



Central Bank of Iceland

Prospects and policy challenges during the recovery

Már Guðmundsson

Governor, Central Bank of Iceland

British Icelandic Chamber of Commerce

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The economic policy challenges

- Support the recovery while fiscal consolidation is completed (primary surplus in 2012 and overall surplus in 2014) and inflation is contained
- Maintain the conditions for and proceed with removal of controls on capital outflows:
 - Macroeconomic balance
 - Medium-term fiscal sustainability
 - Sound financial sector
 - Sufficient external liquidity

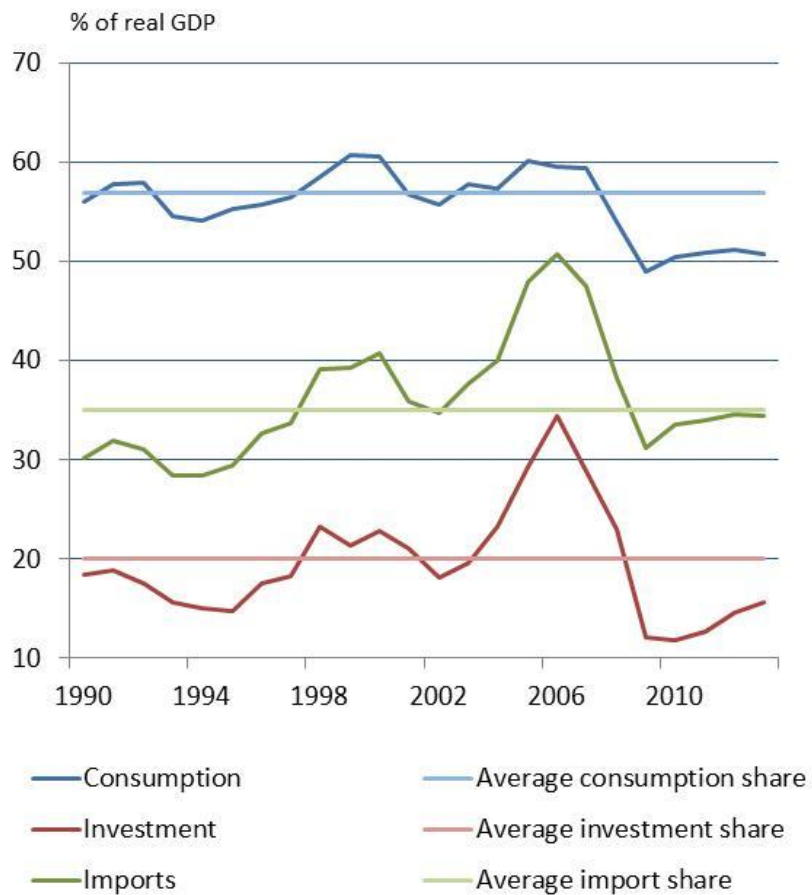
Adjustment and three shocks

- The subsiding of the large macroeconomic imbalances in 2005-2007 was bound to be associated with a significant slowdown, if not an outright recession (from 2006 onwards, the CBI consistently predicted a recession in 2009).
- Shocks: currency crisis in early 2008; collapse of the banks in October 2008; global contraction.
- GDP contracted by almost 12% from its peak in Q4/2007 to its trough in H1/2010.

