



## Economic Survey of Iceland, 2009

**What effect has the financial crisis had on Iceland's economy?**

**How does the IMF Stand-By Arrangement help in overcoming the crisis?**

**What reforms to prudential supervision are needed?**

**What needs to be done to restore the smooth functioning of the financial system?**

**How has the crisis strengthened the economic benefits of entering the euro area?**

**How could the necessary fiscal consolidation best be achieved?**

**For more information**

**For further reading**

**Where to contact us?**

**Observer** oecd

### Summary

Against the backdrop of the global financial turmoil and recession, Iceland has been struck by a banking crisis of unprecedented proportions and the economy has plunged into a deep recession. The plight of the banking system was in part the consequence of the sudden shutdown of global capital markets. But Icelandic banks' aggressive expansion strategies in an atmosphere of ineffective supervision rendered them highly vulnerable. Faced with events having potentially dramatic economic and social consequences, the government sought the assistance of the international community in support of the medium-term adjustment programme to restore policy credibility and economic growth. While progress has been made in implementing the programme, much remains to be done.

**Weaknesses in financial supervision revealed by the crisis need to be corrected.** Following their privatisation in 2003, the banks expanded rapidly and became so big in relation to the economy that they could not be rescued when they got into trouble. They also became so complex and interconnected that the financial supervisors, with their limited powers, could no longer effectively restrain their activities. In the future, financial stability will require a smaller and simpler banking system, tougher supervision and a strong macro- and micro-prudential framework, focusing on both systemic and individual risks.

**For the economic recovery to take hold, the banking system needs to function smoothly once again.** In the wake of the crisis, the authorities created three new banks by transferring all domestic deposits and claims on residents previously held by the old banks. While an effective temporary solution, the present setup is not viable over time. The new banks hold impaired assets, they are too big and they should not stay forever in state ownership. The authorities should take the necessary steps to prepare their full privatisation and should encourage foreign banks to participate.

*This Policy Brief presents the assessment and recommendations of the 2009 OECD Economic Survey of Iceland. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.*

**Removal of capital controls should be started as soon as feasible.** The programme supported by the IMF Stand-By Arrangement introduced restrictions on capital flows to prevent massive outflows, stabilise the exchange rate and protect households and firms with large un-hedged foreign currency exposures. These restrictions should be lifted as soon as can be safely done to allow the resumption of normal financial relations with foreign markets.

**If it were to become an EU member, Iceland would be advised to seek entry into the euro area as soon as possible, so as to reap the economic benefits.** Past monetary policies based both on exchange rate and inflation targeting have produced unsatisfactory results. By joining the euro area, Iceland would share the benefits of the ECB's credibility, including lower risk premiums.

**Substantial fiscal consolidation is required to put public finances on a sustainable path.** The collapse of Iceland's financial institutions has increased government debt, while the recession and rising debt servicing costs entail a sharp widening of the budget deficit. Corrective fiscal measures should continue to be implemented. Initially most of the consolidation will occur through tax increases but subsequently the weight of expenditure reductions will have to grow. There is substantial scope to reduce health and education expenditure without adversely affecting the quality of services provided, as discussed in previous *OECD Economic Surveys of Iceland*. ■

## What effect has the financial crisis had on Iceland's economy?

Iceland has plunged into its deepest economic recession in decades after succumbing to a widespread financing crisis and a collapse of domestic demand. The meltdown of Icelandic banks unfolded against the backdrop of faltering global capital markets, which reached a climax in September 2008 with the failure of Lehman Brothers. By the fourth quarter of last year, almost all OECD countries were experiencing sharp declines in real GDP and world trade was plummeting. After years of rapid expansion, the economic situation in Iceland also turned for the worse when the country's three main banks collapsed, capital markets seized up and financial relations with foreign countries were shut down. While Iceland is in part a victim of the international crisis, its severe plight largely results from a recent history of ineffective bank supervision, exceptionally aggressive banks and inadequate macroeconomic policies. The government has devised a medium-term adjustment programme to restore policy credibility and economic growth, which is being implemented in the context of an IMF Stand-By Arrangement. The origins of Iceland's severe banking and macroeconomic difficulties and policies for a sustainable recovery are discussed in this *Economic Survey*.

