



LSE European Institute 'Challenges for Europe' Series:

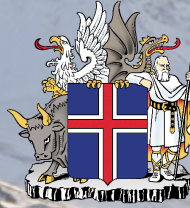
Iceland's Road to Recovery – Key Lessons

Speaker: Lilja Alfreðsdóttir, Iceland's Minister for Foreign Affairs and External Trade

Chair: Professor Kevin Featherstone, Head of the European Institute, LSE

Wednesday 19 October, 18:30 – 19:30
Hong Kong Theatre, Clement House,
LSE

Twitter Hashtag: *#LSEIceland*
@LSEEI



ICELAND'S BUMPY & UPHILL

ROAD TO RECOVERY

LILJA ALFREDSDÓTTIR
MINISTER FOR FOREIGN AFFAIRS

1. ICELAND AND THE GLOBAL FINANCIAL CRISIS
2. SUSTAINABLE ECONOMIC STRATEGY
3. OUTCOME
4. KEY LESSONS



THE REPUBLIC OF ICELAND

- POPULATION: **330 thousand**
- LIFE EXPECTANCY: **82 (♂) to 84 (♀) yrs**
- INDEPENDENCE: **1944**
- GDP: **16,7 Bn USD**
- GDP per capita: **50,5 K USD**
- CURRENCY: **Icelandic króna**
- CURRENT GOVERNMENT: **Two-party center-right coalition**
- FIFA RANKING: **27th**





BOOM LIKE NO OTHER

ICELAND AND THE GLOBAL FINANCIAL CRISIS:

ROBUST **ECONOMIC GROWTH** IN 2005 - 2007

- Net Government debt close to zero
- +5% fiscal surplus
- AAA ratings
- Banks well capitalized
- Banks profitable – big five auditors
- High policy rate
- Strong capital inflow (FDI & Carry trade)
- Strong institutions
- Qualified labor
- Inflation targeting framework
- Abundant, cheap credit at the global level.
- The IMF approves – “enviable prospects” (June, 2008)

ICELAND AND THE GLOBAL FINANCIAL CRISIS:

SEVERE **ECONOMIC IMBALANCES** IN 2008

CHALLENGES IN THE REAL ECONOMY

- Current Account Deficit of 26% of GDP
- Significant depreciation of the currency
- Strong capital inflow fueled a credit and asset price boom
- Capital outflow pressures

UNSUSTAINABLE BANKING SYSTEM (11 X GDP)

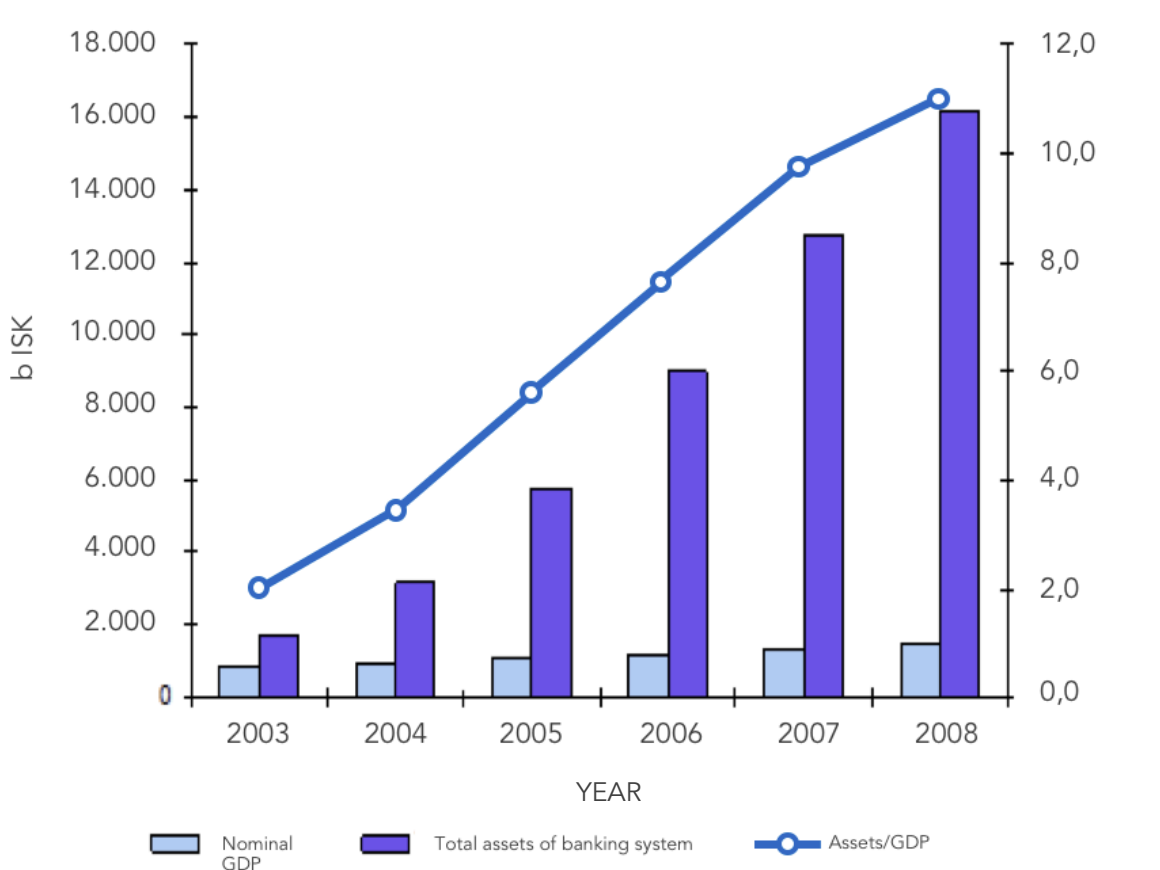
- Unfunded obligations where global liquidity was scarce
- Concentrated risk and connected lending
- FX assets were 70% of the balance sheet of the Icelandic banks
- Lender of last resort in FX not be found



ICELAND AND THE GLOBAL FINANCIAL CRISIS:

BANKING SYSTEM MUTATION IN ONLY FIVE YEARS

TOTAL BANKING ASSETS / GDP



A wide-angle landscape photograph of a tundra. The foreground is dominated by a dense carpet of green moss and small, vibrant red and yellow flowers. The terrain is uneven, with small mounds and depressions. In the middle ground, the tundra extends to a low horizon line. In the background, a large, dark, rounded mountain peak stands prominently against a dramatic sky. The sky is filled with soft, wispy clouds, transitioning from a warm orange and yellow glow near the horizon to a deep, dark blue and purple at the top. The overall mood is serene and majestic.

10 / 2008

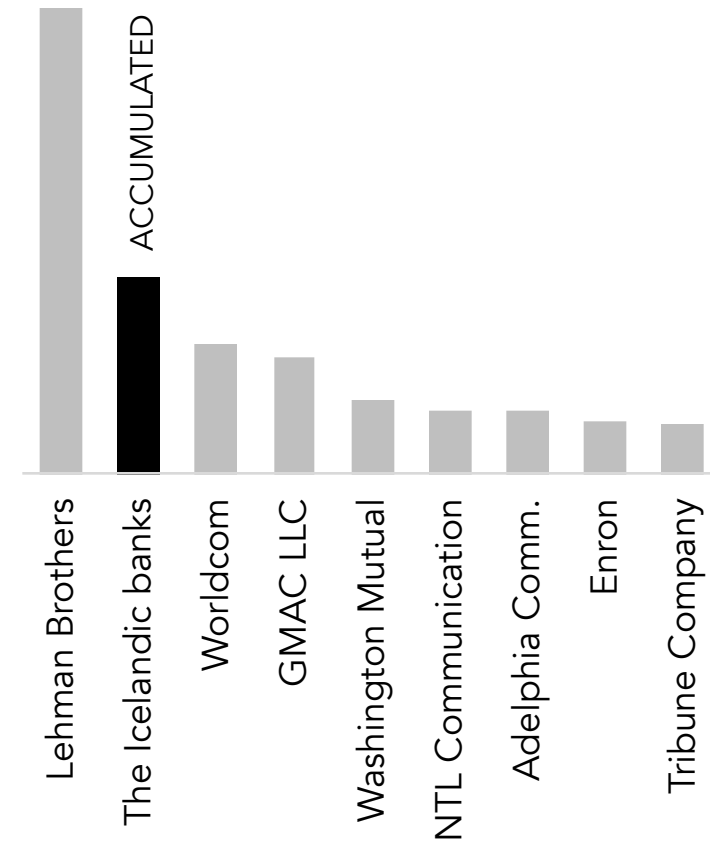
- IN OCTOBER 2008 **ALL THE MAJOR BANKS**, REPRESENTING 88% OF THE BANKING SYSTEM IN ASSET TERMS, **COLLAPSED IN ONE WEEK.**
- IN MARCH 2009 A SECOND WAVE INCREASED IT TO **97%.**
- LARGE INTERNATIONAL PRIVATE SECTOR DEFAULTS WERE A DEVASTATING BLOW FOR A **SMALL ECONOMY.**

