



Seðlabanki Íslands

Iceland: From boom to bust and back again

Guests from German Federal Ministry of
Economics and Technology

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Thórarinn G. Pétursson

Chief Economist and Monetary Policy Committee member



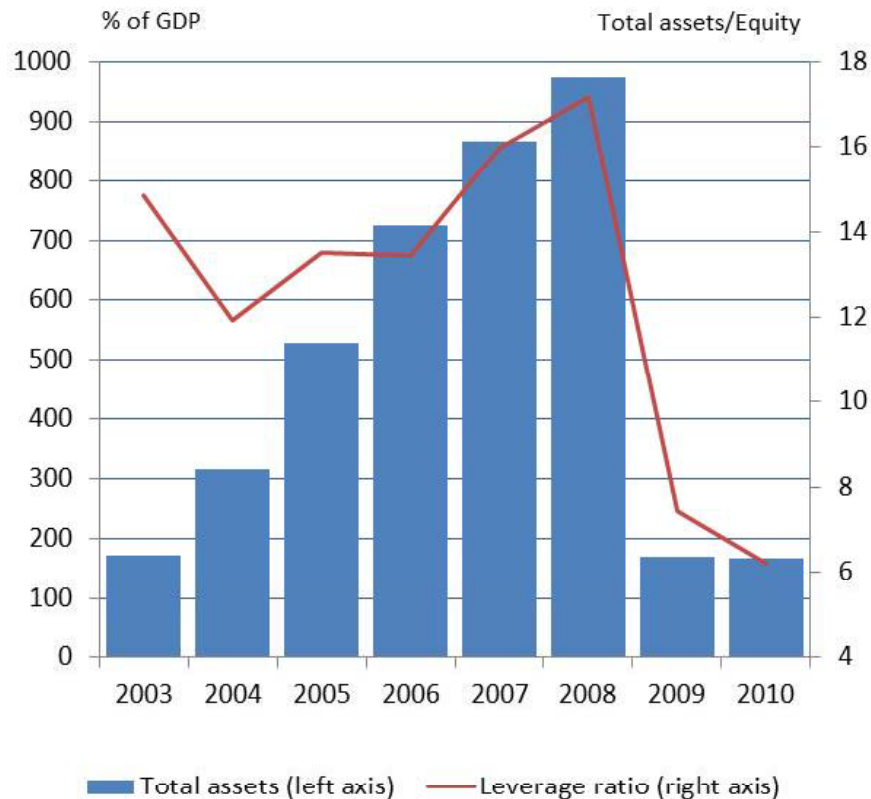
Background:

The build-up and unwinding of large imbalances



The rise and fall of an enormous banking system

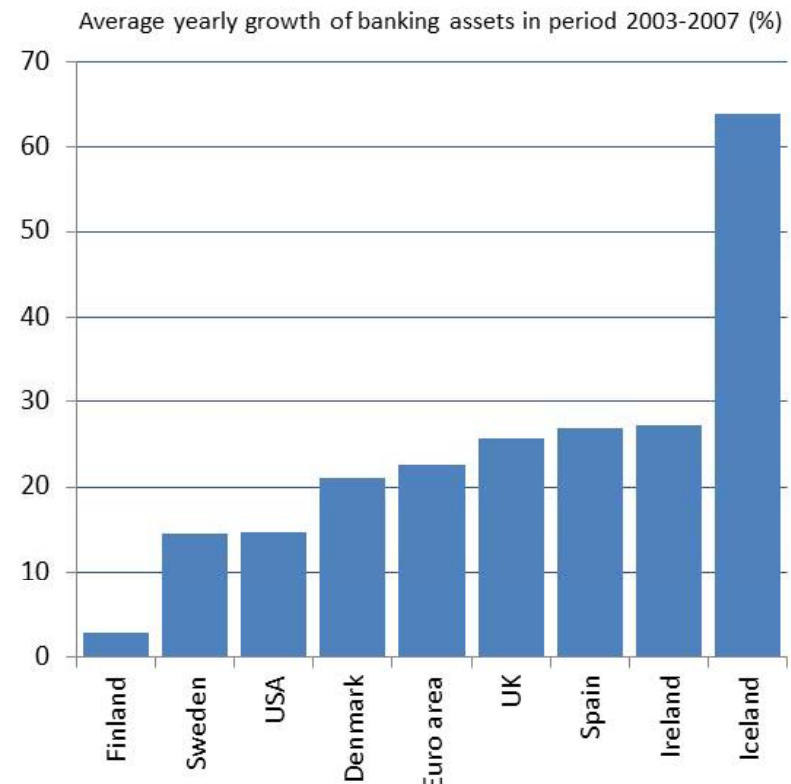
Banking system assets and leverage



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

Source: Central Bank of Iceland, Financial Supervisory Authority, Statistics Iceland.

Expansion of bank balance sheets in the run-up to the financial crisis

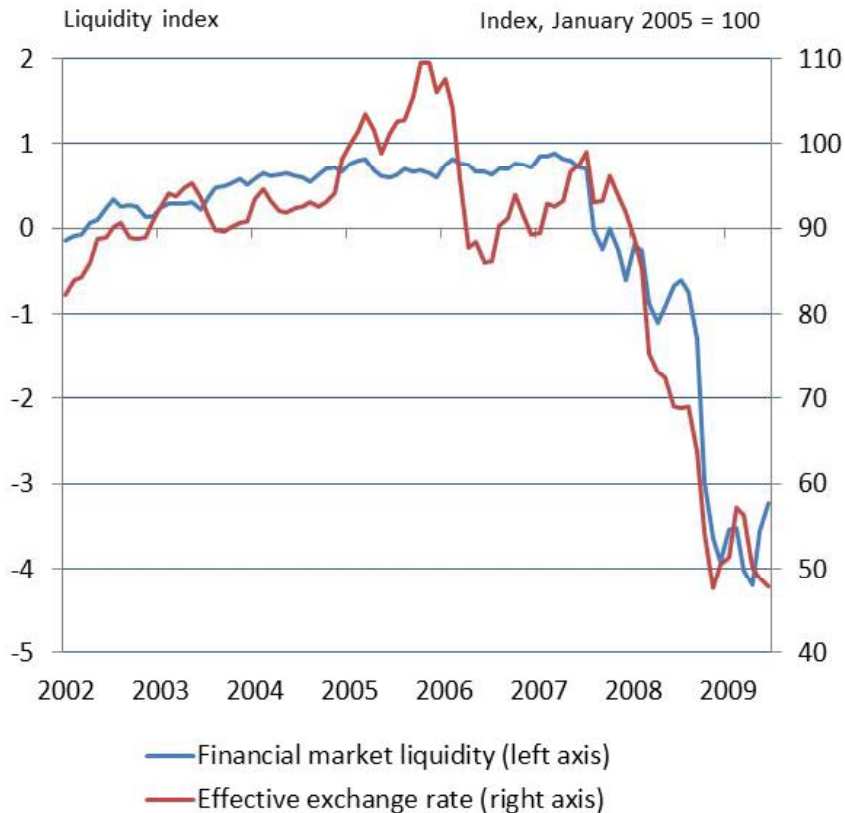


Source: IMF, Central Bank of Iceland.