A banking crisis of extreme severity is unfolding in Iceland. After five years of brisk expansion, the country's three main banks, representing 85% of the banking system, all collapsed during the same week in October 2008. The failure of Iceland's banks was not an isolated event: in most other OECD countries, banks also came under severe stress following the sudden meltdown of global capital markets. But Icelandic banks were particularly vulnerable to such a shock because their very aggressive strategies had exposed them to massive equity market risk, and they had relied heavily on precarious sources of funding. Upon their failure, the three banks were put into receivership and new banks were formed to enable the domestic payment system to continue to function smoothly. Complex negotiations between the new banks and the creditors of the old banks were needed to reach a final settlement. With hindsight, it appears that the Icelandic financial supervisory authorities had become overwhelmed by the complexity of the national banking system, and had been unable to stop their expansion. In addition, there was a lack of a macro-prudential framework that would have reacted to unsustainable developments in credit, leverage and risk. By the end, the size of the banks far exceeded the limited capacity of the Icelandic authorities to rescue them. Although the size of the banking sector has been reduced substantially, there is still a need to rethink the regulatory and supervisory framework.

A direct consequence of the crisis is that Iceland has entered a deep recession. The economy had already started to weaken in the first half of 2008 and, following the failure of the banks, the contraction in all components of domestic demand deepened markedly. The retrenchment of domestic demand is already much greater than in other OECD countries. Deep cuts in employment and working time were made, pushing up the

unemployment rate sharply from 2.5% in the third quarter of 2008 to 7.1% by the first quarter of 2009. A sharp drop in the exchange rate of the króna caused inflation to soar initially, although it had slowed to 11.6% by May 2009 as the effects of the depreciation eased and depressed economic conditions weighed on firms' pricing power. Wages have adjusted quickly to the crisis, falling by 6¾ per cent in real terms in the year to April 2009, with the fall being much more marked in the private – than the public sector. On the basis of announced macroeconomic policies (see below), the OECD projects a deep recession this year, with GDP shrinking by around 7%, and a gradual recovery beginning next year assuming that large energy-related projects get underway as planned. The unemployment rate is projected to rise to a peak of 10% in 2010 while inflation should fall to around 2½ per cent. ■

### How does the IMF Stand-By Arrangement help in overcoming the crisis?

Faced with an unprecedented crisis, the Icelandic authorities turned to the IMF for help and agreed to a programme supported by a Stand-By Arrangement. In the near term, the programme seeks to prevent a further sharp depreciation of the króna to reduce the risk of adverse balance-sheet effects, which arise notably from the high shares of foreign-exchange denominated and inflation-indexed debt in the economy. To this end, the programme foresees a tight monetary policy to make króna assets more attractive and exchange controls to be maintained on the capital account. Beyond this immediate goal, the programme seeks to restore the smooth operation of the banking system. It also calls for strong fiscal consolidation to ensure medium-term sustainability. The Stand-By Arrangement envisages access to official financing, from the IMF and other sources, of about US\$5 billion. ■

