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Crisis, Policy Responses and Recovery in Iceland

Looking back and looking forward
CBI conference

Már Guðmundsson, Governor

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The autumn of 2008

- Iceland's three internationally active banks failed in the first week of October 2008 (almost 10 times GDP and 90% of the banking sector).
- Combined, this was the 3rd biggest corporate failure in the history of mankind.
- At that point, Iceland was already in a currency crisis and on its way into recession after an unsustainable boom during 2005-2007.
- Icelandic private sector was heavily indebted and there were big currency mismatches in domestic balance sheets.
- Many expected a very deep recession and even that the sovereign might default on its obligations.

Two separate but interrelated stories

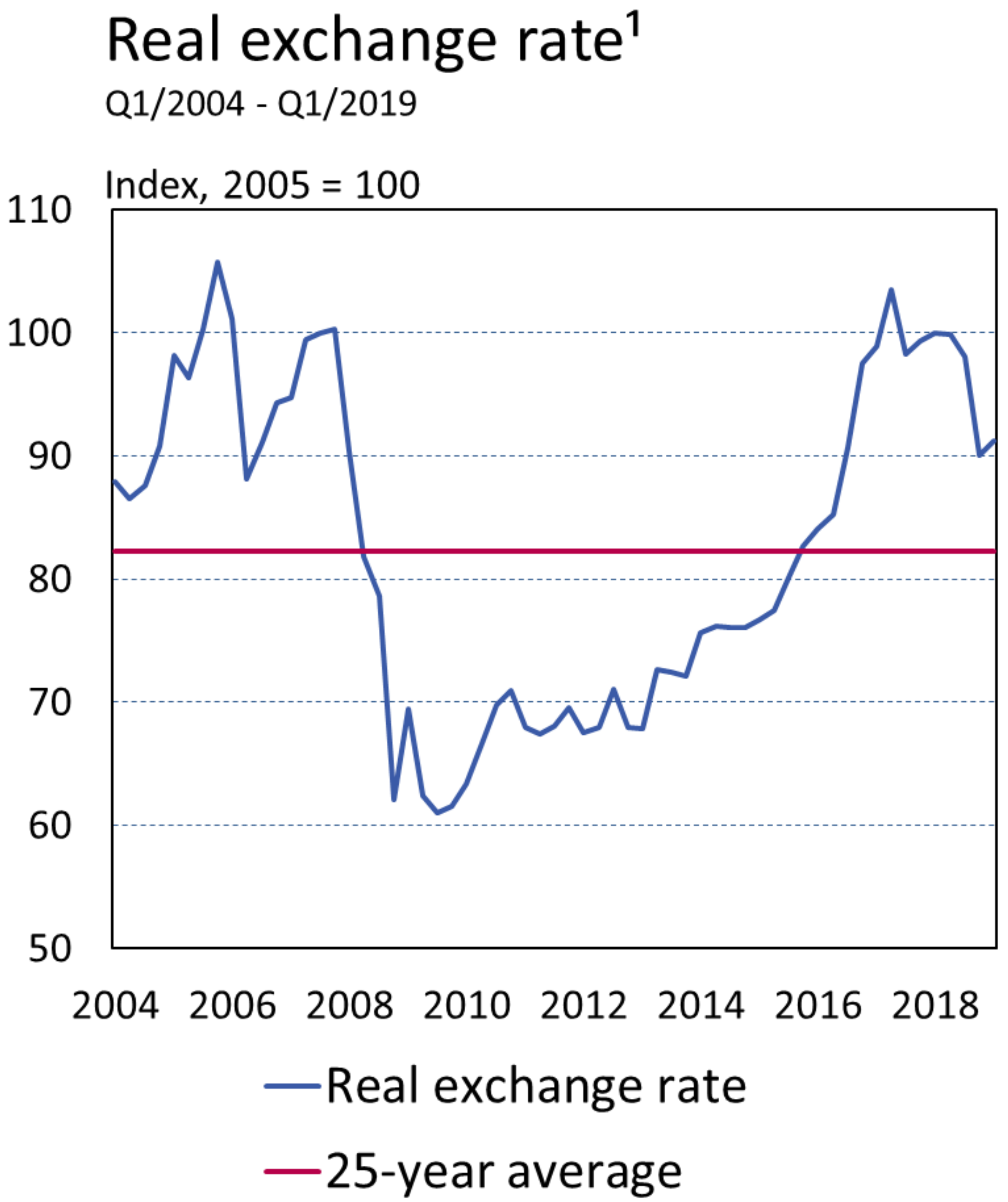
- Iceland’s boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies.
- The rise and fall of three cross-border banks operating on the basis of EU legislation (the European “passport”).

