



ICELAND

THE ICY & UPHILL ROAD TO RECOVERY

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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)

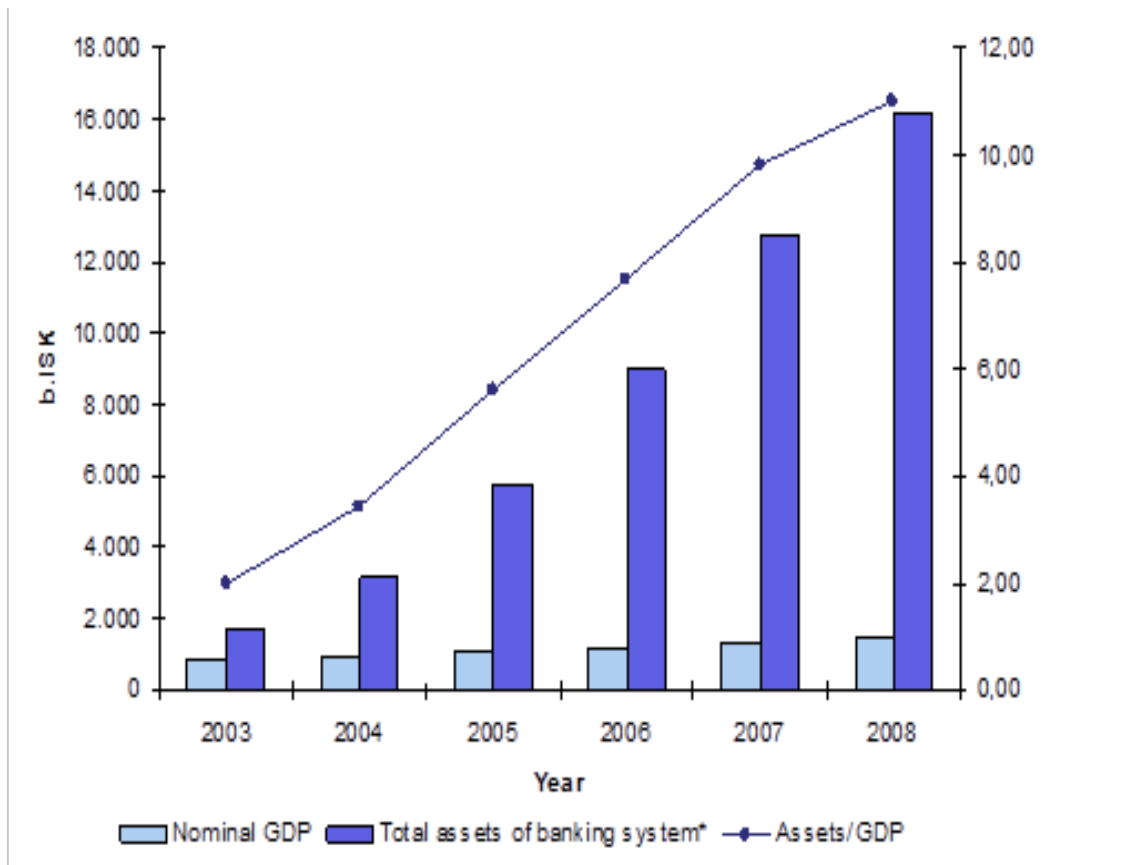
- Unfunded obligations where global liquidity was scarce
- Concentrated risk and connected lending
- FX assets were 70% of the balance sheet of the Icelandic banks
- Lender of last resort in FX not be found



ICELAND AND THE GLOBAL FINANCIAL CRISIS:

BANKING SYSTEM MUTATION IN ONLY FIVE YEARS

TOTAL BANKING ASSETS / GDP

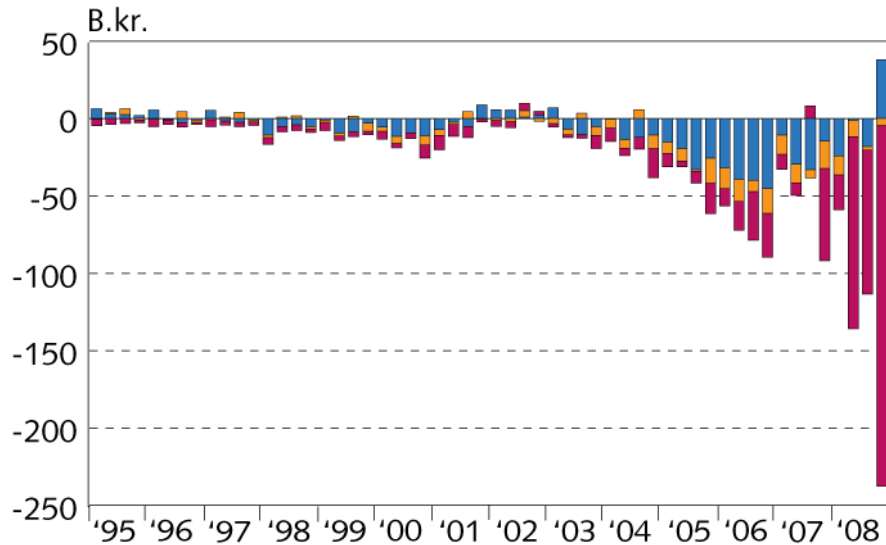


A wide-angle landscape photograph capturing a vast, flat tundra covered in green moss. The foreground is filled with vibrant, low-lying plants in shades of red, orange, and yellow, interspersed with patches of white lichen. In the distance, a dark, rounded mountain peak stands prominently against a sky transitioning from a warm orange glow on the left to a deep, dark blue on the right. The overall scene is serene and captures the beauty of a high-altitude or northern environment during autumn.