An asset price boom-bust cycle

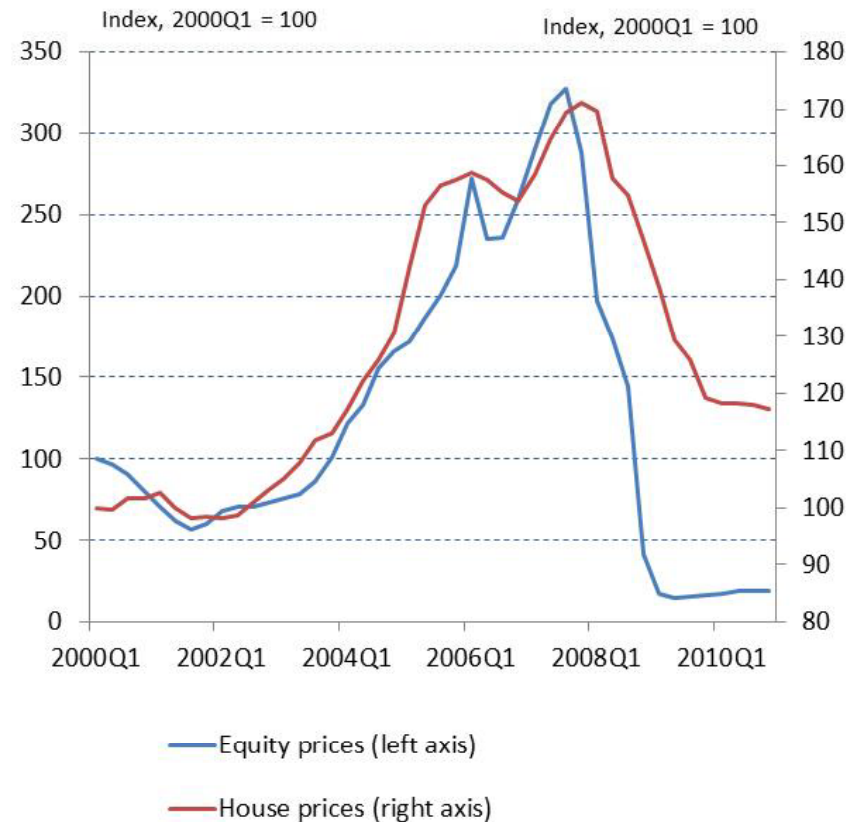
International financial market liquidity and the króna exchange rate



The liquidity index shows the number of standard deviations from the mean (exponential moving average) from a simple average of nine liquidity measures,

Source: Bank of England, Central Bank of Iceland.

Real asset prices

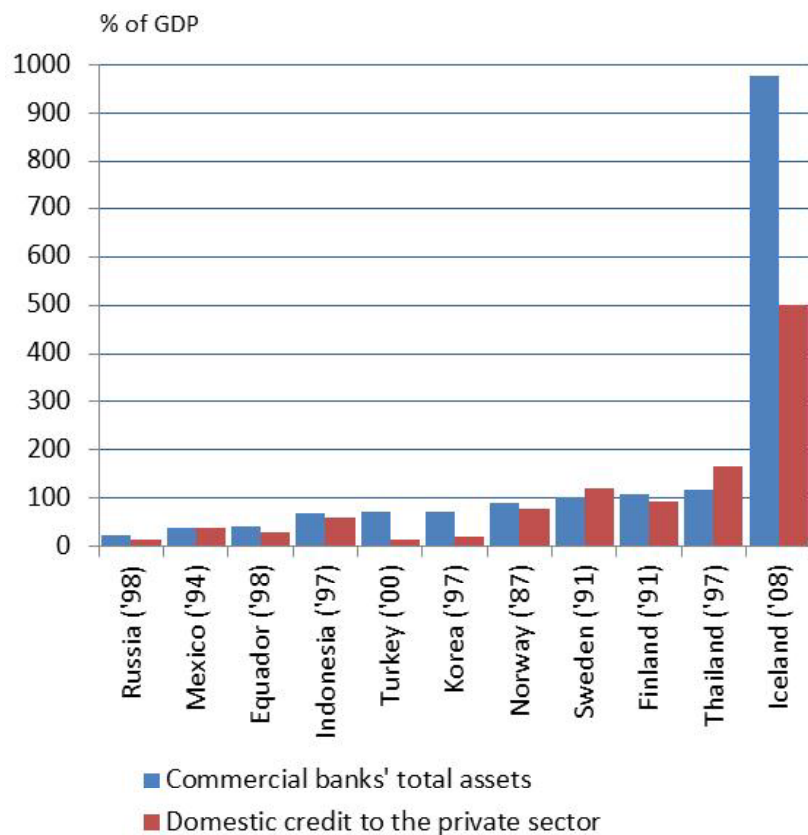


Source: Statistics Iceland, Central Bank of Iceland.



High debt levels were accumulated with a significant FX exposure

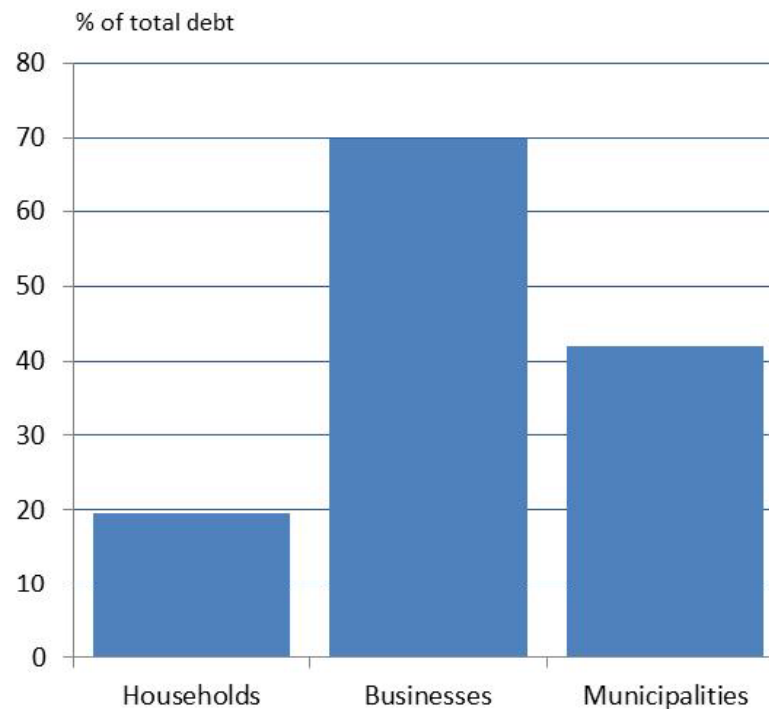
Bank assets and private sector debt in the run-up to the crisis



The year in parentheses represents the onset of the crisis in the country concerned.

Source: Reuters EcoWin, Bank of England, Central Bank of Iceland.

Proportion of total foreign-denominated debt

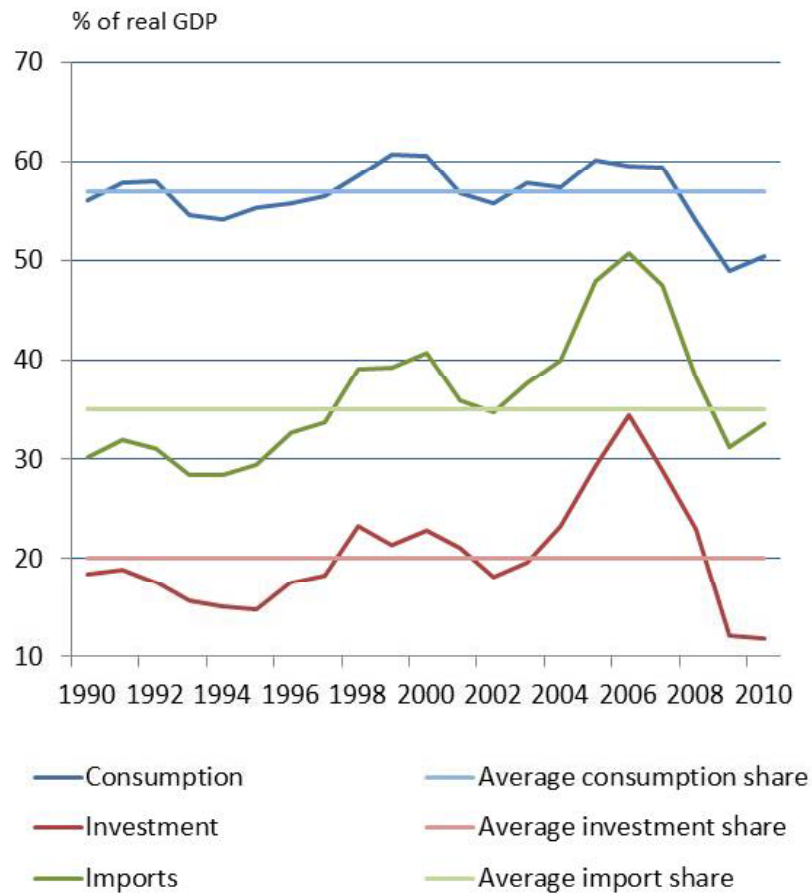


Source: Central Bank of Iceland.



