



28 January 2016

## Iceland's recovery: Facts, myths, and the lessons learned

**Már Guðmundsson, Governor of the Central Bank of Iceland,  
OMFIF City Lecture, 28 January 2016, London.**

Chairman, Ladies and Gentlemen,

I would like to begin by thanking OMFIF for giving me the opportunity to speak to you here today in the City of London about Iceland's recovery. This is interesting for me because, for better and worse, the UK and Iceland deeply shared some aspects of the financial crisis, and because the City of London has for decades been Iceland's international financial centre. But it also gives me great pleasure to see so many in the audience who have in various ways helped Iceland over the years.

Today I will focus on the recovery from the crisis and the current challenges, including the task of lifting capital controls. But the recovery cannot be understood without an understanding of the nature of the negative shocks that hit Iceland during the crisis.

It is well known that Iceland was the first advanced country to experience a full-scale banking crisis in autumn 2008, when its three big cross-border banks failed. It was also the first advanced country to go on an IMF programme during the Great Financial Crisis. What is somewhat less well known is that at that point, Iceland was already on its way into a recession after an unsustainable boom and serious overheating during 2005-2007 and a currency crisis in the first half of 2008. The banking collapse and the associated wealth loss and further currency depreciation made the recession significantly worse, of course, as did the global recession that began in the fourth quarter of 2008.

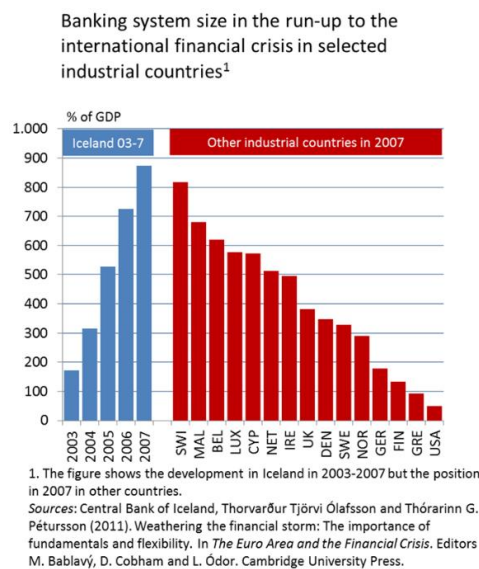
In autumn 2008, two separate but interrelated sub-stories of the recent Icelandic saga converged in a tragic grand finale.

The first story was related to Iceland's boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies. This is a story that has played out many times around the globe, and many of its elements have been seen before in

Iceland. It might have been somewhat more extreme this time around, but it wasn't fundamentally different. All the usual suspects were present, including strong capital inflows fuelling a credit and asset price boom that subsequently turned into a bubble at the same time as the economy overheated and an unsustainable external position developed, as could be seen in a double-digit current account deficit. And macroeconomic and prudential policies were not up to the task. Quite the contrary: there was a policy conflict between monetary policy and the demand levers pulled by the Government, and the risks inherent in capital flows, FX balance sheets, and credit and asset price booms were left under-regulated and insufficiently supervised.

The second story was the rise and fall of three cross-border banks operating on the basis of EU legislation (the European "passport"). This story was much more unique, as it was part of the first banking crisis in Europe since the EU single market was formed in the early 1990s. This framework, along with the prevailing conditions in international financial markets that provided for ample and cheap credit, facilitated the cross-border expansion of the newly privatised Icelandic banks. In less than five years, from the end of 2003 to mid-2008, the combined balance sheet of these banks went from under two times GDP to almost ten times GDP, topping other small European countries with international financial centres, as can be seen on Figure 1:

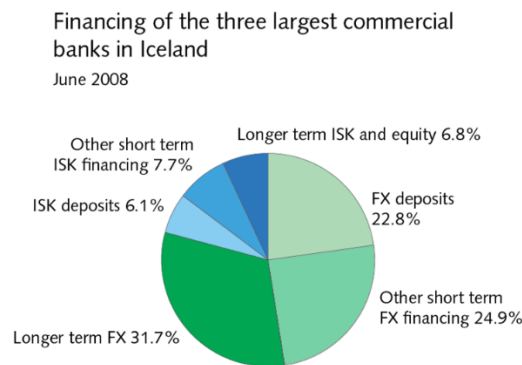
Figure 1:



