Central Bank of Iceland

Crisis and recovery in Iceland and the lessons to be learnt

Már Gudmundsson
Governor, Central Bank of Iceland

EU Ambassadors to Iceland
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Preamble: the crisis and the policy response

The recent Icelandic saga

Two separate but interrelated sub-stories:

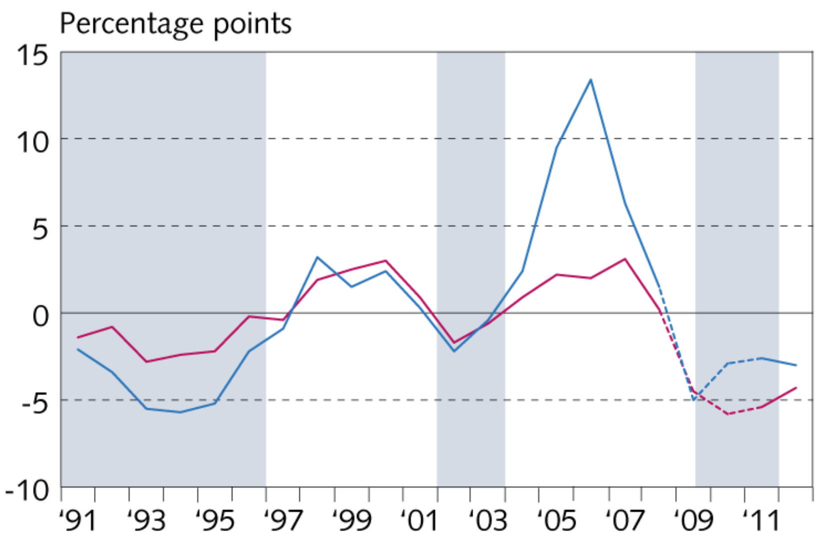
1. Iceland's boom-bust cycle and problems with macroeconomic management in small, open, and financially integrated economies
2. The rise and fall of three cross-border banks operating on the basis of EU legislation (the European "passport")

The two converged in a tragic grand finale in early October 2008, when Iceland's three commercial banks failed and were placed in special resolution regimes.

Positive investment shock, followed by overheating

Business investment as % of GDP 1991-2012[1]

Deviation from average for 1970-2007



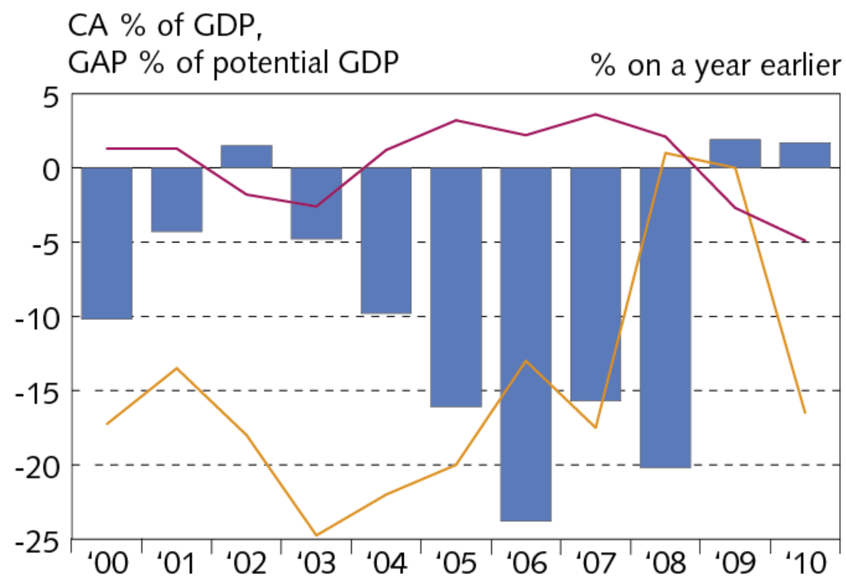
— Business investment

— Business investment excluding aluminium and power stations

1. Central Bank baseline forecast 2009-2012. Shaded areas show periods with negative output gap.

Sources: Statistics Iceland, Central Bank of Iceland.

Current account, output gap and inflation



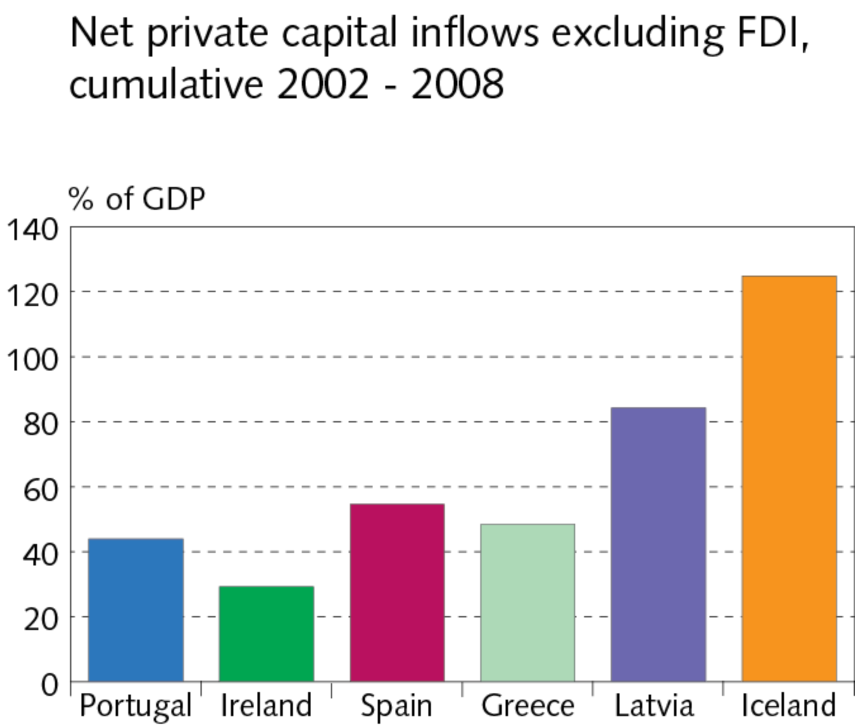
Current account balance excl. DMBs undergoing winding-up proceedings (left)

— Output gap (left)

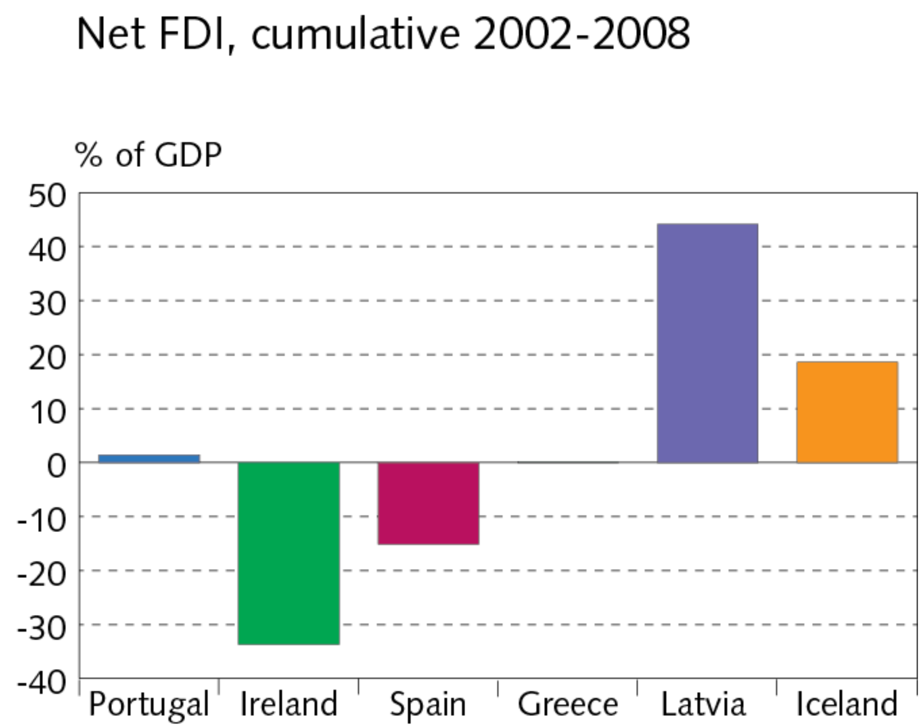
— Inflation (right)

Sources: Statistics Iceland, Central Bank of Iceland.

