

The good, the bad and the ugly

Presentation at “Iceland’s Recovery—Lessons and Challenges”

IMF and government of Iceland conference

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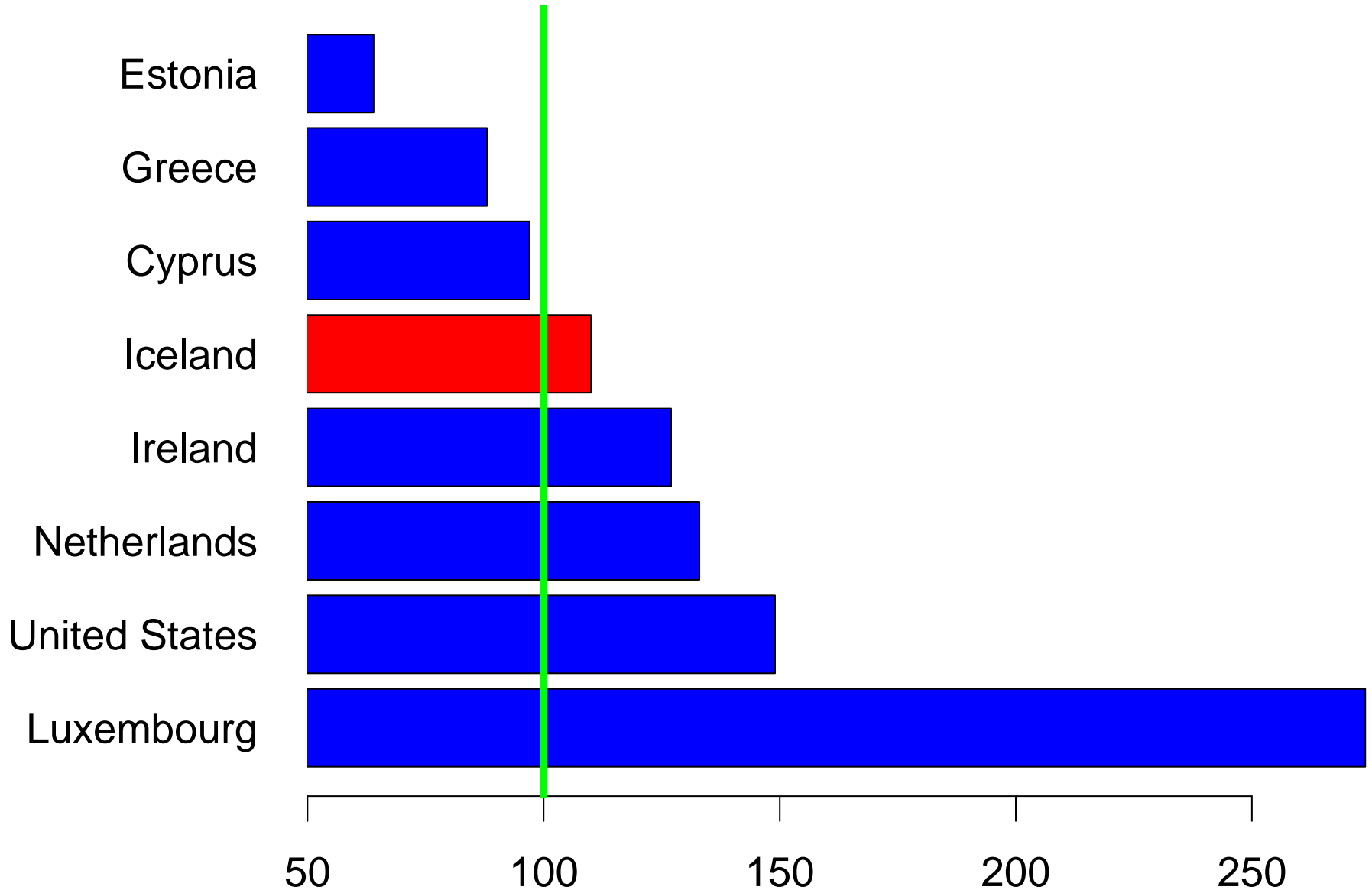
Paper on VoxEU.org today on topic