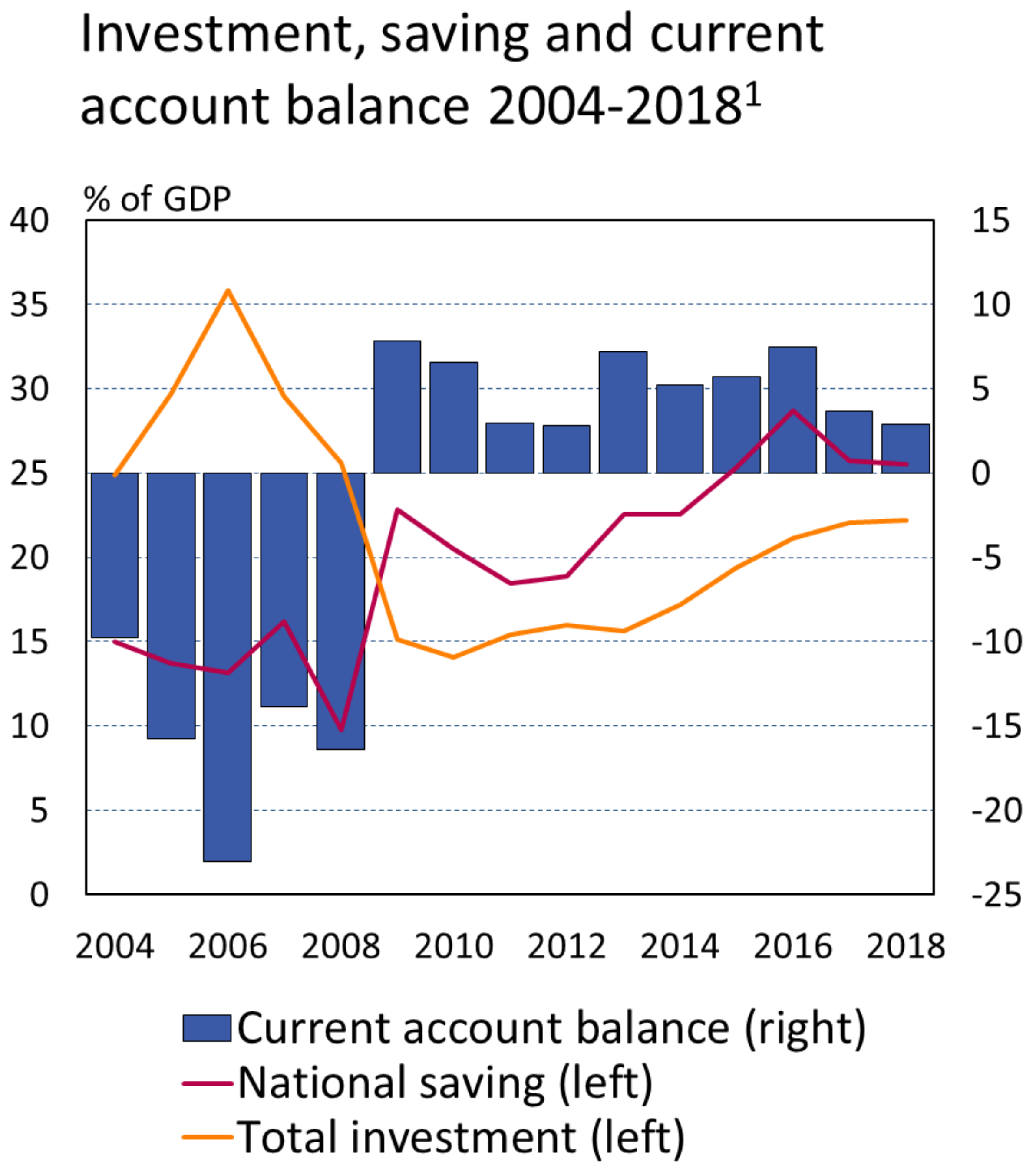
The immediate policy response

- Failing banks placed in resolution regimes and domestic banks carved out (1.7 times GDP).
- Focus on keeping payment intermediation working – deposit preference introduced.
- IMF programme three key goals: exchange rate stability, fiscal sustainability, and financial sector reconstruction.
- Comphrehensive capital controls were a key element in the programme:
  - Stabilise the exchange rate.
  - Space to clean up balance sheets.
  - Space for domestic economic policies.

Recession and recovery

Real depreciation and rebalancing





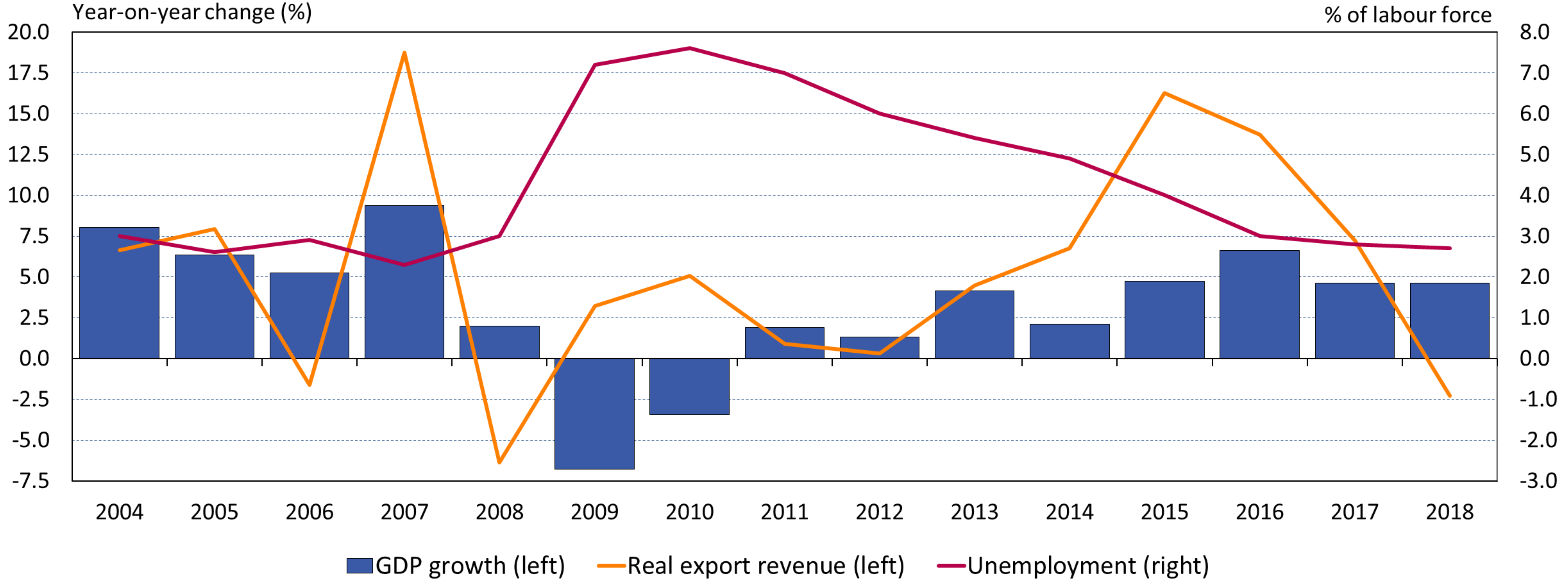
1. Current account balance and national saving based on estimated underlying current account balance in 2008-2015.
Sources: Statistics Iceland, Central Bank of Iceland.

Deepest recession since around WWI and longest expansion since the end of WWII

- GDP contracted by 13% from Q1/2008 to Q1/2010.
- Unemployment peaked in Q4/2010 at just over 8% (post-war high)
- A relatively weak recovery began in Q2/2010 but gained strong momentum during 2015-2017 with record tourism and strong improvements in the terms of trade.
- Pre-crisis peak in GDP reached in 2015 and per capita in 2016.
- Total employment (man years) reached pre-crisis peak in 2014.

