IMF Survey : Iceland Makes Strong Recovery from 2008 Financial Crisis

Karin Hammar IMF Survey

ECONOMIC HEALTH CHECK

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

- IMF Country Focus
- IMF Survey Interview

March 13, 2015

- Macroeconomic conditions at their best since the crisis
- Recovery achieved without compromising welfare model
- Full re-integration with global financial markets remains a key challenge

Iceland has rebounded after the 2008/9 crisis and will soon surpass pre-crisis output levels with strong performance in tourism and fisheries. Debt ratios are on a downward path and balance sheets have broadly been restored. The financial sector is back on track though with some important items remaining on the docket.

In an interview with *IMF Survey*, Peter Dohlman, IMF Mission Chief for Iceland, explained what sets Iceland apart from other countries having experienced the financial crisis.

***IMF Survey*: Iceland was in a state of collapse in 2008 but is now back on its feet and has become a success story. Can you give us a sense of Iceland's economic picture today?**

Dohlman: Overall, macroeconomic conditions in Iceland are now at their best since the 2008/9 crisis. Iceland has been one of the top economic performers in Europe over the past several years in terms of economic growth and has one of the lowest unemployment rates. A particular bright spot for Iceland has been the booming tourism industry, which has also contributed to a strong current account surplus.

Other indicators of Iceland's successful trajectory are its low inflation, stable exchange rate, and ready market access. Iceland's strong balance of payments has allowed it to repay early all of its Nordic loans and much of its IMF loans while maintaining adequate foreign exchange reserves.

There are of course some important remaining vulnerabilities and risks. Public and external debt ratios are still high, though on a downward sustainable path. The prospect of funds exiting quickly and disrupting external stability in the absence of capital controls is still a potential and important vulnerability. Downside risks emanate from significant wage pressures and an uncertain external environment, including risks of slower demand and deflationary pressures from trading partners.

***IMF Survey*: What are some of the main factors behind Iceland's remarkable recovery?**

Dohlman: Iceland has of course made good use of its natural resources, including the traditional fishing industry, but also the energy sector and most recently tourism. Iceland's geothermal clean energy has attracted energy-intensive industries, including in recent years data storage centers and silica plants. Since 2010, Iceland's tourism industry has boomed with promising prospects.

Iceland's recovery can also be explained by sound policies. The quick restoration of the domestic banking system and early steps to facilitate domestic debt restructuring were important. Steady fiscal adjustment, while carefully preserving its Nordic welfare model, has made Iceland one of just a handful of European countries running budget surpluses. Central bank policies have helped steer inflation close to target while capital controls continue to provide breathing room to address remaining vulnerabilities. In addition, the country has maintained much of the boost in competitiveness spurred by the early depreciation of the krona, contributing to a rebalancing towards export-oriented sectors. It is also important to recognize both Iceland's strong ownership and performance under the 2008-2011 IMF-supported program.

***IMF Survey*: How does Iceland's experience differ from that of other European countries that still struggle with the impact of the global financial crisis?**

Dohlman: Iceland has done relatively well. This year, Iceland will become the first 2008-10 crisis country in Europe to surpass its pre-crisis peak of economic output. The key differentiating factors supporting Iceland's relatively strong recovery are worthy of further study, but rapid external adjustment through depreciation and limited government absorption of private financial sector debt were likely important factors. Iceland also had a low debt ratio going into the crisis. Relative to past financial crises in Nordic countries, Iceland's experience has actually been quite similar.

***IMF Survey*: Are there any unresolved issues in the financial sector?**

Dohlman: This is an important question. The core banking sector looks strong. The nonperforming loan ratio is down and capital and liquidity buffers are high. Banks have been profitable and lending is rebounding. But there are some important areas that need further attention.

First, the ownership of the core banking sector, which remains in the hands of government and the failed old bank estates, needs to be normalized by putting them in the hands of 'fit and proper' owners.

Second, the loss-making government-owned Housing Financing Fund, which currently dominates the mortgage market, needs to be unwound as its business model is no longer viable and replaced by a financially viable successor housing program that meets public policy housing objectives.

Third, there is a need to further strengthen financial safety nets in Iceland such as the deposit insurance system, the bank resolution process, and emergency liquidity assistance. The Financial Supervisory Authority of Iceland should proceed with plans to strengthen bank supervision.

***IMF Survey*: What are the economic and financial sector priorities going forward?**

Dohlman: A key economic policy challenge is to re-integrate Iceland's financial markets with the rest of the world through removal of capital controls. These controls continue to provide stability but have a distorting effect and their macroeconomic costs rise over time. The authorities are now updating their capital account liberalization strategy and expect to make significant progress this year and are keenly aware of the need to preserve stability.

It is important for Iceland to support the liberalization process by maintaining sound policies. In addition to the financial sector reforms I already mentioned, Iceland can use fiscal policy to rebuild fiscal buffers and support growth while carefully assessing distributional consequences. This could include a shift towards more public investment in roads and the health sector, and revisiting the mix of direct and indirect taxes. Steps to strengthen Iceland's budget framework and the independence and accountability of the central bank will also be important.

Progress in these areas should provide a solid foundation for continued growth in Iceland.