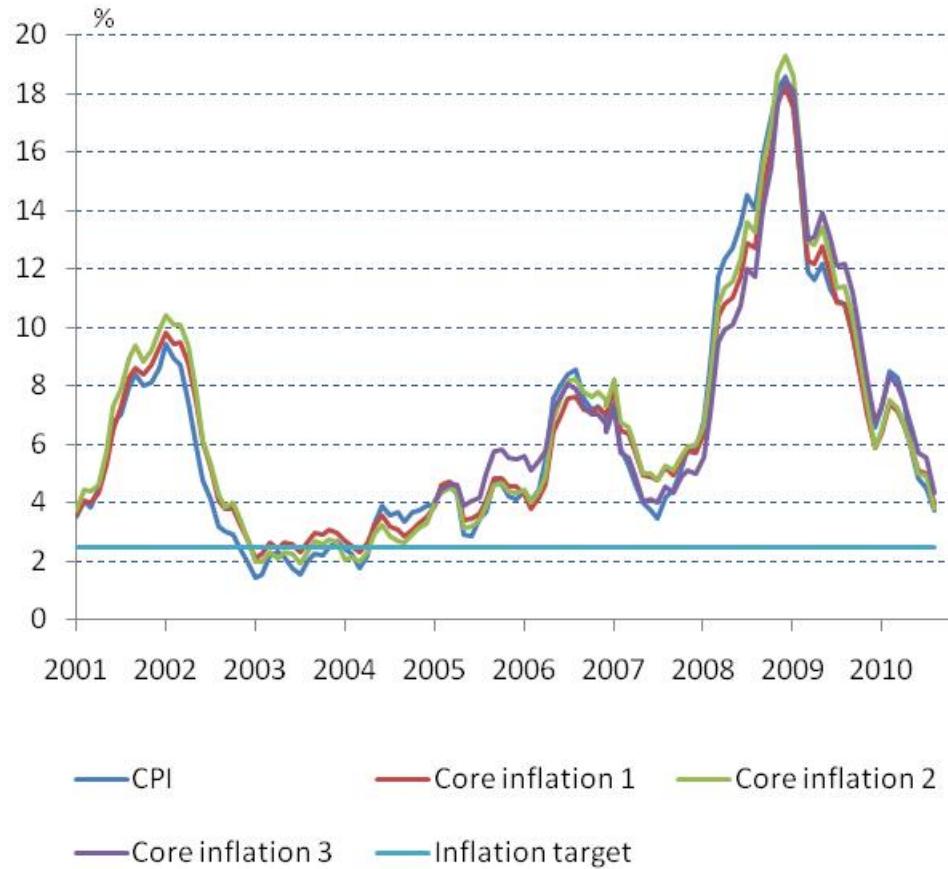
- From the beginning of the year the króna has strengthened in TW terms by 11% and by 10% and 13% against the USD and EUR respectively - without any Central Bank intervention
- The real exchange rate has continued to rise, with the increase measuring nearly 11% so far in 2010
- Nonetheless, it remains 22% below the average over the past 30 years