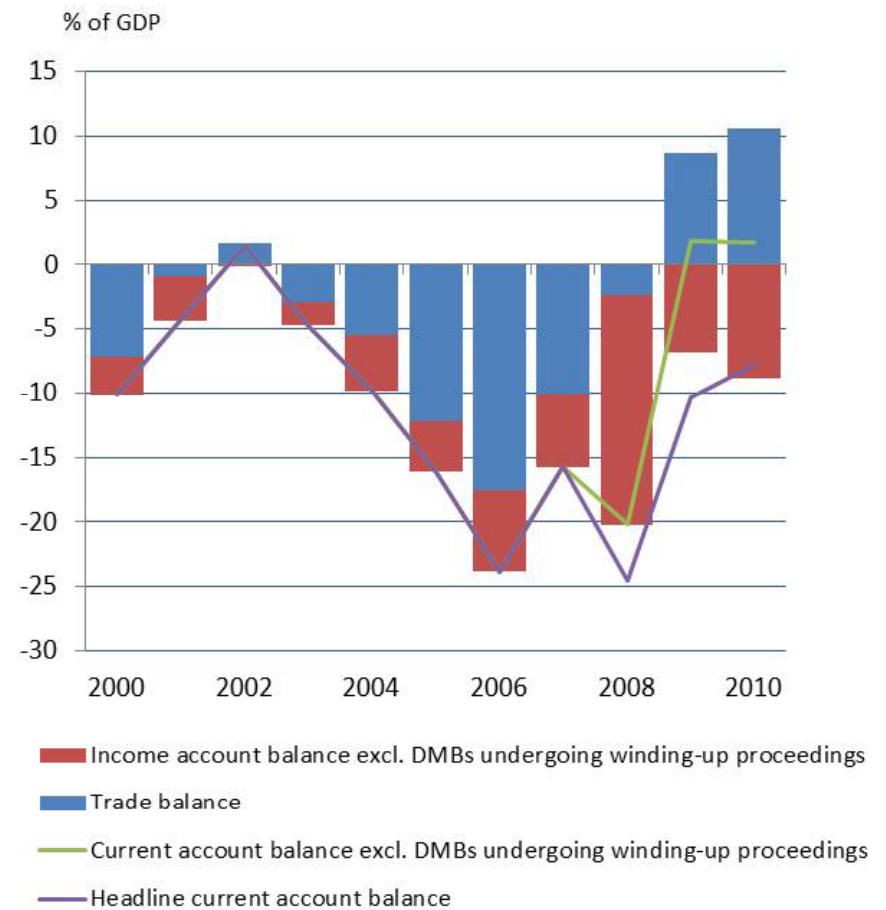
Huge imbalances build up and then unwind

Expenditure shares in GDP and 30 year average shares



Source: Statistics Iceland, Central Bank of Iceland.

Current account balance

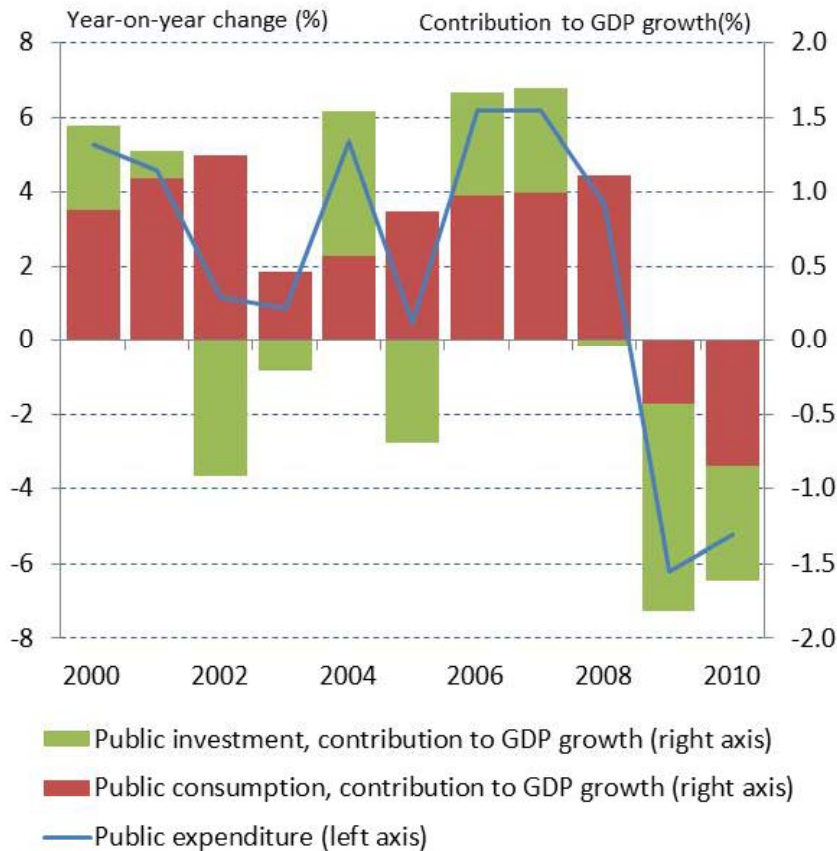


Source: Statistics Iceland, Central Bank of Iceland.



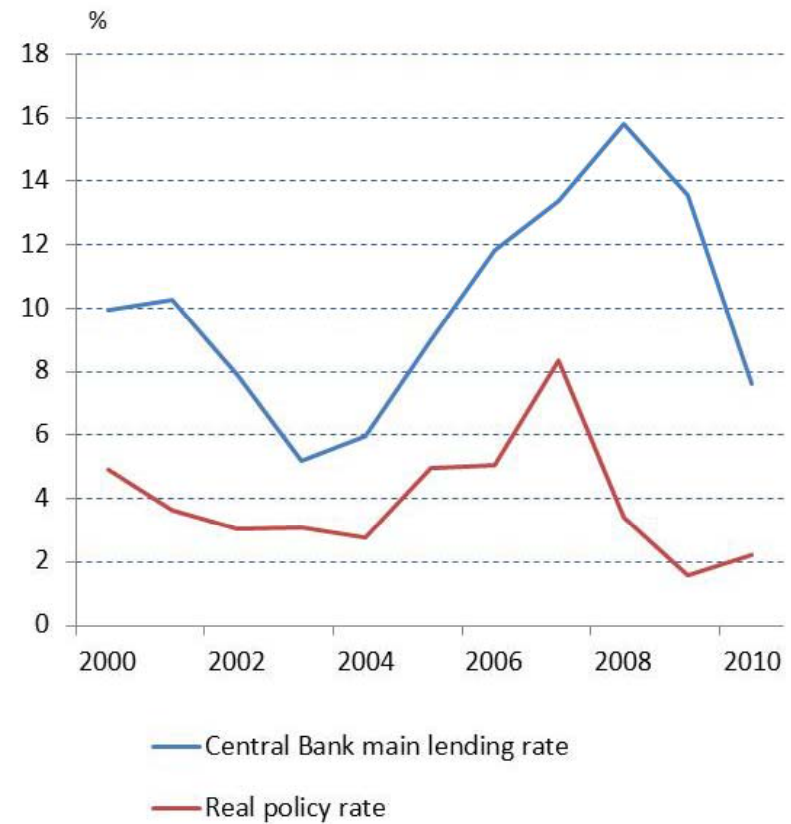
Policy responses proved insufficient and the policy mix inappropriate

Fiscal policy



Source: Statistics Iceland, Central Bank of Iceland.

