SEÐLABANKI ÍSLANDS

Post-Crisis Recovery, Resilience Building and Policy Reforms in Iceland

Government Borrowers Forum 2019

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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
- Net international investment position was -130% of GDP
- 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 (USD 5.1 with bilateral loans) and 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

Where are we now?

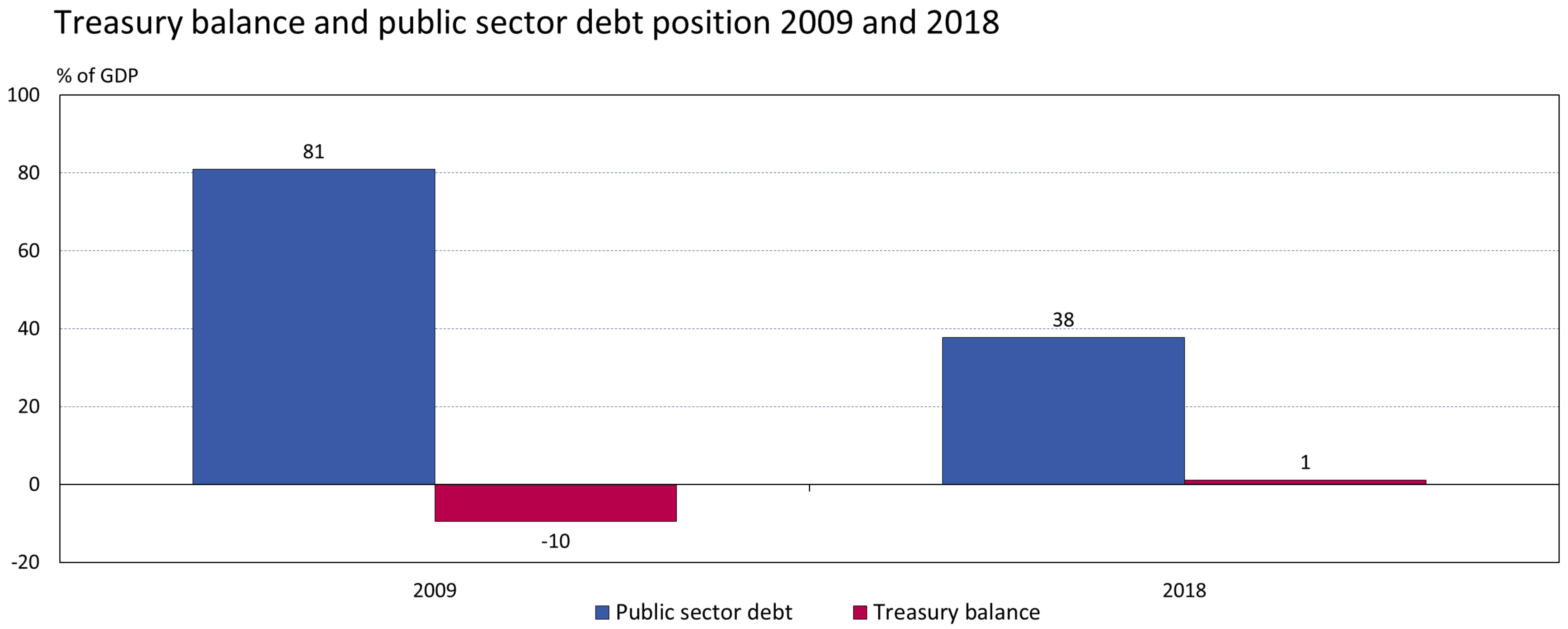
Where are we now?

- 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
- Inflation close to target for about five years
- Fiscal position strong
- Private sector debt has fallen steeply and is low in historical context

Where are we now? 2

- External assets exceed external liabilities by 21% of GDP
- Strong, domestic-oriented banking system
- The capital controls have been lifted 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
- Overall we have built strong resilience and can face temporary setbacks