Towards the end, around two-thirds of the combined balance sheet of the three cross-border banks was denominated in foreign currency. On the liabilities side, the share of FX-denominated debt was actually higher, as can be seen on the right side of the slide, with almost half of the financing in the form of FX deposits and other short-term FX

financing. The FX part of the balance sheet therefore had a significant maturity mismatch. However, there was a very limited safety net of the type we have in a national setting, in the form of liquidity provision and lender of last resort (LOLR) to back it up. It was an accident waiting to happen, and happen it did, with a vengeance, at the peak of the international financial crisis in autumn 2008, when there was a wholesale run on the FX financing of internationally active banks. After having done a post mortem on the failed banks, we now know, however, that they also had other ailments that would probably have done them in at a later stage, although the process might have been somewhat less disorderly.

*Figure 2:*



Sources: Banks interim consolidated accounts.

The combination of the macroeconomic imbalances, an unsustainable banking system, and the full eruption of the Great Financial Crisis meant that Iceland faced unprecedented challenges in 2008. The financing of the current account deficit became impossible when Iceland experienced a full-scale sudden-stop currency crisis early in the year, when the currency plummeted by 26%. Then, in the first week of October, almost 90% of the banking sector failed. This resulted in a further 26% depreciation of the currency. Although the depreciation would later contribute to the recovery, at that point it exacerbated the crisis through negative balance sheet effects on a private sector that was heavily indebted in foreign currency, both directly and indirectly, through price indexation. The outlook was bleak indeed, and many expected that the sovereign would be forced to default on its obligations.

That outcome was avoided, and the economy has performed better than seemed likely that dismal autumn. Part of the reason is the nature of the shocks. The macroeconomic adjustment and rebalancing was unavoidable and was facilitated over time by the real depreciation of the currency. The shocks disproportionately affected overblown sectors (banking and construction), whereas most of the export base remained

intact. Much of the impact of the banking collapse hit countries other than Iceland. Another important reason was the policy responses that mitigated the recession and promoted recovery. Let me now turn to those.

The policy responses took two main forms: crisis management during the collapse of the banks and the economic programme developed by the Icelandic authorities in co-operation with the IMF.

From at least early 2008, the Icelandic authorities were aware of potential foreign currency liquidity problems at the banks and took action by trying to negotiate swap lines and tap foreign capital markets – in both cases, with limited success. Given the lack of international co-operation, the Icelandic authorities were forced to consider radical solutions when the banks failed. Although they were not necessarily articulated in full at the time, these solutions entailed several goals: to preserve a functioning domestic payment system, ring-fence the state in the case of bank failures, limit the socialisation of private sector losses, and create the conditions for rebuilding a domestic banking system.

The adopted solution was embedded in the so-called Emergency Act, which was passed by Parliament on 6 October 2008. The Emergency Act saved the domestic operations of the banking system by creating new banks, which involved carving domestic assets and liabilities out of the old, failing banks. The rest – and the much larger part – went into a resolution process.

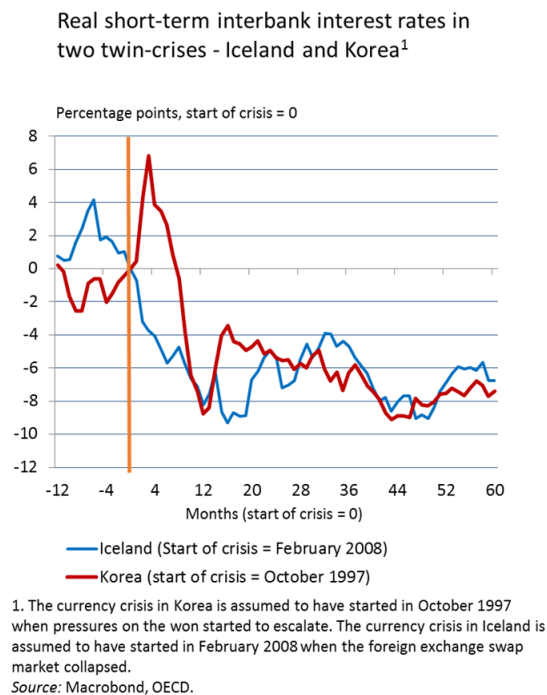
In order to reverse the ongoing run on domestic deposits, a declaration was made that all deposits in Iceland were safe. This did not include deposits in foreign branches, as Iceland did not have the necessary access to FX to make such an implicit guarantee credible. All deposits in Icelandic-headquartered banks were, however, given priority over other unsecured claims, including those in foreign branches. This decision was a key to the outcome that deposit claims from the foreign branches have now been paid in full from recoveries of the old banks' estates.

