

# Turmoil in Iceland

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# IBK



# Crises

- Currency crisis
- Financial crisis
  - Banking crisis
  - 30-60% of non-financial firms technically bankrupt
- Inflation and rising unemployment
- Political crisis
  - Government lacks trust domestically
  - Unresolved disputes with European countries
- A deep recession (10% fall in GDP) and lower living standards
- Uncertainty about future directions

# Outline

- **Privatisation of banking system**
- **Global savings glut**
- **Excessive borrowing**
- **A Minsky moment**

- **Monetary policy** ←
  - Inflation targeting
  - Central bank governors
  - Carry trade and the policy mix

- **Oversized banking sector** ←
  - Too big to save
  - Regulatory capture
  - Icesave ←
  - Inter-country banking and the EU

- **Belief in own abilities**
- **Corruption and social pressures**

## **Warnings**

### **Collapse**

### **Reaction**

- Payment systems
- IMF programme
- Miracle cures!

### **Future prospects**

### **Immediate problems**

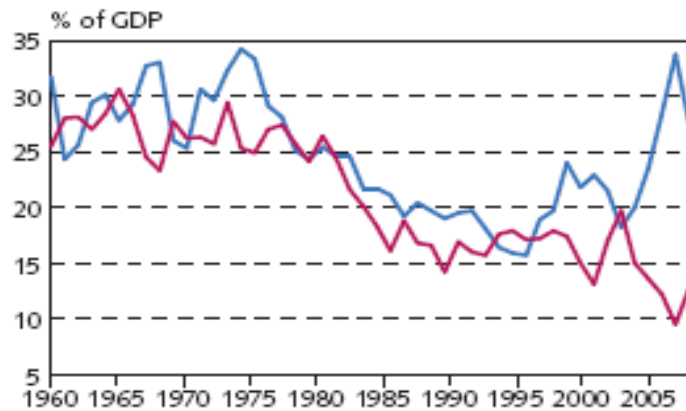
- Trust domestically ←
- Trust abroad
- Bankruptcies and unemployment

### **European union application?** ←

# Savings and investment

Chart 7

Gross national saving and fixed capital formation 1960-2007<sup>1</sup>



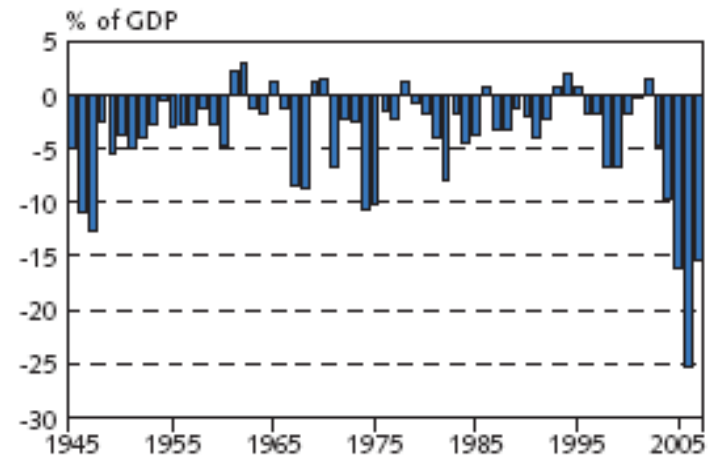
— Gross fixed capital formation  
— Gross national saving

