Bank Restructuring

Typical street scene in Santa Ana, El Salvador. (Photo: iStock)

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IMF Survey: Iceland Gets Help to Recover From Historic Crisis

By Camilla Andersen
IMF Survey Online

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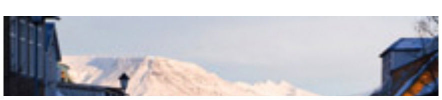
- IMF Executive Board agrees $2.1 billion loan for Iceland
- Official bilateral creditors also expected to help
- Program aims to restore confidence in the Icelandic króna

The financial crisis now engulfing the world claimed Iceland—which has a population of just 300,000—as one of its early victims.



Related Links

Cars parked in Iceland's capital Reykjavik, where despite the crisis, the economy remains flexible. (photo: Gavin Hellier/Corbis).

- Iceland and IMF (/external/country/ISL/index.htm)
- IMF press release (/external/np/sec/pr/2008/pr08296.htm)
- Video: Restoring confidence (/external/mmedia/view.asp?eventID=1329)
- IMF talks to crisis countries (/external/pubs/ft/survey/so/2008/new102208a.htm)
- Quick, cooperative action needed (/external/pubs/ft/survey/so/2008/NEW100908A.htm)
- Stress hits emerging economies (/external/pubs/ft/survey/so/2008/POL110908A.htm)
- Iceland video briefing (/external/mmedia/view.asp?eventID=1328)

In response, Iceland formulated a comprehensive program to tackle the fallout from the crisis, for which it requested IMF support. On October 24, an IMF package totaling $2.1 billion was announced under the Fund's fast-track emergency financing mechanism.

The IMF's Executive Board approved (/external/np/sec/pr/2008/pr08296.htm) the two-year Stand-By Arrangement for Iceland on November 19, making $827 million immediately available to the country and the remainder to be paid in eight equal installments, subject to quarterly reviews. Iceland's economic program envisages that the IMF loan will fill about 42 percent of the country's 2008-10 financing gap. The remainder will be met by official bilateral creditors.

In this interview (/external/mmedia/view.asp?eventID=1329), the IMF's mission chief for Iceland, Poul Thomsen, talks about the crisis and the country's plans for dealing with the repercussions.

***IMF Survey online*: What went wrong in Iceland?**

Poul Thomsen: Iceland allowed a very oversized banking system to develop—a banking system that significantly outstripped the authorities' ability to act as a lender of last resort when the system ran into trouble. Only a few years ago, Iceland had a banking system that was the normal size. But after the privatization of the banking sector was completed in 2003, the banks increased their assets from being worth slightly more than 100 percent of GDP to being worth close to 1,000 percent of GDP.

When confidence problems intensified this fall, Iceland was one of the first victims because the market realized that the banking system was far too big relative to the size of the economy. As investors started to pull out, it quickly spilled over into trouble for the Icelandic króna. Within a week the three banks collapsed, the króna's value dropped by more than 70 percent, and the stock market lost more than 80 percent of its value. For a small economy that is totally dependent on imports, this was a crisis of huge proportions.

***IMF Survey online*: What is the IMF-backed program hoping to achieve?**

Thomsen: In the short run, the program is narrowly focused on stabilizing the króna. Iceland still has a highly leveraged economy. Most of the debt is either denominated in foreign exchange or indexed to inflation, so when the króna depreciates, debt servicing becomes much more expensive. If we don't stop the decline of the króna, we will probably see a wave of defaults in the corporate and household sectors, and that would further harm the economy.

That is why the IMF-backed program is proposing to use monetary and exchange rate policy to restore confidence in the króna over the next couple of months. In the short run, this will mean higher interest rates. Iceland will also have restrictions in place on the movement of capital. We are advising the government not to lift these restrictions before stability returns to the foreign exchange market.

"I suspect that after this relatively sharp downturn, the economy could rebound fairly fast."

IMF Survey online: **Isn't it unusual for the IMF to agree to capital controls?**

Thomsen: Capital controls have de facto been in place since the three banks collapsed in early October as only payments for priority imports and other current account transactions have been permitted since then. It is a priority under the IMF program to eliminate all restrictions on both the current and capital accounts so that Iceland can return to the freely convertible currency it had for many years. Indeed, all restrictions on the current account have now been lifted as a first important step towards normalization.

But to prevent large capital outflows from causing a further sharp drop in the króna, existing capital account restrictions will remain in place in the near future. With this in mind, the authorities legally formalized the existing de facto regime during the last week of November to make it more effective, rules-based, and transparent. It is an important goal under the IMF-supported program to lift all capital controls during the program period, as confidence improves.