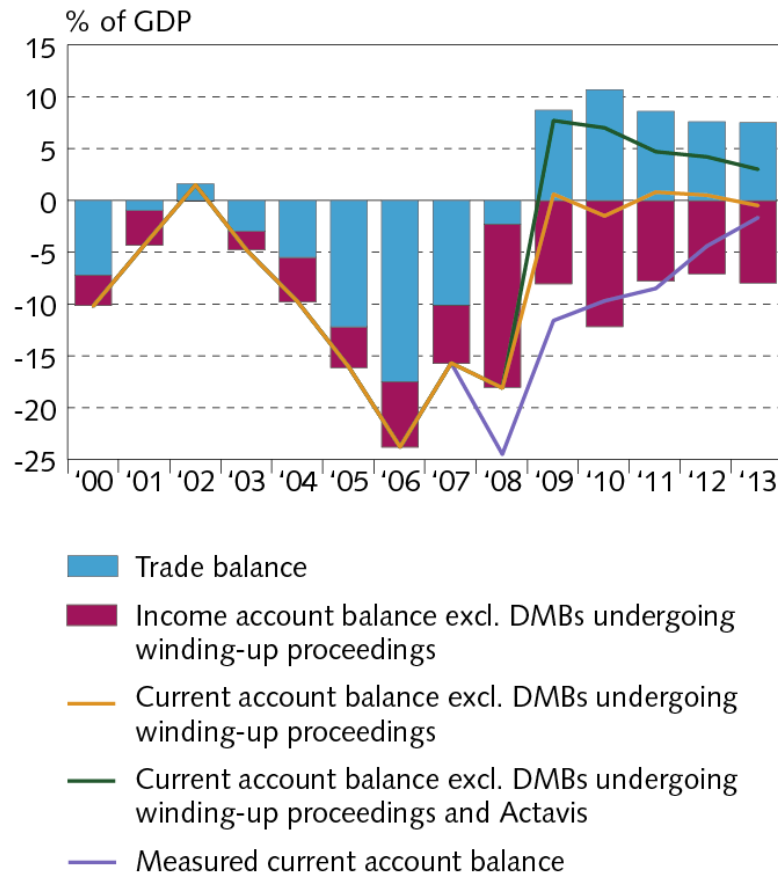
The crisis triggered a large adjustment in the real economy



Expenditure shares in GDP and 30 year average shares



Current account balance 2000-2013¹



Source: Statistics Iceland, Central Bank of Iceland.

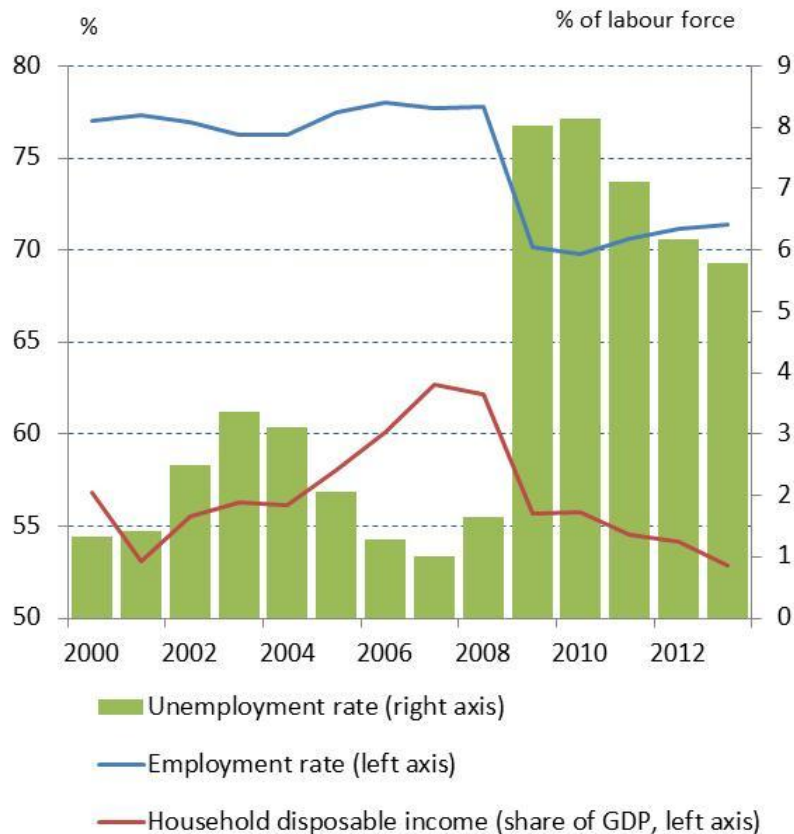
1. Net current transfer is included in the balance on income. Central Bank baseline forecast 2011-2013.

Source: Statistics Iceland, Central Bank of Iceland.