### What reforms to prudential supervision are needed?

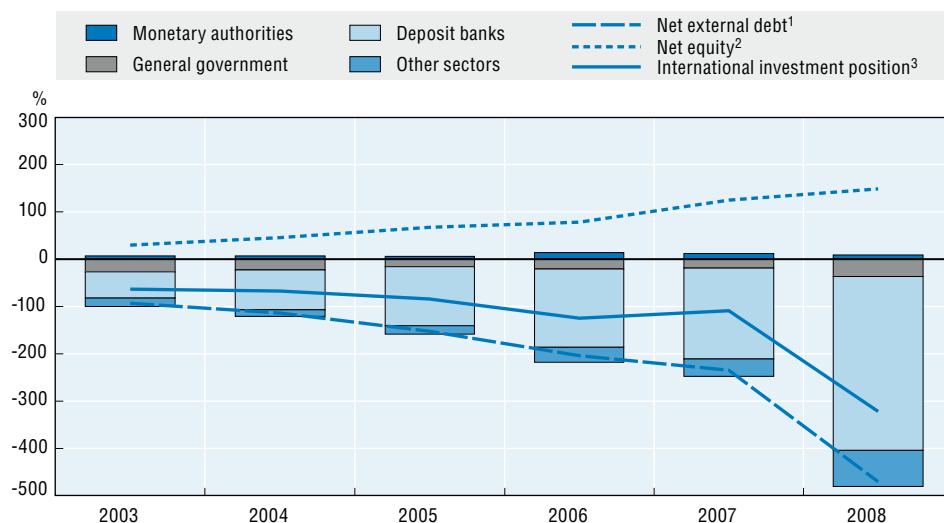
The financial collapse largely results from the banks' risky strategies. After the completion of banking privatization in 2003, the new owners set the banks on a path of international expansion and greater risk taking. Global financial market conditions were favourable at the time, enabling the banks to finance their expansion cheaply, mainly through wholesale markets. They grew quickly, increasing their consolidated assets to the equivalent of 880% of Icelandic GDP by the end of 2007, a very large amount by any standard. As they expanded, the banks increasingly made loans to a few Icelandic investment companies, typically controlled by the main shareholders of the banks, which were taking equity stakes in foreign firms. To finance these loans, the banks borrowed in foreign capital markets, increasing Iceland's net external debt by 142 percentage points of GDP over the four years to end-2007. This strategy indirectly exposed the banks to equity market risk. In the wake of the global financial meltdown in September 2008, fear about the solvency of the three Icelandic banks became widespread, effectively shutting them off from the wholesale markets and preventing

the refinancing of maturing obligations. As the banks were far too big to be recapitalised by the government, the Financial Supervisory Authority (FME) had no choice but to place them all into receivership.

The expansion of the banks entailed a major build-up of systemic risk in Iceland's financial system – all of them had significant exposures to the same risk factors: reduced liquidity in global bond markets, a decline in equity markets and exchange-rate depreciation. In addition to these risks, domestic bank lending underpinned an asset price boom in Iceland, increasing risks further. Finally, the banks grew to be too big for the Iceland government to rescue. Banking in these circumstances became very dangerous when the global financial crisis deepened. *To restrain the build-up of systemic risks in the future, macro-prudential supervision needs a legal basis to restrain bank behaviour, such as through countercyclical capital adequacy requirements.* To implement this reform effectively, it may be necessary to merge the Central Bank of Iceland, the macro-prudential supervisor, and the FME, the micro-prudential supervisor, or at least bring them under the same administrative umbrella (as in Finland and Ireland), as planned.

Although it will take some time to fully understand the causes of the financial crisis, some light was shed by studies commissioned by the authorities. The report of the former Finnish supervisor, Mr. Jännäri, notes that the first big mistake made was to allow local investor groups (with

**Figure 1.**  
**INTERNATIONAL INVESTMENT POSITION**  
End of year, as per cent of GDP



1. Net external debt is residents' debt claims on non-residents net of non-residents' debt claims on residents.
2. Net external equity is residents' equity assets (i.e. foreign direct investment and portfolio investments in shares) abroad net of non-residents' equity assets in Iceland.
3. The international Investment Position (IIP) is the sum of net external debt and net external equity asset positions.

