

Challenges Ahead

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The Icelandic economy has by most measures made a substantial recovery since the dramatic events of 2008. These left the country without a working financial system, the bulk of domestic financial assets damaged or destroyed, depleted reserves, a collapsed currency, rampant inflation, huge fiscal deficit, many corporate and household balance sheets in ruin and major industries like construction and import services with very little demand for their output.

Three years later Iceland has returned to growth and is still one of the wealthiest countries in the world with an enviable standard of living, both in a historical or international perspective. Purchasing power is rising, unemployment falling, the fiscal deficit is under control, access to international capital markets at least partially restored, a very substantial current account surplus has been sustained, the banking system is both solvent and liquid and balance sheet issues have been reduced although certainly not eliminated.

Clearly, substantial progress has been made, well above expectations. There are nonetheless many challenges ahead, both in the short to medium term and the long run. I will in this presentation try to

address the most pressing ones, starting with imminent challenges and then moving on to the long-term view.

The first obvious challenge that Iceland faces is to maintain and hopefully strengthen the economic recovery that started about a year ago and is predicted to result in a GDP growth rate of 2-3% per year in this year and upcoming years.

This should lead to an improvement of major macro-economic variables, including a decline in unemployment, albeit at a slow pace, some recovery of household purchasing power, increased government revenues, improved cash-flow for the private sector and alleviate somewhat the problems of households and companies that are struggling with debt. The current account surplus will decline but not disappear.

This projection is of course based on various assumptions. Although these seem reasonable at the moment, the recovery is still fragile and depends in part on developments outside Iceland.

The components of GDP that are least certain in this respect are investments and exports. Both can be affected by global developments, in particular within the European Union, Iceland's by far most important trading partner. Part of the uncertainty is reflected through the terms of trade, with both fish prices and aluminum prices, Iceland's two main exports, being quite volatile. That is not just a short-term problem for Iceland; the heavy dependence of the economy on two resource based export sectors

with volatile revenues is an unwelcome source of instability also in the long run. There is very little that can be done about that in the short run.

Likewise there is little that Iceland can do to help stabilize the global financial system. Here we must simply hope for the best and prepare for the worst. We should certainly not try to convince others to adopt the “Icelandic solution” to their problems. It may have been suitable, even the only available, solution for Iceland, but it does not scale very well, at least not all aspects of it.

Ironically, Iceland is at the moment better situated to weather a storm in the global financial system than most other Western countries. Iceland has a newly resurrected banking system with mainly domestic assets and liabilities, toxic assets already written down, ample equity reserves and the local currency sheltered by capital controls. There is thus relatively little risk of importing financial instability from overseas for the time being.

This does not of course isolate Iceland completely from the global storms. Exports are at risk, as previously mentioned, and investments in Iceland can also be seriously affected. Icelandic entities also need to roll over substantial foreign debt in upcoming years.

A global downturn affects investor confidence everywhere and reduces the likelihood of investments being made in export industries in Iceland.

Increasing investments in Iceland is in the short run the most important factor in reducing slack in the economy and generating growth. It is of course also important for long run growth, although the massive investments of the bubble era in the energy intensive sector, infrastructure, housing etc. mean that there is no shortage of physical capital in Iceland for the time being. The building we are in being a good symbol of this, brand new and paid for in large part by involuntary contributions from hapless foreign creditors.

The capital controls are yet another challenge for Iceland in the short term. They are without a doubt not helping attract and finance investments, even if capital inflows in foreign currency are exempted from the controls. The controls have other costs or disadvantages as well.

Lifting them is however easier said than done. I will not go here into the technical details or my analysis of the pros and cons of various plans to lift them.

Any plan will however at some point call for inflows of foreign currency, to roughly match expected outflow of savings now held in ISK nominated assets in Iceland, both by foreigners and local investors.

In this respect it would be quite helpful if at least one of the two new banks that are now owned by the estates of the old banks would end up being owned by a suitable foreign investor, preferably a reasonably healthy bank.

Another helpful development would be an expansion of investment opportunities in Iceland by listing more companies on the local stock exchange, which has only made a very limited recovery since the autumn of 2008. This would at least help retain funds held by domestic parties by providing an alternative to government bonds, deposits and real estate.

The current account surplus is of course also important in this context. However, eventually someone will have to sell foreign assets (or take on foreign liabilities) to roughly match the sale of domestic assets for foreign currency that is expected. The hope of course is that this can happen without even further depreciation of the króna, which is already well below a reasonable long-term equilibrium. At the moment no candidate is in sight, except perhaps the Icelandic government.

Yet another current challenge is the on-going effort at dealing with balance sheet problems. This task is not complete even if substantial progress has been made, with a large proportion of Icelandic companies still in need of financial restructuring. To this one might add all the estates that are being wound up, in particular those of the banks and various holding companies.