Monetary policy

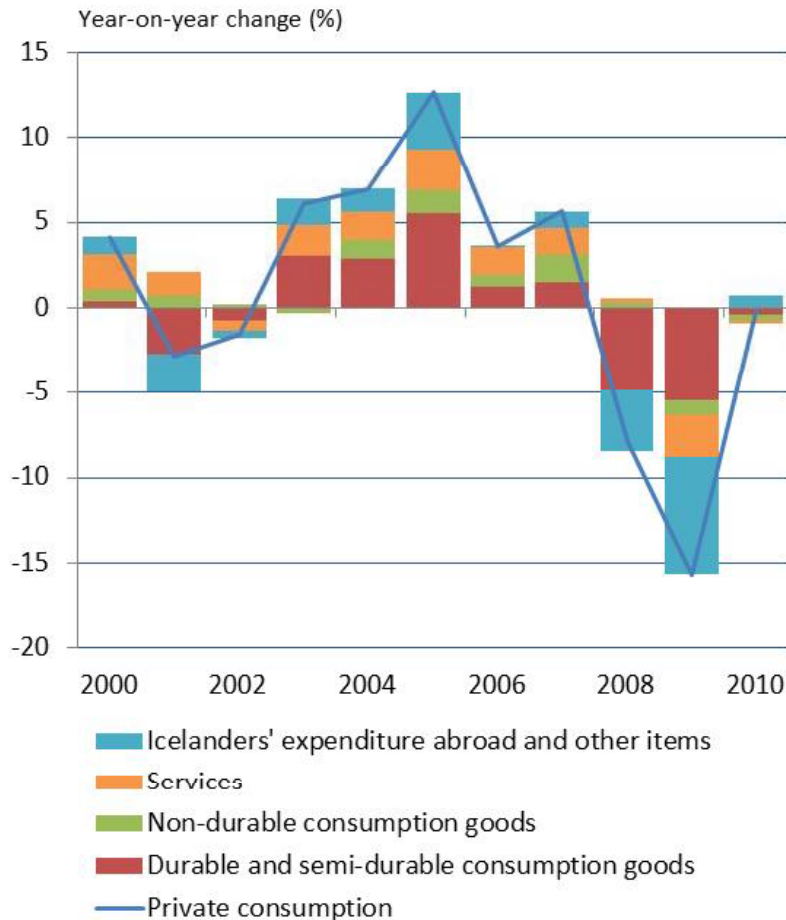


Source: Statistics Iceland, Central Bank of Iceland.



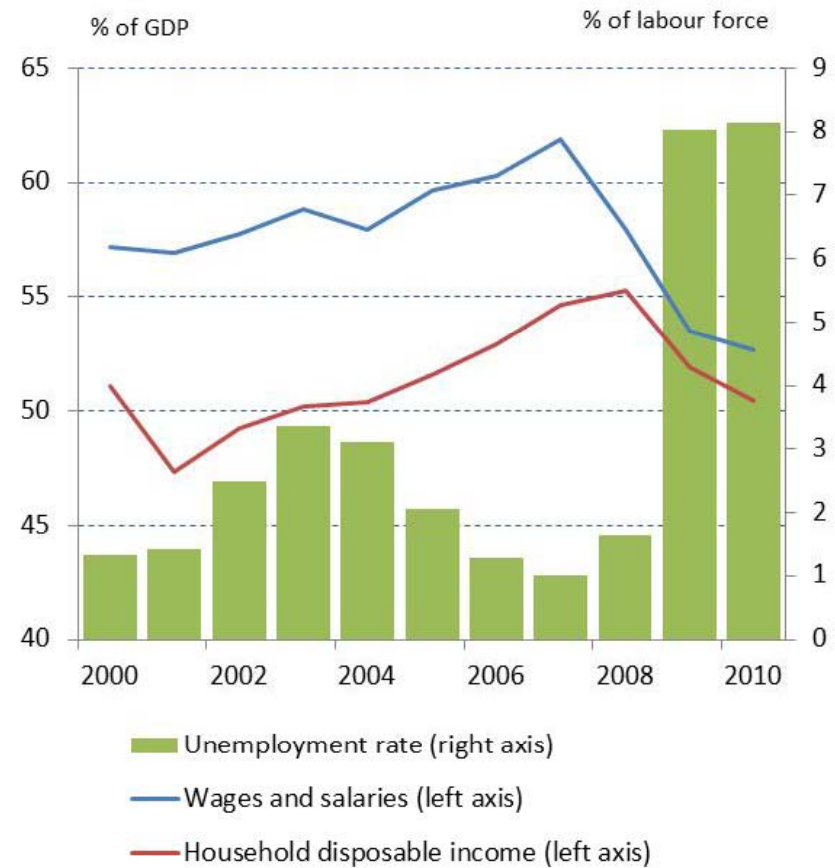
The collapse triggered a large adjustment in income and demand...

Private consumption and contributions of its main components



Source: Statistics Iceland.

Wages, income and unemployment



Source: Statistics Iceland, Directorate of Labour, Central Bank of Iceland.



... But net exports provided a buffer for output

World trade and Icelandic exports in the current crisis

Volume index (seasonally adjusted), 2008Q3 = 100

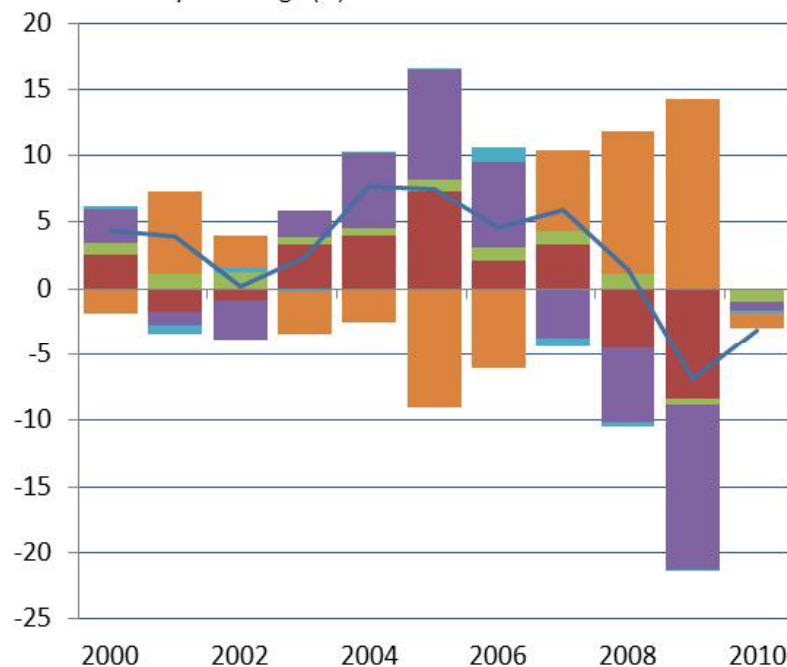


— Iceland's exports (excluding transitory airplane transactions)
 — Total imports among Iceland's main trading partners

Source: OECD, Central Bank of Iceland.