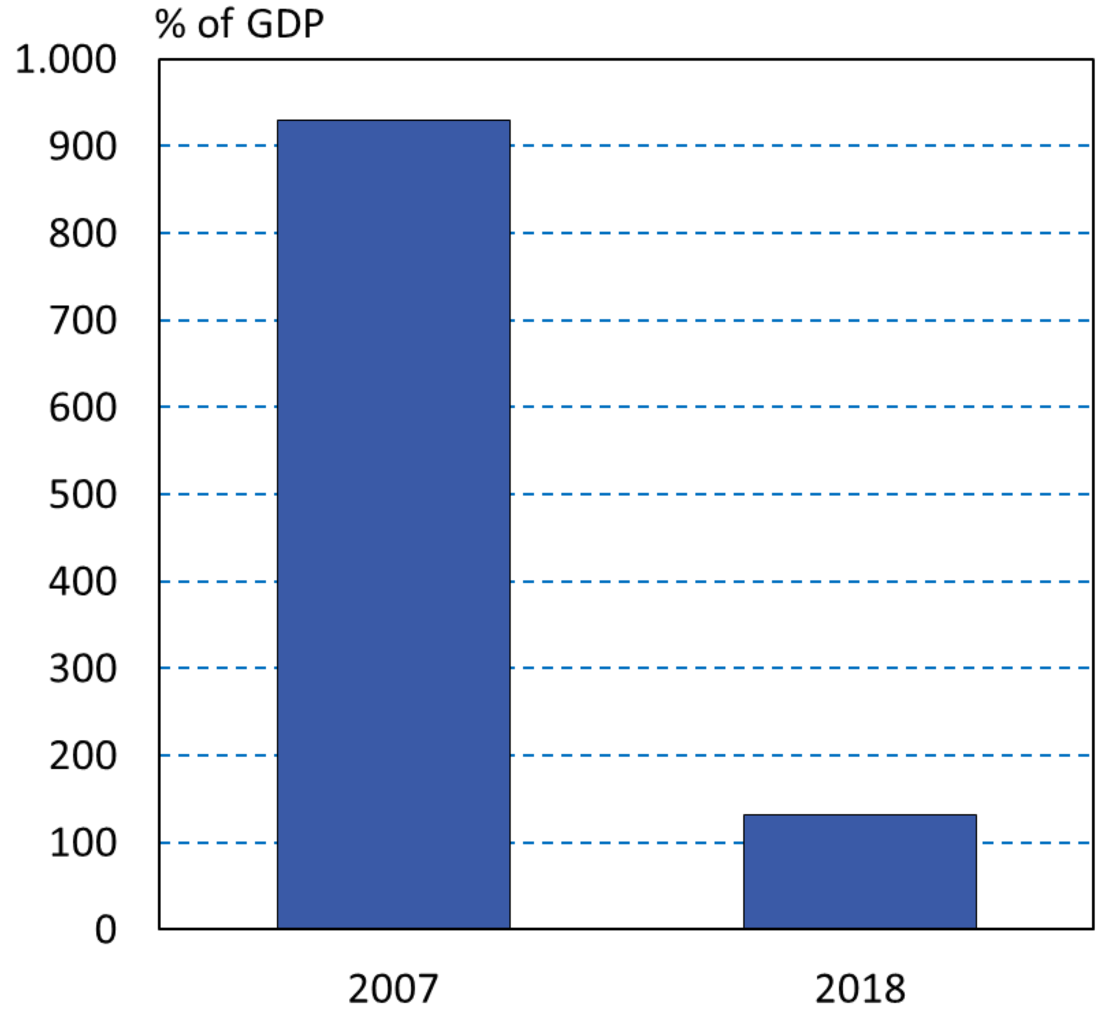
Big improvement public sector finances



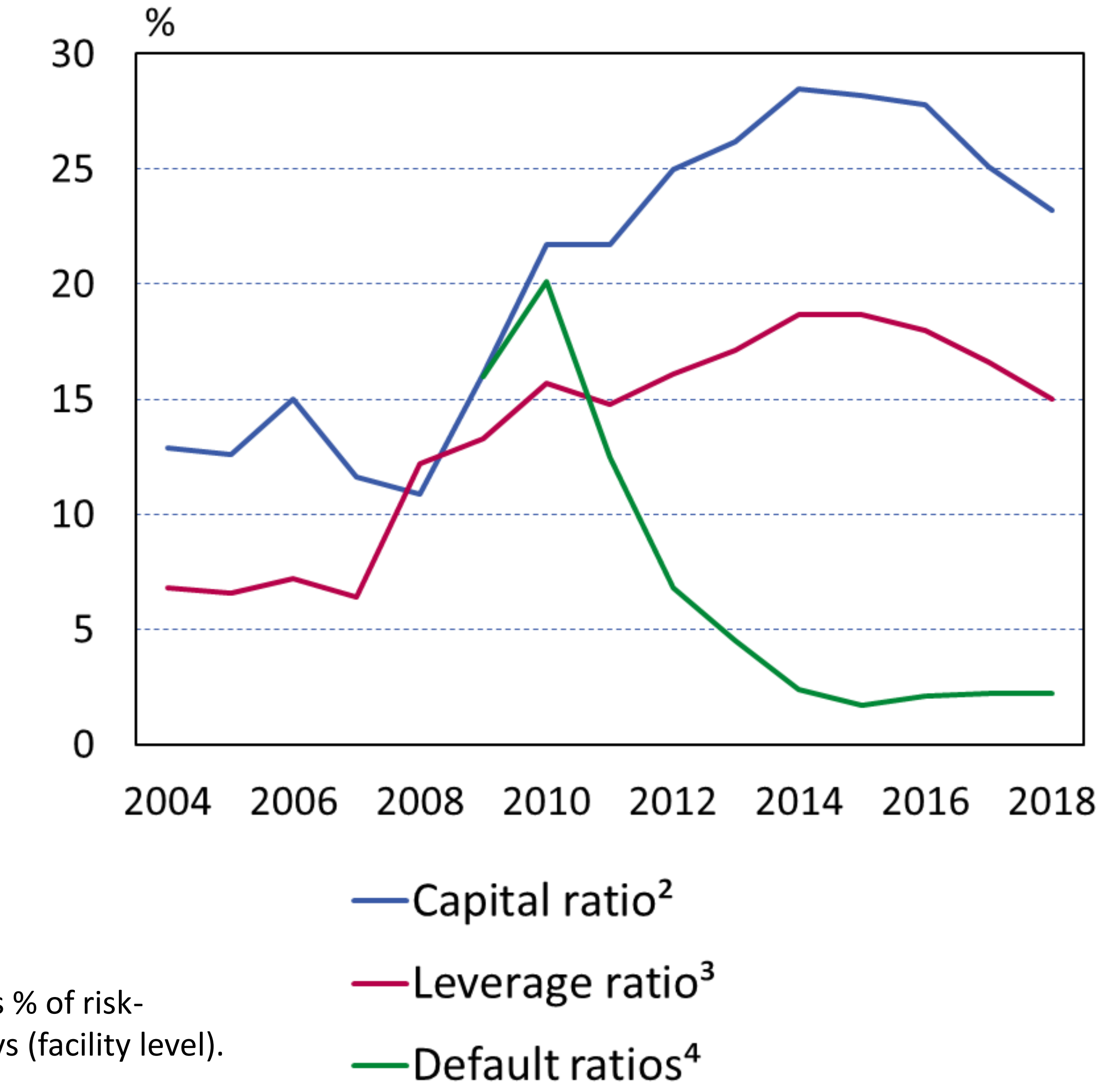
Sources: Ministry of Finance and Economic Affairs, Statistics Iceland, Central Bank of Iceland.

