Central Bank of Iceland

Iceland's crisis and recovery: are there lessons for the eurozone and its member countries?

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Levy Institute conference, Athens, 8 November 2013

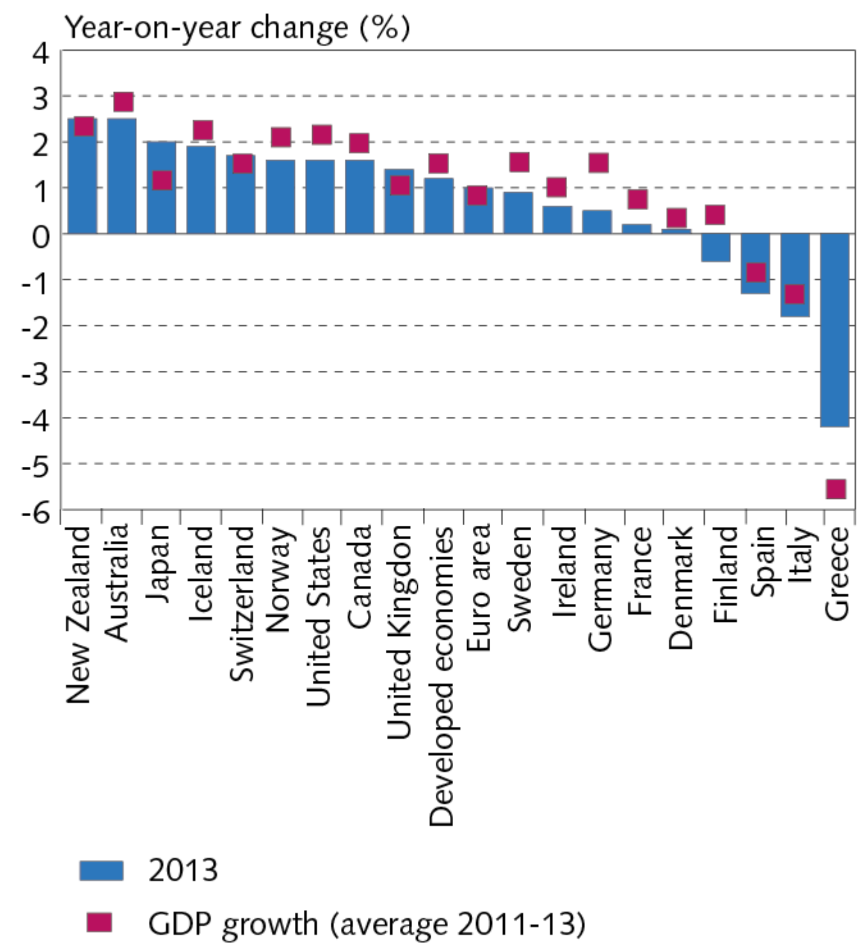
The autumn of 2008

- Almost 90% of Iceland's banking sector failed in the first week of October
- Combined, this was the 3rd biggest corporate failure in the history of mankind
- Losses shared widely across borders
- At that point, Iceland was already in a currency crisis and on its way into recession after an unsustainable boom during 2005-2007
- Many expected a deep recession and that the sovereign might default on its obligations

Where are we now?

- No talk of sovereign default
- Investment-grade rating and the sovereign has tapped foreign capital markets twice since the crisis
- Economic recovery since Q2/2010
- Domestically oriented banking system has been rebuilt

GDP growth in developed countries



Sources: Eurostat, IMF, OECD, Statistics Iceland.

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.

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 nature of the economic problem

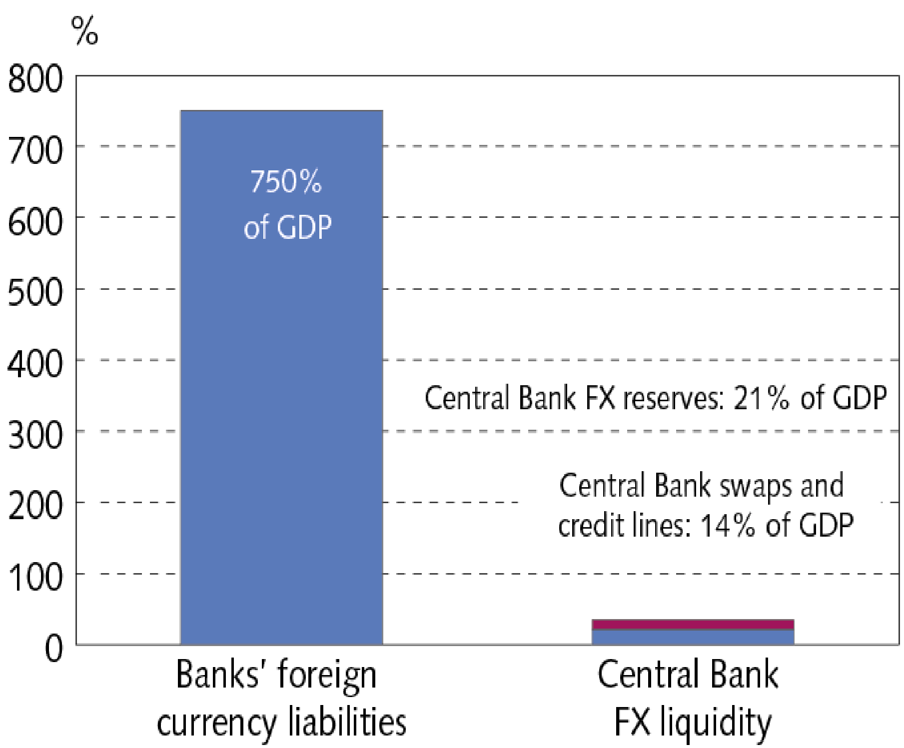
- Unsustainable expenditure imbalances?
- Over-indebtedness?
- Over-extended sectors (finance and construction)?
- Lack of effective demand?
- More “Hayekian” and “Fisherian” elements than “Keynesian” in the Icelandic crisis
- Iceland is a very small, open economy => internal effective demand problems are usually less of an issue than in bigger economies. The lack of effective demand was more a temporary result of the crisis rather than a significant cause.