Output growth and contribution of its main components

Year-on-year change (%)



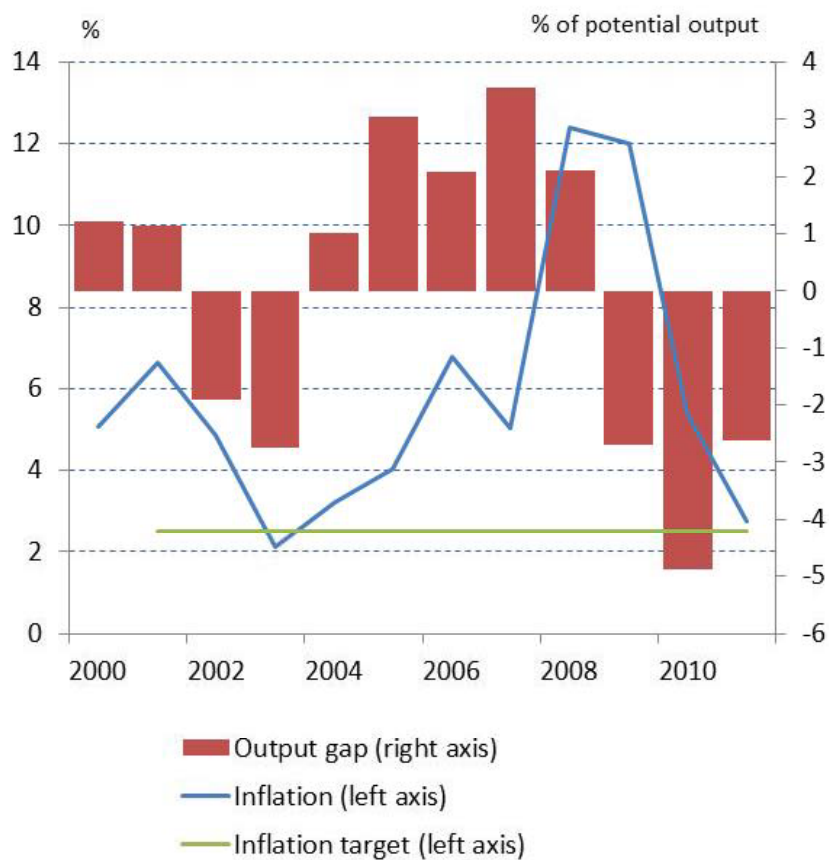
■ Private consumption ■ Public consumption
 ■ Investment ■ Change in inventories
 ■ Net trade ■ Output growth

Source: Statistics Iceland.



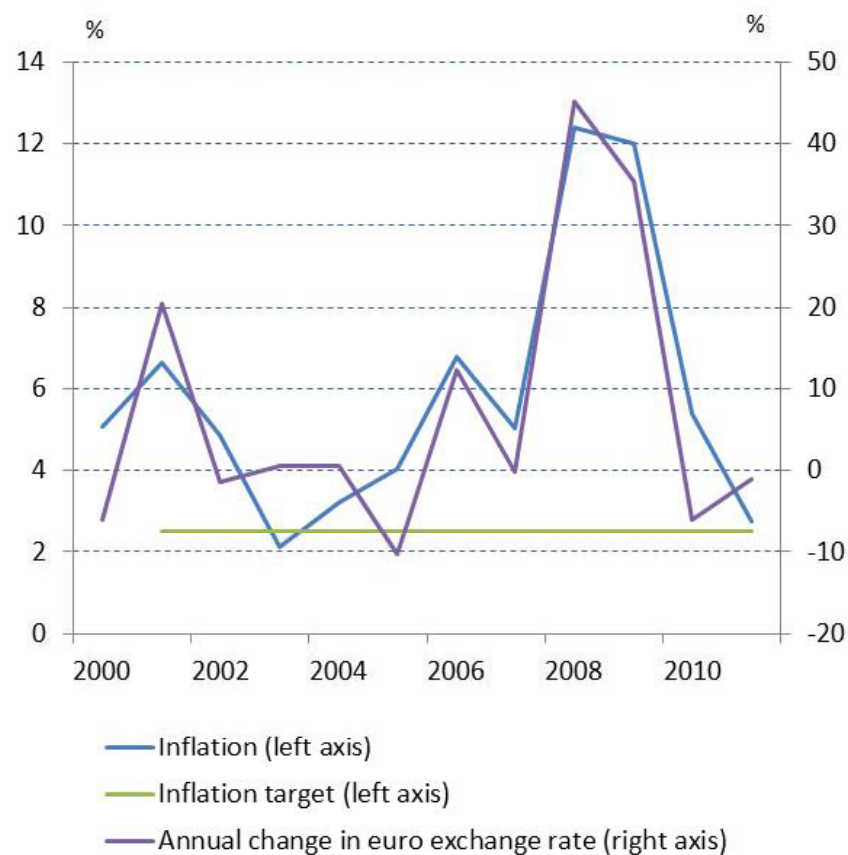
Inflation was high pre-crisis but soared after the currency collapse

Inflation and domestic imbalances



Source: Statistics Iceland, Central Bank of Iceland.

Inflation and the exchange rate cycle

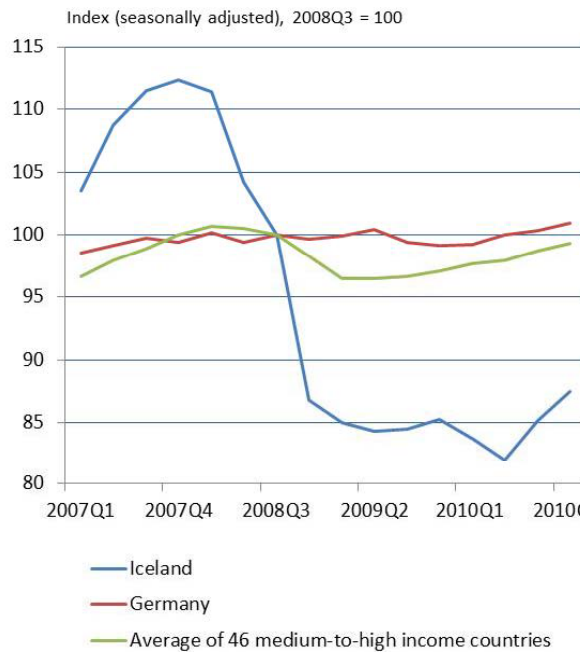


Source: Statistics Iceland, Central Bank of Iceland.



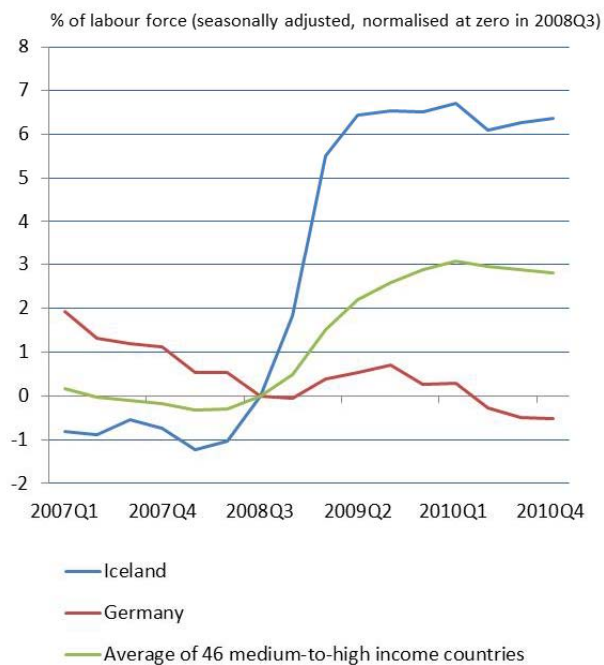
A large contraction in international comparison...

