Five Years on

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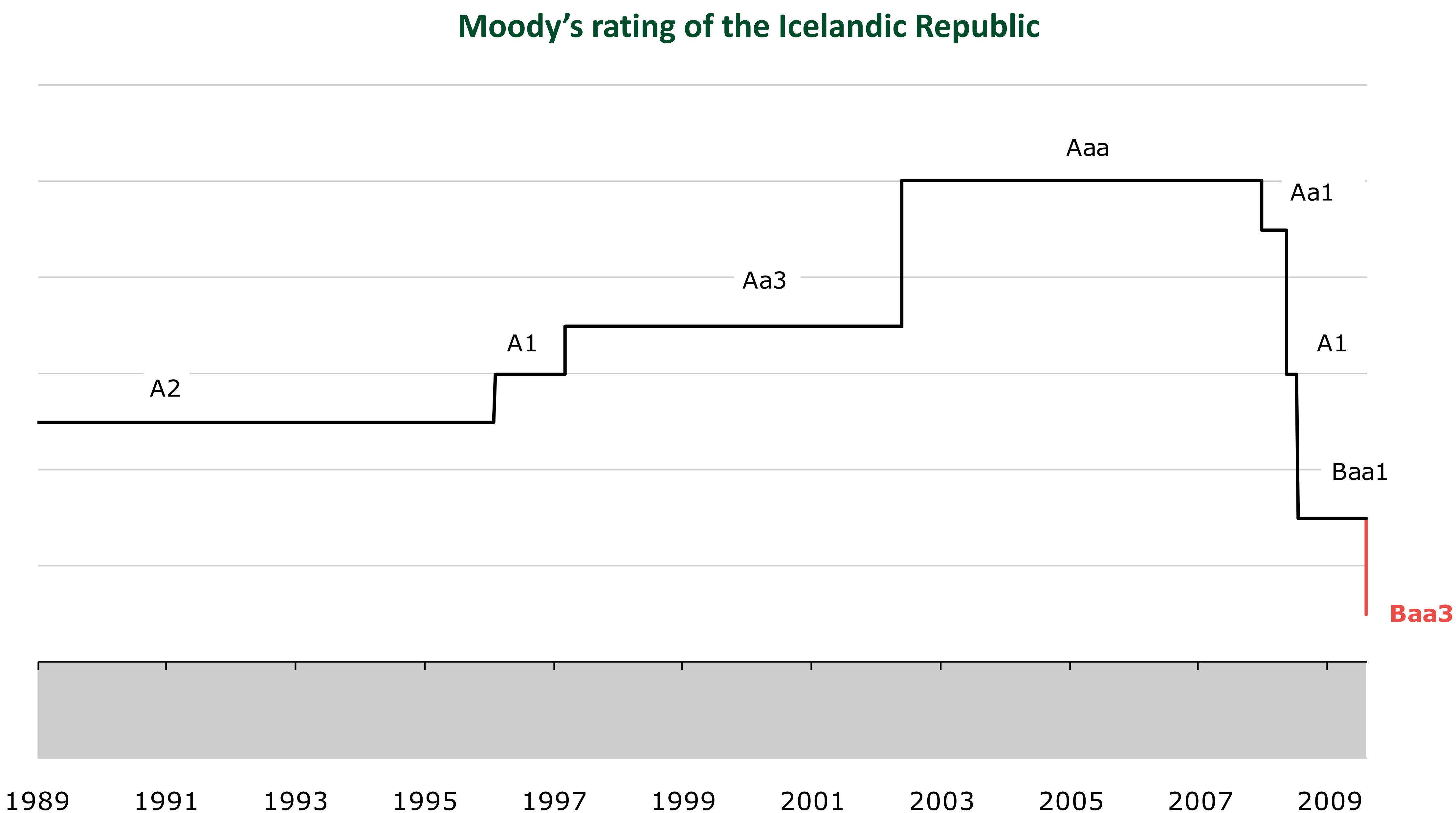
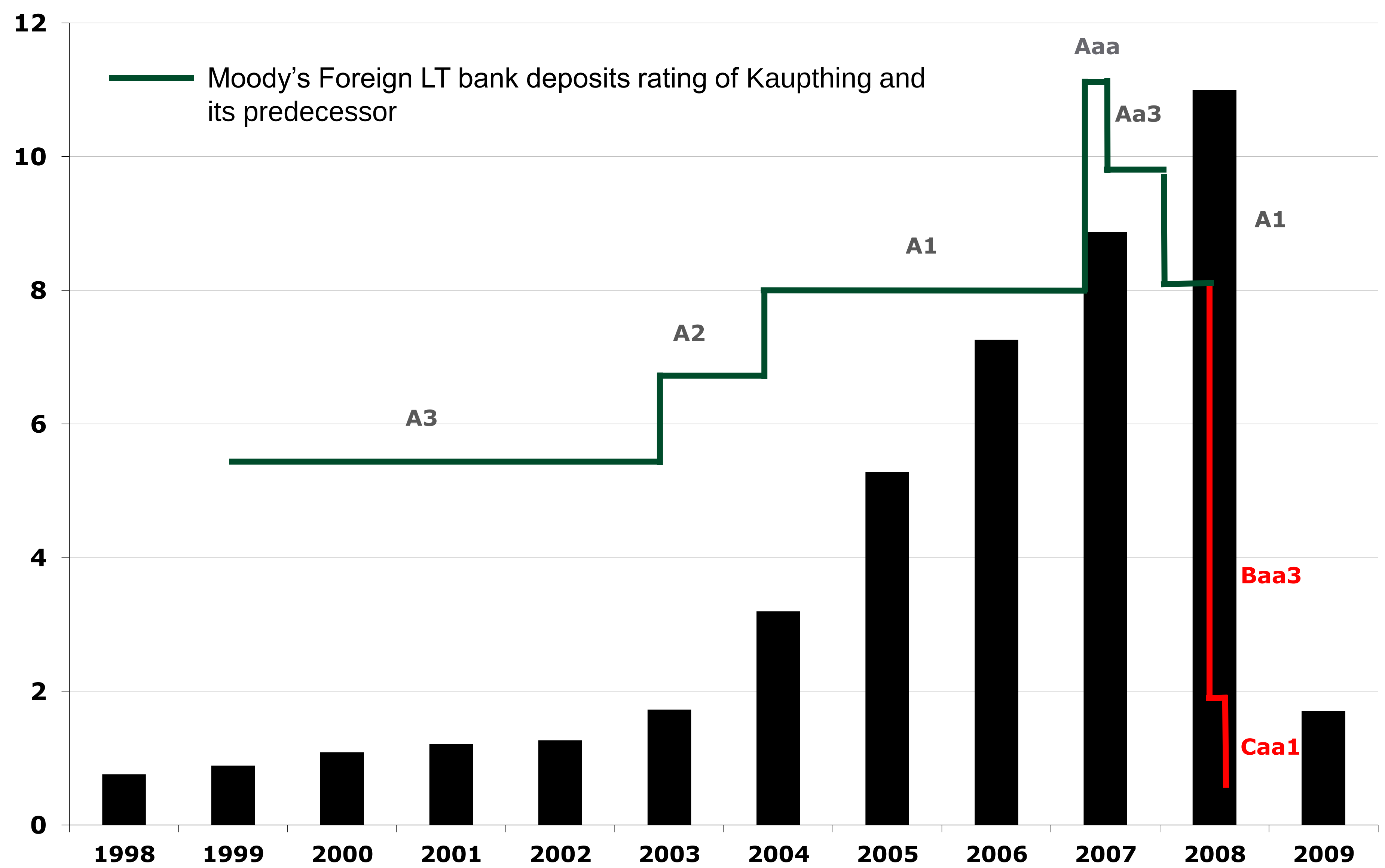
I. A tale of two bubbles
II. The resolution of the banking bubble
III. The resolution of the Currency Bubble
IV. Where are we now?
V. What must be done
VI. Conclusion

Virtious economic policies , leading to higher ratings, was the main driver for bubble

