19 October 2010

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# The Icelandic economy two years after the crash

Chairman and honoured guests,

It gives me great pleasure to be with you here today and give a speech at this meeting of the Icelandic-American Chamber of Commerce. In my remarks, I would like to take stock of the current economic situation, two years after the collapse of the bulk of Iceland's banking system, and assess the prospects for robust recovery.

I am well aware that this only gives a partial picture. The saga of economic and financial developments in Iceland during the last decade or so is made up of two separate but interrelated stories. On the one hand, there is Iceland's boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies. This is a well-known story that has played out in other countries several times. On the other hand, we have the story of the rise and fall of three cross-border banks operated on the basis of European Union legislation (the European "Passport"). That story, at least for smaller countries, is much more unique than the first. Today I will focus on the first story and will have to refer you to another speech[1] and a forthcoming article[2] for my views on the latter. However, I am willing to answer questions on both during the Q&A session.

While these two stories are different, they interact in important ways. The unsustainable boom that Iceland experienced during the years 2005-2007 was fuelled by a combination of favourable external conditions, macroeconomic mismanagement, and aggressive domestic

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[1] Gudmundsson, Már (2010). "The faults in cross-border banking." Speech at the FIBE meeting in Bergen on 7 January. Online source: http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=7592 (access date: 18 May 2010).

[2] Gudmundsson, Már and Thorsteinn Thorgeirsson (2010). "The fault lines in cross-border banking: lessons from the Icelandic case", forthcoming in SUERF Studies.

bank lending. It may well be that the banks' international activities and the easy access to foreign credit that came with those activities fuelled stronger growth in domestic bank lending than would have occurred in a more traditional small-country banking system. But we cannot be sure about the magnitude of this effect, as we know that unsustainable domestic credit booms fuelled by capital inflows can very well take place in countries that are not home countries to international banks.

As so often occurs in great tragedies, the two stories converged in a grand finale in early October 2008, when nearly nine-tenths of Iceland's banking system collapsed when its three large cross-border banks – Glitnir, Landsbanki, and Kaupthing – were taken into special resolution regimes on the basis of the emergency legislation that had just been passed by Iceland's Parliament. By that time, however, the Icelandic economy was already on its way into a recession as a result of the inevitable adjustment of the economy after its serious overheating in 2005-2007 and the currency crisis earlier in 2008. As a matter of fact, Iceland was struck by three negative shocks in 2008.

The first was the currency crisis in early 2008, when the currency collapsed as capital inflows experienced sudden stops and the banks were no longer able to refinance their foreign currency liabilities. The currency depreciation had strong negative effects on the balance sheets of households and those corporations with foreign currency debt and no foreign currency income, which in turn contributed to a further drop in domestic demand.

The second was the collapse of the banking system in October 2008, in the wake of the failure of Lehman Brothers, when cross-border banks in many countries around the world faced a run on their foreign currency liabilities. The Icelandic banks were particularly vulnerable in this regard, as the foreign-denominated part of their balance sheets amounted to 7½ times Iceland's GDP. By comparison, the reserves of the Central Bank of Iceland, a swap agreement with the Nordic countries, and committed credit lines amounted to just over one-third of GDP. This major vulnerability came on top of other malignant diseases that plagued the banks and have been revealed in the report compiled by the Parliamentary Special Investigation Commission. The banking collapse triggered further currency depreciation and contributed to a significant destruction of household assets (e.g., bank equity, mutual funds, and pension assets).

The third shock was the international economic recession in the fourth quarter of 2008 and the first half of 2009.

The subsequent recession was shaped by the post-boom adjustment, the three aforementioned shocks, and the policy responses of the authorities. It is an interesting topic for future research to try to quantify the relative effects of the three shocks on the subsequent recession. We cannot take it for granted that the banking collapse is the most important one in that respect, although it commands the first place in the psyche of the population. The asset destruction that was associated with the banking collapse took place in several countries, mostly in Northern Europe, and in absolute terms the loss of the foreign creditors is bigger than that of domestic residents. The currency crisis and the banking crisis are linked, of course, as the banks exacerbated the former. However, with a floating exchange rate, the burst of the unsustainable macroeconomic boom was always going to be associated with a major depreciation, irrespective of what happened to the banks and whether Iceland had a cross-border banking system or not.