10 / 2008

COMPONENTS OF THE CURRENT ACCOUNT

Q1/1995 – Q4/2008



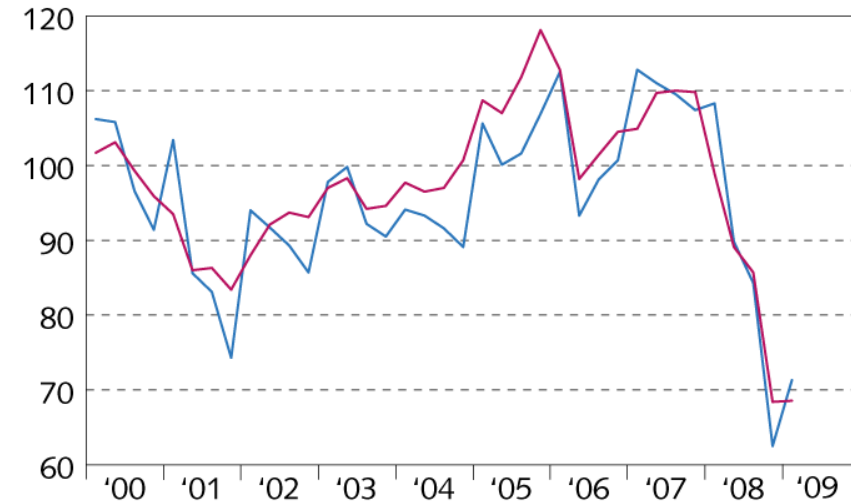
- Trade balance
- Services balance
- Income balance

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



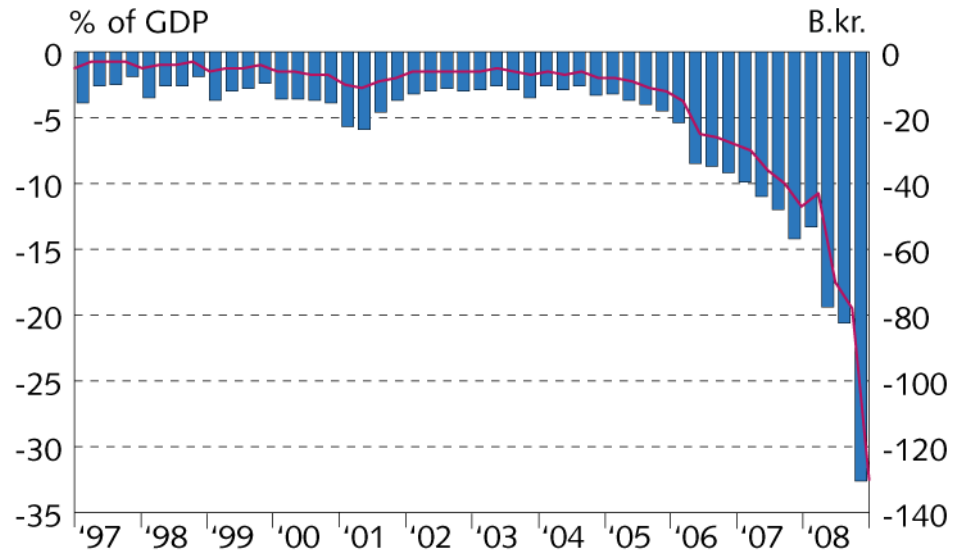
- Relative unit labour cost
- Relative consumer prices

Source: Central Bank of Iceland.



NET FOREIGN INTEREST INCOME

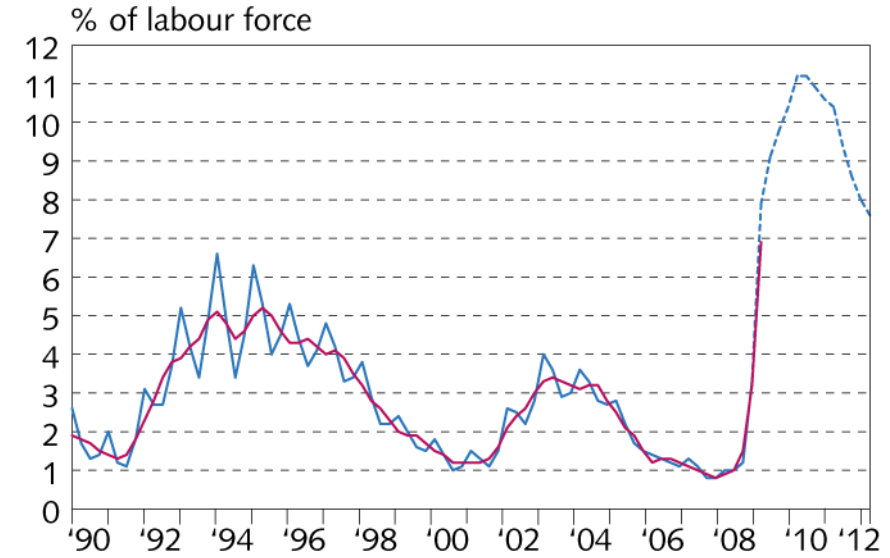
Q1/1997 – Q4/2008



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

Sources: Statistics Iceland, Central Bank of Iceland.

UNEMPLOYMENT RATE



- Unemployment
- Seasonally adjusted unemployment

1. Central Bank baseline forecast Q1/2009 - Q1/2012.

Sources: Directorate of Labour, Central Bank of Iceland.