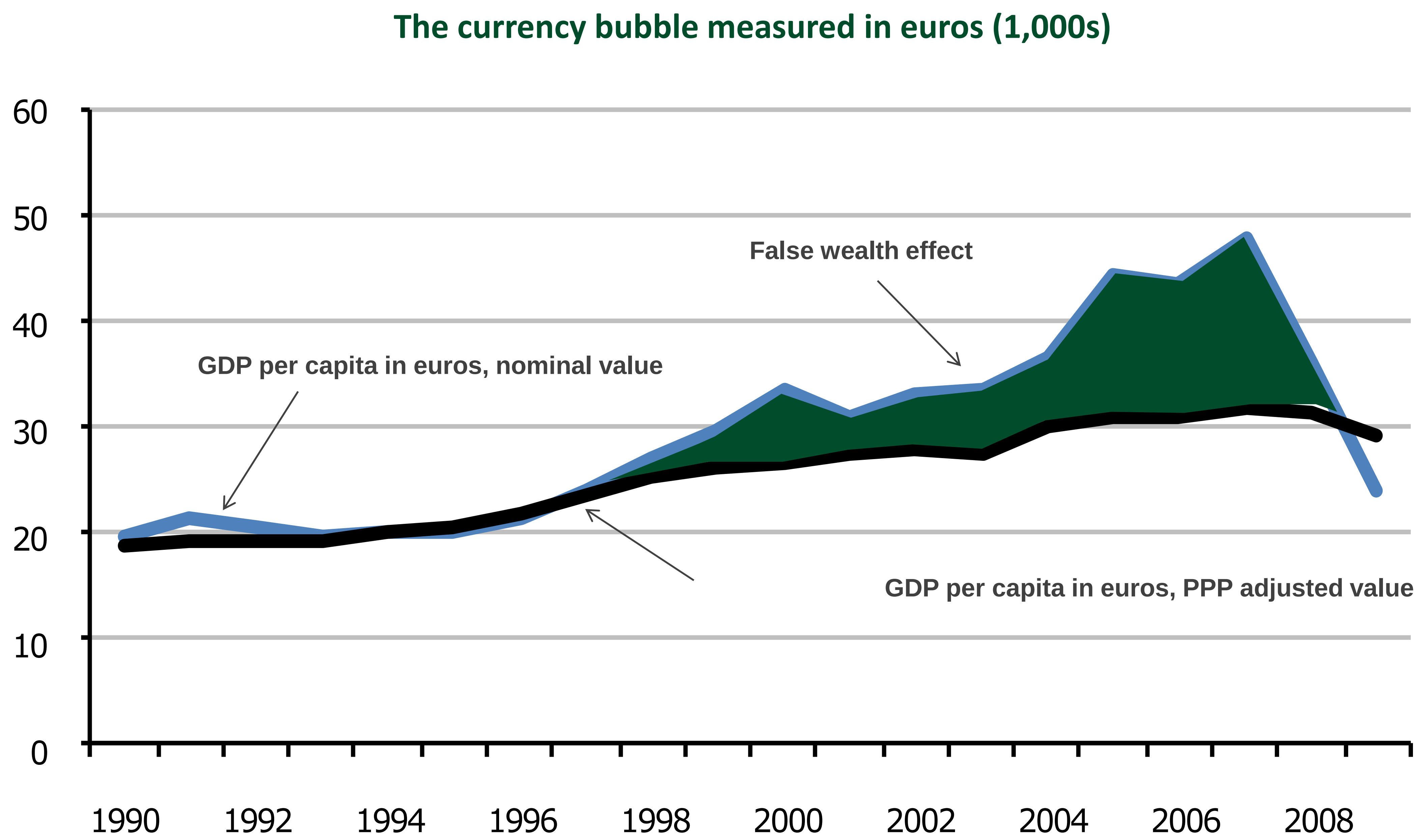


Rating upgrades were also the main driver for the banking bubble

Bank assets – As a factor of Iceland’s GDP



A ten year currency bubble driven by inflows



Being too small to save

- The total collapse occured not only because the Icelandic banks were **too-big-to-save** but Iceland itself was **too-small-to save**.
- Since Iceland was not part of the European Union and the failure of its banking system wasn't sparking any "contagion" fears, no other major central banks were willing to lend to a hypothetical Icelandic bank-bailout scheme.
- Iceland is probably the first triple-A rated country to so utterly lose confidence of international markets, and its collapsed banks now have the dubious distinction of being the first A-rated enterprises in history to default.
- What was seen as a disaster three years ago is, however, increasingly being seen as good fortune.
- Icelanders may have lost their financial system, but instead they were spared the burden of nationalizing private debts, and that makes all the difference.

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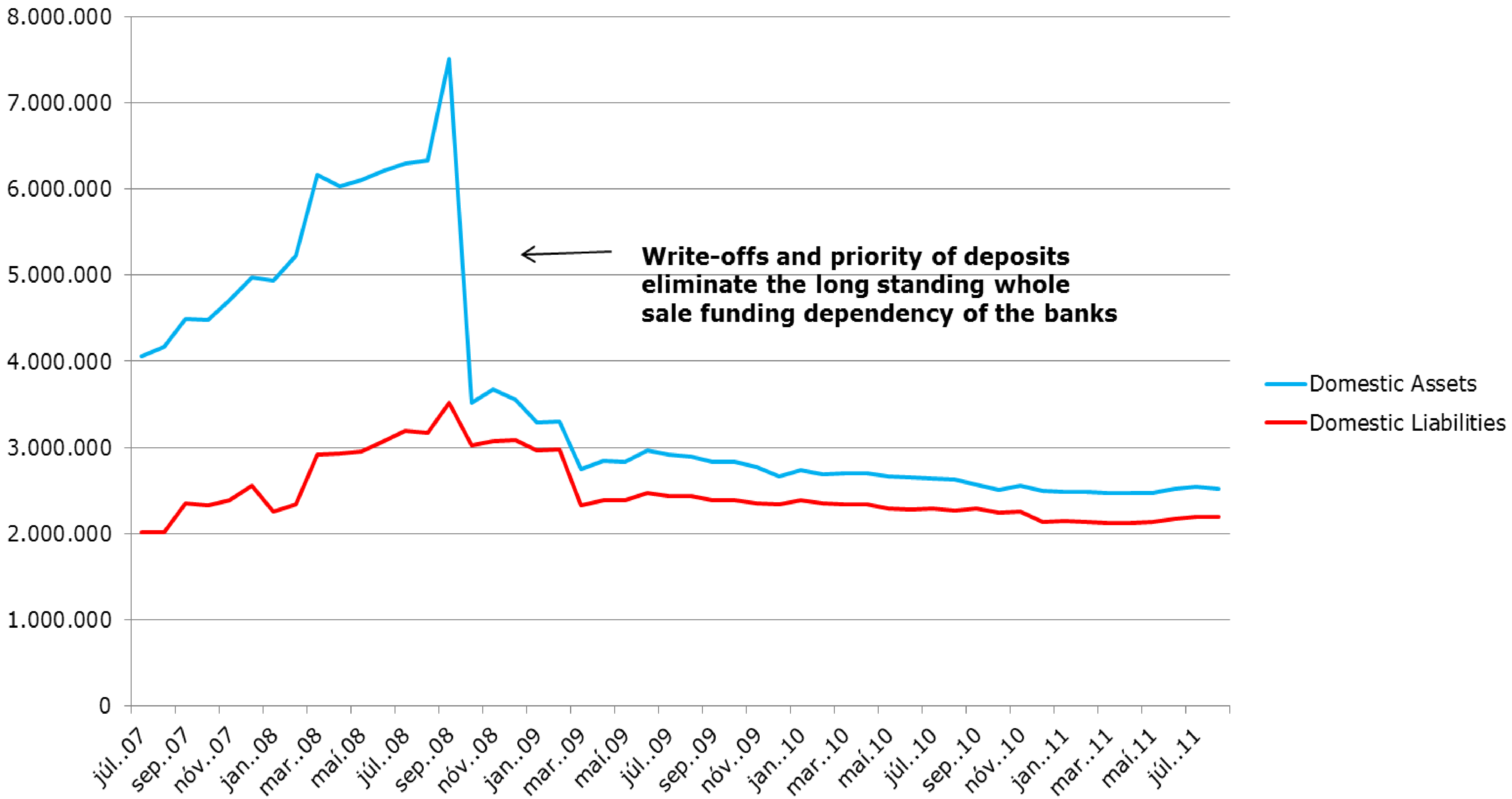
October 6th 2008 - the Emergency Legislation

