ICELAND'S RECOVERY

Opening remarks

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When the IMF mission came to Iceland in October 2008 they described the situation as the *Perfect Storm.*

Everything that could go wrong went wrong at the same time.

We had a banking crisis that here, as everywhere else, was the result of reckless banking practices and systemic undervaluation of risk. The bankruptcies of the three big Icelandic banks each rank among the ten biggest corporate bankruptcies in world history. And these three banks have the dubious distinction of being the first A-rated enterprises in history to default.

We had a currency crisis which threatened to evolve into a ruinous downwards spiral.

We had a drastic downturn which was an unavoidable consequence of the overheating of the economy in the years before.

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What was seen as a disaster for Iceland three years ago is increasingly being seen as good fortune with the passing of time. Icelanders may have lost their financial system but instead they were spared the burden of nationalizing private debt.

Although the banking system defaulted, the Sovereign of Iceland has never defaulted and remains solvent with debt levels close to the European average of between 80% and 90% of GDP.

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The Icelandic emergency measures in early October 2008 and subsequent policy is founded on a single principle, namely that <u>we cannot accept the socialization of losses.</u>

We applied this principle in the face of a bank run both home and abroad, and pending collapse.

The response took the form of the Emergency Legislation which had two main points:

First, deposit holders were given priority to the bond holders of the banks.

Second, all domestic assets were transferred, along with deposits, to new banks at a "fair" value.

The new banks, capitalised by the State, then assumed the role of the old banks in the payment system. The international operations of the old banks were however put into liquidation in regular bankruptcy proceedings.

In the process the system shrunk from being 10 times Iceland's GDP to about 2 times GDP. The new banks had to operate without a balance sheet for a year while "a fair value" price of the transferred assets from the "old banks" to the "new banks" was negotiated ex post with the defaulted estates. In the end, the debate on the fair price of the assets was solved with the creditors of two out of three of the old banks taking ownership by placing capital into the new banks and thus ensuring their stake in an Icelandic recovery.

The bondholders of the banks had to accept being put behind depositors in the order of claims. Would they have been better off without the Emergency Legislation? One thing is certain: The value of Icelandic assets would have been decimated in the economic catastrophy that would have followed the collapse of the payment system and the illiquidity of both households and corporates in Iceland. No state can economically or politically freeze the domestic deposit base in a defaulted estate. Through the Emergency Legislation the Government ensured the vital interests of the Icelandic economy and thus much better recovery for all parties involved. I am pleased that most foreign banks now appear to appreciate this fact and do not hold grudge towards us for taking these measures.

The IMF was, as were others, hesitant towards this approach. The common wisdom at the time – and still is to certain extent, was that governments should, at all costs, prevent banks from failing. Our approach – defining the strategically vital operations of a bank and refinancing those – was widely considered heresy back in 2008. But it is now reflected and recognized in one way or the other in recent reform proposals in most countries.

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We have been firm in avoiding socialisation of debt. We have also applied that principle to domestic debt-restructuring. We want debt in excess of ability to pay to be written off.

As a result of the methodology used in the separation between the old and the new banks, the new banks are well capitalized and are mostly funded with deposits. In the process of the transfer, their assets were subjected to very stiff precautionary write-offs and their balance sheets have been thoroughly house-cleaned. That effectively means that the new banks have the ability to restructure both corporate and household debt and still maintain solvency, and hopefully have an upside when the economy picks up again.

We have developed a variety of stimulants through regulation and surveillance in order to encourage financial institutions to realise losses and write off debt as much as possible, as quickly as possible. That is an existential need for a highly leveraged economy. We expect banks and their owners to shoulder the costs of reevaluating their debt portfolio.

So inactivity is not an option.

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We also applied this principle by refusing to prepay the UK and the Netherlands for their payment of deposit guarantees to their citizens with Icesave accounts. We did not consider us under a legal obligation to do so and therefore we didn't.

In this respect I have to recall the unhappy experience of Iceland, when our application for an emergency stand-by from the IMF in November 2008 was repeatedly held up, as a result of pressure from the UK and Dutch Governments over the Icesave issue. Initial delays were eventually overcome through constructive and innovative approach taken by the IMF staff and several board members, for which we are greatful. These delays did however damage our sense of the fairness we had expected from multilateral international organisations based on equal treatment and the rule of law.

From the outset we pointed to the fact that the Emergency Legislation ensured priority of all deposits and thus depositors would be made whole. The Government went far in seeking a negotiated resolution of this difficult dispute, but we were twice refused consent by our public, which held dear the principle that we should not socialize losses through shouldering burdens which we were not clearly legally obliged to carry.

Now we see that the resolution process of the fallen banks will recover sufficient funds for all depositors to get reimbursements. Thus, in all likelihood no depositor, regardless of nationality, will lose a single cent of deposits. That fact is a singular praise for the methodology used in the Emergency Legislation.

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The cooperation with the IMF has indeed been very beneficial and dynamic. But many were sceptical towards this co-operation and some downright hostile. For most of us it was a defining moment: Would Iceland use this opportunity to reconnect to the wider world and seek to learn from international best practise or would fear ensure that we would dig us deeper into the hole, convince ourselves yet again that foreigners were generally lacking in understanding of all things Icelandic and shirk from our responsibility to make things right? We took the right decision.