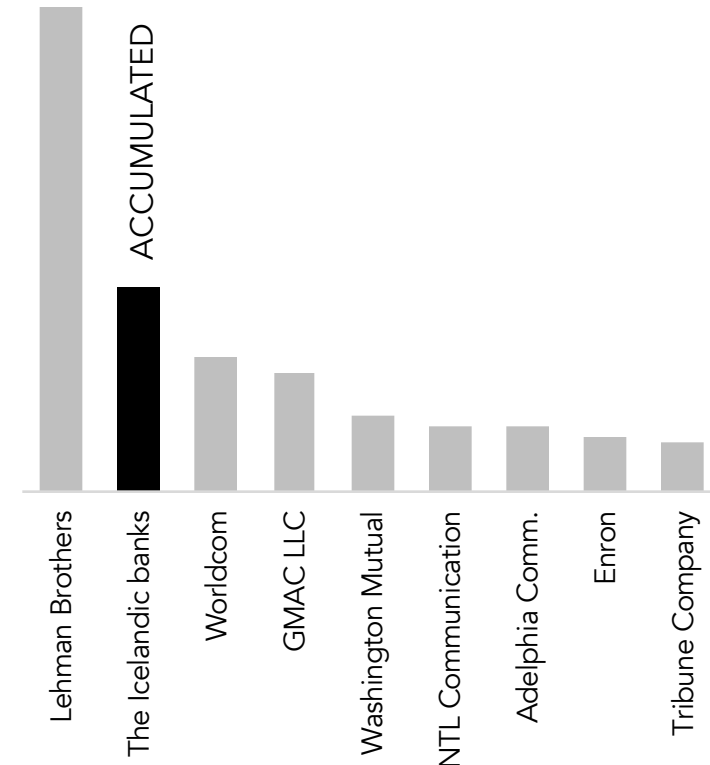


- IN **OCTOBER 2008** ALL THE MAJOR BANKS, REPRESENTING 88% OF THE BANKING SYSTEM IN ASSET TERMS, **COLLAPSED IN ONE WEEK.**
- IN MARCH 2009, A 2ND WAVE INCREASED IT TO **97%.**
- LARGE INTERNATIONAL PRIVATE SECTOR DEFAULTS WERE A DEVASTATING BLOW FOR A **SMALL ECONOMY.**

ICELAND AND THE GLOBAL FINANCIAL CRISIS: 180th BIGGEST NATION: **2nd BIGGEST DEFAULT**

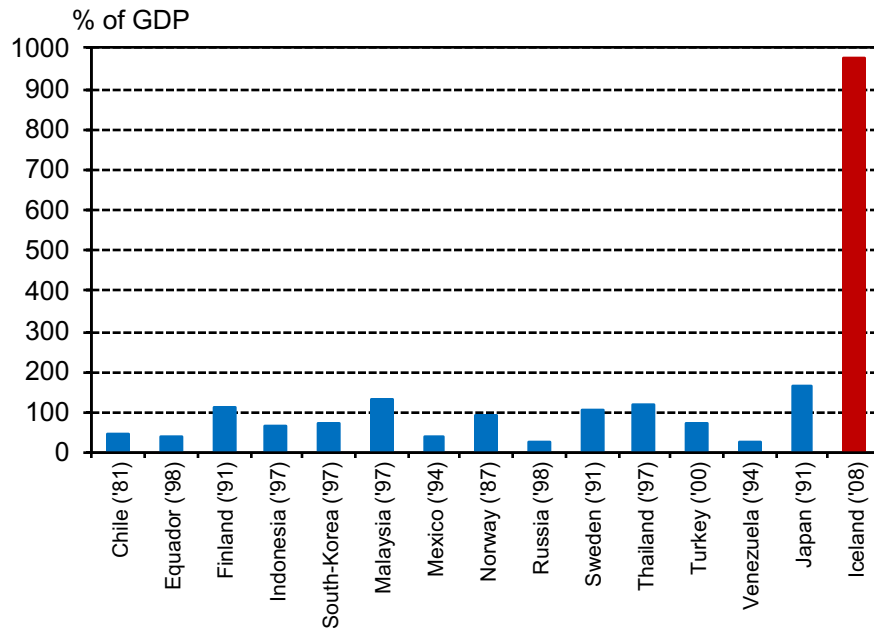
LARGEST MOODY'S - RATED DEFAULTS (1920 – 2008)

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**

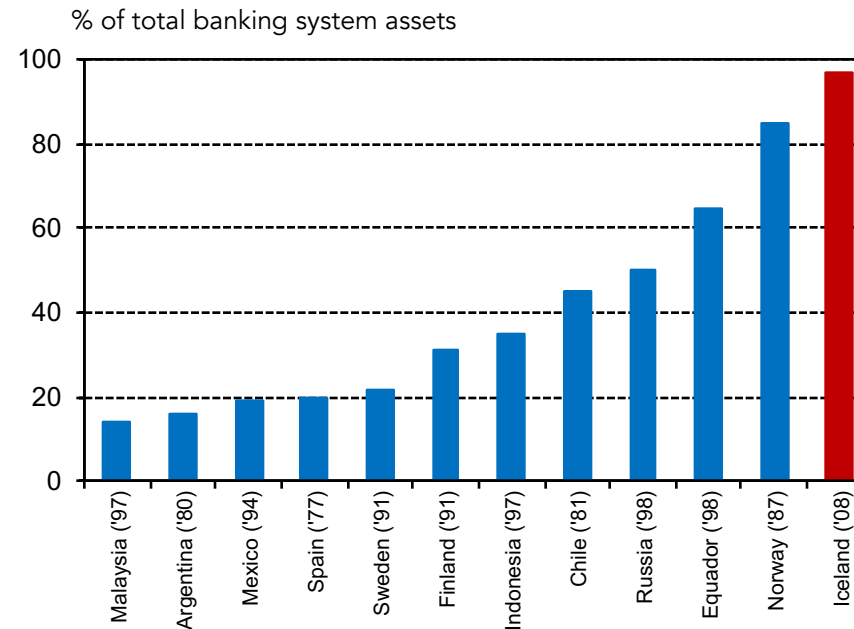
Commercial banks' assets in various previous financial crises



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.



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 uniform colors (white, yellow, blue, green, red, orange) 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.