Fuelled by strong capital inflows



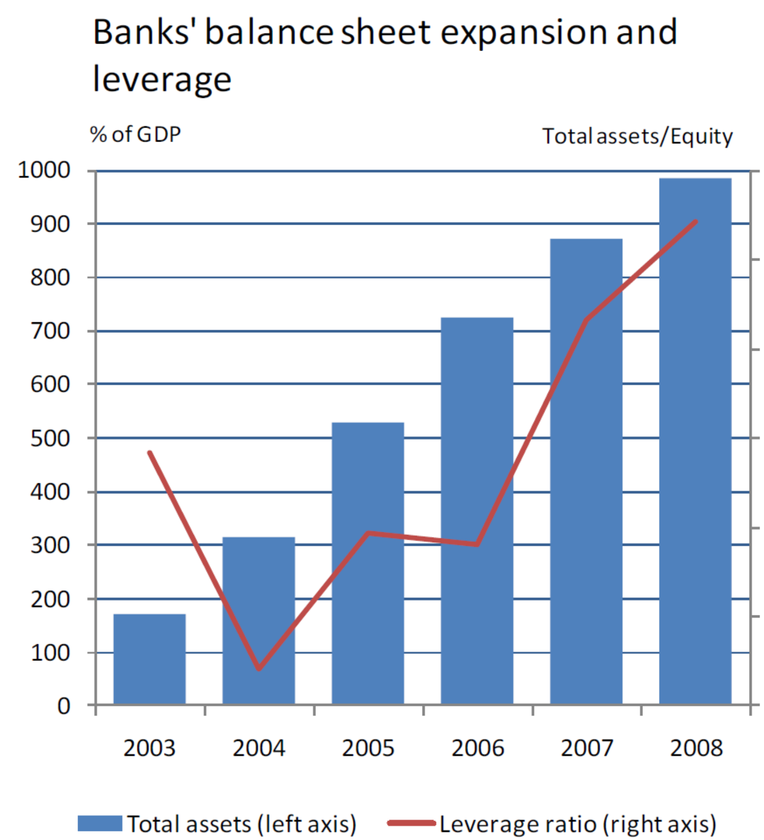
Sources: Various Central Bank websites.



Sources: Various Central Bank websites.

Cross-border banks facilitated by EU framework

- EU "passport" with common legal and regulatory framework...
- ...but national supervision, deposit insurance, LOLR and crisis management, and resolution
- Over ⅔ of total lending and deposits in foreign currency
- 41% of assets in foreign subsidiaries

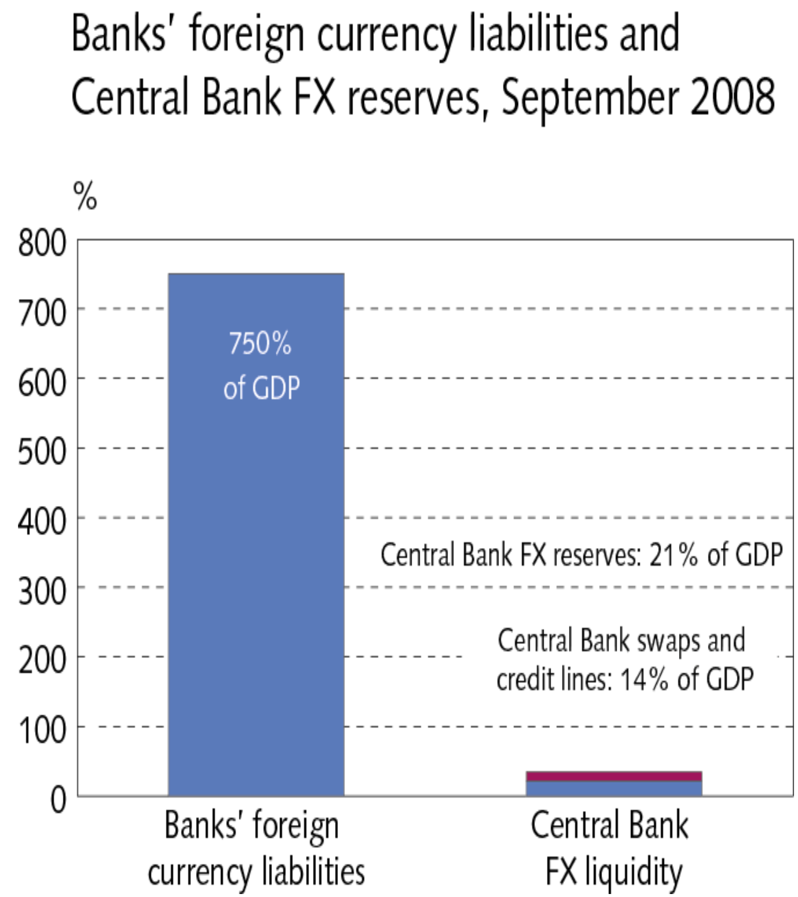


Consolidated accounts of three largest commercial banks. 2008 data is end-June.

Source: Central Bank of Iceland.

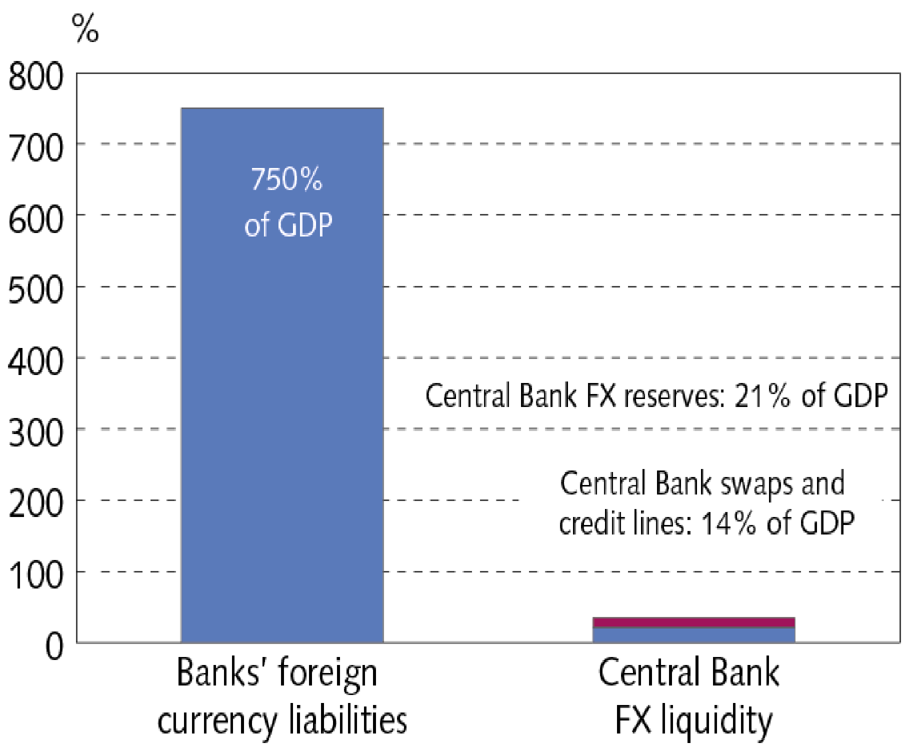
A run on foreign currency liabilities

- The Icelandic banks were largely unable to refinance foreign currency liabilities after the outbreak of the international financial crisis in August 2007.
- Run on FX liabilities of banks post-Lehman in late September 2008.