Deep recession but full recovery with strong growth in export sectors

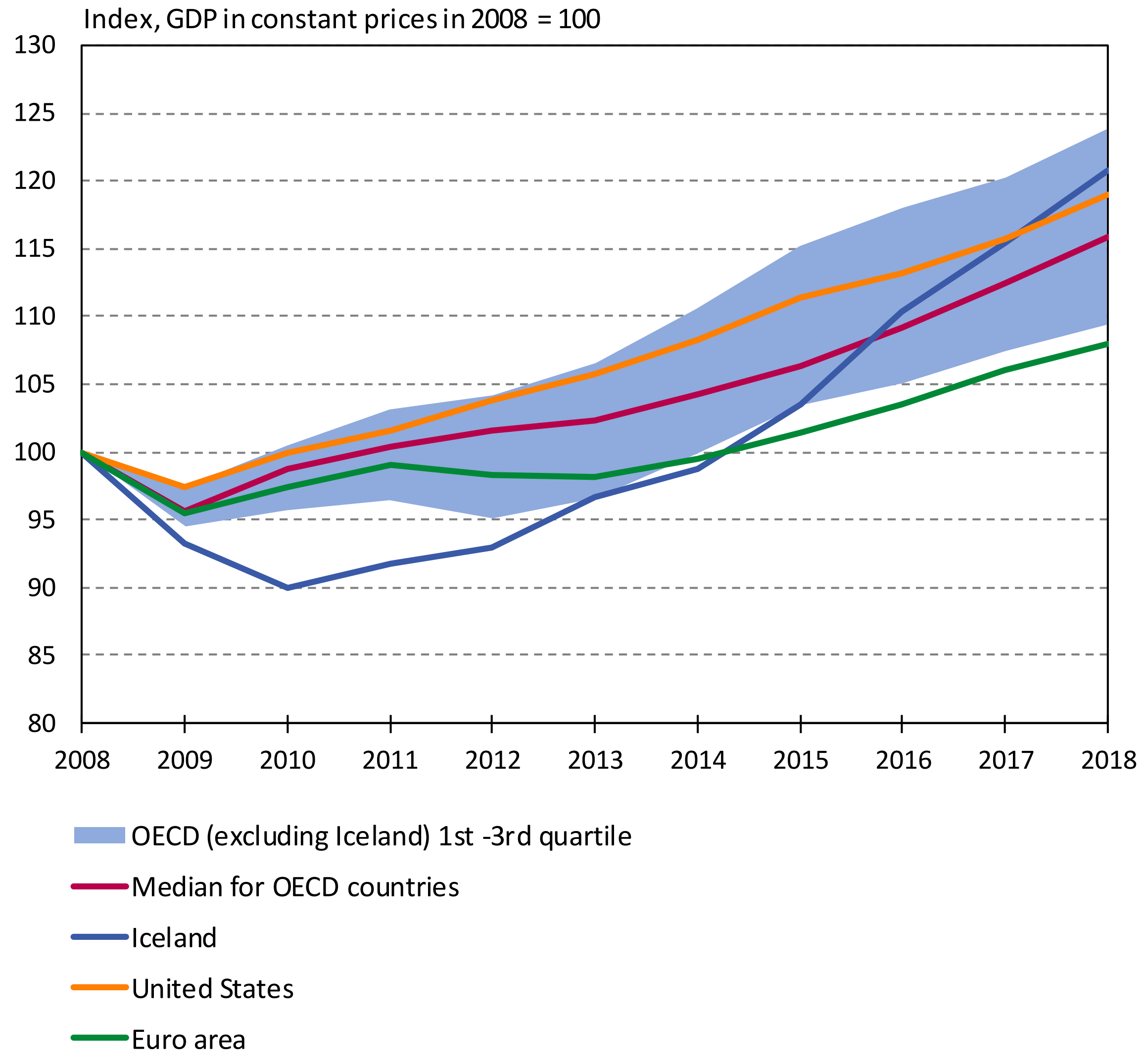
GDP growth, unemployment and real export revenue 2004-2018



Sources: Statistics Iceland, Central Bank of Iceland.

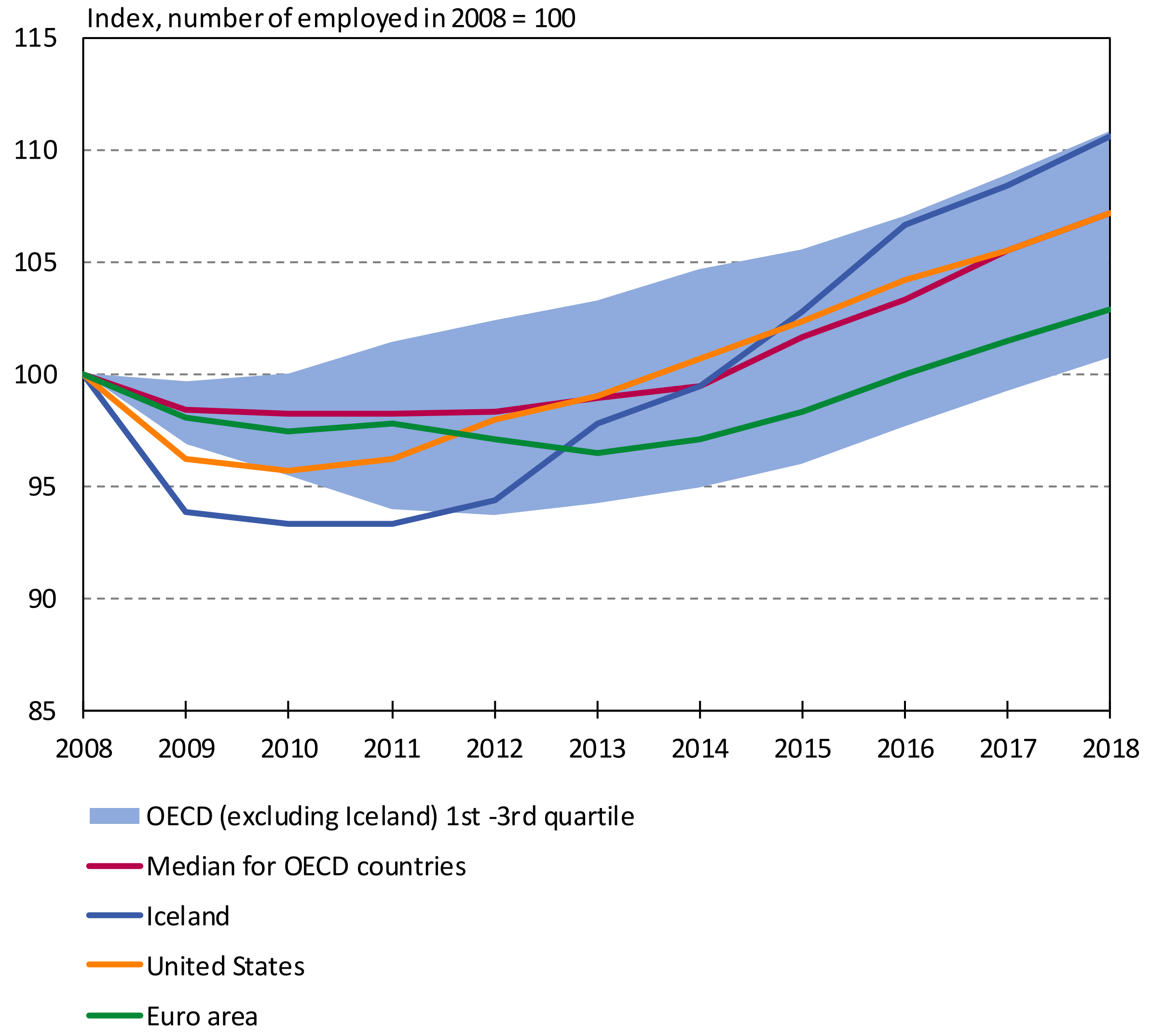
Iceland´s GDP recession was relatively deep, but its employment recovery relatively strong