The effects of the currency collapse and the associated outburst of inflation, which rose from below 4% in late 2007 to 18% in early 2009, were magnified, as it hit one of the most indebted private sectors among advanced economies, with a high share of foreign-denominated or exchange rate-linked debt (20% for households, 70% for businesses, and 40% for municipalities). In addition, households' CPI-indexed debt amounted to 75% of their total debt and the pass-through of exchange rate depreciation to inflation was speedy due to the magnitude of the depreciation and the lack of credibility of monetary policy at the time.

Having set the scene, I shall now turn to the policy responses. The framework for these was set by the two-year Stand-By Arrangement agreed with the IMF in November 2008. The total financing associated with the programme amounts to around USD 5 bn, with just over USD 2 bn coming from IMF resources and USD 3 bn provided by bilateral loans from the Nordic countries, Poland, and others. The original Stand-By Arrangement provided for quarterly reviews; however, the first review was delayed, partly because of the deposit insurance dispute between Iceland and the Netherlands and UK, relating to online foreign overseas branches of the failed Landsbanki. The first review was completed in October 2009, the second in April 2010, and the third on 29 September 2010.

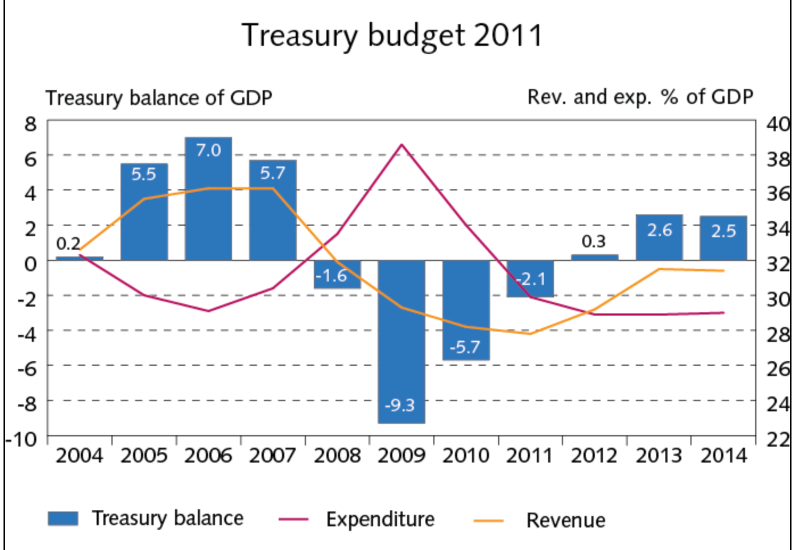
The programme had three key policy goals: (i) to stabilise the exchange rate, (ii) to put government finances on a sustainable path and (iii) to rebuild a financial sector serving the domestic economy. The first goal was imperative in order to stop an adverse spiral of fading confidence, exchange rate depreciation, and increased inflation and inflation expectations. It was also needed in order to stop the negative balance sheet effects coming through FX-denominated or FX-linked loans and CPI-indexed loans. The second, fiscal sustainability, was needed in order to stop adverse public debt dynamics from turning an external liquidity crisis into a potential solvency issue, which would have made it impossible to regain internal and external trust in the Icelandic economy. The third, financial sector reconstruction, is a precondition for private sector debt restructuring and economic recovery.

As a result, exchange rate stability became the first priority of monetary policy. However, given the lack of confidence and the overhang of non-resident holdings of speculative ISK positions, estimated at the time to amount to ISK 600 bn, it would have required exorbitant interest rates to stabilise the exchange rate through interest rate policy alone, and the room for manoeuvre to use monetary policy to support the domestic economy would have been non-existent, at least in the short run. For this reason, it was decided to introduce comprehensive capital controls, which allowed more space to lower interest rates in line with falling inflation and provide some support to the domestic economy. There were, of course, “cold turkey” alternatives, but they were considered too risky at the time.