# Stabilisation: Inflation

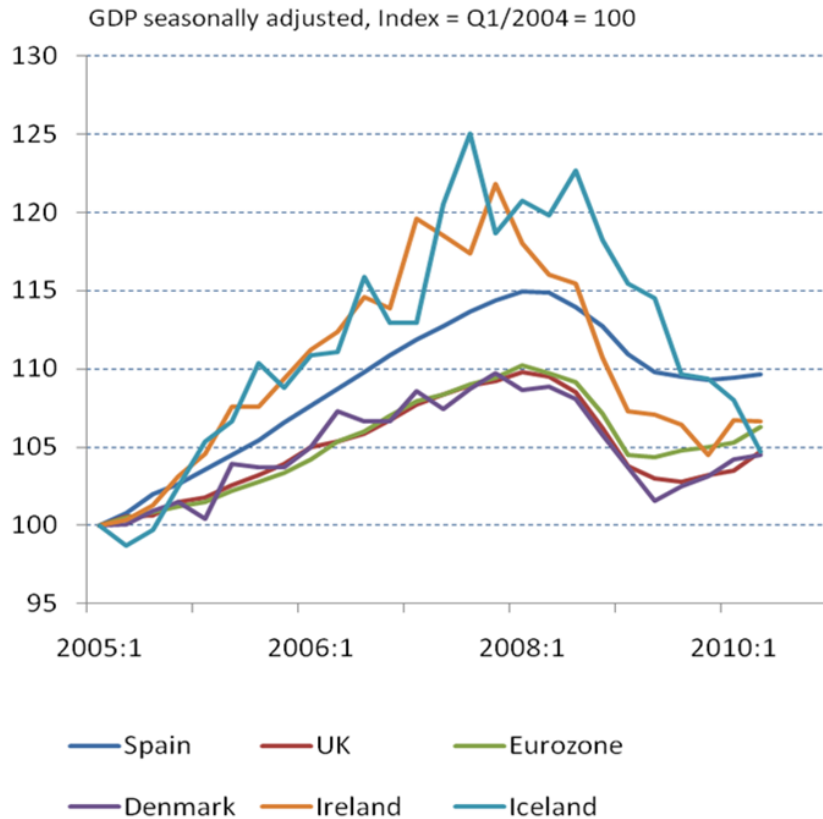


Inflation January 2001 - September 2010<sup>1</sup>



Source: Statistics Iceland.

# But still no growth!



Sources: Global Insight, Statistics Iceland.

- Recovery predicted to begin in the second half of 2010
- Around 2½% growth predicted for 2011
- A historically low level of capital formation and financial constraints are creating obstacles in the way of a robust recovery

# Monetary policy

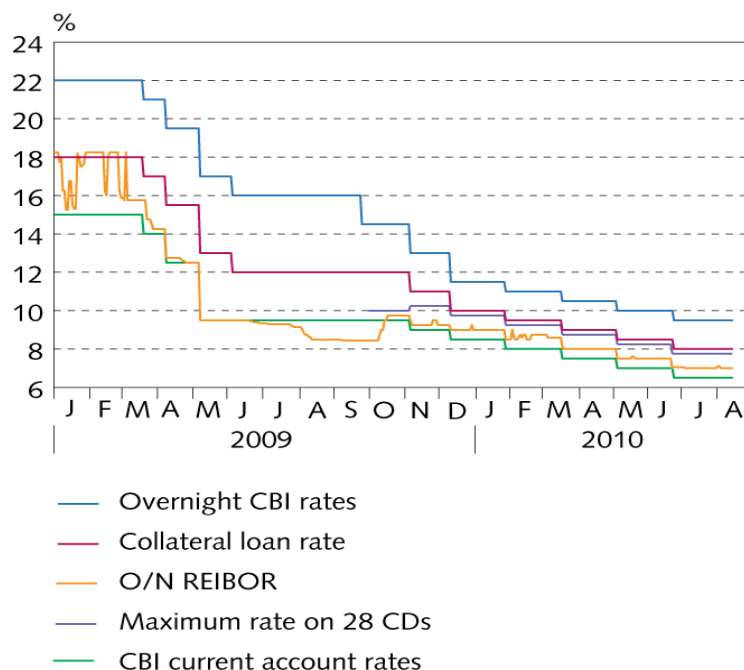


- Exchange rate stabilisation had first priority
- Supported by comprehensive capital controls
- Created space to cut nominal interest rates to give support to the domestic economy and as inflation came down
- Monetary policy setting and communication is becoming more complicated:
  - As the exchange rate stabilises and the share of FX debt declines
  - As rates get lower
  - As the preconditions for lifting capital controls become closer to being met

# Monetary policy: Interest rate setting

Central Bank of Iceland interest rates and short-term market interest rates

Daily data 1 January 2009 - 13 August 2010



Source: Central Bank of Iceland.

- At the beginning of 2009 the CB interest rate that affected short-term market rates most strongly (the CB collateral lending rate) was 18.0%.
- CB rates have been lowered in several steps since the beginning of 2009 and the effective policy rate (average of CD and CA rates) is currently around 5½%.