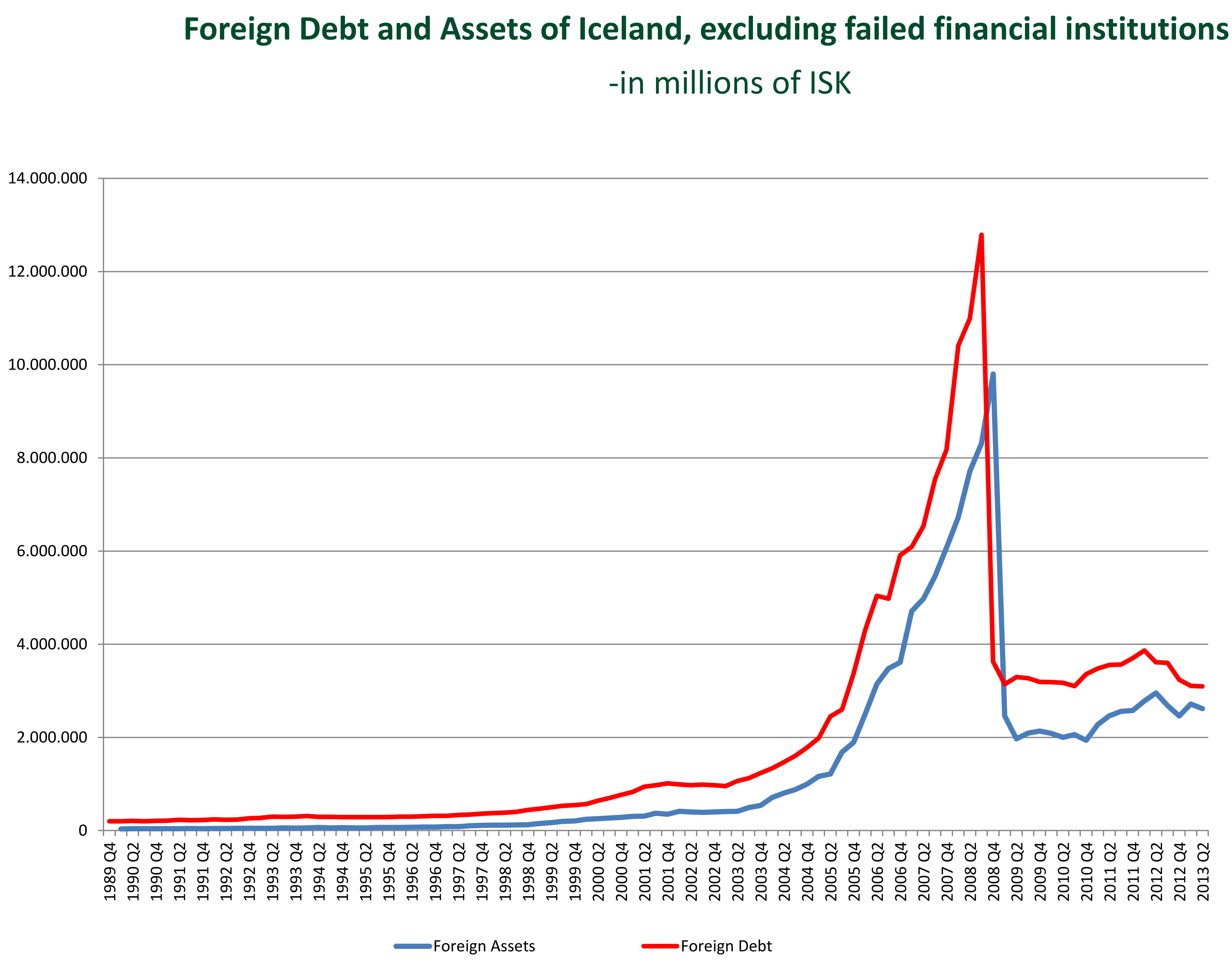
- **Facing the collapse, Iceland took force majeure rights to grant deposit holders priority over bondholders.**
  - Not only in Iceland but also internationally
- **Domestic deposits were ring-fenced in new banks that assumed domestic responsibilities of the old banks.**
- **Creditors (international and Icelandic) left with claims to “international” assets of old banks**
- **This effectively meant that:**
  - The Icelandic banking system was downsized by 80%
  - Deposit holders were bailed out at the expense of bondholders
  - Iceland now has almost solely deposit financed system
- **Total recovery of the old banks will be around 60-70%**
  - Deposit holders will get 100% recovery – bondholders 10-30% recovery (depending on the deposit to loan ratio of the banks)

New banks were founded with the domestic deposit base

Domestic assets and liablities of the Icelandic banks, in millions of ISK



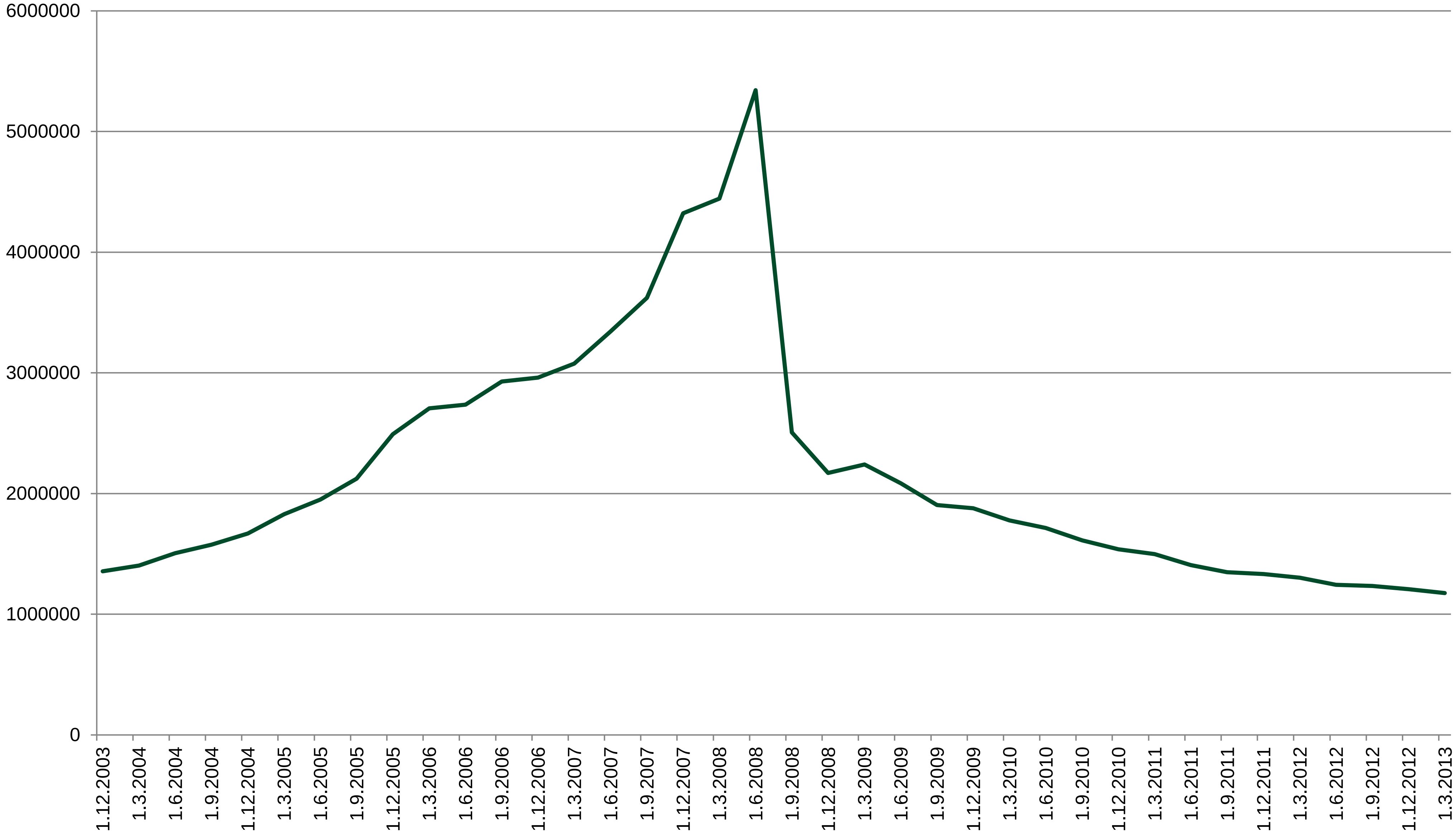
The foreign debt position was significantly reduced