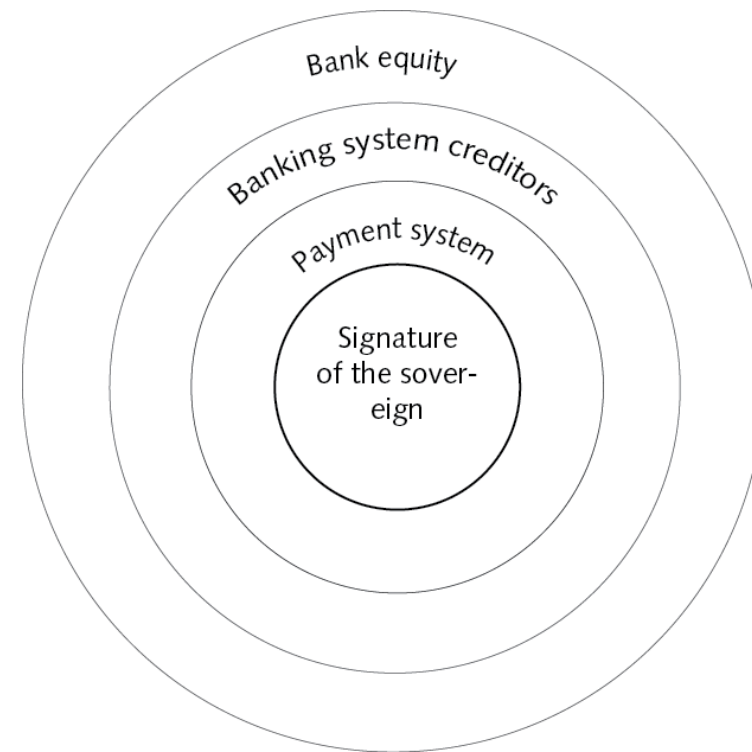
CREATIVE SOLUTIONS NEEDED

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



\$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

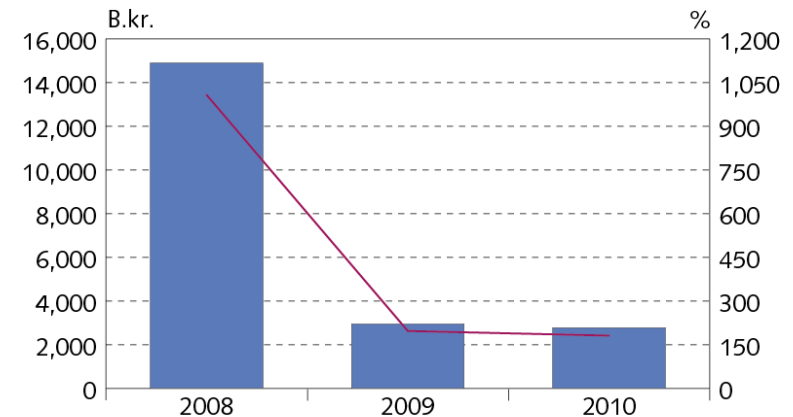
SUSTAINABLE ECONOMIC STRATEGY

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



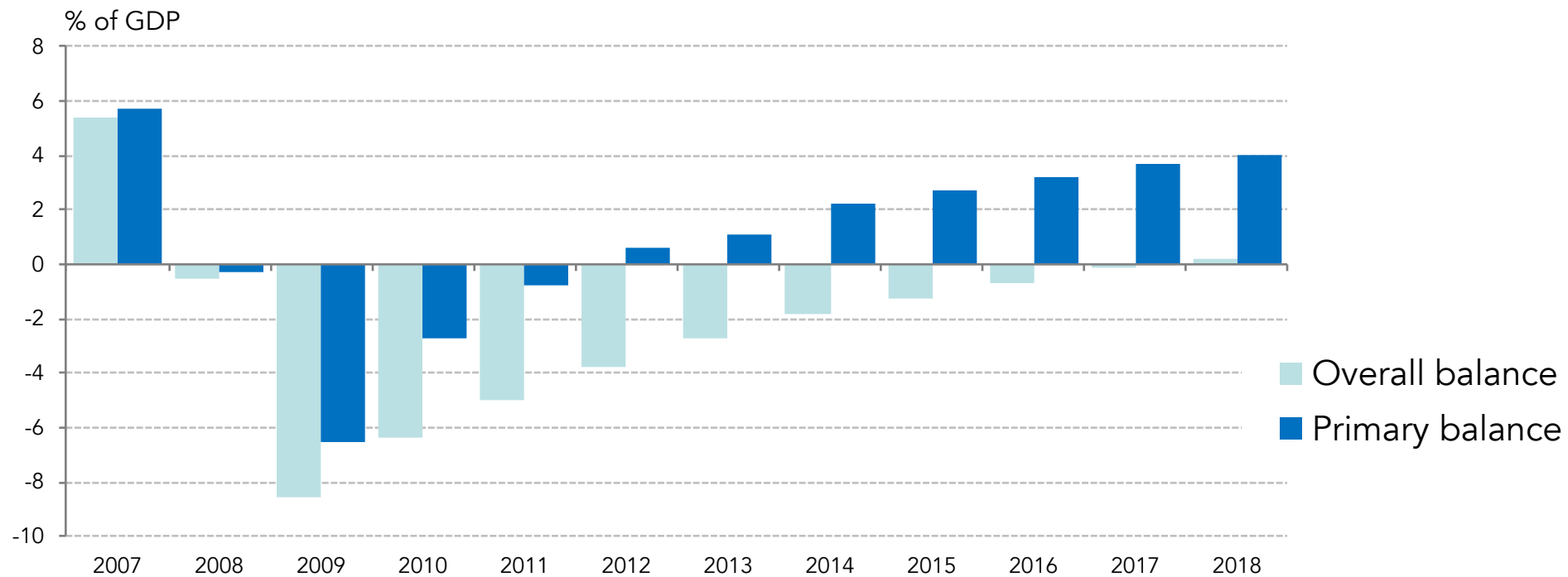
■ Total assets (left)
— Assets as % of GDP (right)

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.