# Financial constraints



- Impaired financial sector
- Internal private sector debt crisis => need for debt restructuring
- But not a public sector or external debt crisis
- Inadequate level of FX reserves and lack of access to foreign capital markets
- Capital controls

# Banking system restructuring

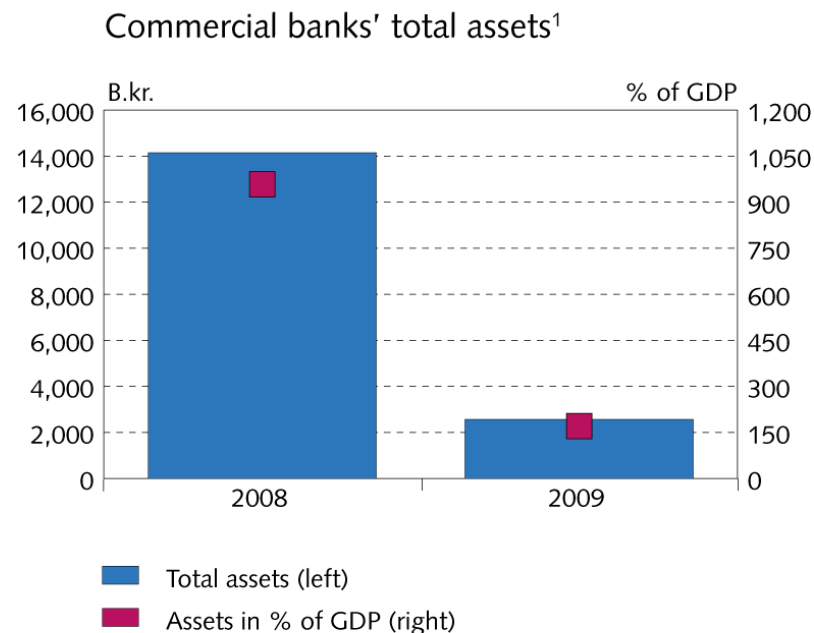


- Recapitalisation of the banking sector is near completion
- Two of three major commercial majority owned by creditors of the failed banks
- New Landsbanki majority owned by the Government
- Recapitalisation of the savings banks is well advanced
- Minimum CAD is 16% and the three big commercial all meet that (mostly common equity)
- Regulatory and supervisory practices are being strengthened significantly in 2010-2011

# The banking system in 2010



- The banking system is now much smaller than in 2008 (just under 2 x GDP)
- Five commercial banks with domestic operations
  - Around 90% of the banking system
- 12 savings banks
- The majority of the banking system is now foreign owned



1. Commercial banks' parent companies, September 2008 and December 2009.

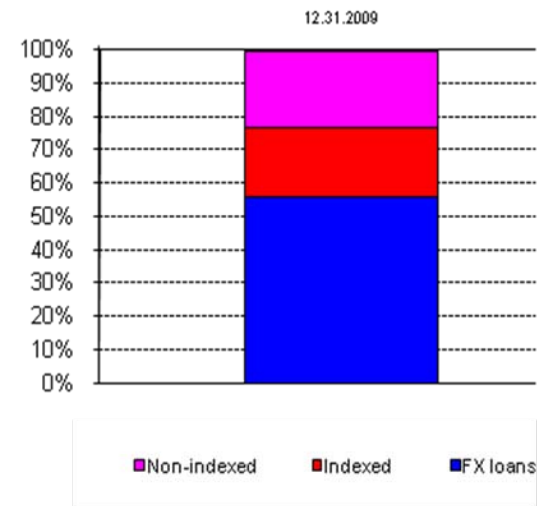
Source: Central Bank of Iceland.