In international discussion, a number of myths have developed about this process. There have been claims that Iceland allowed its banking system to collapse, with what now seem reasonable results, and that others should consider doing the same. The fact is that Iceland kept the domestic part of its banking system running throughout, and at significant expense; otherwise, the consequences would have been dire. Some have claimed that the banks were nationalised. They were not. The failed private banks are private companies in winding-up proceedings governed by law. The Government fully recapitalised one

of the new banks. The other two have been private banks owned primarily by the estates of the old banks. Others have claimed that Iceland defaulted and got away with it. The opposite is true. The credit of the sovereign was preserved, and all debt obligations have been paid in full and on time.

On the whole, these measures were successful, which mitigated the effect of the banks' failure on the economy. The domestic payment system functioned more or less seamlessly throughout, and there was continuous access to deposits and basic banking services in Iceland. The economic programme with the IMF was initiated in November 2008. It had three key goals: stabilisation of the exchange rate, fiscal sustainability, and reconstruction of the financial sector. Financing amounted to USD 4.4 bn. with 1.4 bn. coming from the IMF and the rest from bilateral loans from the Nordic countries and Poland. Despite some initial delays due to the bilateral dispute on deposit guarantees, which I will not discuss here, the programme was very successful, and all three goals were reached. The programme ended in August 2011. The Nordic bilateral loans were prepaid in 2012-2015, and the IMF facility and the Polish loan were prepaid in autumn 2015.

Figure 3:



Comprehensive capital controls were an important element in the programme, but their rationale was to help to stabilise the exchange rate

after the currency had fallen more than 50% in 2008, where foreign króna positions - a legacy of carry trade and capital inflows - amounted to around 40% of GDP, and where a large fiscal deficit that had to be financed in the domestic market had developed. In this situation, the capital controls gave monetary policy more scope to focus on the domestic economy, as is demonstrated in Figure 4, which compares developments in short-term real interest rates during and after the currency and banking crises in Korea in 1997 and Iceland in 2008. In Korea there is a clear spike in real rates at the time of the crisis, as interest rates were used to stabilise the exchange rate whereas this spike is missing in the case of Iceland.

Figure 4:

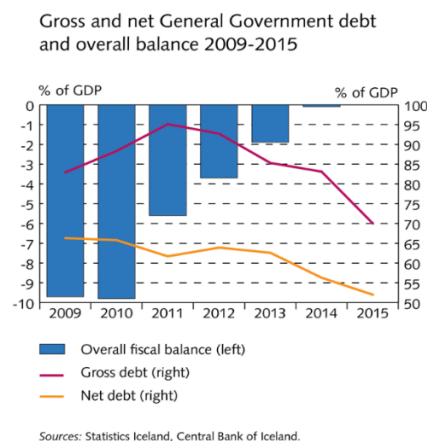
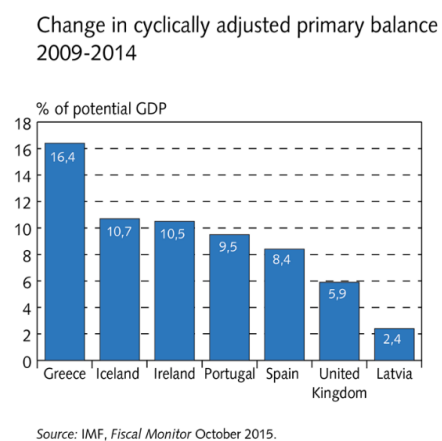


Figure 5:



The economic programme with the IMF included a medium-term fiscal consolidation plan. Automatic stabilisers were allowed to work fully during the contraction of 2009, however, resulting in a significant public sector deficit, as can be seen from Figure 4. The fiscal consolidation that commenced in 2010 arrested the rise in the headline deficit relative to GDP and then reduced it once the economy began to recover. In international comparison, the fiscal effort was sizeable, as can be seen on Figure 5. But it did not derail the recovery that began around mid-2010 and was key to restoring confidence and paving the way for Iceland's renewed market access. It helped that monetary policy could be relaxed over the course of 2010, as the closure of loopholes in the capital controls in late 2009 helped stabilise the exchange rate.