The good

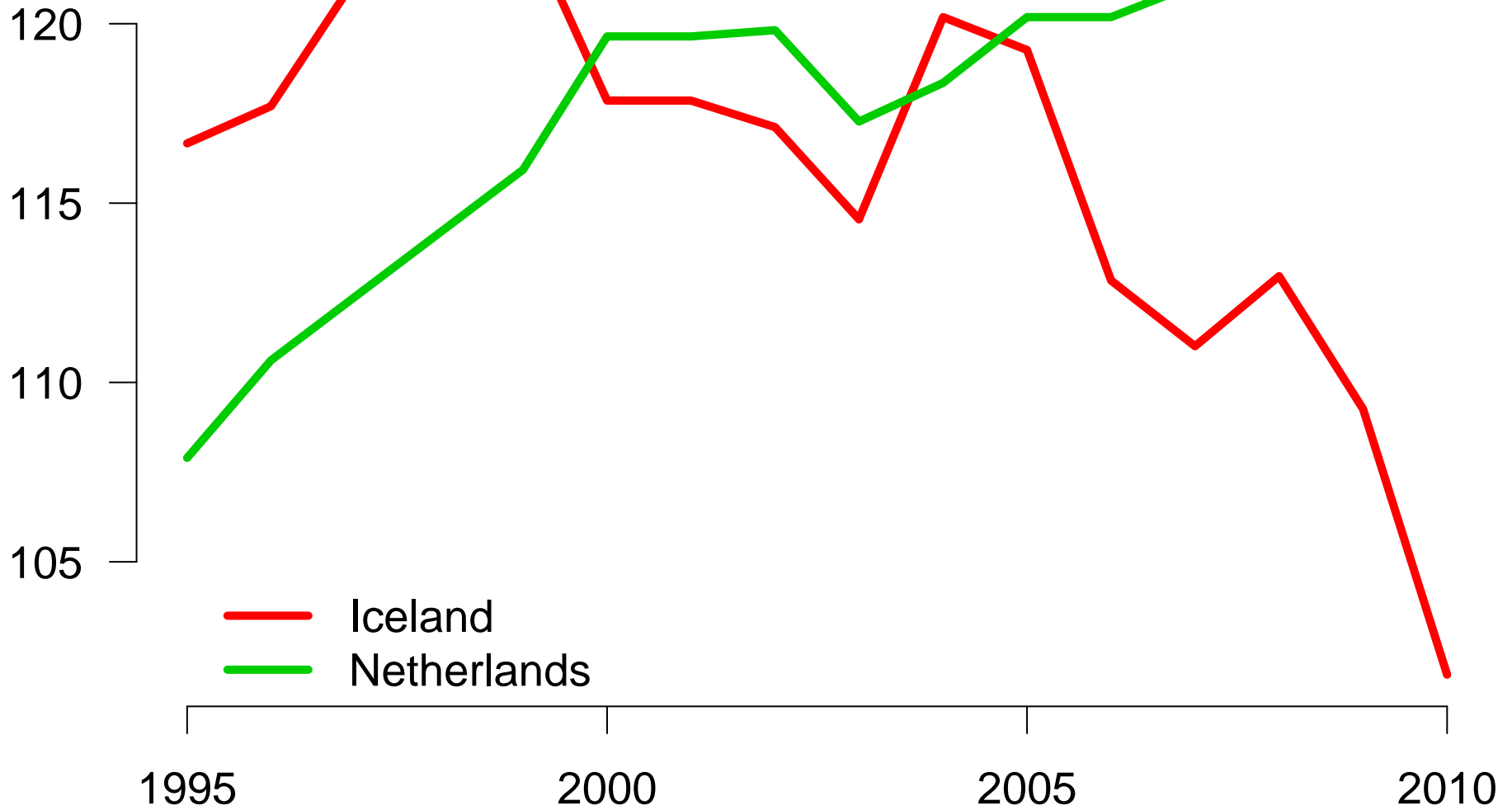
- Economic contraction much smaller than feared (-4% per year). Volatile GDP growth
- Sovereign default averted
- No debt repudiation
- Access international capital markets at favorable rates (but spreads increasing)
- Unemployment from 2.3% to 7.6%

2010 PPP GDP

Relative to Eurozone (100)