Post-crisis economic recoveries in output in selected countries[1]



1. Estimates for 2018 are based on IMF's WEO database.
Sources: IMF, Statistics Iceland, Central Bank of Iceland.

Post-crisis economic recoveries in employment in selected countries[1]



1. Estimates for 2018 are based on IMF's WEO database.
Sources: IMF, Statistics Iceland, Central Bank of Iceland.

Economic and financial policies

The IMF programme

- Approved in November 2008.
- Total financing 3.9 b € or 44% of GDP in 2008 (1.6 b € from IMF and 2.3 b € from Nordic countries and Poland).
- Interest rates: IMF: initial 3.3%. Nordic: initial 3.15% (2.75%+Euribor).
- Fully drawn but not used except to increase the level of reserves.
- Loan from the Faroe Islands amounting to 300 m DKK (40 m €). No conditionality.
- Ended in August 2011.
- Nordic loans repaid 2012-2014, IMF 2012-2015 and Polish loan in spring 2015.
- All main goals were reached – strong local ownership.

Comprehensive capital controls on outflows

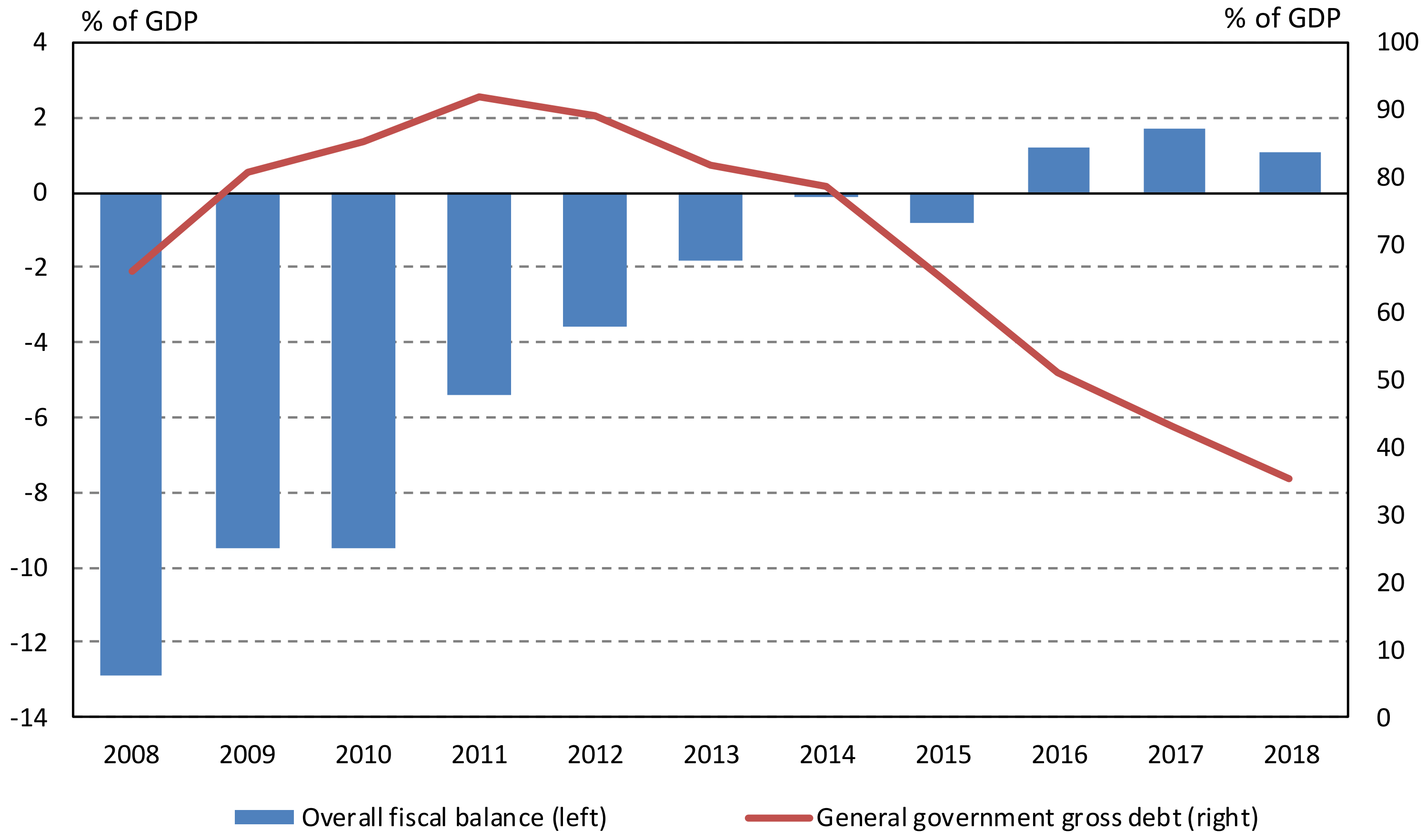
- Helped to stabilise the exchange rate after 50% fall in 2008.
- Big currency mismatches in domestic balance sheets.
- Direct foreign króna positions 40% of GDP.
- Created space for monetary policy, the domestic financing of the fiscal deficit and the cleaning up of domestic balance sheets.
- Mostly lifted 2015-17 without derailing economic and financial stability, without tapping the Central Bank's FX reserves excessively, and without discernible legal repercussions from the measures taken to lift the controls.