The recession was driven partly by the unavoidable adjustment of imbalances that required a lower level of domestic demand and a shift in its composition, and partly by the negative shocks that deepened the recession further. The recession was indeed deep, as Iceland lost just over 11% of output during the recession that ended in Q1/2010 and unemployment peaked at 8% in Q4/2010. The shift in the composition

of demand was even more dramatic, as is witnessed by the swing in the current account from a deficit 17% of GDP in 2008 to a surplus of 8% in 2009. To a significant degree, this was induced by a drop in the real exchange rate amounting to 44% from the pre-crisis peak to the November 2008 trough.

The recovery began as previous imbalances were corrected and the economy found its bottom in the underlying strength of its traditional export sectors, the non-traded goods sector took advantage of the low real exchange rate, and the stabilisation of the economy and later real wage gains rekindled consumption. And then we have had the phenomenal growth in tourism in the recent years, which seems to be due to much more than the historically low real exchange rate.

Figure 6:

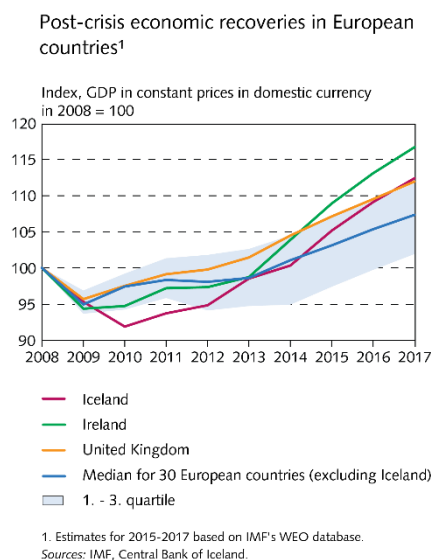
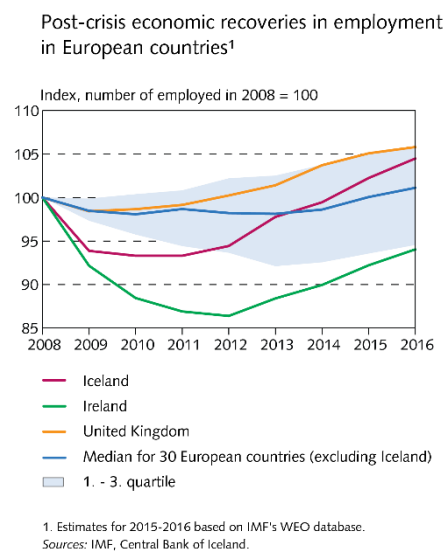


Figure 7:



These figures show developments in GDP and employment during the recession and subsequent recovery in Iceland, with predictions extending into 2017 for GDP and 2016 for employment. For comparison, it shows the median and the 1st-3rd quartiles of the distribution of these variables for 30 other European countries, with Ireland and the UK highlighted. It shows that Iceland's recession was significantly deeper than the median in Europe, and the same goes for Ireland, although to a lesser degree. Both countries have been doing better than average during the recovery, especially lately and in the forecasts. By this measure, Iceland seems to have levelled with the UK in terms of the level of GDP compared to before the crisis, and Ireland is surpassing both. But developments in employment are significantly more favourable both in Iceland and the UK. The flexible exchange rate probably plays a role here, but the price is weak productivity growth.

Iceland has now been recovering for about six years and has now surpassed its pre-crisis peak output level and has more than absorbed the slack in the economy, as can be seen in the unemployment rate, which has fallen to just over 3½% in seasonally adjusted terms. Unlike the pre-crisis peak, however, the current level of output is associated with a relatively well-balanced economy, both internally and externally, although there concerns about tensions in the labour market and a growing positive output gap. Inflation has now been below the 2½% target for almost two years despite strong wage increases, as international developments and the appreciation of the króna have so far counterbalanced those. The current account surplus has remained sizeable.

So is Iceland out of the woods? Not quite. The financial crisis casts a long shadow. Both household and corporate debt levels have declined significantly relative to income, through debt restructuring and income growth. The household debt-to-income ratio is back to around the 2005 level, and the corporate debt-to-GDP ratio is at its lowest since mid-2004. But there are significant pockets of financial fragility, with some of the households that bought and borrowed at the peak of the market still facing very heavy debt service burdens. And even though gross public debt is now on a declining path relative to GDP, at 70% it is still high in historical terms.