The Central Bank of Iceland’s effective policy rate peaked at 18% in early 2009 (at the time, the seven-day collateral lending rate) but has now been reduced to around 5½% (now the average of the rates on certificates of deposit and current accounts). The exchange rate stabilised in the second half of 2009 with no supporting intervention since early November 2009. So far this year, the exchange rate has appreciated by 11% in trade-weighted terms, again without any supporting intervention. This has alleviated pressures on impaired private sector balance sheets and contributed to relatively speedy disinflation.

Fiscal policy was set within a medium-term fiscal consolidation programme covering the period 2009-2013. The programme aims at a primary surplus in 2011 and a substantial overall surplus in 2013, making it possible to reduce Treasury debt from that year onwards. The announcement of a medium-term plan made it possible for automatic fiscal stabilisers to work more or less unhindered in 2009, with fiscal consolidation taking hold in 2010. This was important in two respects. First, it limited the negative demand effects of fiscal consolidation precisely when the recession was at its steepest. Second, it sent a signal that adverse public sector debt dynamics would be addressed over the medium term, thus reducing risk premia in domestic and foreign interest rates facing the sovereign. Graph 1 shows the progress that has been made so far with fiscal consolidation and the plans embedded in the fiscal budget for 2011. Provided the plans are carried out, the consolidation involved will be impressive in both historical and international comparison, with a roughly 9 percentage point improvement in the non-cyclically adjusted fiscal balance from 2009 to 2012, even though there will be a significant slack in the economy for most of the period.

Graph 1



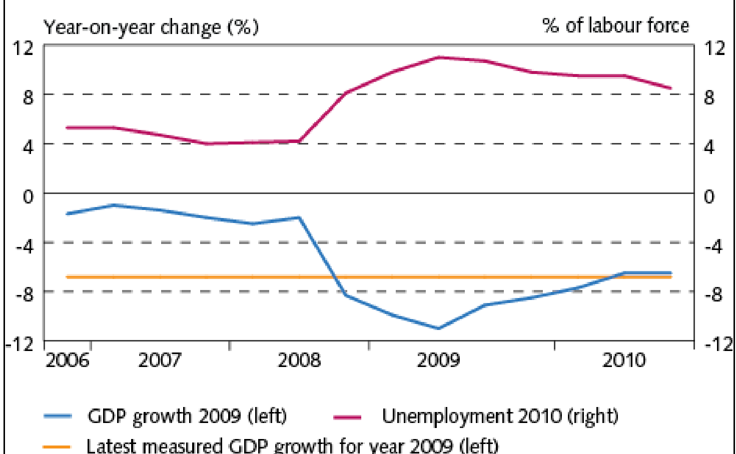

17.5 b.kr. Avens revenues not included in 2010.
ISK 192 billion in write-offs of outstanding claims excl. in 2008 exp.
*Source:* Ministry of Finance.

Although it has been delayed and has faced obstacles on the way, the reconstruction of the domestic financial sector is far advanced. The three major commercial banks have been recapitalised, with foreign creditors taking a majority stake in two of them and the State holding a majority in the third. At the end of June, all three had capital ratios above 16%, most of it common equity. As a result, Iceland‘s banks meet Basel III requirements more than two times over. The recapitalisation of the savings banks is in its final stages. In June of this year, however, question marks were raised about the capital position of the banking system when the Supreme Court of Iceland ruled that linking ISK loans to exchange rates was illegal. The banking system had a large number of such contracts on its books. The precise scope of the problem was uncertain, but more importantly, it was not clear what interest rates these loans should carry when they were no longer exchange rate-linked. Should they carry contractual foreign rates or some typical ISK rate, such as the benchmark rate published by the Central Bank of Iceland? In the former case, the blow to the capital position of the banking system would have been very serious indeed, requiring massive recapitalisation and possibly jeopardising the overall stability of the system. Those responsible for financial stability gave a sigh of relief when the Supreme Court ruled in mid-September that loans with illegal exchange rate linkage clauses should carry reference ISK rates published by the Central Bank of Iceland. After this decision, it is clear that the blow to capital ratios should be well manageable and only a very limited recapitalisation will be called for, if any.

