

# HORFT TIL FRAMTÍÐAR

SFF-dagurinn 14/5 2009

Dagskrá:

Ávarp fjármálaráðherra

Ræðumenn:

Kaarlo Jännäri, fyrrv. forstjóri finnska fjármálaeftirlitsins

Franek J. Rozwadowski, sendifulltrúi IMF á Íslandi

Gunnar Andersen, forstjóri FME

Ráðstefnustjóri:

Margrét Kristmannsdóttir

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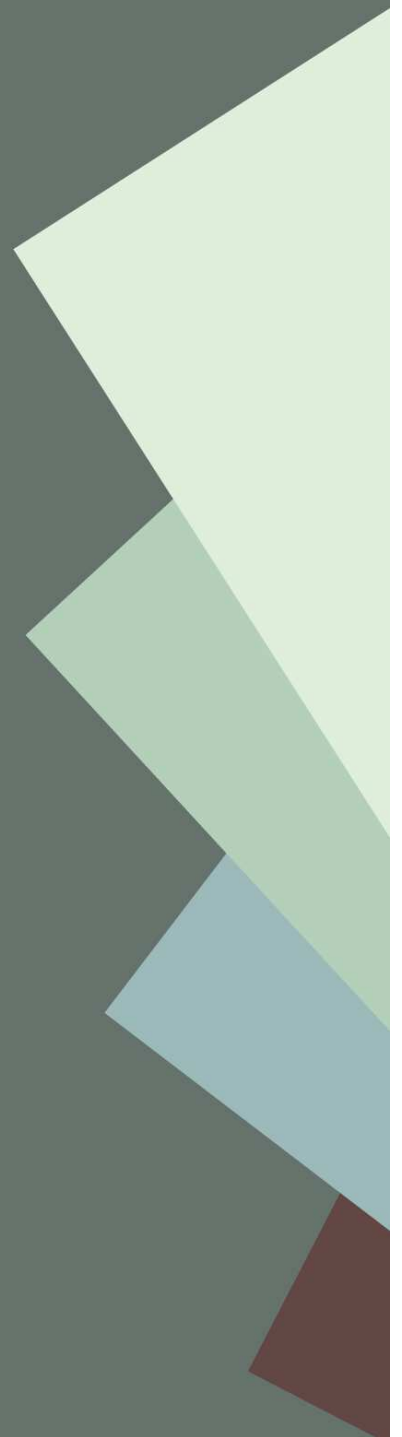
## Kaarlo Jännäri

Reflections on the present financial crisis in  
general and in Iceland in particular

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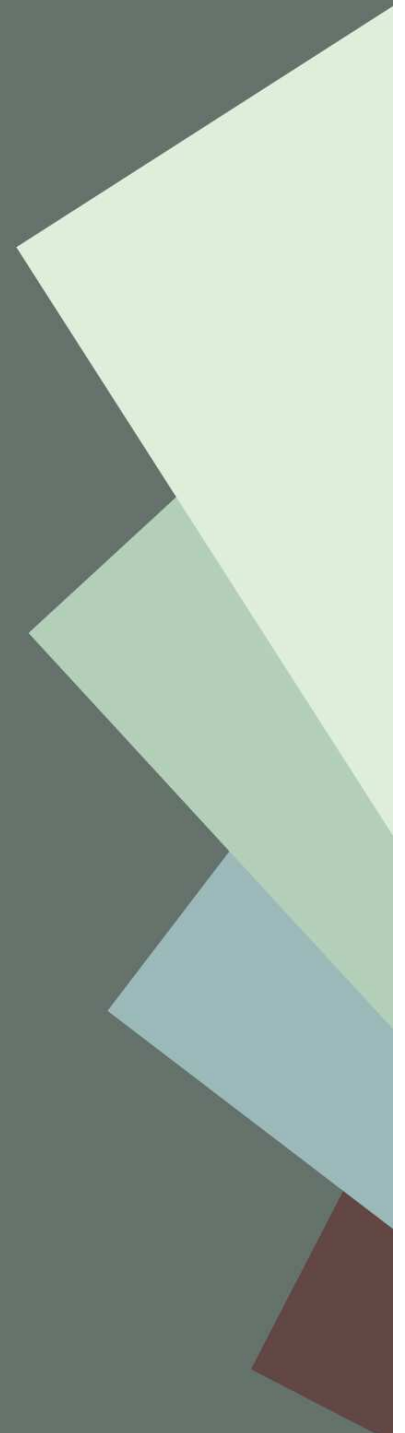
**Franek Rozwadowski**

Resident Representative  
International Monetary Fund

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## HORFT TIL FRAMTÍÐAR

# Overview

- I. Background to the crisis
- II. The crisis
- III. The recovery program
- IV. Where does the program stand?

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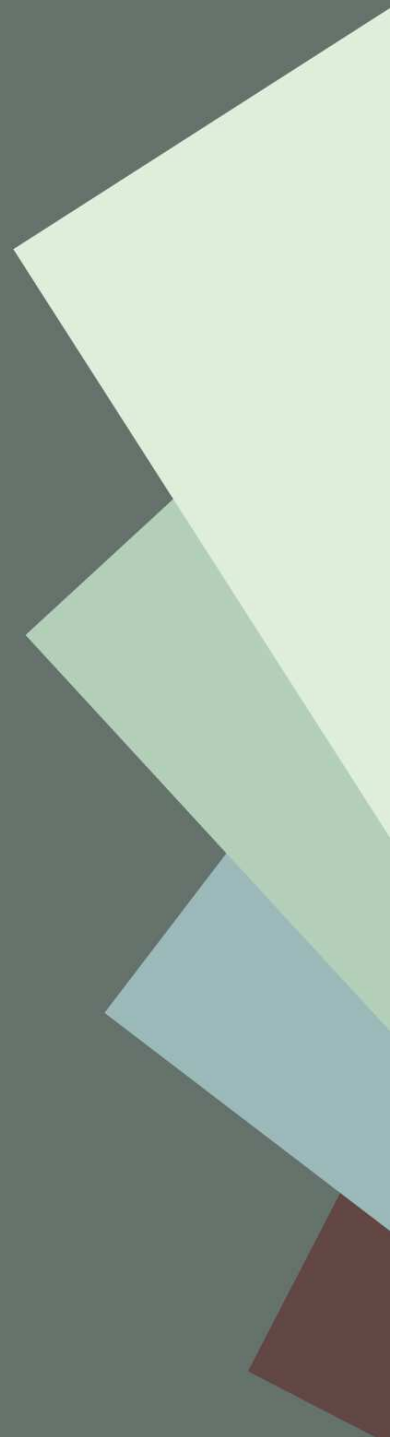
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## I. BACKGROUND TO THE CRISIS

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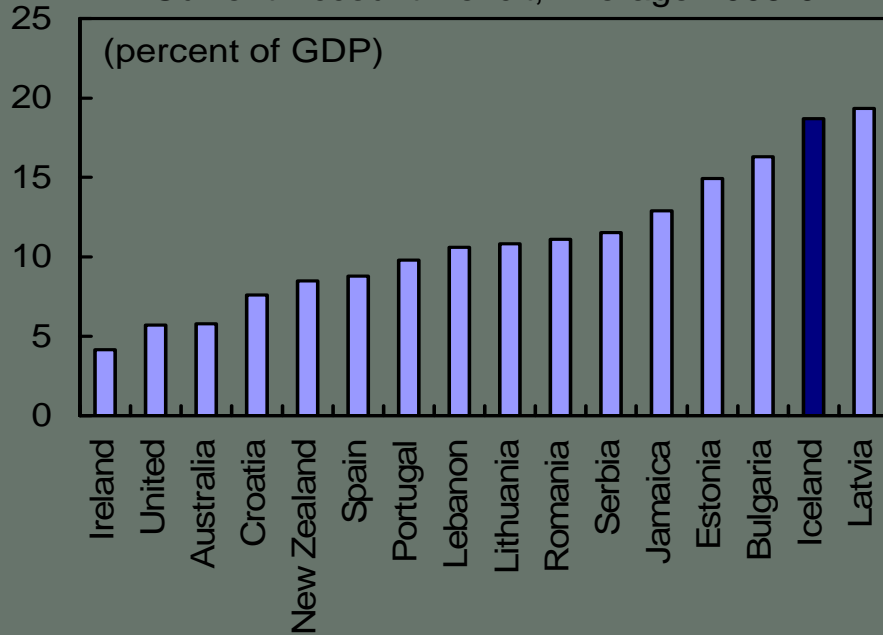