1. Preliminary 2007.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 8

Current account balance 1945-2007<sup>1</sup>

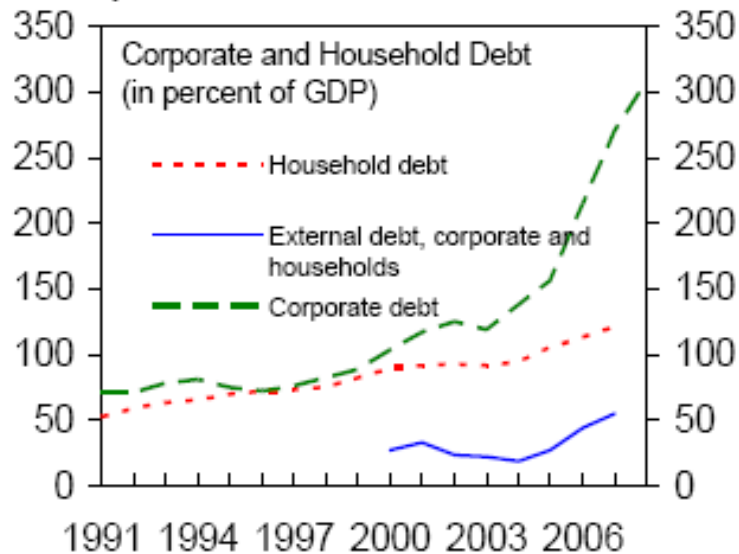


1. Preliminary 2007.

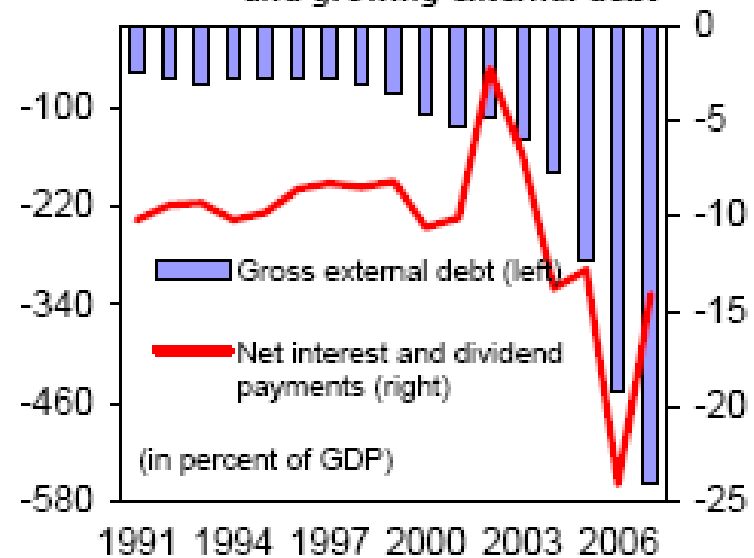
Source: Statistics Iceland.

