Iceland: Crisis Management

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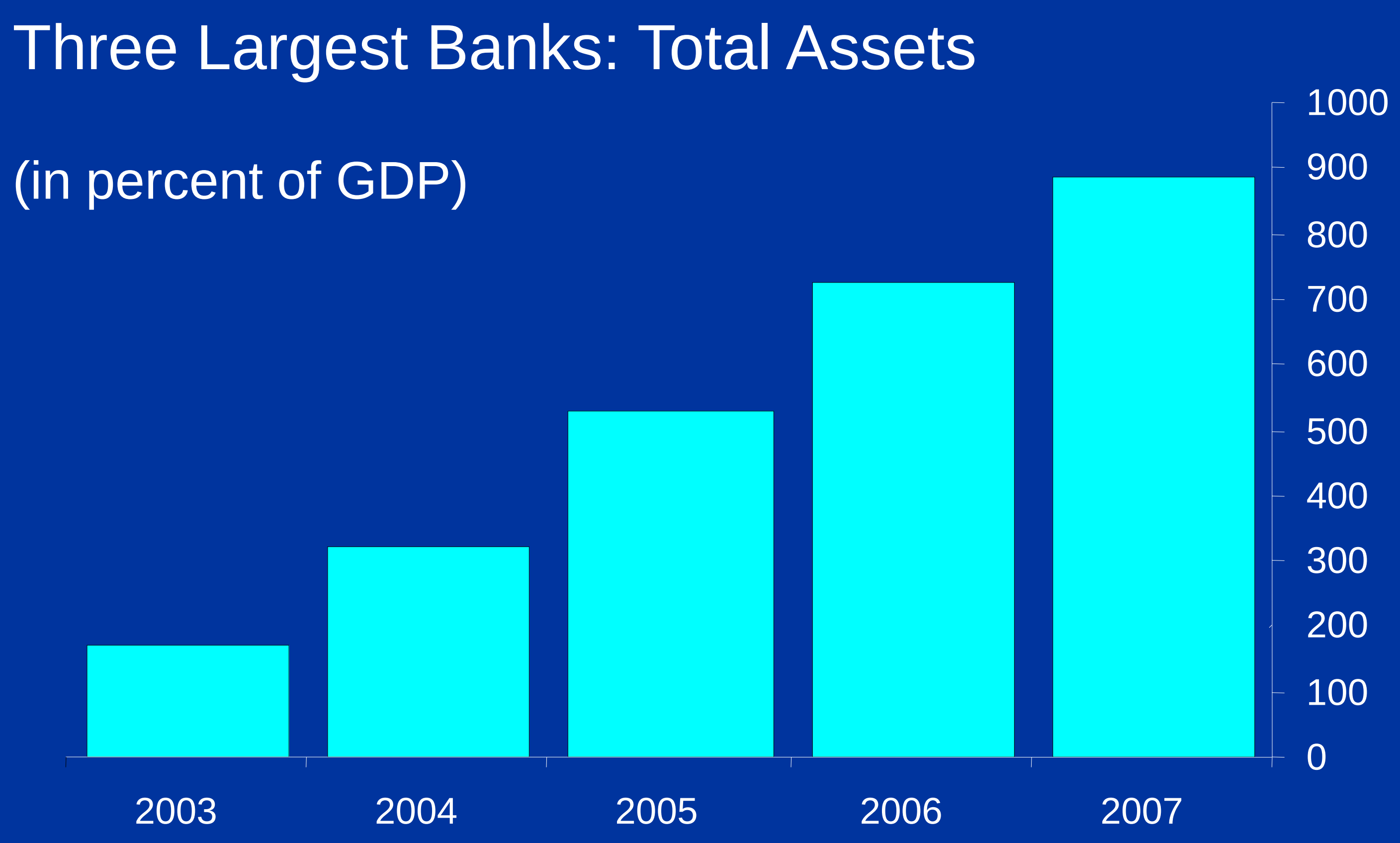
I. The Crisis

Severe imbalances set the stage:
--Current account deficits 15-20 percent of GDP
--asset boom
--distorted structure of production
--and not least…

An Untenable Position



Source: Icelandic Authorities.

The Crisis

Global financial turmoil

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Collapse in investors' confidence in Iceland

- Rapid and disorderly depreciation of krona
- Collapse in asset prices
- Large capital outflows
- Country risk premium skyrocketed

October 2008: Massive disruptions—
Collapse of the three largest banks

II. Program Design

Three key challenges identified at outset

--prevent further depreciation

--ensure fiscal sustainability (but later)

--develop bank restructuring strategy

Focus on Stabilization

- Initial focus exclusively on exchange rate stabilization
- Need to prevent exchange rate overshooting to avoid more severe balance sheet problems
- Insufficient reserves to defend the currency amid extreme distress and loss of confidence
- Capital controls: necessary tool

Fiscal: Mitigate the downturn

- Allow automatic stabilizers to work in full to cushion real economy
- Fiscal adjustment would begin later
- Gave the authorities time to design a fiscal strategy.
- Capital controls created fiscal space

Discussions of fiscal measures put off until first review

Lessons From Asia

- Streamlined and focused conditionality throughout
- No structural conditionality outside the financial sector
- Not overburden a small administration
- Less intrusive—more ownership—stronger implementation

Economic Stabilization