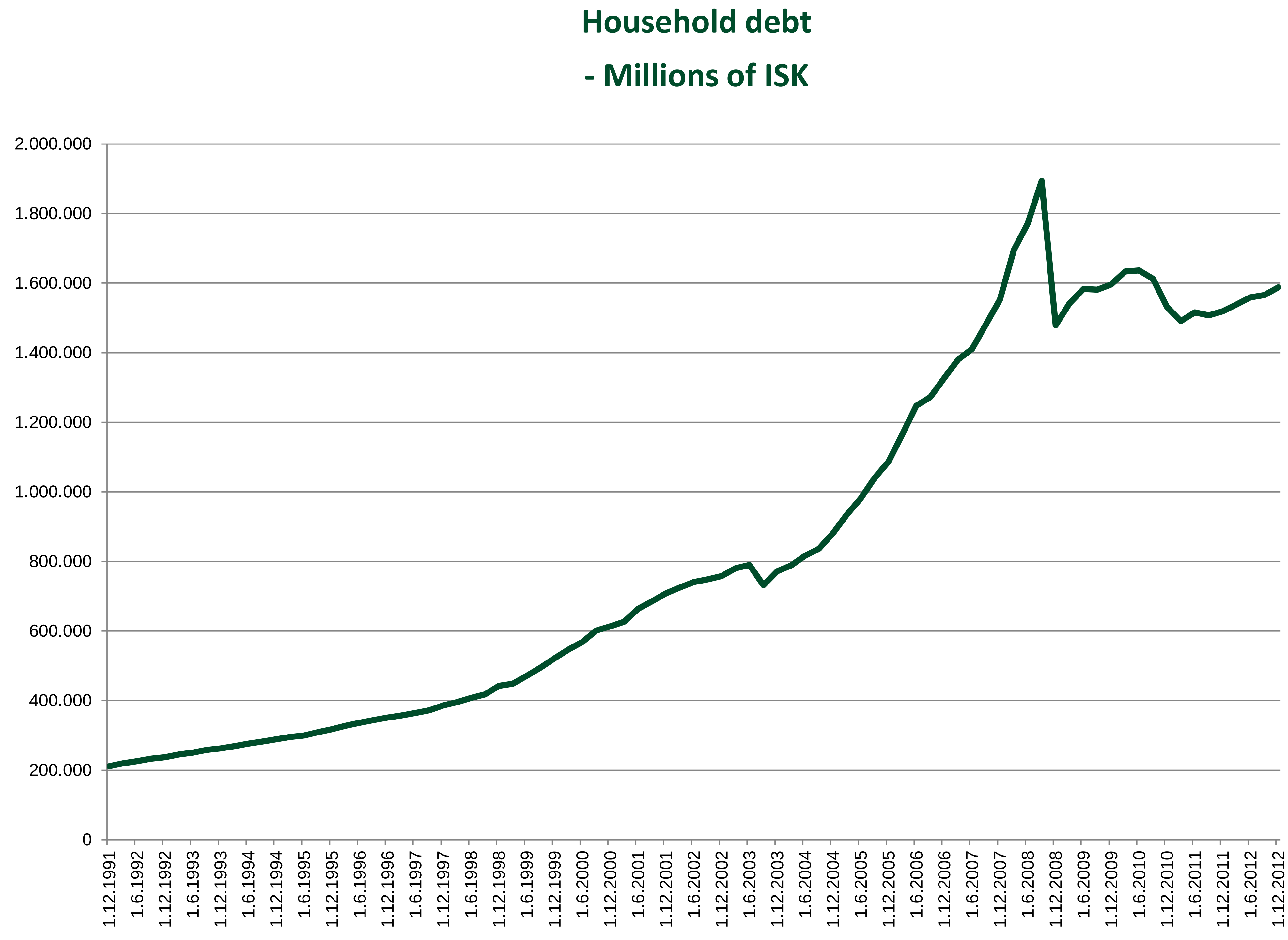
Corporate debt was restructured

Real value of corporate debt in Iceland 2003 to 2013

-in millions of ISK



For the households – indexation has kept the debt level up



Four main mistakes made after the crisis

1. **Creditors were given ownership of the equity in Íslandsbanki and Aríon banki**
   - ✓ The hefty profit from the economic recovery is now kept by creditors who now own sizeable ISK assets in Iceland.
2. **The Creditors of Landsbanki were given a currency linked bond that – since the bank is state owned – is effectively government guaranteed.**
   - ✓ This bond has been looming over the currency market ever since
3. **Costly and ineffective attempt was made to bail out the Savings Bank System**
4. **Costly and disastrous attempt was made to shore up the government owned Housing Financing Fund instead of liquidating the Fund at the same time as the banks.**

- **The Icelanders should have kept to letter of the emergency legislation**

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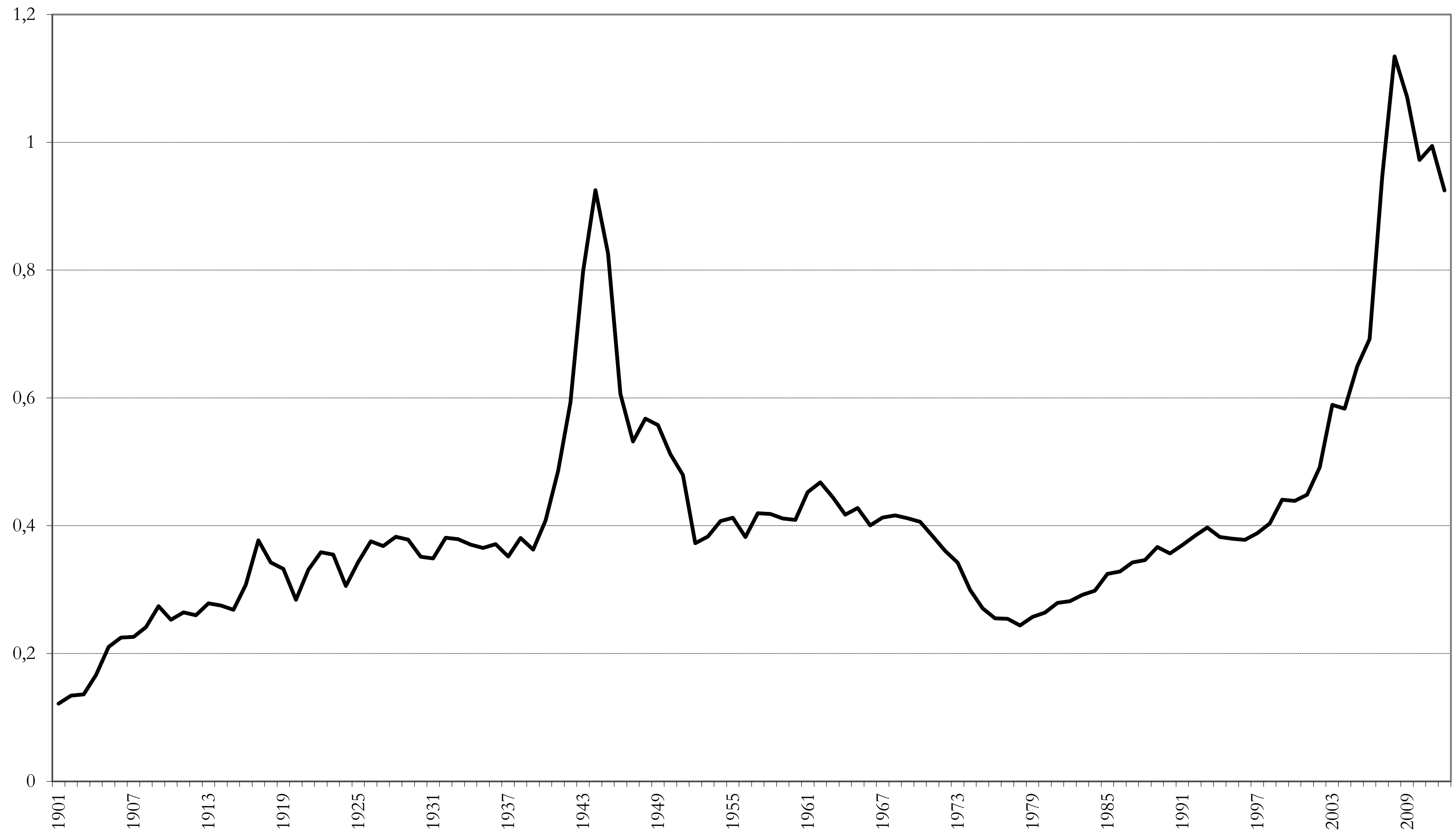
November 28th, 2008 – Capital controls