The policy response

- Emergency Act: intervention powers, deposit preference, 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 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

Deposit protection and FX deposits on the so-called Icesave accounts

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



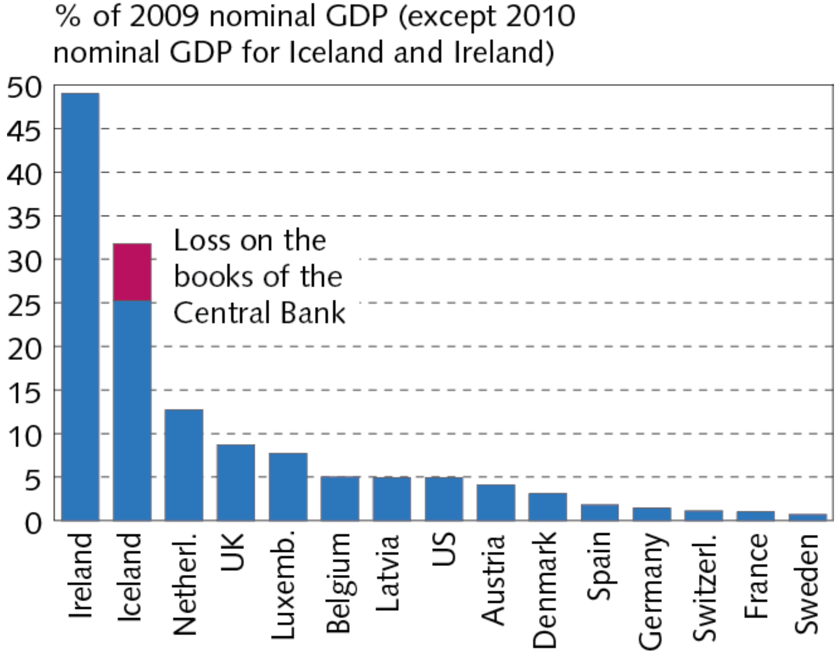
- Promising to protect deposits works only if they are mostly in your own currency.
- CBI FX reserves €2½ bn, Icesave deposits €11½ bn, including insured deposits of €4½ bn.
- => Impossible at the time. Insurance paid by UK and Netherlands authorities.

Icesave dispute on settling deposit insurance

- 3 negotiated settlements and 3 bills passed in Parliament; rejected twice in referenda.
- EFTA Court ruled that there was no sovereign liability.
- Estimated recovery from the Landsbanki estate will most likely cover both insured and uninsured deposits.
- The priority given to deposits in the Emergency Act is key for that result.

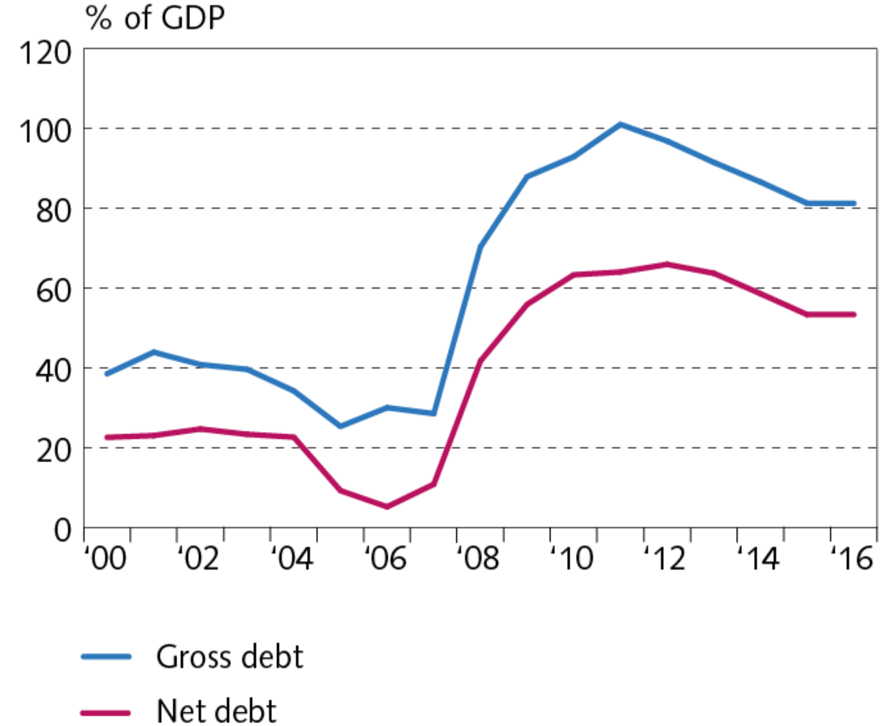
The crisis hit government finances hard

Direct fiscal costs of the financial crisis



Sources: Laeven and Valencia (2010), "Resolution of banking crises: The good, the bad, and the ugly", IMF Working Paper, no. 10/146, OECD (2011), except OECD Economic Surveys: Iceland, and The Icelandic National Audit Office (2012). Fiscal cost of recapitalizing financial and Government institutions following the financial crisis. Report to Parliament, for Iceland and Ireland.

General government debt 2000-2016[1]