The co-operation has had many benefits.

Although the private sector was heavily indebted, the Government was virtually free of foreign debts, net of foreign reserves, in 2008. The crisis changed this picture, as

revenues fell and the State had to carry the cost of capitalising new banks. This cost from the crisis has been tallied and accounted for under the auspices of the IMF and we can safely say that there are not hidden or implicit liabilities. Moreover, we have gained valuable assistance in creating a credible path towards a balanced budget by 2014.

The relationship prompted us – as well as the IMF mission – to be innovative. There has been complete frankness on both sides, true transparancy and great willingness to seek solutions to all the myriads of problems that had to be solved.

Let me mention examples:

In late November 2008 we introduced severe capital account restrictions. We moved on the advice of the IMF, which is no advocate of capital controls. The advice was a departure from traditional IMF thinking, but an unavoidable decision to take.

Contrary to the criticism levelled at the IMF in the 1990´s, fiscal adjustment was effectively delayed as the Icelandic IMF plan foresaw us making full use of the automatic stabilisers – the unemployment and welfare benefits – for the first year of the program. It helped us to deal with the situation much more effectively than otherwise would have been the case and helped to avoid a much more severe downturn.

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The biggest remaining challenge is making sure that Iceland can thrive in the future as a free and open market in a globalised world.

Since the Icelanders were unable to smooth their way out of crisis with near-zero interest rate and quantitative easing, like larger currency areas were able to, the macroeconomic adjustment was both rapid and painful led by sharp depreciation in Icelandic krona. The average Icelandic household has seen a 30% reduction in purchasing power since 2008 and the country is now running a merchandise trade surplus of 10% of GDP. Iceland is now well on its way in achieving an export based recovery. It is therefore easy from the outside to make the case for the Icelandic krona and see only the benefits brought by the floating exchange rate for the economic recovery.

That is however only one side of the story and I am afraid we can not allow us such a romantic and short term view of the whole currency question. The krona was a major factor in getting us into trouble in the first place.

The banking crisis was preceded by a currency crisis. The Icelandic Central bank raised interest rates to stem inflation. High interest rates in an open economy attracted carry-trade and an endlessly appreciating krona encouraged unsustainable foreign borrowing by households and the corporate sector. The krona had therefore placed us in an economic strait-jacket, well before the events of 2008.

The fall of the krona also excacerbated the problem of overindebtedness of the private sector. With 70% of all corporate lending in foreign currency almost all equity in the corporate sector has been wiped out. This is the biggest single reason for anemic investment and growth: Overindebted companies do not invest. Similary, with the household sector overindebted and nearly the entire stock of mortgages linked to inflation, mortages have increased by more than 30% and interest payments as a share of total disposable income have risen from 20% in 2008 to over 30% in 2010. How are households to smooth consumption over time and make plans for the future when they face such uncertainties? The fall of the exchange rate may therefore have eased the shock in the labour market, but the position of the household and corporate sector has been dire nonetheless due to these severe balance sheet effects.

This leads us to the more existential question about whether Iceland can continue to be a part of the European single market with its own very small national currency. As our Central Bank Governor has repeatetly pointed out, Iceland's own experience shows the contradiction between a single European regulatory framework for financial services, on the one hand, and the national frameworks for crisis management and resolution on the other. This framework allows for risks that banks from small countries with independent currencies are more exposed to than others. Moreover, recent research shows that flexible exchange rates increase the risk of a banking and currency crisis while they seem to create problems for policy makers - without solving any – for small rich economies.

Iceland‘s ability to be a free and open economy is closely linked to the question of our future currency framework. An independent krona requires at least some restrictions on free movement of capital. Will the krona be worth the restrictions?

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All over the western world questions are being asked about the sustainability of the financial system. Most of our countries have for a long time been on an unsustainable path in terms of debt levels and growth prospects. Can we address our problems only through the traditional means of austerity and more borrowing – one or the other? I don't think so. The longer term success – both economic and democratic – will depend on the level of structural reforms undertaken. We can not thrive in societies lacking social cohesion. The social contract stands for both an active safety net **and** equal opportunities for all. We now see groups within society and even entire generations having little hope of meaningful employment and finding themselves excluded, while others enjoy relative job security. Some workers have to make do with the basic pension while others enjoy more generous provisions. These examples are endless. Structural reforms, taking on vested interests and empowering people may be difficult but they are absolutely essential.

We can not base prosperity on the participation of the few and disillusionment of the many.

I am often asked what lessons can be drawn from the Icelandic experience for the wider world. Paul Thomsen, the first IMF mission chief, yesterday described what this society went through in 2008 as “a near death experience”. It has certainly been a difficult journey but we have used this experience as an opportunity. Maybe that is the lesson to be drawn: Difficulties provide opportunities. They force you to focus on your relative strenght and enable you to deal with weaknesses, in spite of the general resistance to change. That opportunity needs to be seised by responsible government, in time of crisis.