- **Capital transactions forbidden but the current account is open**
  - The ISK has been floating on trade flows in the currency market – but with heavy involvement from the Central Bank
  - The general public faces limits on foreign currency withdrawals but otherwise does not sense the burden from the controls
- **The capital controls allowed Iceland to restructure the banking system and lower interest rate without the risk of capital flight.**
- **Significant amount of foreign carry-trade funds are still locked in the financial system with ISK positions.**
- **The controls have allowed the Icelandic government to refinance itself at a much reduced rate and have averted a public finance crisis.**
- **However, the controls have had a depressing impact on both investments and exports and have created the sense of isolation within the business community.**

Leftovers from the Icelandic QE policy – the banking system is now full of foreign owned ISK liquidity

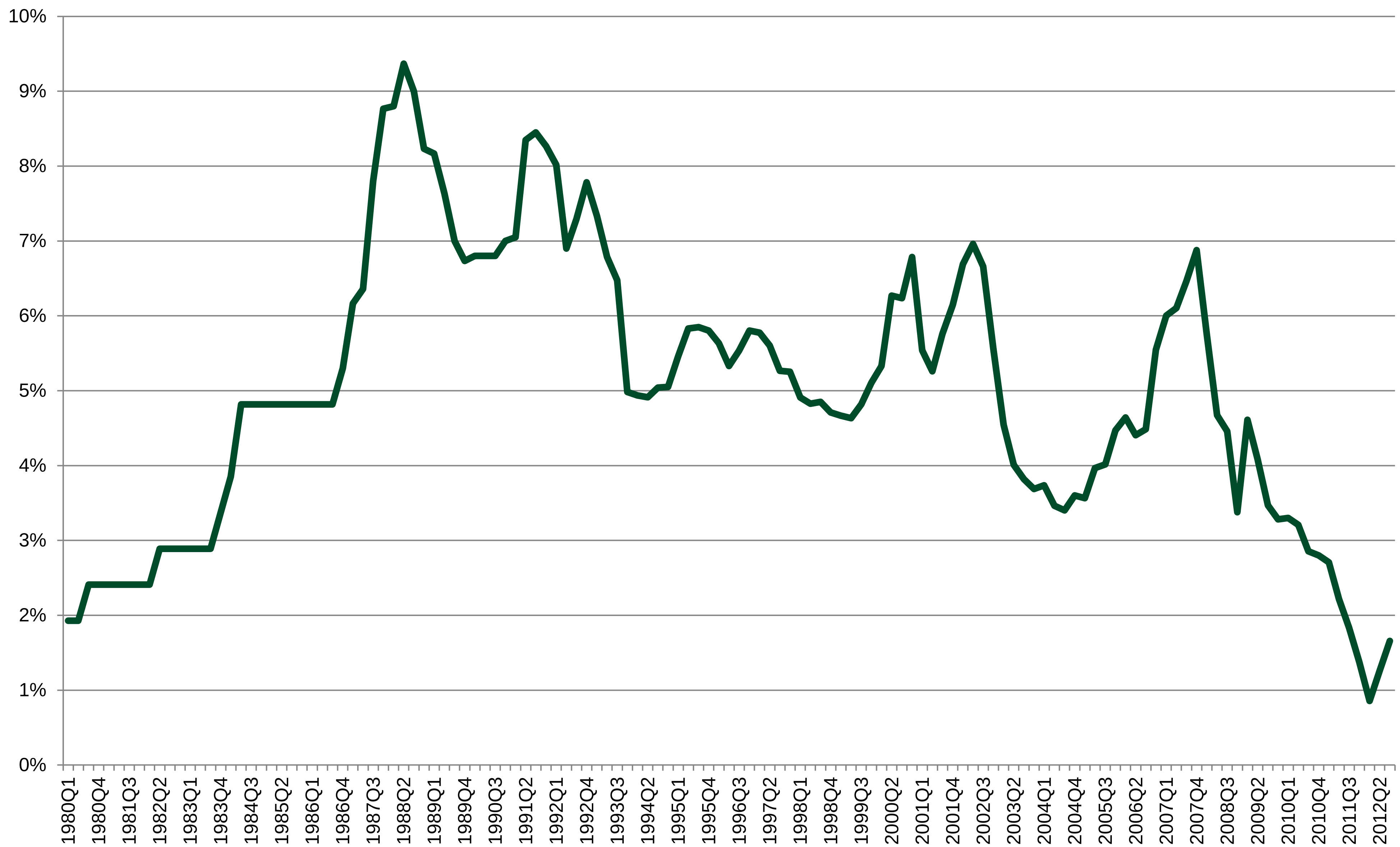
M3 as ratio of GDP



Excess liquidity behind capital controls has lowered the real rates

The 5-year indexed rate in Iceland

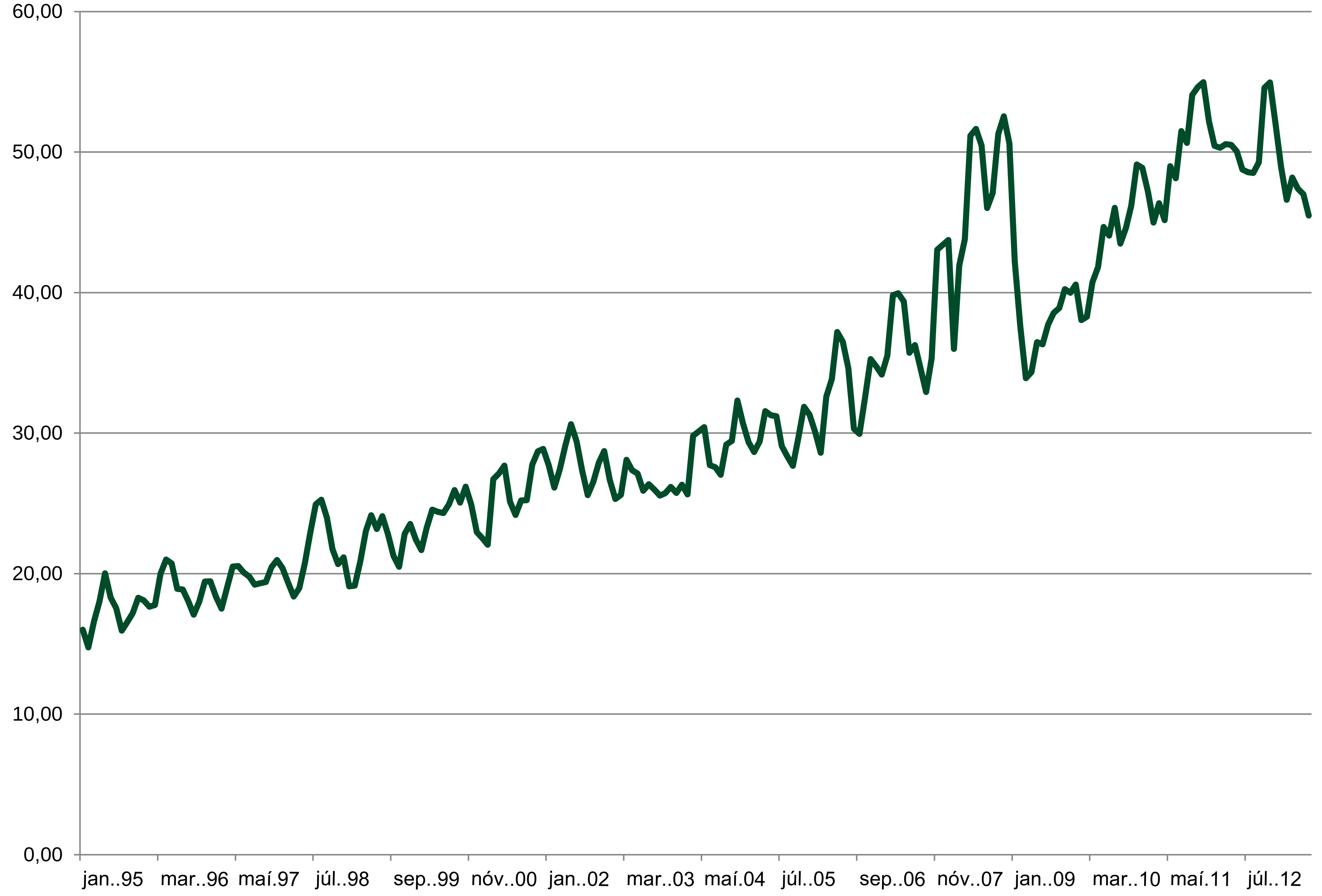