# Supreme Court ruling on foreign currency indexed loans



- Illegal to index-link ISK loans to exchange rates of foreign currencies but straight foreign currency denominated loans are legal (16 June '10)
- Lowest ISK interest rates published by the CB should be applied to these contracts (16 Sept '10)
- Capital ratios will take some hit but uncertain whether limited recapitalisation will be needed

Picture V-3  
Loan categories<sup>1</sup>



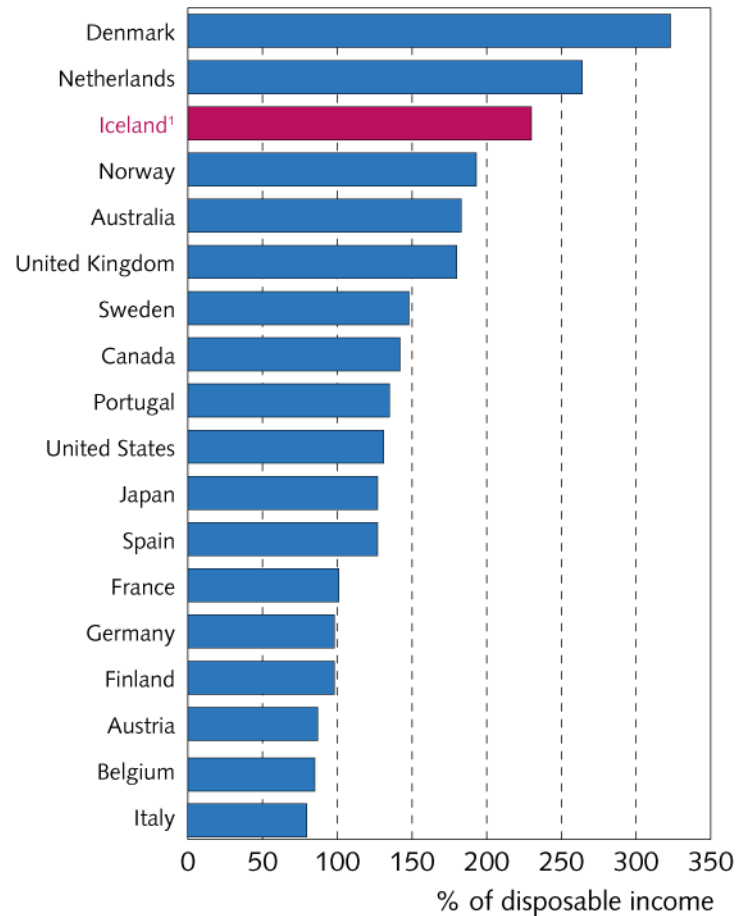
1. Commercial banks parent companies, 2009  
Himnir: Central bank of Iceland



# Household liabilities in 2008



Household liabilities in 2008



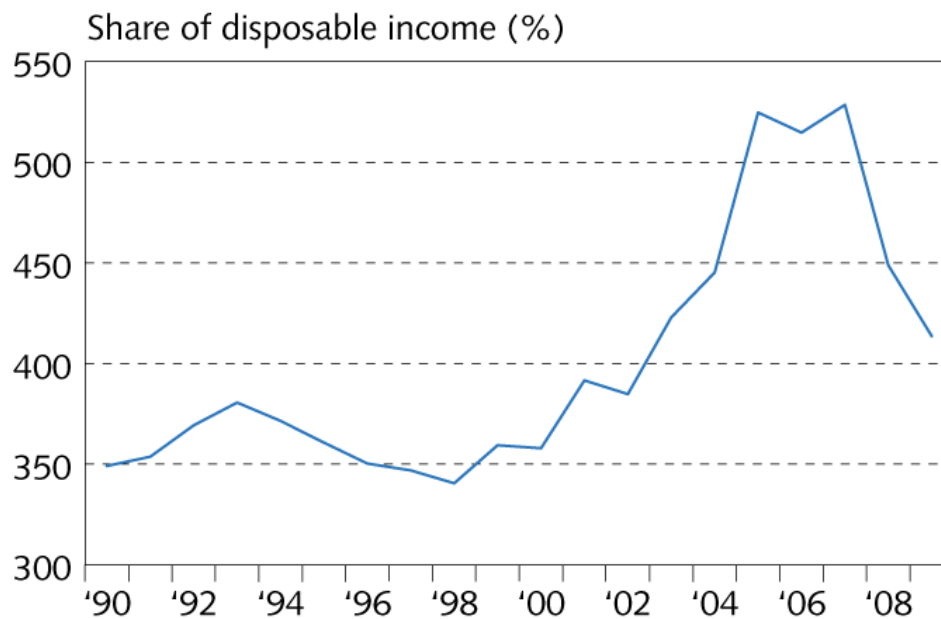
1. The value is for September 2008.