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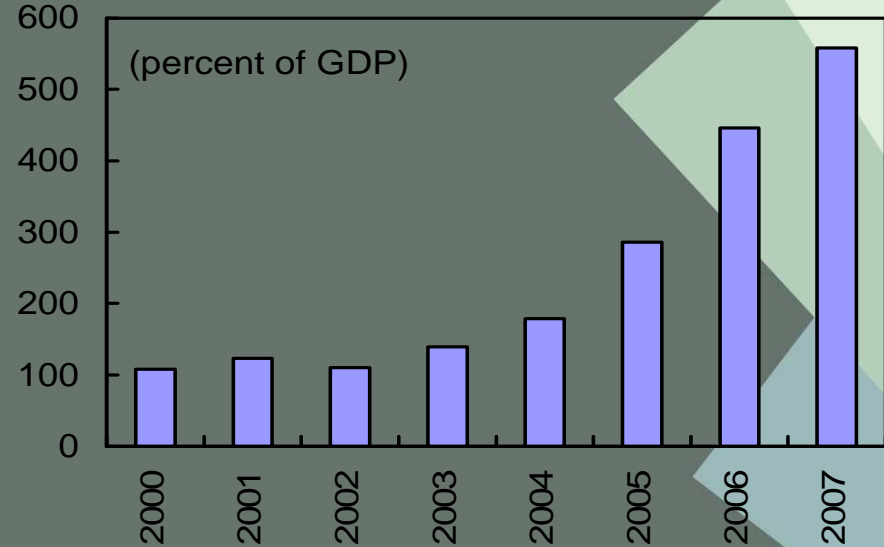
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## A BUILD UP OF LARGE EXTERNAL IMBALANCES...

Current Account Deficit, Average 2005-07



Gross External Debt



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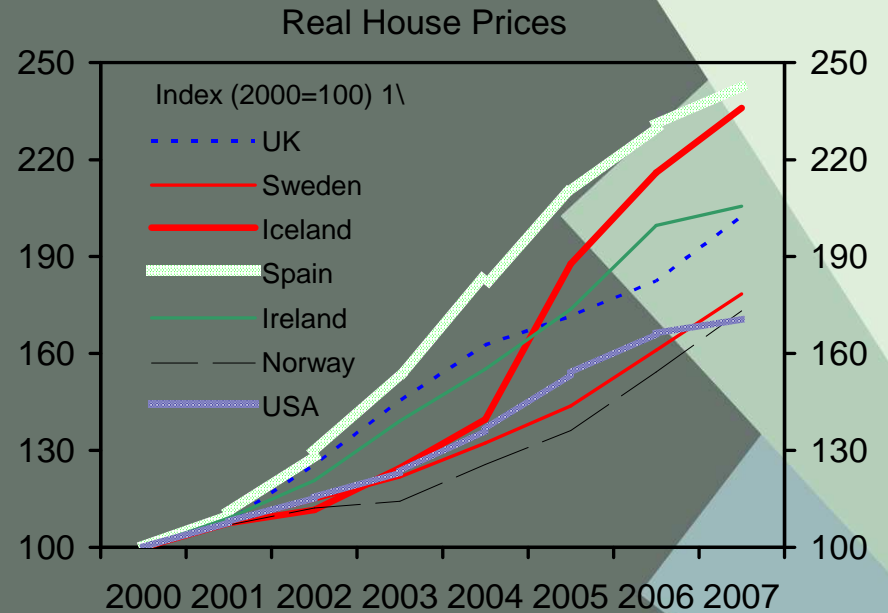
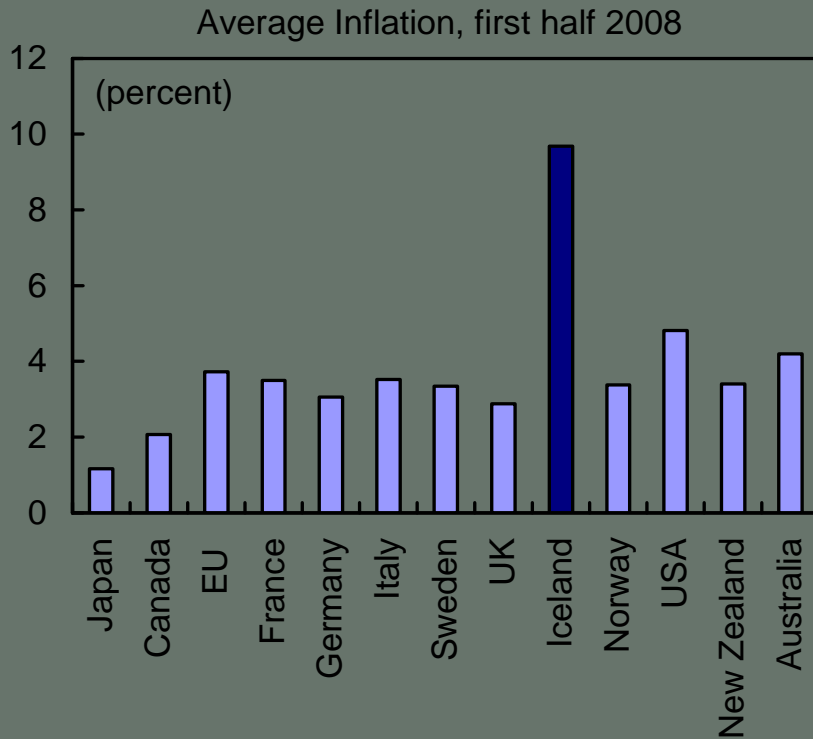
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Source: IMF and Central Bank of Iceland.

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## ... and internal imbalances.



Source: IMF.

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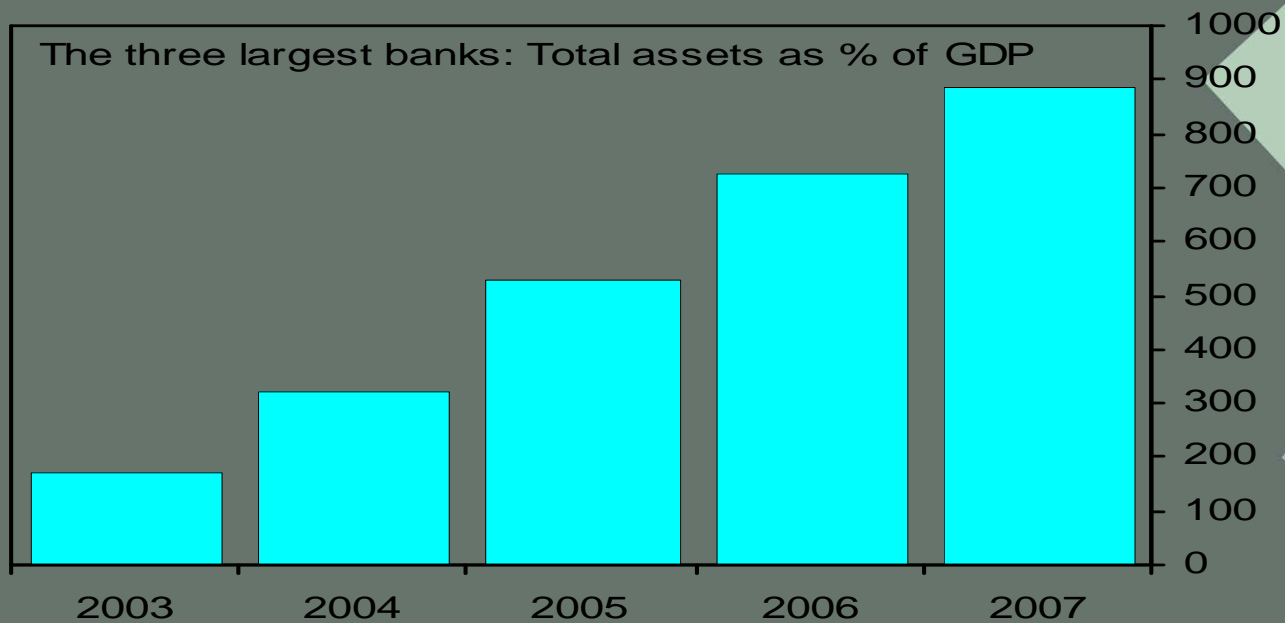
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# Banks' balance sheets expanded out of proportion to the economy...