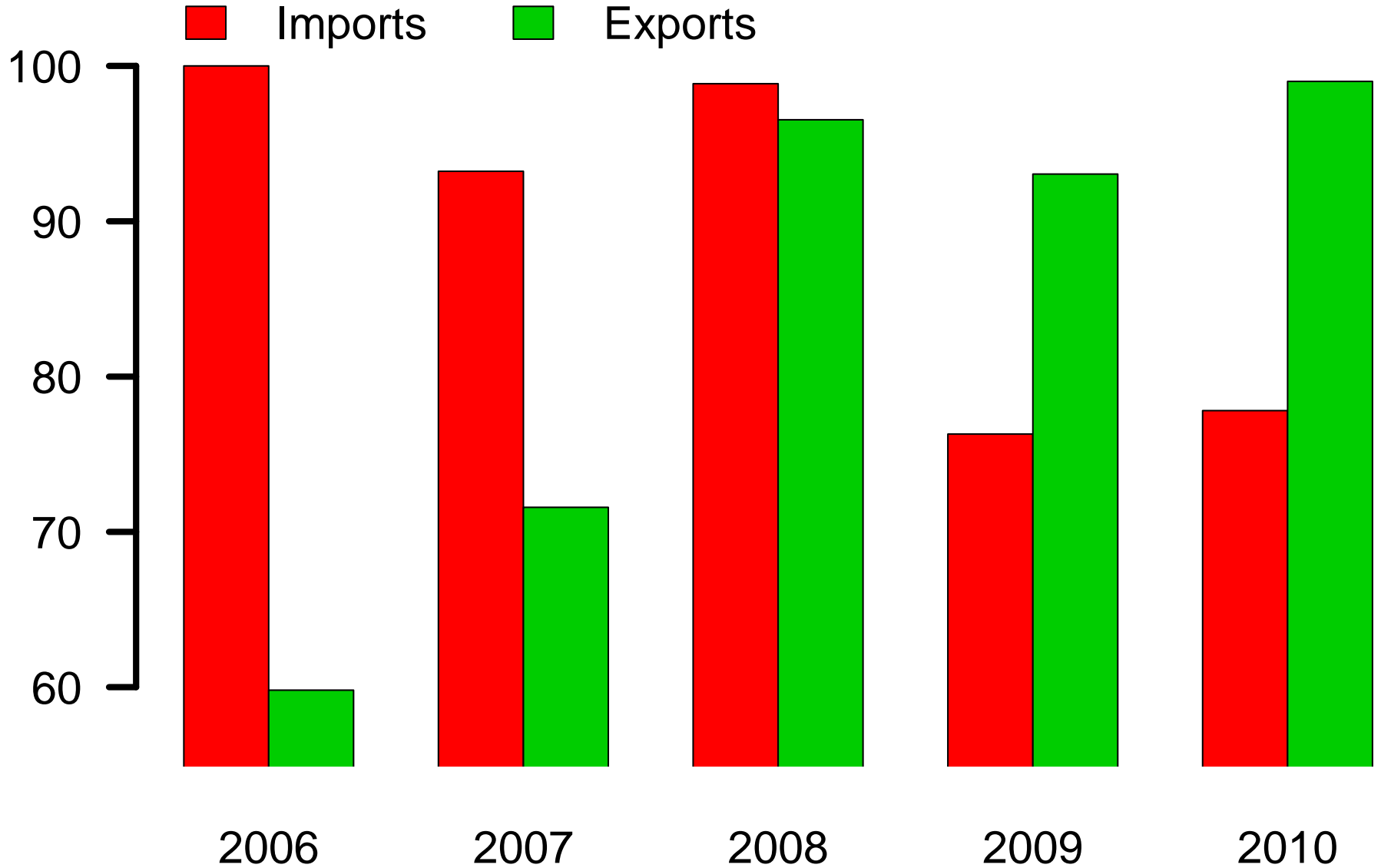
PPP GDP over time



Currency depreciation

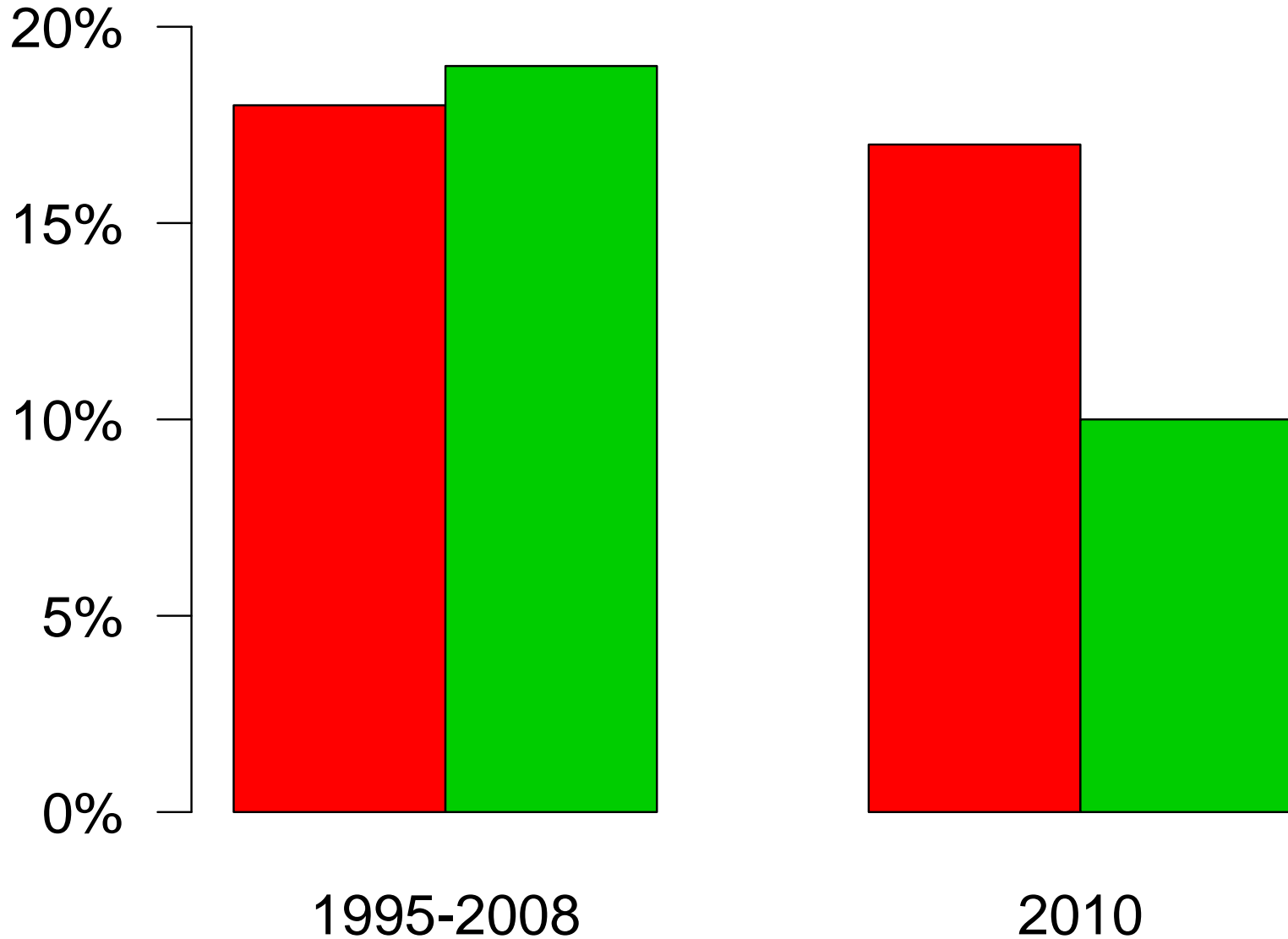
- What saved the economy, but
- One might expect exports to pick up
- And investments

Trade (real)