Sources: OECD Economic Outlook No. 87 (May 2010),  
OECD Statistics, Central Bank of Iceland.

# Household assets excluding pension reserves 1990-2009



## Household assets excluding pension reserves 1990-2009<sup>1</sup>



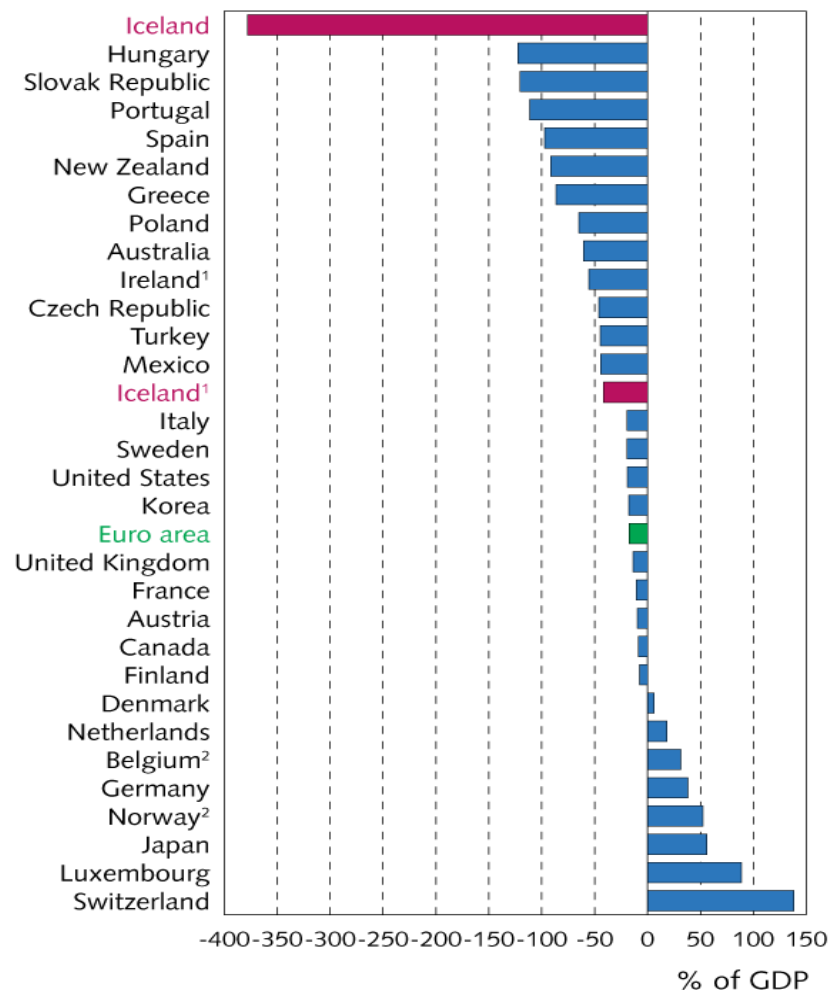
1. Value for disposable income in 2009 is a forecast.

Sources: Statistics Iceland, Central Bank of Iceland.