# Debt

**Corporate and household debt ballooned.**

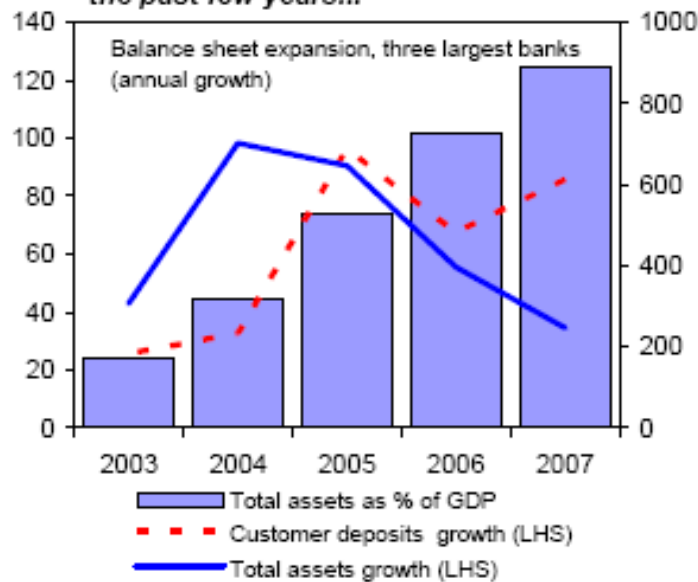


**and growing external debt**

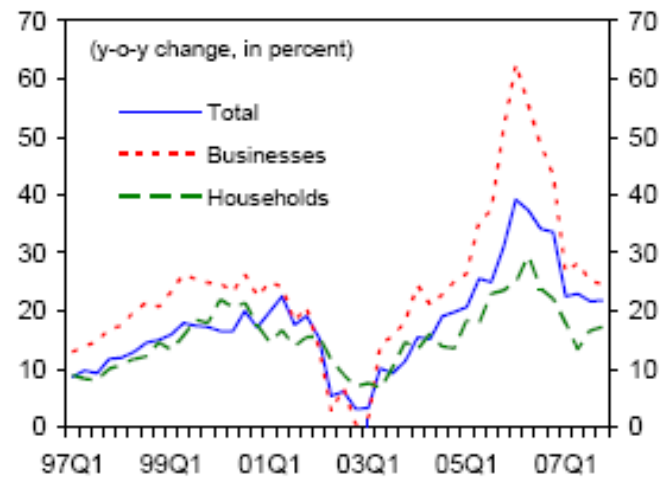


# Credit expansion

*Banks expanded tremendously over the past few years...*



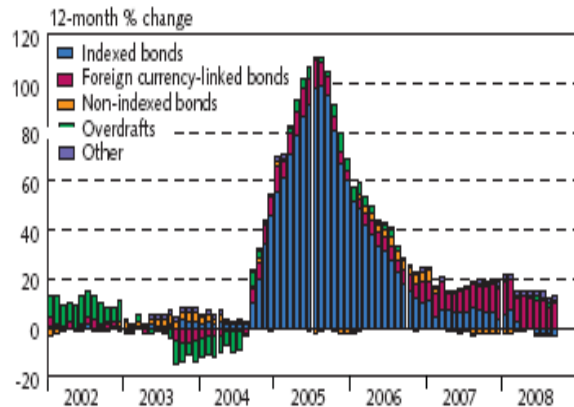
*Credit Growth Boomed*



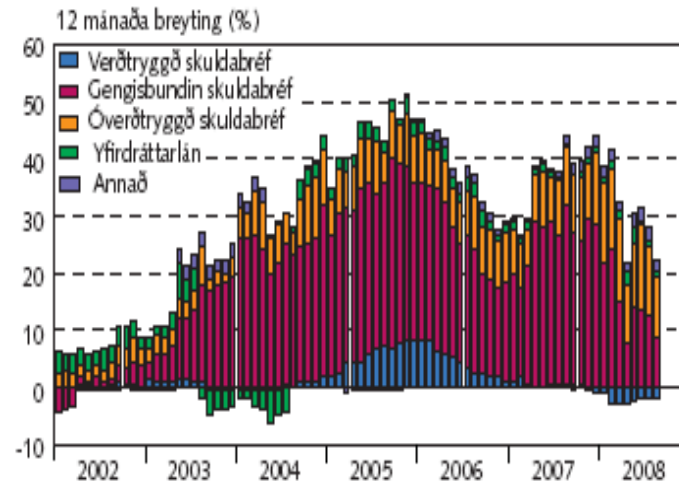
# Credit expansion -- continued

VII-0

DMB credit to households  
Contribution to credit growth



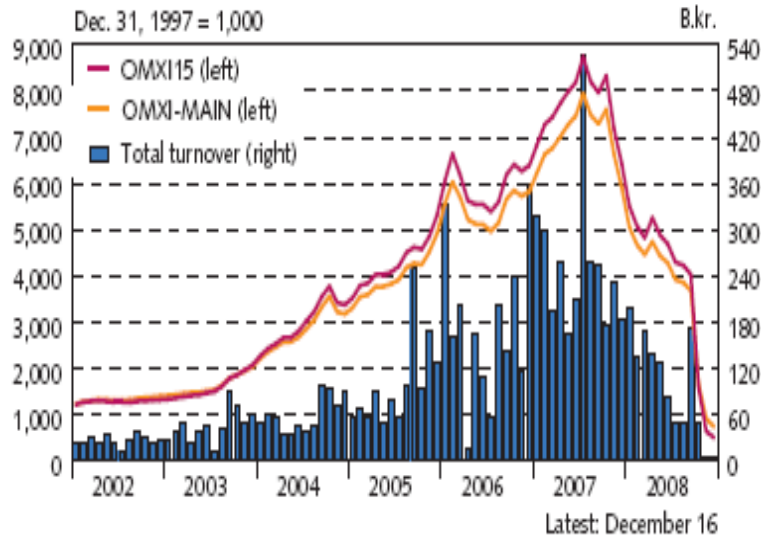
Útlán innlánsstofnana til fyrirtækja  
Framlag einstakra liða til útlánsvaxtar