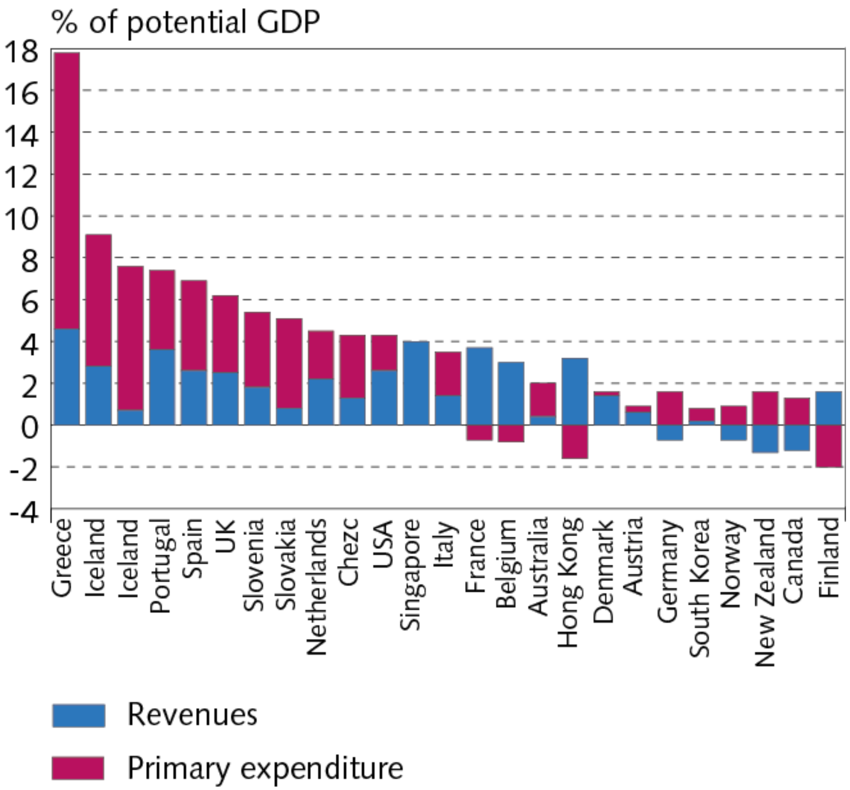


1. Central Bank baseline forecast 2013-2016.

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

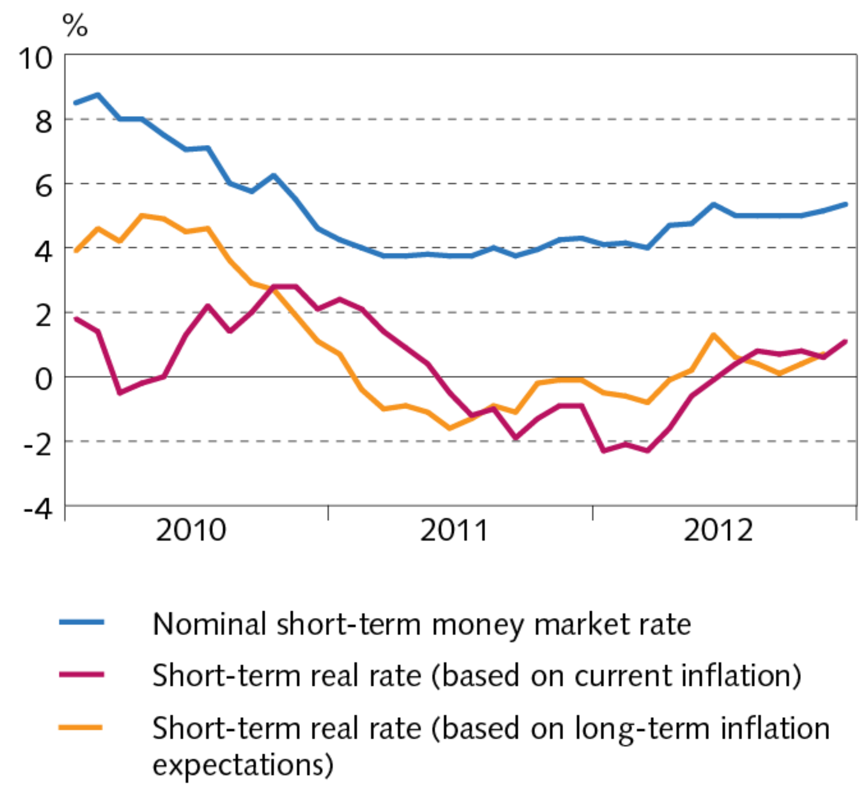
Fiscal consolidation with monetary support …

Composition of adjustment in several industrialised countries, 2009-2013[1]



1. Adjustment of cyclically adjusted primary balance.
Source: IMF, *Fiscal Monitor*, October 2013.

Monetary policy stance
2010-2012

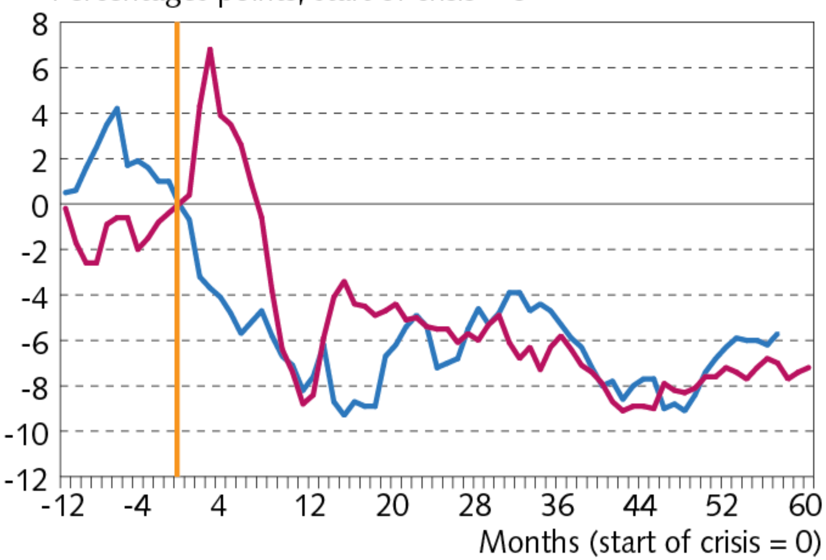


Sources: Statistics Iceland, Central Bank of Iceland.

… and helped by capital controls

Real short-term interbank interest rates in two twin-crises - Iceland and Korea[1]

Percentages points, start of crisis = 0



Iceland (Start of crisis = February 2008)

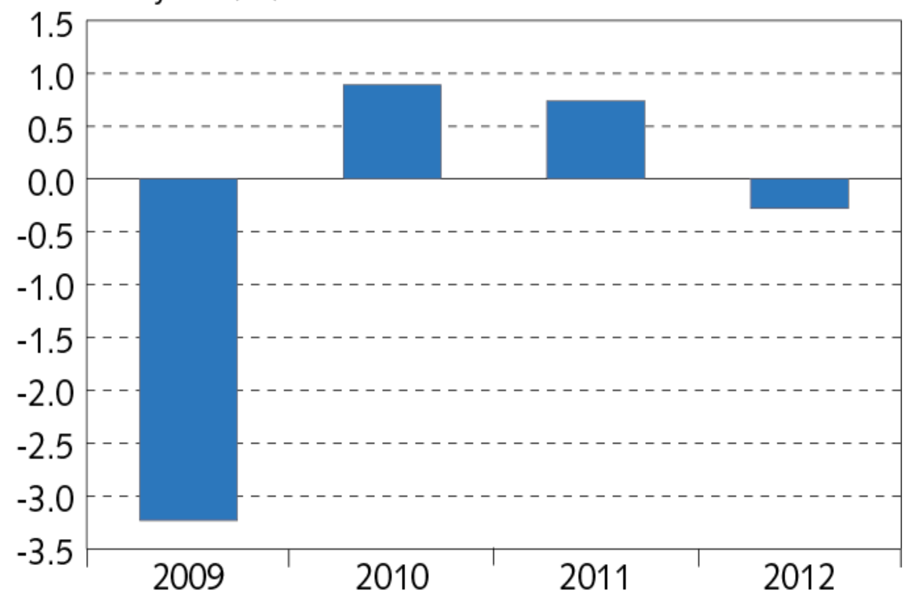
Korea (Start of crisis = October 1997)

1. The currency crisis in Korea is assumed to have started in October 1997 when pressures on the won started to escalate. The currency crisis in Iceland is assumed to have started in February 2008 when the foreign exchange swap market collapsed.

Sources: Macrobond, OECD.

Treasury's real interest rates on domestic issuances

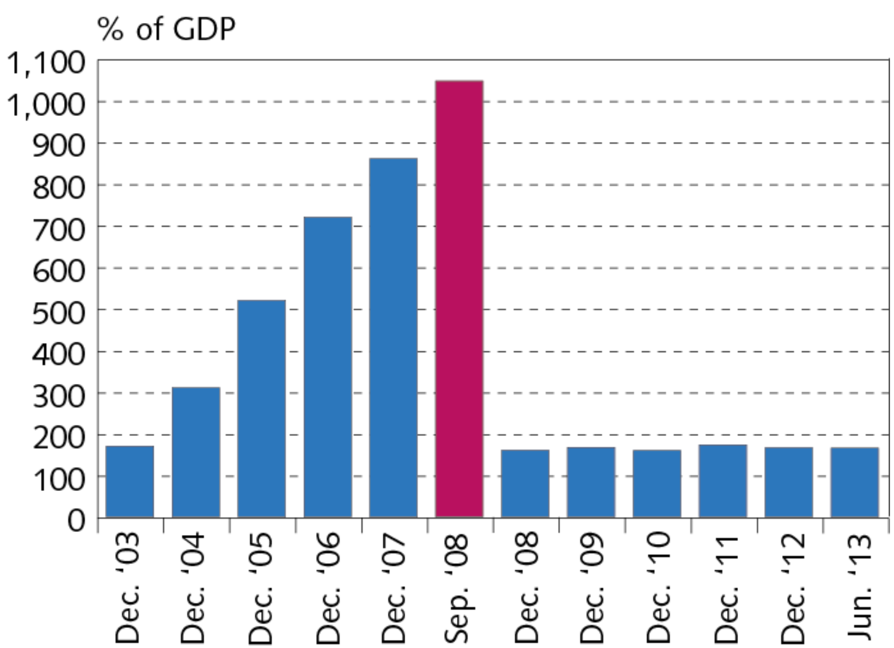
Real yield (%)



Source: Central Bank of Iceland.