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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

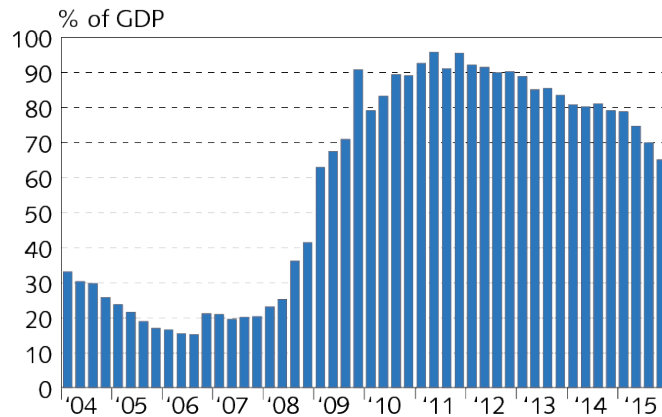


HOUSEHOLDS

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

GOVERNMENT DEBT AS % OF GDP

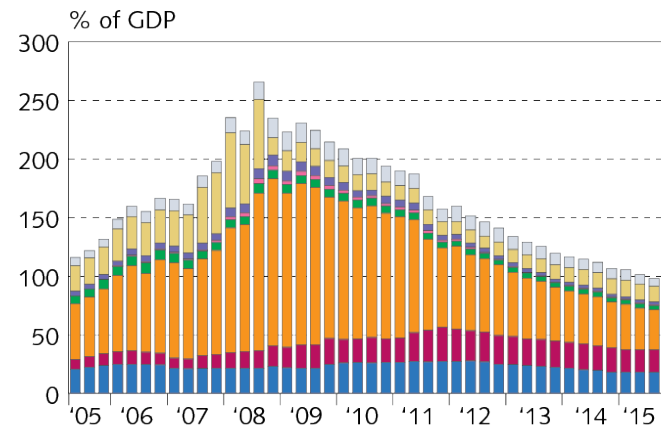
Q1/2004 – Q4/2015



Source: Statistics Iceland.

CORPORATE DEBT AS % OF GDP¹

Q1/2005 – Q4/2015

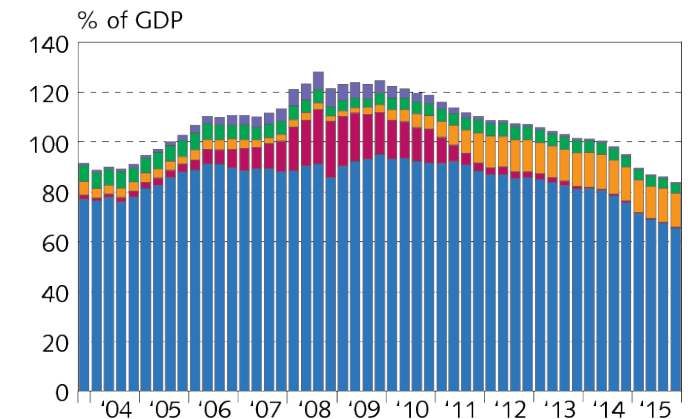


- Indexed
- Non-indexed
- FX loans
- Overdraft
- Asset financing agreements
- Domestic bonds issued
- Foreign bonds issued
- FX overdraft

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.



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

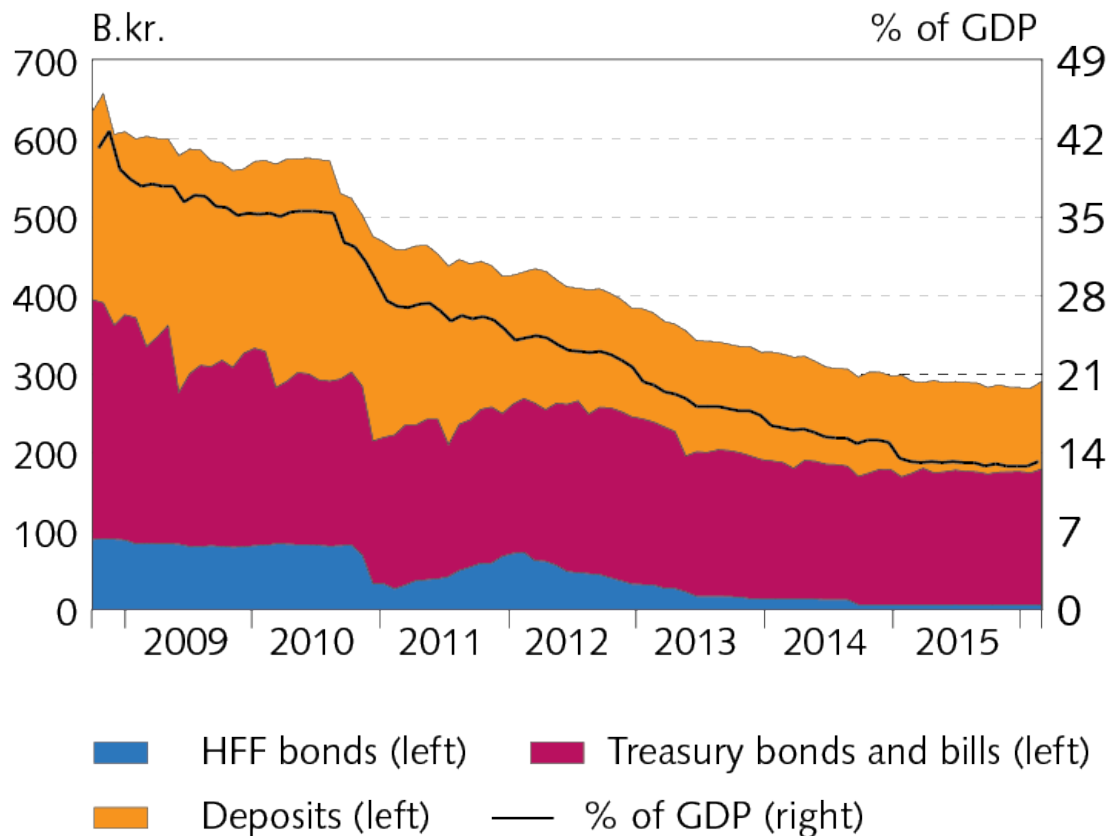
- CARRY TRADE FROM 2005
- SIGNIFICANT BALANCE OF PAYMENT PRESSURES
- AUCTION IN **JUNE 2016**



SUSTAINABLE ECONOMIC STRATEGY

OFF-SHORE KRÓNA **ASSETS**¹

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.”