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

Bank balance sheets 2007 and 2018



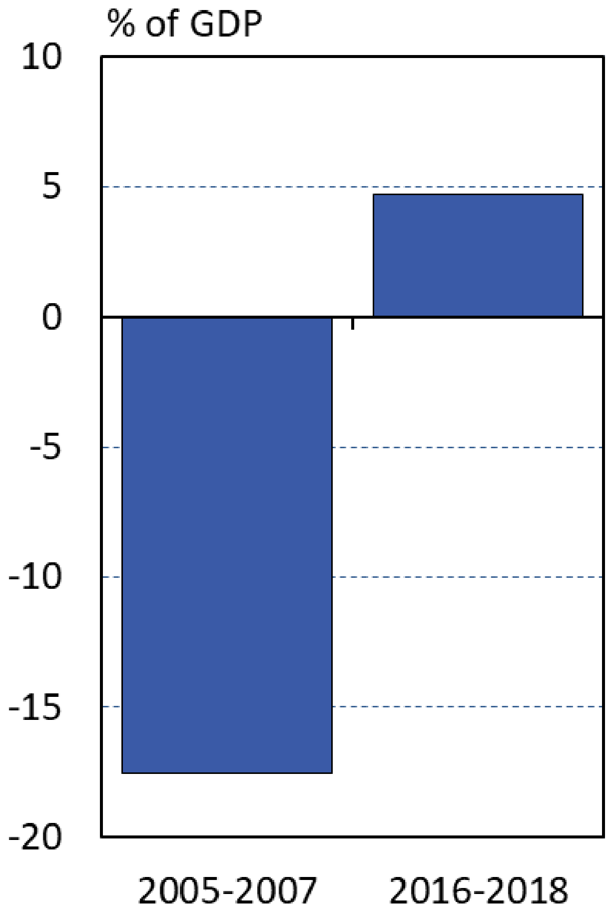
Deposit institutions: capital, leverage and default ratios[1]



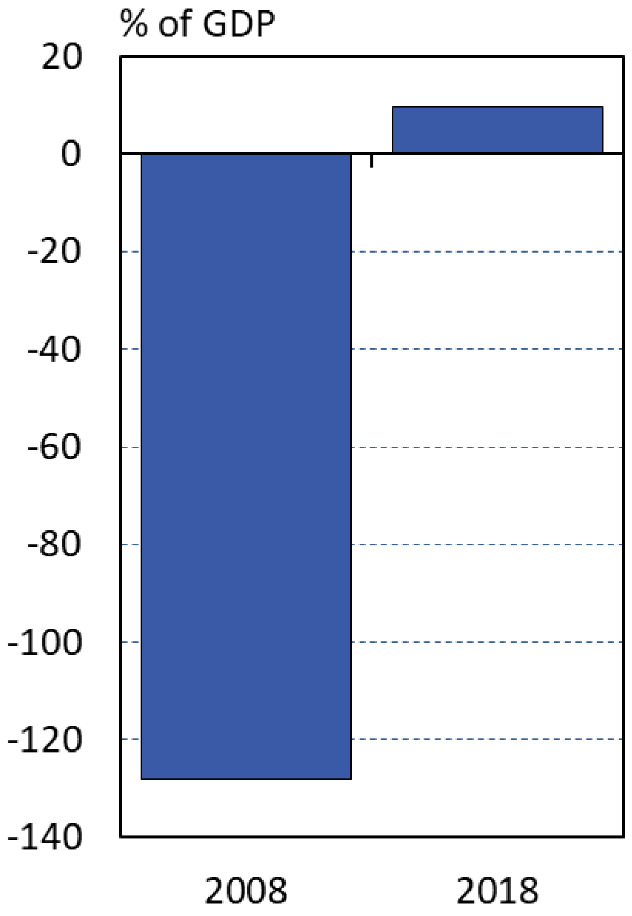
1. Domestic systemically important banks, consolidated figures. Average of ratios. 2. Capital base as % of risk-weighted assets. 3. IFRS Tier 1 leverage ratio. 4. Loans in default; i.e., loans past due by over 90 days (facility level).
Sources: Deposit institutions' financial statements. Statistics Iceland,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