ICELAND AND THE GLOBAL FINANCIAL CRISIS:

180th BIGGEST NATION: **2nd BIGGEST DEFAULT**

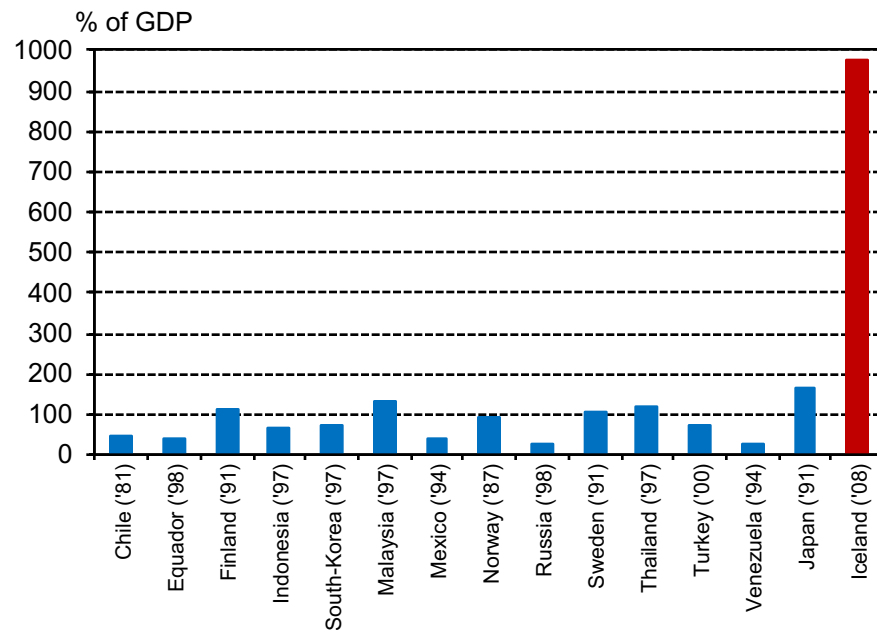
LARGEST MOODY'S - RATED DEFAULTS (1920 – 2008)

Corporate Family	Volume (US\$ Mil)	Default year	Genre	Domain
1. Lehman Brothers Holding	\$120,483	2008	FIRE: Finance	USA
2. Worldcom	\$33,608	2002	Telco	USA
3. GMAC LLC	\$29,821	2008	FIRE: Finance	USA
4. Kaupthing Bank	\$20,063	2008	Banking	Iceland
5. Washington Mutual	\$19,346	2008	Banking	USA
6. Glitnir Banki	\$18,773	2008	Banking	Iceland
7. NTL Communication	\$16,429	2002	Media	UK
8. Adelphia Communications	\$16,256	2002	Media	USA
9. Enron	\$13,852	2001	Energy	USA
10. Tribune	\$12,674	2008	Media	USA
11. Landsbanki	\$12,161	2008	Banking	Iceland



ICELAND AND THE GLOBAL FINANCIAL CRISIS: HUGE COMPARED TO **PREVIOUS CRISES**

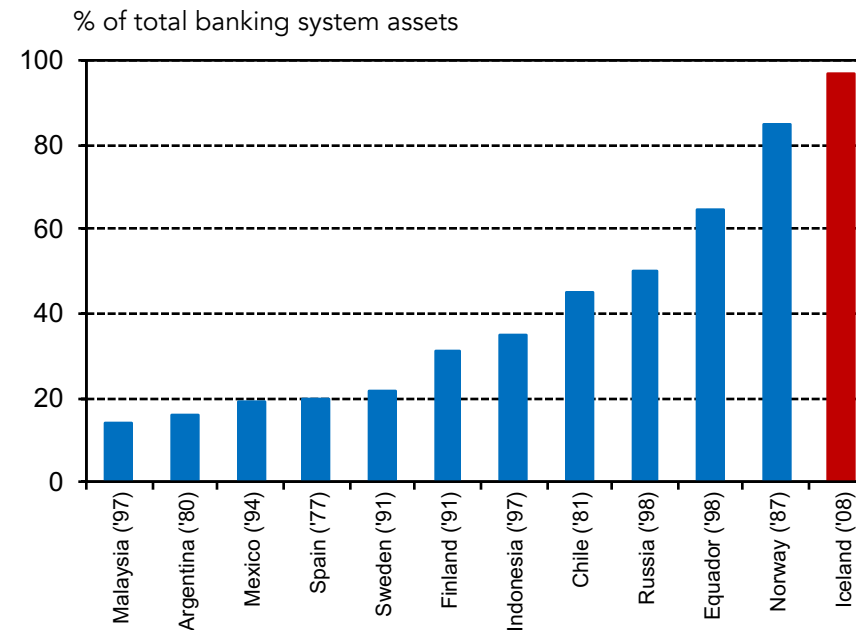
Commercial banks' assets in various previous financial crises



1. The year in parentheses represents the onset of the crisis in the country concerned.

Sources: Bank of England, Central Bank of Iceland.

Share of banking system in insolvency in various previous crises



1. The year in parentheses represents the onset of the crisis in the country concerned.

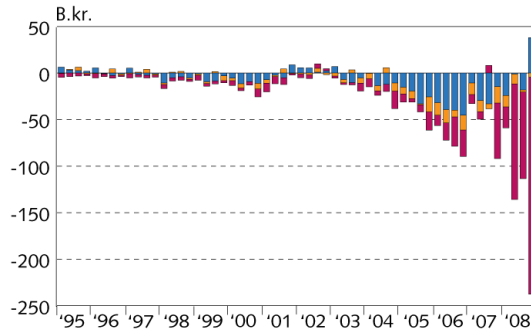
Sources: Caprio, Klingebiel, Laeven and Noguera (2005), Central Bank of Iceland.



ICELAND AND THE GLOBAL FINANCIAL CRISIS: **SHARP CHANGES ON ALL FRONTS**

COMPONENTS OF THE CURRENT ACCOUNT

Q1/1995 – Q4/2008

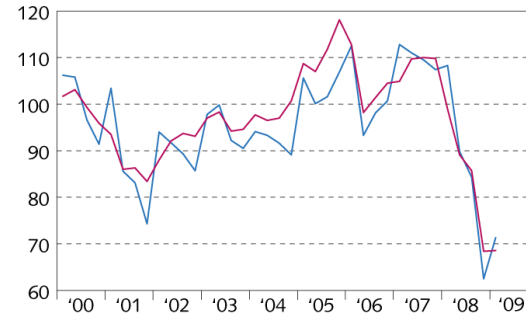


- Trade balance
- Services balance
- Income balance

1. Net current transfer is included in factor income.
Sources: Statistics Iceland, Central Bank of Iceland.

REAL EXCHANGE RATE QUARTERLY DATA

INDEX, AVERAGE 2000 = 100

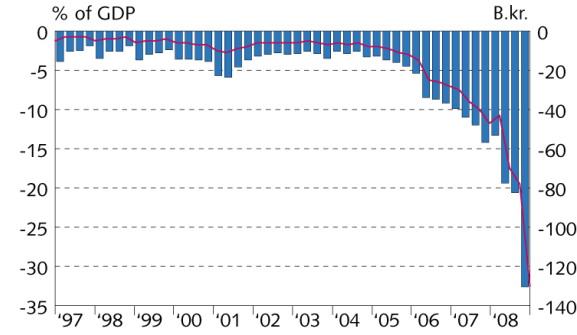


- Relative unit labour cost
- Relative consumer prices

Source: Central Bank of Iceland.