But net exports provided a buffer for output and employment

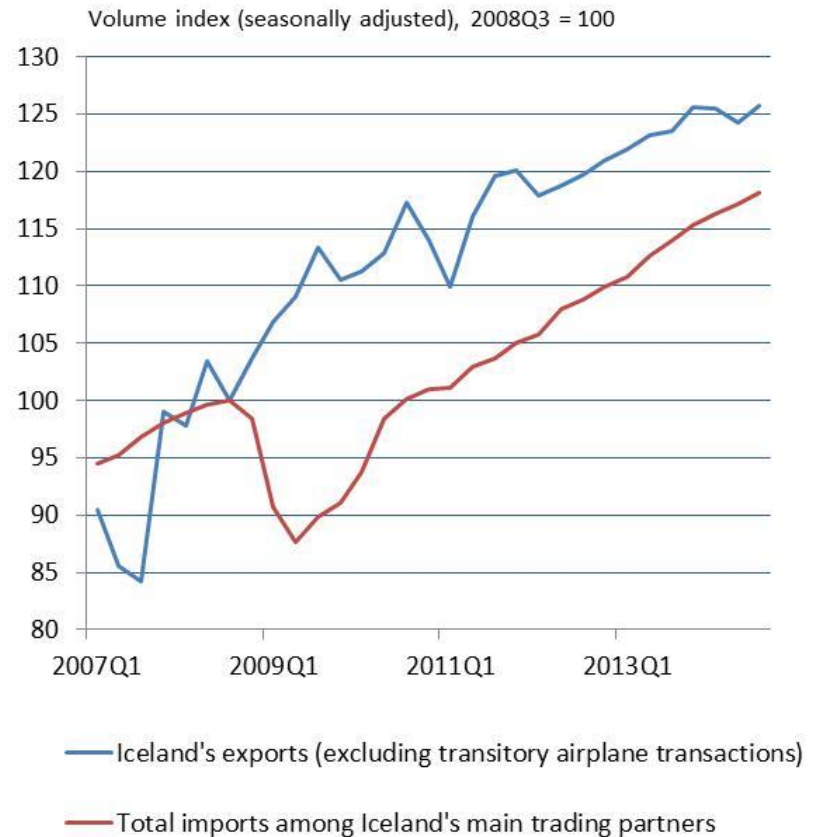


Disposable income, employment and unemployment



Source: Statistics Iceland, Directorate of Labour, Central Bank of Iceland.

World trade and Icelandic exports in the current crisis

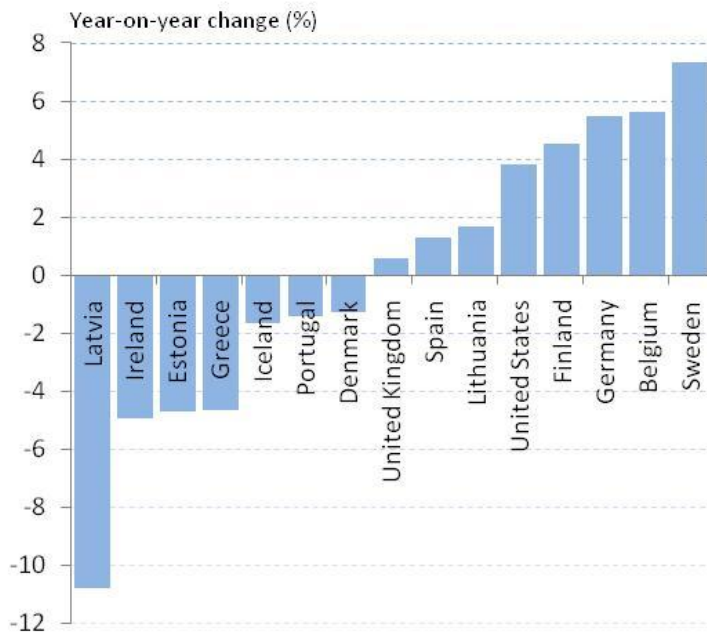


Source: OECD, Central Bank of Iceland.