- On indexed government bonds



The controls have stifled the export based recovery

12 month change in Exports and Imports

- percentage change, controlling for exchange rate changes



Iceland unplugged, from the world economy

- The controls have unplugged Iceland from the World Economy.
- The problem is not only that potential foreign investors are locked out by controls but Icelandic corporation are locked in
- The controls have brought stability and lower interest rates and creating a cosy, but false comfort.
- It is the nature of bankrupt estates to turn asset into cash – that is what the fallen banks have busy with for the past 5 years.
- Foreign creditors are slowly gaining ownership of the Icelandic money supply as assets are sold at revalued price from the new banks.
- The domestic money stock is turning into an externtal liability
- **Capital controls were probably a mistake that is getting ever more difficult to correct!**

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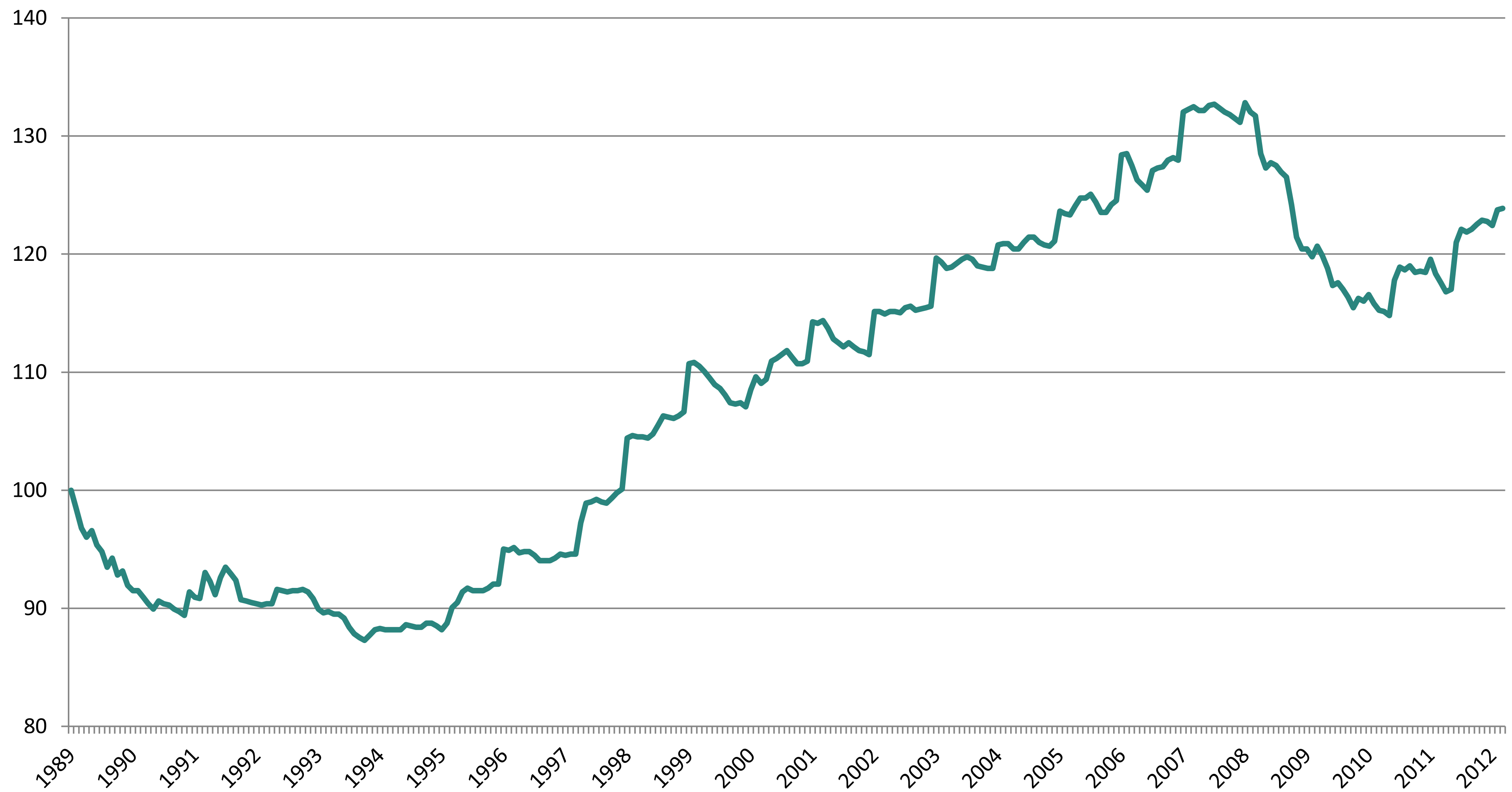
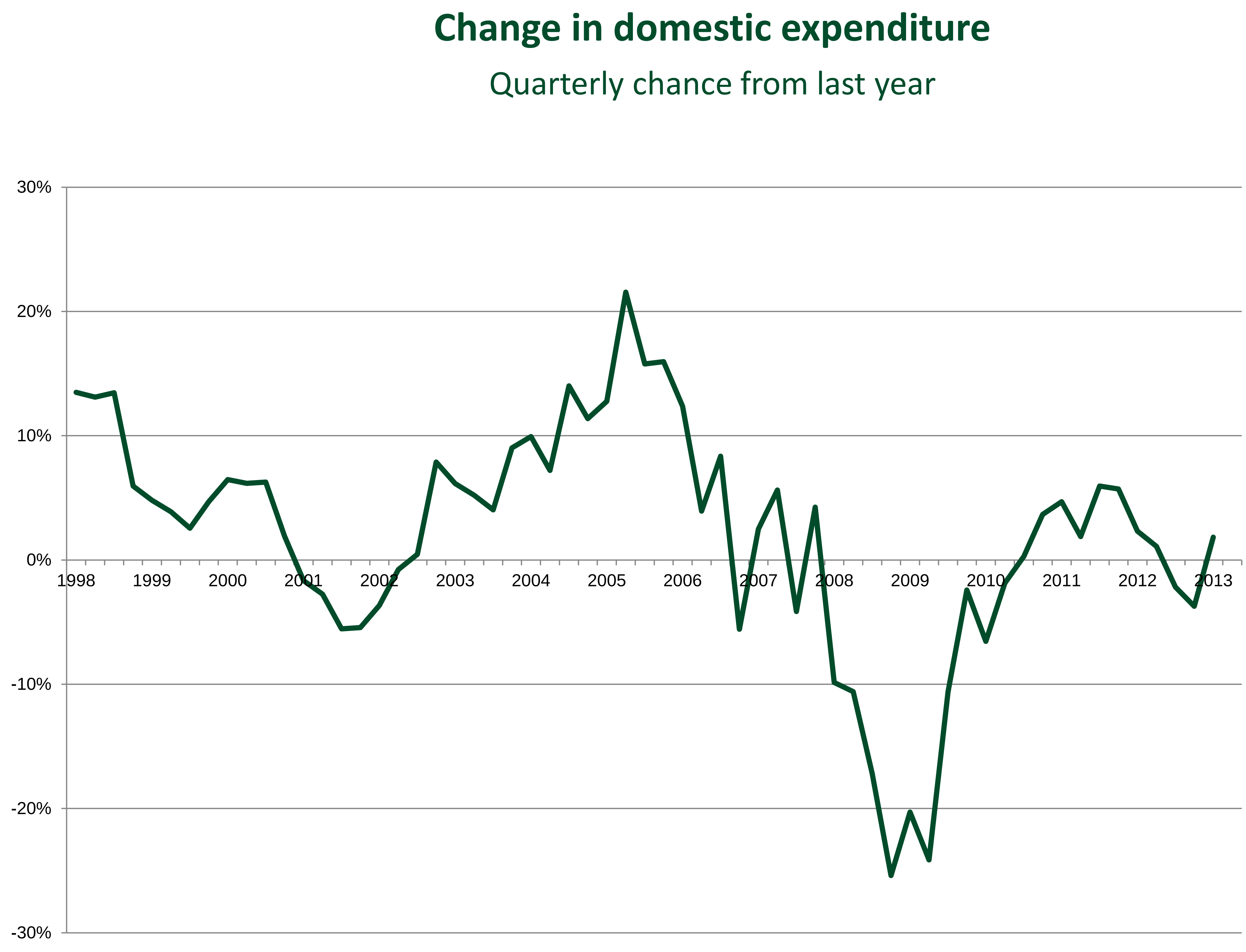
Real purchasing power dropped by 20-30% in the crisis