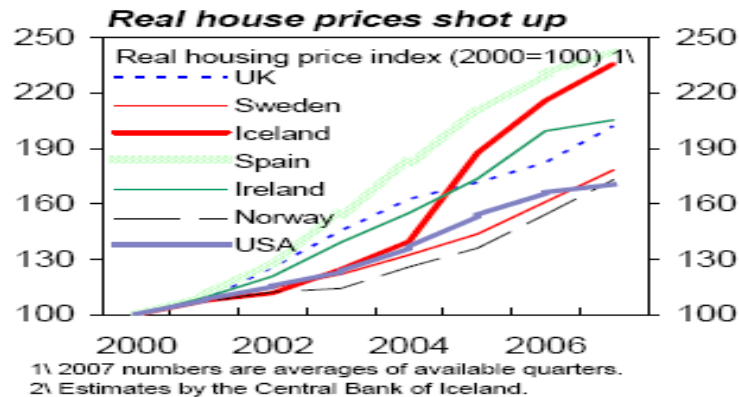
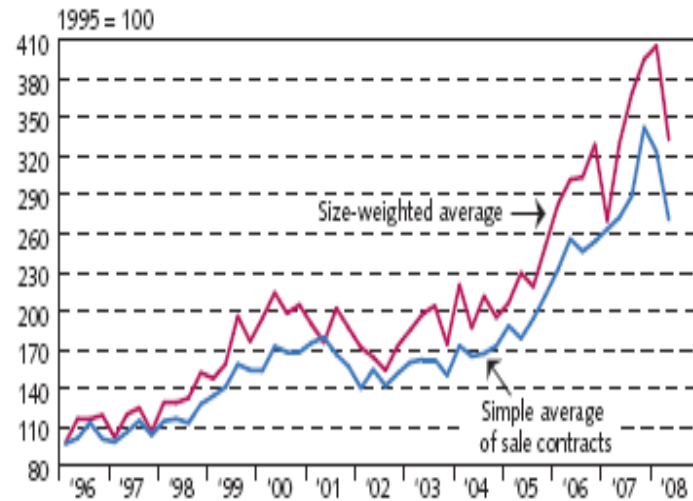
# The mother of all bubbles

VI-1

OMXI equity market  
Monthly turnover and equity prices

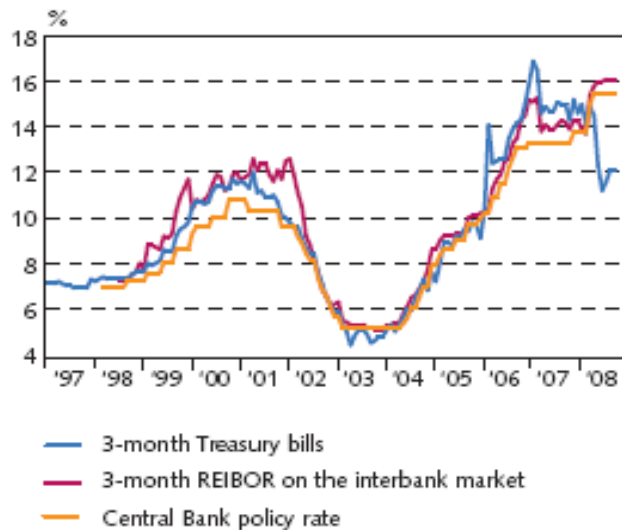


Commercial property prices in Greater Reykjavík  
Weighted average of industrial, retail and office premises in real terms



# Monetary policy

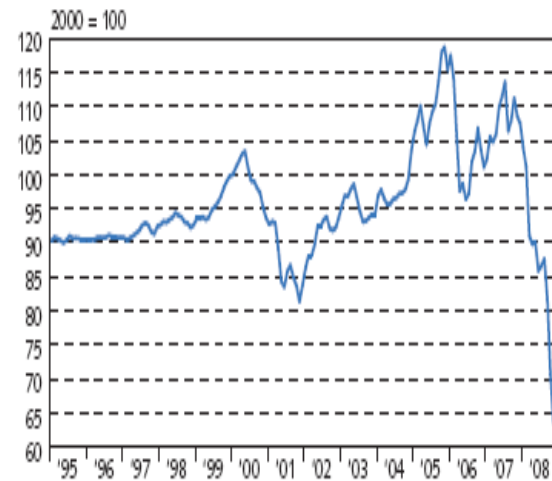
Chart 20  
Short-term interest rates  
January 1997 - September 2008  
At end of month



Source: Central Bank of Iceland.

