THE ICY & 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
COMPONENTS OF THE CURRENT ACCOUNT


REAL EXCHANGE RATE QUARTERLY DATA

INDEX, AVERAGE 2000 = 100

1. Net current transfer is included in factor income.

Sources: Statistics Iceland, Central Bank of Iceland.
NET FOREIGN INTEREST INCOME

Q1/1997 – Q4/2008

<table>
<thead>
<tr>
<th>% of GDP</th>
</tr>
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<tbody>
<tr>
<td>-35</td>
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<tr>
<td>-30</td>
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<tr>
<td>-25</td>
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<tr>
<td>-20</td>
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<td>-15</td>
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<td>-10</td>
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<td>-5</td>
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<td>0</td>
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<thead>
<tr>
<th>B.kr.</th>
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<tbody>
<tr>
<td>0</td>
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<tr>
<td>-20</td>
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<tr>
<td>-40</td>
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<td>-60</td>
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<td>-80</td>
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<tr>
<td>-100</td>
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<tr>
<td>-120</td>
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<tr>
<td>-140</td>
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</table>

Sources: Statistics Iceland, Central Bank of Iceland.

UNEMPLOYMENT RATE

<table>
<thead>
<tr>
<th>% of labour force</th>
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<tbody>
<tr>
<td>0</td>
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<tr>
<td>1</td>
</tr>
<tr>
<td>2</td>
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<td>3</td>
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<td>10</td>
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<td>11</td>
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<td>12</td>
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</tbody>
</table>

Sources: Directorate of Labour, Central Bank of Iceland.


LILJA ALFREDSDÓTTIR, MINISTER FOR FOREIGN AFFAIRS
• In October 2008 all the major banks, representing 88% of the banking system in asset terms, collapsed in one week.

• In March 2009, a 2nd 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)

<table>
<thead>
<tr>
<th>Corporate Family</th>
<th>Volume (US$ Mil)</th>
<th>Default year</th>
<th>Genre</th>
<th>Domain</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Lehman Brothers Holding</td>
<td>$120,483</td>
<td>2008</td>
<td>FIRE: Finance</td>
<td>USA</td>
</tr>
<tr>
<td>2. Worldcom</td>
<td>$33,608</td>
<td>2002</td>
<td>Telco</td>
<td>USA</td>
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<tr>
<td>3. GMAC LLC</td>
<td>$29,821</td>
<td>2008</td>
<td>FIRE: Finance</td>
<td>USA</td>
</tr>
<tr>
<td>4. Kaupthing Bank</td>
<td>$20,063</td>
<td>2008</td>
<td>Banking</td>
<td>Iceland</td>
</tr>
<tr>
<td>5. Washington Mutual</td>
<td>$19,346</td>
<td>2008</td>
<td>Banking</td>
<td>USA</td>
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<tr>
<td>6. Glitnir Banki</td>
<td>$18,773</td>
<td>2008</td>
<td>Banking</td>
<td>Iceland</td>
</tr>
<tr>
<td>7. NTL Communication</td>
<td>$16,429</td>
<td>2002</td>
<td>Media</td>
<td>UK</td>
</tr>
<tr>
<td>8. Adelphia Communications</td>
<td>$16,256</td>
<td>2002</td>
<td>Media</td>
<td>USA</td>
</tr>
<tr>
<td>9. Enron</td>
<td>$13,852</td>
<td>2001</td>
<td>Energy</td>
<td>USA</td>
</tr>
<tr>
<td>10. Tribune</td>
<td>$12,674</td>
<td>2008</td>
<td>Media</td>
<td>USA</td>
</tr>
<tr>
<td>11. Landsbanki</td>
<td>$12,161</td>
<td>2008</td>
<td>Banking</td>
<td>Iceland</td>
</tr>
</tbody>
</table>
ICELAND AND THE GLOBAL FINANCIAL CRISIS: HUGE COMPARED TO PREVIOUS CRISSES

Commercial banks' assets in various previous financial crises

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.
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
SUSTAINABLE ECONOMIC STRATEGY
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 GDP

<table>
<thead>
<tr>
<th>Year</th>
<th>B.kr.</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>16,000</td>
<td>1,200</td>
</tr>
<tr>
<td>2009</td>
<td>12,000</td>
<td>900</td>
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<tr>
<td>2010</td>
<td>8,000</td>
<td>600</td>
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SUSTAINABLE ECONOMIC STRATEGY
IMF PROGRAMME: FROM FISCAL DEFICIT TO SURPLUS

GENERAL GOVERNMENT BALANCE 2007-2018

Source: IMF Third post review August 2013.