A major change in the external position

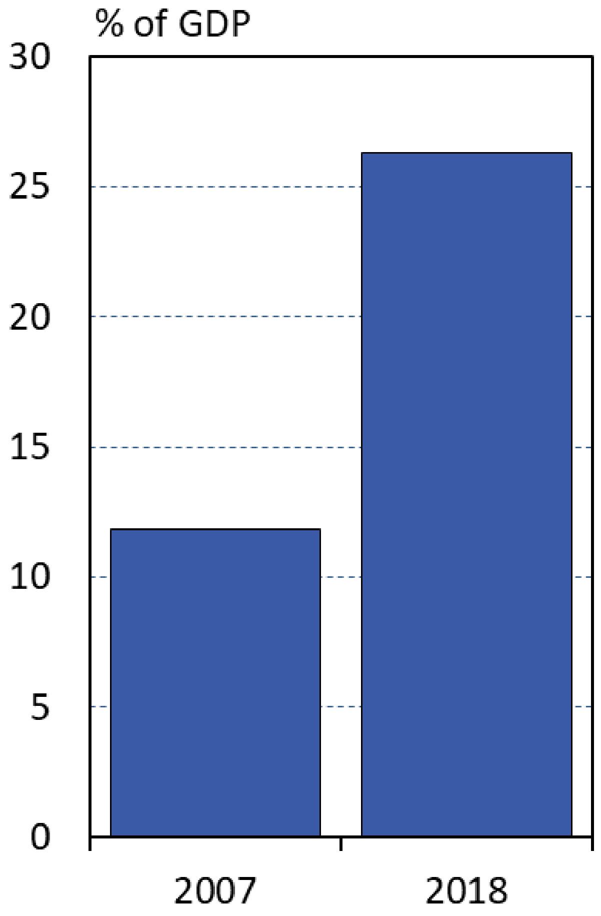
Current account[1]



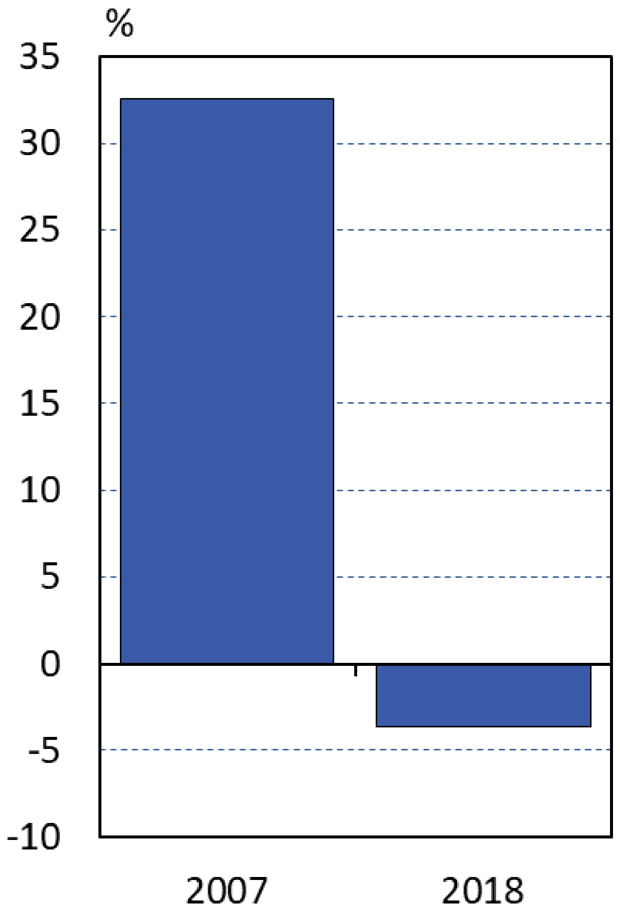
Net international investment position[2]



Central Bank foreign reserves[3]