NET FOREIGN INTEREST INCOME

Q1/1997 – Q4/2008

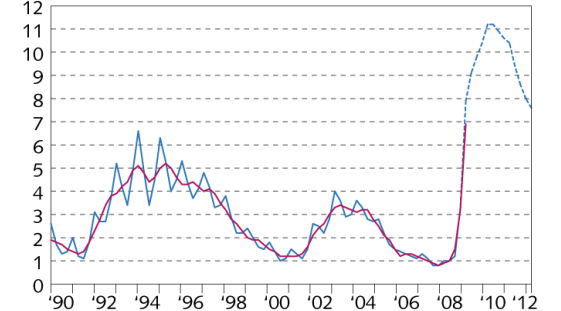


- Net interest income % of GDP (left)
- Net interest income (right)

Sources: Statistics Iceland, Central Bank of Iceland.

UNEMPLOYMENT RATE

% of labour force



- Unemployment
- Seasonally adjusted unemployment

1. Central Bank baseline forecast Q1/2009 - Q1/2012.
Sources: Directorate of Labour, Central Bank of Iceland.



ICELAND AND THE GLOBAL FINANCIAL CRISIS: & WHEN WE THOUGHT WE'D SEEN IT ALL: **ICESAVE**

- From 2006 to 2008 the UK & Dutch branch of Landsbanki accumulated deposits from 340 thousand people to their **Icesave Saving Accounts**.
- When Landsbanki collapsed the British & Dutch national deposit guarantee schemes covered repayment up to the maximum limit for the national deposit guarantees. **The British & Dutch states covered the rest**, and got claims towards the estate of Landsbanki
- They then made **claims against Iceland** to guarantee their claims on the estate of Landsbanki.

A close-up photograph of a person's hands holding a Rubik's cube. The person is wearing a dark, long-sleeved shirt. The Rubik's cube is partially solved, with some faces showing solid colors (white, yellow, blue, orange, green, red) and others showing a mix of colors. The text "CREATIVE SOLUTIONS NEEDED" is overlaid in white, bold, sans-serif font across the center of the image.

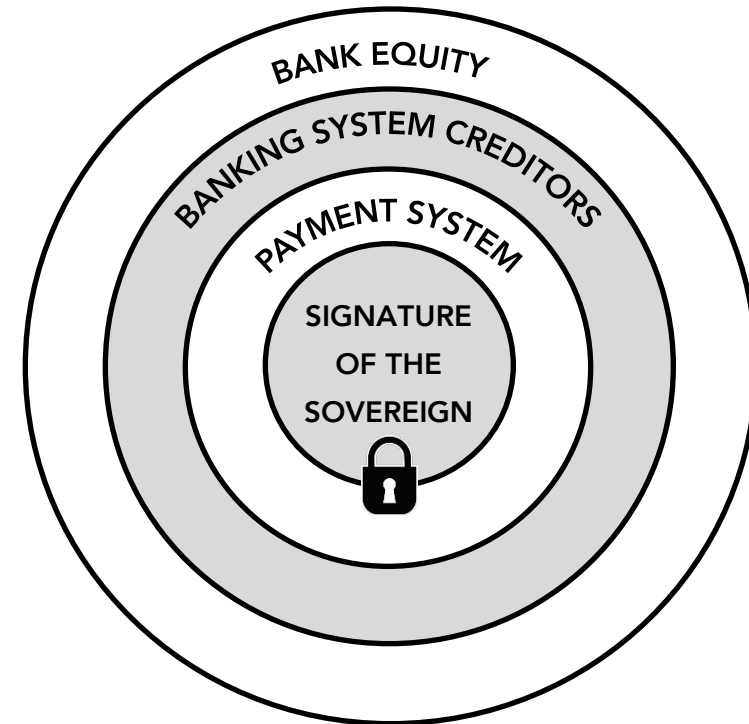
CREATIVE SOLUTIONS NEEDED

SUSTAINABLE ECONOMIC STRATEGY

RADICAL FIRST **RESCUE MISSION** STEPS

Strategy framework:

- **Ring-fence** the sovereign
- **Not socializing** the losses of the private sector
- **Banks split** into domestic and foreign operations



UNPRECEDENTED SITUATION AND ACTIONS

Emergency Act

- Taking over Operations
- Disposing of/or Merging
- Appointment of Resolution Committee
- Powers of Shareholders' Meetings

Deposits Guaranteed

- Priority of Claims

Capital controls

- To help to stabilize the exchange rate after the currency had depreciated fallen more than 50% in 2008

SUSTAINABLE ECONOMIC STRATEGY

SECOND WAVE OF ACTIONS

- IMF PROGRAMME
- STRUCTURED DEBT POLICY
- FAILED ESTATES APPROACH
- OFF-SHORE KRÓNA HOLDINGS



SUSTAINABLE ECONOMIC STRATEGY

\$2.1 BN **IMF PROGRAMME** + \$2.5 BN **BILATERALS**

- **Exchange rate:** Containing the negative impact of the crisis by restoring confidence and stabilizing the exchange rate in the near-term
- **Financial sector:** Promoting a viable domestic banking sector and safeguarding international financial relations by implementing a sound banking system strategy in a non-discriminatory and collaborative way
- **Fiscal position:** Safeguarding medium-term fiscal viability by limiting the socialization of losses in the collapsed banks and implementing a multi-year fiscal consolidation program

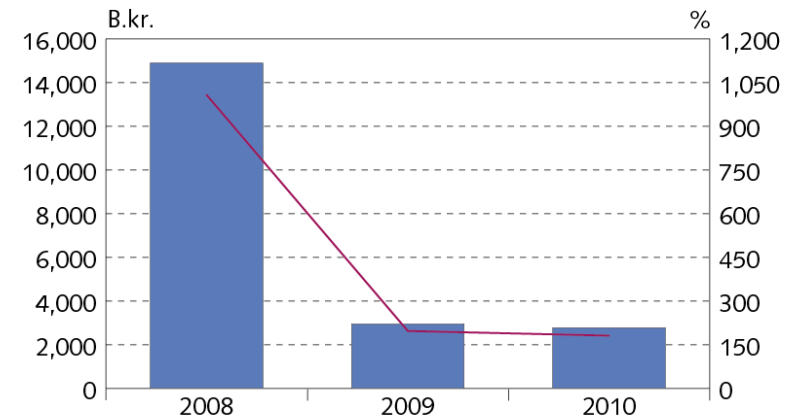
SUSTAINABLE ECONOMIC STRATEGY

RESTRUCTURING THE FINANCIAL SYSTEM

- Total assets of the financial system amounted to 7,600bn ISK at year-end 2010
- Banks and saving banks (DMB's) are the largest entity in the financial system
- DMB's assets totalled about 2,800 b.kr – just under two times GDP at the end of 2010 and declined year on year