Footnote deposits in foreign branches markets

Banks' foreign currency liabilities and Central Bank FX reserves, September 2008



- CBI FX amounted to €2½ bn in September 2008, and access to foreign capital markets was closed.
- FX deposits in UK and Netherlands branches of Landsbanki amounted to €11½ bn.
- Paying out EU minimum deposit insurance would have required €4½ bn.

Adjustment and three shocks

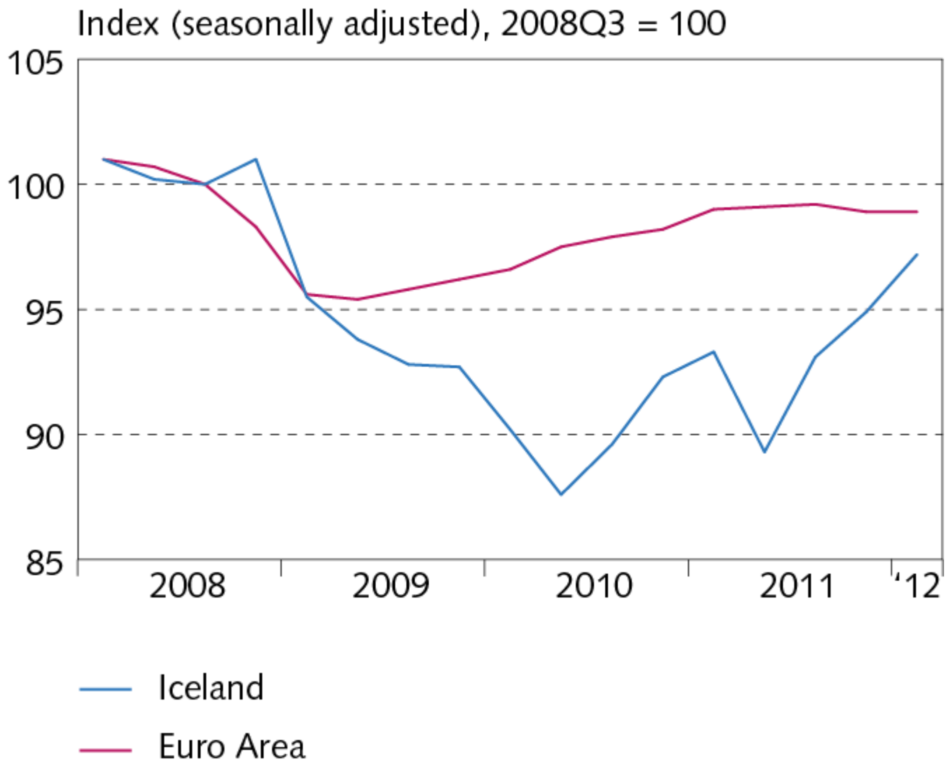
- Unusually large external and internal macroeconomic imbalances in 2005-2007.
- Their subsiding was bound to be associated with a significant slowdown, if not an outright recession (from 2006 onwards, the CBI consistently predicted a recession in 2009).
- Currency crisis in early 2008 (exchange rate fell by 26% in the first half).
- Collapse of the banking system in October 2008 (exchange rate fell by another 26% to year-end).
- Global contraction in Q4/2008 and the first half of 2009.

The policy response

- Emergency Act: intervention powers, deposit preferance, authorisation for capital injections
- Statement that all deposits in Iceland were secure
- Failing banks placed in resolution regimes and domestic banks carved out (1.7 times GDP)
- IMF programme (USD 5.1 bn with bilateral loans) and three key goals: exchange rate stability, fiscal sustainability, and financial sector reconstruction
- Comphrehensive capital controls a key element in the programme

The recession was deep in international comparison

GDP level
Q1/2008 - Q1/2012

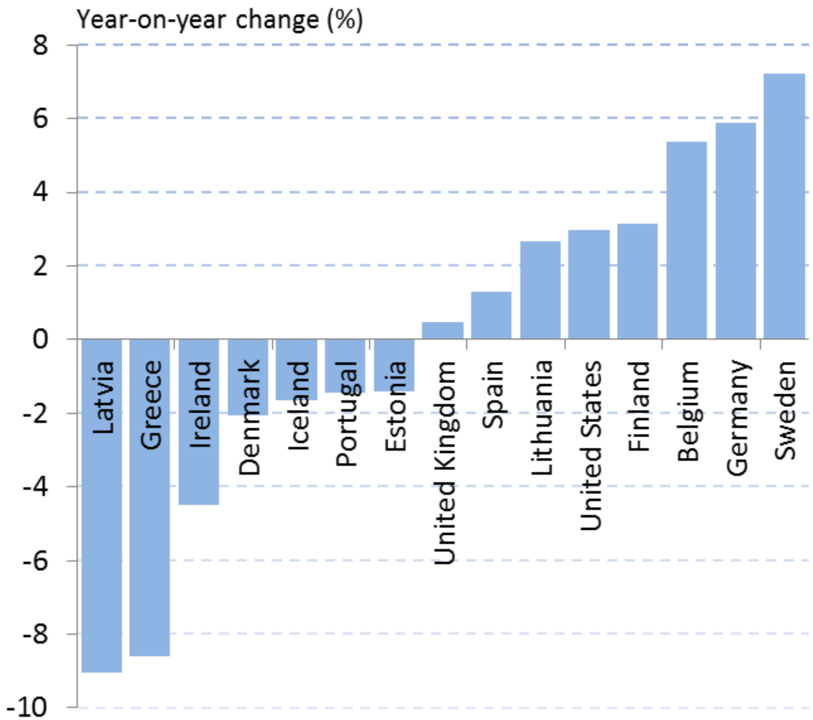


Source: Eurostat.

- GDP contracted by almost 12% from its peak in Q4/2007 to its trough in H1/2010
- But that was a decline from an overheated level

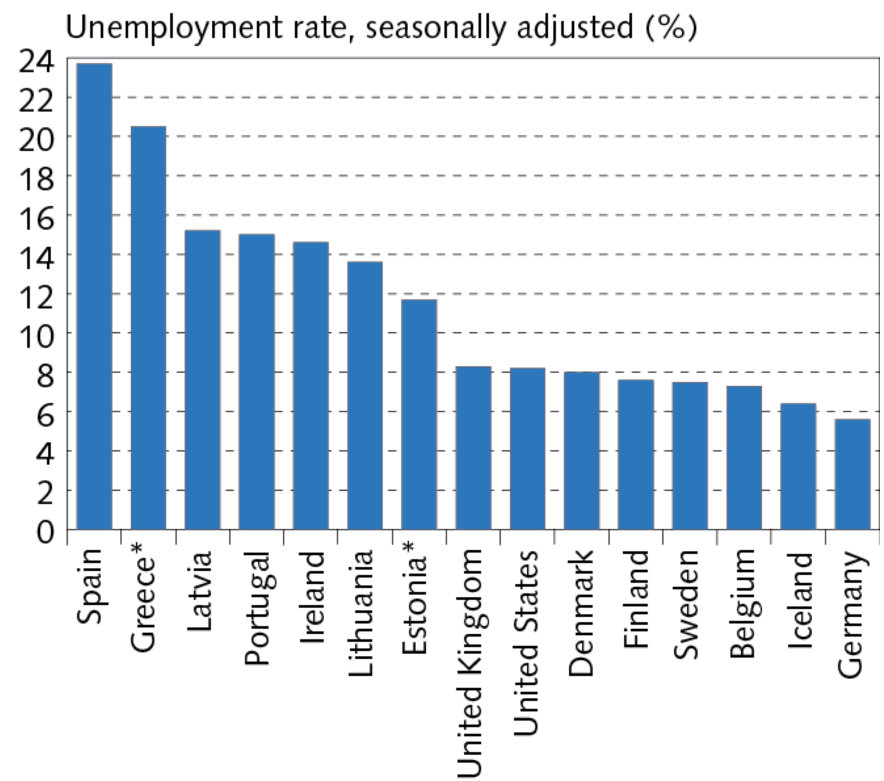
But Iceland was not the hardest hit

Percentage change in GDP from the average of 2005-2007 to 2011[1]



