LOOKING BACK
THE PATH TO ECONOMIC NORMALIZATION

Iceland, hit hard by the 2008 financial crisis, had to implement complex policies under difficult circumstances with substantial legal and reputational risks involved

1. Develop a banking resolution regime overnight

2. Seek financial support from IMF and neighboring countries

3. Impose capital controls to prevent further depreciation of the currency

4. Restore public finances on a sustainable path and deal with the direct fiscal cost of the banking crisis

5. Restore access to international capital markets and repay financial support

6. And most recently, roll out a capital account liberalization strategy
In the fall of 2008, the Icelandic banking system collapsed, giving rise to a general economic recession and a severe currency crisis. Substantial fiscal consequences followed.

Iceland was the first advanced economy to experience the full force of the 2008 global financial crisis.

- And subsequently the first to seek financial support from the IMF.

With one of the most severe economic collapses in the developed world in recent history in the making and without any clear roadmap to follow, the Icelandic government was in early October 2008 faced with difficult decisions on how to:

- Prevent further depreciation of the currency
- Ensure fiscal sustainability
- Develop a bank restructuring strategy

**Chart: Total Assets of Three Largest Banks (% of GDP)**

Source: CBI
THE 2008 FINANCIAL CRISIS: ‘ICELANDIC TRAP’ – BANKS TOO BIG TO BAIL OUT

» Insolvent financial system virtually impossible to save
  • Icelandic taxpayers should not have to shoulder excessive private sector losses

» ‘The Emergency Act’ - A bail-in banking regulation developed and implemented
  • Banking system allowed to fail with companies placed in receivership
  • Domestic assets, liabilities and operations of the failed banks transferred into new Icelandic-centric banks
  • Burden put on the industry’s uninsured creditors rather than taxpayers
    – Striking similarities with the EU’s bank resolution regime which were adopted years later

» The collapse of a banking system triggered an even further capital flight
  • Capital controls were imposed

Chart: The largest bankruptcies in the US in comparison with the failure of Iceland’s three banks

ASSETS IN USD BILLIONS

<table>
<thead>
<tr>
<th>Company</th>
<th>Assets (USD billions)</th>
<th>Share of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lehman</td>
<td>691</td>
<td>1035%</td>
</tr>
<tr>
<td>Washington Mutual</td>
<td>328</td>
<td>472%</td>
</tr>
<tr>
<td>The three Icelandic banks, total</td>
<td>182</td>
<td>5%</td>
</tr>
<tr>
<td>WorldCom</td>
<td>104</td>
<td></td>
</tr>
<tr>
<td>General Motors</td>
<td>91</td>
<td></td>
</tr>
<tr>
<td>Kaupthing Bank</td>
<td>83</td>
<td></td>
</tr>
<tr>
<td>CIT Group</td>
<td>80</td>
<td></td>
</tr>
<tr>
<td>Enron</td>
<td>66</td>
<td></td>
</tr>
<tr>
<td>Conseco</td>
<td>61</td>
<td></td>
</tr>
<tr>
<td>Landsbanki Islands</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Glitnir Bank</td>
<td>49</td>
<td></td>
</tr>
</tbody>
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at average exchange rate 1988-2008; GDP Iceland: ISK 1,547bn, GDP USA: USD 14,549bn
Stabilizing the exchange rate was imperative to stem highly adverse balance-sheet effects
- Two-thirds of local corporate debt foreign currency-linked and extensive indexation of household debt

The exchange rate stabilized shortly after restrictions were imposed and helped revitalize the economy
- Created fiscal space
- Allowed for the easing of monetary policy
- Provided breathing room to restructure and resolve impaired balance sheets across the economy (banks, corporates, households etc.)

The removal of controls was to be initiated as soon as balance of payments developments permitted and once financial sector stability was solidified

Chart: Total Household Debt (% of GDP)
Chart: Real Effective Exchange Rate (Index, pre-crisis year =100)
THE BOP PROBLEM
There are five groups of parties wanting to transfer capital out of Iceland once the controls have been lifted creating an balance of payments (BOP) overhang.

As the dust settled it became evident that this BOP overhang was unprecedented in global and historical context.

According to the IMF report from March 2015, short-term capital outflows from these five groups could total up to 70 percentage points of GDP if no countervailing action were taken.

If the capital controls were lifted all at once, and without a detailed liberalization strategy, the economy would collapse again.

Chart: Overhangs as a share of GDP: historical comparison

<table>
<thead>
<tr>
<th>Country</th>
<th>% of GDP</th>
</tr>
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<tbody>
<tr>
<td>Malaysia</td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td></td>
</tr>
<tr>
<td>Iceland</td>
<td>112%</td>
</tr>
</tbody>
</table>
LIBERALIZING CAPITAL CONTROLS: LAUNCH OF A COMPREHENSIVE PLAN

The Icelandic Government announced a comprehensive capital account liberalization strategy last June

A threefold solution aimed at maintaining macroeconomic and financial stability

- **01** Failed banks’ estates
- **02** Offshore ISK
- **03** The real economy

<table>
<thead>
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<th>Failed banks’ estates</th>
<th>Stability conditions – stability tax</th>
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<td>Offshore ISK</td>
<td>Auction and reinvestment</td>
</tr>
<tr>
<td>The real economy</td>
<td>Increased freedom, prudential rules, and investment authorisations</td>
</tr>
</tbody>
</table>
Liberalizing capital controls: Failed banks’ estates - stability conditions

Stability conditions, and if the estates would not satisfy the conditions before the deadline, a stability tax would have been levied on them.