DMB's TOTAL ASSETS

% OF GDP¹



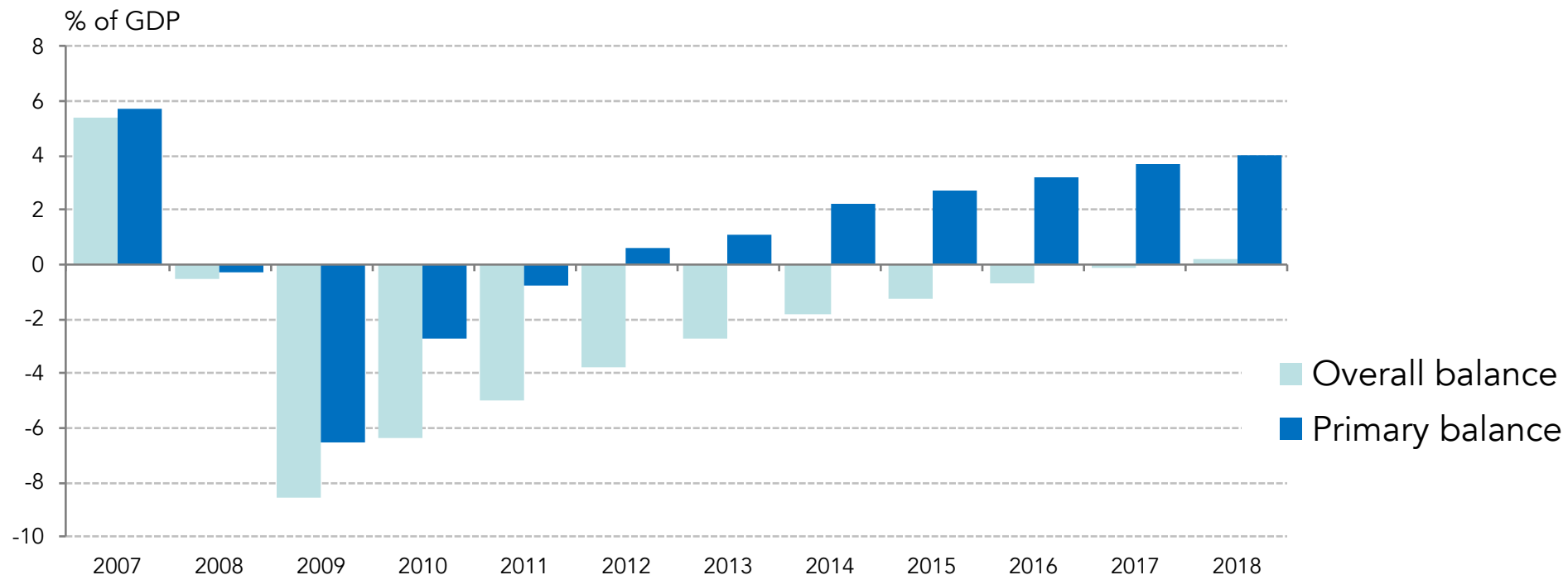
■ Total assets (left)
— Assets as % of GDP (right)

1. DMBs: September 2008, December 2009 and 2010. Parent companies.
Sources: Central Bank of Iceland.

SUSTAINABLE ECONOMIC STRATEGY

IMF PROGRAMME: **FROM FISCAL DEFICIT TO SURPLUS**

GENERAL GOVERNMENT BALANCE 2007-2018



Source: IMF Third post review August 2013.

LILJA ALFREÐSDÓTTIR, MINISTER FOR FOREIGN AFFAIRS



UTANRÍKISRÁÐUNEYTIÐ
Ministry for Foreign Affairs Iceland

SUSTAINABLE ECONOMIC STRATEGY

DEBT REDUCED BY STRUCTURED POLICY



GOVERNMENT

From **90%** to **60%** of GDP



CORPORATE

From **260%** to **100%** of GDP

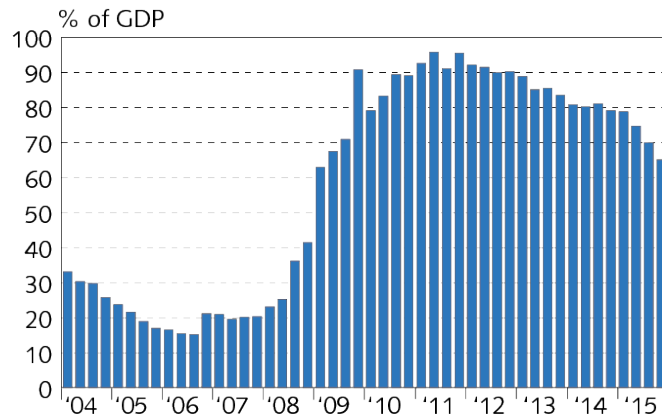


HOUSEHOLDS

From **126%** to under **80%** of GDP

GOVERNMENT DEBT AS % OF GDP

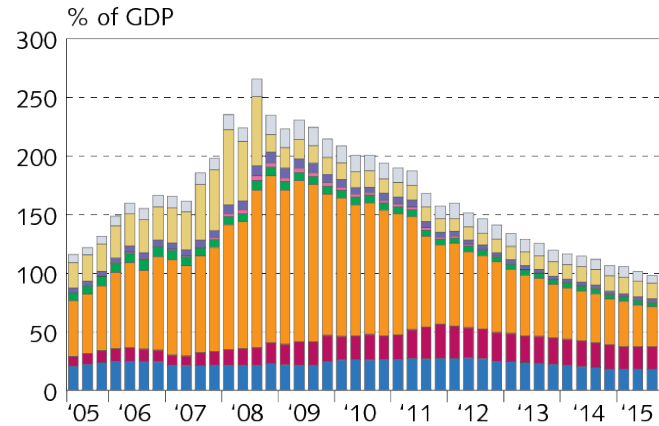
Q1/2004 – Q4/2015



Source: Statistics Iceland.

CORPORATE DEBT AS % OF GDP¹

Q1/2005 – Q4/2015

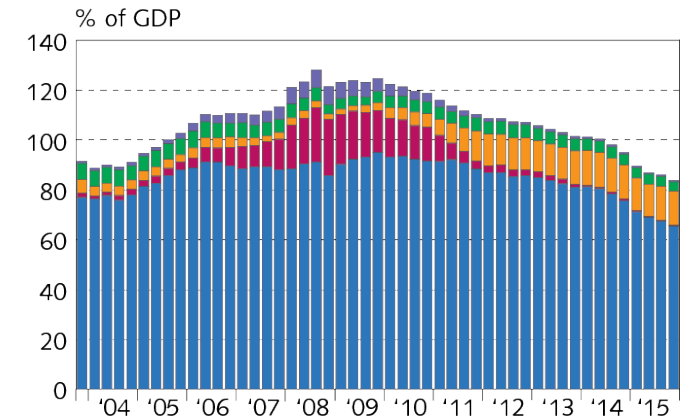


- Indexed
- Non-indexed
- FX loans
- Overdraft
- Asset financing agreements
- Domestic bonds issued
- Foreign bonds issued
- FX overdraft

1. Debt owed to domestic and foreign financial undertakings and market bonds issued. Excluding debt owed by holding companies.
Sources: Statistics Iceland, Central Bank of Iceland.