The reconstruction of the domestic financial sector paves the way for badly needed debt restructuring among households and businesses. This issue has remained unresolved due to delays in recapitalising the banks and the uncertainty following the first Supreme Court ruling. But it has also lagged because the framework for such debt restructuring has been a highly contested political issue.

Graph 2

CBI forecasts of GDP growth for year 2009 and unemployment for year 2010



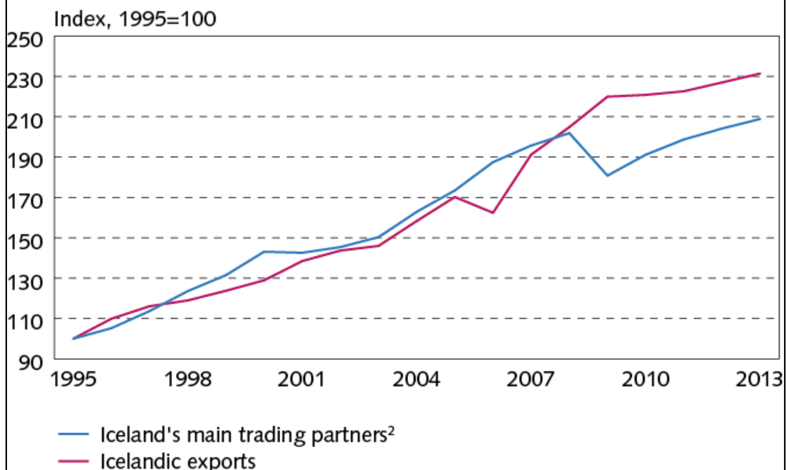

1. Central Bank of Iceland baseline forecast 2006-2010.
*Source:* Statistics Iceland, Central Bank of Iceland.

We have seen that Iceland has made significant progress on three main policy fronts. But before investigating how this progress has stabilised the economy, let us turn back to the recession in the Icelandic economy. As I said earlier, Iceland was well on its way into recession in 2009 before the banks collapsed in the autumn of 2008, and actually before the currency crisis materialised earlier in 2008. In fact, the Central Bank had been predicting a recession in 2009 since at least 2006, as can be seen from the graph that shows predictions for 2009 GDP growth at different dates. The predicted recession was supposed to be a mild one, but then we need to bear in mind that recession forecasts tend to be dampened while the times are still good!

Graph 3

World trade and Icelandic exports

Annual data 1995 - 2013[1]

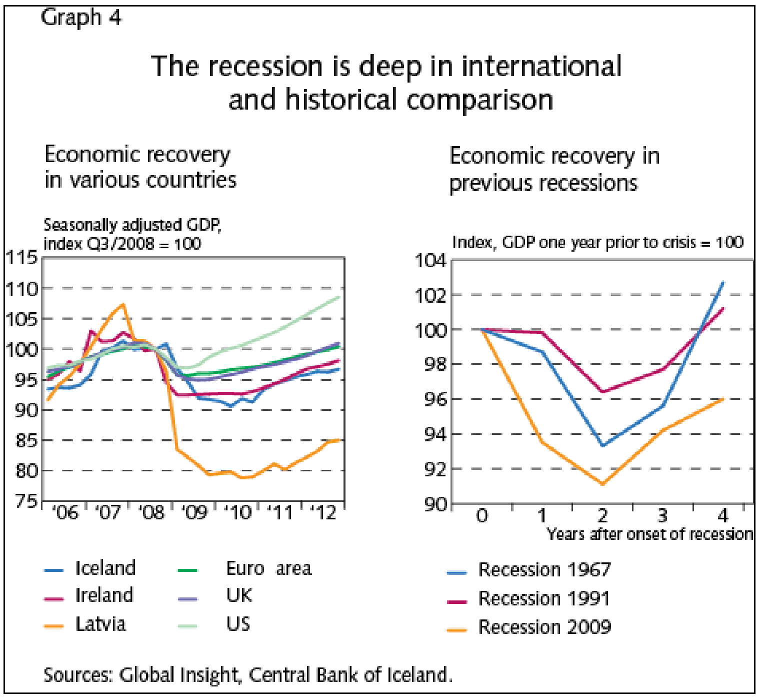



1. Central Bank of Iceland forecast 2010 - 2013. 2. Imports of goods and services in Iceland's main trading partners.

*Sources:* OECD, Central Bank of Iceland.

