

Iceland: Economic Prospects and Challenges

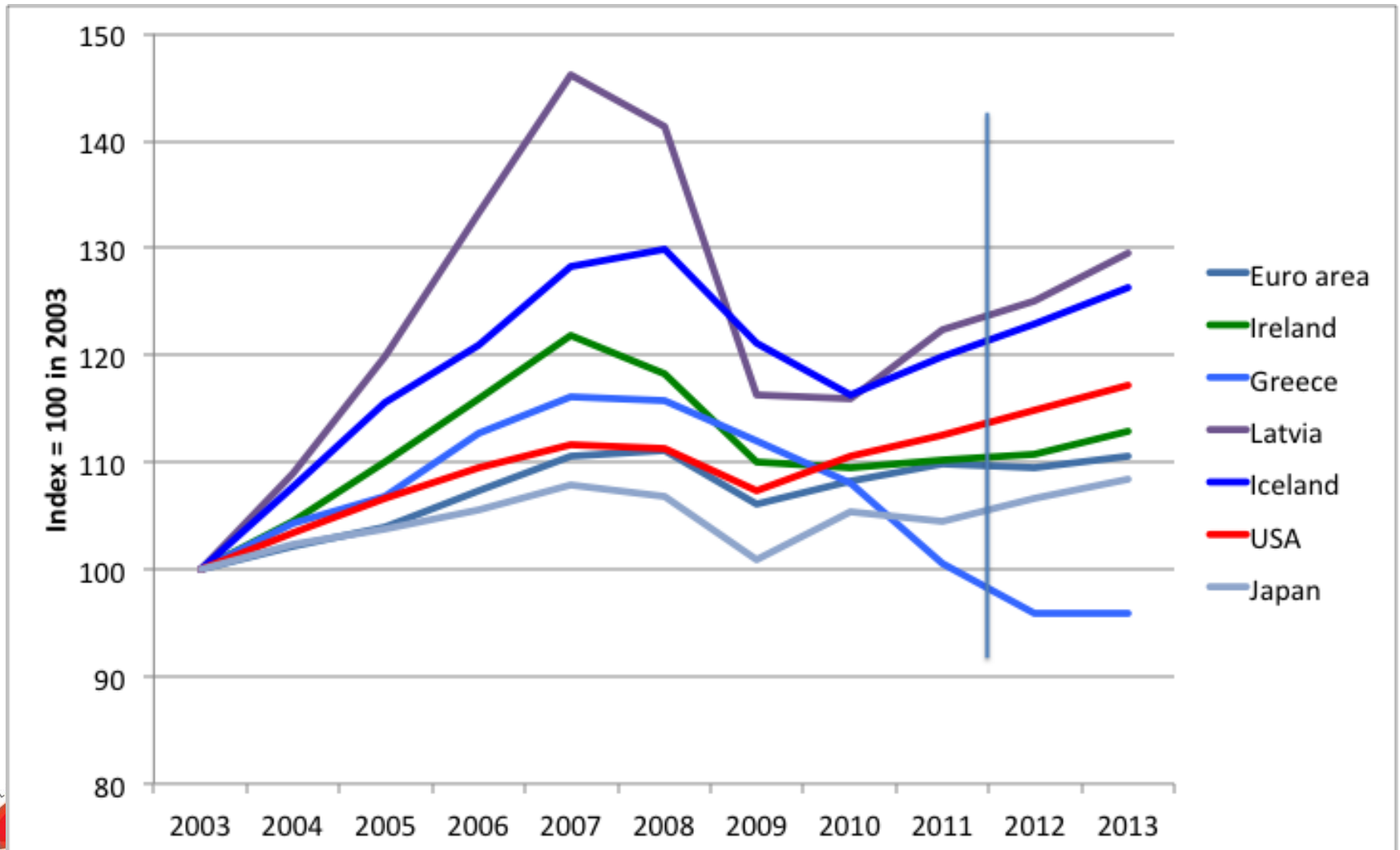
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SENIOR BUDGET OFFICIALS**