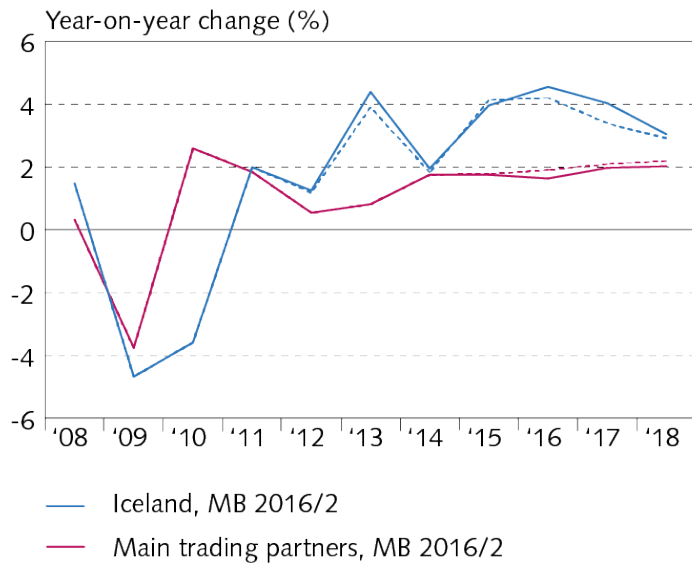
MOODY’S

SEPTEMBER 2016

OUTCOME: STRONG ECONOMIC GROWTH

GDP GROWTH IN ICELAND & TRADING PARTNERS

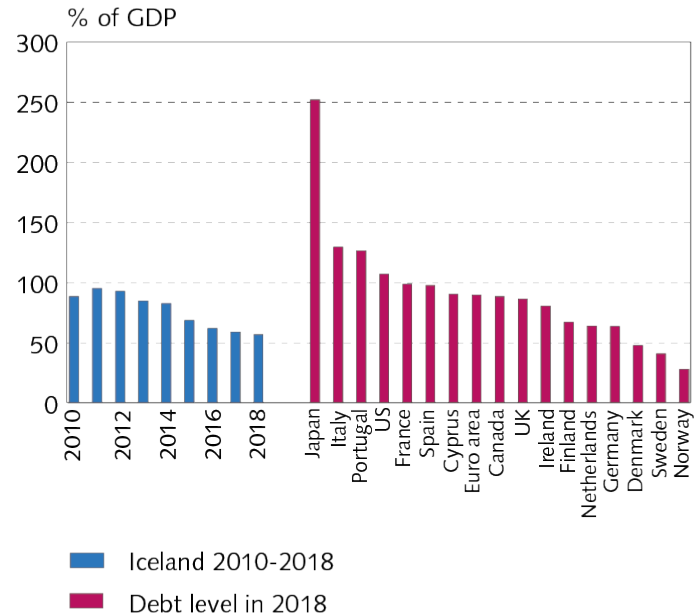
2008 – 2018¹



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



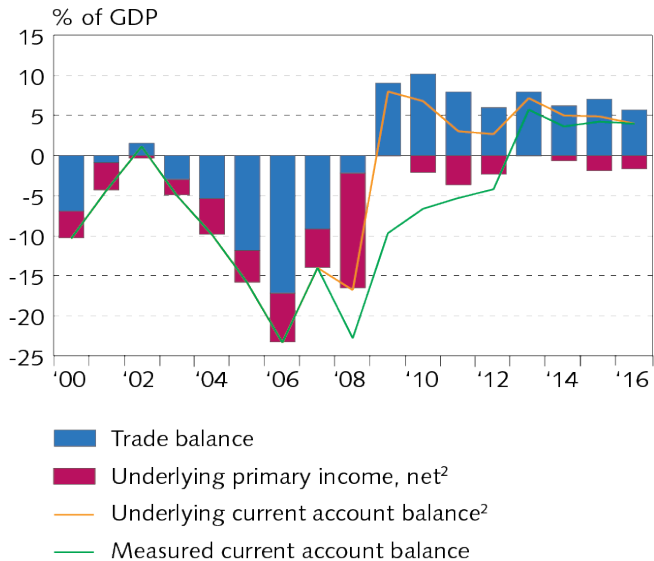
Sources: International Monetary Fund, Ministry of Finance and Economic Affairs, Central Bank of Iceland.



OUTCOME: CURRENT ACCOUNT SURPLUS

CURRENT ACCOUNT BALANCE

2000 – 2016¹



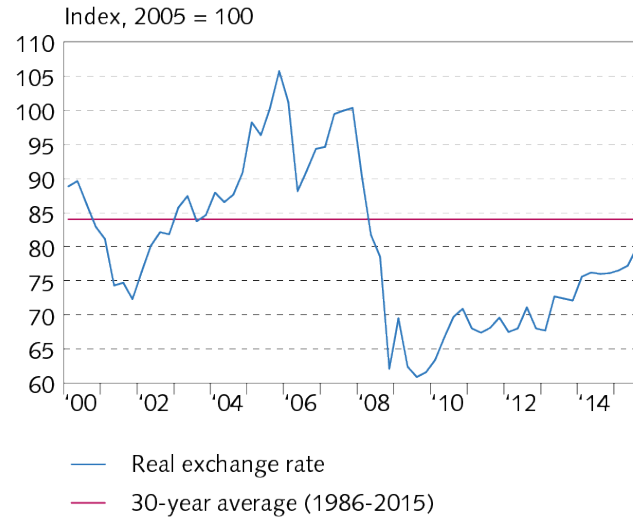
1. Including secondary income. Central Bank baseline forecast 2016.
2. Excluding the calculated income and expenses of DMBs in winding-up proceedings and the effects of pharmaceuticals company Actavis on the balance on income until 2012. Also adjusted for the failed DMBs' financial intermediation services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

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REAL EXCHANGE RATE

Q1/2000 – Q4/2015



Source: Central Bank of Iceland.