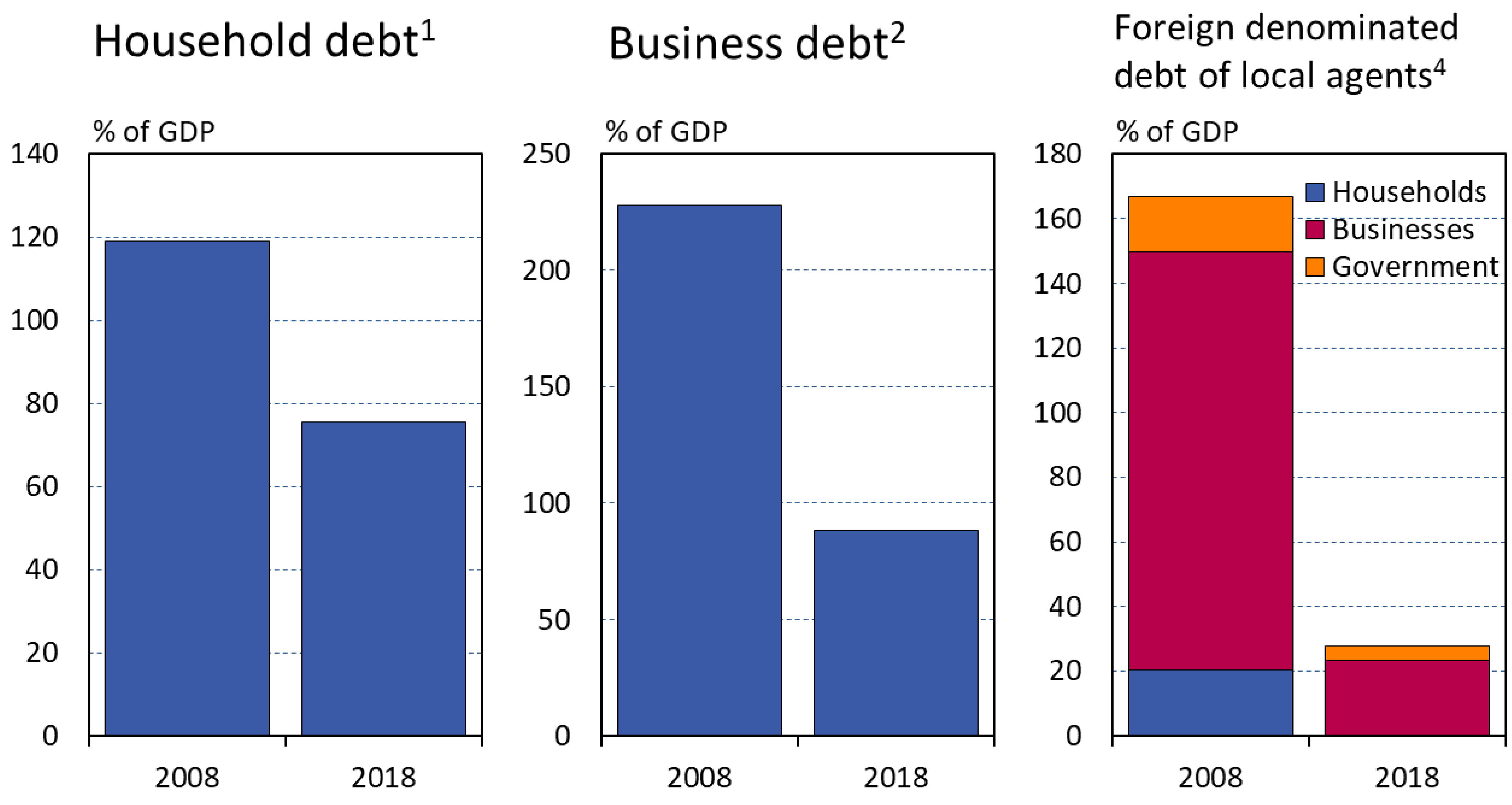
Deviation of real exchange rate from equilibrium[4]



1. Current account as % of GDP. 2. Net foreign position as % of GDP. 3. Foreign reserves as % of GDP. 4. Deviation of the real exchange rate from the estimated equilibrium real exchange rate.

Sources: Statistics Iceland, Central Bank of Iceland.

Sharp drop in private sector debt and foreign currency-denominated debt



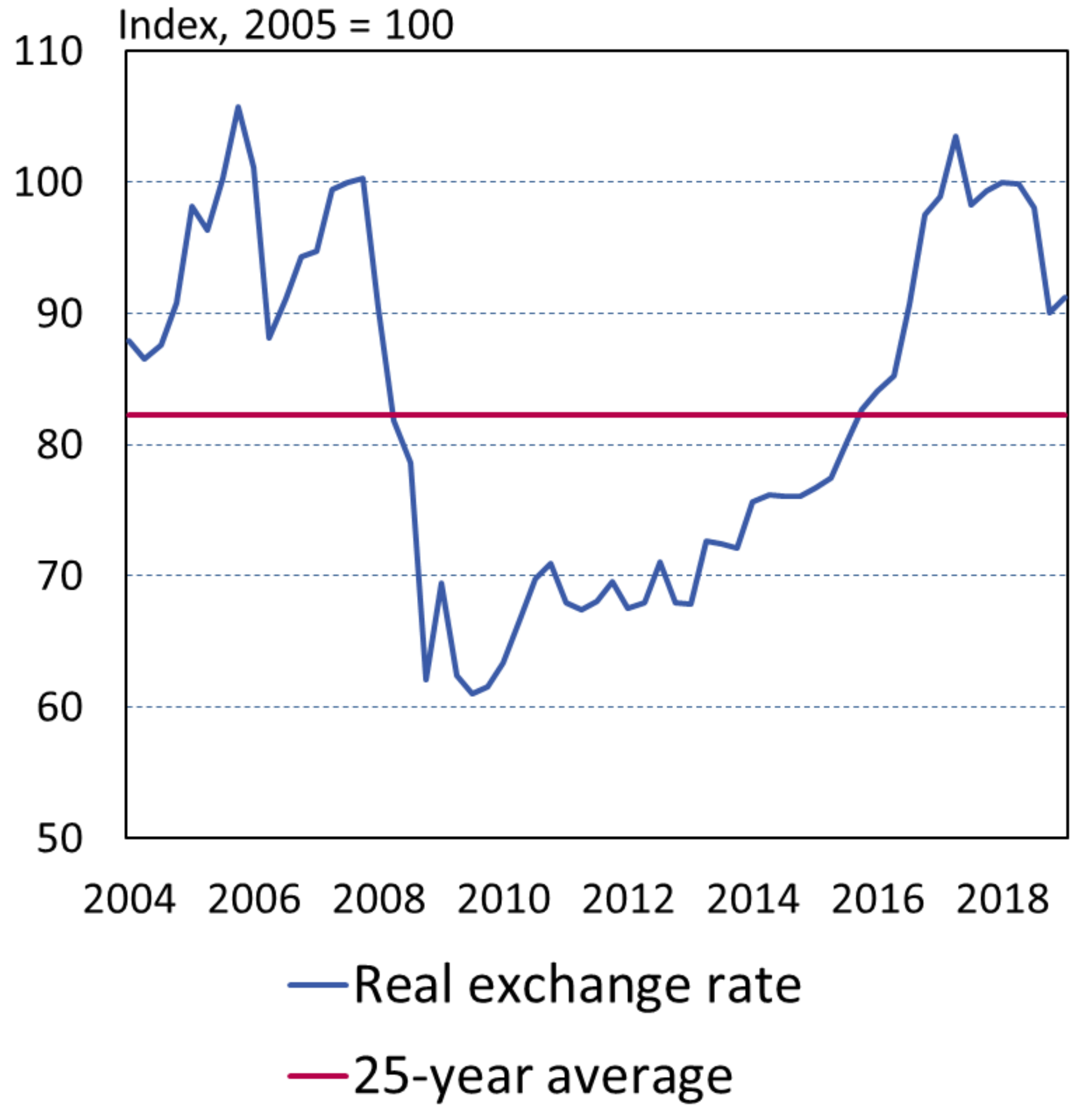
1. Total debt of households as % of GDP. 2. Total debt of businesses (debt and issued bonds) as % of GDP. Businesses excluding financial services firms (including holding companies). 3. Gross public debt as % of GDP. 4. Foreign denominated debt or debt linked to foreign currencies as % of GDP. Businesses 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.