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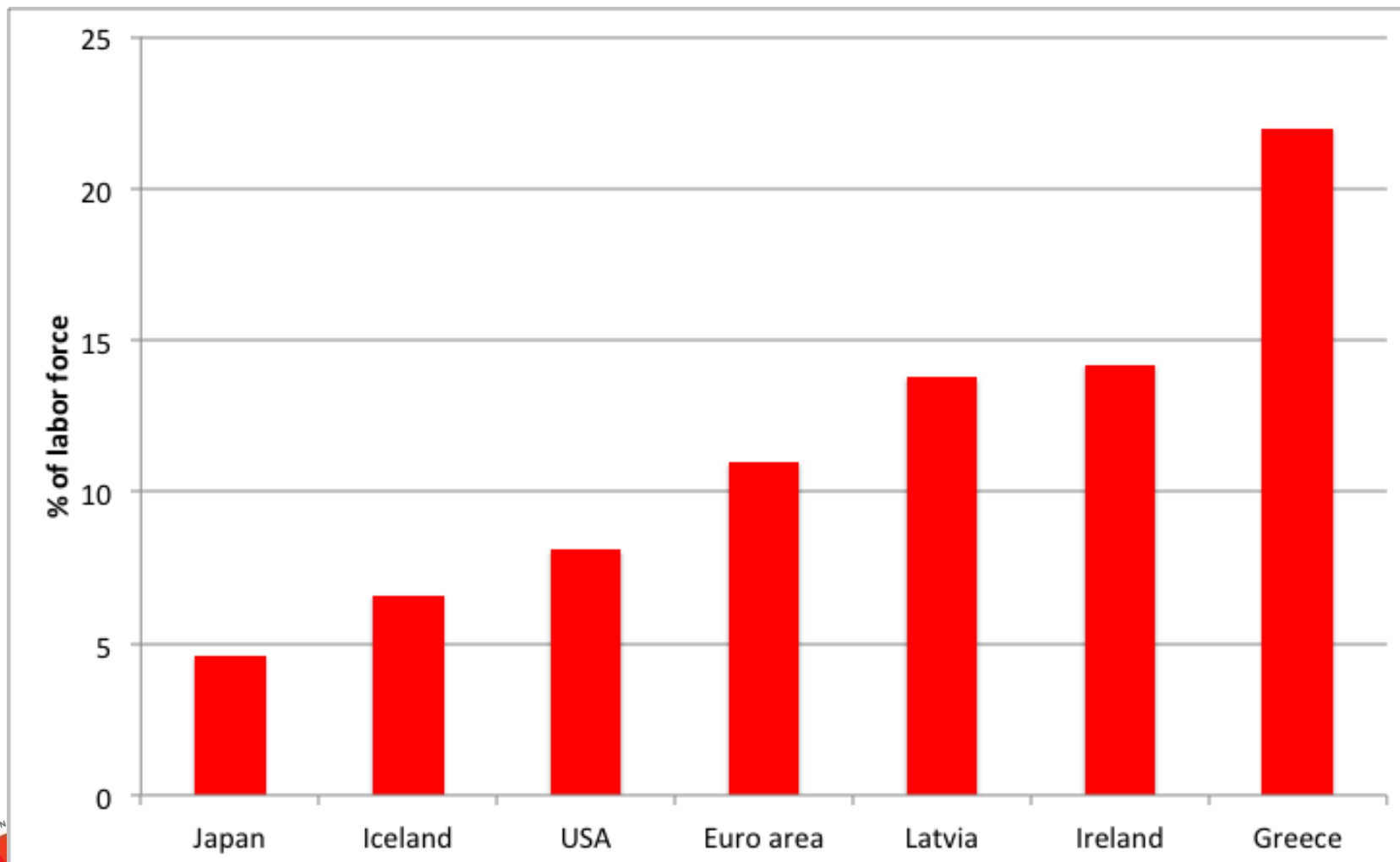