Iceland was not the hardest hit



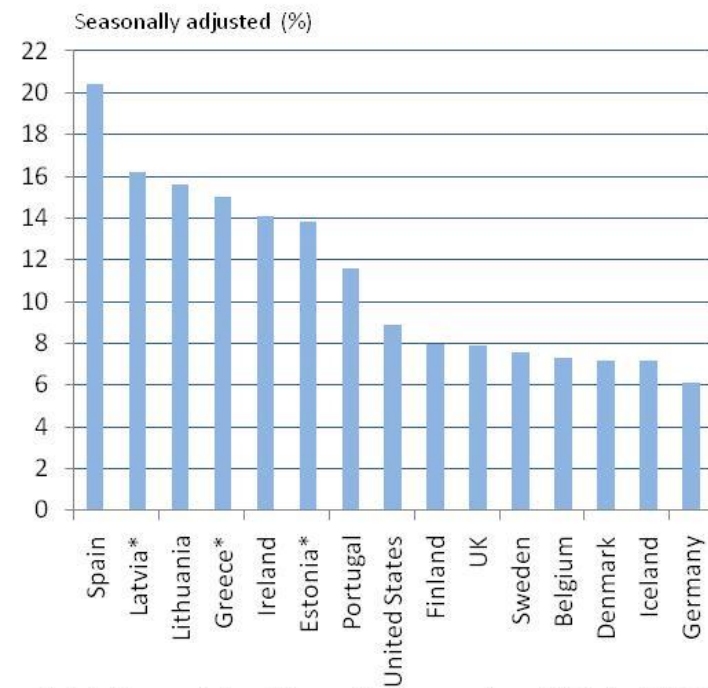
Percentage change in GDP from the average of 2005-2007 to 2011¹



1. Based on forecasts for 2011.

Source: Eurostat, Global Insight, Statistics Iceland, Central Bank of Iceland.

Unemployment rate Q2 2011¹



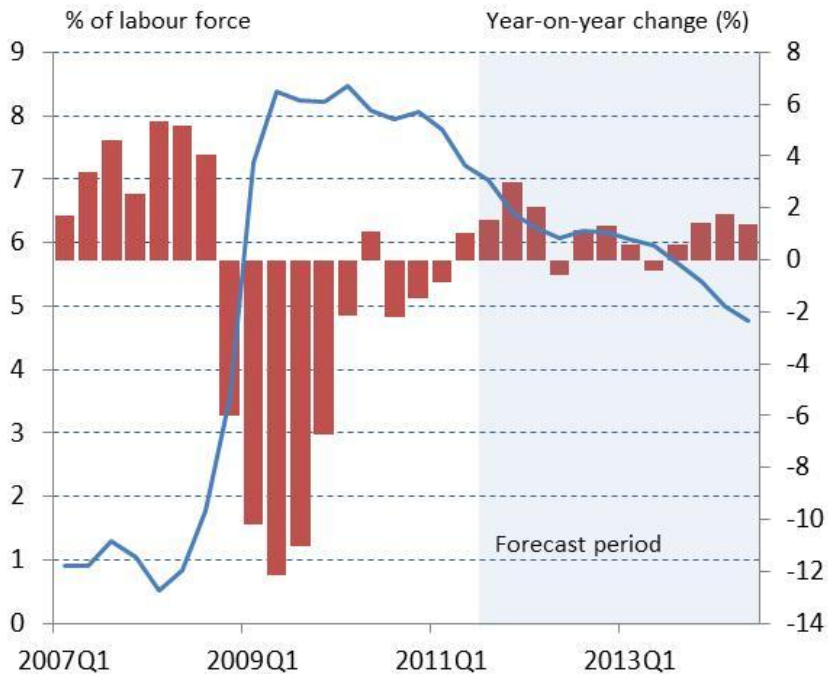
1. Data for countries with an asterisk are only available for Q1/2011.

Source: Macrobond, Central Bank of Iceland.