How did we get here?

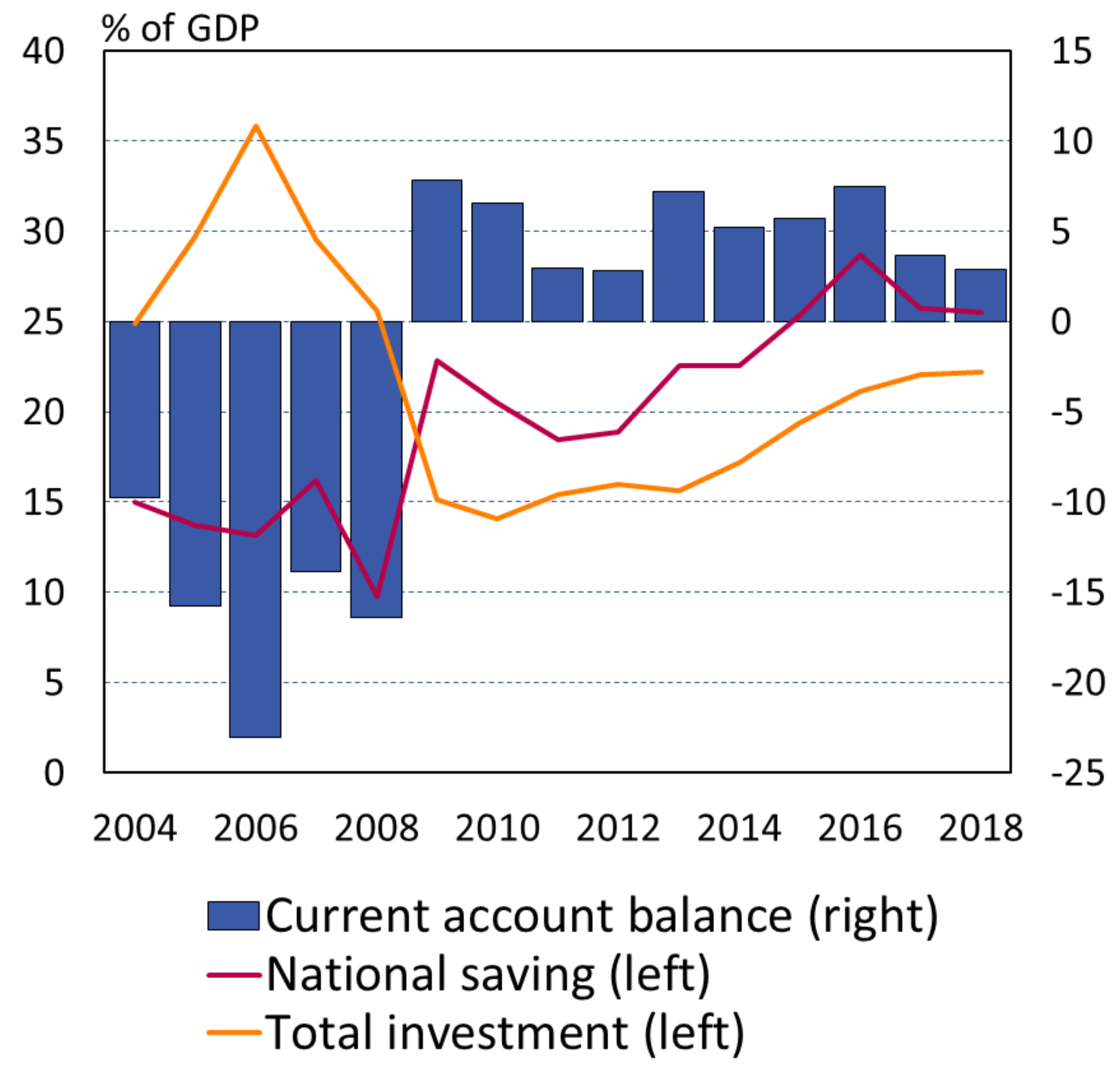
Real depreciation and upward shift in savings propensity created a dramatic turnaround in the current account