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IMF 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

CORPORATE DEBT AS % OF GDP
Q1/2005 – Q4/2015

HOUSEHOLD DEBT AS % OF GDP

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

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SUSTAINABLE ECONOMIC STRATEGY
FAILED BANK-ESTATES EQUIVALENT TO GDP (YEAR-END 2015)

- Significant **balance of payment** pressures
- **Capital controls** managed potential outflow
- Strategy: Failed estates would receive **exemptions** from the capital controls in order **to go into composition** and make distributions to creditors while offering to **fulfill stability criteria** that fully mitigate the negative effect on the exchange rate/FX reserve.
SUSTAINABLE ECONOMIC STRATEGY
ENSURING ECONOMIC STABILITY

STABILITY CONTRIBUTIONS

• Objective: To reduce the negative impact of distributions of ISK assets on the balance of payment.
• Conversion of domestic FX assets to long-term funding.
• Funding of prepayment of Government credit facilities for the new banks.

STABILITY TAX

• General stability tax, 39%
  Tax deduction for domestic commercial banks’ medium term FX funding.
• Effective tax rate adjusted for potential deductions estimated at 27% of total assets, or 620 b.kr.
SUSTAINABLE ECONOMIC STRATEGY

OFF-SHORE KRÓNA HOLDINGS

• CARRY TRADE FROM 2005
• SIGNIFICANT BALANCE OF PAYMENT PRESSURES
• AUCTION IN JUNE 2016
SUSTAINABLE ECONOMIC STRATEGY
OFF-SHORE KRÓNÁ Assets

OCTOBER 2008 – FEBRUARY 2016

1. ISK assets held by non-residents and locked in by the capital controls. Adjusted for new investment in Treasury bonds during the period. Possibly underestimated because of outflows relating to new investment. The Central Bank is currently working on improving data on outflows so as to make it possible to account for this.

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

SEPTEMBER 2016
OUTCOME: STRONG ECONOMIC GROWTH

GDP GROWTH IN ICELAND & TRADING PARTNERS
2008 – 2018

Year-on-year change (%)

GENERAL GOVERNMENT GROSS DEBT

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


Iceland, MB 2016/2
Main trading partners, MB 2016/2

Iceland 2010-2018
Debt level in 2018

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OUTCOME:
CURRENT ACCOUNT SURPLUS

CURRENT ACCOUNT BALANCE
2000 – 2016

REAL EXCHANGE RATE
Q1/2000 – Q4/2015

1. Including secondary income: Central Bank baseline forecast 2016
2. Excluding the calculated income and expenses of DMIs in winding-up proceedings; and the effects of pharmaceuticals company Actavis on the balance on income until 2012. Also adjusted for the failed DMIs' 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.

Source: Statistics Iceland, Central Bank of Iceland.

Index, 2005 = 100

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 INFLATION

12-month change (%)

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

Source: Central Bank of Iceland.
OUTCOME:
EXTERNAL CONDITIONS HAVE HELPED

• SIGNIFICANT GROWN IN TOURISM
• LOW OIL PRICES
• LOW INTERNATIONAL INFLATION
• FAVORABLE COMMODITY PRICES
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
KEY LESSONS:
ICELANDIC & US FINANCIAL CYCLES LINKED (CBI RESEARCH)

- Strikingly strong ties between the Icelandic financial cycle and its global counterpart
- 6 of 7 peaks in the Icelandic cycle occur close to global cycle peaks
- Domestic and global cycle are roughly 75% of the period in the same phase notwithstanding different policy and openness regimes
- Spillover effects seem to grow stronger over time
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.


ROAD TO RECOVERY

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