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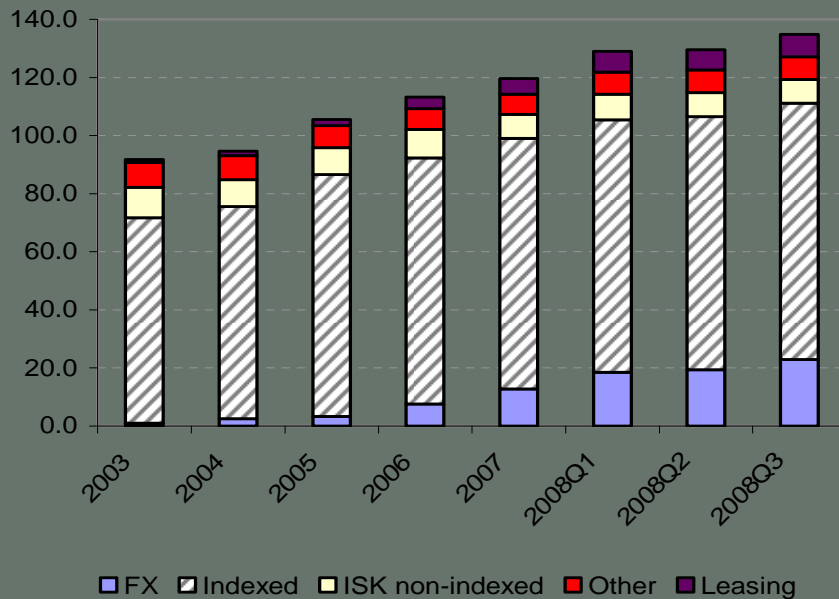
Source: Icelandic Authorities.

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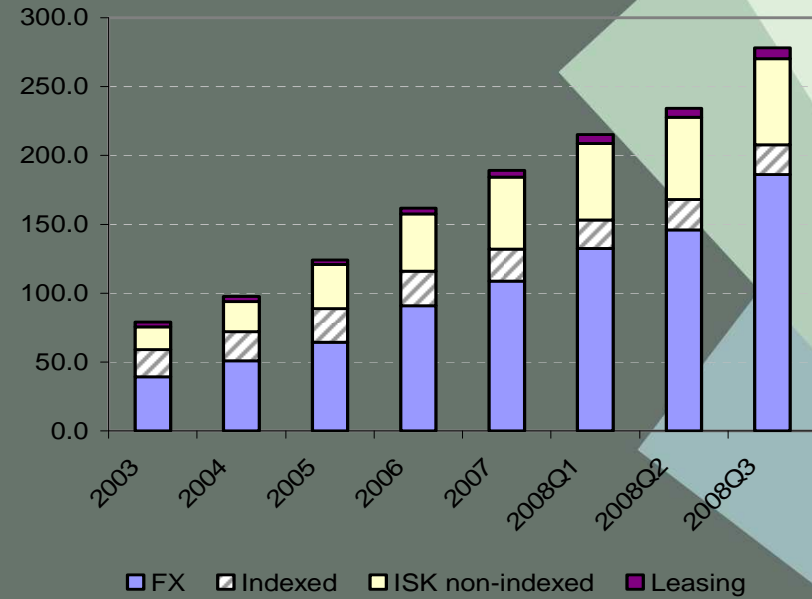
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## ...while vulnerabilities also built up on corporate and household balance sheets.

Iceland: Household Borrowing from the Credit System  
(In percent of GDP)



Iceland: Corporate Borrowing from the Credit System  
(In percent of GDP)



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Source: Central Bank of Iceland.

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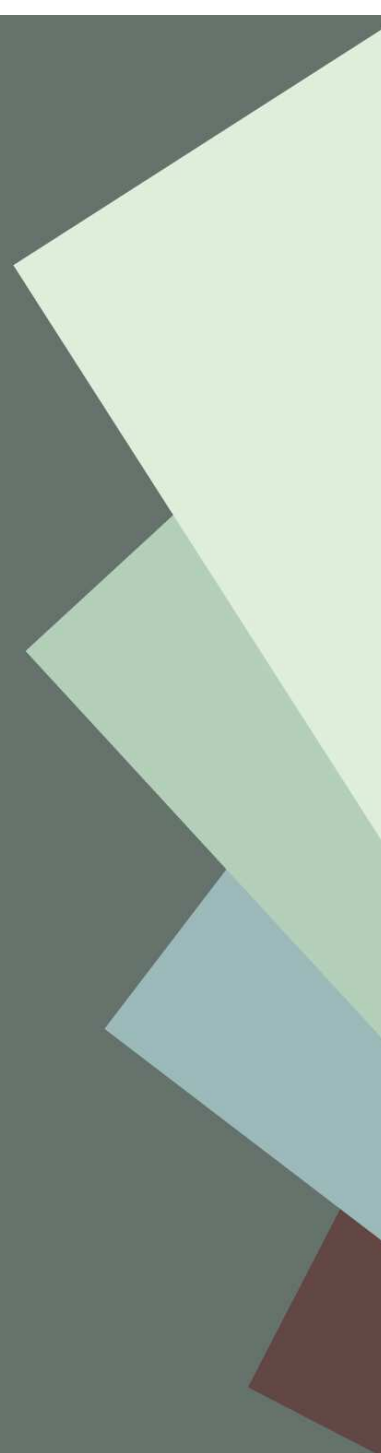
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## II. The crisis

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## The crisis

Global financial turmoil

Three largest Icelandic banks collapsed in October 2008

Government intervened and guaranteed all deposits, creating large external obligations and large fiscal burden

