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ICELAND CONFERENCE

## Iceland's Recovery: Can the Lessons Be Applied Elsewhere?

IMF Survey online

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- International conference to look at lessons learned in Iceland and challenges ahead
- Modest recovery under way, with declining unemployment
- \$2.1 billion IMF-supported program expired in August this year

**A**s the first country to experience the full force of the global economic crisis, Iceland is now held up as an example by some of how to overcome deep economic dislocation without undoing the social fabric.

To take stock of Iceland's crisis and recovery, the IMF and the Icelandic government are co-hosting a [conference](#) on October 27 that will see prominent economists such as Nobel Prize winner Paul Krugman and international economists Willem Buiter and Simon Johnson [debate](#) civil society, academics and IMF officials on whether the lessons learned can be applied elsewhere.

Key to Iceland's recovery was an IMF-supported program worth \$2.1 billion that was agreed in November 2008, shortly after the country's three main banks collapsed in spectacular fashion. The program included controversial measures such as capital controls and a decision not to tighten fiscal policy during the first year. It also sought to ensure that the restructuring of the banks would not require Icelandic taxpayers to shoulder excessive private sector losses.

"The dynamic cooperation with the IMF helped preserve the Nordic welfare model in my country," Minister of Economic Affairs Árni Páll Árnason said ahead of the conference.

In an interview, the IMF's mission chief for Iceland, Julie Kozack, takes stock of what the program achieved, and discusses the challenges still ahead for Iceland as it seeks to rebuild its economy.

**IMF Survey online: Iceland's program with the IMF expired in August this year, ending three years of close cooperation. What do you regard as the main achievements of the**



The Icelandic government and the IMF are co-hosting a conference in Reykjavik to take stock of Iceland's crisis and recovery (photo: ZUMA Press/Newscom)

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## **program?**

**Kozack:** The program had three objectives: to stabilize the exchange rate, put the public finances on a sustainable path, and restructure the financial system. All three of these objectives were met by the time the program expired. This was really an enormous achievement, given the severity and depth of the crisis that Iceland faced at the time.

The exchange rate had depreciated sharply in the run-up to the crisis, and there was a deep concern that it would plummet in a disorderly way. This is why capital controls were imposed.

The government had to use its balance sheet to recapitalize the banks and rebuild the financial system. This meant that public debt became very high. Therefore, public finances needed to be restored. During the past couple of years, the government has taken a number of fiscal measures that have put the country's finances back on a sustainable path.

Finally, restructuring the banking system was obviously a huge challenge. The size of the banking system was equivalent to about 1,000 percent of GDP before the crisis. It now stands at 200 percent of GDP, so there has been an enormous downsizing. The core banking system has been recapitalized and is fully functioning, a significant achievement for the authorities.

### ***IMF Survey online: A moderate recovery is now under way, but how long will it take Iceland to fully recover all the wealth and output that was lost as a result of the meltdown of the banking system in 2008?***

**Kozack:** This will take some time. Unfortunately, households, corporations, and the government all became highly indebted as a consequence of the boom and bust. Our projections are for a moderate recovery that will not be fully robust until the debt in the household and corporate sectors has been worked out.

### ***IMF Survey online: Now that the banking system has been streamlined, what are the prospects for further diversifying the economy and creating jobs in other industries such as the geothermal industry, fishing, and tourism?***

**Kozack:** Iceland is fortunate because it is endowed with tremendous natural resources. Fishing is a mainstay of the economy. Tourism is also increasingly becoming an important source of growth—this summer, record numbers of people traveled to Iceland. There is a good chance that this trend will continue.

Iceland also has, as you mentioned, geothermal clean energy, and that has attracted a number of energy-intensive industries. The government is interested in diversifying the types of industries that Iceland attracts, complementing the traditional focus on aluminum production with new areas such as data storage and silica.

### ***IMF Survey online: The unemployment rate has started to come down. Is that because of jobs being created in these areas?***

**Kozack:** We have observed a decline in unemployment. This partly reflects seasonal factors, mainly increased hiring associated with the summer tourism season. But the truly good news is that we also do see jobs being created as part of the wider recovery. There has been a pickup in both investment and consumption and this has created enough confidence among employers that they feel they can start hiring people again.

### ***IMF Survey online: Capital controls have played a key role in stabilizing the economy by preventing capital flight and stabilizing the exchange rate, but they remain controversial. When will they be phased out?***

**Kozack:** The authorities have developed a strategy for lifting capital controls that is conditions-rather than time-based. As conditions fall into place, the controls will be phased out gradually. These conditions mainly relate to the stability of the financial system and the strength of Iceland's

international reserves position. It is also essential that the government has access to international capital markets. What we want is to ensure that the stabilization gains that have been achieved during the past three years are not eroded.

***IMF Survey online: In that respect, how big a milestone was Iceland's successful issuance of a \$1 billion bond in June this year?***

**Kozack:** It was very important for two reasons. First, the government needed to roll over some maturities that were falling due and this issuance enabled them do that with ease. Second, it was a clear signal that the financial markets have confidence in the economic recovery that is underway and the achievements of the past three years. Reaching this milestone will make it easier to lift the capital controls.

***IMF Survey online: As the mission chief for Iceland during the final phase of the program, what do you see as the key factors behind the success of the government's economic policies and its cooperation with the Fund?***

**Kozack:** The policy roadmap was already largely in place when I arrived. We did, of course, have to make adjustments along the way, but the general direction was set. So it was really a matter of working with the government and the central bank to ensure that policies stayed broadly on track and were adapted, when needed, in a way that was consistent with the program's objectives.

The IMF's contribution to Iceland's recovery was advice on a set of policies to tackle the crisis and its aftermath, as well as some financing. The design of the program was unique from the Fund's perspective, particularly with respect to the capital controls, but it was necessary given the severity and the depth of the crisis.

For their part, the authorities put their own stamp on the program. They took full ownership of the program policies and implemented some very difficult measures. But they did this in their own way—we never imposed a particular set of measures but rather worked closely with the government to find the best way to achieve the goals of the program.

This combination of program design, ownership, and implementation really worked in the case of Iceland, and that is what we will be discussing in Reykjavik on [October 27](#).