When all three shocks had hit, the mood changed dramatically, as can be seen from Graph 2. The bleakest forecast was made in May 2009, when GDP was predicted to contract by 11% in 2009 and unemployment for 2010 was forecasted to reach 11%. However, the outcome turned out to be much better – a contraction of 6.8% – and the prospects for peak unemployment have also improved markedly. I think this due not to ordinary forecast errors but to various factors that supported domestic demand and export production in 2009, some of which were temporary. These included temporary permission to withdraw a specified maximum amount from third pillar savings, with use amounting to 1½% of GDP in 2009. This measure is akin to a fiscal stimulus of a similar size. But these factors also included other measures to support households, which mitigated the decline in private consumption. Furthermore, the delay in corporate and household restructuring, although detrimental in the medium term, postponed some of the short-term contractionary effects that tend to accompany it. Finally, the low real exchange rate stimulated exports and other traded goods sector activity. Moreover, the composition of Iceland's exports is such that they are somewhat less cyclically sensitive than, for example, exports of motor vehicles and consumer durables. The net result was that Iceland's exports held up well in comparison to world trade overall, as can be seen in Graph 3.

Some of these factors were temporary, however, and the price was paid this year. Contrary to earlier (probably unrealistic) expectations, Iceland did not recover from recession in the first of half 2010. That means that Iceland will emerge from recession later than most other countries, many of which began to recover in the second half of 2009. But given the huge imbalances in the Icelandic economy during the boom and the size of the shocks it sustained, this is not surprising when measured against the broader historical record of countries experiencing major financial crises. In both international and historical comparison, Iceland has gone through a deep and a somewhat drawn-out recession, as can be seen from the following graph.

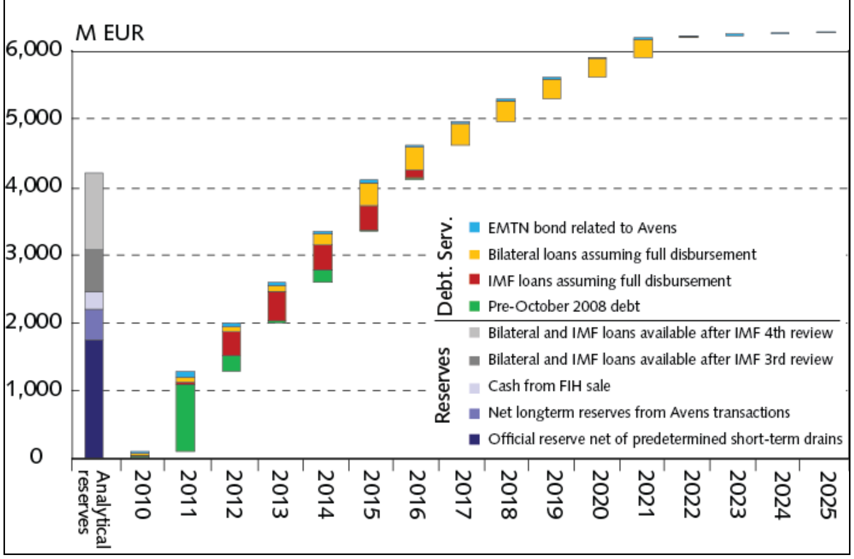



Perhaps recovery has only just started, but the signs of stabilisation are all over the place. The huge current account deficit of the boom period has turned into a surplus if we exclude the accrued interest on the debt of the failed banks, interest that will probably never be paid. The underlying surplus, in this sense, gives support to the exchange rate, which has already appreciated significantly, as I mentioned earlier. As a result, the inflation rate has come down sharply, from 18% in early 2009 to less than 4% at present. We are now expecting to reach the Central Bank's 2½% inflation target around the turn of the year, at least if we discount temporary effects of higher indirect taxes on the price level.