Collapse in investors' confidence in Iceland

Pressure on the krona

Collapse in asset prices

Large capital outflows

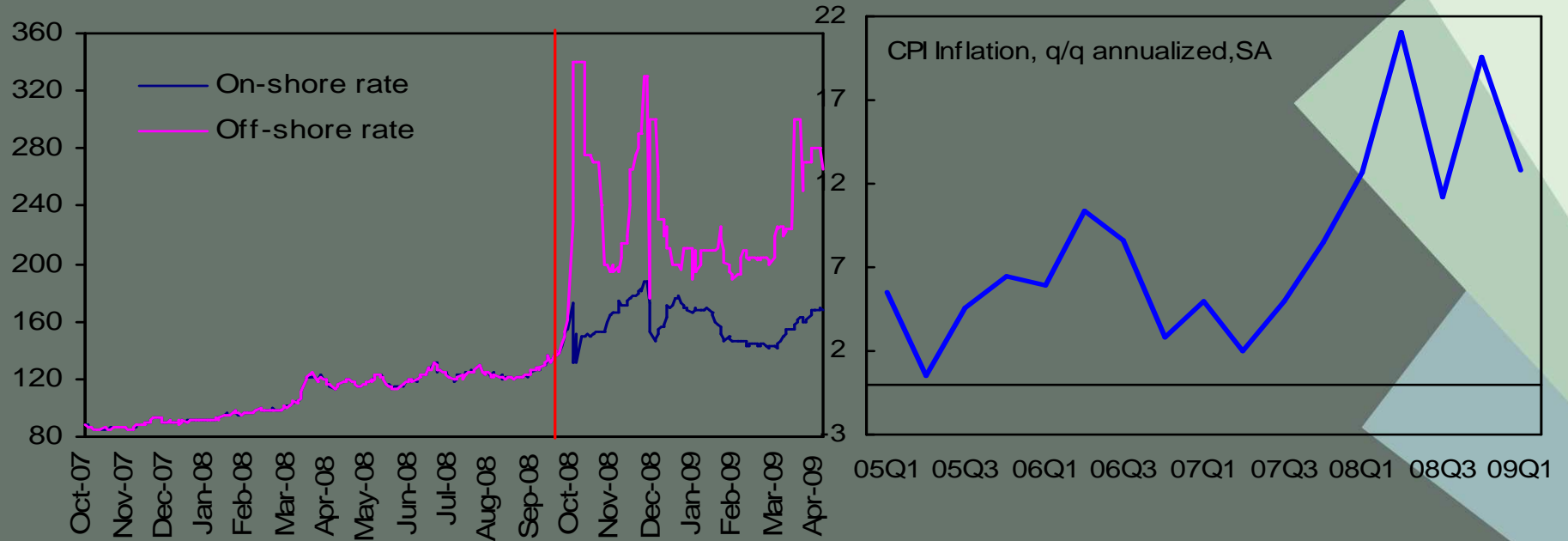
Country risk premium skyrocketed

Impact on the real economy: sharp contraction  
Impact on the ability to pay external obligations: large external financing gap

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**Immediate pressure on the currency and inflation.  
Some signs of stabilization.**

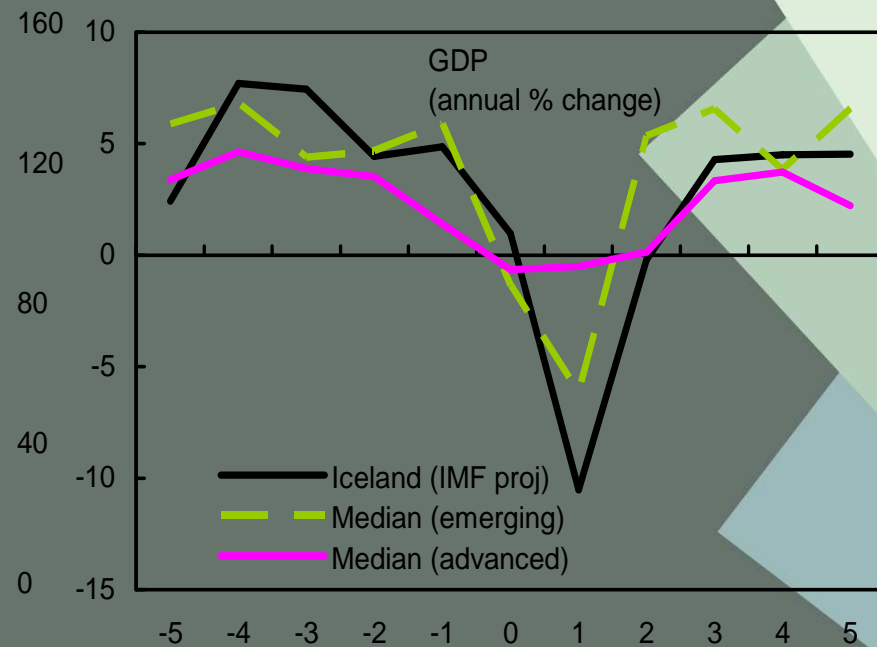
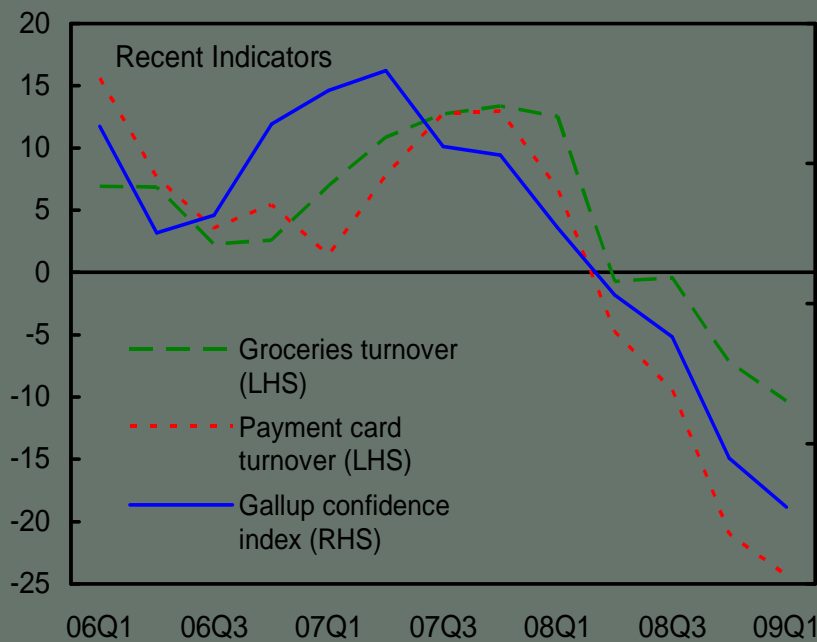


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## A sharp contraction of GDP.

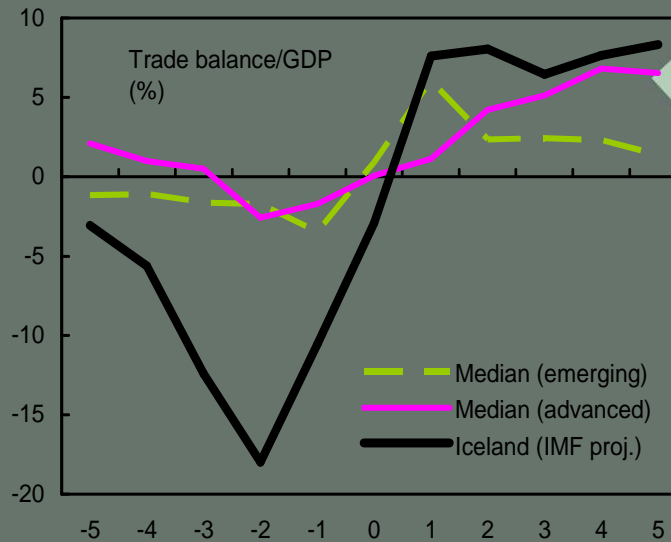
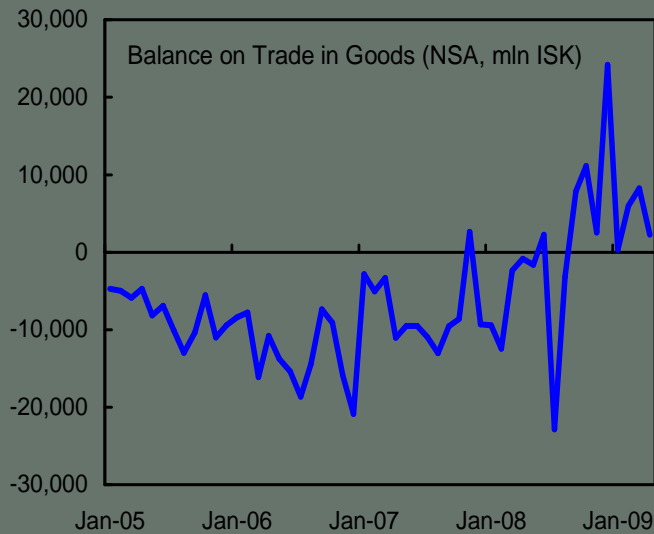
### International experience--recovery could come soon.