Source: Central Bank of Iceland, *Monetary Bulletin*, 2009-2.

major expansion plans) to gain controlling stakes in the banks when they were privatised. The FME was not satisfied with this decision, which it considers to have been political, but acquiesced after lengthy deliberations. The report also points to a variety of practices that would have been considered elsewhere as inconsistent with basic banking regulation. Although banks seemed well capitalised, evidence suggests the capital was of poor quality, sometimes coming from connected parties. The banks had large exposures to investment groups and to each other (via shareholdings), implying a high degree of common vulnerability. While banking regulations were largely transposed from the European Union, Iceland's supervisors were unable to keep up with the complexity and size of the system as it grew rapidly and applied rules in an excessively legalistic manner. *In the future, Iceland's supervisors should not allow the banking sector to become so complex and so large that they cannot effectively fulfil their supervisory duties. Also, bank supervisors should lay down tougher rules and, subsequently, apply stricter practice on large exposures, connected lending and quality of owners, using discretionary best judgement when necessary.*

An important cross-border banking issue raised by the financial crisis was that national deposit guarantee systems may not have enough resources to honour the minimum EU deposit guarantee obligations. The government was obliged to stand behind Iceland's Depositors' and Investors' Guarantee Fund (DIGF) to enable it to meet these obligations, thus exposing Icelandic taxpayers to a large cost. While this issue goes beyond Iceland and would involve reforms of EU-wide practices, *the Icelandic authorities should review and improve the deposit guarantee system, closely following the developments within the EU, to protect the taxpayer from new large costs.* ■

### What needs to be done to restore the smooth functioning of the financial system?

Following the banking collapse, the authorities decided to create three new banks by transferring the domestic deposits and claims on residents previously held by the old banks, thus effectively separating domestic from foreign operations. While this preserved the functioning of the domestic payment system, the new banks have no capital and there is considerable uncertainty about the value of their assets and liabilities. Once the compensation instruments between the new and old banks have been issued, the government will recapitalise the new banks, which will enable them to provide more normal financial intermediation services. *To eliminate uncertainties about the strength of the balance sheets of the new banks, the government should move low-quality domestic assets into an asset management company, which will dispose them over time.* In addition, there is evidence that the banks remain oversized for the Icelandic markets, thus weakening their profitability. *The banks should be streamlined to make them profitable, including by merger if necessary (provided that this does not undermine competition in banking services).* All of these measures would help to prepare the banks for full privatisation within the next few years. *To facilitate privatisation, foreign direct investment into the Icelandic banking system should be encouraged.* Other

small countries, such as New Zealand, have found that having a banking system that consists almost entirely of well-run fully-owned subsidiaries of foreign banks works well and has been particularly advantageous during this period of global financial turmoil.

Iceland has imposed capital controls to prevent disorderly outflows from causing a fall in the external value of the króna, especially outflows of non-resident investors' large holdings of króna-denominated securities, which would have driven many un-hedged firms and some households into bankruptcy. As well, by disallowing investments abroad, the capital controls in effect forced domestic creditors to lend to domestic borrowers, thus sharply reducing the risk premium and lowering market interest rates. *Nonetheless, lifting capital controls should start as soon as this can be done safely, to normalize relations with foreign markets and allow firms to tap financial sources abroad.* The authorities plan to lift the capital controls gradually once a medium-term fiscal consolidation plan is well in train, the banking sector has been put back on its feet and there are sufficient international reserves. According to available information, some 20% of household debt was denominated in foreign currency in September 2008 and was not hedged while 50% of corporate borrowers with foreign-currency denominated debt do not have foreign currency earnings. ■