# International investment position



International investment position  
of OECD countries 2009



1. IIP excluding DMBs undergoing winding-up proceedings.

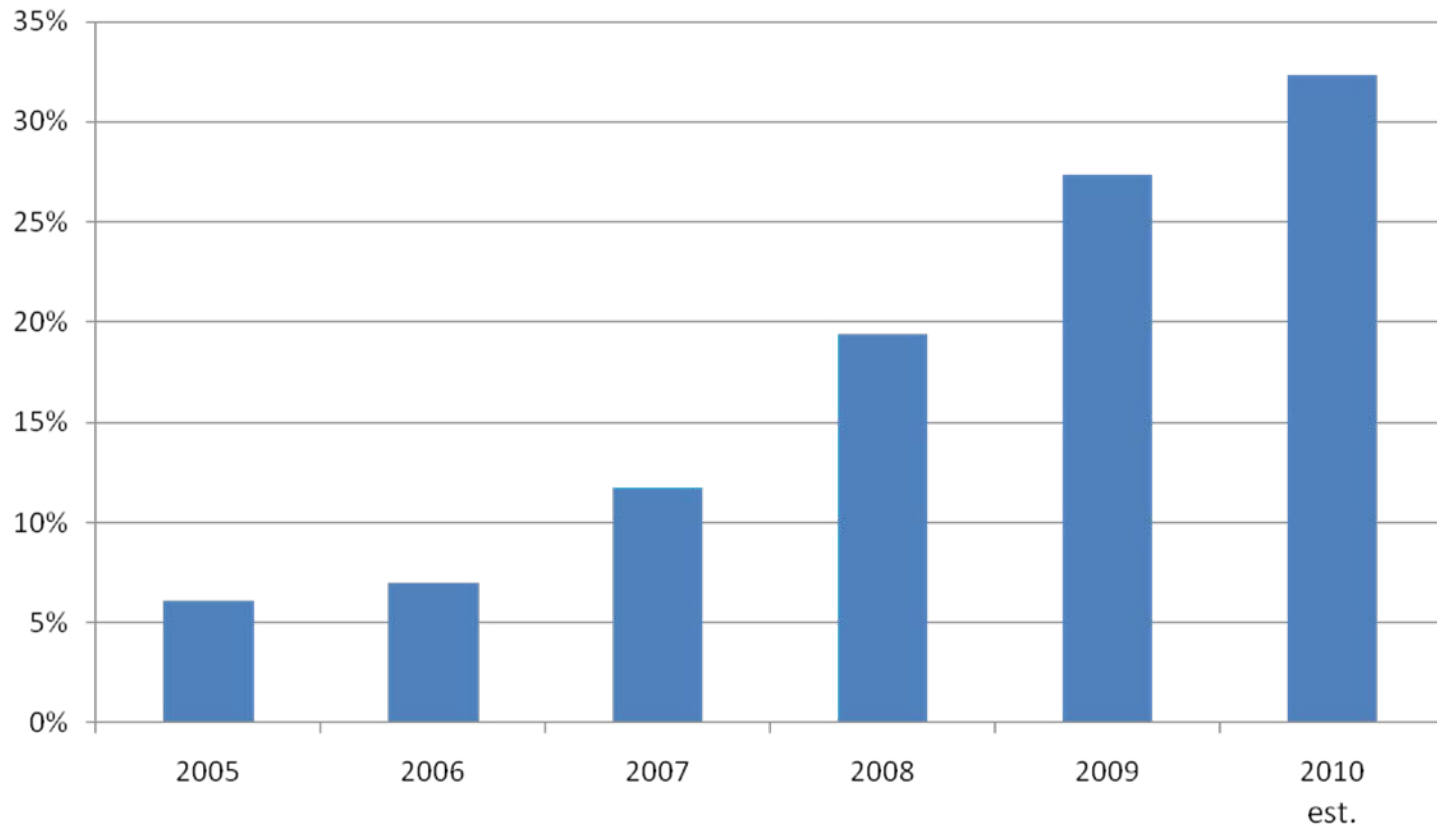
2. Figures are for 2008.