At the same time, the Central Bank's gross foreign exchange reserves have grown strongly as a result of the financing associated with the IMF programme and other transactions, such the purchase of offshore ISK assets held as collateral by the Central Bank of Luxembourg and the subsequent sale of those assets to Icelandic pension funds against foreign currency (the so-called Avens deal), and the sale of a Danish Bank that the Central Bank held as collateral against a foreign currency lender-of-last-resort loan granted to Kaupthing shortly before it failed. The foreign exchange reserves could reach EUR 3 bn before year-end if we draw fully on the IMF and bilateral loans available after the third review of the IMF programme – and this is after deducting short-term foreign currency liabilities such as the forex deposits of the failed banks' resolution committees (see Graph 5). Compare that to sovereign foreign debt payments initially amounting to EUR 1½ bn in 2011 and 2012 but now reduced by EUR 400 m through debt buybacks. It is therefore no wonder that concerns about Icelandic sovereign debt default have largely evaporated. This can be seen in the spread on Iceland's sovereign credit default swaps, which has fallen significantly this year and is currently at 288 basis points, well below those of Ireland and Portugal.

Graph 5

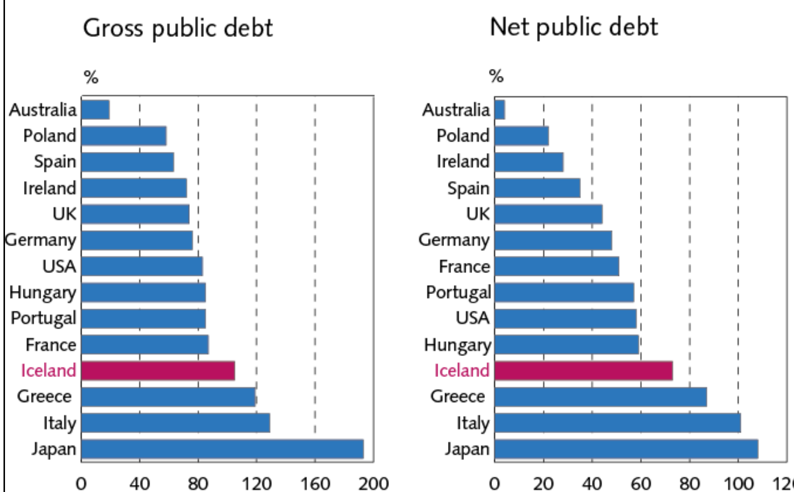
FX reserves and Treasury foreign debt service




Before turning to the outlook and near-term policy challenges, let me mention two important problems that Iceland will not face if present policies remain on course. The first is an unsustainable public debt level. As Graph 6 shows, the gross debt of Iceland's general government (central and local government) exceeded 100% of GDP at the end of 2009. That is very high, of course, although there are countries with higher gross debt, as the graph shows. However, Iceland's net public debt is significantly lower and is sustainable given the prospects for repayment of Treasury debt in net terms from 2013 onwards. In addition, if we factor in the Central Bank's foreign exchange reserves, the bulk of net public debt is denominated in Icelandic krónur. But what about the unsettled Icesave debt? The answer is that it will not fundamentally change the picture, as present estimates of the amount and speed of recovery of the assets of the failed Landsbanki and indications of what might be on the table in terms of financing costs in a new settlement suggest that the net present value of the settlement will be significantly lower than in previous agreements.