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## The trade balance has improved and should remain in surplus.



Source: IMF and Central Bank of Iceland

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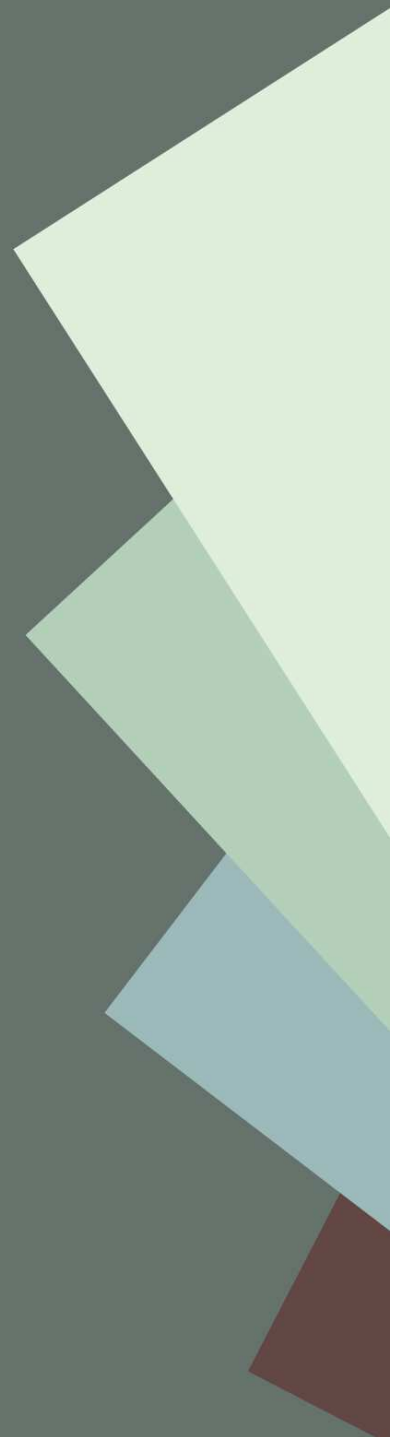
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## III. The recovery program. Financing and adjustment policies

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## The IMF Program

### Financing

Two-year IMF Stand-by Arrangement totaling \$2.1 billion; \$827 million upfront, and remainder in 8 equal installments.

Official bilateral creditors commit an additional \$3.2 billion.

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### Adjustment policies

#### Monetary policy

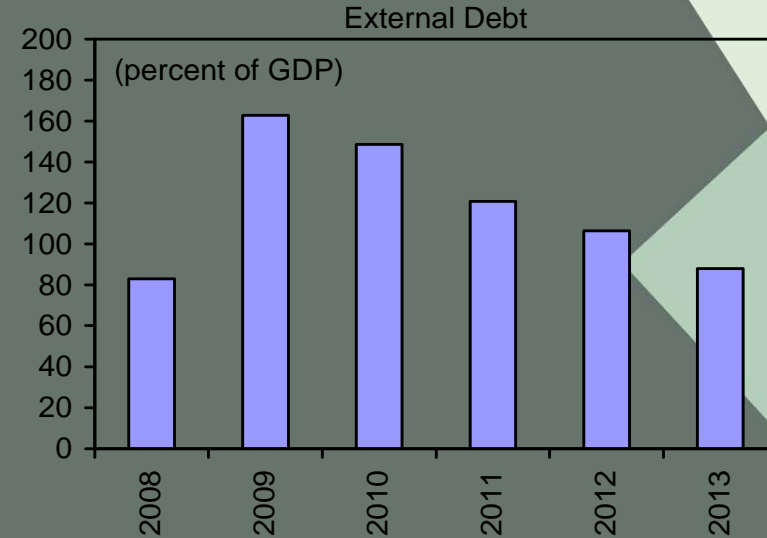
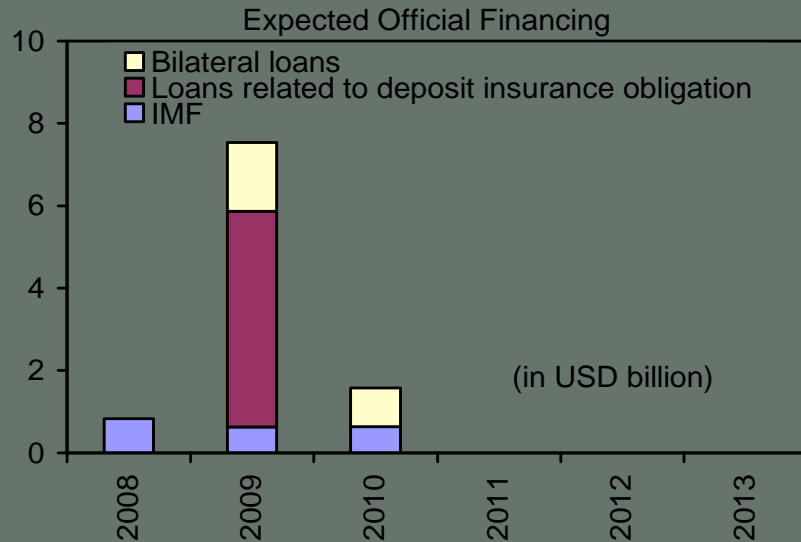
#### Fiscal policy

#### Financial sector policy

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## Program financing



Source: Central Bank of Iceland and IMF Staff projections

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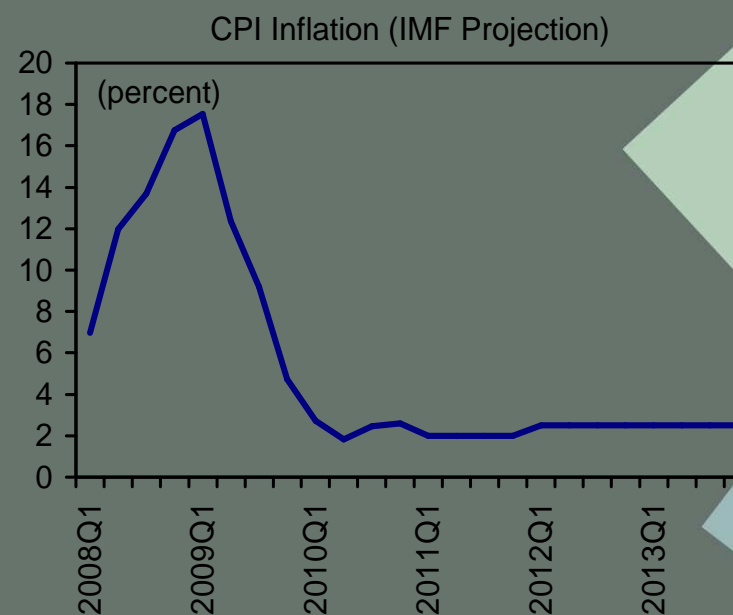
- External debt sustainability is robust to a variety of shocks. Key factors:
  - High current account surpluses (fed by improvements in competitiveness)
  - Asset recovery in the banking sector (conservative assumption made)

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# Monetary policy: Stabilization then support

- Stabilization:
  - stabilize the exchange rate
  - stabilize financial markets
    - Largely accomplished
- Support recovery:
  - Normalize the regime
    - Remove capital controls
    - Reduce interest rates
  - Keep inflation low



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Source: Central Bank of Iceland and IMF Staff projections

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# More on Normalizing the Monetary Policy Regime

### Interest rate strategy:

- Balance sheet considerations require continued focus on exchange rate stability
- Fiscal consolidation and debt restructuring may in time create more room for reductions--but this is not evident now.