Fiscal consolidation

- A medium term fiscal consolidation programme was a key element in the programme with the IMF.
- It worked well.
- Automatic stabilisers were allowed to work in the beginning as the fiscal deficit went to almost 10% of GDP in 2009.
- Fiscal consolidation then eliminated the deficit over 2010-2014 without derailing the economic recovery.
- Effort was big in international comparison.

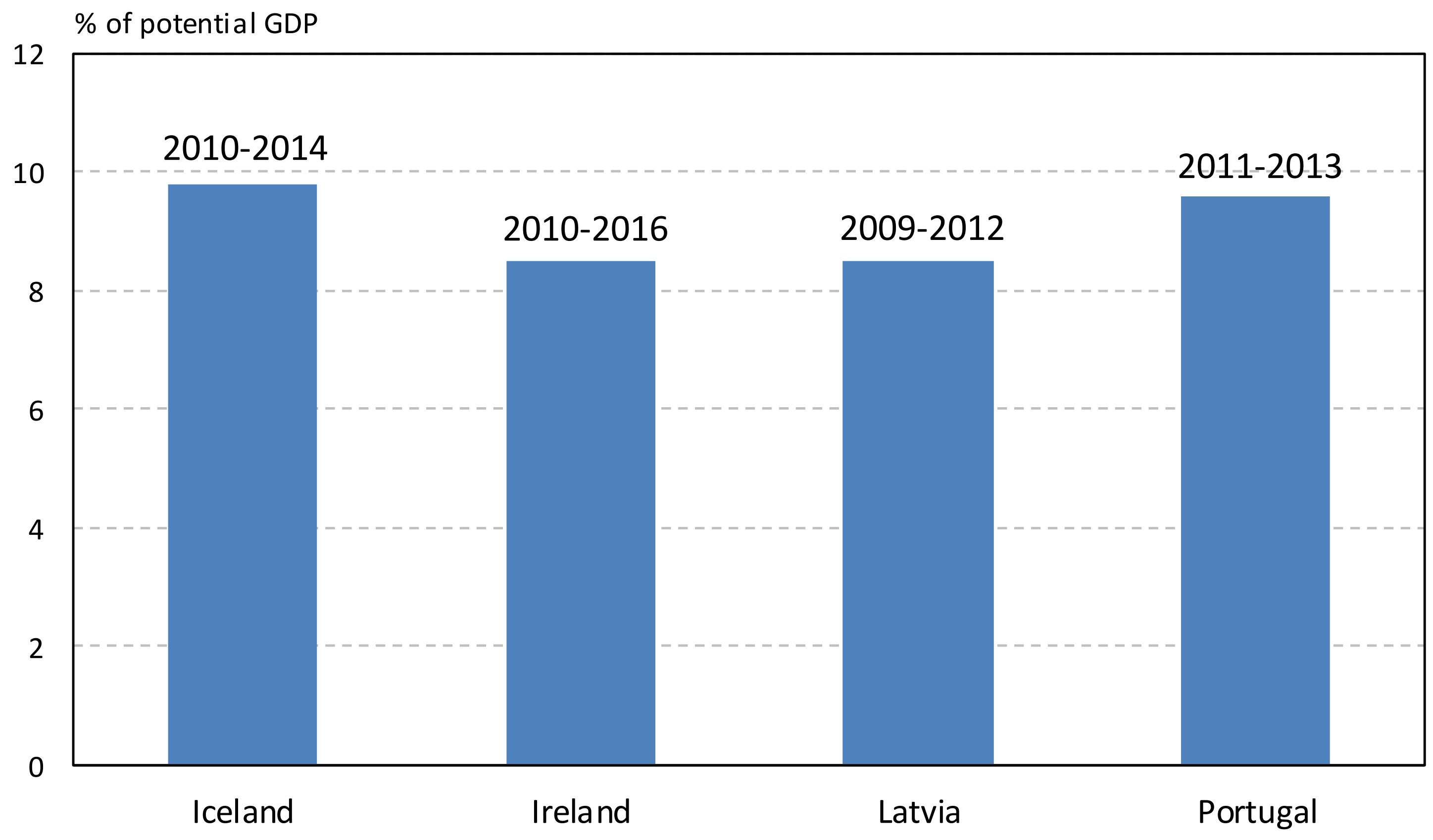
Fiscal consolidation and falling public debt

General government overall fiscal balance and gross debt 2008 - 2018[1]



1. Adjusted for stability contributions.
Sources: IMF Fiscal Monitor, Central Bank of Iceland.

Fiscal consolidation: period and positive change in the cyclically adjusted primary balance of general government