HOUSEHOLD DEBT AS % OF GDP

Q4/2003 – Q4/2015



- Indexed
- Foreign-denominated
- Non-indexed
- Overdraft
- Asset financing agreements

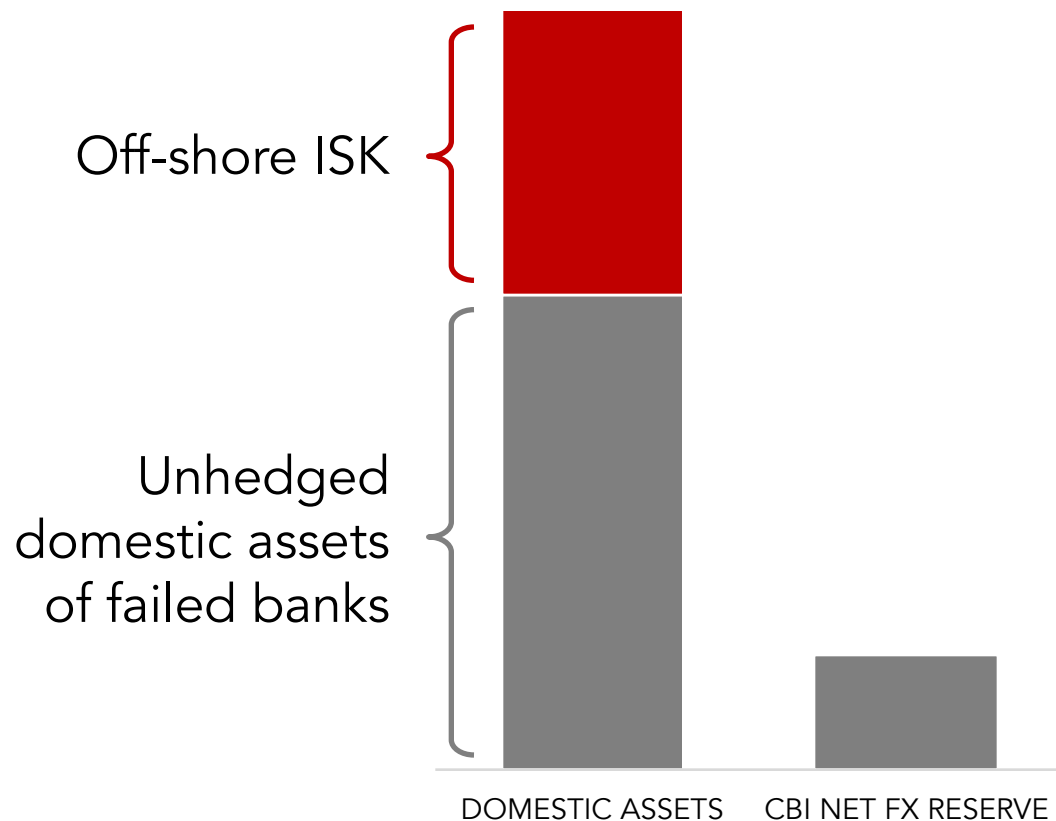
Sources: Statistics Iceland, Central Bank of Iceland.



RESOLVING LEGACY ISSUES PREREQUISITE FOR LIFTING CAPITAL CONTROLS

- The failed estates caused **balance of payments problem** as they had decent amount of domestic assets but the vast majority of creditors were non-residents
- The remains of the **pre-crisis carry trade caused balance of payments problem** as the trade is short term by nature
- Icelandic authorities introduced capital controls to maintain economic stability and **to manage the outflow** of capital

SMALL FX RESERVE - **ECONOMIC THREAT**

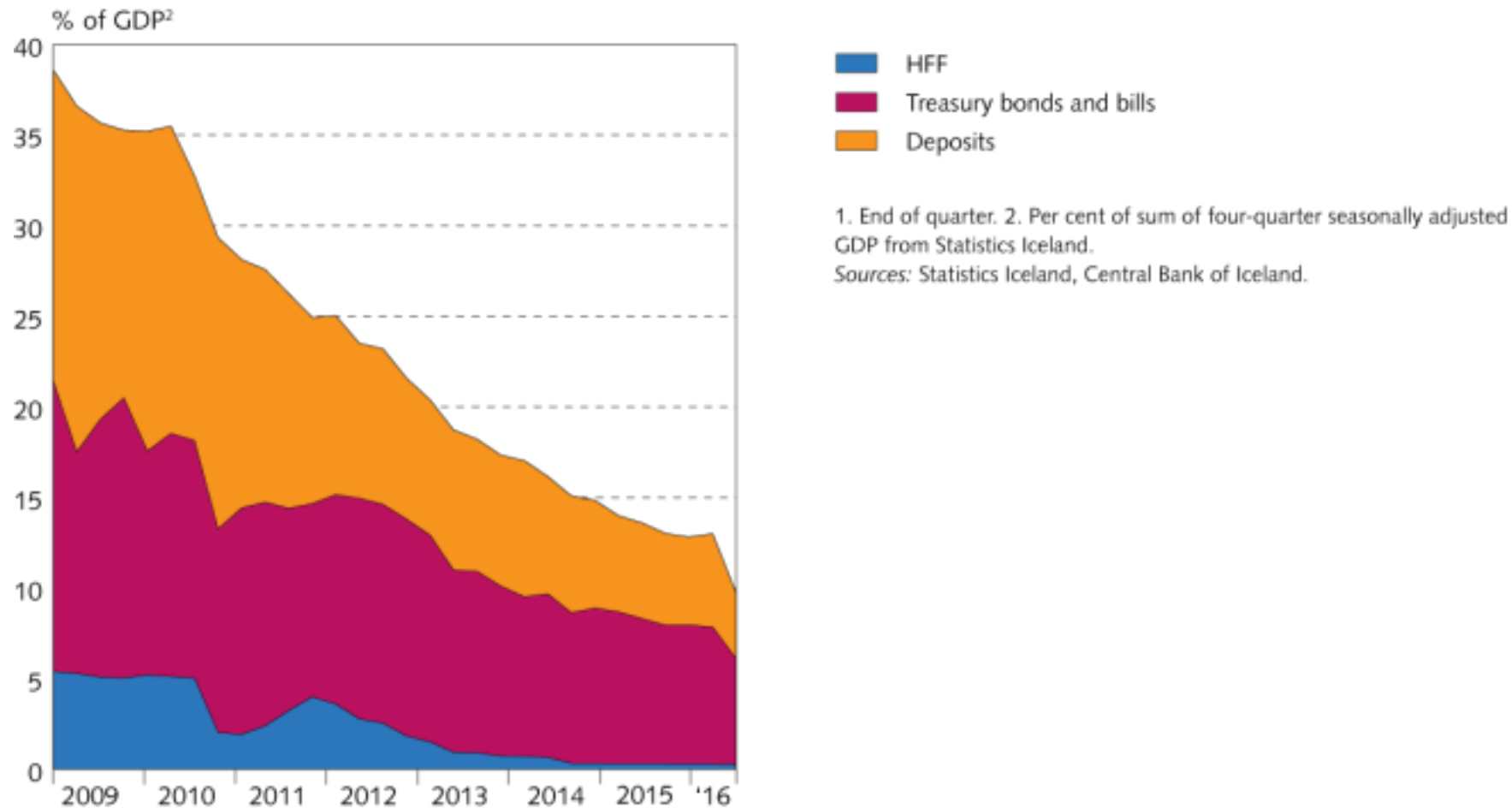


- Strategy: Failed estates to **fulfill stability criteria to mitigate the negative effect** on the balance of payments in order to receive exemptions from the capital controls, compose and make distributions to creditors
- Off-shore ISK holders offered to exit or extending term of position (23 currency auctions).

SUSTAINABLE ECONOMIC STRATEGY

OFF-SHORE KRÓNA **ASSETS**¹

OCTOBER 2008 – JUNE 2016



THE ICESAVE DISPUTE **RESOLVED**

- UK & Dutch authorities insisted on a guarantee by state of Iceland although they had a claim on the failed estate of Landsbanki
- The 2009 – 2013 Icelandic government negotiated with Dutch & UK authorities to guarantee the claims **plus interests**
- The **agreement was rejected twice** in a national referendum, instigated after the President of Iceland denied the government his signature of a law confirming the Icesave bill.
- UK & Netherland referred the case to the EFTA court, which **cleared Iceland of all charges**

A close-up photograph of a person's hands pointing at a map of Iceland. The person is wearing a grey knitted sweater, a blue watch, and several rings. The map shows various geographical features and place names in Icelandic, including Húsavík, Höfjökull, and Vatnajökull. The text "SO, WHERE ARE WE NOW?" is overlaid in large, white, bold letters across the center of the image.