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

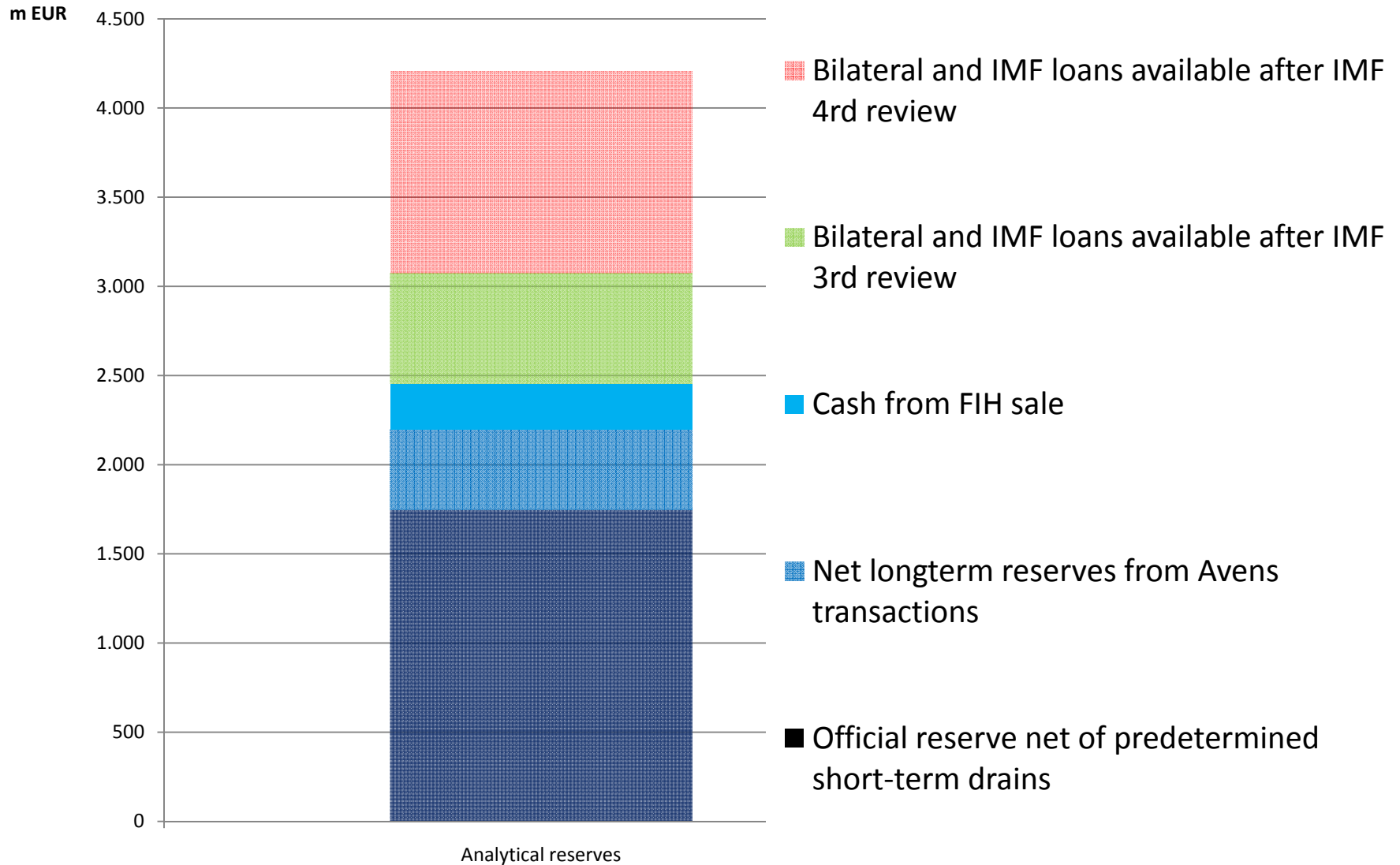
# Gross FX reserves have increased significantly