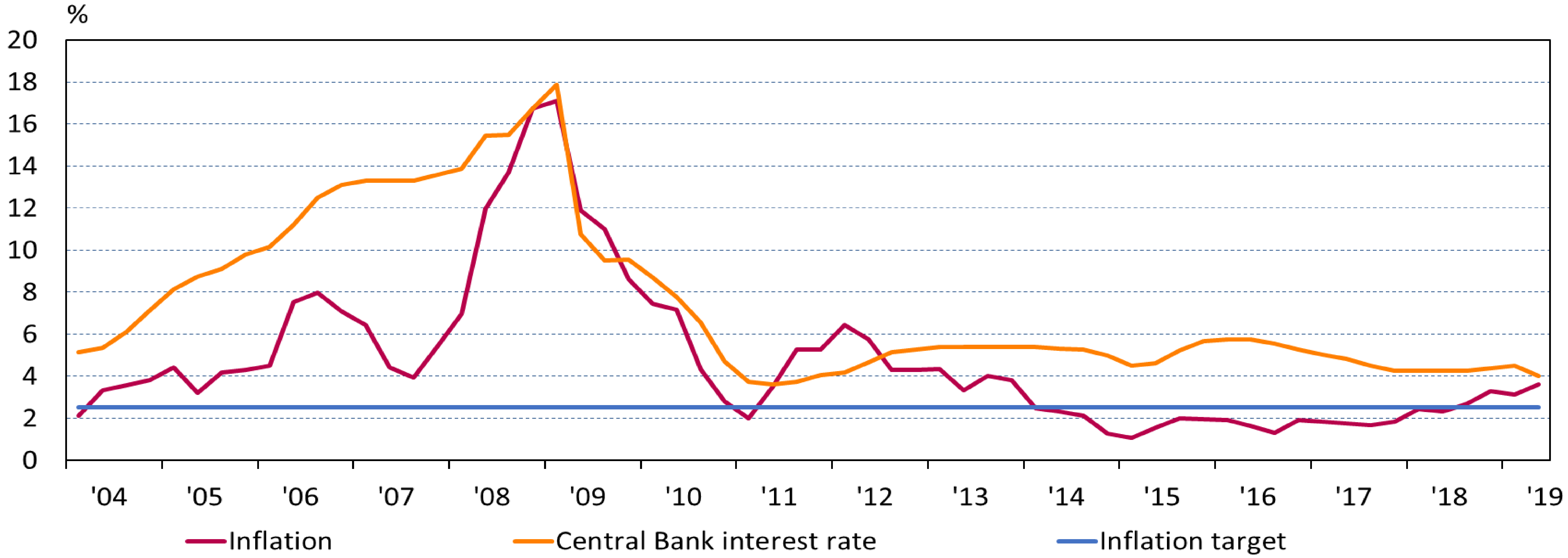
Sources: IMF Fiscal Monitor October 2017 & 2018.

Monetary policy

- Inflation fell to target as the exchange rate stabilised in 2009 and appreciated in 2010.
- Created scope to cut the policy rate.
- Monetary policy was successful in bringing inflation expectations down to target after 2012 and keeping inflation close for five years without employment costs.

Inflation peaked in 2009 but declined steadily after the exchange rate stabilised. Monetary policy succeeded in keeping inflation close to target in recent years.

Inflation and policy rate Q1/2004-Q1/2019 and latest



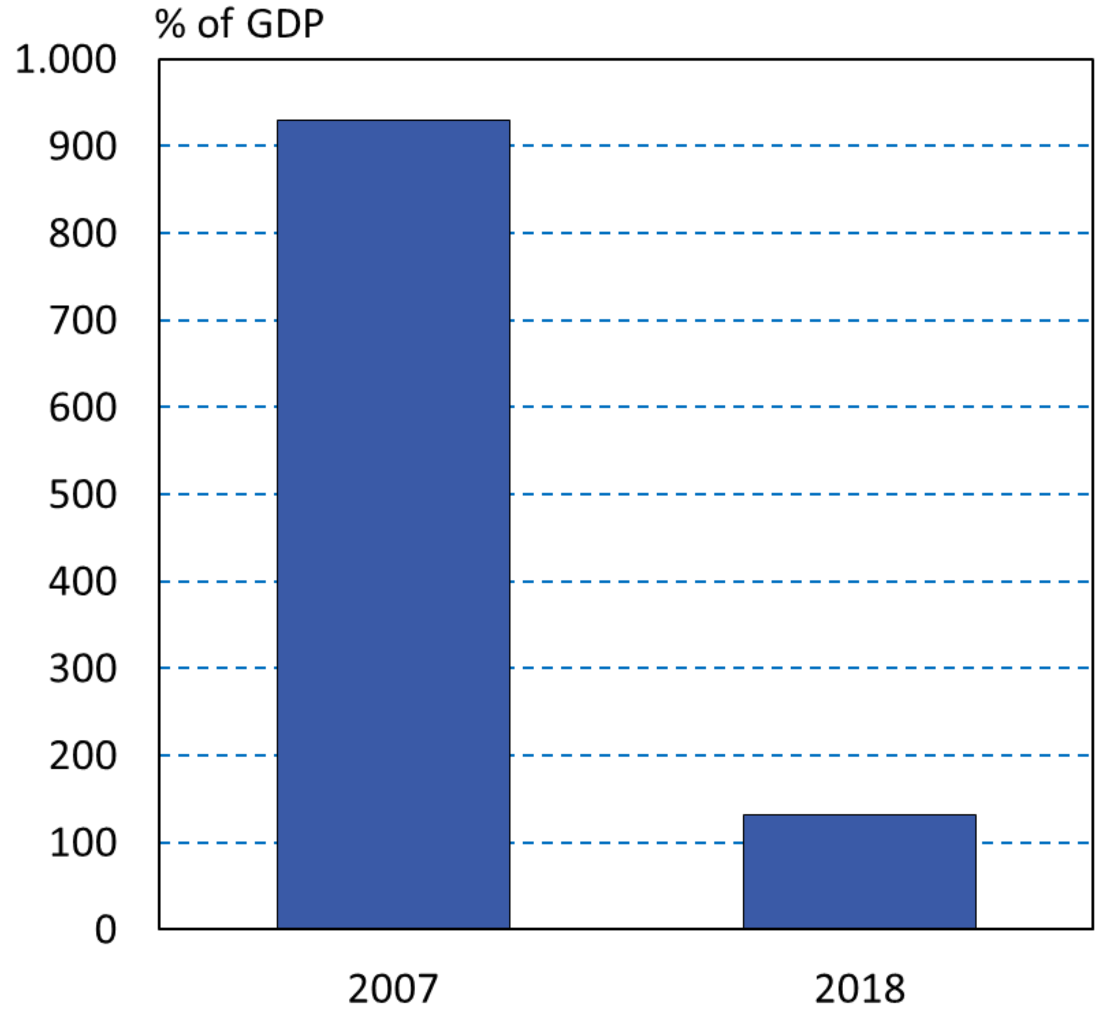
Sources: Statistics Iceland, Central Bank of Iceland.