### How has the crisis strengthened the economic benefits of entering the euro area?

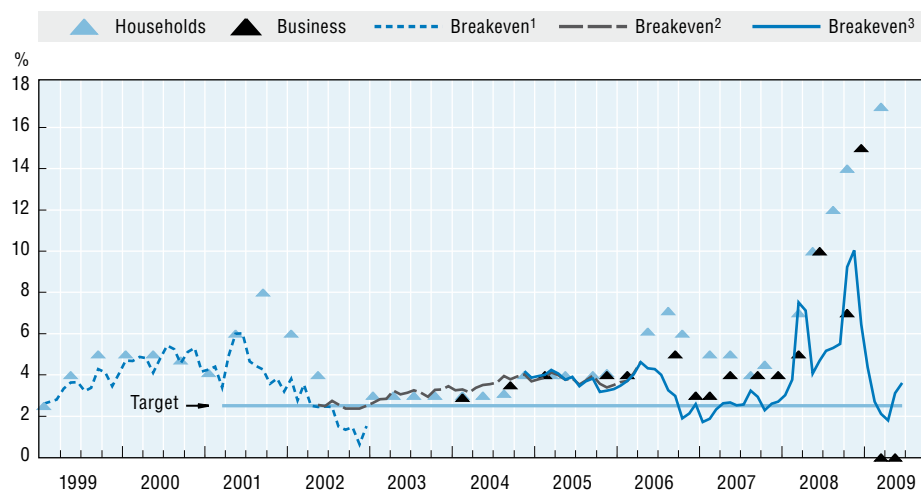
Monetary and fiscal policy challenges have grown hugely. Formulating an exit strategy from the temporary regime of capital controls and high interest rates is a major task. The lack of satisfactory monetary policy outcomes under different regimes in past years points to the limitations of an independent monetary policy in a very small, open country like Iceland, particularly in the context of large capital inflows associated with global carry trade transactions. Moreover, the crisis has imposed a very high budgetary cost. The large fiscal deficits need to be reduced and eventually eliminated and the rising national debt will need to be turned around.

Iceland's monetary policy credibility has been seriously damaged by the financial crisis. Even before the crisis, unsatisfactory inflation outcomes had already undermined the credibility of the monetary framework and, consequently, inflation expectations were poorly anchored. Rebuilding credibility is likely to take time and, even then, maintaining it might be very difficult. In the meantime, risk premiums on króna assets will remain high. *In view of these considerations, the best way forward for Iceland would be to seek entry into the euro area, which would require accession to the European Union.* Iceland would thereby participate in the credibility of euro-area monetary policy, which would be a stabilising influence and would lower interest rate premia. Lower real interest rates would reduce the government's debt servicing costs, ease balance-sheet adjustment for the private sector and lower the cost of capital to the private sector. The sharing of a common currency would reinforce trade linkages with other euro-area economies

and would likely increase the synchronicity of the business cycle. On the other hand, Iceland would lose the option of exchange rate adjustments following idiosyncratic shocks. This consideration may be less important for Iceland than for other countries because its economy is already very flexible. Nevertheless, such a consideration points to the need to maintain and even increase flexibility in labour and product markets. Achieving the macroeconomic conditions for euro adoption – low inflation, stable exchange rate and low deficits and debt – will pose a difficult policy challenge in the years ahead but would in any case be an important ingredient in securing the necessary macroeconomic stabilisation following the crisis. The authorities need to be steadfast in using macroeconomic policy instruments to achieve these goals.

Euro-area entry is, however, some time off, even under the most optimistic circumstances. For the time being, monetary policy should remain geared towards supporting the króna and protecting the balance sheets of unhedged borrowers. Exchange rate stability is the main goal of the capital controls, but since capital controls do not work perfectly, monetary policy needs to maintain a relatively strict stance. *Until concerns about disorderly capital outflows diminish, monetary policy should stay focussed on maintaining exchange rate stability, which may limit the scope for further reductions in the interest rate.* Once the capital account has been liberalised, a managed exchange rate regime will be increasingly difficult to implement. *The authorities should thus adopt an inflation-targeting framework geared to meeting the Maastricht Treaty inflation criteria, which would imply switching from the official CPI to the internationally-comparable harmonised CPI (HICP).* To improve the functioning

**Figure 2.**  
**INFLATION EXPECTATIONS**



1. Spread between: RIKB 03 1010 and RIKS 03 0210 for January 2000 to April 2002.
2. Spread between: RIKB 13 0517 and RIKS 15 1001 for May 2002 to October 2004.
3. Spread between: RIKB 13 0517 and HFF 15 0914 since then.

