

The financial crisis in Iceland.



Economic and social disaster?

Lilja Mósesdóttir

The largest bank collapse !

- z The profit of the liberalised and privatised banking system was privatised while the debt will be nationalised.

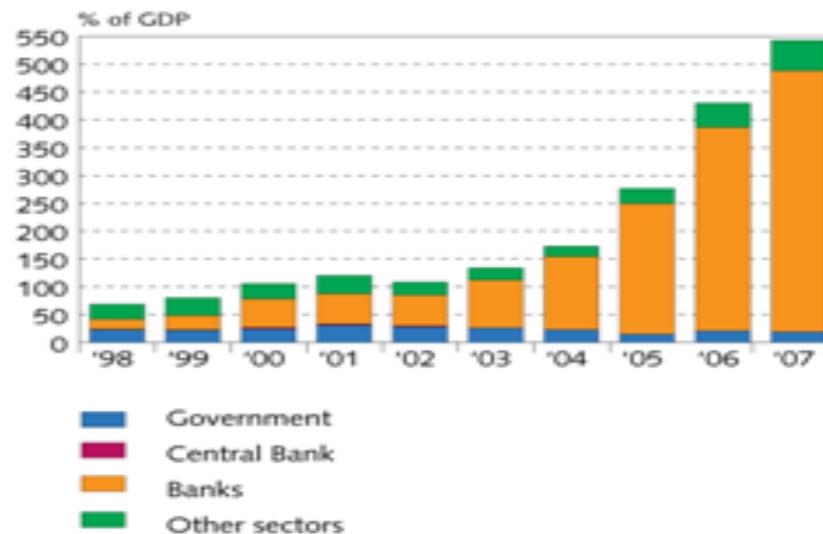
- z The total debt of the central government (sovereign debt):
 - y A. Pre-crash debt : 653 billion Iskr.
 - y B. Nationalised debt due to the crash:
 - x ICEsave/Edge: 695 billion Iskr.
 - x (secured) loans lost by the Central bank 220 billion Iskr.
 - x Recapitalisation of the banks 385 billion Iskr.
 - x Short sale losses 35 billion Iskr.
 - x Fiscal deficit 2009 154 billion Iskr.
 - x FIH bank 63.6 billion Iskr.
 - y **Total 2205.6 millj. Iskr.**

- z National debt becomes **145%** of GDP

Chapter 8: Domestic and foreign debt



Chart 8.3
Estimated external debt by sector
1998-2007



Source: Central Bank of Iceland.

The economic situation

%

	2007	2008	2009
Real GDP growth	4.9	-0.1	-9.6
Inflation (CPI)	5	12.4	13.1
Budget Balance (% GDP)	5.5	-1.4	-13,2
Foreign currency (average price) change in Iskr)	-2,5	40.1	22.6
Unemployment	2,3	3.0%	10%

Sources: Ministry of Finance, (2009) and Statistics Iceland (2008)

Emergency law in October to ensure full access of Icelanders to their bank deposits

IMF backed program in Iceland

z The loan(s):

- y IMF: 2.1 billion US\$
- y Others: 3 billion US\$ (Nordic countries, Russia & Poland)
- y Conditions:
 - x 1. Implement IFM economic program
 - x 2. Demonstrate commitment to solve the dispute around ICESave/Edge

z IMF program focus on:

- y 1. Currency stabilisation
 - x Currency stability the goal of monetary policy
 - Capital controls
 - Central bank interest rate up to 18%
- y 2. Bank restructuring
 - x New regulatory structure

Criticism of the IMF program

- z 1. Free floating currency instead of capital controls (right wing)
- z 2. The program fails to take into account :
 - y the real economy
 - x The private sector (fishery sector) technically bankrupt
 - x Fish prices are falling due to the global recession
 - y counter-cyclical measures
 - x Fiscal policy: Fiscal deficit only allowed in 2009
 - x Monetary policy: High interest rate
 - y Almost illiquid currency (Iskr)
 - x Keep Iskr. - limits the size of the banking and corporate sector
 - x Unilateral adaptation of foreign currency – no lender of last resort

Threats to social cohesion

z 1. Inequality:

- y Rich investors and households :
 - x Better able to hedge in advance and run away
 - x More likely to receive compensation when bank bailouts occur
 - x Better protected when the crisis spreads to the real economy
- y Urban poverty increases more than rural poverty (may protect the poor)

z 2. Poverty:

- y Unemployment (10%) and shorter working hours
- y Large fall in real wages (16%)
- y Price indexed housing loans

z 3. Wealth transfers:

- y From the poor to the rich
- y From few domestic investors to even fewer domestic investors

Social unrest in Iceland

- z IMF program does not tackle the indebtedness of firms and households.**
 - y No emergency plan
 - y Social policy measures focuses only on the most needy
 - y Banks accused of applying discriminatory rules when deciding on loans to firms

- z So far, no consultation with trade unions and interest groups**

- z Poverty and inequality likely to increase in Iceland:**
 - y Full access to deposits –capital owners compensated by the state
 - y Limited progressiveness of the tax system
 - y Price indexed housing loans and high real interest rate
 - y Voluntary pay decreases
 - y Low replacement rates of welfare benefits