1. Based on forecasts for 2011.
Source: Eurostat, Global Insight, Statistics Iceland, Central Bank of Iceland.

Unemployment rate Q1 2012[1]



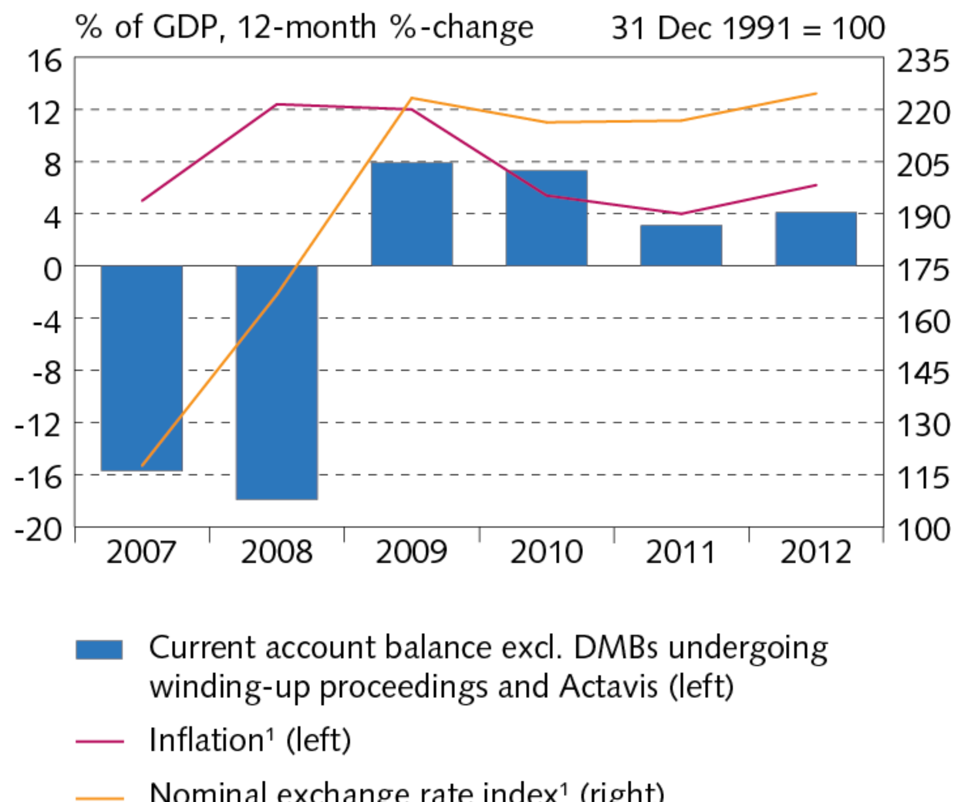
1. Data for countries with an asterisk are only available for Q4/2011.
Source: Macrobond.

Stabilisation and recovery

Stabilisation

- Pre-crisis current account deficit in double digits has swung into a significant underlying surplus
- Exchange rate stabilised in H2/2009 and appreciated in 2010
- Inflation and interest rates followed down

Current account balance, inflation and nominal exchange rate 2007-2012

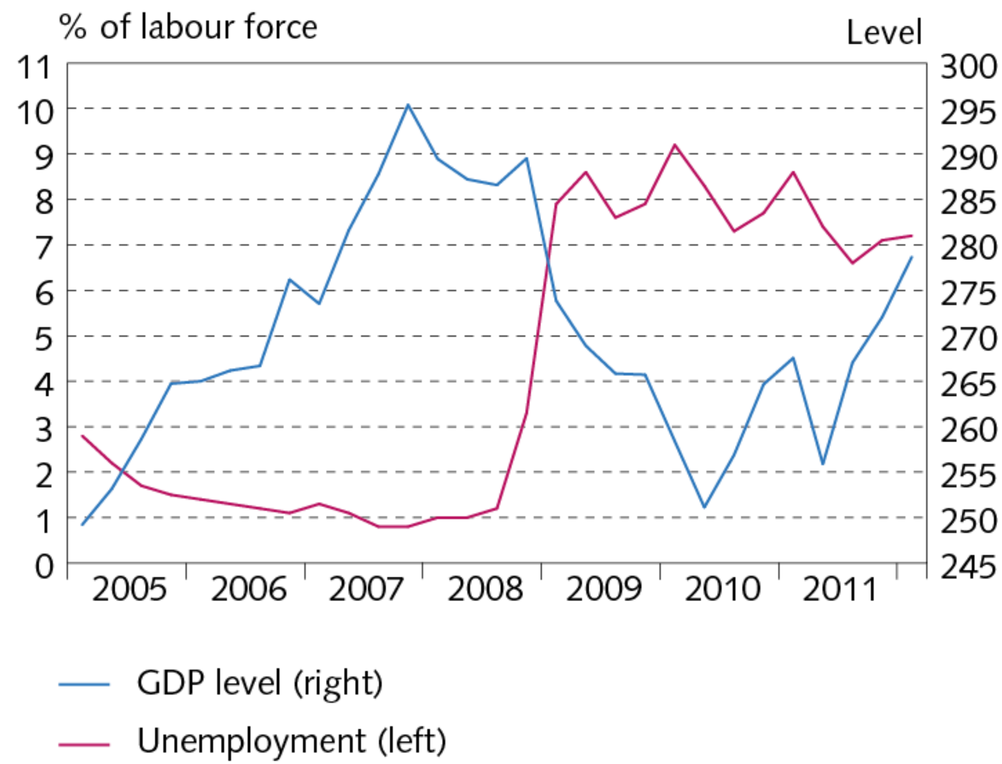


1. For the year 2012, the exchange rate and the inflation are shown as averages from 1 January - 15 June 2012.
Sources: Statistics Iceland, Central Bank of Iceland.

Recovery

- Recovery of GDP began in H2/2010
- Growth 3.1% in 2011 and 4.5% in Q1/2012.
- GDP in Q1 was 5.7% below the previous peak in Q4/2007.
- Unemployment has been declining (5½% in May).