SO, WHERE ARE WE NOW?

OUTCOME:

IN 2016 ICELAND IS **BACK ON ITS FEET**

- Robust **GDP growth** of 4,9%
- CA **surplus**
- **Low** inflation
- **Low** unemployment rate
- Significant **debt reduction**; government, corporates & households
- **Appreciation** of the real exchange rate
- Net International Investment Position from -120% of GDP to almost a **balance**
- **Net surplus** of the financial crisis for the government
- Significant **FX inflow** – increase in the net foreign reserves



OUTCOME:

A3 – STABLE OUTLOOK

“**The upgrade** of Iceland’s government rating reflects the speed and extent of the country’s recent **progress in recovering** from its 2008 crisis. Sustained growth and fiscal restraint allowed a very sizeable **reduction in government debt** over the past year, which is **expected to continue** and to be sustained with the deployment of the proceeds of the failed banks’ estates over the coming years.”

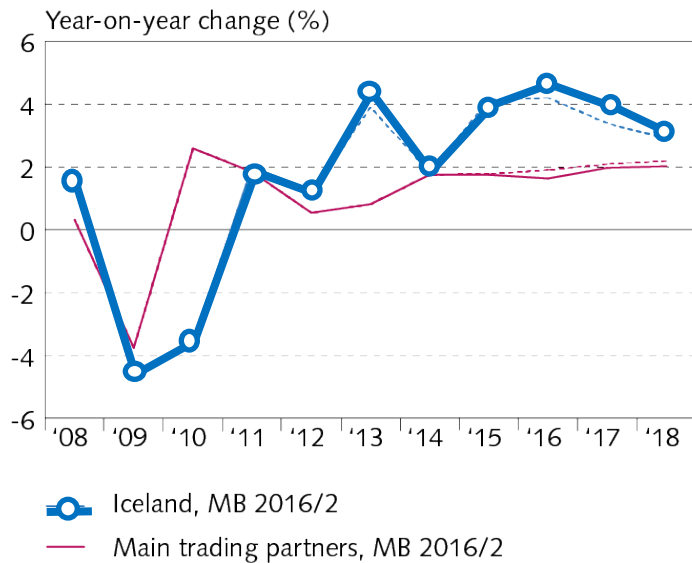
MOODY’S

SEPTEMBER 2016

OUTCOME: STRONG ECONOMIC GROWTH

GDP GROWTH IN ICELAND & TRADING PARTNERS

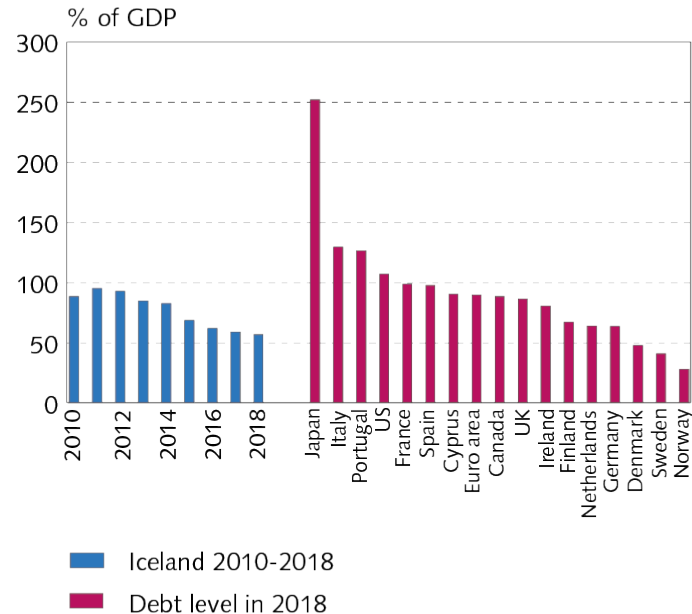
2008 – 2018¹



1. Central Bank baseline forecast 2016-2018. Broken lines show forecast from MB 2016/1.

Sources: Macrobond, Statistics Iceland, Central Bank of Iceland.

GENERAL GOVERNMENT GROSS DEBT



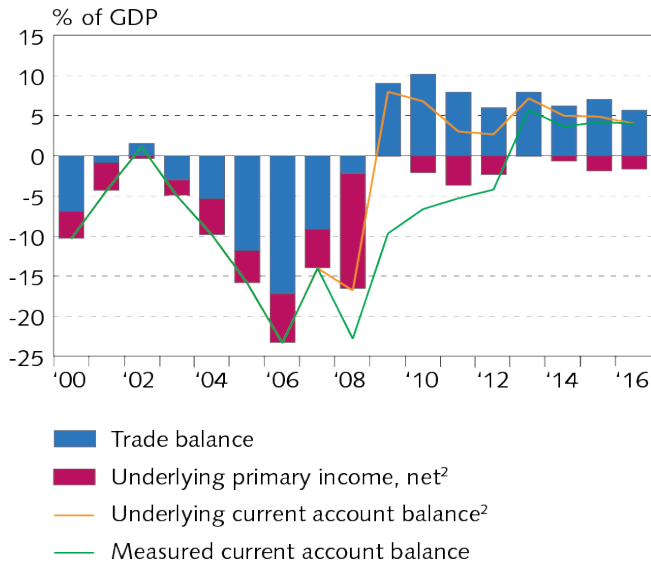
Sources: International Monetary Fund, Ministry of Finance and Economic Affairs, Central Bank of Iceland.



OUTCOME: CURRENT ACCOUNT SURPLUS

CURRENT ACCOUNT BALANCE

2000 – 2016¹

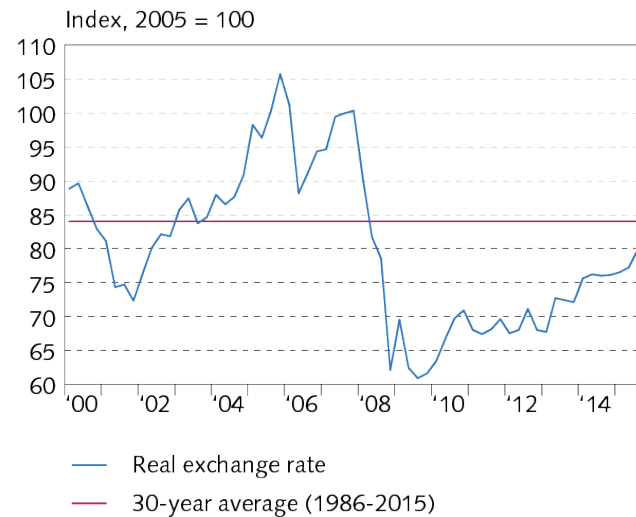


1. Including secondary income. Central Bank baseline forecast 2016.
2. Excluding the calculated income and expenses of DMBs in winding-up proceedings and the effects of pharmaceuticals company Actavis on the balance on income until 2012. Also adjusted for the failed DMBs' financial intermediation services indirectly measured (FISIM). With the recent settlement of the failed banks' estates, as of 2016 there is no longer any difference between headline and underlying current account numbers.

Sources: Statistics Iceland, Central Bank of Iceland.