Real exchange rate[1]

Q1/2004 - Q1/2019



Investment, saving and current account balance 2004-2018[1]

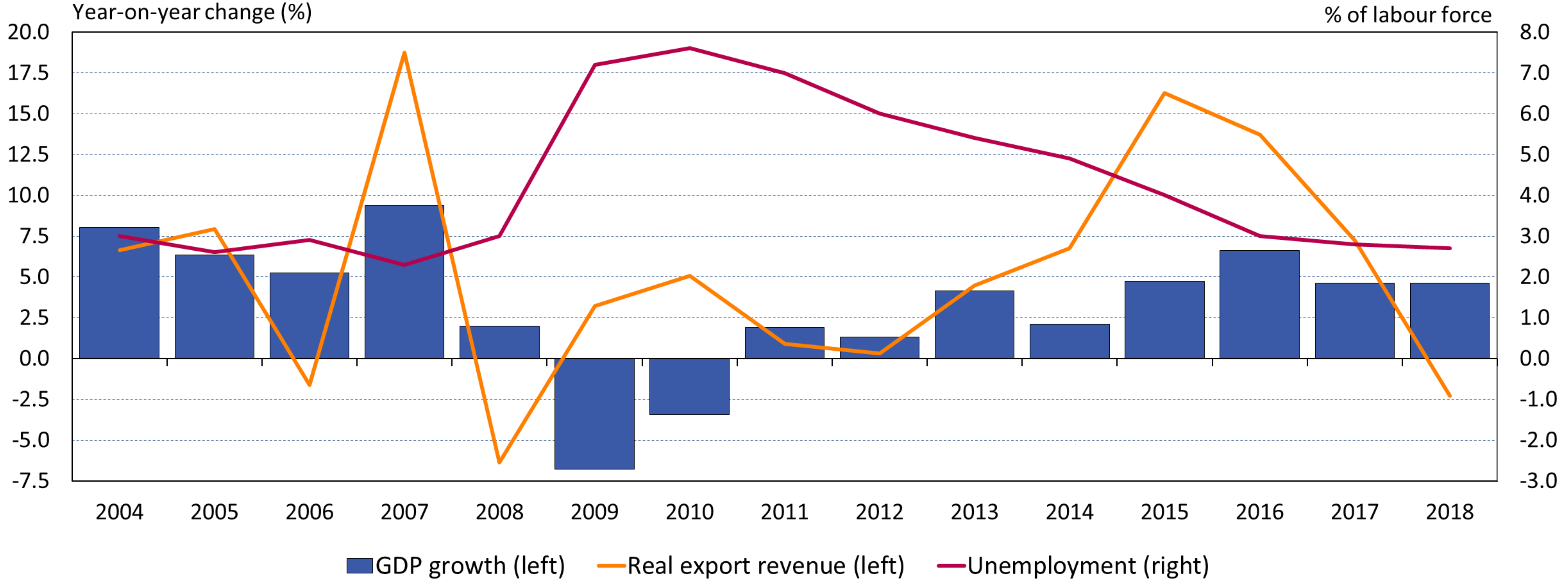


1. Current account balance and national saving based on estimated underlying current account balance in 2008-2015.

Sources: Statistics Iceland, Central Bank of Iceland.

Deep post-crisis contraction but full recovery with strong growth in export sectors

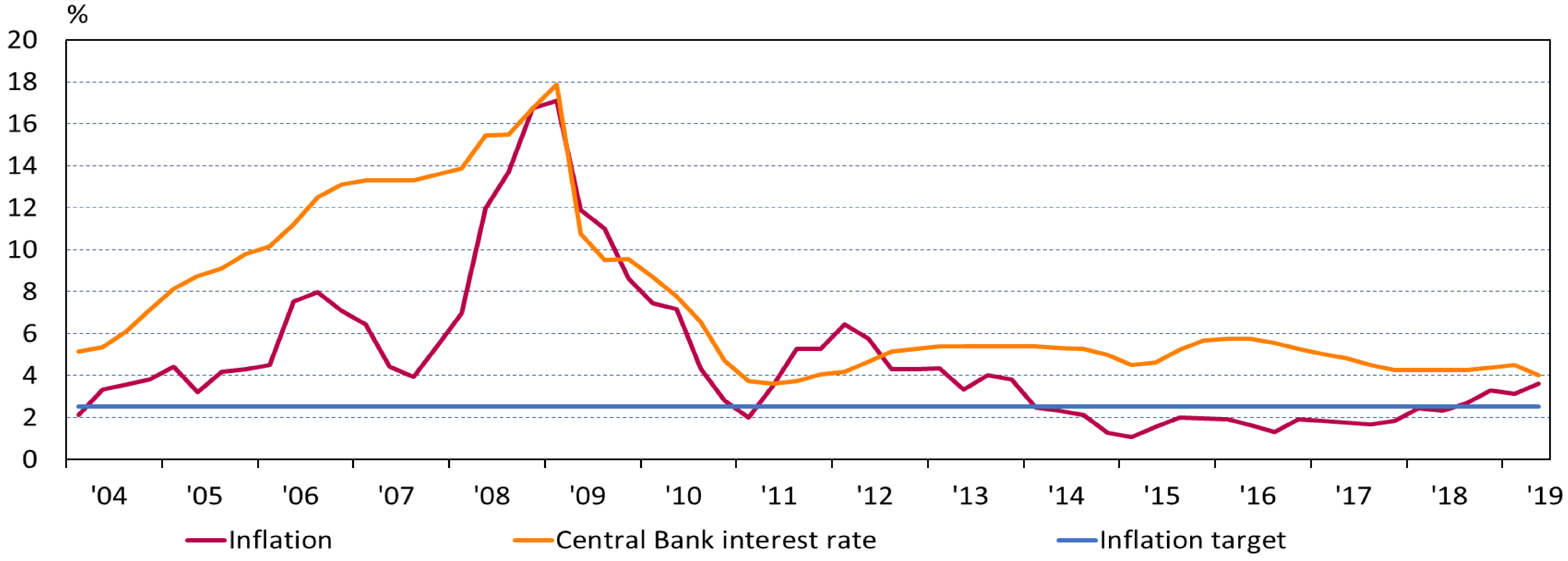
GDP growth, unemployment and real export revenue 2004-2018