Consumption levels in current crisis



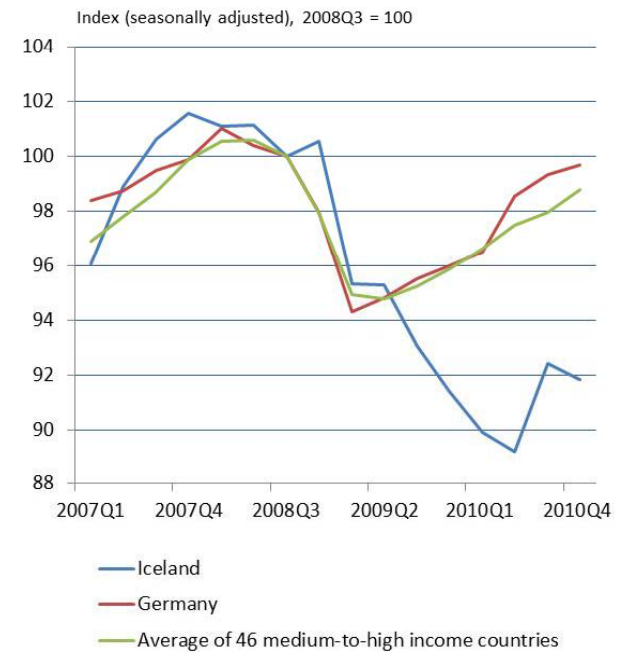
Source: Macrobonds, Central Bank of Iceland.

Unemployment in current crisis



Source: OECD, Macrobonds, Directorate of Labour, Central Bank of Iceland.

GDP levels in current crisis



Source: Macrobonds, Central Bank of Iceland.

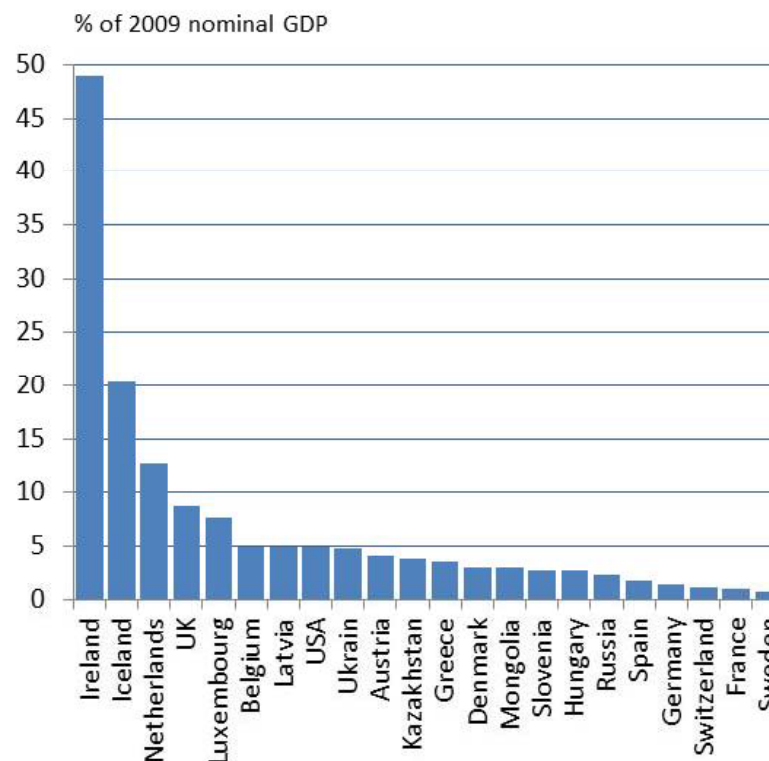


... and the direct fiscal costs are larger than in most other countries

Composition of direct fiscal costs for Iceland (% of 2009 nominal GDP)

Losses on loans to failed banks made by Central Bank	11.1
Other losses on loans to failed banks	1.8
Net costs of recapitalisation of failed banks	3.8
Costs of recapitalisation of Housing Finance Fund	2.1
Costs of called loan guarantees	1.5
Total costs	20.3

Direct fiscal costs of the financial crisis over 2007-2009



Sources: Laeven and Valencia (2010), "Resolution of banking crises: The good, the bad, and the ugly", IMF Working Paper, no. 10/146, and the OECD (2011) for Iceland and Ireland.



Post-crisis policy responses

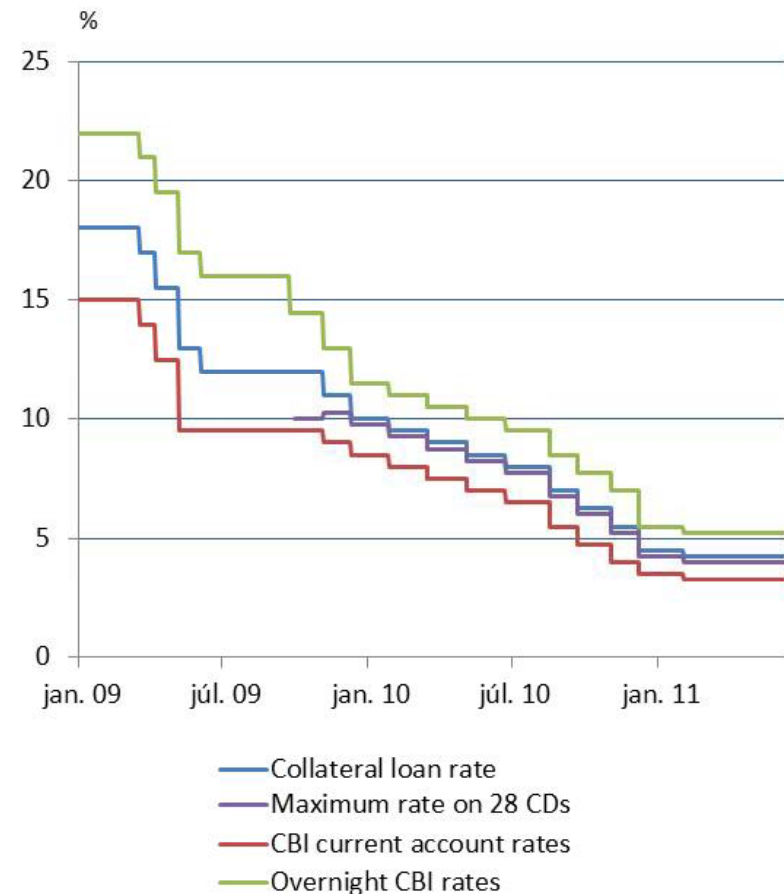


Monetary policy

Focus on stabilising currency and disinflation

- High debt and FX exposure meant that the ISK collapse wreaked havoc in domestic balance sheets
- Initial focus of monetary policy
 - Fostering stability of ISK while the restructuring and recovery of balance sheets takes place
 - Avoid disorderly capital outflows further weakening the ISK
- Using interest rate policy and capital controls
- Exchange rate stability and disinflation allowed for gradual easing of monetary policy