Business investment

■ Eurozone ■ Iceland



Capital controls

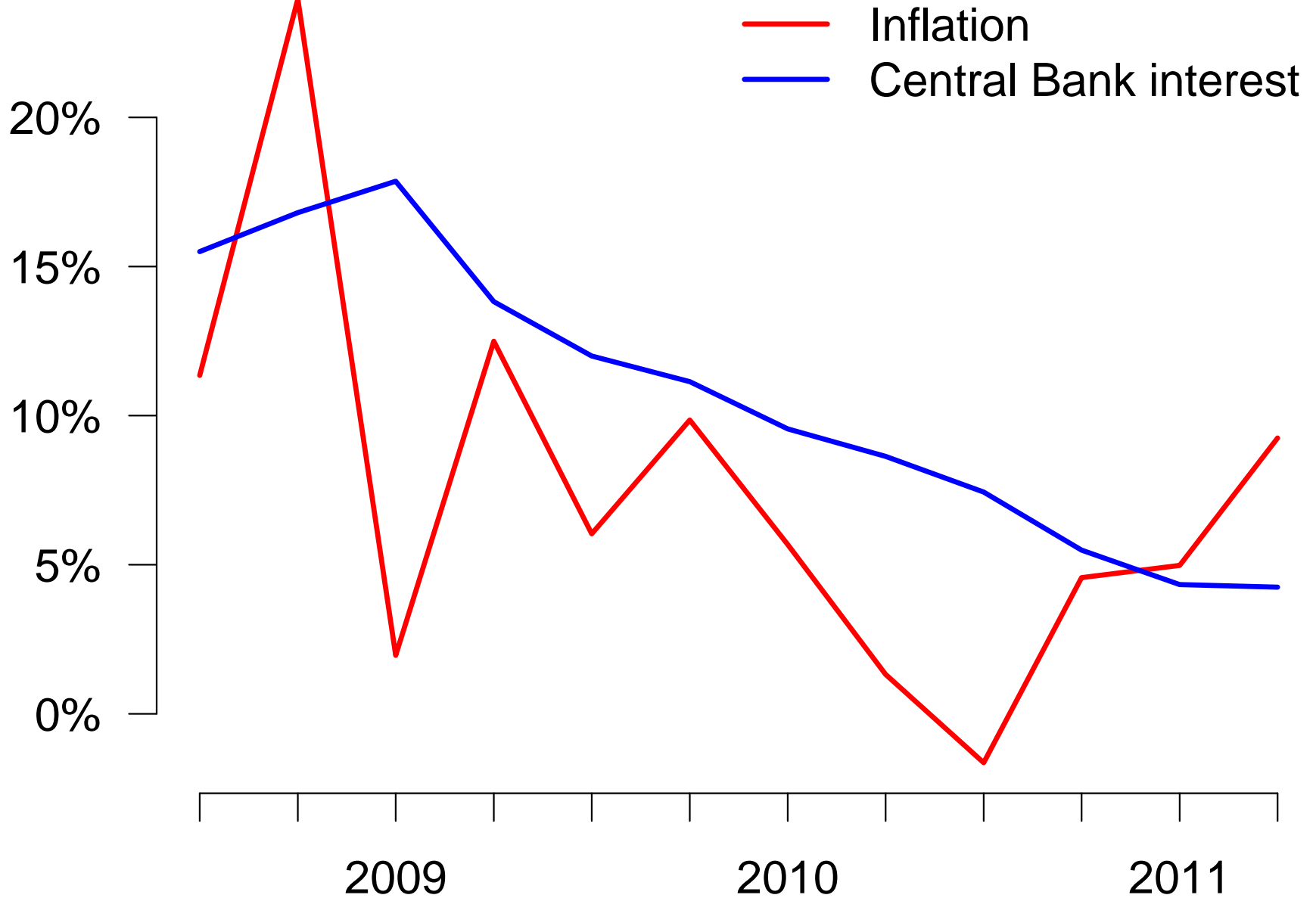
- The harsh 1950s type
- Not the soft recent type – discourage hot money flows
- To prevent sharp depreciation in 2008
- Touted as temporary, now here to stay
- Central bank runs a licensing regime
- Dual (off-shore) market
- Auction + float + special tax better

Still FX volatility

Last year annualized

- Euro-krona exchange 10%
- Euro-Swedish krona 7%

Monetary policy



Resolution of banking crisis

- 3 main banks collapse in 2008
- Best practice in banking resolution is good bank – bad bank split
- Iceland did domestic – foreign split
- Banks passing in hands of foreign vulture funds
- Maximize short term asset recovery not provide banking services

Banking policy

- Too little regulation before crisis
- Too much after the crisis
- Compliance encouraged, banking discouraged

- Banks control 50% of firms, (the badly run who failed) favor them with access to funds
- In turn discourages investment

Evergreening and debt writedowns

- Evergreening loans the norm
 - Standard banking practice is writing down bad loans
 - Not so in Iceland
- Skews the balance sheets of lenders
- And holds back recovery

Summary

- Public finances are not on a sustainable path
- Monetary policy was too orthodox
- Investment has collapsed
- Capital controls hold back recovery
- The financial sector is dysfunctional

- Sovereign default averted
- Government can tap foreign capital markets