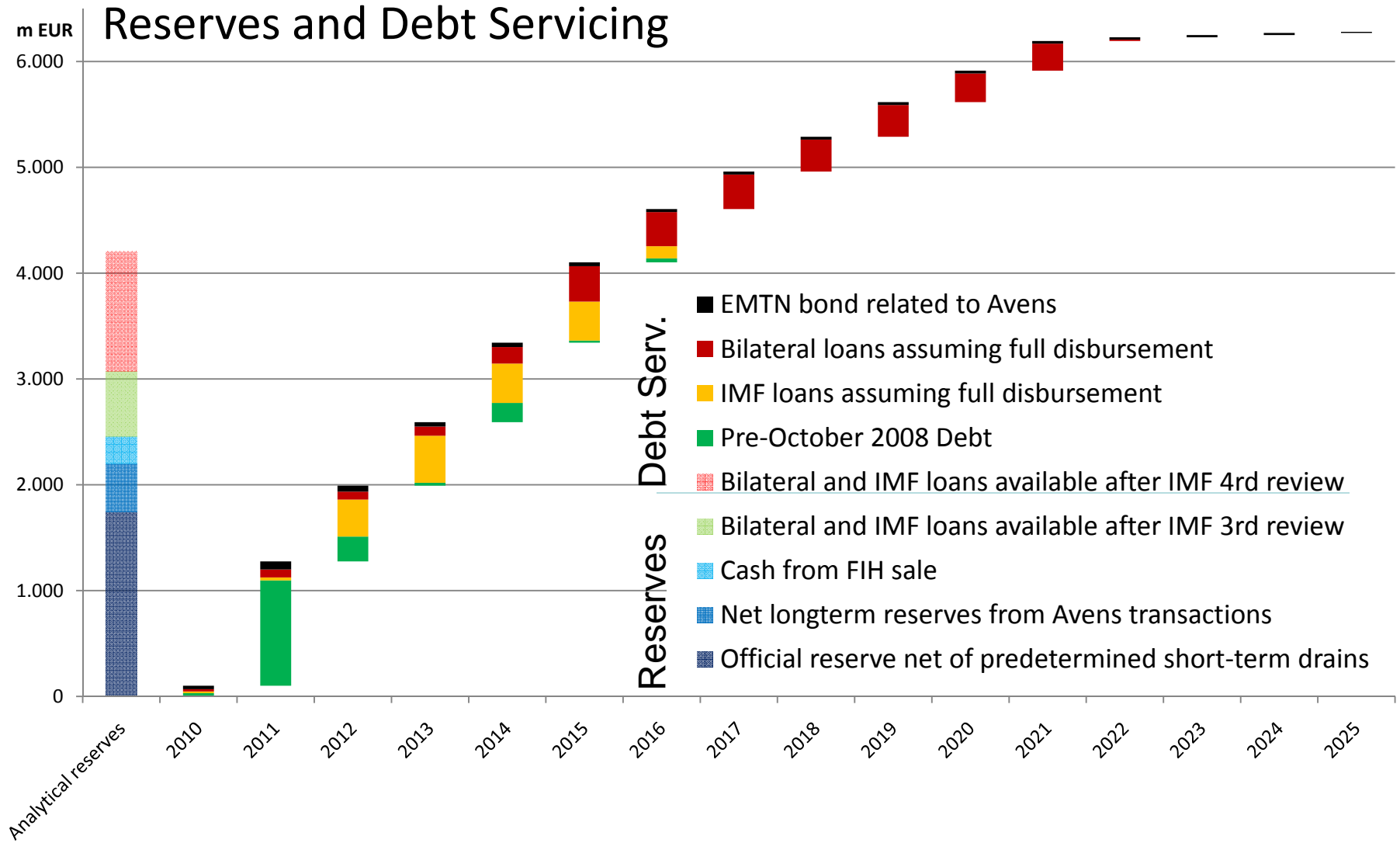
Reserves (% of GDP)



# CBI Reserves



# Reserves and repayment



# Lifting capital controls



- At end-October 2009, the first phase of the liberalisation strategy was implemented, as controls were lifted on new investment.
- Preconditions:
  - Macroeconomic stabilisation and confidence in the sustainability of government debt
  - Adequate reserves
  - Sound financial sector
- Further liberalization can continue once the preconditions are in place



## To conclude

The Icelandic economy has stabilised, and is ready for a lift-off and a reintegration into global financial markets