A recovery is under way



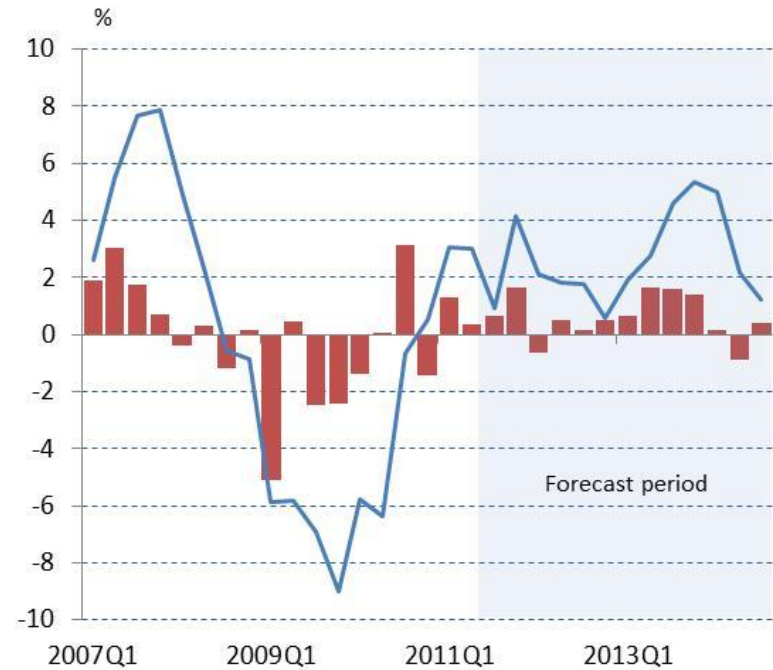
Unemployment rate and employment growth



- Employment growth (right axis)
- Unemployment rate (seasonally adjusted, left axis)

Source: Statistics Iceland, Directorate of Labour, Central Bank of Iceland.