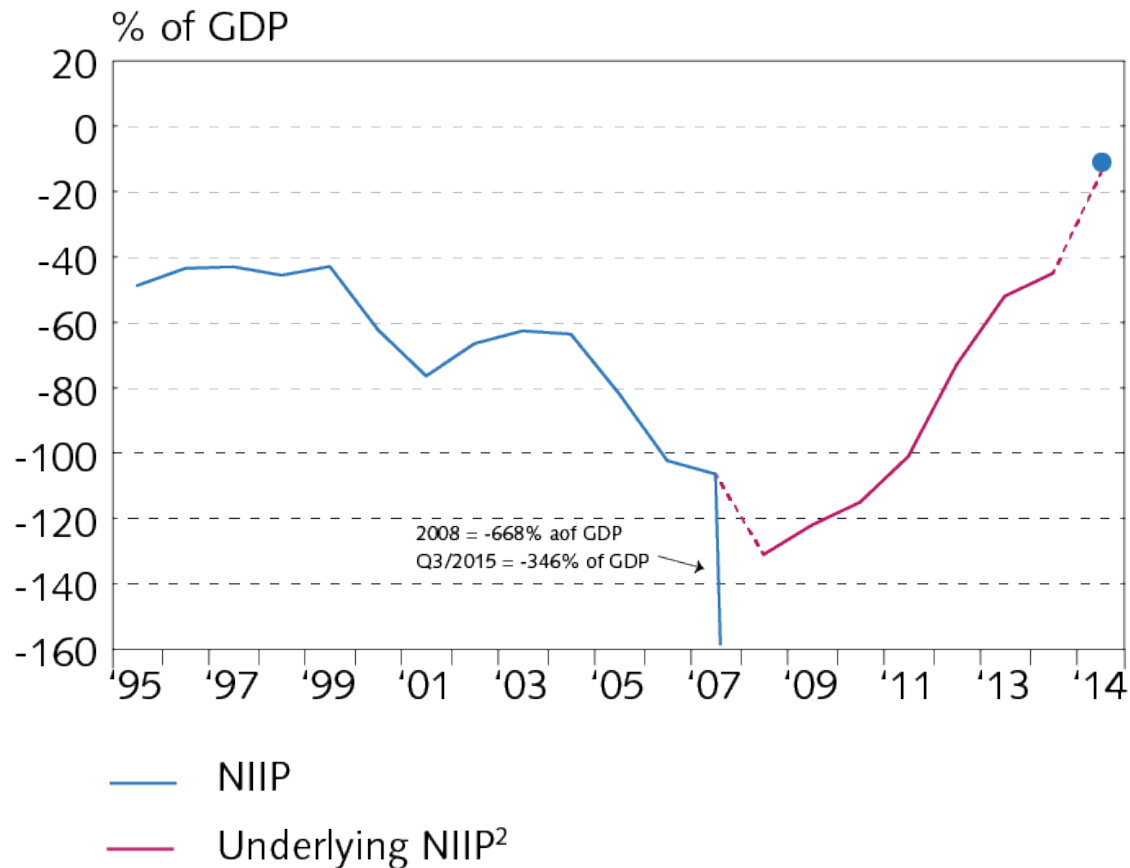


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OUTCOME:

NIIP POSITION CLOSE TO BALANCE

NET INTERNATIONAL INVESTMENT POSITION¹



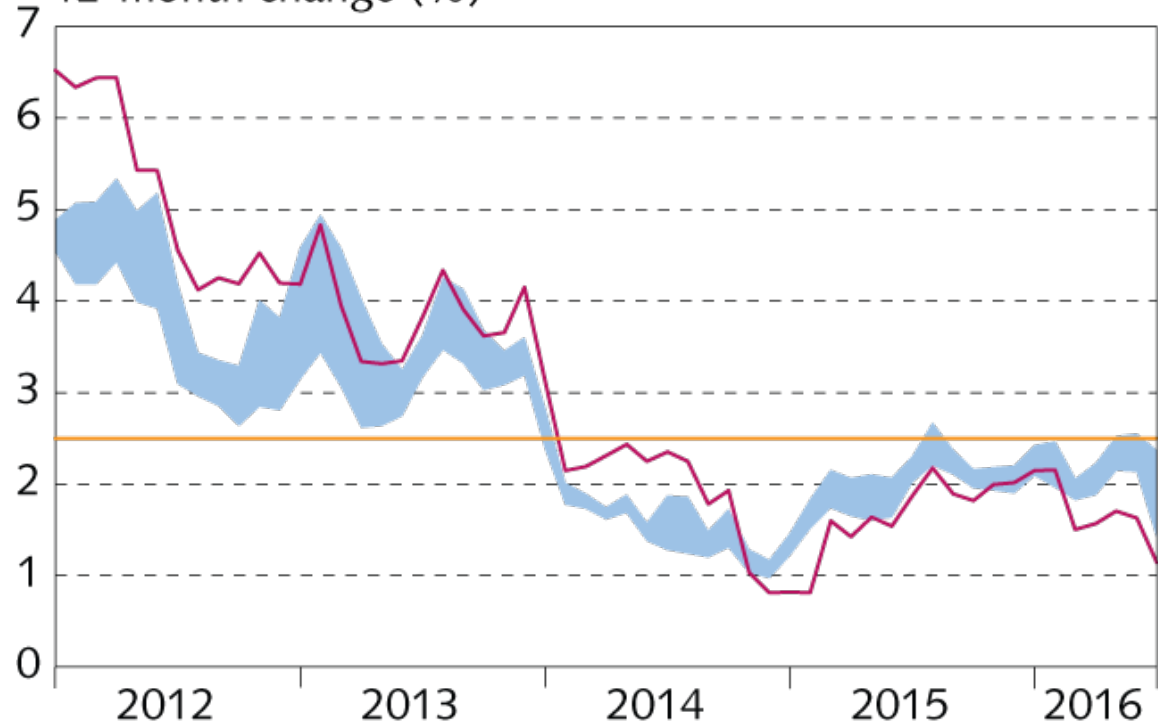
1. At the end of 2015, the estates of the failed financial institutions reached composition agreements entailing the write-off of a large portion of their debt. As a result, there was no difference in the NIIP and the underlying NIIP at year end 2015. 2. Adjusted for the effects of settlement of the 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

12-month change (%)



- CPI
- Inflation target
- Interquartile range

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.