Source: Central Bank of Iceland.

of the monetary framework, the Central Bank's credibility should be improved. A good start has been made in this regard with recent reforms to communication policy and to the governance structure of the Central Bank, including the appointment of a Monetary Policy Committee with both internal and external members, coming with adequate credentials, to take interest rate decisions. *It is also crucial that the conduct of monetary policy be more decisive than in the past and that the government fully respects the Central Bank's independence.* ■

### How could the necessary fiscal consolidation best be achieved?

The financial collapse has increased government debt. With the recession and rising debt servicing costs, the public deficit is projected to be above 10% of GDP in 2009, adding to the public debt burden. A considerable fiscal consolidation is therefore required to put public finances back on a sustainable path and to pave the road for a successful euro-area entry. *The deficit should be reduced vigorously in the coming years, with the goal of reaching balance.* This path is consistent with that called for in the IMF Stand-By Arrangement. Both tax increases and spending cuts will be needed, although the former are easier to introduce immediately. *The starting point for the tax increases should be to reverse tax cuts implemented over the boom years, which Iceland can no longer afford. This would involve increases in the personal income tax and lifting the reduced rate of VAT.* Just undoing the past tax cuts is unlikely to yield enough revenue. *In choosing other measures, priority should be given to those that are less harmful to economic growth, such as broadening tax bases, or that promote sustainable development, such as introducing a carbon tax.* *The government should also increase unemployment insurance contributions to a level that would be expected to balance the fund's accounts over the economic cycle, as planned.*

The planned fiscal consolidation will necessarily also involve substantial measures to contain expenditures. *Expenditures that expanded rapidly in recent years are good areas to look at for savings.* Government wages often outpaced those in the private sector, as the then-booming financial sector raised the demand for more skilled workers. *With retention no longer a problem, government wages should be frozen or even cut in nominal terms, implying significant declines in real terms, at least in 2009.* For the same reason, public investment, which rose at an annual average rate close to 10% over 2003-2007, should also be scaled back as much as possible, as is already planned. *Budget expenditure growth ceilings must also be respected, in contrast to what has happened in the past. To this end, the role of the National Audit Office in the monitoring of the budget should be strengthened. Advice on the macroeconomic consequences of fiscal policy decisions should be further enhanced.*

A number of public programmes could be reformed to reduce costs while still achieving the same outcomes. Above all, as discussed in the special chapter of the 2008 OECD Economic Survey, there are several options for enhancing spending efficiency in the health sector. *The cost of running*

hospitals, which accounts for a high share of healthcare spending, could be reduced by introducing cost sharing and by rapidly implementing activity-based funding arrangements that reward productivity. Analysis in the 2006 OECD Economic Survey identified significant savings in education expenditures, which could be made from reducing the average duration of upper-secondary school toward international standards and, as planned, by consolidating the higher education sector. Municipalities, which are responsible for pre-school and primary education, are also facing pressure to cut in these areas as their revenues have fallen and their access to external financing sources is limited. Teacher-to-student ratios, which are high by international comparison, should be reduced. More generally, there is still scope to achieve economies through greater consolidation of municipalities. The crisis also provides an opportunity to reduce support to agriculture, which is the highest in the OECD.

While macroeconomic policy currently runs high on the policy agenda, this should not obviate the need to conduct growth-friendly structural reforms, notably in the labour market and the product market. The labour market is flexible overall with high participation rates, ease of entry for migrants, strong work incentives and unemployment benefits of short duration by international standards. With Iceland being confronted for the first time in recent history with a massive increase in unemployment, it will be important to avoid introducing policies that would undermine the good functioning of the labour market, such as higher replacement rates and longer duration for unemployment benefits, as this would contribute to a rise in long-term unemployment. Another strength of the Icelandic labour market is that real wages are highly flexible, thus helping to smooth economic adjustment in the face of shocks. Real wage cuts have in the past come in the form of consumer price inflation exceeding the growth of nominal wages. If Iceland joins the euro area, nominal wage flexibility will become more important as a mechanism for adjusting to asymmetric shocks. Although the product markets generally function well, several areas need attention, as indicated in past OECD Surveys. The energy sector is dominated by the state-owned National Power Company and should be opened to foreign investment. In the mortgage market, although the Housing Finance Fund is currently an element of stability, policy makers might have to reassess its role as it benefits from a government guarantee that prevents fair competition and distorts the allocation of resources. More generally, experience of euro-area countries underlines the need for greater flexibility throughout the economy if adjustments to shocks are to occur smoothly and contribute to sustainable growth and high living standards. ■

**For more  
information**

For more information regarding this *Policy Brief* and the *OECD Economic Survey of Iceland*, please contact:

David Carey, tel.: +33 1 45 24 87 29, e-mail: [david.carey@oecd.org](mailto:david.carey@oecd.org).