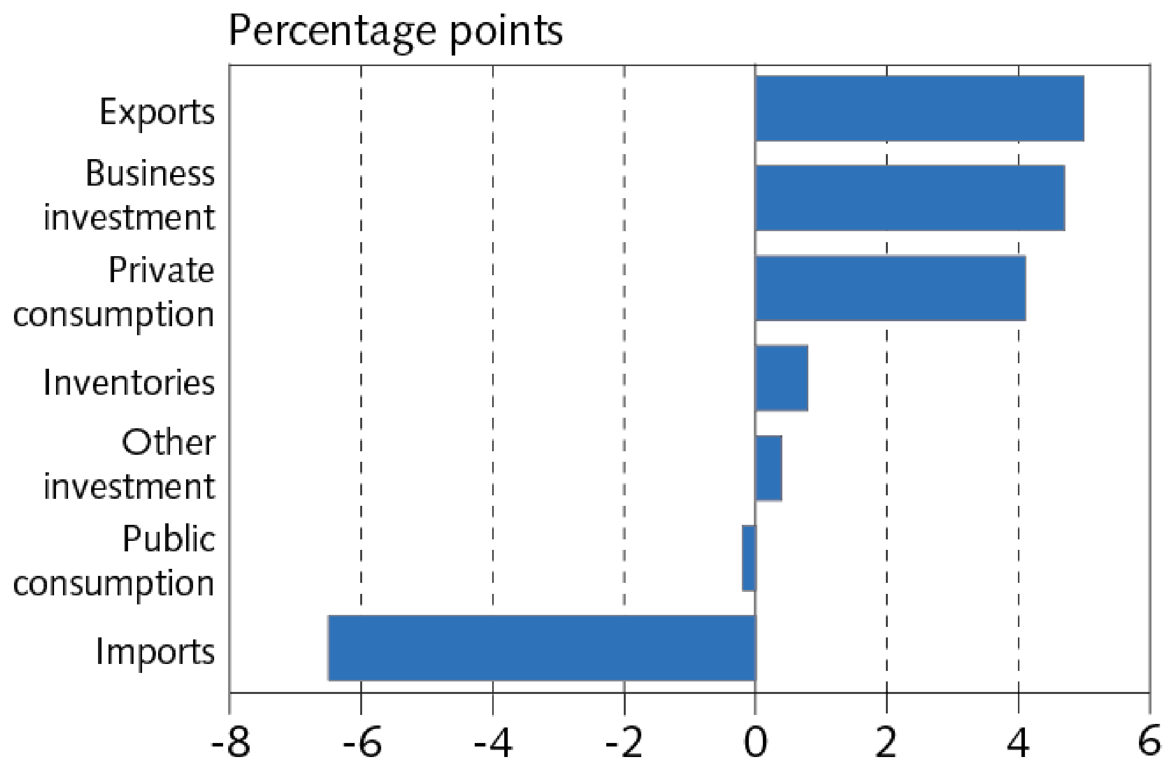
GDP level and unemployment
Q1/2005 - Q1/2012



Sources: Directorate of Labour, Statistics Iceland.

Drivers of the recovery

Contribution of GDP components to economic recovery[1]

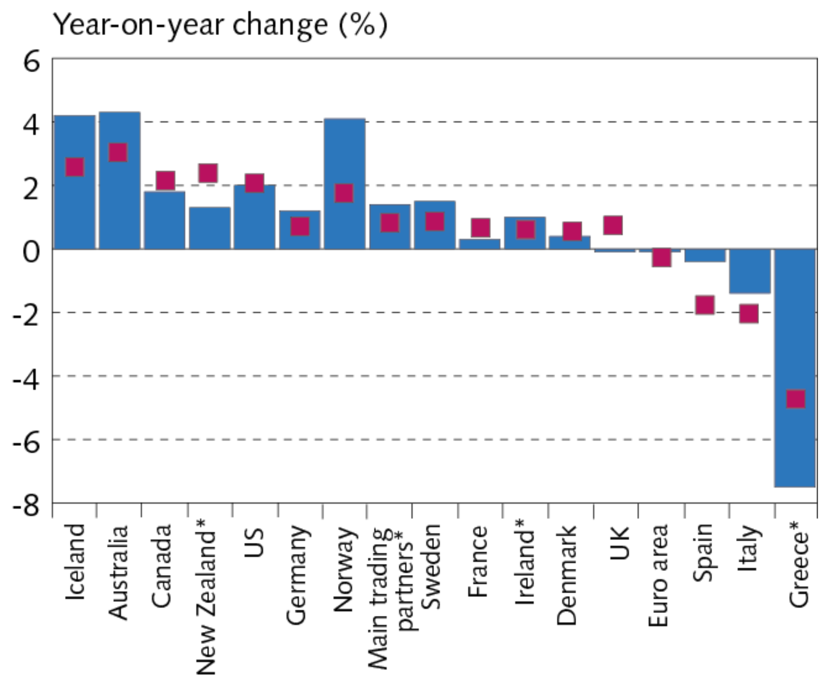


1. From Q2/2010 - Q4/2011.

Sources: Statistics Iceland, Central Bank of Iceland.

Latest GDP growth and prospects for 2012 in international comparison

GDP growth on Q1/2012 and outlook for GDP growth in 2012

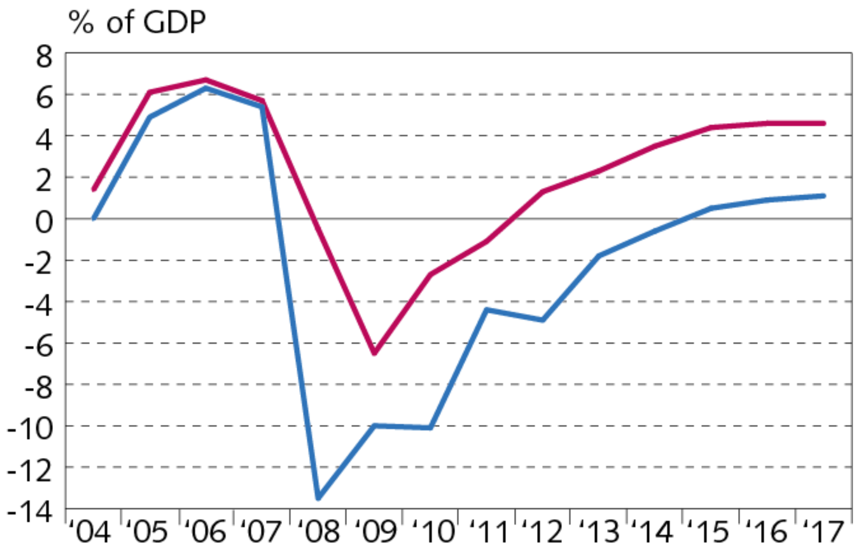


Data for countries with an asterisk are only available for Q4/2011.

Sources: Eurostat, IMF, OECD, Statistics Iceland.

Fiscal consolidation is progressing

General government balance 2004-2017



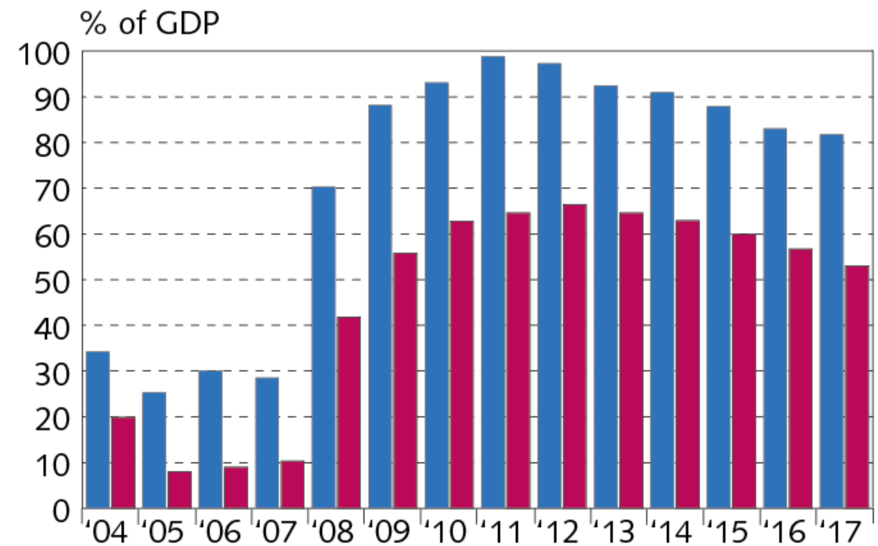
General Government overall balance[1]

General Government primary balance

1. Including Write-offs. IMF forecast for 2012-2017.

Sources: IMF, Statistics Iceland.