Central Bank of Iceland interest rates



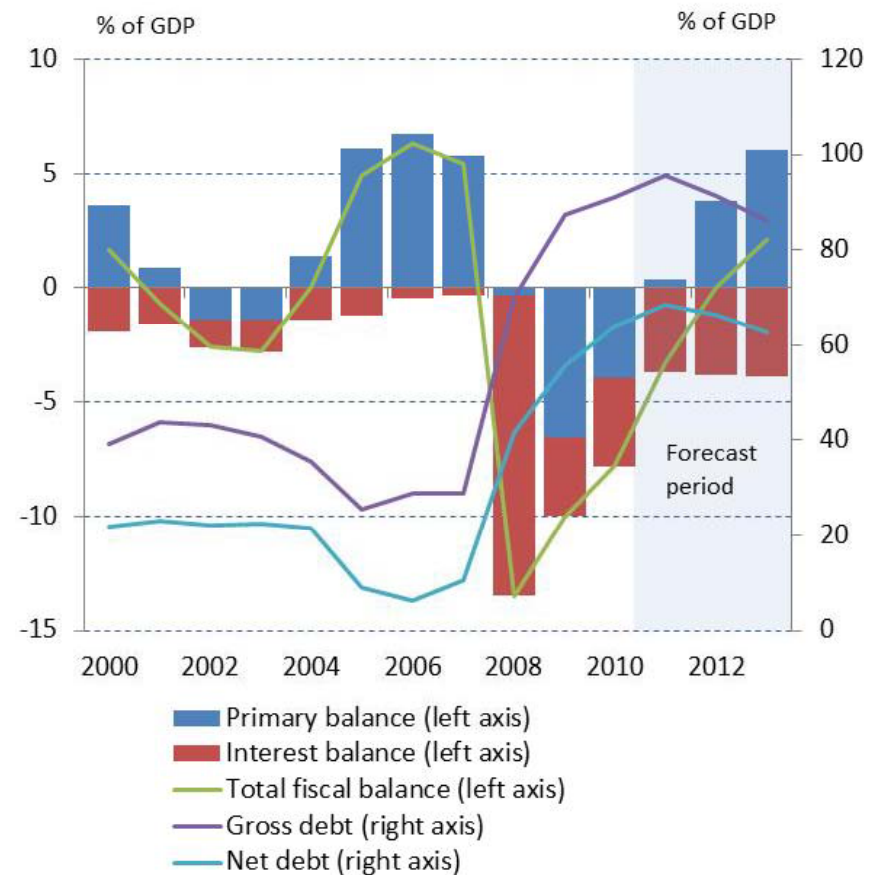
Source: Central Bank of Iceland.

Fiscal policy

Consolidation to ensure debt sustainability

- Fundamental changes in Government finances
- The crisis led to a sharp reversal from surplus to deficit
 - 2007: +5.4% of GDP
 - 2008: -13½% of GDP
- Gross debt increased from below 30% of GDP in 2007 to 95% this year
- Expenditure cuts and increased taxes needed to ensure a gradual closing of the deficit and a sustainable debt path

Public sector finances



Source: Ministry of Finance, Statistics Iceland, Central Bank of Iceland.



The economic outlook: The road to recovery



The króna has stabilised as risk premia has subsided

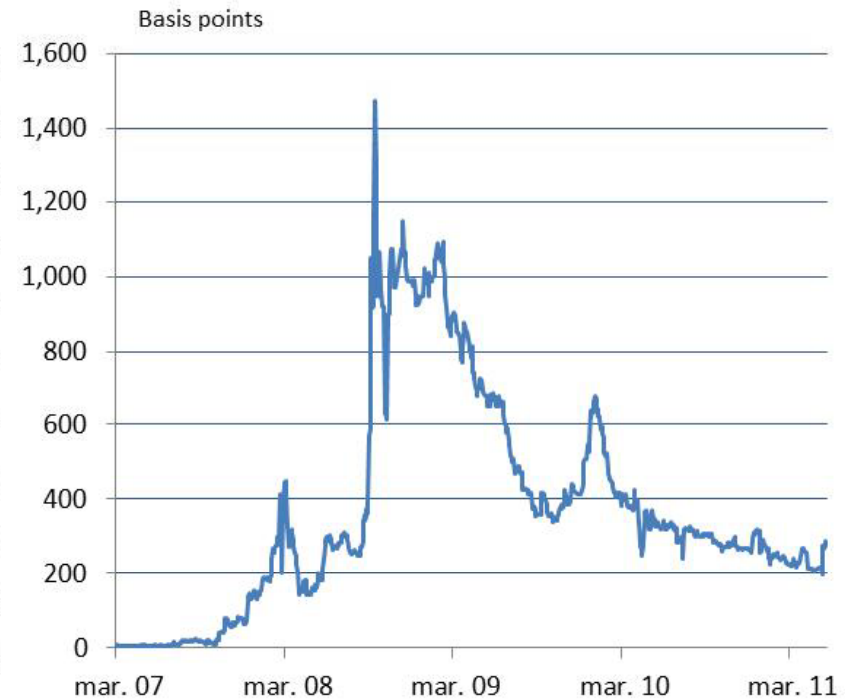
Exchange rate of the króna



- EURISK (left axis)
- 90 day standard deviation of daily changes in the EURISK exchange rate (right axis)

Source: Central Bank of Iceland.

CDS spread for Iceland



Source: Bloomberg.



An uneven and fragile recovery has taken hold

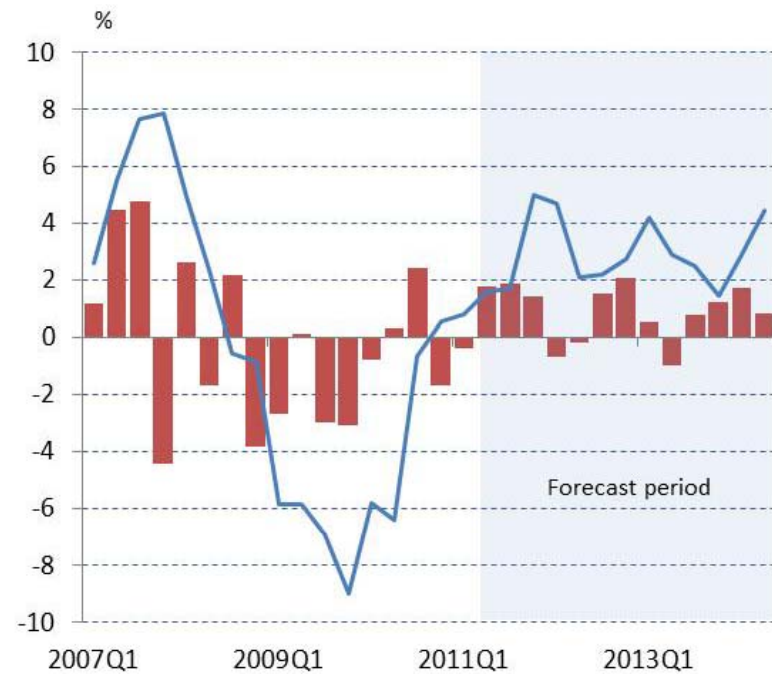
Unemployment rate and employment growth



■ Employment growth (right axis)
— Unemployment rate (seasonally adjusted, left axis)

Source: Statistics Iceland, Directorate of Labour, Central Bank of Iceland.

Output growth



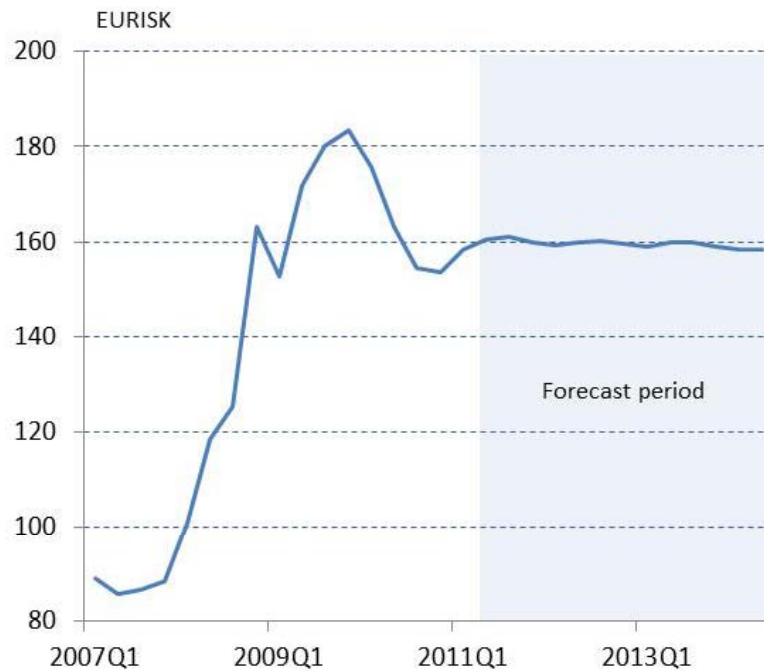
■ Quarterly GDP growth (seasonally adjusted)
— Annual GDP growth

Source: Statistics Iceland, Central Bank of Iceland.