Output growth

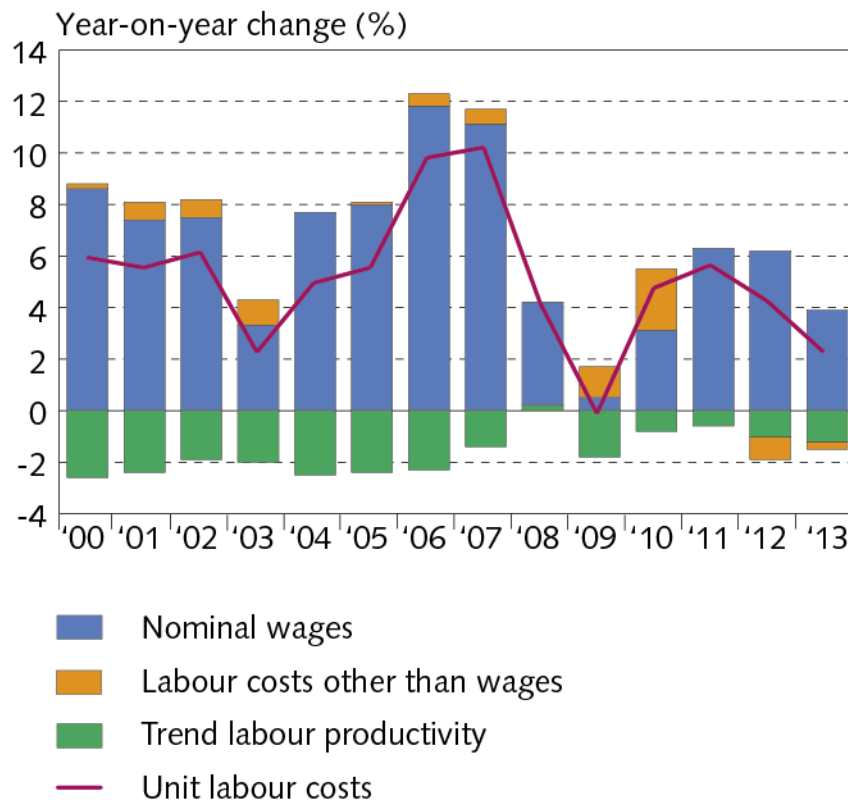


- Quarterly GDP growth (seasonally adjusted)
- Annual GDP growth

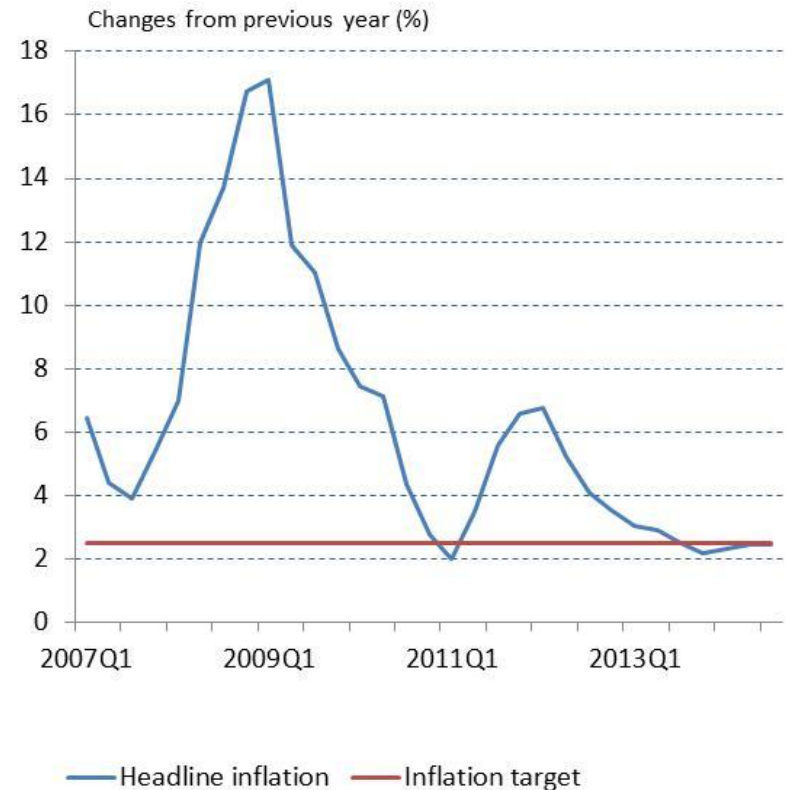
Source: Statistics Iceland, Central Bank of Iceland.

But inflation has begun to rise again on the back of large wage increases

Unit labour costs and contributions of underlying components 2000-2013¹



Inflation outlook



1. Labour productivity growth is shown as a negative contribution to an increase in unit labour costs. Central Bank baseline forecast 2011-2013.

Sources: Statistics Iceland, Central Bank of Iceland.

Source: Statistics Iceland, Central Bank of Iceland.

Macroeconomic policies

- Fiscal policy: consolidation from 2010 onwards, with the primary Treasury balance expected to increase by almost 6½% of GDP from 2009 to 2011. Contractionary demand effects in the short run but positive confidence effects over the medium term.
- Due to worsening inflation prospects and high inflation expectations, CB rates were raised by 25 bp in August (7-day LR at 4.5%) and the positive bias was kept.
- Monetary policy is still highly accommodative, with a negative real policy rate supporting the recovery.