General government debt ratios 2004-2017[1]



General Government gross debt

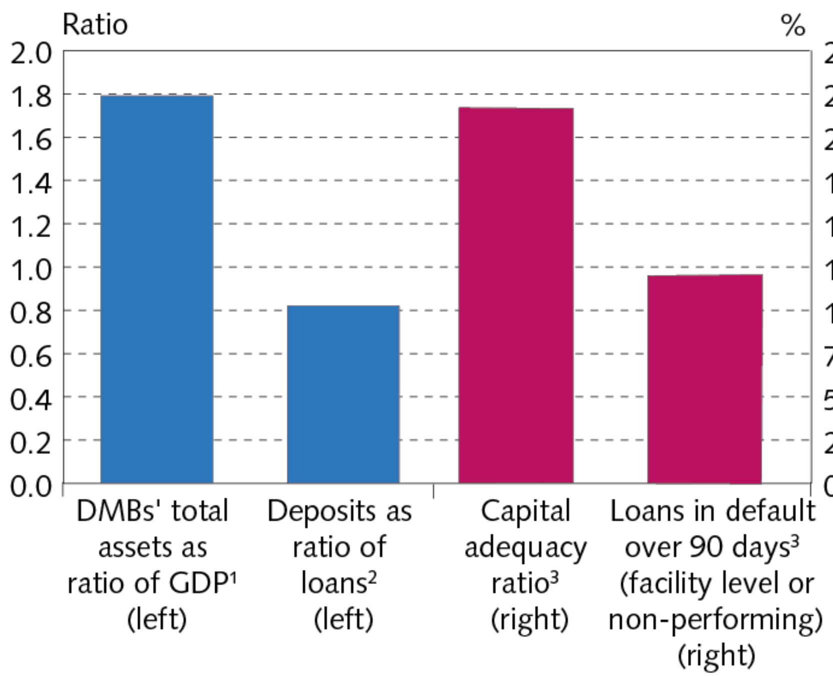
General Government net debt

1. IMF forecast for 2012-2017.

Sources: IMF, Statistics Iceland.

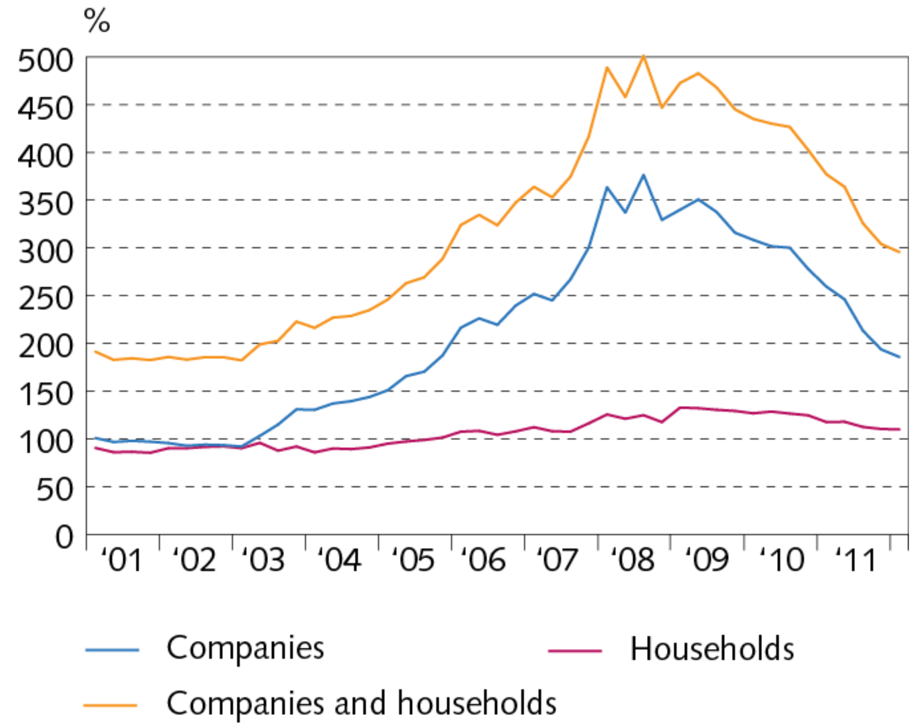
The domestic financial sector has been rebuilt and private sector debt restructuring is underway

Key metrics of the banking system year-end 2011



1. Includes commercial banks and savings banks.
2. Includes all commercial banks.
3. Includes the three largest commercial banks.

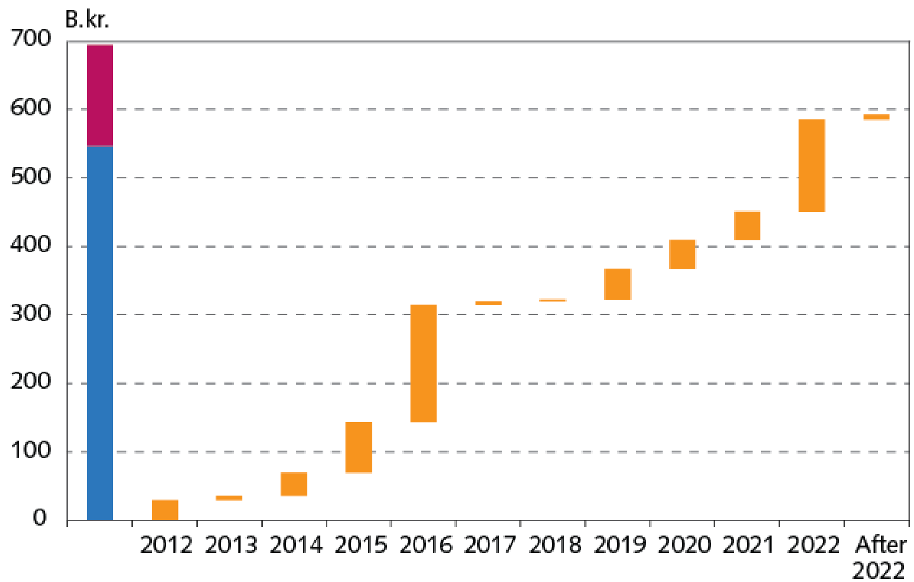
Private sector debt



Source: Central Bank of Iceland.

FX reserves cover sovereign debt service beyond 2022 and foreign debt is on a declining path

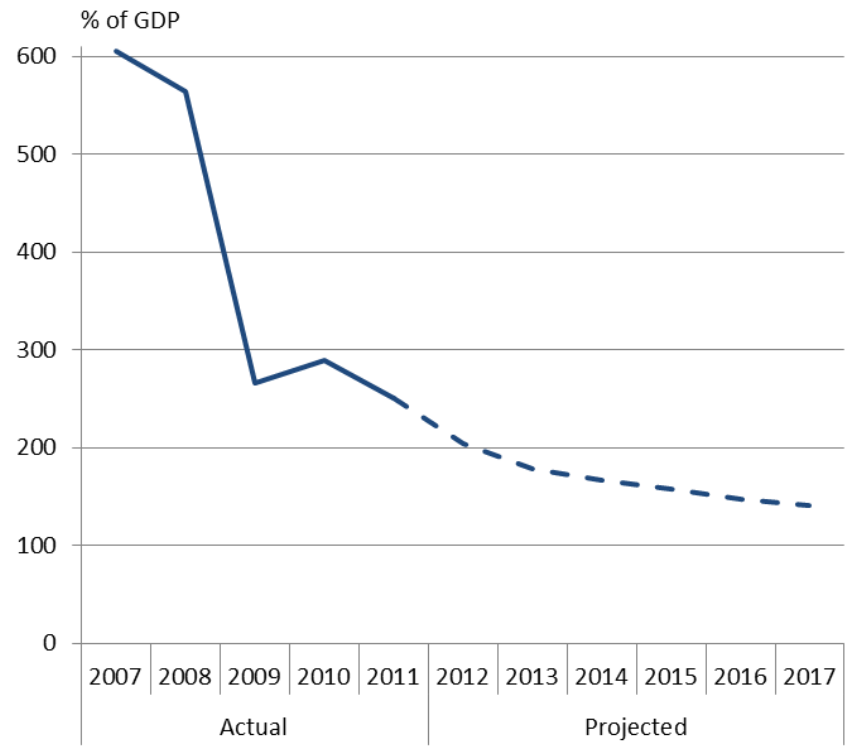
Maturity profile: Treasury and Central Bank foreign debt