GDP in selected countries/areas



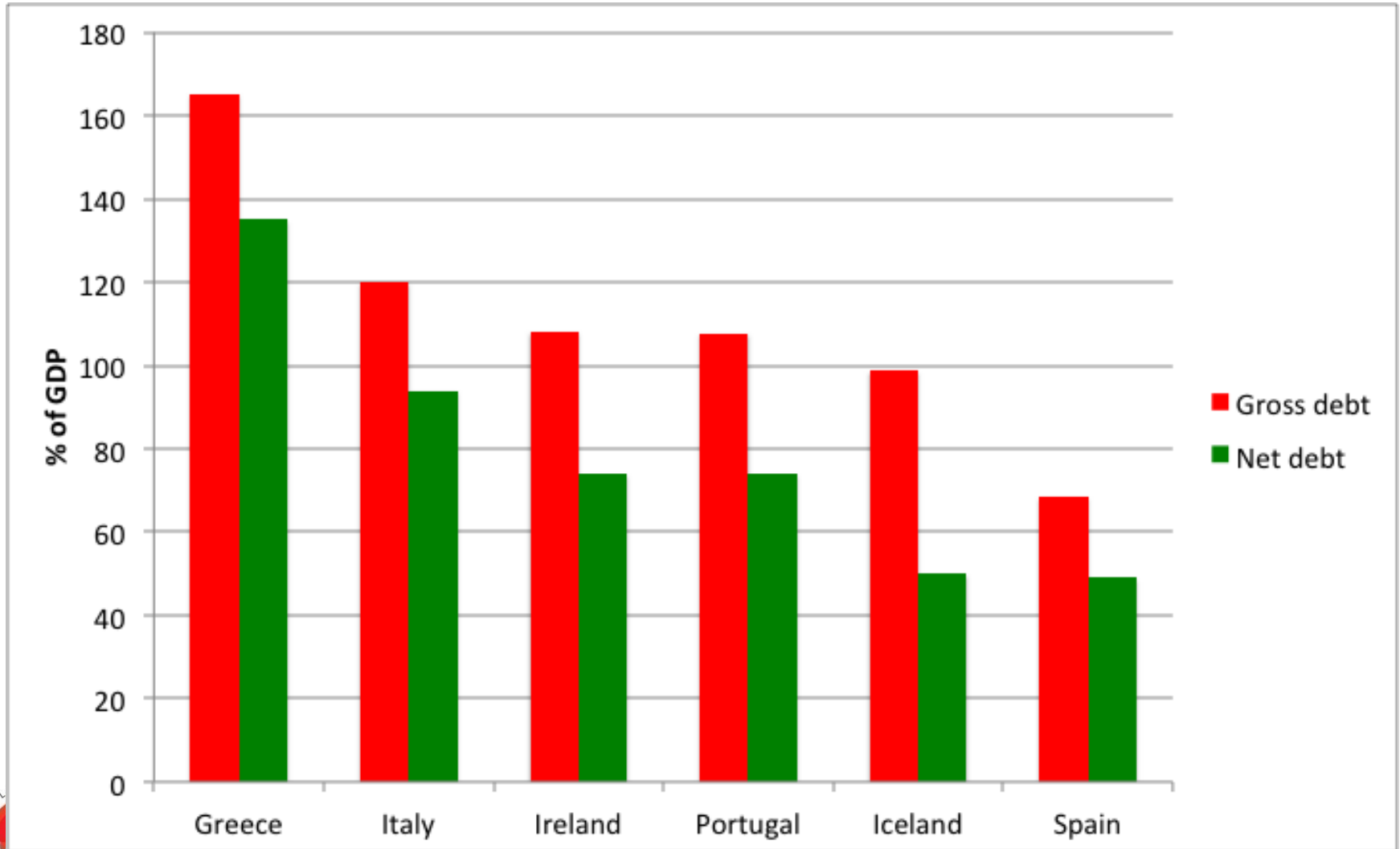
Source: Eurostat, Central Bank of Iceland (for Iceland 2012-13)