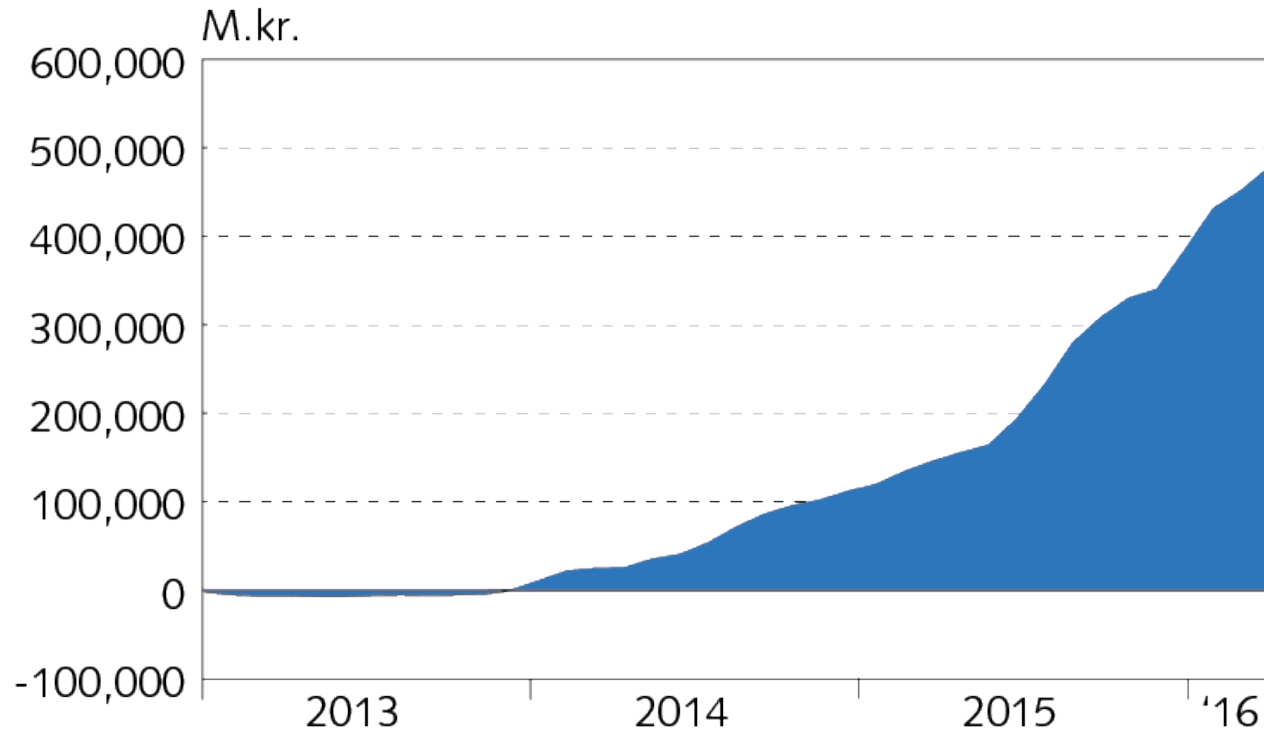
Sources: Statistics Iceland, Central Bank of Iceland.



OUTCOME:

FX INFLOW & **GROWING RESERVES**

ACCUMULATED CENTRAL BANK INTERVENTION
IN THE FX MARKET FROM JANUARY 2013



OUTCOME:

EXTERNAL CONDITIONS **HAVE HELPED**

- SIGNIFICANT **GROWN** 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

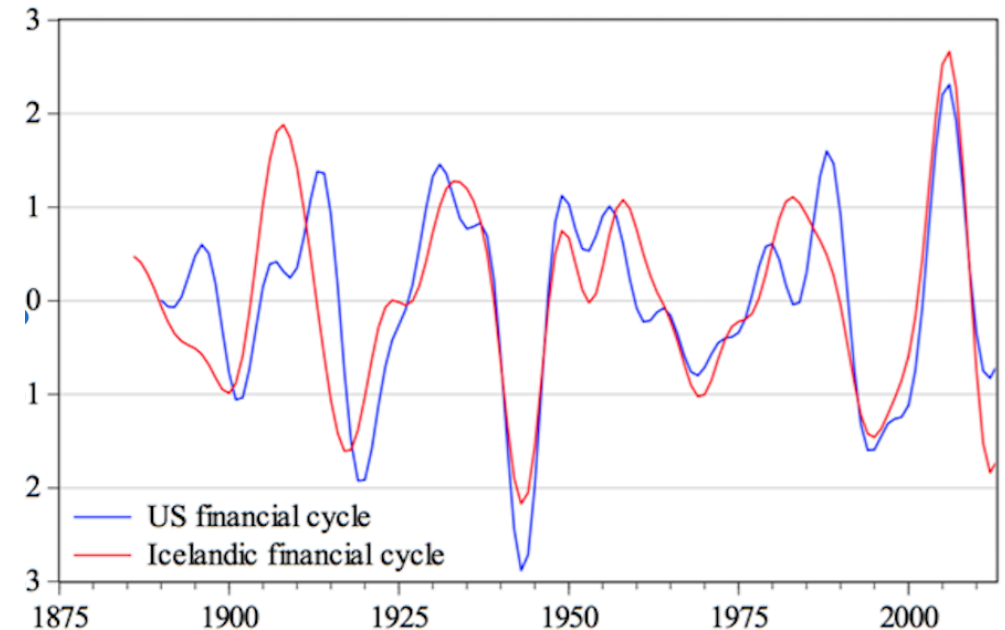
- The sovereign must be **protected by all means**
- Capital controls provide **vital breathing space**
- **Extensive analytical work** in policy making is crucial
- Strong **political ownership** of policies is necessary
- **Domestic engagement** is a deciding factor
- **Capital Flow Management** is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

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

THE US AND ICELANDIC FINANCIAL CYCLES



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. 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

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