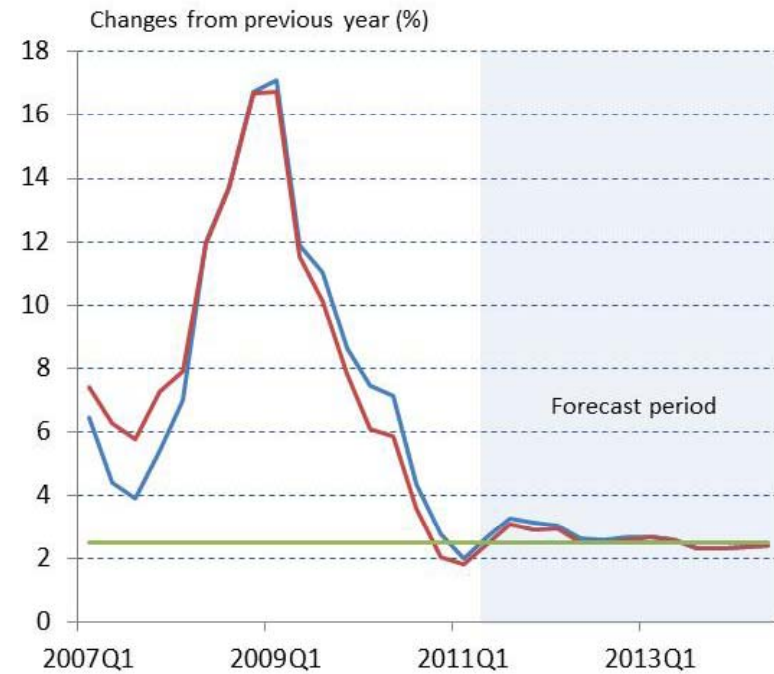
Inflation has declined and is expected to remain close to target

Exchange rate of the króna



Source: Central Bank of Iceland.

Inflation outlook



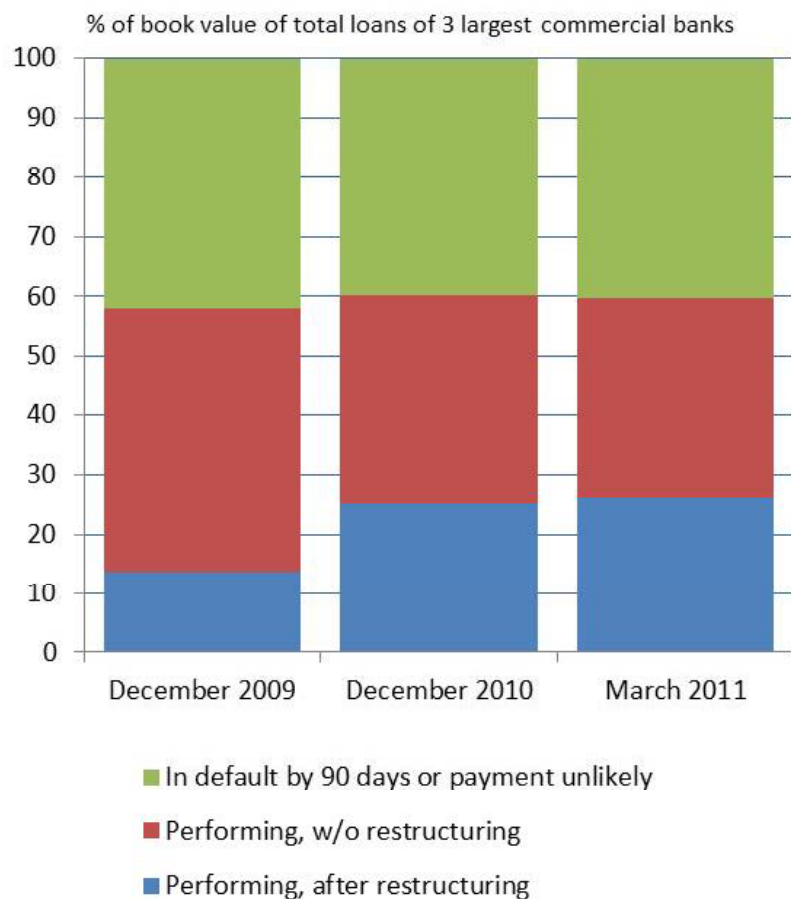
- Headline inflation
- Inflation excluding direct tax effects
- Inflation target

Source: Statistics Iceland, Central Bank of Iceland.



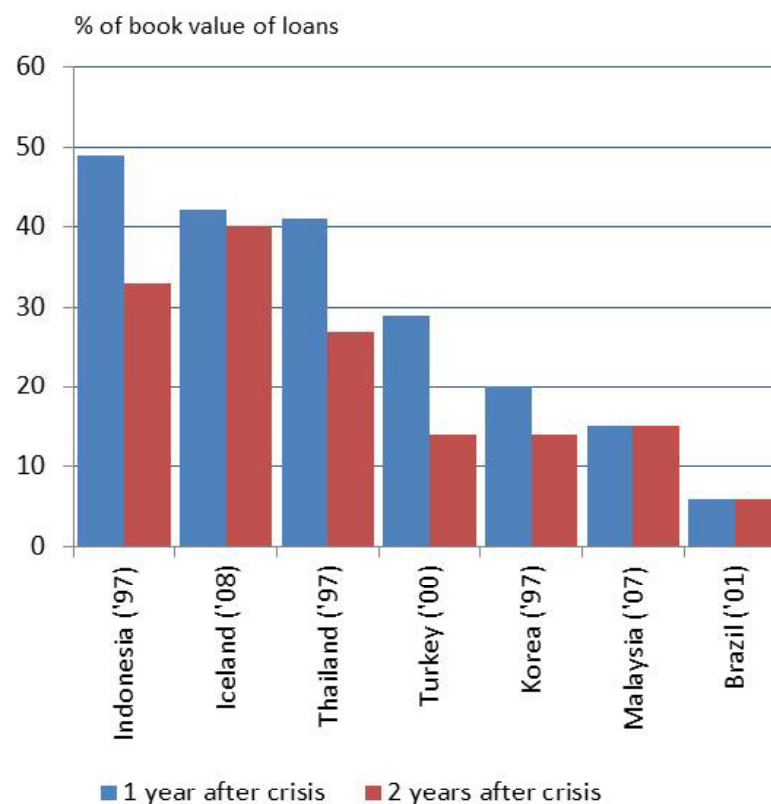
But challenges remain – chief among them the slow pace of debt restructuring

Composition of loan book



Source: Central Bank of Iceland, *Financial Stability Report*, 2011/1.

Share of non-performing corporate loans in selected post-crisis episodes



The year in parentheses represents the onset of the crisis in the country concerned. Values for Korea and Thailand refer to 2-3 years after the crisis.

Source: Central Bank of Iceland, *Financial Stability Report*, 2011/1.