Iceland’s program with the IMF 2008-2011

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Let me begin with a little background on the Icelandic banking crisis. The three Icelandic banks, Landsbanki, Glitnir and Kaupthing, had grown very quickly over the four years before their collapse and their combined balance sheets were about tenfold the GDP of Iceland. The banks’ annual external refinancing needs were of the same order as GDP and four to five times the Central Bank’s currency reserves. So there was no credible lender of last resort for the banks.

Soon after the fall of Lehman in September 2008 a credit line of Glitnir Bank was cancelled and Glitnir was subsequently unable to meet a payment on a loan. In an attempt to restore confidence in the banks the Government of Iceland tried to nationalize Glitnir on September 29. This had the opposite effect to that intended: credit rating agencies downgraded the Republic of Iceland which was now seen as having taken on the task of trying to save its banks – as Ireland did a day later with a blanket guarantee of liabilities of its banks. A retail and wholesale run on Icelandic banks followed. Iceland was hit by a “perfect storm”.

Landsbanki collapsed in the early hours of October 7. A few hours before, the Icelandic Parliament passed what has become known as the “Emergency legislation” (Act no. 125/2008) to prevent the collapse of the banks from becoming a collapse of Icelandic society. The Act gave deposits and deposit insurance priority over other claims on the banks and gave the Icelandic FSA the authority to ring-fence the domestic part of distressed banks by transferring domestic assets and liabilities into new banks. This was then done as the banks fell one by one. All deposits in Icelandic branches were transferred into the newly created banks. Deposits in foreign branches were given priority status as claims on the old banks. Bondholders of the banks – including foreign parties but also Icelandic pension funds and the Central Bank of Iceland – were left with claims to assets remaining in the old banks, second in line after deposits and deposit insurance.

Glitnir and Kaupthing soon suffered the same fate as Landsbanki. Market confusion and panic reached a climax on October 10 after the UK authorities had seized Landsbanki’s London branch under anti-terror legislation, and Kaupthing’s London subsidiary under the Northern Rock Act, and the British Prime Minister had threatened to seize all Icelandic assets in the UK.

It was clear that Iceland would suffer a balance of payments crisis unless it would get outside support. Apart from the certainty of Iceland experiencing a classic currency crisis there was a risk – at least a perceived one – that Iceland would suffer financial retribution for its actions and possibly be shut out of international payments systems. Informal contact with the IMF began soon after the collapse of Landsbanki. Icelandic authorities were, however, reluctant to seek help from the IMF at first and sought other sources of financing. The Central Bank announced that Russia was willing to lend 4 billion dollars to Iceland on very advantageous terms and subsequently pegged the exchange rate to the euro. But the Russian loan proved elusive and the exchange rate peg only lasted for two days. It finally became clear to the government that the IMF was the right negotiating partner. The fund would not only provide financing and expertise, but also be a much needed provider of credibility.

After the initial doubts were pushed aside, preparation of a Stand-By-Arrangement for Iceland began on October 9. Intense work on a plan for Iceland followed. A deal with the IMF was finalized and made public on October 24. This had a calming effect which was realized as news of the negotiations came out a few days before the agreement.

It was by no means a foregone conclusion that the IMF deal would come off. There were the usual contentious points in IMF programs, such as how fast to consolidate public finance and how high to set interest rates. But there were also difficult issues more particular to Iceland such as the need to impose capital controls and the Icesave issue – whether Iceland should guarantee deposit insurance for Landsbanki's UK and Netherlands branches to the tune of half Iceland's GDP. There was also some uncertainty about Icelandic policy – the ground shifted several times under our feet; once quite severely. But the deal was struck in the end.

The IMF program had three main components:

1. Banking sector restructuring and insolvency framework reform
2. Consolidation of public finances
3. Monetary and exchange rate policy, with stabilization of the exchange rate and inflation as key elements

Against the assurance of following the economic policies of the program, the IMF and friendly nations lent Iceland 5 billion dollars – 40% of GDP – to serve its external financing needs over the next three years.

Some of the policies implemented in Iceland as part of the IMF program have been called heterodox. In particular the imposition of capital controls has been so characterized but also the "repudiation of debt", that is, letting institutional creditors of the banks bear the costs of their collapse rather than Icelandic tax payers – although I should note that there were substantial costs: the net direct fiscal cost of the banking crisis amounts to approximately 20% of GDP and, within the OECD at the latest reckoning, comes second only to that of Ireland.

The most controversial element of the monetary and exchange rate policy part of the program was the imposition of capital controls. That interest rates were raised to 18% initially is now a distant, albeit an unpleasant, memory, but the controls are still with us. Why was it necessary to impose this odious regime? Consider the following:

1. In January 2008 65% of bank loans to firms were in foreign currency or linked to foreign currency – as it turned out there was a crucial difference between these two apparently equivalent forms of loan contracts – and 15% of bank lending to households was linked to foreign currency.
2. As the carry trade inflows which had supported the krona were first halted and then reversed, the exchange rate depreciated by 40% over the first three quarters of 2008.
3. Household lending in kronur was (and still is) largely indexed to consumer prices and historically there is a quick pass-through of exchange rate movements to prices. Inflation was already approaching 20% in October 2008.