III-20

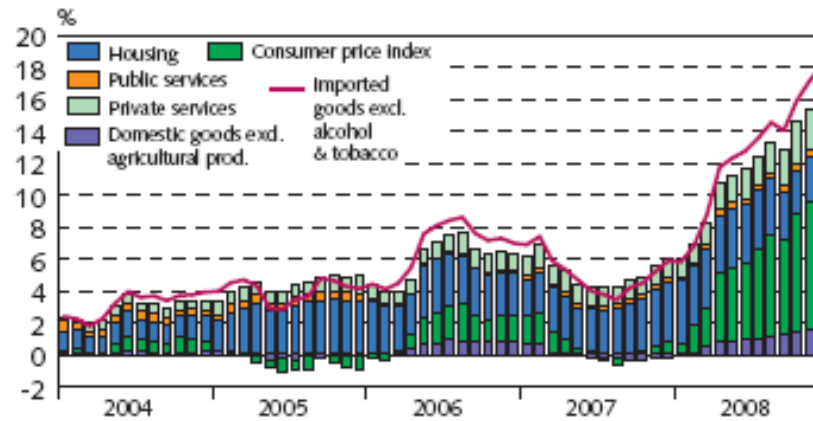
Real effective exchange rate of the króna  
Monthly data, relative consumer prices



# Inflation

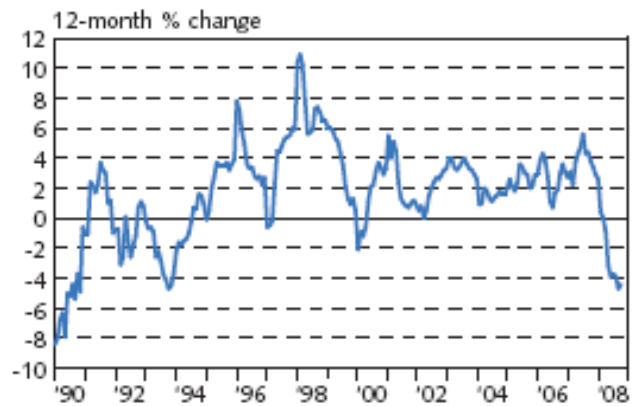
I-3

Components of CPI inflation  
Contribution to inflation in past 12 months



# Labour market

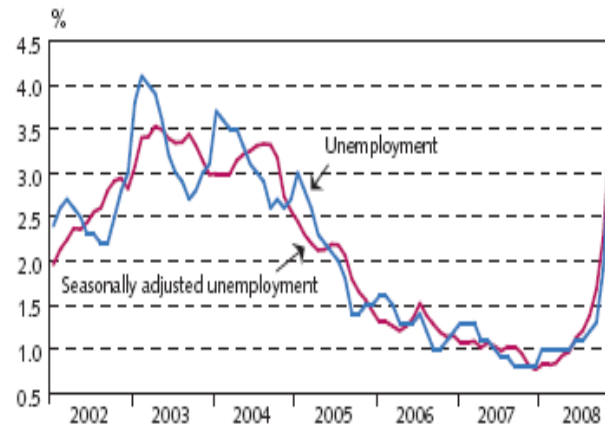
Chart 18  
Real wages January 1990 - September 2008



Source: Statistics Iceland.

IV-1

Unemployment  
Percentage of labour force



# Reaction

- New banks – payment system preserved
- IMF programme
  - Currency market
  - Fiscal austerity
  - Bank restructuring
- Restoring trust and confidence at home and abroad
  - Committee researching the origins of the crash and any illegalities
  - Special prosecutor appointed
- More distant future!
  - EU membership application or not!

# Lessons

- EEA treaty imperfect
  - Big firms and feable institutions
    - Two possible responses
      - Leave treaty, or
      - Join EU
- Other benefits of EU
  - Current institutions lacking credibility
  - Importance of personal relationships among officials
  - Solid monetary system – integrated capital markets

# In the meantime!