### Capital control strategy:

- Pre-conditions for easing: financial system stability and adequate reserves
- Current forecasts suggest that the process must be gradual
- To maximize benefits to Iceland, focus first on new investment, then gradually release legacy non-resident holdings (approach used in other countries)

### Interactions between rates and controls:

- Despite capital controls, interest rate policy is still needed to: (i) encourage exporters to repatriate in foreign exchange; (ii) encourage reinvestment of interest earnings; and (iii) contain capital control circumvention.
- Interest rates must be high enough when new investment is liberalized to prevent large net outflows.

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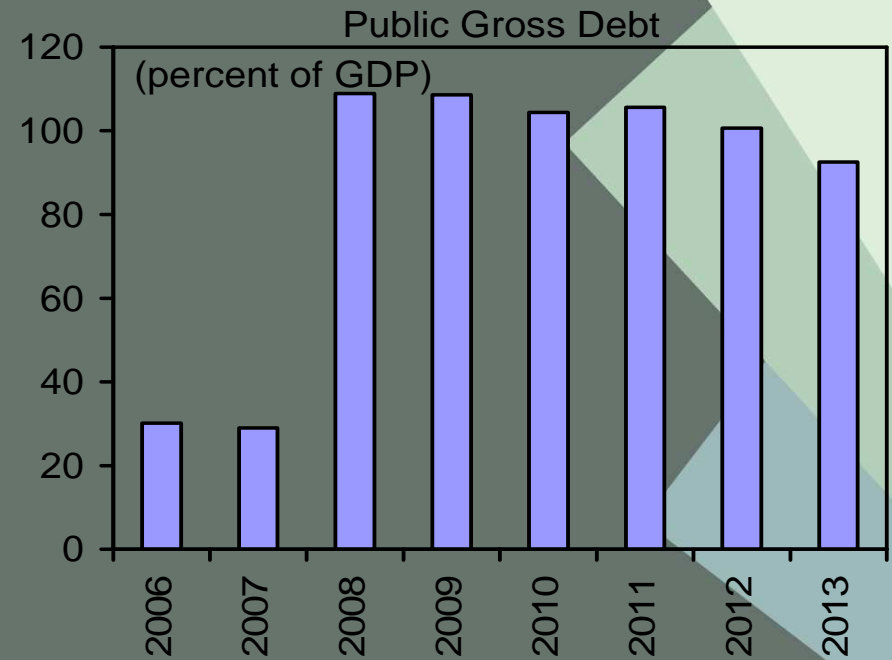
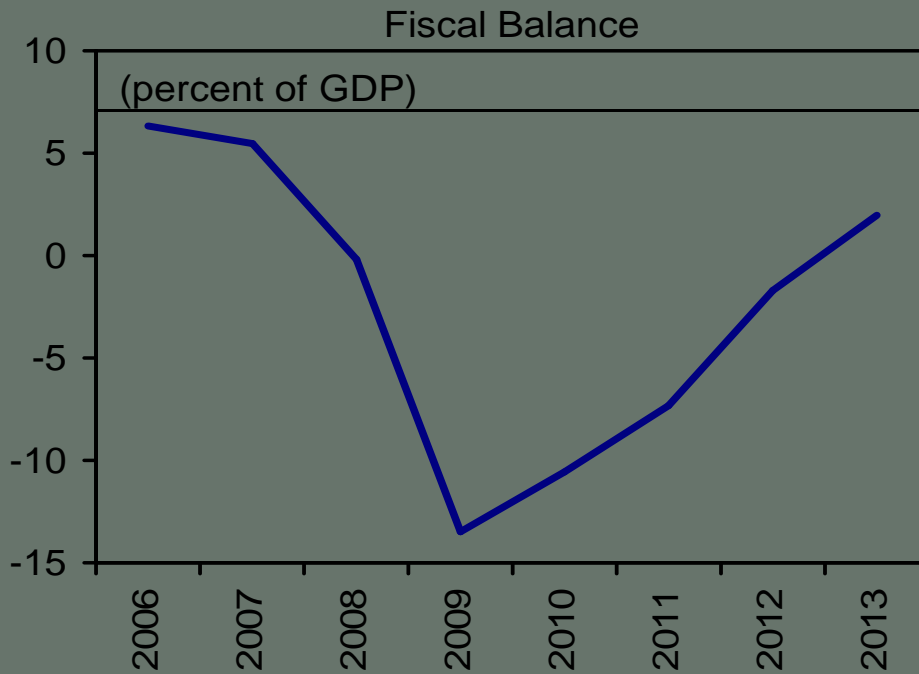
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## Fiscal policy: Gradual consolidation and reduction of public debt

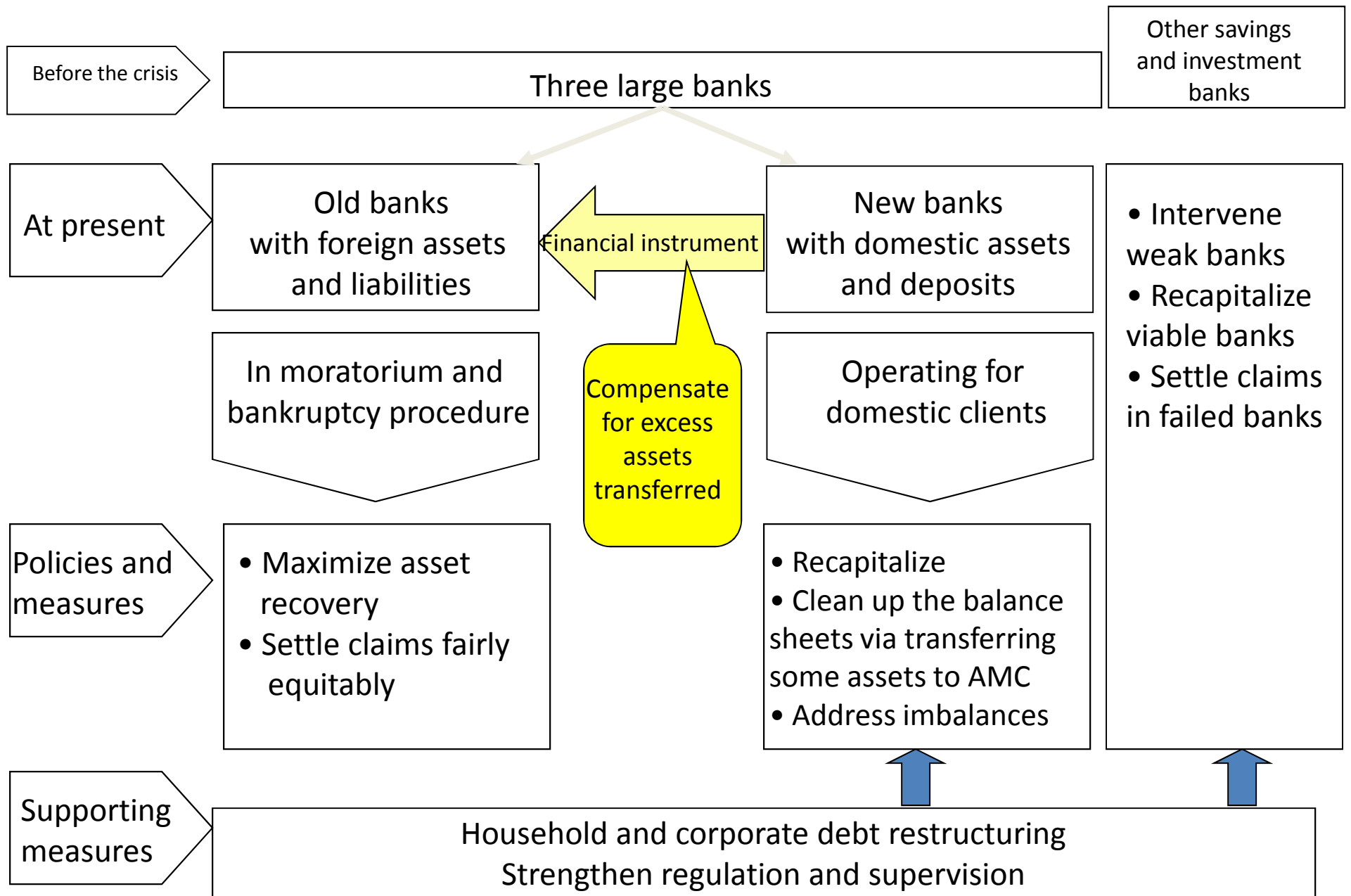


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Source: Ministry of Finance and IMF Staff projections