Information about the latest as well as previous *OECD Economic Surveys of Iceland* is always available at [www.oecd.org/eco/surveys/Iceland](http://www.oecd.org/eco/surveys/Iceland).



## For further reading



**OECD Economic Surveys:** *Economic Surveys* review the economies of member countries and, from time to time, selected non-members. Approximately 18 Surveys are published each year. They are available individually or by subscription. For more information, consult the Periodicals section of the OECD online Bookshop at [www.oecd.org/bookshop](http://www.oecd.org/bookshop).

**Additional Information:** More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's website at [www.oecd.org/eco](http://www.oecd.org/eco).

### **Economic Outlook Interim Report**, March 2009.

More information about this publication can be found on the OECD's website at [www.oecd.org/eco/Economic\\_Outlook](http://www.oecd.org/eco/Economic_Outlook).

### **Economic Policy Reforms: Going for Growth**, 2009 edition.

More information about this publication can be found on the OECD's website at [www.oecd.org/economics/goingforgrowth](http://www.oecd.org/economics/goingforgrowth).

---

OECD publications can be purchased from our online bookshop:

[www.oecd.org/bookshop](http://www.oecd.org/bookshop)

OECD publications and statistical databases are also available via our online library:

[www.SourceOECD.org](http://www.SourceOECD.org)

---

## Where to contact us?

### OECD HEADQUARTERS

2, rue André-Pascal  
75775 PARIS Cedex 16  
Tel.: (33) 01 45 24 81 67  
Fax: (33) 01 45 24 19 50  
E-mail: [sales@oecd.org](mailto:sales@oecd.org)  
Internet: [www.oecd.org](http://www.oecd.org)

### GERMANY

**OECD Berlin Centre**  
Schumannstrasse 10  
D-10117 BERLIN  
Tel.: (49-30) 288 8353  
Fax: (49-30) 288 83545  
E-mail:  
[berlin.centre@oecd.org](mailto:berlin.centre@oecd.org)  
Internet:  
[www.oecd.org/berlin](http://www.oecd.org/berlin)

### JAPAN

**OECD Tokyo Centre**  
Nippon Press Center Bldg  
2-2-1 Uchisaiwaicho,  
Chiyoda-ku  
TOKYO 100-0011  
Tel.: (81-3) 5532 0021  
Fax: (81-3) 5532 0035  
E-mail: [center@oecdtokyo.org](mailto:center@oecdtokyo.org)  
Internet: [www.oecdtokyo.org](http://www.oecdtokyo.org)

### MEXICO

**OECD Mexico Centre**  
Av. Presidente Mazaryk 526  
Colonia: Polanco  
C.P. 11560 MEXICO, D.F.  
Tel.: (00.52.55) 9138 6233  
Fax: (00.52.55) 5280 0480  
E-mail:  
[mexico.contact@oecd.org](mailto:mexico.contact@oecd.org)  
Internet:  
[www.oecd.org/centrodemexico](http://www.oecd.org/centrodemexico)

### UNITED STATES

**OECD Washington Center**  
2001 L Street N.W., Suite 650  
WASHINGTON DC. 20036-4922  
Tel.: (1-202) 785 6323  
Fax: (1-202) 785 0350  
E-mail:  
[washington.contact@oecd.org](mailto:washington.contact@oecd.org)  
Internet: [www.oecdwash.org](http://www.oecdwash.org)  
Toll free: (1-800) 456 6323

The OECD Policy Briefs are prepared by the Public Affairs Division, Public Affairs and Communications Directorate. They are published under the responsibility of the Secretary-General.