Domestically oriented banking system has been rebuilt

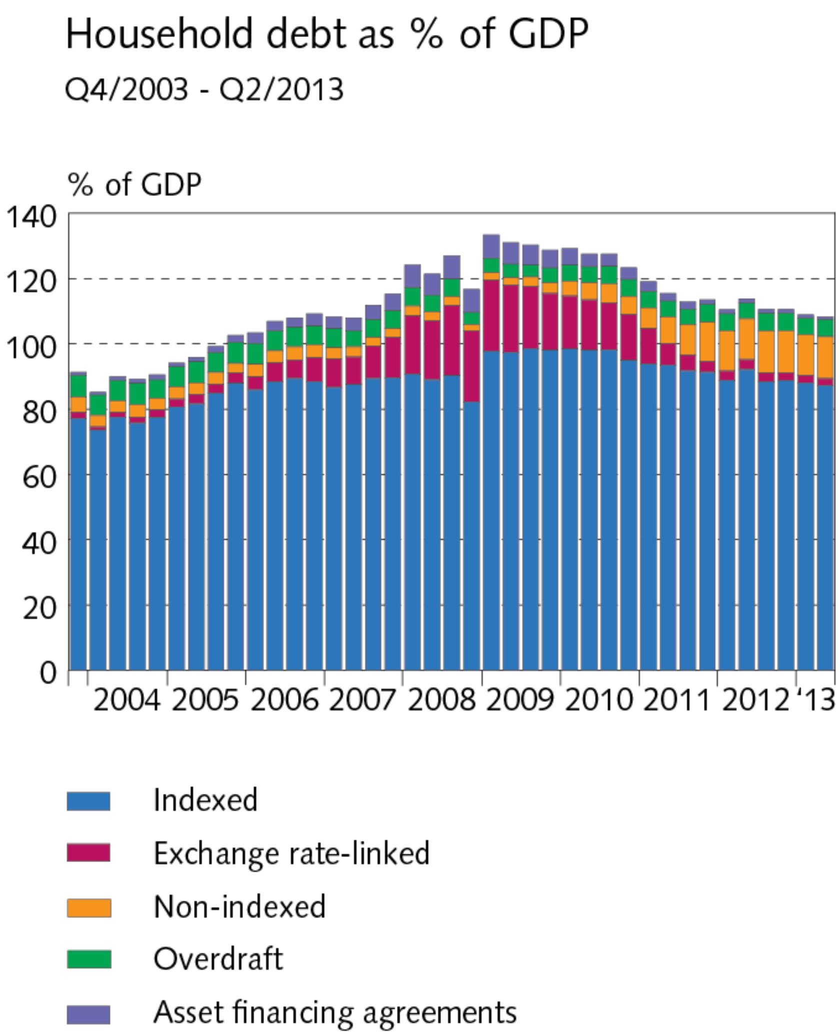
Commercial banks assets[1]



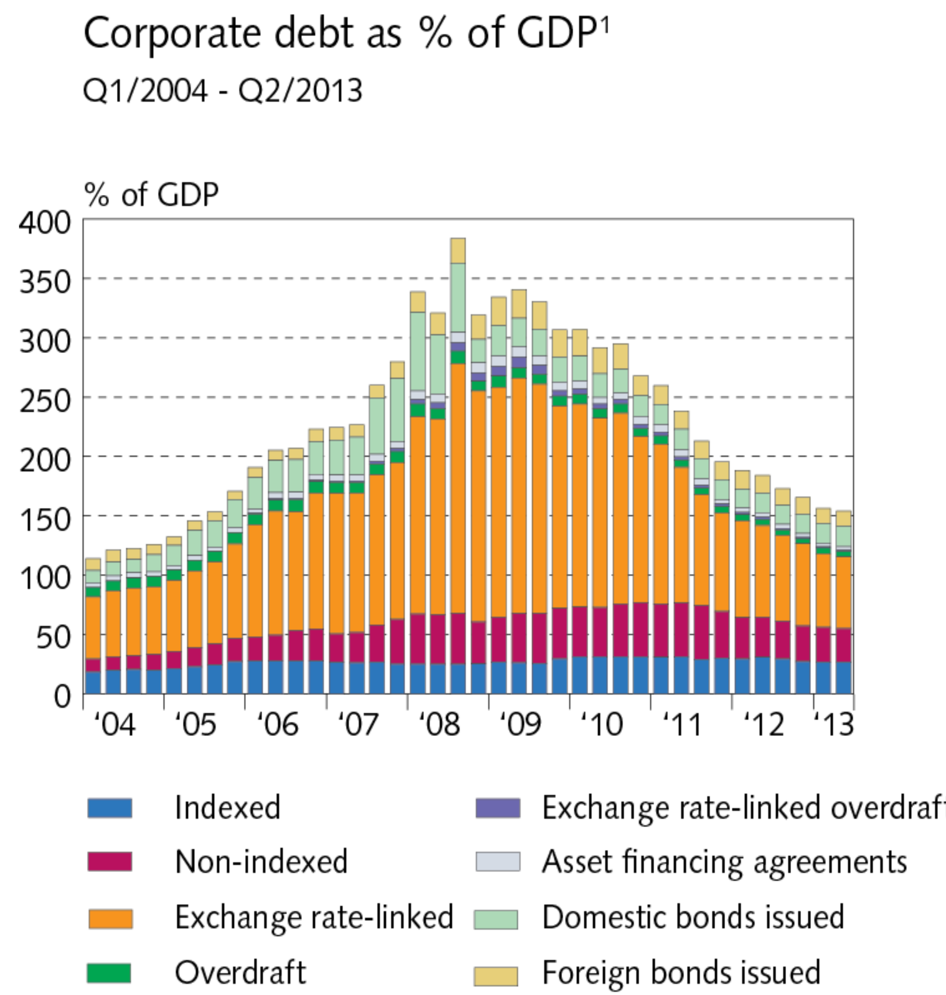
1. The three large commercial banks.
Sources: Statistics Iceland, Central Bank of Iceland.