Tackle poverty and inequality

- z **Social costs of financial crisis large and durable (Finland)**
- z **The crisis offer an opportunity to introduce better policies:**
 - y Lower real interest on housing loan and changes to the indexation
 - y Progressive tax (flat rate tax rate 37,38%)
 - x Lower tax rate among low earners stimulates demand more than among high earners
 - x Women's labour supply more sensitive to tax changes than men's
 - y Policies focused on reducing poverty essential and more acceptable during crisis **(IMF constrains)**
 - x Income support
 - x Workfare - infrastructure and R&D
 - x Knowfare (opportunity cost of schooling falls)
 - y Centralised wage negotiation to protect those in vulnerable position

Tackle wealth transfers

z Real estate

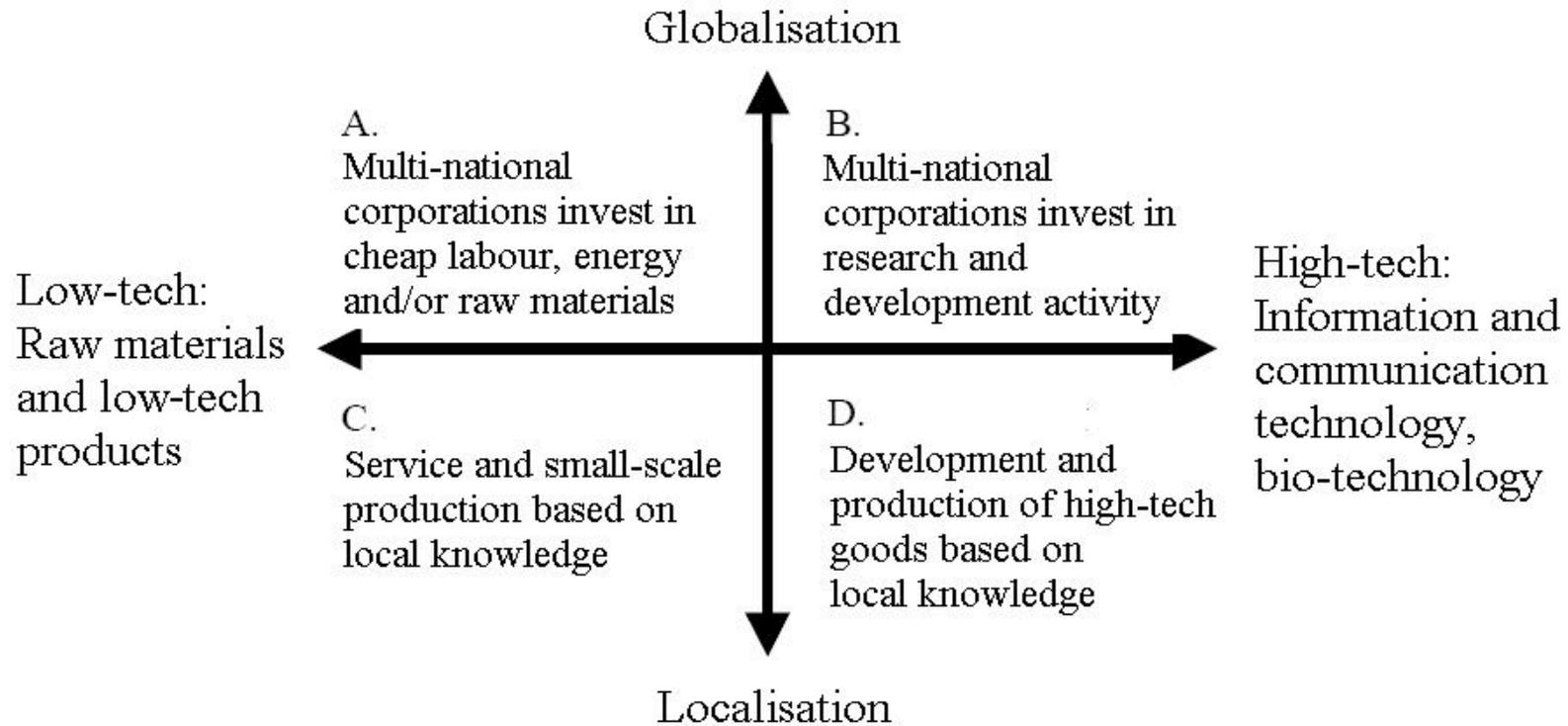
- y Bubble 1997-2007 250%
- y Household debt as % of GDP (2008,Q3) 115%
- y Price fall 2008-2010 30%
- y **Solution: real estate turned into housing cooperatives??**

z Stock market (OMX Iceland 15)

- y Bubble 2001-2007 500%
- y Firm debt as % of GDP (2008,Q3) 316%
- y Price fall (last 12 months) 94%
- y **Solution: Restructuring fund (RSF) – the state (+pension funds)**
 - x Depreciate/subordinate debt and injecting capital (share holder/owner)
 - x Depreciate /subordinate debt and allow employees to take over firms

z Relax rules concerning bankruptcy of households and firms₀

Growth strategies



Source: Ívar Jónsson (2003)

Growth strategy for Iceland?

- z Export-led growth strategy based on the utilisation of natural resources and foreign direct investment in aluminium & ferro-silicon
 - y Falling fish prices
 - y Falling energy prices
 - y Too capital intensive strategy
 - y Likely to involve economic growth without much employment growth
 - y Require relatively low skill level
 - y How to manage ownership and utilisation of natural resources

- z Import-substitution strategy
 - y Manufacturing production instead of service provision
 - y Natural resources used to produce for domestic or foreign markets
 - y Free trade agreements constrain