- Central Bank foreign reserves excluding financial institutions' deposits, after prepayment
- Treasury and Central Bank foreign currency assets
- Maturity profile of Treasury and Central Bank foreign debt

Source: Central Bank of Iceland

IMF External Debt Baseline Projection



Source: IMF Article IV Review, 2012

Current policy challenges

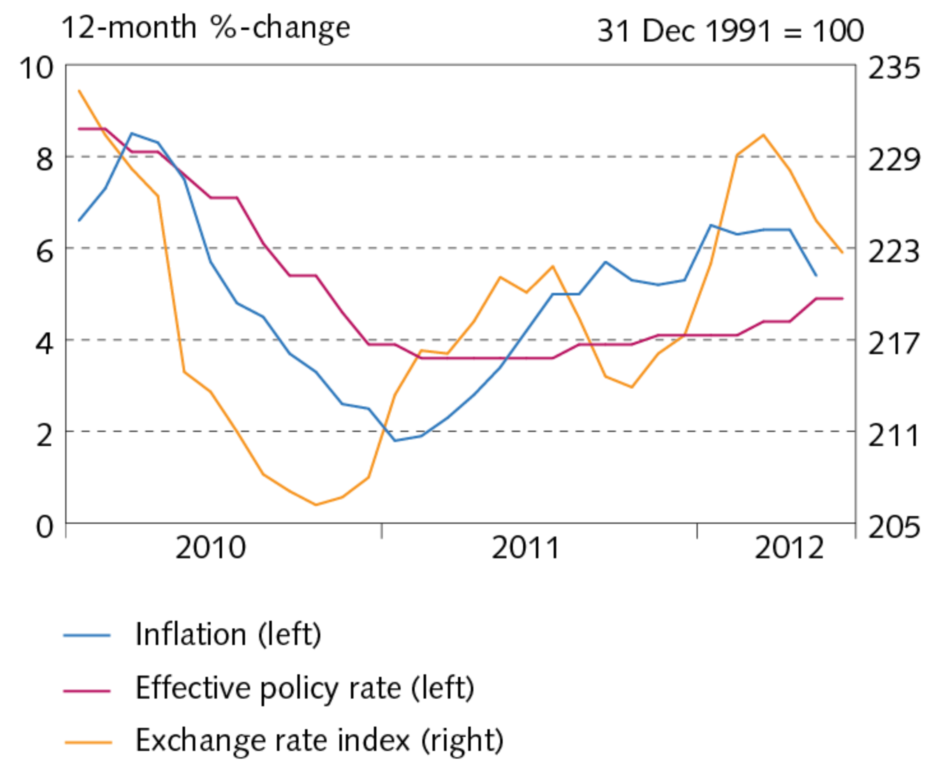
Policy challenges

- Maintaining the momentum of fiscal consolidation through the political cycle
- Bringing inflation back to target
- Lifting controls on capital outflows

Monetary policy and inflation

- Inflation has increased significantly since reaching target in early 2011
- Fuelled by exchange rate weakness and high wage increases, which in turn are fuelled by the strong position of export sectors
- Monetary policy has responded by raising the policy rate by 1.5 percentage points since August 2011
- Negative real rates supported the recovery

Inflation, exchange rate index and effective policy rate
January 2010 - June 2012

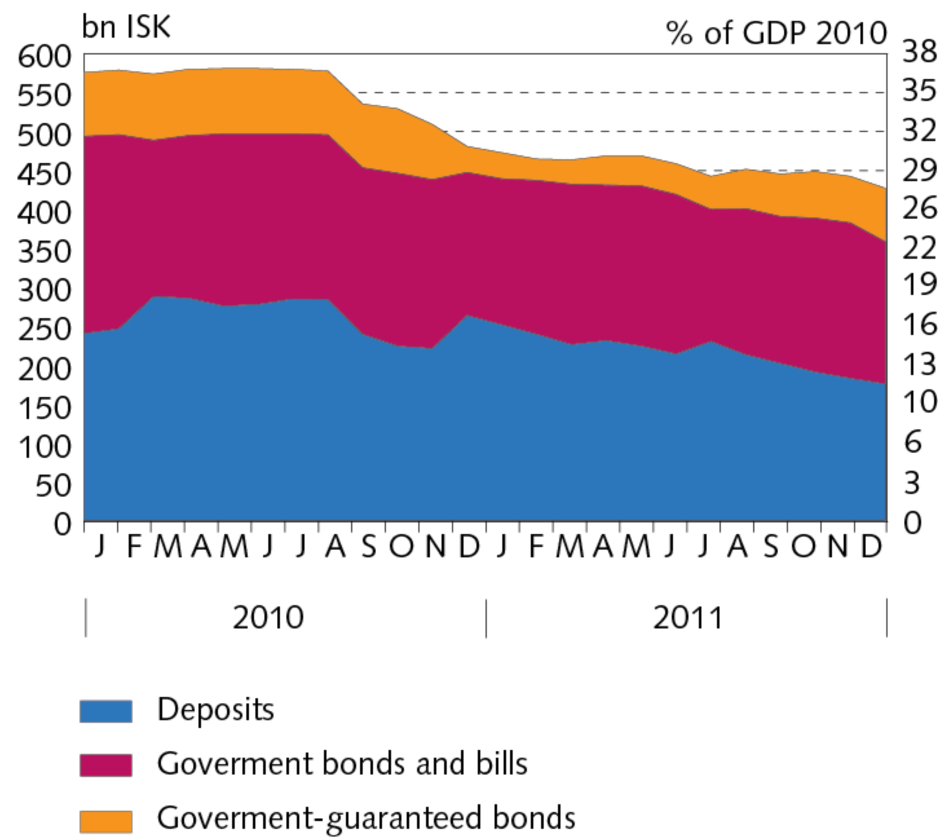


1. For June 2012, exchange rate is shown as an average from 1 June - 15 June.
Sources: Statistics Iceland, Central Bank of Iceland.