- Profitable (ROA 2.3%) and high capital (CAR 26%) and liquidity buffers
- Leverage (debt-to-equity) is 4.6
- But shielded behind capital controls
- NPLs coming down (5% – peak was 18%) but uncertainty still ahead

Private sector debt restructuring



Sources: Statistics Iceland, Central Bank of Iceland.



1. Debt owed to domestic and foreign financial undertakings and market bonds issued.

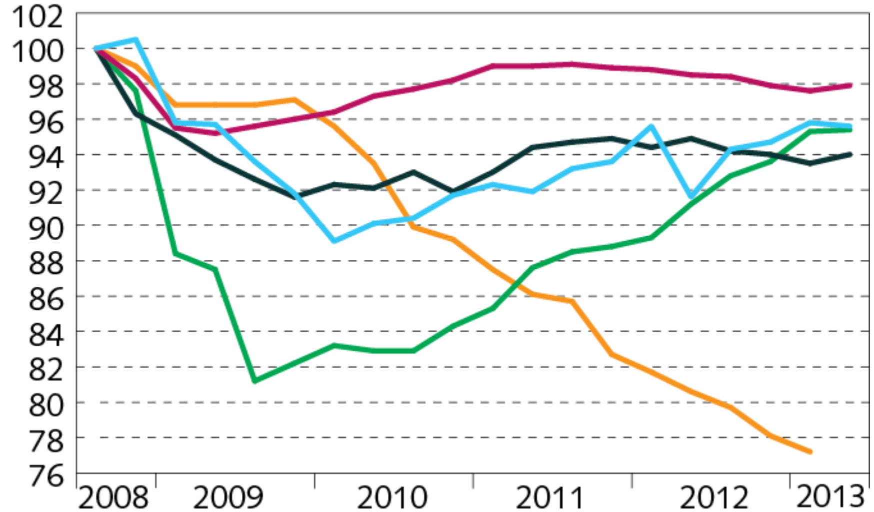
Sources: Statistics Iceland, Central Bank of Iceland.

Recession and recovery

The recession was deep, but Iceland has not been the hardest hit

Level of GDP[1]

Index, (seasonally adjusted) Q3/2008 =100



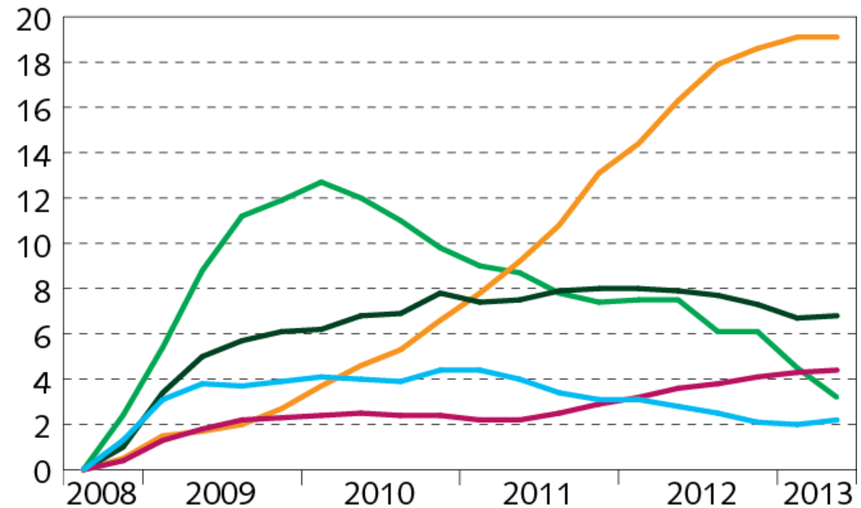
Output loss 12% (07Q4-10Q1)

1. GDP data for Iceland is seasonally adjusted by the Central Bank of Iceland.

Sources: Eurostat, OECD, Central Bank of Iceland.

Unemployment rate[1]

% of labour force (normalised at 0 in Q3/2008)



Unemployment peak 8% (09Q2)

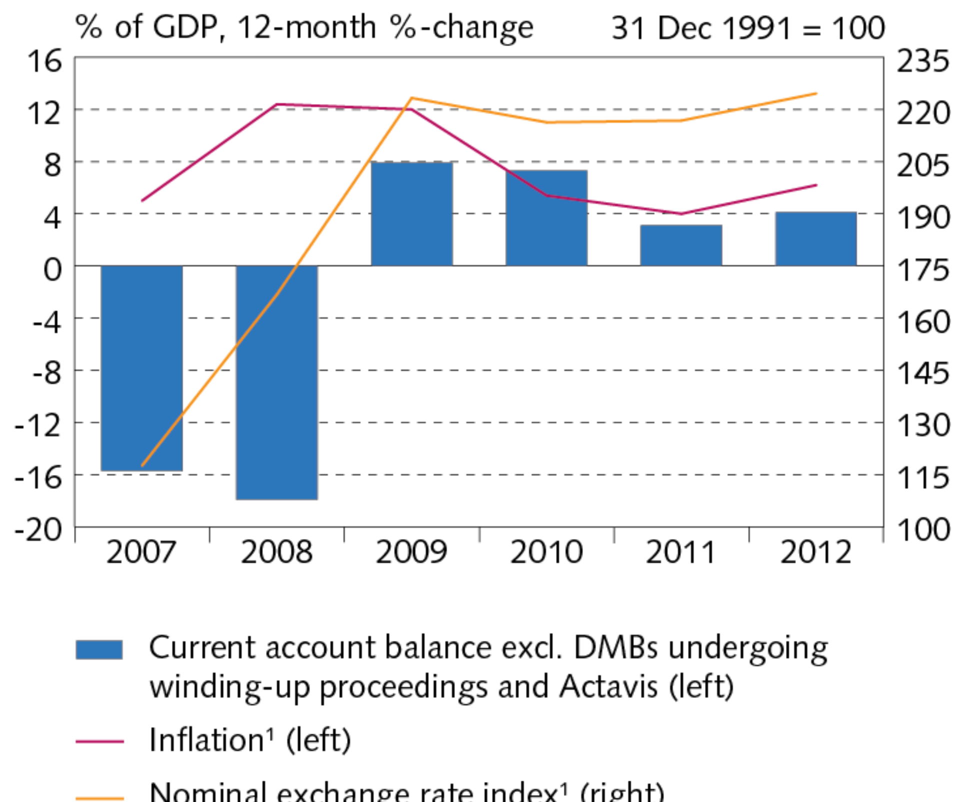
1. Seasonally adjusted harmonised unemployment rate, except for Latvia, as the series are seasonally adjusted by Eurostat.

Sources: Eurostat, OECD.