Household purchasing power – back to 2001

- Index based on average wages and inflation



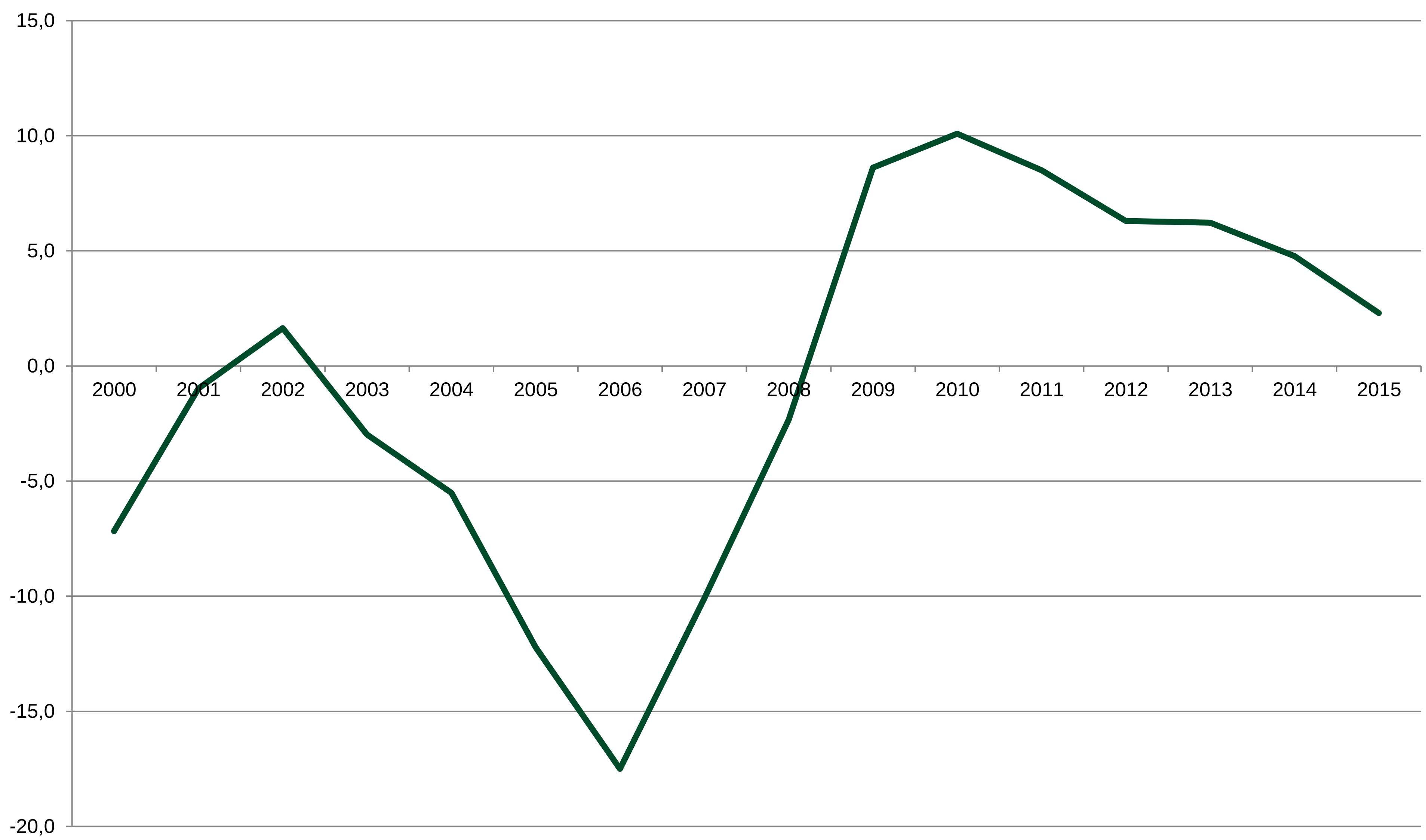
The recovery in domestic demand has been fragile