# Restoring the banking system



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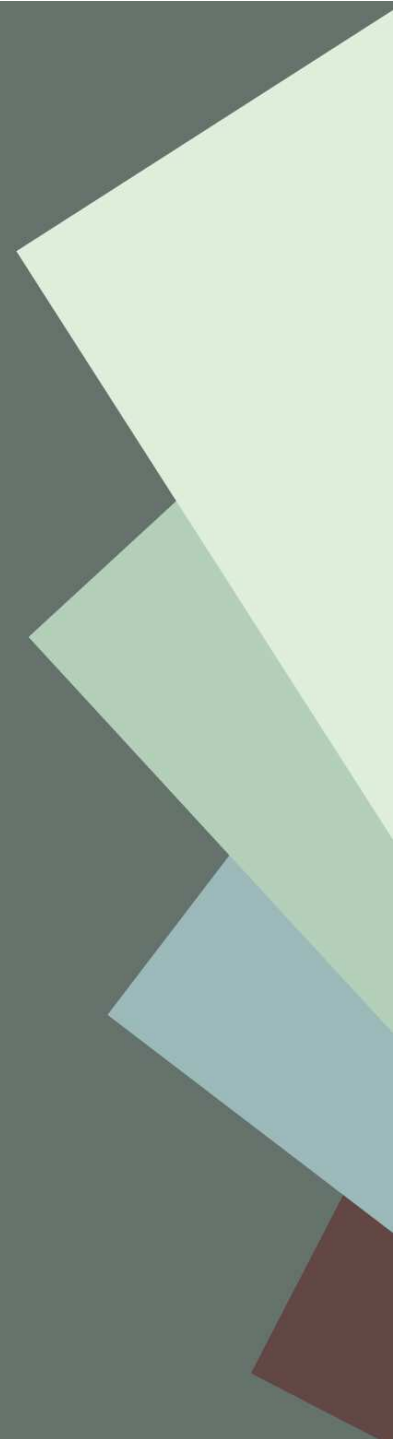
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## IV. Where does the program stand now?

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### Policies

#### Monetary policy:

Significant easing in last two months. Preconditions not yet in place for further easing. Need to monitor conditions.

#### Fiscal policy:

Authorities defining measures to effect fiscal consolidation

#### Financial sector:

Asset valuation done. Next steps are to define instrument of compensation, recapitalize, address imbalances, cut costs, and define asset management strategy.

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# Work towards the next IMF disbursement

- Program has quarterly reviews
- Discussions on first program review ongoing
- The next tranche to be disbursed after IMF executive board approval of the review

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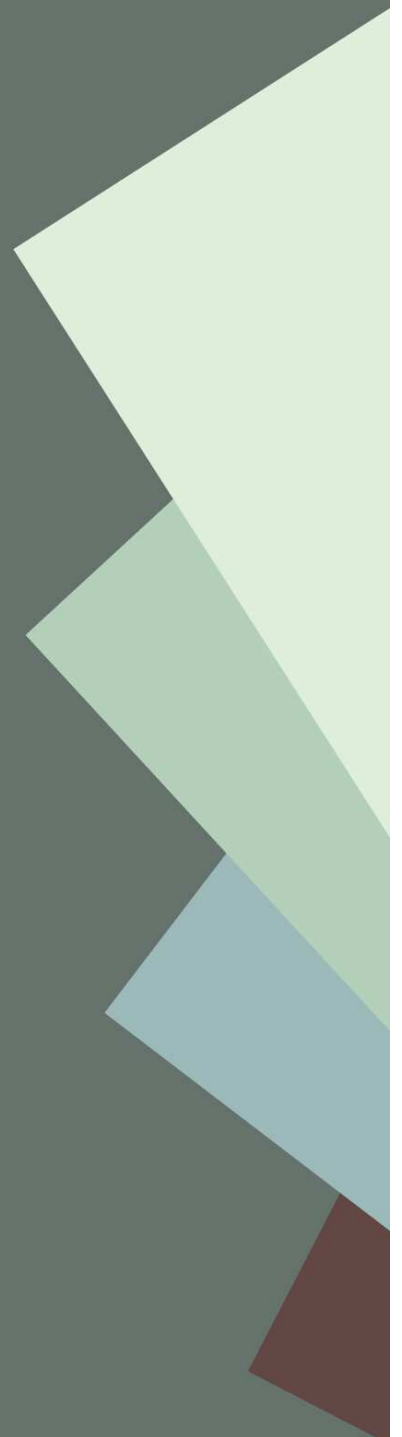
**Gunnar Andersen**

Director General of the FME

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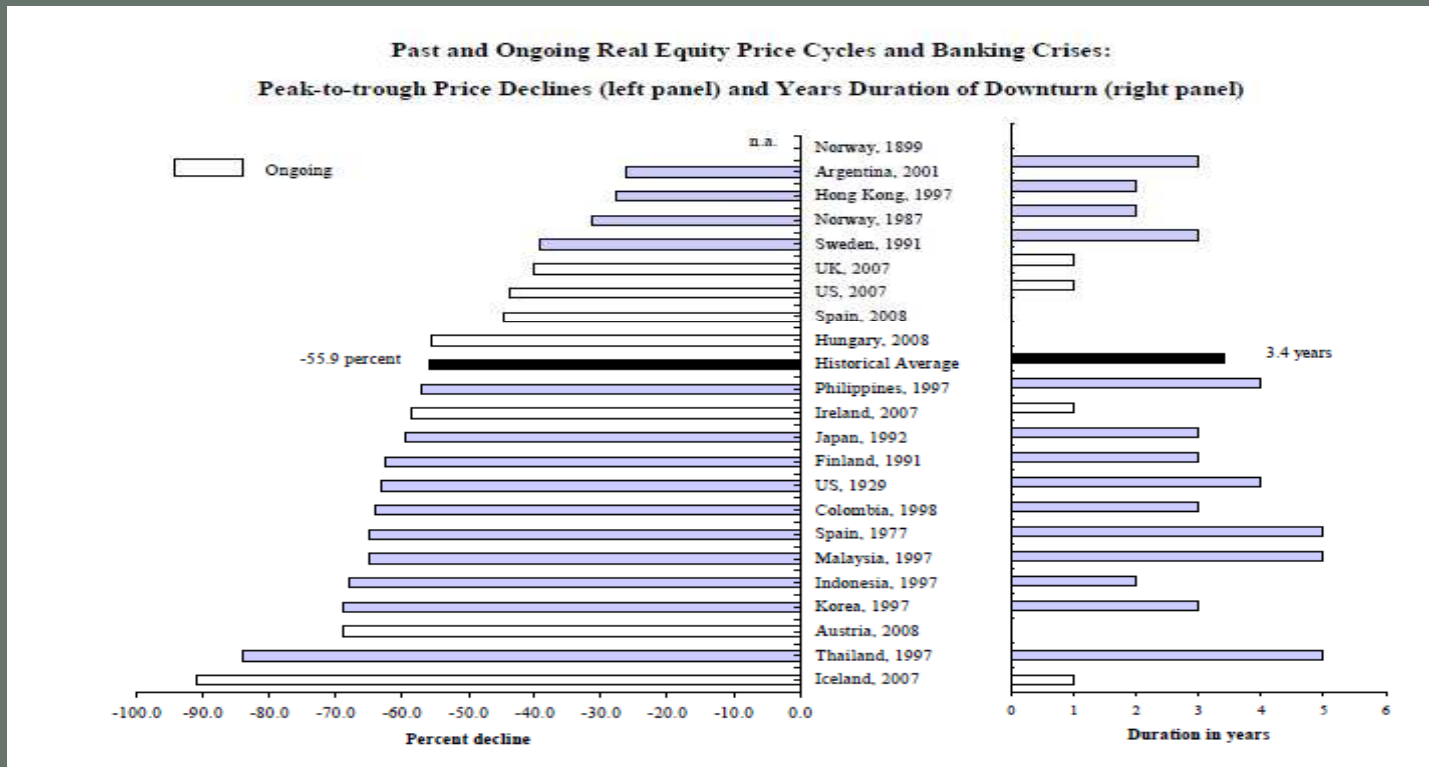
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## Comparison of systemic banking crises