Lifting capital controls: the overhang

- Liquid króna positions held by non-residents are a legacy of pre-crisis capital inflows and carry trade
- They are a key obstacle to removal of controls on capital outflows
- Have been reduced through auctions and bilateral deals
- 12% of GDP will be added by estates of failed banks but will be offset by somewhat larger FX payments to residents

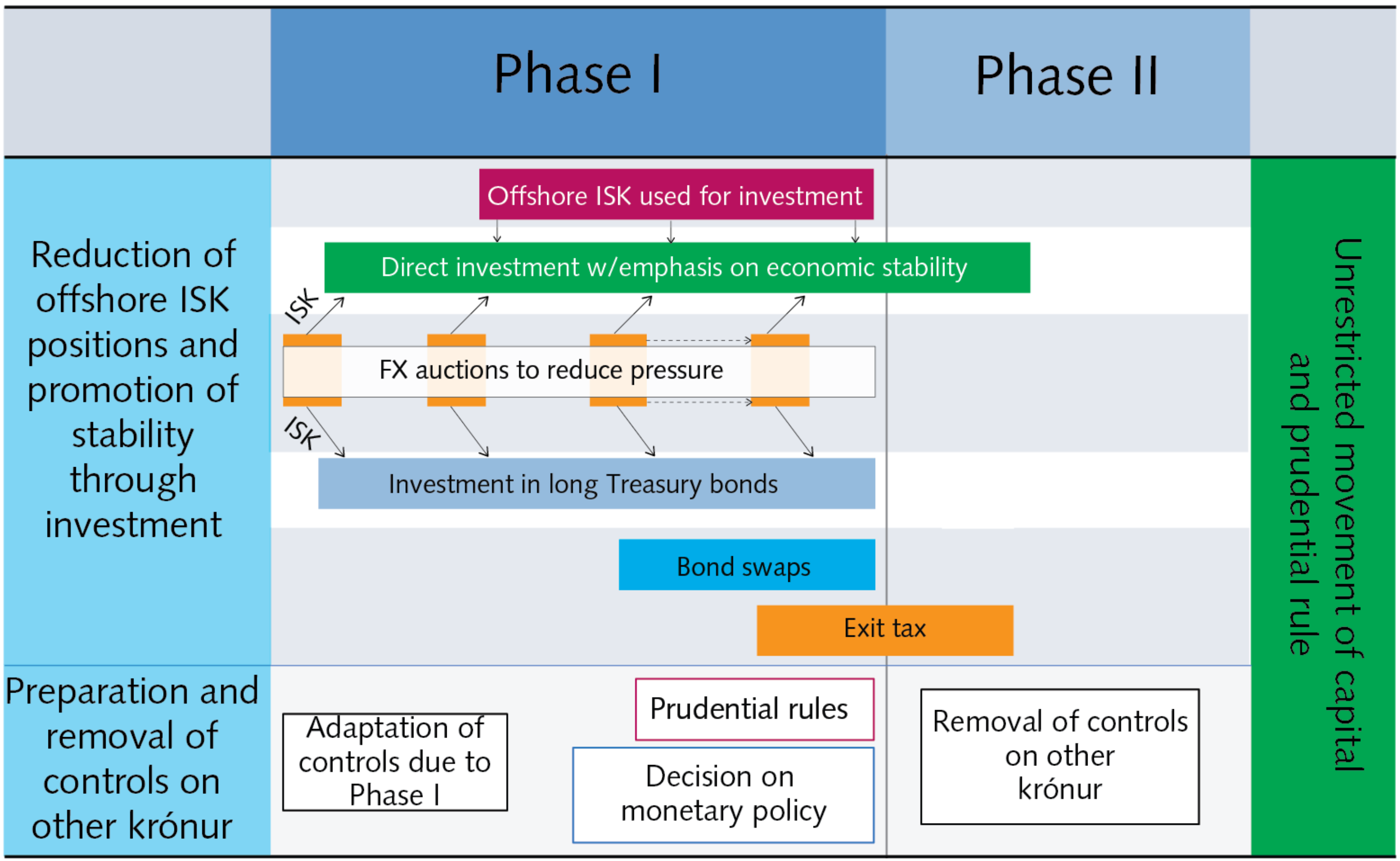
Non-residents' ISK assets



Source: Central Bank of Iceland.

Strategy for removing the capital controls

Capital account liberalisation: Phases and steps



Lessons to be learnt and reflections on the “Icelandic model”

Macroeconomic management in small, open economies

- Policy conflicts are very dangerous in small, open, and financially integrated economies.
- Do not be afraid of large government surpluses during booms.
- Traditional government balances only tell part of the story – look at all channels through which government policy affects demand.
- Current account deficits matter.

Cross-border banking

- Cross-currency risk and maturity mismatches in terms of foreign currency (=> rollover risk) was underestimated prior to the crisis =>
- Under-regulated and insufficiently backed by capital or safety net facilities (e.g., LOLR).
- EU/EEA framework is flawed and poses particular risk to small countries outside the euro area.
- We need to move towards EU supervision, deposit insurance, crisis management and resolution regimes for cross-border banks. Domestic banks could remain within the national safety net.

Exchange rate regime

- In Iceland, the floating exchange rate contributed to the problem but is also part of the solution.
- Membership in the euro area would have prevented the currency crisis and greatly reduced the problem of FX balance sheets without LOLR => the banking crisis would have been less severe.
- This is a key factor behind Iceland’s EU application.
- But you can still have a banking crisis and a sovereign debt crisis, as recent experience has demonstrated!

The Icelandic model?

- Useful recipe for others
- Allowing private banks to fail but protecting retail depositors, not bondholders, and ring-fencing the sovereign from the failing banks (limiting socialisation of private losses)
- Flexible exchange rate as a tool for adjustment
- Capital controls as a tool for stabilisation

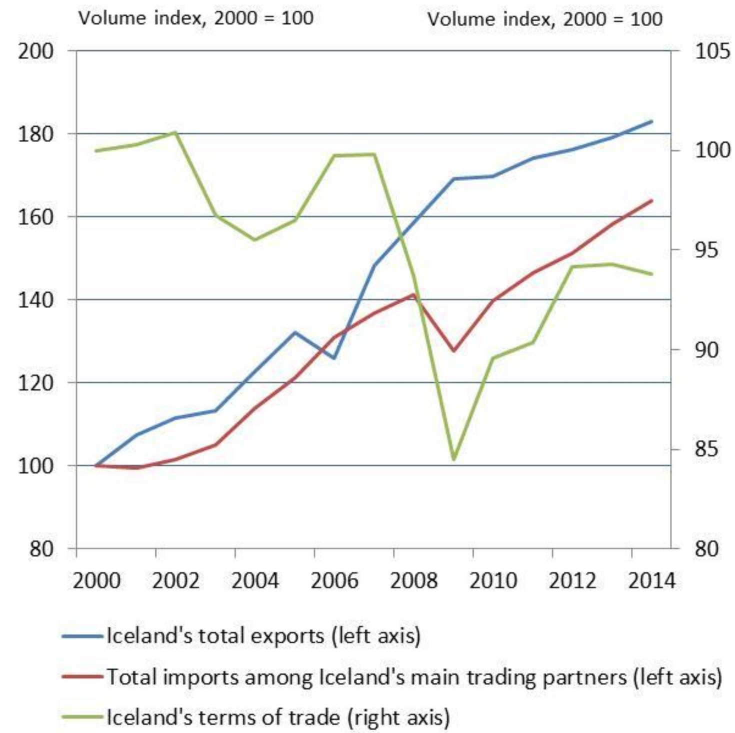
Allowing banks to fail?

- Private banks that were too big for the Icelandic authorities to save
- In terms of loss of asset values, the burden of the banks' collapse was borne mostly by foreign creditors (currently holding 85-90% of claim values on the old banks)
- The option will look different in larger countries
- But it makes sense to ring-fence sovereigns from private banks as much as is feasible
- And bailing out bondholders is certainly not a sacred principle!

Flexible exchange rate?

- Part of the problem and part of the solution!?
- Supply constraints in the export sector
- Private sector debt directly and indirectly connected to the exchange rate
- Disequilibrium between the tradable and non-tradable goods sectors

Figure 8 Export volumes and terms of trade 2000-2014



Sources: OECD, Central Bank of Iceland.

Capital controls?

- Capital controls were a key in stabilising the exchange rate, facilitated the financing of the sovereign and the banks, and provided fiscal and monetary policies the room for manoeuvre to support the domestic economy.
- But they might be more difficult to introduce in larger, more complex, and more connected economies, and the costs might be higher.
- Lifting them has also proved challenging, and the microeconomic costs increase with time.
- The jury is still out!