Unemployment in selected countries/areas in April 2012



Source: Eurostat

General government debt in selected countries at end-2011



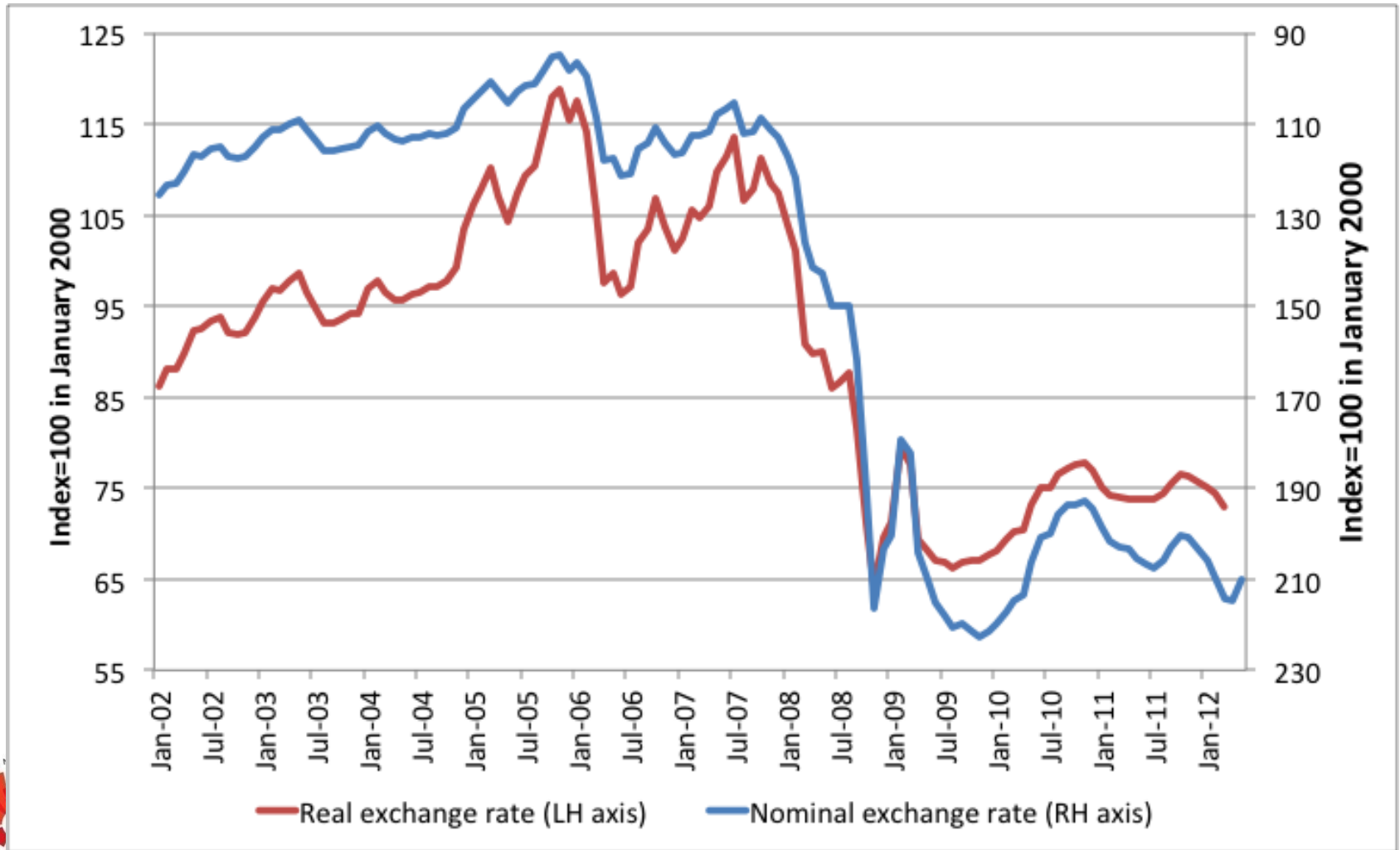
Challenges?

- Banking and private debt
 - Collapse messed up firms' and households' balance sheets
 - Banking sector has made important progress, but still dysfunctional and bloated
 - Too many firms have low or negative equity
 - Limited incentives for investment and growth
 - But indications that restructuring is making progress
- Macro
 - Growth prospects too low to markedly reduce unemployment
 - Investment has picked up from historical lows, but still too low for needed sustainable growth
 - Inflation much too high at 5.4%
 - Capital controls and krona

Structural reforms needed for long-term growth



Exchange rate of the Icelandic krona



Source: Central Bank of Iceland



Main near term challenge: lifting capital controls

- Support exchange rate
- Depress interest rates
- Overhang of hot money – off-shore kronas – about €6 bn
 - \approx 60% of annual GDP, 100% of annual exports
- Recently had to be tightened to prevent major weakening of krona
- Highly damaging in long-run
 - New firms locate elsewhere and existing firms tempted to leave
 - Resources wasted in demoralizing rent-seeking
- Central Bank is tapping off-shore kronas off, but the progress is very slow
 - Will take years at current rate

Prospects

- Can and need to grow faster than the 2.5-3% currently forecast
- Fundamentals are good
 - Natural resources
 - Human resources
 - Physical and social infrastructure
- Many interesting things happening
 - Although they are hard to spot in the statistics
- With good policies – and a benign external environment – Iceland can get “back to normal” (in a good sense) within a few years