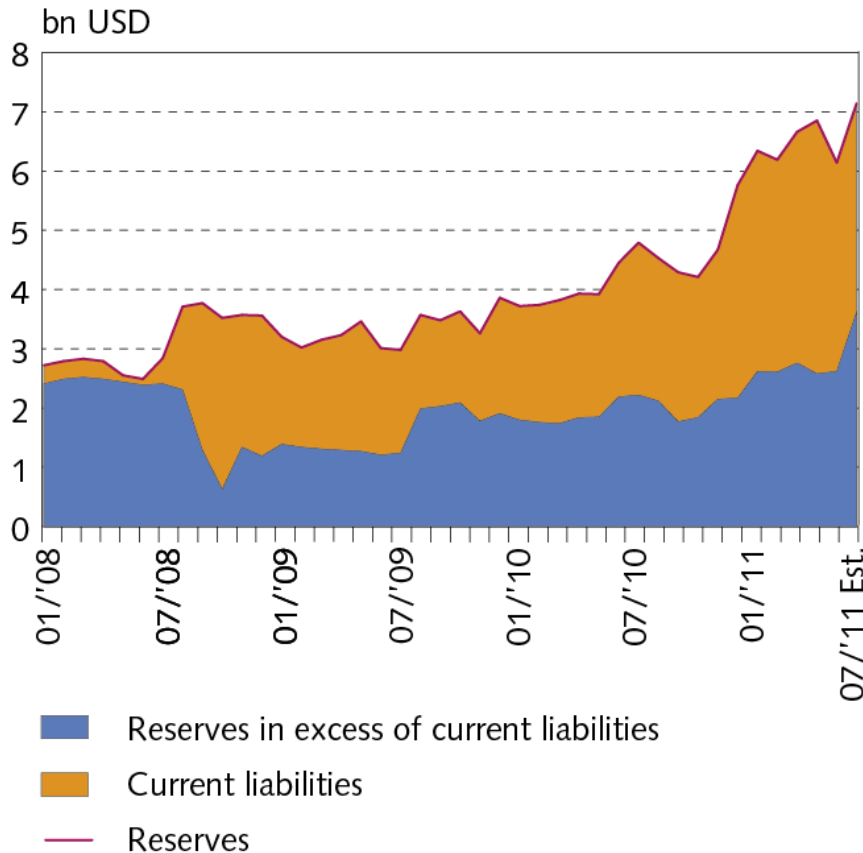
International headwinds

- Strength, duration and effects on Iceland are uncertain.
- Very different from 2008 due to a changed banking system, capital controls, strong external liquidity and pre-financing of the Treasury (including \$1bn in foreign borrowing in June)
- “Old-fashioned” real economy effects (export demand, terms of trade, global inflation, FDI)
- Wealth effects (pension funds, estates of failed banks, CB foreign asset recovery)

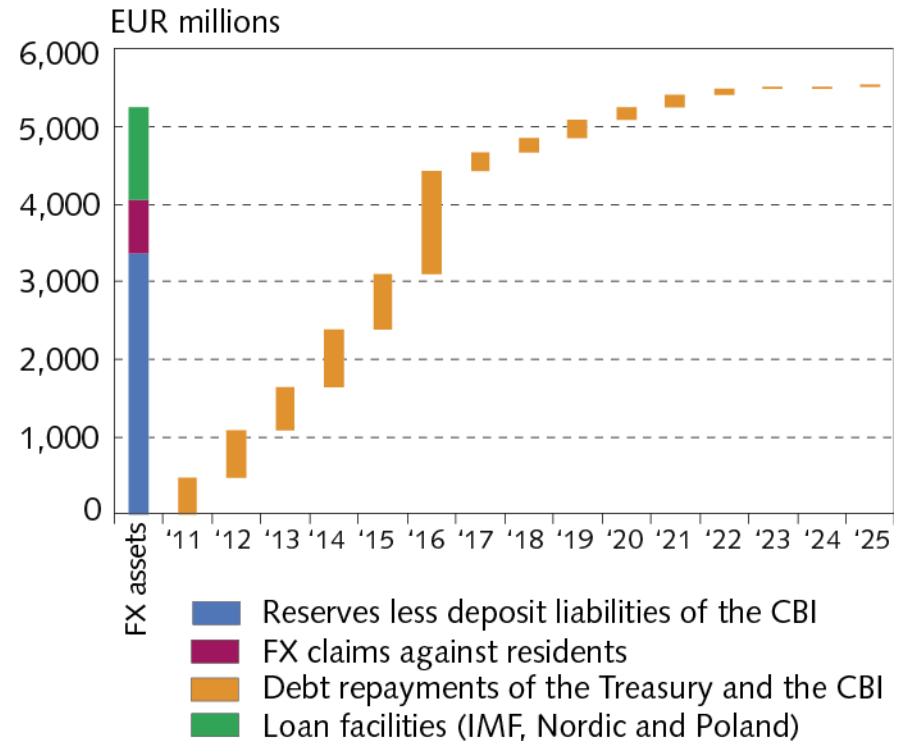
External liquidity has improved significantly



Foreign exchange reserves



FX reserves and repayment profile for Treasury foreign loans



Source: Central Bank of Iceland.