The consequence was that inflation and exchange rate linked debt shot up. Balance sheets of most firms and many households were already in tatters. But it was still crucially important to stabilize the exchange rate in order to prevent even more damage.

Currency reserves had been depleted to the extent that by the end of October they did not suffice to cover known outflows over the next twelve months let alone the huge stock of carry trade money still left in Iceland. The 18% policy rate would perhaps have sufficed to slow down outflows and stabilize the exchange rate under other circumstances, but as things were it is questionable whether any interest rate would have stopped capital flight and a complete collapse of the krona in the absence of capital controls.

A key prerequisite for lifting the controls was met last June when Iceland regained access to international capital markets and issued a bond of 1 billion US dollars.

Consolidation of public sector finances seemed a Herculean task. In October 2008 the IMF estimated the gross fiscal cost of the crisis to be 80% of GDP – over half of that due to foreign deposit insurance. There was pessimism about asset recovery so net costs were projected to be similar to gross costs. Still, it was decided to postpone spending cuts for one year. A former Prime Minister of Sweden visited Iceland soon after the IMF program was announced and declared that this made no sense, we should take the bull by the horns and cut public spending drastically at once. I think he was wrong. In the winter of 2008-2009, as private demand collapsed and unemployment shot up to levels not seen since the Great Depression the support given to aggregate demand by public spending was very important.

The progressive fiscal tightening of 2-3% of GDP annually in the three following years has of course been painful, but it was unavoidable. One can argue whether the mix between the raising of taxes and spending cuts has been right. It is regrettable how little has been done on structural policies. But, on the whole, this is the most successful part of the program. Net public debt is now a manageable 44% of GDP. That gross public debt is still excessively high in Iceland is mostly due to the large currency reserves financed by external loans, and equity stakes in the new banks financed by domestic borrowing. This situation can and should be unwound in coming years in order to lower gross debt to a sustainable level.

An important issue – one which has largely been overlooked – is that the IMF implicitly supported the emergency legislation. On that premise, Iceland was to rebuild its banking system, refinance the new banks, and to ensure "fair, equitable and non-discriminatory treatment of depositors and creditors in line with applicable law" as the Letter of Intent had it. Most of us are all too familiar with the consequent Icesave dispute which has ignited high emotions inside and outside Iceland, but recovery from the Landsbanki estate is set to be much better than originally estimated and the quarrel seems likely to fade away.

From a banking perspective the old-bank/new-bank split that was executed in Iceland was questionable. It would surely have been better from that point of view to do a bad-bank/good-bank split, as in Sweden in the early 1990s. But there were good legal grounds for the choice that was made. A strong legal argument can be made for the constitutionality of the domestic ring-fencing that was done – although even this is yet to be confirmed by Iceland's Supreme Court. The EFTA Surveillance Authority has, however, opined that the split did not violate EEA law. On the other hand, moving all the good loans to new banks along with domestic deposits and leaving the bad loans in the old would hardly have passed legal muster.

It was clear from the outset that an efficient insolvency regime would be needed for Iceland in order to manage widespread insolvency among firms as well as households after the crisis and to quickly place the new banks on a sound footing – to make them into "good banks". Progress on this front has been slow. This has been a costly failure. Court decisions on illegality of exchange rate linked loans have created uncertainty about the value of such loans – as well as providing some debt relief. But progress on debt workout of firms has still been excruciatingly slow – delinquent loans are 30% of the loan book of the banks. It took more than two years to change the law on personal insolvency such that households deeply in debt can be provided a fresh start in a similar way as under the US regime, and the execution has progressed very slowly. The consequence – and to some degree the cause – of this has been that the government has to an extent given in to demands for across the board debt reduction – a costly, ineffectual and regressive policy.

Iceland's situation has gradually been normalized over the three years of the program. It is by no means an ideal situation yet: unemployment is still high, growth is anemic, and inflation too high. But we have reached a turning point where we can see better times ahead. Iceland is an island in a geographic sense only and our material fortunes are and shall be linked with those of our neighbors. Yet, it is up to us to use our wits to make the most of our abundant opportunities. We would do well to complement those wits with some good expert advice. In that regard I look forward to today's discussion.

Dr. Fridrik Mar Baldursson is Professor of Economics and Dean of the School of Business at Reykjavik University. In addition to publishing his research in international academic journals Professor Baldursson has written extensively on Icelandic economic affairs both locally and in international fora. Baldursson has participated in public policy making in Iceland since the late 1990s and has, in particular, contributed to policies on utilisation and management of Iceland‘s marine and energy resources. In early October 2008 Professor Baldursson was recruited by the Prime Minister‘s Office to lead negotiations with the IMF on Iceland‘s behalf.