Sources: Statistics Iceland, Central Bank of Iceland.

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.

What explains the success?

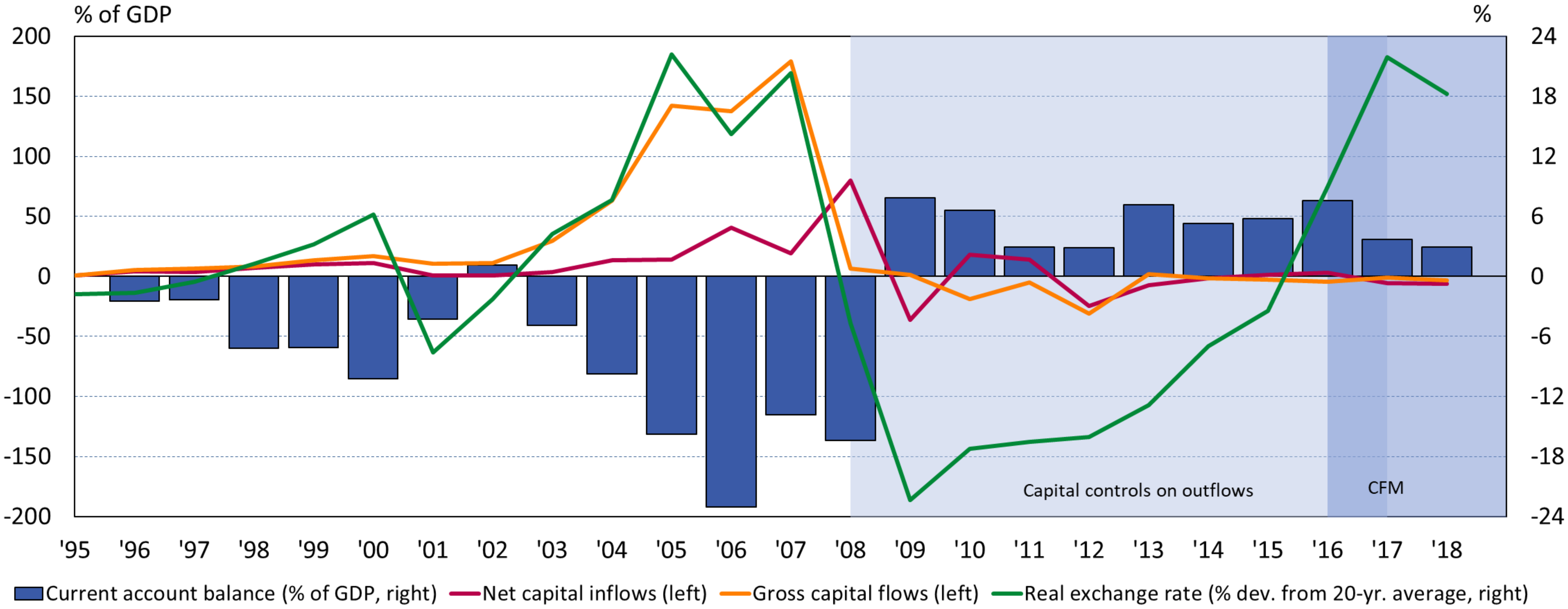
What explains the success?

- 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 MP and FP 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

Preserving stability in small, open and financially integrated economies (SOFIES)

The capital flow problem in Iceland

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.

Policy reforms in Iceland related to the SOFIE problem

- More active use of FX interventions – managed float instead of free float
- Tighter regulation of FX-risk:
  - LCR and NSFR in FX for banks
  - CB given powers to restrict FX lending to unhedged borrowers
- Macropru framework (FSC) and development and activation of "orthodox" macropru tools (e.g. countercyclical capital buffers and LTV)
- Capital flow management (CFM): special non-renumerated reserve requirement on capital inflows into the bond market and high yielding deposits. Originally (June 2016) 40% for a year – has now been taken to zero.

Some of the key lessons learned

Some lessons

- It is not save to let the whole banking system go under but banks can be to big to save. Preserve access to deposits and save the payment system
- Capital controls can be helpful under certain conditions
- The exchange rate can both be a shock amplifier and a shock absorber. There are policies that can help in this regard
- It is becoming more difficult to preserve monetary and financial stability in SOFIES
- It requires sound regulation and supervision of FX risk and more policy tools: FX intervention, macropru and sometime CFM