Stabilisation

- Current account deficit of double digits prior to the crisis has swung into a significant underlying surplus
- Exchange rate stabilised in H2/2009 and rose in 2010
- Inflation and interest rates came down

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

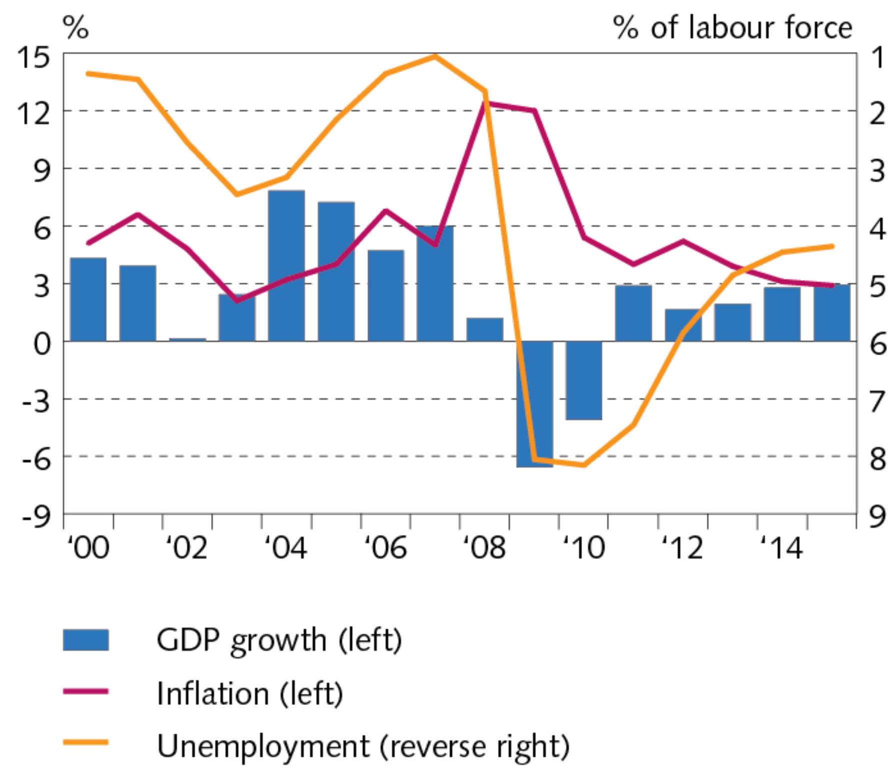


1. For the year 2012, the exchange rate and the inflation are shown as averages from 1 January - 15 June 2012.
Sources: Statistics Iceland, Central Bank of Iceland.

Recovery

- Economy growing since Q2/2010, with output gaining 7½% of the loss until Q2/2013
- Unemployment down from peak of just over 8% to current rate of around 5%
- Growth predicted at 2.3% this year, picking up to the 2½-3% range in 2014 and 2015

GDP growth, output gap and unemployment rate[1]

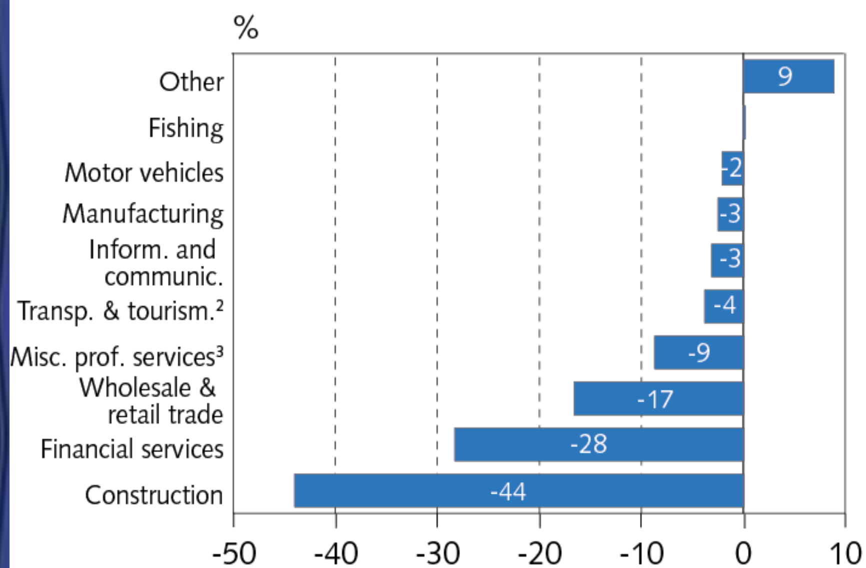


1. Central Bank baseline forecast 2013-2015.

Sources: Directorate of labour, Statistics Iceland, Central Bank of Iceland.

Contribution of economic sectors to recession and recovery

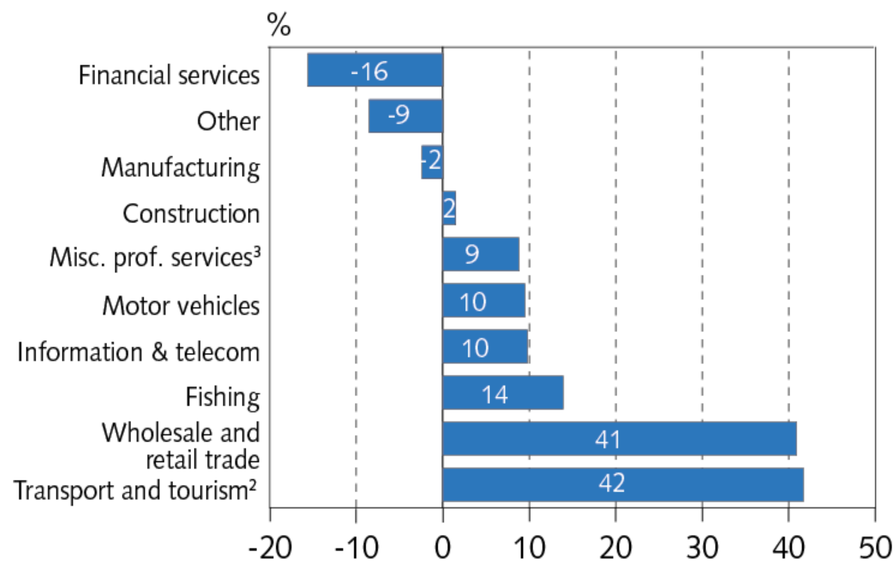
Sectoral contributions to the economic contraction in 2008-2010[1]



1. Based on Gross domestic factor income according to the productional approach to the national accounts. 2. This group includes transport and storage, accommodation and food services, travel agencies, and rental and leasing activities (other than housing). 3. Without travel agencies and rental and leasing activities.

Sources: Statistics Iceland, Central Bank of Iceland.

Selected sectors' estimated contribution to the economic recovery in 2010-2012[1]



1. Based on Gross domestic factor income according to the productional approach to the national accounts 2010-2012 where the 2012 value is assessed from volume indices. 2. This group includes transport and storage, accommodation and food services, travel agencies, and rental and leasing activities (other than housing). 3. Without travel agencies and rental and leasing activities.