Stability conditions

- Stability contribution
  Deadline for fulfilment of conditions: year-end 2015

- Stability tax
  Tax was to be levied on 15 April 2016
The estates of the three failed banks, Kaupthing, Glitnir and LBI, all got composition agreements confirmed in courts in December.

Stability contribution agreements finalized in beginning of 2016 and Treasury receives stability contributions.

The stability contribution amounts to 384 bn. ISK in total – about 20% of GDP.

Contribution combined of cash, assigned assets, retained assets, shares in Íslandsbanki and a bond issued by Kaupthing (collateral: Arion bank).

A multi-product auction is planned in first half of 2016 to deal with off-shore krona holdings.

No unresolved legal disputes related to compositions.
RatingsDirect®

Research Update:
Iceland Ratings Raised To 'BBB+'' On Further Progress Toward Capital Account Liberalization And Declining Debt Levels
» BETTER BALANCED ECONOMY
POLICY FRAMEWORK AND OBJECTIVES

» Sustainable fiscal policy with the aim of reducing debt levels.
» Lifting of capital controls without threatening economic and financial stability.
» Reducing regulatory burden and simplification of taxes.
» Increasing productivity through education reforms and R&D investment.
» A stable and inviting environment for investors.
ICELAND: FASTER AND STRONGER RECOVERY THAN MOST OF EUROPE

Out of recession faster than IMF programme countries

Outperforming strongest EU members

Source: IMF database 2015.
TREASURY PRIMARY BALANCE 2005-2019*

* excluding irregular items
Adjusted for the transfer of the services for disabled people from the state to local governments.
TREASURY OVERALL BALANCE 2005-2019*

* excluding irregular items
Adjusted for the transfer of the services for disabled people from the state to local governments.
DEALING WITH DEBT
GROSS DEBT AND NET FINANCIAL POSITION

Bn. ISK

% of GDP


Gross debt. (l.ax.) Net financial position (l.ax.) Debt-to-GDP. (r.ax.)
DEBT COMPOSITION AFTER MEASURES TAKEN I2016*

- Total debt of 150 bn ISK pre-paid in 2015
- Total debt is estimated to reduce by 178 bn. ISK in 2016
- Debt-to-GDP ratio estimated at 49.5% at year end

* Estimated composition year end 2016
RECENT DEVELOPMENTS
THE ICELANDIC ECONOMY

- Iceland is emerging steadily from a recession caused by the 2008 collapse of its economy and banking system
- Inflation (2015): 1.6%
- GDP growth (Q1-Q3 2015): 4.5%
- Unemployment (2015): 2.9%
- Life expectancy (2014): Men: 80.6, women: 83.6

Export of goods and services by type 2014

- Tourism 28%
- Other Service Sectors 20%
- Other Manufactured Goods and Products 9%
- Marine Products 23%
- Aluminium and Ferrosilicon 20%
- Marine Products
- Other Service Sectors
- Other Manufactured Goods and Products
- Tourism
- Aluminium and Ferrosilicon

Icelandic population

GDP per capita, USD PPP

- Total inhabitants
- % of foreign citizens
- Iceland
- EU 28
RECENT DEVELOPMENTS

GDP, year-over-year

Private consumption, year-over-year

Inflation

Real wages

- CPI
- CPI less housing cost
- CB Target
KEY SECTORS ARE STRONG
TOURIST SECTOR

Foreign tourists in Iceland

Number of foreign tourists  % change between years (r. Ax)

Hotel nights in Iceland (jan–dec)

2011  2012  2013  2014  2015

Occupancy rate of hotel rooms

Total  Capital area

Credit card usage of foreign tourists

Hotels  Restaurants  Car rentals  Shops
ICELAND’S RECOVERY: BANKS ASSET QUALITY & KEY RATIOS IMPROVING

Default Ratios of the Three Largest Commercial Banks

Profitability, Interest Margin and Cost Ratio

Commercial Banks’ Funding

Commercial Banks’ Capital Adequacy Ratios

Loans to Borrowers with At Least One Loan in Default Over 90 Days (Cross-default Method)
Loans in Default Over 90 Days (Facility Level or Non-performing Loans)

Sources: Commercial banks’ annual and interim financial statements,

Return on Total Assets (ROA)
Net Interest Income (NII) as % of Total Assets
PRIVATE DEBT LEVELS HIGH BUT FALLING

Corporate Debt Outstanding

% of GDP

Total Household Debt

% of GDP

Household debt, international comparison

% of GDP

FX Borrowing by Households

ISK billion

ISK billion

Foreign denominated borrowing as a % of household's borrowing (L-axis)
ICELAND’S RECOVERY: FISCAL COST FROM THE BANKING CRISIS

Direct fiscal cost of little over 40% of GDP

Source: IMF WP/15/166.
Were will Iceland end up ranking on this graph?

Source: IMF WP/15/166.
MANGE TAK!