The good news here is that this process is on-going without the various operating companies, those that actually produce goods and services, employ people etc. halting operations. It was unavoidable that the process would take several years, given the scale and

complexity of the task and the importance of completing it with minimum interruption of the real economy and no fire sale of distressed assets.

It is still vital that this financial reorganization is completed sooner rather than later. It is not good for firms to be kept in intensive care by banks for prolonged periods; it is not good for their customers or competitors and very unlikely to generate economic growth and sensible investments. It is also both distracting and costly for the banks involved.

One thorny problem here is the shortage of well-financed entrepreneurs that are willing and able to provide equity for firms emerging from financial reorganization and can take the firms forward, putting new management teams into place or backing up the incumbent management. The Icelandic pension funds can play some role here, they have funds that need to be invested, but the pension funds are ill suited to playing a leading role in managing private enterprise. A recovery of the stock market would help in this respect.

Other short to medium-term challenges include a mountain of legal issues that resulted from the collapse of the financial system and need to be sorted out. This includes both various civil claims, some of them with very high stakes, and criminal investigations and subsequent legal proceedings. This is taking up a lot of time and human resources and will almost inevitably continue for several more years. It is not a pretty process, but definitely needed.

Moving on to the more fundamental or long term challenges, I will start with our battered currency, the króna.

This topic alone would be more than sufficient for several seminars like this.

First, it has to be acknowledged that the dramatic depreciation of the króna in 2008 played a substantial role in shifting domestic demand from imported goods and services to locally produced ones. It also helped exports, not much in the short run though, in part because the two largest export sectors are capacity constrained.

This mitigated the dramatic decline of private consumption and investment so that it did not lead to an equivalent drop in demand for local products. This helped keep the drop in GDP that Iceland experienced to 10%, on the high side but not horrific by the standards of the time. For the same reason unemployment did not rise as dramatically as feared. It is not very high by European standards, although it reached unprecedented and unacceptable heights by local standards.

That said, the mess that the króna helped sort out, was also made far worse by this same flexible currency. The dramatic depreciation of the króna, by almost 50%, played a substantial role in creating the balance sheet problems Iceland is dealing with and added to the destruction of financial assets. It furthermore caused a far larger than necessary drop in real wages and household purchasing power. This

amplified the household debt problem and of course reduced the standard of living. It damaged both the government's balance sheet and tax base, leading to more need for fiscal consolidation than otherwise and so on. Furthermore it left us with the aforementioned capital controls.

Historically, the króna has been a chronic problem. It played a different, but even greater, role in the last major financial crisis Iceland experienced, some thirty years ago. Then the currency and savings collapsed, with inflation at one point reaching more than 100% in a 12-month period. Like now the bulk of financial assets in Iceland were destroyed, the main exception being inflation linked government bonds, much like now.

Even in "normal" times the króna has not performed well, with double-digit inflation, dramatic depreciations and capital controls being the norm in Iceland for much of the 20th century.

This is a fundamental problem that needs to be addressed. For the moment, we are stuck with the króna and will do the best we can under the circumstances. That is though not a promising long-run scenario.

The Euro is a more promising option, not available immediately, but perhaps in five years time or so. By then we will presumably know a lot more, both about the recovery of the Icelandic economy and just as importantly, how the European Union resolves the current crisis.

That should tell us whether the option to adopt the Euro is in the money, so to speak.

If not, we will have to try to do a much better job at managing our currency than until now, with greater monetary and fiscal discipline, wage moderation and probably at least some restrictions on short-term capital flows.

Other long run challenges include dealing with both public and private debt. Public debt is actually straightforward, at least in theory. Gross debt will foreseeably be reduced in the years to come by selling assets and reducing the over-sized currency reserves that Iceland has borrowed.

Net public debt is not terribly alarming, being not much higher than before the bubble era. It is however still prudent to reduce this gradually by running a small annual fiscal surplus. The same goes for the main off-balance sheet liabilities, namely only partially funded government pensions. These have to be funded by gradual contributions financed by a fiscal surplus in the long run.

The long run challenge of creating sustainable growth is formidable in Iceland, as in most other countries. In Iceland that will mean moving beyond resource dependence to industries, both services and manufacturing, that rely primarily on a good business environment and a well educated workforce for their competitive advantage. In essence, Iceland must build up more of the sort of industries that have served our former colonial masters in Denmark well.

Finally, Iceland has a long-term challenge, which is not unique to Iceland, namely constructing and implementing a framework for the financial sector that allows that sector to play a constructive role in the economy without generating excessive risk or using excessive resources.

Iceland has already taken some important steps in that direction but the journey is not complete. A tiny country like Iceland can hardly be expected to come up with all the necessary solutions on its own. A radical rethinking of the global financial system is needed. To that process, Iceland can contribute some very interesting stories and hard earned experience.