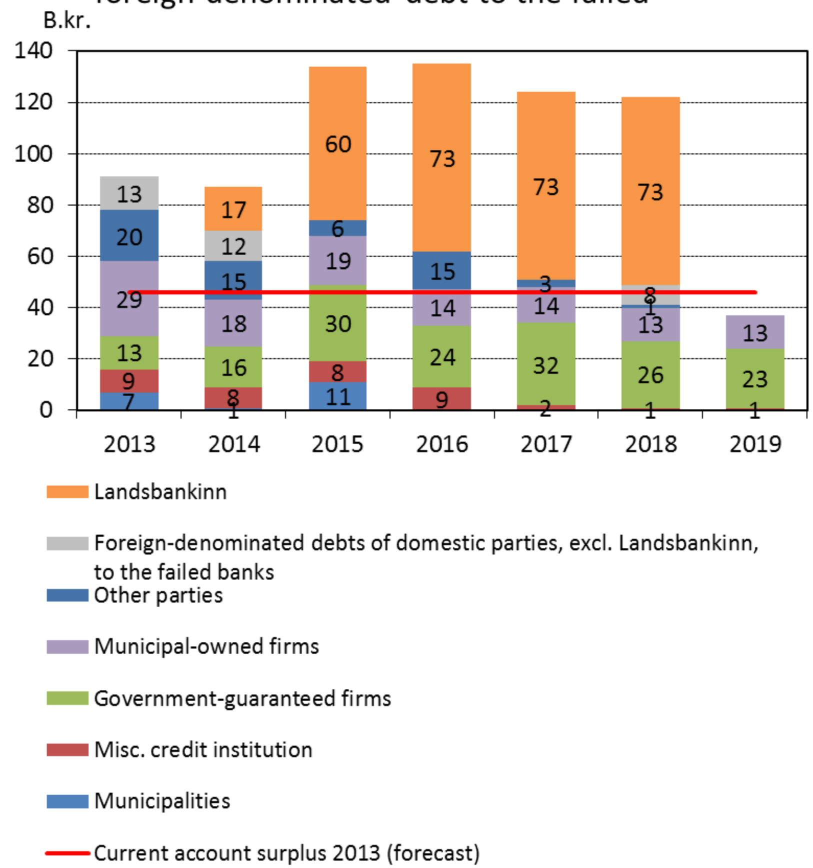
Sources: Statistics Iceland, Central Bank of Iceland.

The biggest current challenge

Iceland’s balance of payments crisis

- Three elements:
  - Contractual foreign debt repayment in excess of reasonable estimates of the current account surplus
  - The current overhang of non-resident króna positions
  - Unwinding of old banks

Estimated payments by parties other than the Treasury and CBI on foreign loans and foreign-denominated debt to the failed

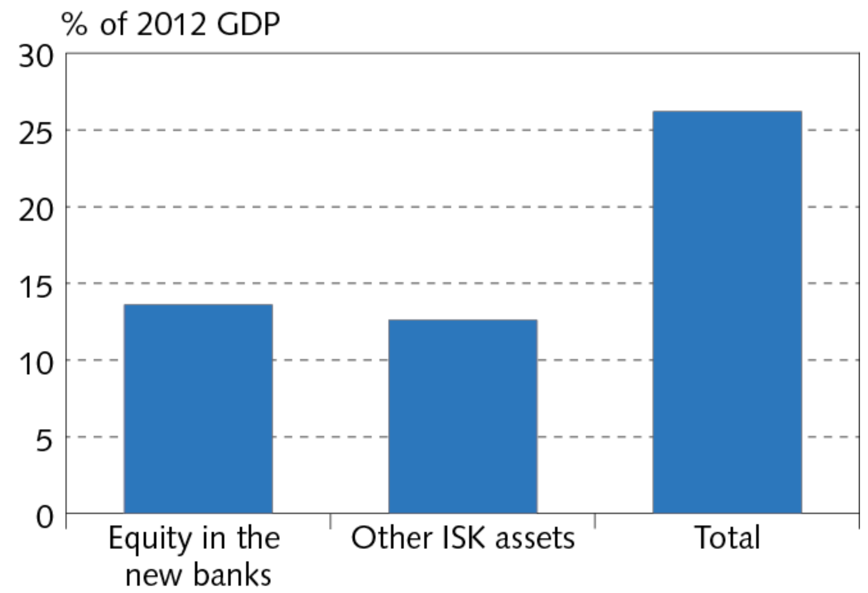


1. All figures as of year-end 2012 and exchange rate of 29 August 2013.
Source: Central Bank of Iceland.

The króna overhang

- The current overhang of liquid krónur in the hand of foreign residents is 20% of GDP (down from 43% at the beginning of the crisis)
- Unwinding of old banks: 95% of claims foreign, but around a third of assets domestic
- Potential addition to króna overhang is up to 26% of GDP

Share of foreign residents in króna assets of the old banks



Sources: Financial informations Glitnir, Kaupthing and LBI, Statistics Iceland, Central Bank of Iceland.

Lifting the capital controls will be challenging

- Iceland does not face a sovereign debt problem
- Iceland’s net external debt position is sustainable in the traditional sense
- But to lift the controls requires smoothing of the foreign debt service profile and realistic valuations in terms of FX of the offshore króna positions and króna recoveries of the failed banks.

Lessons for others (including the eurozone and its member countries)?

Ring-fencing the sovereign in the face of private bank failure

- Failure of three-cross border banks: assets in excess of 10x GDP, with around 2/3 of the balance sheet in foreign currencies.
- Guaranteeing the whole banking system would very probably have resulted in sovereign default.
- In the absence of international cooperation, forced downsizing through resolution and winding-up was the only option.

Allowing banks to collapse?

- Two key considerations:
  - To preserve the domestic payments system and common citizens' access to their deposits
  - To ring-fence the sovereign vis-à-vis the failing banks
- But Iceland saved the domestic part of its banking system at significant cost
- The international part had to go into resolution
- It is not safe to allow the whole banking system to collapse
- Avoid socialisation of private sector losses

Flaws in the EU/EEA framework for cross-border banking

- European freedoms are not matched by public action at the European level (supervision, deposit insurance, LOLR, crisis management and resolution)
- FX risk was largely ignored
- Country size and bank size relative to countries matter for risk and the viability of bailout options (Iceland is a clear example)
- There was a built-in vulnerability/risk in this setup, especially for small countries outside the euro area