The biggest legacy problem, though, is the comprehensive capital controls. During the early stages of the crisis, the controls were helpful in stabilising the economy and providing the shelter needed to repair balance sheets and rebalance the economy. But over time – and increasingly, as the economy and the rest of the world recover – they become obstacles to economic growth.

However, there have been major hindrances to speedy removal of capital controls, due to the legacy balance of payments problem reflected in huge króna positions indirectly or directly owned by foreign residents. These take two forms.

The first and more important were the domestic assets of the old banks in winding-up proceedings. The problem here is that most of the claims on these banks are foreign but their net domestic assets amount to 25% of GDP. When considering the complication this creates for Iceland, you should bear in mind that it is partly because the resolution of the third-largest bankruptcy in the history of mankind is taking place in one of the smallest countries in Europe and is intertwined with its balance of payments and international investment position.



The second is the so-called offshore krónur owned by foreign residents. These currently total 14½% of GDP, after having been more than halved through auctions, bilateral deals and nominal GDP growth since capital controls were introduced.

Therefore, potential capital outflows amounting to almost 40% of GDP might have sought a speedy exit if capital controls had been lifted overnight. This would have had serious consequences for economic and financial stability in Iceland. This was not going to be allowed to happen and, as a matter of fact, the population has been promised solutions entailing no negative effect on the exchange rate.

A co-operative solution vis-à-vis the failed bank's estates that allows them to go into composition and pay out to creditors by fulfilling so-called stability criteria has been decided and is being implemented. Had that not been forthcoming, we would have had to impose an on-off stability tax of around 31% to deal with the externality, as we could no longer hold the Icelandic nation hostage to the situation.

The stability criteria are these: the estates pay stability contributions by transferring a significant part of their króna assets to the government, lengthen the maturity of current FX financing of domestic banks, repay government and central bank support and debt. Taken together, these measures fully mitigate the potential negative balance of payments effect from unwinding the estates.

We are currently working on a solution regarding offshore krónur that would fulfil the same criteria regarding the exchange rate and make it possible for us to move to the third and final stage of lifting capital controls, which is vis-à-vis domestic residents. The difference is that this time around we are putting part of our own FX reserves on the table to facilitate the solution. It will be offered in an auction, along with long-term euro and ISK bonds. The aim is to release and tether the offshore overhang so we do not have to worry about it when we lift the controls on domestic resident's outflows. For that final step, we need a solid external position, a resilient financial sector, and sizeable FX reserves that are to a significant degree not financed by foreign borrowing - all of which we have or are on the way to securing. This is why we bought FX in the market for an unprecedented 12½% of GDP last year and have continued on the same path this year.

Before lifting capital controls on domestic residents, we will have to finalise the necessary adaption of monetary policy and financial stability frameworks to the potentially rough seas of unrestricted capital movements. For monetary policy, it means what we call IT+, where IT is coupled with a managed float, supported by macroprudential policies

and possibly on-and-off capital flow management tools to deal with excessive inflows related to carry trade that greatly complicate the conduct of monetary policy, as indeed happened in Iceland last summer and autumn. For financial stability, it means putting the finishing touches on the implementation of prudential rules on FX liquidity and financing of banks that would greatly curtail their ability to build oversized FX balance sheets with rollover risk. This would be part of our current policy to have predominantly domestic-oriented banks as long as global and regional frameworks make cross-border banking in small countries with their own currency unsafe.

Let me finally and very briefly mention some of the lessons learned. We can expand on those and other topics during the Q&A session if you wish.

It is too risky to headquarter big international banks in small countries unless a credible multilateral financial safety net is available.

The framework for cross-border banking in the EU was and is deeply flawed. A full banking union will take care of that, but not for EEA countries outside the Eurozone, due to potential FX risks on bank's balance sheets.

A flexible exchange rate can be both part of the problem and the solution.

Capital controls in some form are here to stay as part of the toolbox, but comprehensive capital controls should not be imposed lightly.

There are limits to independent monetary policy in small, open, and financially integrated economies, even if the exchange rate is flexible.

Let me finish here and I look forward to your questions.