The trade surplus is declining as domestic demand is picking up

The balance of Trade, and the Central bank forecast until 2015

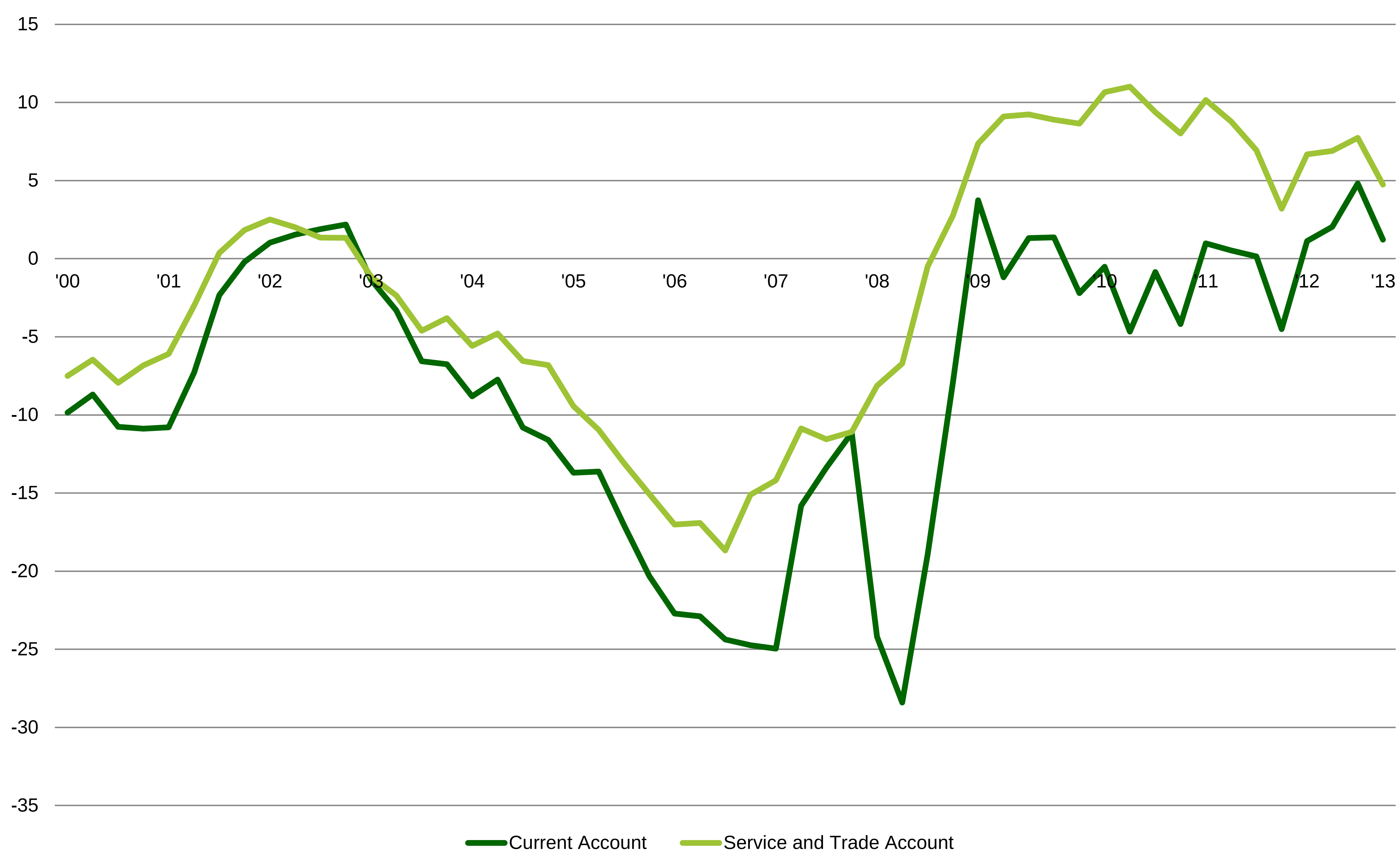
- as percentage of GDP



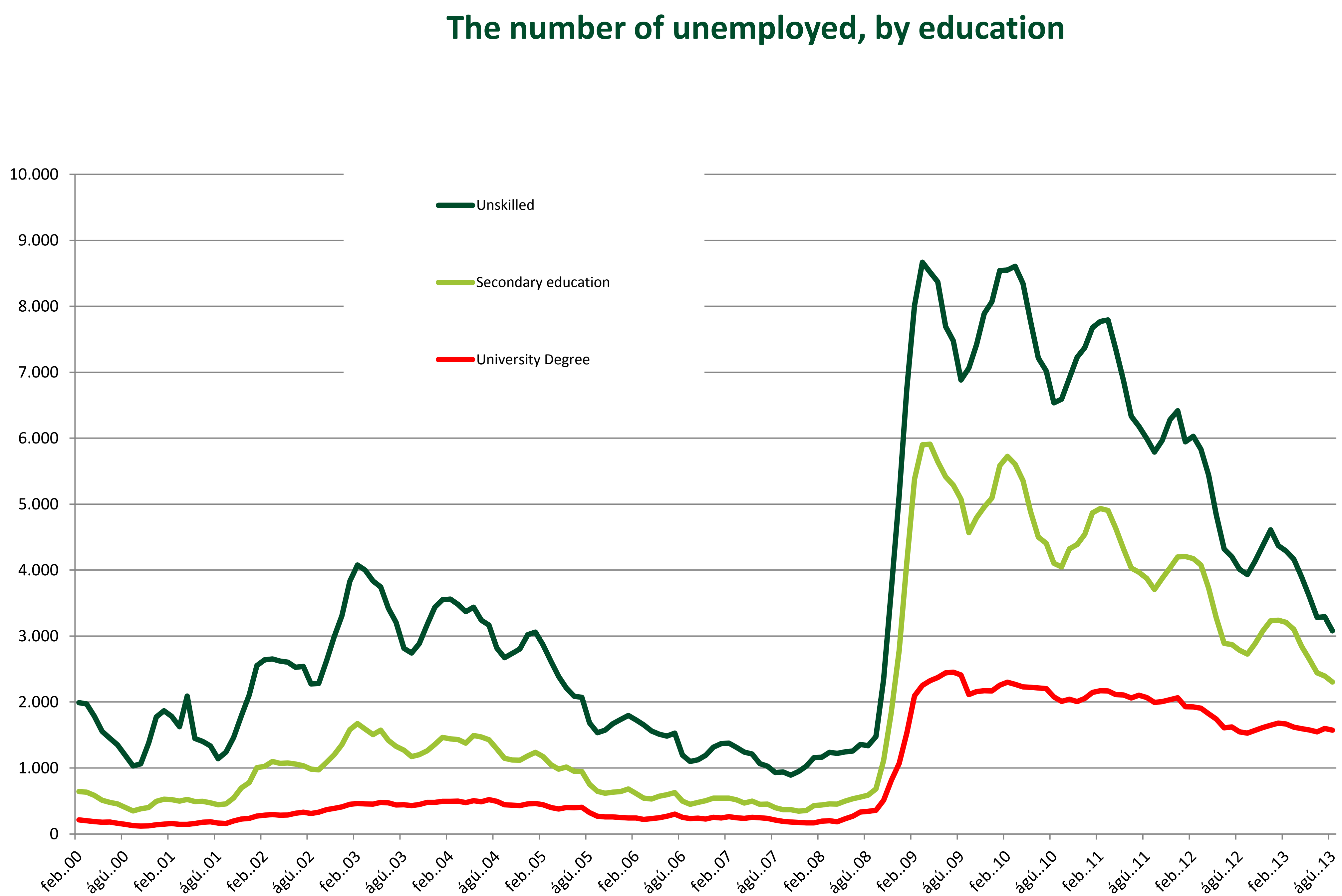
Interest paid out of the country have mostly consumed the trade surplus

The Current Account and Service and Trade accounts

- as percentage of GDP



Tourism had created new jobs in the service sector, mostly for the unskilled



Heading into full employment but at a very low real wage

- The economy is now heading into full employment but at a very low real wage
- Iceland has not been able to expand its export base in the past 5 years despite the competitive advantage given a by a very low currency rate.
- The collapse in domestic demand in 2008-2009 was the key to the trade surplus.
- The risk now imminent that an increase in domestic demand will decimate the surplus and lead to a new currency collapse.
- The current trade surplus is just enough to service the still outstanding foreign debts of the country...
- But not turning the massive ISK holdings of foreign parties into foreign currency.
- Iceland can not be re-financed through the current account – the country is now stuck in a deadlock, and with capital controls.

I. A new downsized balance sheet
II. The QE hangover
III. Foreign Trade
IV. Domestic Economy
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Some of the challenges Iceland faces

- **Problem 1** – the recovery is fragile and economic growth has been sluggish
- **Problem 2 –** household debt is 85% inflation indexed and people have to service their debts on a much lower real income
- **Problem 3** – investment has not picked up despite a low currency and low interest rates.
- **Problem 4** - the banking system is full of foreign owned liquidity that wants to leave the country at some point in time.
- **Problem 5** – the collapse has had a lasting impact on the political climate, which have been fraught with division.
- **Problem 6** – there is no clear plan of how the capital controls should be abolished and under what monetary policy regime Iceland can rejoin world´s financial markets.

The Transfer problem must be addressed

- Foreign parties now own about about 1000-1300 bilion worth of ISK assets which constitutes about 60-80% of the total money supply and 50-70% of GDP.
- This is wealth that cannot be transferred out of the country unless risking hyperinflation or just plain poverty with the Icelandic populace.
- This is a transfer problem comparable to the payment of war damages by Germany by the treaty of Versailles after the first world war.
- These holdings must either be turned into long-term liabilities or transferred out of the country at a much reduced price.
- Time is not on the side of the creditors – as the deadlock drags on the imbalances become larger within the Icelandic economy and the risk of another showdown akin to the emergency legislation of 2008 becomes greater.

Is it the question of size? Or are we just asking for too much?

- **Iceland has bountiful natural resources**
  - Green energy from both geothermal and hydrothermal sources and the highest electricity production per capita in the world.
  - Rich fishing grounds and intensely profitable fishing sector
  - Countless tourist magnets in natural wonders
  - Potential oil fields north of the country
- **Iceland has third-world demographics.**
  - The median age is only 34 years
- **The main problem is how to keep economic stability in the world´s smallest independent currency area!**
- **No other nation below the population of 1 million has its own independent currency.**
- **There has always been a trade-off between openess an stability in Iceland since sovereignty in 1918.**