Deposit insurance, LOLR, and FX liquidity

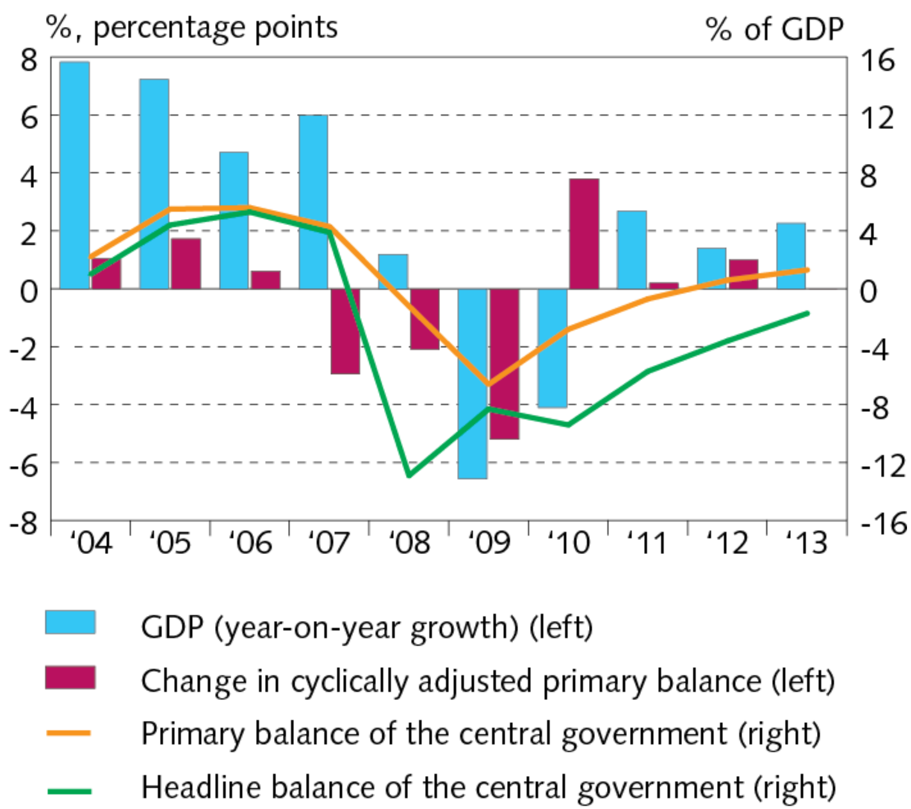
- LOLR and deposit insurance are devices to prevent and stop runs
- Works well when everything is in domestic currency – bank liabilities flow into central bank liabilities that can be recycled against collateral. Large short-run capacity to expand CB balance sheet.
- Run on FX liabilities?
- LOLR and deposit insurance no longer credible in the absence of international co-operation; e.g., USD swaps.

Reforms of the EU/EEA framework

- Match EU passport with EU supervision, resolution and safety net (LOLR and deposit insurance
- Banking union makes a perfect sense based on Iceland's experience
- But only for the eurozone, and then it has to include all three elements
- Only solves part of the problems for the EU countries outside the eurozone and EEA countries – leaves the currency or the LOLR problem

Fiscal consolidation (austerity) and economic recovery

Fiscal policy and the economic cycle[1]



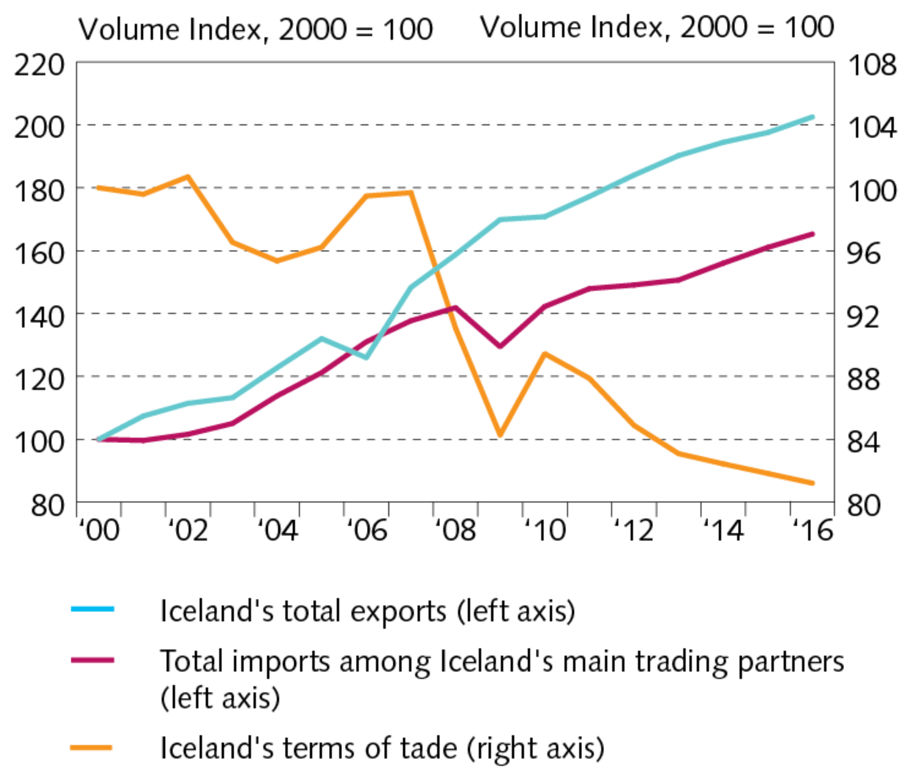
1. Central Bank baseline forecast 2013.
Sources: Sources: IMF, Statistics Iceland, Central Bank of Iceland.

- Automatic stabilisers allowed to work in 2009
- Fiscal consolidation from 2010
- A case of short-term stimulus embedded in a medium-term consolidation plan
- Key for restoring confidence and opening market access
- Did not derail the recovery

Flexible exchange rate?

- Part of the problem and part of the solution!?
- Misalignment in the build-up to the crisis
- Big negative private sector balance sheet effects during the currency crisis
- But: key in turning around the current account in 2009 and stimulating exports going forward
- However: supply constraints in the export sector

Export volumes and terms of trade
2000-2016



Source: OECD, Central Bank of Iceland.

Comprehensive capital controls on outflows?

- Helpful in stabilising the economy
- Currently they are an important tool for preserving stability during the unwinding of the old banks
- But microeconomic costs accumulate with time
- ...and they might be more difficult to introduce and manage in larger, more complex, and connected economies, and the costs will be higher
- Lifting them has also proved challenging
- Should only be used in extreme situations
- Better to deal with the inflow at the time

Small, open economies

- Policy conflicts are very risky in small, open, and financially integrated economies.
- Do not worry about big government surpluses during booms
- Current account deficits matter
- There are pros and cons of exchange rate regimes; they vary between countries but as such do not prevent financial crises
- Act on the specific risk profile of the financial sector in the country, also when introducing regional or international regulations

Concluding remarks: why Iceland's relatively successful recovery?

- Shocks hit in the first instance frothy sectors (finance and construction), but the export base and many other fundamental were intact
- Flexible economy – especially the labour market
- Flexible exchange rate
- Private sector debt restructuring
- The economic programme with the IMF
- Fiscal prudence: good initial position, limited socialisation of private banks' liabilities, and medium-term financial consolidation

Concluding remarks: lessons for others?

- Not safe to let the whole banking system collapse
- => Ring-fence infrastructure elements and aim for separation in resolution
- Fiscal consolidation can be consistent with growth but timing and degree matter
- We need to make financial globalisation safer, both as regards cross-border banking and volatile capital flows