REAL EXCHANGE RATE

Q1/2000 – Q4/2015



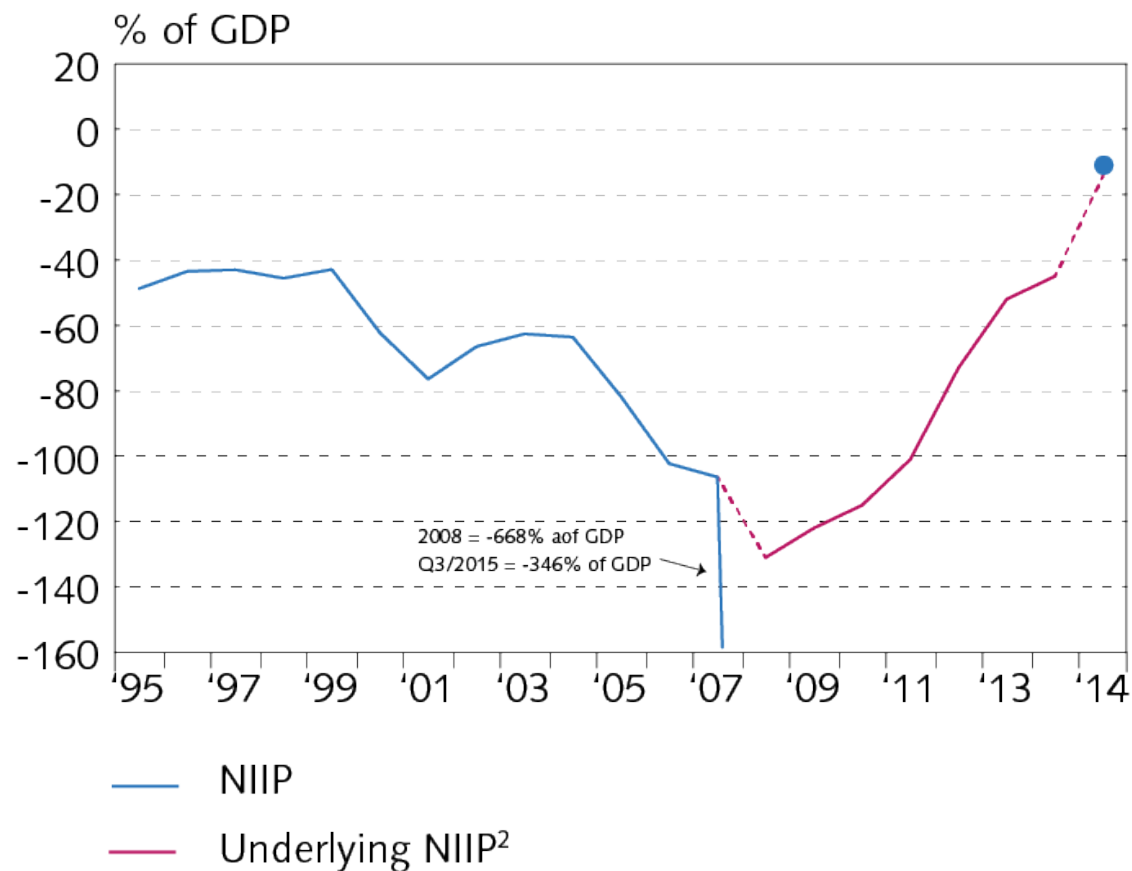
Source: Central Bank of Iceland.



OUTCOME:

NIIP POSITION **CLOSE TO BALANCE**

NET INTERNATIONAL INVESTMENT POSITION¹

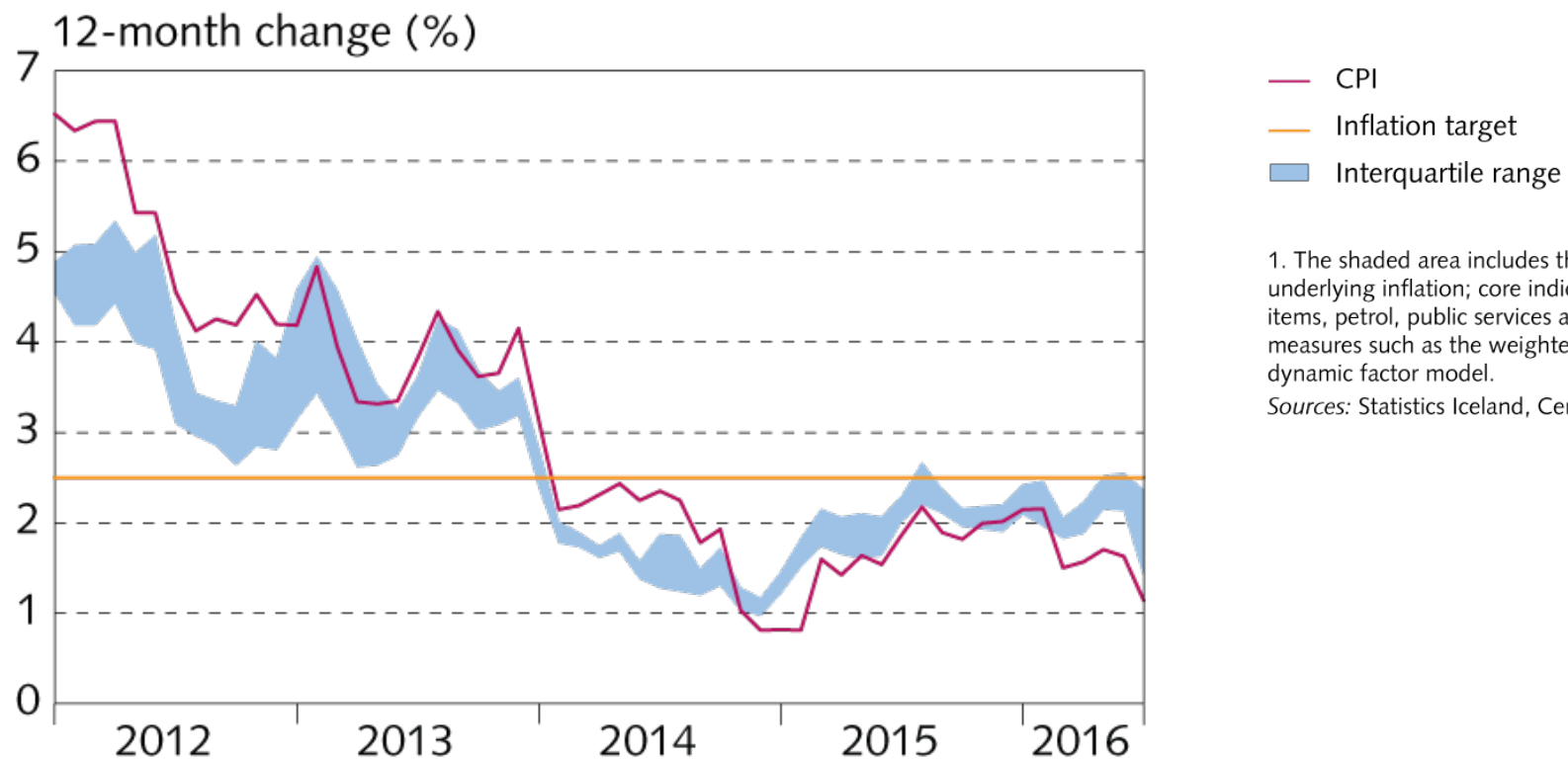


1. At the end of 2015, the estates of the failed financial institutions reached composition agreements entailing the write-off of a large portion of their debt. As a result, there was no difference in the NIIP and the underlying NIIP at year end 2015. 2. Adjusted for the effects of settlement of the deposit institutions in winding-up proceedings, assuming equal distribution of assets to general creditors until Q4/2015.

Sources: Statistics Iceland, Central Bank of Iceland.