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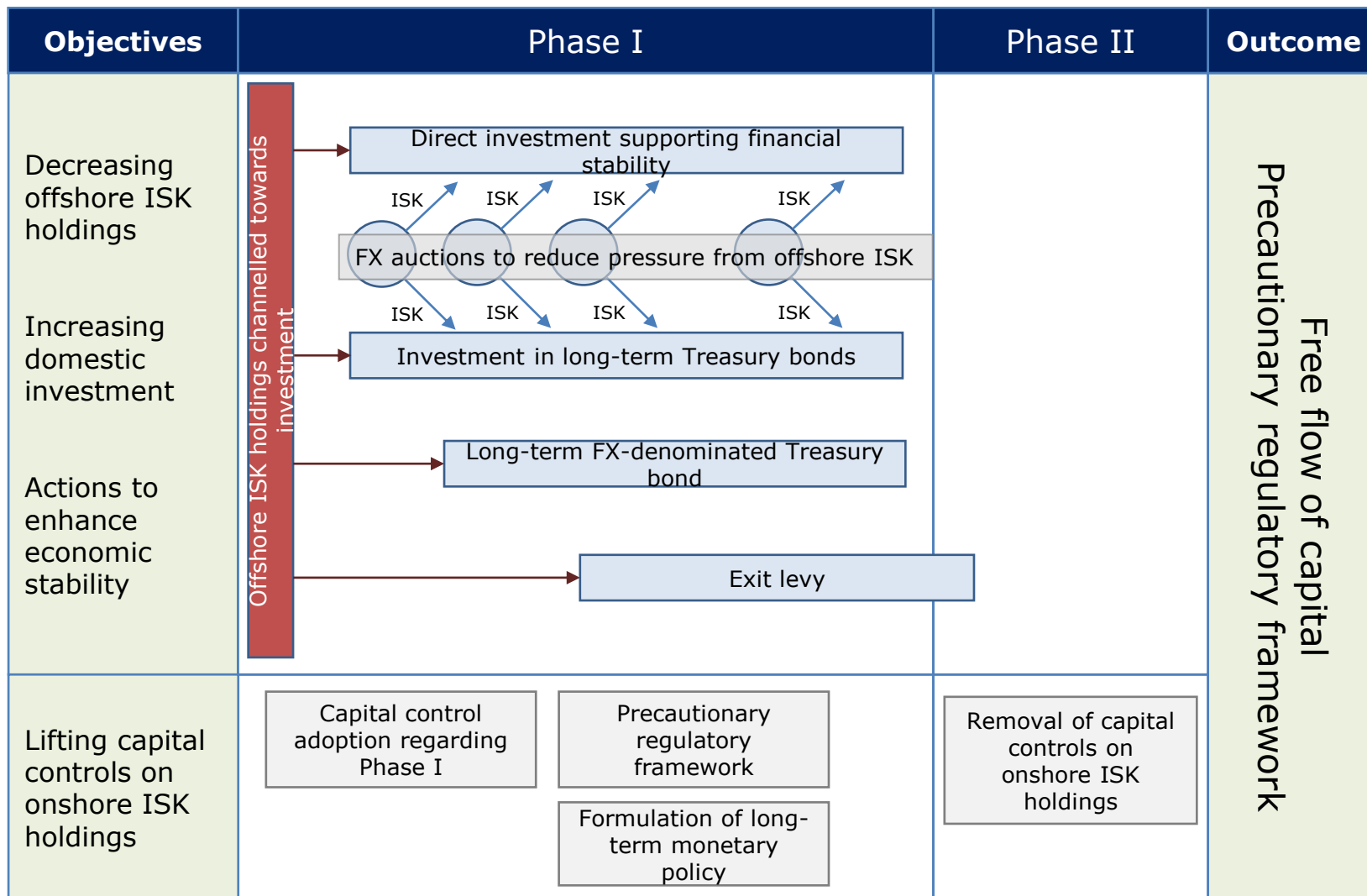
Financial sector soundness and stability

- The new banks' accounts probably seem confusing at first glance (strong capital position and high return on equity concurrent with very high NPL ratios).
- This is explained by the nature of the balance sheets when the new banks were established (e.g., transfer of assets at deep discounts).
- Capital position is strong: average CAD for three major banks is 21% in H1/2011, well above the 16% regulatory minimum – mostly common equity.
- Liquidity and funding after capital controls?

Removal of capital controls

- Revised capital account strategy published on 25 March 2011
- New legislation in September 2011:
 - Legal mandate for controls extended to end-2013
 - Existing regulations codified in law
 - Central Bank given clearer powers to take necessary measures in order to abolish controls
- Bill of legislation to be put before Parliament by November, with the aim of simplifying and removing unnecessary restrictions

Capital account liberalisation



Final remarks

- Iceland has stabilised through the programme with the IMF.
- Iceland is currently recovering.
- The next tasks are to:
 - maintain the recovery through international headwinds;
 - contain inflation;
 - remove the capital controls without undue exchange rate instability, while securing financial sector soundness.