Rebuilding the banking system

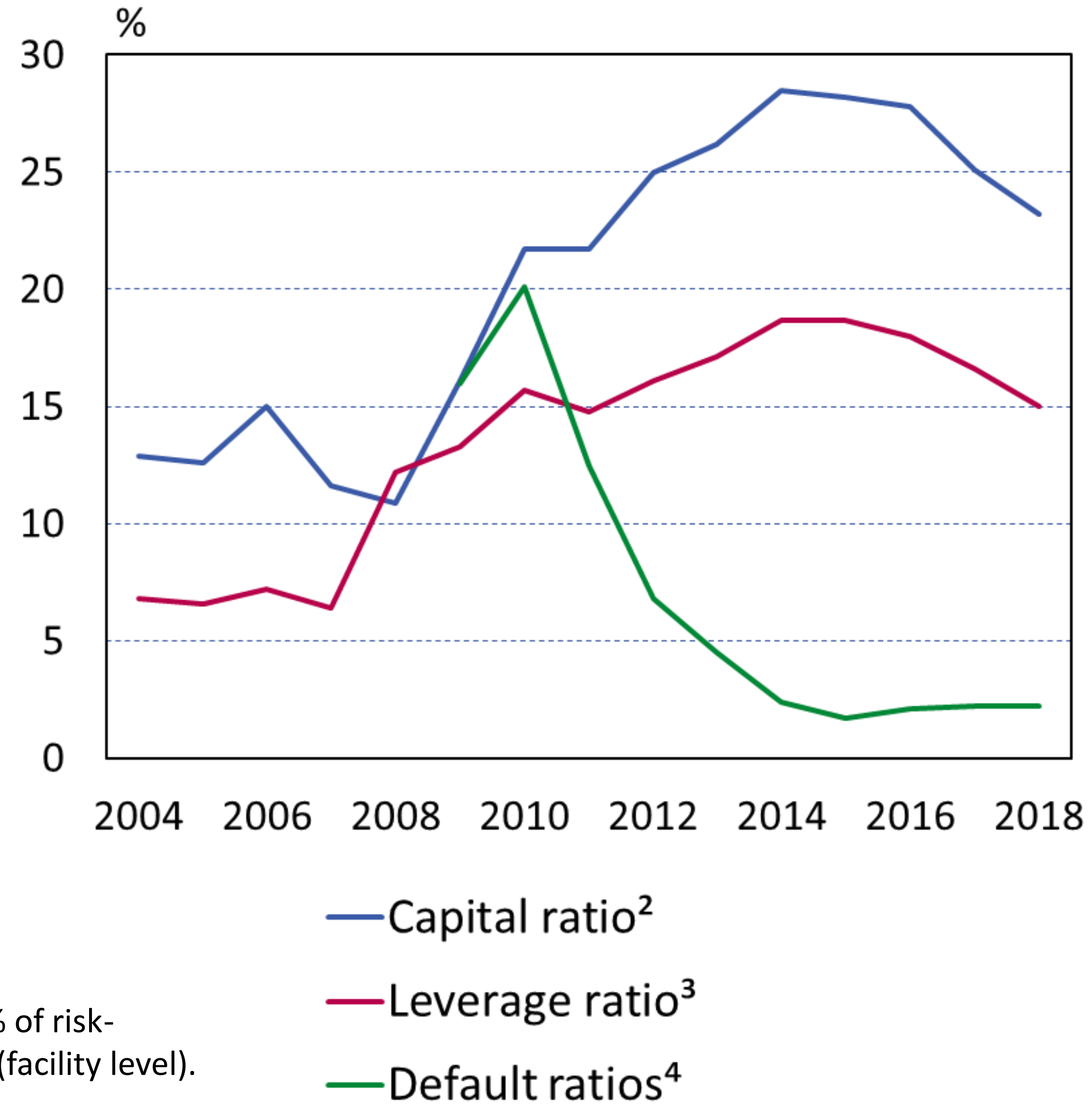
- The banking system primarily serves domestic households and business.
- 15% of the size of the pre-crisis banking system.
- Bank regulation has been greatly improved.
- Resilient with high capital adequacy ratios and sound liquidity position.

Banking system now focuses mainly on domestic households and businesses and is much more resilient than before

Bank balance sheets 2007 and 2018



Deposit institutions: capital, leverage and default ratios[1]



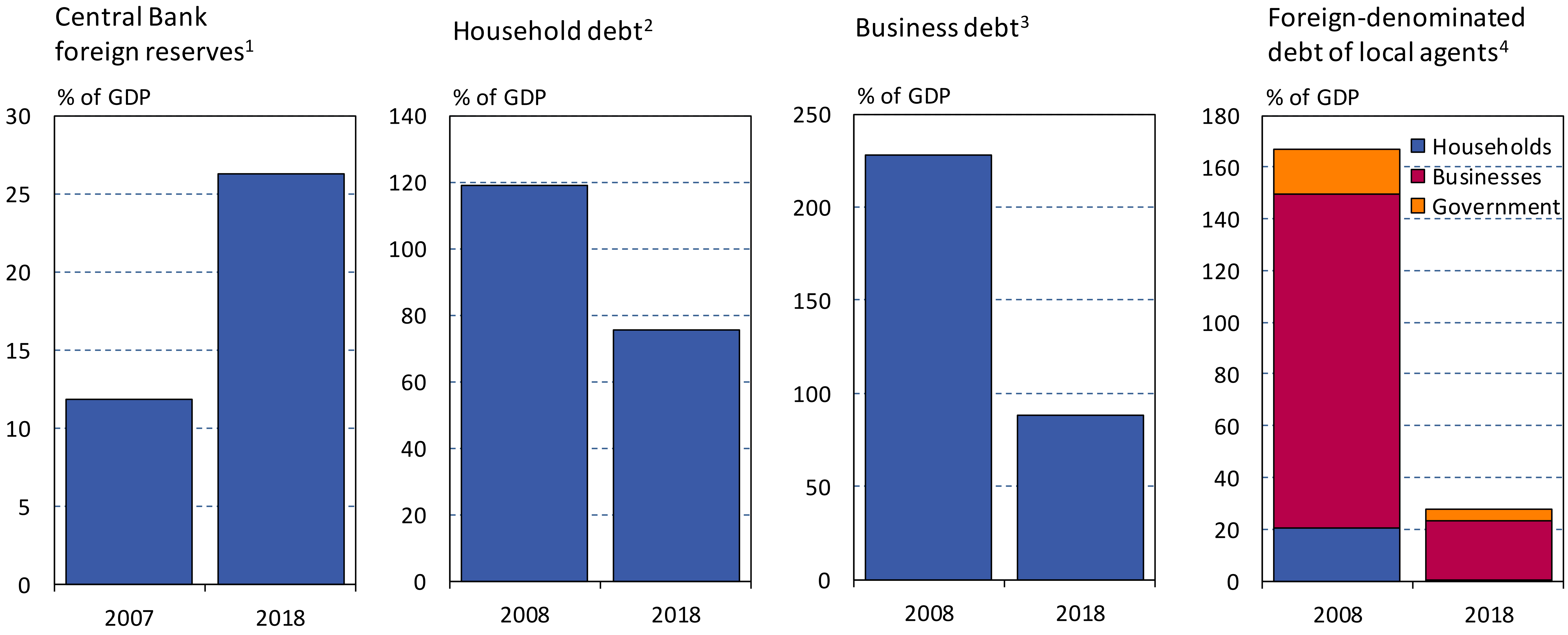
1. Domestic systemically important banks, consolidated figures. Average of ratios. 2. Capital base as % of risk-weighted assets. 3. IFRS Tier 1 leverage ratio. 4. Loans in default; i.e., loans past due by over 90 days (facility level).
Sources: Deposit institutions' financial statements. Statistics Iceland, Central Bank of Iceland.