IMF Survey online: **Is the IMF asking Iceland to cut back on spending?**

Thomsen: We are not telling Iceland to tighten its belt in the middle of a recession. During the first year of the program, automatic fiscal stabilizers will be allowed to work. This means there will be an increase in the primary fiscal deficit from about ½ percent of GDP in 2008 to about 8½ percent of GDP in 2009. We in the IMF are not suggesting resisting this deterioration because we think it is wrong, in the face of a deep recession, to embark on fiscal consolidation.

Having said that, Iceland will need to consolidate its finances once the recession has bottomed out. Because of the banking crisis, Iceland has gone overnight from being one of the lowest indebted countries in Europe, to being among the highest indebted advanced countries in Europe: Taking care of the problems in the banking sector will probably cost the public sector about 80 percent of GDP. How exactly the government achieves this consolidation—through either expenditure cuts or higher revenues, or a combination of both—will be up to Icelandic authorities to decide.

IMF Survey online: **What will the IMF's role in restructuring the banks be?**

It is important to acknowledge that Iceland has expressed its commitment to recognize the obligations to insured depositors, and also to a fair and equitable approach in the bank restructuring process. The government's strategy for dealing with the banking problems has been to adopt a new bank/old bank approach—the "new" banks were allowed to service domestic banking needs whereas the "old" banks would deal with the difficult task of sorting out most of the foreign liabilities.

The IMF will help Iceland restructure the banks within this broad framework. The strategy includes plans for valuation of the assets of both new and old banks in line with international best practice, compensation from the new banks to the old banks for any discrepancy in the fair value of assets and liabilities taken over, recapitalizing the new banks with the aim of eventually privatizing them, and maximizing asset recovery in the old banks. Bank supervision and regulation will also be overhauled to make sure a banking crisis of this magnitude never happens again.

IMF Survey online: **So what does the future hold for Iceland?**

Thomsen: There is no doubt that Iceland will face a couple of years of hardship. This is a dramatic and unprecedented shock. It could be the most expensive bank restructuring that the world has ever seen relative to the size of the economy. We expect that, even if we succeed in stabilizing the króna, GDP could fall by 10 percent next year, and there might even be a further small decline in 2010.

The good news is that the Icelandic economy is very flexible. Because of its dependence on fishing and aluminum, Iceland has been exposed to rather big shocks in the past, but it has always been able to adjust very effectively. So I suspect that after this relatively sharp downturn, the economy could rebound fairly fast.

IMF Survey online: **What would success look like?**

Thomsen: Success would look like this: within the next couple of months, the government succeeds in stabilizing the króna and normalizing the country's foreign exchange operations so that all companies that export and import have access to the foreign exchange market.

Once the currency has stabilized, the government should be able to gradually reduce interest rates in 2009, gradually lift the capital controls, and begin to tackle the fiscal problems.

The potential for success is very good because the economy is so flexible. I expect that by the end of the two-year program, Iceland's economy will be growing again.

***IMF Survey online*:** **What would have happened if the IMF had not stepped in with financing?**

Thomsen: The alternative would have been, I am convinced, further significant decline in the value of the króna. Significant strain on household that have their mortgages fixed in foreign exchange; a wave of defaults in the corporate sector that has loans fixed in foreign exchange; a much higher increase in unemployment; and an even bigger decline in GDP than the 10 percent currently predicted.

Poul Thomsen is a Deputy Director in the IMF's European Department.

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Program summary

The program with the IMF focuses on addressing the key challenges at hand:

• **Preventing further sharp króna depreciation** by maintaining an appropriately tight monetary policy in the context of a flexible exchange rate policy. Restrictions on capital outflows will remain in the near term.

• **Developing a comprehensive and collaborative strategy for bank restructuring** by (i) putting in place an efficient organizational structure to facilitate the restructuring process, (ii) proceeding promptly with the valuation of banks' assets, (iii) maximizing asset recovery in the old banks, (iv) ensuring the fair and equitable treatment of depositors and creditors of the intervened banks, and (v) strengthening supervisory practices and the insolvency framework.

• **Ensuring medium-term fiscal sustainability**. While automatic fiscal stabilizers will be allowed to work in full during 2009, the program includes the development of a strong medium-term fiscal consolidation plan to be launched in 2010. This effort is needed to deal with the very substantial increase in public sector debt that is likely as a result of the budgetary cost of recapitalizing the banking system fulfilling the deposit insurance obligations to depositors in foreign branches of Icelandic banks.

Read further details: http://www.imf.org/external/np/sec/pr/2008/pr08296.htm (/external/np/sec/pr/2008/pr08296.htm)

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