Graph 6

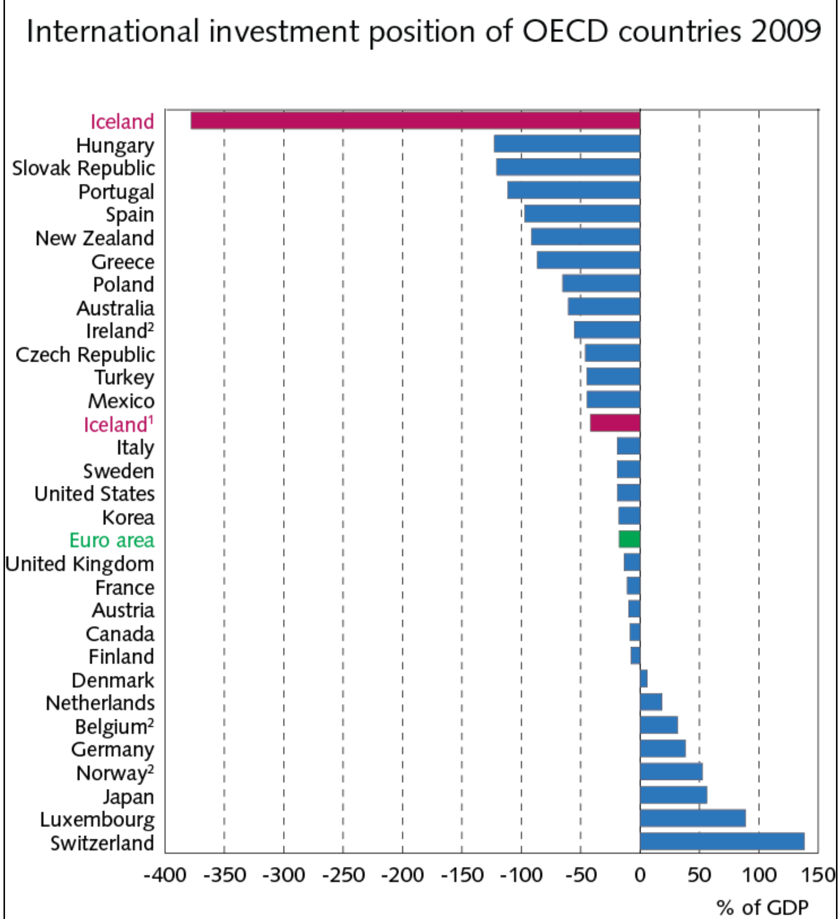
Public debt in international comparison




*Sources*: Global Insight, IMF, various central banks' websites, Central Bank of Iceland

The same applies to net foreign debt, where Iceland will be even more of a middle-of-the-road country when the dust has settled and the failed banks have been wound up, as can be seen from Graph 7.

Graph 7




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

When the economy has stabilised and sovereign debt concerns have subsided, what are the key economic challenges facing Iceland? At the most fundamental level, they could be captured in one sentence: create the conditions for robust growth and reintegrate Iceland into international capital markets. But there are many elements that must fall into place if this is to happen. The Central Bank has been predicting that recovery will take hold in the second half of this year, which means that recovery should have started by now. There are actually signs, but not hard data, to support this. But it is not a strong or a robust recovery. If it is to turn into a robust recovery, we need much more progress on internal private sector debt restructuring and we must increase business investment from its present historically low level. This, in turn, requires a lower level of uncertainty about future demand and businesses' operating conditions, and more foreign direct investment would be very helpful as well.

If successfully carried out, the removal of the comprehensive controls on capital outflows and the reintegration into international capital markets should also support growth going forward. The Central Bank has stated that there are three prerequisites for taking the next steps in lifting capital controls. These are: (i) macroeconomic stabilisation and confidence in the sustainability of government debt; (ii) an adequate level of foreign exchange reserves; and (iii) a sound financial sector. After the third review of the IMF programme, the first two are in place and there are prospects that the third will be fulfilled before the end of the year. The challenge is then to design and sequence the process in such a way that the risk of temporary exchange rate and domestic financial market instability is minimised to the extent possible, given the urgency of lifting the controls sooner rather than later.

Let me conclude by saying that stabilising the Icelandic economy was a challenging task. The next step is equally so. However, it is imperative for Iceland's future prosperity that we be as successful in taking that step as we have been in stabilising the economy.

Thank you very much.