Iceland`s Recovery
Lessons and Challenges

Conference

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SAMTÖK ATVINNULÍFSINS

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Programme Elements

- Money
  - IMF: 2.1 billion USD
  - Nordics, Poland, Russia: 3 billion USD
- Economic programme
  - Exchange rate stability
  - Bank restructuring strategy
  - Medium-term fiscal sustainability

IMF Programme Needed

- Economic crash after banks´collapse
- Iceland was financially isolated and basically shut off
- Chaotic political stituation
- Social unrest
- Iceland needed financial help
- Iceland needed to rebuild confidence
- IMF Programme the first step

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Exchange Rate Stability
The Fund was thinking…

- *in the near term, restore confidence and stabilise the exchange rate through strong macroeconomic policies (Staff Report, page 4)*
- *Preventing a further sharp króna depreciation: by maintaining a flexible exchange rate policy and, in the near term, capital controls to stabilise the exchange rate (Staff Report, page 10)*
- *While current account restrictions should be lifted very soon, capital account restrictions might have to be maintained for a somewhat longer period. (Staff Report, page 11)*

Exchange Rate Stability
The government was thinking….

- *To temporarily maintain restrictions on capital account transactions. We realise that such restrictions have considerable adverse implications and intend to remove them as soon as possible. But their interim use is necessary until we have ensured that our monetary policy instruments are correctly calibrated to deal with the extreme uncertainty and lack of confidence that followed the banking sector collapse (Letter of Intent, page 6)*

What was the message?

- That all currency transactions related to current account transactions would be open and all normal business activity between Iceland and foreign business partners would be functioning without interference
- That the focus of capital account restrictions would be on the problem of ISK assets held by foreigners
- Expectations of 3 months duration of capital controls were created by official circles

The Outcome

- Wide ranging capital controls imposed on Nov 28, 2008
- First imposed as a provisional article for two years (end of IMF programme)
- Now extended to end 2013 as a permanent part of the currency trading legislation
- Who is responsible for this deception??

No Exit Strategy

- There was no exit strategy when the controls were imposed
- The Central Bank first issued an exit strategy August 5, 2009 without any clear timetable
- The Central Bank has always been much more concerned about enforcement, leakages and tightening than lifting the controls
- The controls will last forever if the goal is to preserve krona stability. The perfect excuse

Capital Controls Expensive Mistake

- Declaration of no-confidence in the króna
- Who should believe in the króna if the Icelandic government does not?
- Economic operators only choose the króna to pay for domestic costs or pay off debt.
- Long term pressure on lower króna value
- Inflows from substantial FDI projects can temporarily lead to króna appreciation
- Imbalances between export and domestic sectors create inflation risks.
- Deterrent for competition in the financial market, private companies even can�much borrow
- Brake on economic growth

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Bank Restructuring Strategy

- Old banks – new banks
- Estates of fallen banks with foreign assets
- Smaller domestic financial institutions
- Initially all 3 banks state owned
- Independent evaluation of asset values on balance sheets
- Chaotic and slow decision making process

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State Control

- Initial measures aimed at imposing state control over all financial market institutions
- The state as owner, legislator and regulator
- A state asset management company approved by Althingi
- Policy reversal as Arion banki and Islandsbanki were turned over to creditors
- No state asset management company set up
- Decisions decentralised and depoliticised

Competitive Financial Sector

- Danger of moving from too easy regulatory environment and lack of dicipline to overregulation and little tolerance of risk
- The customer always pays or carries the burden
- Need for restucturing and lower costs
- Cost of regulation
- Cost of new taxes
- Cost of higher capital ratios
- Cost of higher liquidity requirements
- Cost of closed market
- Iceland going nowhere without efficient financial market

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Medium-term Fiscal Sustainability

- Allow fiscal stabilisers to work in 2009
- Ambitious budget consolidation programme 2010 – 2013
- Positive primary balance 2012
- Positive overall balance 2013
- Necessary but difficult task
- Debt must be sustainable
- Increased net financial charges should be stabilised at a managable level

Budget Consolidation Successful

- Stability Pact with social partners in June 2009 spelled out targets for tax increases as 45% and expenditure reductions as 55% of consolidation measures
- Primary balance is still projected to be positive 2012 but the overall balance is projected to be positive 2014

Growth Strategy Missing

- In Staff Report November 2008
  - Cost of Crisis
    - GDP growth 2009 – 2010: - 9,9%
  - Recovery
    - GDP growth 2011 – 2013: 13,8%
- In Staff Report August 2011
  - Cost of Crisis
    - GDP growth 2009 – 2010: - 10,2%
  - Recovery
    - GDP growth 2011 - 2013 8,6%

Conclusions

- Success stories
  - Iceland got access to funds at time of need
  - There was a plan and dicipline
  - Necessary budget consolidation
- Criticism
  - Anti-market measures such as capital controls, state ownership of financial institutions and state asset management company
  - Lack of growth strategy

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