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Source: Reinhart & Rogoff, "The Aftermath of Financial Crises", 2008

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## Comparison of systemic banking crises

	Starting date	Worst YoY Real GDP growth, % <sup>1</sup>	Max unemployment Rate <sup>2</sup>	Change in market index, YoY % <sup>3</sup>	Fall in FX rate, % <sup>4</sup>	NPL, % total loans <sup>5</sup>
Iceland	2008	-9.6 [2009e]	6.9 [2010e]	- 91.1 [2008]	-55 [2008]	~50% (est.) <sup>6</sup>
Indonesia	1997	-13.1	11.5	-37.0	-57.8	46.8 <sup>7</sup>
Thailand	1997	-10.5	4.6	-55.2	-31.1	30-45
South Korea	1997	-6.9	7	-42.2	-45.9	35
Norway	1988	-0.2	6	-28.9	-11.6	16.4
Sweden	1991	-1.2	9.3	15.0	-8.7	13
USA	1980	-1.9	9.7	-9.7	-8.2	4.1

1. Source: Indonesia: IMF World economic outlook Oct 2008 (only Indonesia); Others: DataStream

2. Source: Thailand: National Statistical Office of Thailand; Others: DataStream

3. Source: DataStream – UK: FTSE All Share, Norway: MSCI Norway, Sweden: MSCI Sweden, Thailand: Bangkok S.E.T., Korea: Korea SE Composite, Indonesia: Jakarta SE Composite, USA: S&P 500 Composite

4. Source: DataStream: USD to national currency quarterly variation, For USA GBP to USD

5. Source: IMF Systemic banking Crises: A New Database Oct 2008

6. Oliver Wyman analysis

7. Source: Bank of Indonesia

Source of compiled data: Oliver Wyman

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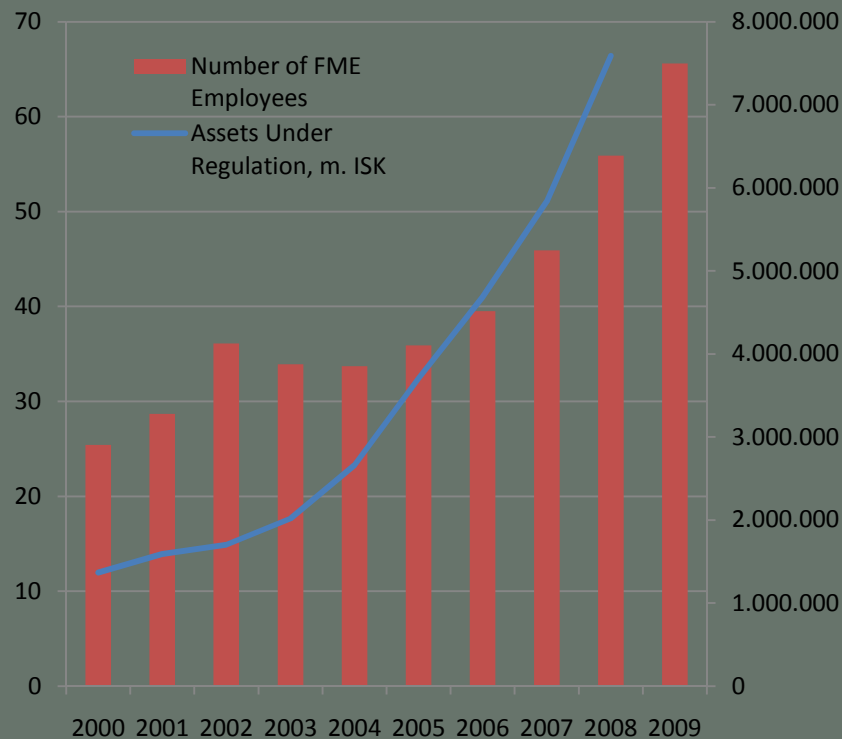
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# Employees versus industry size



- From 2000-2008, FME staffing approximately **doubled**
- Assets of regulated entities grew by **554%** during the same period

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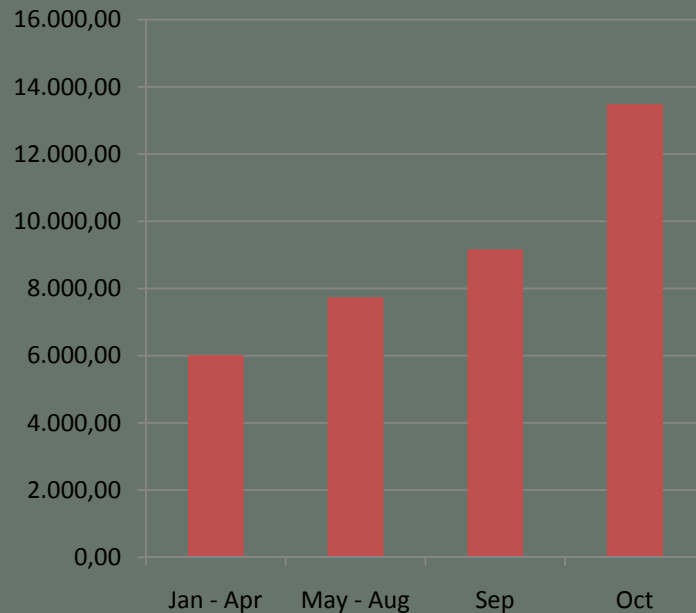
Source: Seðlabanki Íslands, Q3 2008 is last available for 2008

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## FME workload increased dramatically as the crisis unfolded

Case hours logged per month, 2008



- 6,000 hours per month
  - Average in early 2008
- 13,500 task-hours logged October 2008
  - **125% increase**
- Many FME employees logged over 2,000 hours in 2008
  - 600 more than in an average year

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# Active investigations

- Since October 2008, FME has opened 51 investigations into potential wrongdoing by individuals or financial institutions
- Currently, there are 32 issues under investigation
- Many more investigations expected
  - Additional issues arising from independent auditors' reports
  - Tips from former and current financial sector employees
  - Reports on additional financial entities expected mid-2009

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# Referrals

- At present, FME has referred 10 cases to the Special Prosecutor
  - Market manipulation
  - Insider trading
  - Other violations
- Going forward
  - 5 additional cases to be referred in the immediate future
  - 9 more additional cases in next several months
  - More future cases possible in all areas of oversight

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# Regulated entities

- FME currently oversees 119 legal entities in Iceland (**down from 200 in 2000**):
  - Commercial and savings banks
  - Credit undertakings
  - Insurance companies and brokerages
  - Securities companies and brokerages
  - Asset management companies (UCITS)
  - Pension funds
  - Exchange and depository

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# Looking ahead

- Stepped-up supervision
  - On-site inspections
- More forceful regulatory actions
- Greater deployment of IT
- Higher level of international cooperation
- New skills added to toolkit
  - Forensic accounting
- New provisions in law (?)
  - Wider authority

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