Where are we now?

Where are we now?

- National income per capita 12% higher in 2018 than in 2007; we rank higher relative to other countries than before the crisis.
- Above full employment for the past three years – large importation of labour.
- Total employment (man years) was in 2018 11% above the pre-crisis peak.
- External assets exceed external liabilities by 21% of GDP (NIIP negative by 130% of GDP in 2008 excluding failed banks).
- Overall we have built strong resilience, have policy space and can face temporary setbacks.

Increased resilience



1. Foreign reserves as % of GDP. 2. Total debt of households as % of GDP. 3. Total debt of businesses (debt and issued bonds) as % of GDP. Businesses excluding financial services firms (including holding companies). 4. Foreign-denominated debt or debt linked to foreign currencies as % of GDP. Businesses excluding financial services firms (including holding companies). Figures for 2008 are September figures for households and businesses but August figures for the government.

Sources: Statistics Iceland, Central Bank of Iceland.

What explains this success?

What explains the success?

- The nature of the shocks:
  - Bank losses shared across borders.
  - Downsizing of unsustainable sectors and unwinding of imbalances.
- The policy response:
  - Dealing with failed banks.
  - Programme with the IMF.
  - Solution to the balance of payments crisis and lifting capital controls.
  - Policy reforms and good monetary and fiscal policies compared to the past
- Real economic integration with trading partners – cross-border labour mobility.
- Luck:
  - Growth of tourism.
  - Big improvements in the terms of trade 2015-2017.

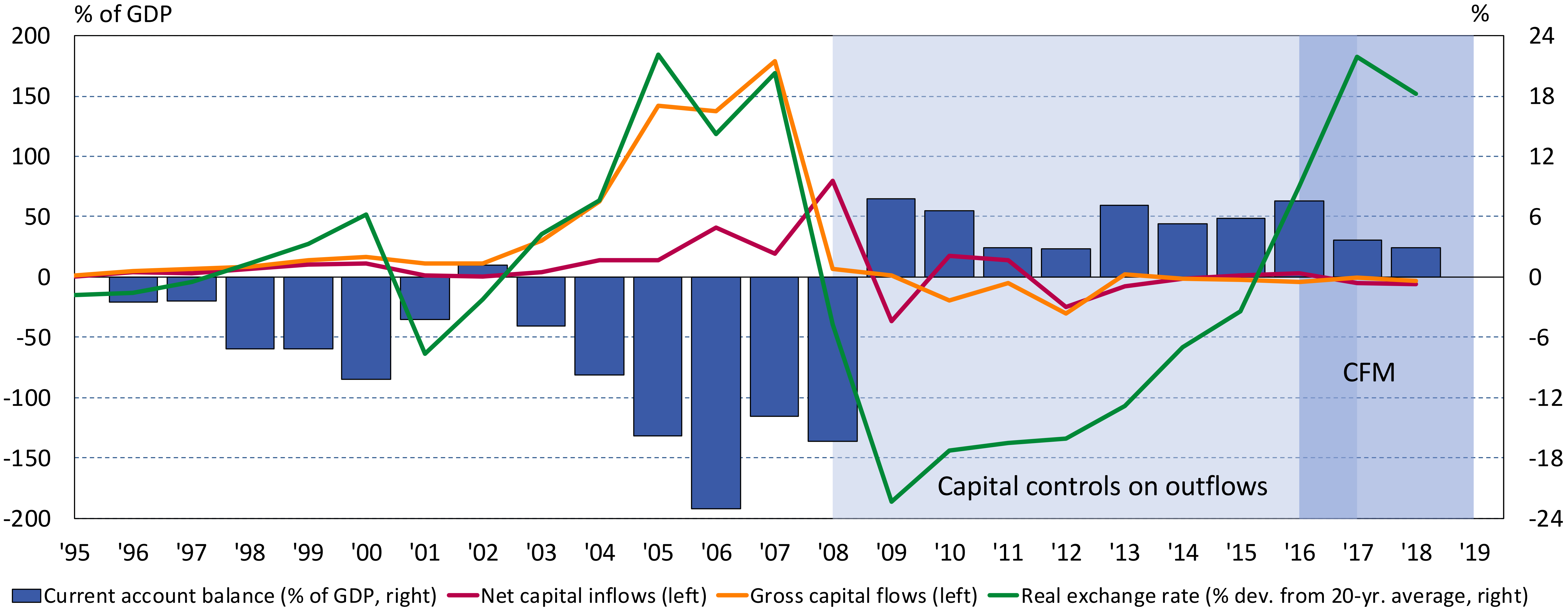
Key lessons regarding capital flows and the exchange rate

Key lessons regarding capital flows and the exchange rate

- The exchange rate can both be a shock amplifier and a shock absorber. There are policies that can affect the outcome.
- It is becoming more difficult to preserve monetary and financial stability in small, open and financially integrated economies.
- It requires sound regulation and supervision of FX risk and more policy tools: FX intervention, macroprudential and sometimes capital flow management.

The capital flow problem in Iceland and the exchange rate

Capital flows, current account balance, and real exchange rate 1995-2018[1]



1. Capital flows excluding change in reserves. Gross capital flows is the average of gross capital inflows and outflows. Current account excluding the effect of failed financial institutions 2008-2015 and the pharmaceuticals company Actavis 2009-2012 on primary income. Also adjusted for the failed financial institutions' financial intermediation services indirectly measured (FISIM). Real exchange rate relative consumer prices (20-year average, 1998-2017).

Sources: Statistics Iceland, Central Bank of Iceland.

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