OUTCOME: INFLATION IS **LOW**

HEADLINE AND UNDERLYING INFLATION¹



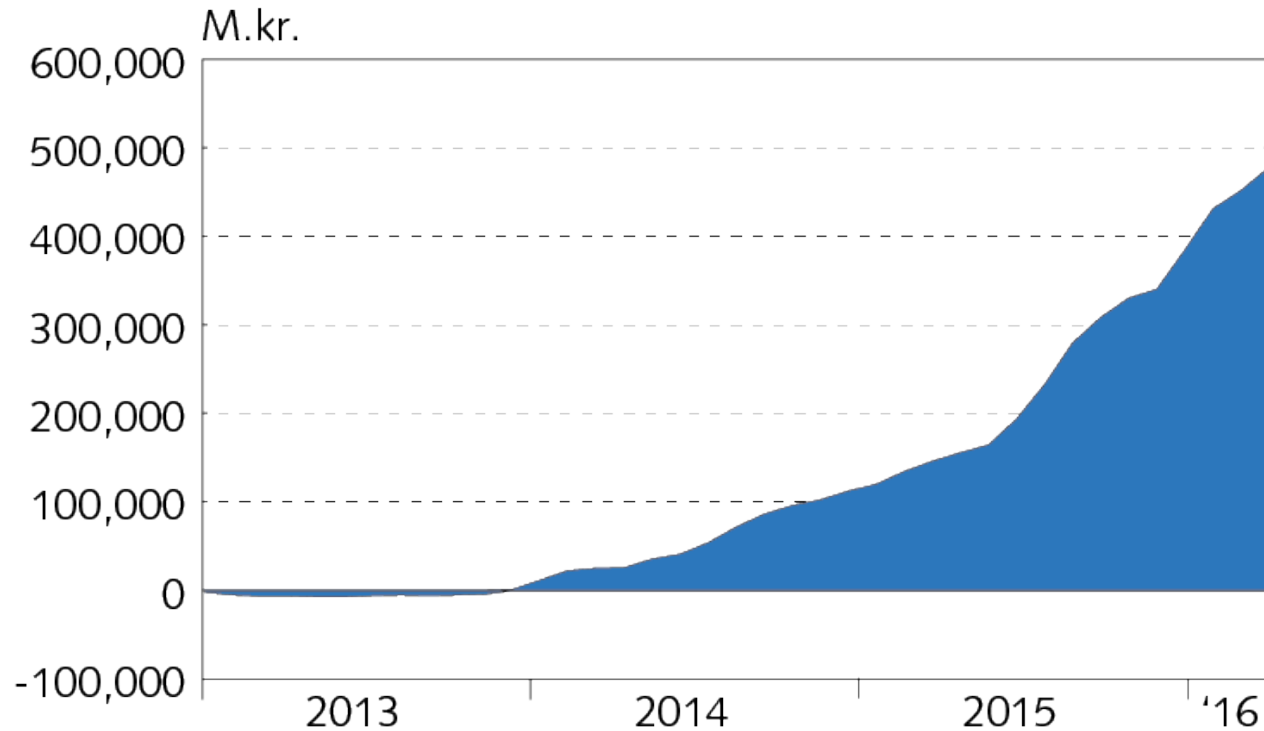
1. The shaded area includes the interquartile range of estimates of underlying inflation; core indices that exclude the effects of volatile food items, petrol, public services and owner-equivalent rent and statistical measures such as the weighted median, the trimmed mean and a dynamic factor model.

Sources: Statistics Iceland, Central Bank of Iceland.

OUTCOME:

FX INFLOW & **GROWING RESERVES**

ACCUMULATED CENTRAL BANK INTERVENTION
IN THE FX MARKET FROM JANUARY 2013



OUTCOME:

EXTERNAL CONDITIONS **HAVE HELPED**

- SIGNIFICANT **GROWTH** IN TOURISM
- **LOW** OIL PRICES
- LOW INTERNATIONAL **INFLATION**
- **FAVORABLE** COMMODITY PRICES



A young man with dark, curly hair, wearing a grey hoodie and dark pants, stands in a library aisle. He is looking down at a book he is holding in his hands. The aisle is lined with tall bookshelves filled with books, creating a sense of depth. The lighting is soft and even. The text "WHAT HAVE WE LEARNED?" is overlaid in the center of the image in a bold, white, sans-serif font.

WHAT HAVE WE LEARNED?

KEY LESSONS

- The sovereign must be **protected by all means**
- Capital controls provide **vital breathing space**
- **Extensive analytical work** in policy making is crucial
- Strong **political ownership** of policies is necessary
- **Domestic engagement** is a deciding factor
- **Capital Flow Management** is important to small open economy

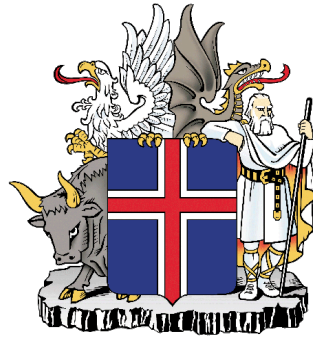
DONE IN 60 SECONDS: **THE BASICS**

1. Iceland suffered an severe economic blow when the banking system collapsed in 2008.
2. The currency depreciated by +50%. Unemployment shot up. Inflation reached double digits and foreign currency reserves were depleted. The current account turned negative by 26%. Gross sovereign debt increased by 60%. Households and companies became heavily indebted.
3. Sovereign ring fenced. Capitol controls implemented. A decision made to not socialize private losses. Domestic deposits guaranteed. International bank-operation split from domestic. Failed bank-estates threat to economic stability avoided. Debt write-offs to households and companies. Currency auctions.
4. Economic growth and fiscal surplus. 2% unemployment rate and inflation below target. Current account surplus and appreciation of the exchange rate. FX inflow bolster reserves. Gradual removal of capitol controls.



ROAD TO RECOVERY

LILJA ALFREÐSDÓTTIR
MINISTER FOR FOREIGN AFFAIRS

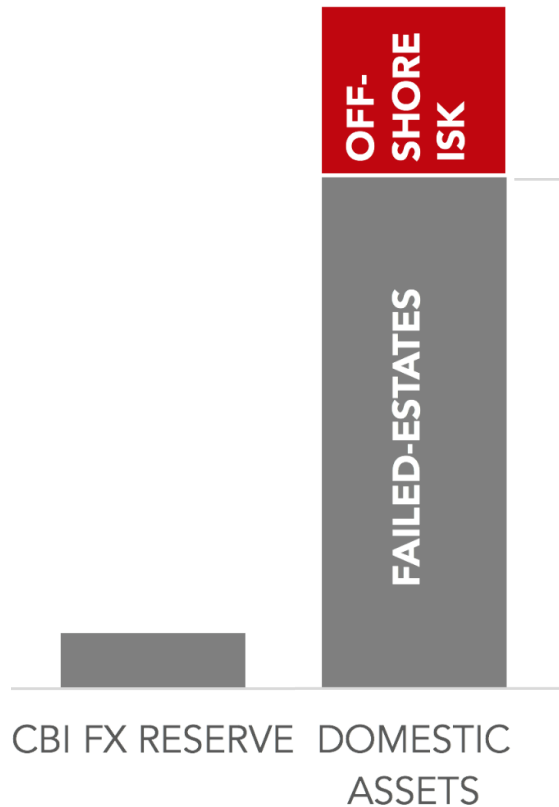


OFF-SHORE ISK HOLDERS **TREATED FAIRLY**

- Iceland is not specifically addressing the concerns of the remaining ISK holders.
- They have operated on the same information as all other stakeholders and they **arrived at their own decisions**.
- Remaining offshore ISK holders bought assets **after capital controls** were put in place at low prices. **They have not suffered losses** as a result of capital controls and our process to remove them.
- A vast majority of the offshore krona holders have participated in the auctions
- The hedge funds in questions **decided not to participate** in the auctions and subsequently their assets were moved to special accounts **as had been prescribed**.
- Hedge funds' profits will not be put ahead of the well-being of Icelanders and the stability of our economy.
- The Icelandic Government has honoured all its government debt in full and on time since the Republic was founded in 1944.

SUSTAINABLE ECONOMIC STRATEGY

CRUCIAL TO **ELIMINATE BOP PRESSURES**



23 CURRENCY AUCTIONS (LATEST IN JUNE 2016)

- TO EXIT OR EXTENDING TERM OF POSITION

STABILITY CRITERIA

- STABILITY CONTRIBUTION EQUIVALENT TO MORE OR LESS **ALL ISK DENOMINATED ASSETS**
- LONG-TERM FINANCING OF NEW BANKS